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The Economic Aftershock

We extend our sympathy to the people of Japan. They are left with a major rebuilding effort and challenges that continue to mount. In addition to the human tragedy, this natural disaster has had repercussions around the world and an almost immediate impact on global capital markets and economies.

Investors around the world are monitoring the economic impact of the Japanese earthquake and tsunami. After watching the footage over the weekend, it became apparent that the devastation and impact was much worse than originally thought. Reports on Friday speculated around 1,000 deaths and \$10 billion in damages. By Sunday evening these numbers were expected to exceed 10,000 deaths and \$160 billion in damages. In addition, last evening Prime Minister Kahn announced that the Japanese government could not rule out radiation leaks from the Fukushima nuclear power plant, which set off an investor panic in Japanese overnight trading with the NIKKEI falling over 1,000 points or 11 percent. (Source: Bloomberg, CNBC)

How are we responding to this situation, and what are we suggesting to our clients? Based on our research and analysis of past natural disasters, we do not see a benefit to making any allocation changes to our client portfolios. We have looked back at history to see the impact of scenarios similar to the current situation in Japan. According to the website TheStreet.com, the following catastrophes have similarly jolted markets over the past two decades.

- 1995 Kobe, Japan, Earthquake (6,300 deaths, \$102 billion in damages)
- 2004 Tsunami in Sumatra, Indonesia (230,000 deaths)
- 2005 Hurricane Katrina, U.S. (\$71 billion in damages)
- 2005 Kashmir, Pakistan, earthquake (80,000 deaths)
- 2008 Sichuan, China, earthquake (68,000 deaths)
- 2010 Port-Au-Prince, Haiti, earthquake (315,000 deaths)
- 2010 Russian heat wave (56,000 deaths)
- 2011 Japanese earthquake and tsunami (10,000+ suspected deaths, \$160 billion in estimated damages)

Equity markets react sharply to events like this. The bulk of any sell-off tends to occur in the first few days after the events. Over the past three trading days, the Japanese NIKKEI sold off approximately 20 percent, with European equities selling off approximately 7 percent, and U.S. equities pulling back approximately 2 percent. After the 1995 Kobe, Japan earthquake, the Japanese NIKKEI dropped 26 percent in the few weeks after the earthquake and then recovered all of its losses over the following few months. (Source: Bloomberg) Japanese equities were trading at a substantial premium in 1995 to current valuation thus leaving their market more vulnerable than today. In fact, prior to these tragic events, on a valuation basis, the Japanese stock market traded at a valuation discount to the world stock markets. (Source: Ned Davis)

The wild card at this point will be the resolution of the radiation contamination. If the nuclear issues can be resolved without substantial damage and losses, much of the market reaction to the situation in Japan may be priced in at this point. If the nuclear situation gets out of control, volatility will remain. According to BCA Research the Japanese economy has only contributed 2-3 percent to global growth over the past five years. Thus even if Japan falls into a short-term recession, the impact on the rest of the world will be small. This is evident in the capital markets as the U.S. equity markets have only receded 2 percent since the announcement of the quake, tsunami, and nuclear concern.

Although we are all deeply saddened by the loss of life and devastation in Japan, the tragedy has also highlighted the importance of international cooperation. The international community is demonstrating its commitment to helping Japan recover. After decades of tension between China and Japan, this weekend, China offered assistance to Japan in a striking show of support. This may help mend a relationship that has historically been strained.

In the short term, the recovery and reconstruction process will create jobs and growth in the Japanese economy. We expect the Japanese Central Bank will inject liquidity into their capital markets, and it appears substantial foreign aid is also forthcoming. While some industries like construction and finance may benefit, recovery for others will depend on the severity of damage to infrastructure. Before selling Japan short, we should remember the country was devastated after WWII and the ability of its people to face adversity is remarkable.

The global equity markets have most likely priced in the information that is currently available. We believe any portfolio maneuver at this point would simply be reactionary and most likely prove to be ill timed.

Our portfolios are constructed with multiple asset classes that mitigate but do not eliminate volatility during times such as these. Most bonds increased in value over the past few days and our hedged equity allocation has held its value as well. We should expect further stock market volatility as a quick resolution to the Japanese situation does not appear imminent

We will continue to monitor the situation and keep you informed from an investment standpoint. Currently our indicators tell us that the most probable path at this point in the cycle is a continued advance of risk assets after this correction has taken its course.

Tony Hallada
Managing Principal
LarsonAllen Financial, LLC

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