



## Market Analysis, Research & Education

A unit of Fidelity Management & Research Company

# Japan Earthquake Adds Uncertainty to Global Outlook

*Fidelity manager provides insight on Japanese stocks*

*The following analysis contains input from Fidelity's market analysis, asset allocation, sovereign debt, and international equity research teams, with commentary from Fidelity Portfolio Manager Bill Kennedy.*

### Potential Impact on Japanese economy

The tragic earthquake and subsequent tsunami has caused a significant disruption in Japanese economic activity. In the most affected areas, transportation and production interruptions have caused severe supply-chain difficulties. The damage to electrical power facilities, including two nuclear plants, has created power shortages that have had ramifications throughout the country. With Japan's economy having already slowed in recent months, the recent events are likely to contribute to significant economic weakness in the near-term.

On the other hand, natural disasters in developed economies have typically put into motion a series of policy and other actions that begin to create a positive counter-effect. Specifically, the initial fall in production and consumption often gives way to a pick-up in economic activity driven by a restoration

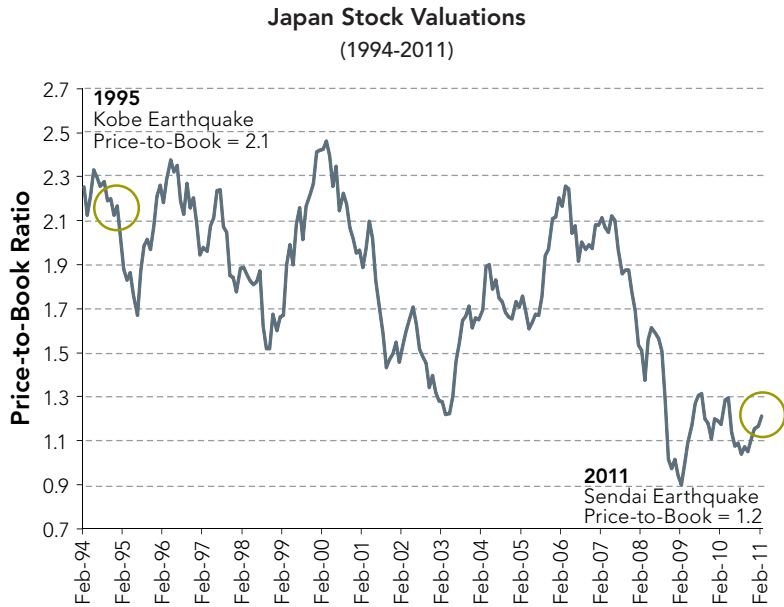
of the damaged capital stock. Historically, government spending, monetary stimulus, and insurance payouts lay the foundation for a reconstruction phase, in which businesses and households rebuild lost and damaged infrastructure. For example, after the Kobe region earthquake in 1995, Japanese industrial production fell by 2.6% during the month of the earthquake but had fully recovered to pre-earthquake levels just two months later.<sup>i</sup> While there are many differences between the Kobe quake and today in terms of the damage inflicted and the overall economic environment, the general historical pattern of sudden decline followed by a reconstruction-led recovery holds across many examples of natural disasters in various developed economies.

Despite near-zero interest rates and a dire fiscal situation, Japan still maintains the wherewithal and likely the motivation to take additional measures to address the urgent situation and spur the reconstruction phase. For instance, the Japanese central bank announced a 10 trillion yen expansion of its quantitative easing program, including increased purchases of risky assets, such as Japanese REIT securities. It also provided an extraordinary level of extra liquidity for the domestic financial system on March 14.<sup>ii</sup> In addition, although the 2011 deficit is extremely high and government debt-to-GDP is at a staggering level above 200%, further fiscal stimulus is likely still possible.<sup>iii</sup> Japan continues to enjoy almost complete domestic financing of its public debt, and there is early evidence that some Japanese investors and financial institutions have sold overseas assets and repatriated them back to Japan in recent days, creating additional potential funds for reconstruction. However, the potential for repatriation of funds from insurance companies and other entities could strengthen the value of the Japa-

### KEY TAKEAWAYS

- As a result of the tragic earthquake and its aftermath, Japan's economy is likely to suffer a near-term slowdown, followed by a reconstruction phase that may help boost output over the medium term.
- Fidelity's asset management organization is closely monitoring the situation, particularly analysts and portfolio managers evaluating the potential impact of recent events on Japanese equity markets.
- On a global basis, the world economy should be able to withstand the near-term deceleration in Japan, though the uncertainty creates the potential for additional volatility in global financial markets.

**EXHIBIT 1: Japanese stock valuations are about half what they were when the 1995 Kobe earthquake struck.**



The Kobe earthquake occurred on 1/17/95. The Sendai earthquake occurred on 3/11/11. Values shown are for the MSCI Japan Index. Source: FactSet, FMRCo. (MARE) as of 2/28/11.

nese yen, which, if not countered by the central bank, could be a headwind for Japanese exporters.

**Japanese equity markets**

On March 14, the first day of trading since disaster struck, the Japanese stock market dropped 6.2%.<sup>iv</sup> An initial sell-off in the aftermath of a natural disaster is a common historical pattern in stock markets, as uncertainty may cause some short-term selling while investors re-assess the outlook. However, the sell-off also makes Japanese equities cheaper, which underscores an important difference between now and the post-Kobe earthquake in 1995 (see Exhibit 1, above). The average valuation level of Japanese stocks today is roughly half the level of valuations 15 years ago, measured on either a price-to-book or price-to-earnings basis. (Note: See commentary from Fidelity Portfolio Manager Bill Kennedy, page 3.)

