Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

MACROCOSM

Meltdown in Japan

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Donald Luskin

Once the bad news is out, Japanese stocks will stabilize -- and the US correction will be short and shallow.

US stocks are finally in a correction after a record run, and they had so much strength behind them that it took multiple bolts from the blue to do it. It wasn't any of the durable bearish narratives that have dominated sentiment over the last several months -- housing double-dip, insolvent states and municipalities, collapse of the Euro Area, real-estate bubble in China, and so on. It was things that *no one* was talking about even three months ago: first, contagious political instability in the Middle East, and then a killer earthquake and tsunami in Japan.

These event-shocks have a panicky quality about them -- by their nature they are unpredictable, and it is easy to extrapolate them into credible systemic disaster scenarios. But our baseline strategic view is that they will stabilize sooner that most expect, and that the present correction in US stocks will be shallower and shorter-lived than the one that set in after a spate of event-shocks in April 2010 (please see the chart below).

Update to strategic view

US STOCKS, ASIA STOCKS, ASIA MACRO: The quake in Japan was the event-shock it took to finally throw US stocks into a correction. The fate of the Fukushima reactor will be settled very soon, and almost whatever the outcome, panic will abate once it is known. As in 1995 after Kobe, Japan can avoid recession and Japanese stocks will stabilize. There is little reason for the panic to have infected US stocks. We expect this correction to be shorter and shallower than the one that began in April last year.

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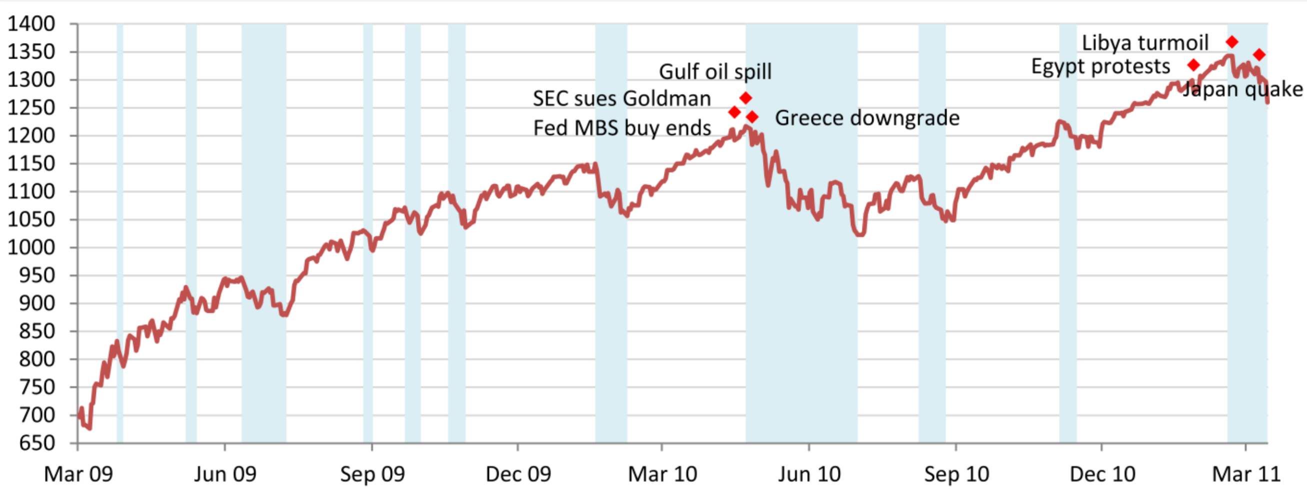
S&P 500 ■ Corrections >3% ◆ Event-shocks



Source: Standard & Poor's, TrendMacro calculations

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Admittedly, we probably think about the quake in Japan with some cognitive bias toward the optimistic. After all, as we write these words from Silicon Valley in Northern California, we sit about a quarter mile from the San Andreas fault.

- At the moment it's almost impossible not to perceive the Sendai quake as an out-of-control catastrophe, with heavy loss of life and property compounded by nightmarish possibilities of radioactive contamination from the damaged Fukushima nuclear power complex.
- So if feels almost trivializing to compare this to the Kobe quake of January, 1994. But that quake was horrific too, with an official death toll of 6,434. The toll from the Sendai quake may end up being greater (officially, it is now above 2,000, and estimated to rise). But it won't be an order of magnitude greater.
- Before the quake, Kobe was one of the world's busiest ports -- losing it was not a trivial disruption for the Japanese economy.
- Costs of the Kobe quake are estimated at about ¥10 trillion, or a bit more than 2% of GDP at the time.
- Following the Kobe quake, Japanese stocks fell by more than 25% over six months. They rallied back to pre-quake levels six months after that (please see the blue line in the chart below).
- The intensely felt uncertainties in Japan now, amplified by the unknowns at Fukushima, have already driven Japanese stocks down by about 16% in mere days rather than months (please see the red line in the chart below). Losses were worse mid-session last night.
- We don't pretend to be experts on nuclear power plants. But unless Fukushima turns out to be a Chernobyl, and renders Tokyo uninhabitable -- and we *really* doubt it will, despite such fantasies

