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INVESTMENT IMPLICATIONS OF THE TRAGEDY IN JAPAN

From the Desk of Our Chief Investment Officer

David L. Donabedian
Chief Investment Officer

Dave Donabedian is chief investment officer of Atlantic Trust, returning to the firm in 2009 after serving as chief investment officer for Ashbridge Investment Management, LLC from 2006 to 2009. As a leading investment expert in our industry, Dave frequently appears on television networks, such as *CNBC*, and provides insights in publications, such as *Barron's*. Previously, from 1996 to 2006, Dave worked with Atlantic Trust as managing director and chief economist. Dave received a B.S. in economics and a B.A. with honors from The Wharton School at the University of Pennsylvania. He subsequently earned an M.B.A. from Columbia University Graduate School of Business.

The horrific events in Japan over the last several days are the latest hotspots in what has been a very eventful month for so-called “macro investment risk”. Other market moving events have been the spread of revolt against dictators in several Middle Eastern/North African (MENA) nations and more sovereign credit downgrades in Europe.

Relative to the blaring headlines, market reaction in the U.S. has been quite orderly and rational. Since events in the MENA region erupted a month ago, the S&P 500 has fallen just over 6% (through March 16, 2011); Year-to-date, the S&P 500 is actually flat. Given the tremendous rally of the last two years – producing a doubling in the broad market averages – a pullback has long been in the offing. Naturally, the Japanese market has been hit the hardest, declining 13% since Friday’s earthquake.¹

One would have hoped for a more mundane set of reasons to spur a market correction. Instead, we are faced with trying to assess the onslaught of fast-moving, incomplete, and often contradictory information in order to process what it means for the global economy and financial markets. Our objective is to stick to the facts as we know them, understanding that they may change, and consider the major sources of market risk. Below we assess the various issues surrounding the Japanese earthquake, tsunami and continuing nuclear crisis.

Impact on the Japanese Economy

The short-term impact is already devastating. Japan will undoubtedly experience a plunge in economic output in the second quarter. The normal pattern in the aftermath of a natural disaster is a “V” shaped economy, with activity plunging and then rather quickly surging as a rebuilding process starts. There are two reasons to think Japan’s recovery process may be delayed. First, 10% of Japan’s power supply is expected to be offline for several weeks. This could get worse depending on the outcome of the ongoing nuclear reactor crisis. In the best of circumstances, this will slow the commencement and pace of rebuilding. Second, at this time it is unknown how severe the nuclear crisis may be as a health hazard.

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Impact on the Global Economy

Japan is the world's third largest economy, just recently surpassed by China.² That makes it important in a global context, but perhaps not as much as one might think. Japan has not been an engine for global growth since the 1980's. For the last twenty years the economy has been marred by stagnation and deflation. As such, a recession in Japan does not mean that the world economy is headed for a tumble. In the short-term, there will be supply disruptions impacting certain industries; however, these should only delay business getting done rather than causing a drop in global demand.

Another important factor is global monetary policy. The Bank of Japan has flooded the capital markets with liquidity as a response to the earthquake. There is speculation that other central banks, including the Fed, may extend easier monetary policies as a result of the earthquake and immediate demand for liquidity. Our forecast is unchanged: continued growth in the U.S. economy, with a slowdown later in the year unrelated to Japan.

Impact on the Capital Markets & Currencies

A key question for global bond markets is: "Can Japan afford to rebuild?" Japan has the biggest public sector debt as a % of GDP in the developed world, with an expensive cleanup and rebuilding process ahead. The cost of insuring Japanese government debt against default has soared to record levels in recent days. Nevertheless, a broader look at the situation leads us to conclude that the resources to rebuild are available.

While the government runs a huge debt, the business and household sectors in Japan are legendary savers. In aggregate, Japan is a creditor nation and is helping to finance the U.S. budget deficit in a major way. Some of the cost will also be offloaded on the global reinsurance industry. Additionally, many foreign nations have offered financial assistance. China appears quite interested in using its vast resources as a way to ingratiate itself with its traditional enemy in a broader quest to expand its global influence.

In recent days, the Japanese Yen has risen to record highs versus the dollar. This could be because Japanese entities are repatriating U.S. investments in preparation for the rebuilding process. Some have speculated that this could lead to a large increase in U.S. interest rates due to Japan's position as the 3rd largest holder of U.S. Treasuries. Given the dramatic drop in yields in recent days during the flight to safety trade, a reversal may well be in order. But the notion of a sustained rise in yields due to massive Japanese selling of Treasuries is contradicted by experience. Similar predictions were made after the 1995 Kobe earthquake, where the rebuilding costs were more than what is forecast for the current situation. The Treasury market suffered no material impact.

Impact on the U.S. Stock Market

As mentioned earlier, U.S. markets have sold off moderately on the news from Japan. This seems appropriate given the circumstances, and we do not expect a bear market to result. Some industries will be impacted directly, such as insurance. Others will experience business disruptions due to supply bottlenecks, such as semi-conductors and autos. Our equity analysts are closely following the situation in their industries. Continued growth in overall corporate earnings and reasonable valuations cause us to remain optimistic about a positive year for U.S. equities.

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Impact on Commodity Prices

Commodity prices have been whipsawed over the last month – first driven higher by MENA supply fears (especially oil), and now driven lower by the destruction and potential threat to global demand posed by the Japanese tragedy. As stated above, we do not expect a global recession to result. In fact, when the rebuilding process begins in Japan, it will require significant amounts of materials and energy – a boost to commodity markets generally. Longer-term, the nuclear power industry has suffered major reputational damage as a viable alternative energy source. This places more long-term demand squarely on traditional energy sources – oil, natural gas and coal – and is likely to support higher prices over time. In short, our bullish secular view on commodity prices is unchanged.

Impact on Atlantic Trust Approved International Managers

Over the last two years, the Asset Allocation Committee has progressively shifted international equity allocations away from the developed markets and toward emerging markets. As a result, direct Japanese exposure is small. Furthermore, our various internal fixed income strategies have no Japanese issues.

Over the past several days we have been in contact with our approved external international managers to discuss their direct and indirect exposures to Japanese capital markets. A common opinion is that Japanese equities are being indiscriminately sold regardless of whether a company's operations have been impacted by the natural disaster. Our managers are carefully evaluating the geographic locations, industries, customer/supplier channels, etc. for each portfolio company. While none plan a major increase to their Japanese equity exposure in the wake of the double-digit market selloff, they are all looking at individual companies which may have been oversold. This is why our investment platform has always favored using managers with local expertise and on-the-ground resources as the optimal way to invest overseas.

Conclusion

With the financial crisis not far in the rear view mirror, it is natural to worry about a repeat of market chaos when unexpected bad news occurs. However, it is important to note that unlike 2008, financial markets around the world are functioning efficiently. There is no doubt that recent events in Japan represent an additional risk factor for investors to consider. But it is also true that markets around the world have very quickly processed the news, and lowered prices on risky assets. We will continue to monitor events as they occur, with an eye toward any asset allocation changes that could improve our clients' risk-adjusted return potential.

¹ The Japanese market referenced is the Nikkei 225 Stock Index

² International Monetary Fund, March 2011

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