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## JAPANESE DISASTER RAISES CONCERNS OVER GLOBAL ECONOMIC RECOVERY

All eyes have turned to the destruction in Japan as that country reels in the wake of the massive earthquake and tsunami on March 11. In this special edition of the RiverPoint Report, we will discuss some of the economic consequences of this disaster. The human toll of this tragedy is devastating and frightening. We extend our deepest sympathies to those affected.

Japanese equity markets have been in a tailspin since the 9.0-magnitude earthquake struck and the tsunami flooded the countryside. Since March 11, Japan's benchmark Nikkei 225 Index (comparable to the S&P 500 in the US) has lost over 10% of its value. Stock market losses pale in comparison to worries about damaged nuclear reactors which threaten to emit radioactive material into the atmosphere. While the threat of a Chernobyl-type meltdown appears unlikely, the situation remains fluid and authorities are still struggling to contain the damage.

From a strictly economic-impact perspective, the region hit hardest by the earthquake accounts for about 8% of Japan's total Gross Domestic Product (or GDP, a measure of total economic activity), meaning that this incident could subtract about 0.2%-0.3% from Japanese GDP growth in the current year. The earthquake and tsunami have also forced several companies to suspend production at multiple factories. Honda, Toyota, Nissan, Sony and Toshiba are among the global companies that have been forced to close facilities. The aftermath of the disaster also threatens numerous suppliers in the consumer electronics, semiconductor and automotive sectors. On top of physical damage, the country has been forced to ration food, gasoline, and power in order to keep its weakened infrastructure up and running. These factors could also have a big impact on Japan's GDP. In response, Japan's central bank has been pouring money into the financial system in order to assure financial stability amid the uncertainty.

On the flip side, the initial hit to GDP could be partially offset by growth

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*Rebuilding efforts following a natural disaster have, in the past, provided a boost to economic growth.*

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derived from rebuilding efforts in the coming months. Historically, natural disasters negatively impact economic growth immediately, but tend to be positive for growth over the medium term. In the current quarter, we will probably see very weak growth, and potentially, a contraction. The rebuilding efforts in Japan will then cause a rebound in investment over the medium term that will provide a floor under Japanese growth. What this means is that the rebuilding of bigger and better buildings, roads and bridges will likely offset the temporary decline in economic activity. Japan has had a relatively large amount of spare capacity in its economy as a result of low growth over the past decade. Now, however, this could help mitigate the immediate slowdown, since production can theoretically be shifted from a damaged plant to one that was running at less than full capacity. It is important to note that the Japanese have demonstrated remarkable resilience following other large disasters in the past; their ability to recover as a country quickly should not be underestimated.

Japan's economy accounts for 9% of total global GDP (the US and European Union account for 50% of world GDP, combined). With global GDP expected to grow 4.0% to 4.5% in 2011, an earthquake-related recession would reduce global growth by about 0.5%. Factoring in the tangential impacts on other economies, we estimate that global growth could be reduced by another 0.25%-0.50%. Domestically, exports to Japan account for less than 1% of total United States economic activity. Any slowdown in the Japanese economy will therefore have a limited direct impact on the American economic recovery. Also, any temporary lift from Japanese rebuilding efforts will also have a limited impact on US GDP growth. Therefore, we do not see a compelling reason to change our overall strategy at this time. We will continue to monitor the situation closely.

The impact on the nuclear energy sector is unclear. The threat to public health from a potential nuclear meltdown will surely cause some countries to re-think whether nuclear energy is a feasible energy source in the future. Under this scenario, companies that design, build, and supply systems to nuclear power plants could suffer declining business as nuclear loses some luster as an alternative energy source. Companies that supply nuclear plants with uranium, however, should be largely unaffected as they typically operate under long-term contracts. Yesterday, in a conference call with company management, Cameco (ticker: CCJ) executives said that all of their uranium production is sold under long-term contracts, and that a shut-down of Japan's nuclear reactors would have no material impact on earnings or cash flow. Given the long lead times and high construction costs of new nuclear facilities, it would be prohibitive for countries to "shift on the fly" from nuclear to another type of power as a result of this disaster.

This is a horrific tragedy whose impact will be felt for many years to come. Economically speaking, however, it appears that the impact on American and global activity will be manageable. Please contact a RiverPoint professional if you have any questions or would like to talk about this in more depth.