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

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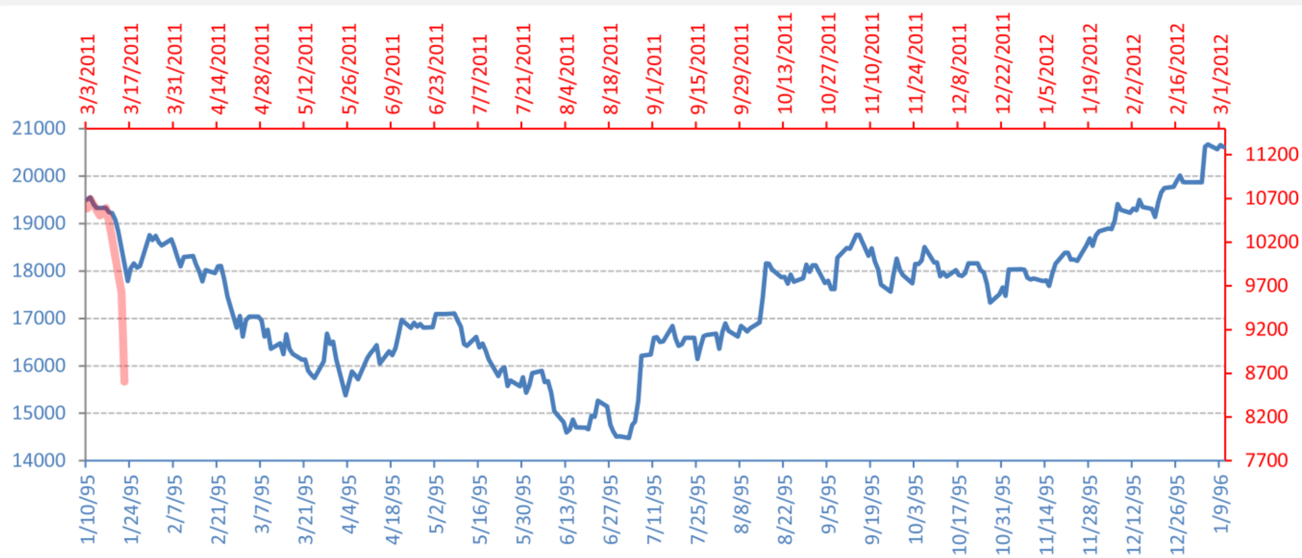
Nikkei 225 Index — After Kobe quake in 1995 — After Sendai quake now
Vertical axes scaled to show comparable percentage ranges



Source: Reuters

making the rounds quite widely this morning -- then this will prove to be one of those classic situations in which getting all the news out in the open, even bad news, is all it takes to break the panic.

- After the panic abates, Japanese stocks will likely do something similar to what they did in 1995 -- wallow around for a while, and then recover.
- We don't want to indulge in the "broken windows" fallacy and pretend that catastrophes are economic windfalls. That said, in GDP terms, destruction of physical capital is not measured, while investment in *new* physical capital to replace it *is*. After the Kobe earthquake, there was no recession in Japan. There doesn't have to be one now.
- We could even go so far as to say that horrific catastrophes have a way of focusing the national mind in a way that can be economically productive. For example, the terrorist attacks of September 11, 2001, didn't cause a US recession -- they ended one. We have already heard anecdotal reports from contacts in Japan of rapid and massive business mobilizations to immediately begin rebuilding and repair.
- Disruptions in Japan can't help but affect the rest of the world, but they will very likely be transitory, and markets will be able to look across the valley. The S&P 500 gained 37.6% on a total return basis in 1995, the year of the Kobe quake.
- By remarkable coincidence, 1995 has another thing in common with 2011 besides a large Japanese earthquake. In 1995, just as now, the US had just restored political balance after two years of Democratic one-party rule, substantially reducing the risk of major anti-growth policy errors (see "The Pendulum Swings Back" November 2, 2010). For 2011, this is a transformative pro-growth development, following on the heels of the Fed's moving away via QE2 from a too-tight posture, and the successful resolution of the 2008-09 banking crisis (see "Are We Running Out of Armageddons?" February 3, 2011).
- Several clients have commented that the quake will be a stress-test of Japan's shaky public finances, given its already extreme indebtedness. Further, any debt problems could spill to the US, through forced liquidation by Japan of its large US Treasury holdings (Japan holds only slightly less US debt than China). We just don't see it, and so far markets don't either -- quite the contrary, with US Treasuries and JGB's both rallying. Yes, this could be just a safe haven response, but if debt problems were such an obvious consequence of the quake, then these havens would not be seen as safe even now. Unless a prolonged recession crashes Japanese national income -- and we don't expect one at all -- there should be no issue in obtaining marginal financing for investment in productive infrastructure.
- The fly in the ointment as of this writing is the large drop in gold. We'd like to think that a positive externality of the quake would be that it could force the Bank of Japan to become significantly easier, perhaps through outright monetization of a great deal of debt -- thus shocking Japan out of its persistent mild deflation. The falling gold price hints at the opposite -- that the BOJ will be too tight. In

our view, that may be the biggest macroeconomic risk for Japan arising from the quake.

Bottom line

The quake in Japan was the event-shock it took to finally throw US stocks into a correction. The fate of the Fukushima reactor will be settled very soon, and almost whatever the outcome, panic will abate once it is known. As in 1995 after Kobe, Japan can avoid recession and Japanese stocks will stabilize. There is little reason for the panic to have infected US stocks. We expect this correction to be shorter and shallower than the one that began in April last year.