Situation Analysis: Perspectives On The Crisis In Japan

Executive Summary
The tragedy in Japan is of historic proportions. The human cost and the effect on the lives of the Japanese people is horrific and we extend our deepest sympathies to those who have been affected.

In the aftermath of this devastation, we believe the economic effects for Japan will likely be a drop in near-term economic activity, followed by a meaningful recovery as Japan secures new energy resources, restarts its manufacturing industries, and begins the rebuilding process. Economic and market effects are likely to be less pronounced in the global economies, primarily due to the shorter-term impacts of the disaster, and also because of Japan’s relatively small contribution to overall global growth. We do acknowledge, however, that events are still unfolding and further observation and assessment will likely be warranted as additional information continues to become available.

The following information is intended to help address some of the questions that may arise related to the effects this disaster might have on the world economy and global markets.

The Earthquake and Potential Economic Impacts
The 9.0 magnitude earthquake and resultant tsunami on March 11th caused significant damage to Japan in numerous ways. The headline issues are currently focused on the growing nuclear crisis and the impact to Japan’s capacity to generate electricity and the potential long-term effects of radiation leakage. The damage from this series of natural disasters is of significant concern to global capital markets because of Japan’s stature as the third largest economy (behind the United States and China). On the heels of the revolutions in the Middle East, which put further pressure on the price of oil, a likely concern for many investors may be whether this disaster in Japan will potentially slow the global economic recovery that has been underway.

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It is our belief that if this situation becomes larger in scale, and creates longer-term disruptions in Japan, there could be a meaningful impact on both the local and global economy. In reaching this opinion, we considered the following statistics:

- In addition to being the third largest economy, Japan is also the third largest industrial economy in the world (China is first and the United States is second). This is important due to the fact the global recovery cycle has thus far been led by manufacturing activity.
- Japan is the fourth largest global exporter, accounting for supplying such items as 14% of global auto parts, 60% of the silicon for all computer chips, and a large share of the heavy equipment parts and supplies that are so in demand within the developing world.
- In total, Japan supplies 13% of China’s total imports, mainly capital goods for China’s manufacturing industries.

The Importance of Nuclear Power to Japan

This disaster has directly hit the most vulnerable aspect of Japan’s economy – its energy industry. The islands of Japan have little natural energy resources. To become the third largest economy, Japan has had to purchase huge amounts of fuel from world market suppliers. For instance, Japan is the world’s largest importer of thermal coal, is one of the largest buyers of oil, primarily from the Persian Gulf, and is also a large purchaser of natural gas. To create its own energy generation capacity and become less dependent on world energy suppliers and markets, Japan has built significant nuclear electricity generation capacity over the last 45 years. Currently, Japan is the third largest producer of electricity from nuclear reactors in the world (United States is first and France is second). One-third of electricity generated in Japan is from their nuclear reactors and the balance is generated from coal, natural gas and oil facilities.

The disaster has caused the following impacts on Japan’s nuclear electricity generation capacity:

- Of the 54 nuclear plants in Japan, 11% have currently been shut down. This represents a 15%-20% reduction in nuclear power generation for Japan.
- As a result of the plant shut downs, rolling blackouts have begun occurring throughout Japan, which has affected production capabilities.
- It is estimated that approximately 10% of Japan’s total electrical capacity will be offline for several months. This is not only due to the lesser damage that was sustained by non-nuclear power generation facilities, but also because of the damage to the nuclear plants.

What Do We Anticipate From Here?

The impact on Japan is still unfolding, but in our opinion it seems clear that Japan’s economy is being negatively affected. Prior to the crisis, consensus forecasts were for Gross Domestic Product (GDP) growth of 1.7% for 2011. Current conditions suggest that Japan’s economy will likely grow at a slower pace, if at all, for the balance of the year. However, large natural disasters that have occurred previously in both Japan and the United States suggest that in most cases, the damage caused has historically resulted in an acceleration of economic activity within one or two years following the disaster. This is due to the large amount of spending needed for reparations that wouldn’t normally have been spent. Significant increase in spending, in areas like construction and support services, tends to act as stimulus to the affected economy. Based on this type of historical comparison, we could anticipate that Japan’s economy, while depressed in the short term, may actually accelerate beyond current expectations in the intermediate term, perhaps over the next year or two.

Historical comparisons aside, the crisis situation in Japan is still unresolved and if surprisingly negative outcomes were to occur, new analysis and forecasts would have to be made.
Our Conclusions: Putting Things in Context

From a global perspective, we believe the crisis in Japan, as it is currently viewed, is likely to have only a modest effect on the global economy. The current consensus forecast from the International Monetary Fund (IMF) is for global growth of 4.4%. A slower economy in Japan and related trade effects might reduce global GDP to 4.3%. The shorter-term resolution of the Japanese disaster is not likely to materially change the direction of the global recovery established during the last two years or so since the financial crisis. Globally, we view the ongoing revolutions and unrest in the Middle East and northern Africa as greater risks to the health of the global economy than the Japanese disaster. However, given Japan’s dependence on world energy markets, further crisis in the Middle East is likely to maintain high relative energy prices and put that much more pressure on Japan’s damaged economy.

Capital markets have been reacting as would be expected in the aftermath of previous natural disasters. Initially, risk asset markets, like stocks, sold off in emotional trading patterns and capital flowed heavily into perceived safety markets, like U.S. Treasuries and cash. Nevertheless, our view is that stock market reactions tend to overshoot immediately after events of this sort and eventually regain a good proportion of lost ground. In light of our view that the Japanese disaster is not likely to have long-term and major effects on the global economy, we are of the view that over-sold conditions in the Japanese equity markets may offer some opportunity. Conversely, compared to other nations, Japan has the highest percentage of sovereign debt to GDP in the world and will likely need to increase debt issuance to fund rebuilding related to damage from the earthquake and tsunami. We therefore would approach Japanese sovereign debt with even greater caution going forward.

The global economy is likely to weather the aftershocks of the Japan crisis with limited damage.

IMPORTANT DISCLOSURES

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