Pacific Crest Financial Advisors, LLC

The Impact of the Japanese Tragedy

The earthquake in Japan will have a negative impact on Japan's economic growth in the near term. It will also disrupt operations of many Japanese companies (and even some non-Japanese companies who do business in Japan). Reflecting these concerns, Japan's stock market has declined over 11% since Friday; so much of the short-term impact may already be priced into equities.

Longer term, we believe the earthquake is unlikely to have a material impact on Japan's economic and stock-market performance, though it is too early to say what the economic cost of this tragedy will be. Japan's last major earthquake, Kobe in 1995, was estimated to cost more than $110 billion, which the country was able to absorb. Today, Japan is a $5 trillion economy so even if this disaster proves more costly, the country should be able to absorb the rebuilding expense. Longer term, as history has shown, countries do recover from such disasters, often with economies stimulated by rebuilding damaged infrastructure. The risk is that Japan's already high public debt (over 2x GDP) and large fiscal deficit (of nearly 7% GDP) constrain its ability to fund necessary expenditures. Japan's household savings rates have declined tremendously over the last two decades and, as a result, more of its borrowing will come from foreigners than in the past. With debt servicing costs as a proportion of revenues at over 40%, even at current low interest rates of around 1%, the country is highly susceptible to a fiscal crisis if foreign investors force borrowing rates up.

We do not expect the Japan tragedy on its own to have a material short- or long-term impact to global economic or earnings growth, although as we write this the nuclear reactor problem is a wild card with the potential for serious consequences at least shorter term. According to the Bank Credit Analyst, an independent global investment research firm, Japan has contributed about 2% to 3% to global economic growth over the past five years on average, so it seems unlikely that an economic slowdown in Japan could bring about a global recession. That said, the global economy is already fighting what we think are more material headwinds, such as deleveraging from developed countries, higher oil and food prices, monetary tightening from emerging markets, etc., and it is possible that Japan could tip it in the negative direction.

The Japan tragedy is another example of why we manage and guide our client investment portfolios to expect the unexpected. All of our clients maintain investment portfolios with established weightings of equities and fixed income holdings in their overall investment portfolios. This deliberate blending of equities and fixed income holdings is our method of dealing with the unexpected. As equities are rising our client portfolios are not performing up to the overall equity markets due to the fixed income allocation but the fixed income allocation is the buffering agent when the equity markets decline. We avoid changing the portfolio asset allocations based on economic or market events. Attempting to time the stock market frequently leads to missing market recoveries.

Alec

Darron

3002 Colby Avenue, Suite 305
Everett, WA 98201
Tel: 425-609-3797
Free: 888-576-1352

1215 Fourth Avenue, Suite 925
Seattle, WA 98161
Tel: 206-428-6012
Free: 888-576-1352