**Potential Global impact**

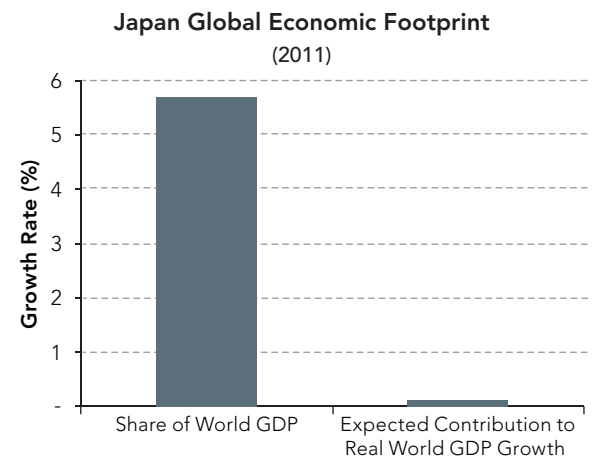
Japan is the world's third largest economy, in addition to being a significant link in the global manufacturing supply chain. As a result, lost output in Japan and disruption to industrial production will undoubtedly have a negative near-term impact on the global economy. At the same time, Japan was not considered to be a major driver of the current expectations for a solid year of global growth in 2011. Most

global growth was expected to come from developing economies and the United States, with Japan accounting for 0.1% of the expected 4.2% real global GDP growth projected by the International Monetary Fund (see Exhibit 2, below). As a result, a temporary decline in Japanese output would likely not be a show stopper for the global economic expansion.

Another potential impact of the Japanese crisis is on world energy and other commodity markets. In the near-term, the decline in Japanese economic output will likely result in lower crude-oil demand, as Japan is the world's third-largest petroleum importer. On the other hand, if the damaged nuclear power plants remain off-line, Japan will have to make up the lost electrical output with fossil fuels, such as natural gas. A rebuild of Japanese infrastructure would likely result in more commodity-intensive activity than expected, which ultimately could increase demand for crude oil and other natural resources.

On March 14, stock markets in Asia and most of the rest of the world declined, but for the most part the losses (outside of Japan itself) were relatively modest. While there has been some speculation that Japanese investors may sell U.S. Treasury bonds to repatriate the proceeds to Japan, long-term bond yields in the United States declined on March 14. Still, given the potentially large reconstruction funding facing Japan, any reduction in foreign demand for U.S. assets may raise the prospects for higher volatility in U.S. Treasury rates.

**EXHIBIT 2: Japan has a fairly large global economic footprint, but prior to the disaster the country had not been expected to contribute substantially to global growth.**



Source: International Monetary Fund, Haver Analytics, FMRCo (MARE) as of 10/6/10.

All in all, the fallout from the Japanese disaster may not in and of itself be enough to derail the global economy, but it is one more source of uncertainty for world financial markets to digest. With markets already jittery due to unrest in the Middle East and North Africa and the rise in crude-oil prices, this development interjects another source of volatility in the outlook for asset prices.

### Investment implications

Developments remain very fluid in Japan, and their impact will depend heavily on how key factors unfold, including the fate of the nuclear reactors, and the ultimate damage to the Japanese economy and confidence. It is too early to predict any lasting trends, but Fidelity's asset management organization will continue to monitor the situation closely. ■

## The Potential Impact on Japanese Stocks...

*Commentary by Bill Kennedy, Portfolio Manager of Fidelity International Discovery Fund and Fidelity Advisor International Discovery Fund*

The recent earthquake and tsunami that ravaged Japan is a tragic situation with a deeply human element, and my sincere thoughts go out to those affected by this natural disaster. From a financial market perspective, this unfortunate situation has created a tremendous amount of near-term uncertainty for Japanese stock investors. I believe the uncertainty was priced into the broader market rather quickly, and is a major reason why the Japanese stock market fell 6.2% during the first trading day after the quake.<sup>iv</sup> Many companies have temporarily shut down their production plants while they assess the impact of the disaster on their business operations, including the availability of electric power, employees, distribution, and key business partners. I suspect this work stoppage will lead to a reduction in the country's domestic economic growth for a short period, but this decline in economic output is likely to be temporary. So far, it appears that the major companies that have the biggest influence on the Japanese economy have not borne the brunt of this natural disaster.

Prior to the recent disaster, there had been structural issues in the country that had long served to prevent the Japanese stock market from advancing in line with the rest of the world during the past couple of years. First, a strong yen relative to other foreign currencies eroded the competitiveness of Japanese companies on the world stage. Second, an aging demographic population served as a hindrance to economic growth. Third, high debt-to-GDP levels have raised concerns about the government's balance sheet.

Despite those issues, certain Japanese stocks had been benefiting from domestic economic improvement in Japan, as well as the global economic recovery. Many export manufacturers have benefited from strong economic growth in emerging-markets, and other exporters have benefited from the improving U.S. economy – a major end market. For example, the factory automation industry has recently experienced solid profit growth due

to higher corporate capital expenditures from the United States.

The past two days have represented the power of Fidelity's extensive global research depth. Our analysts have been working diligently to assess how this natural event may impact companies and their profitability. On Sunday, March 13, I spent the day communicating with our analysts on the ground in several countries, absorbing their research updates on various companies and trying to assess what's in the best interests of shareholders. I have not made any major changes to the funds I manage, primarily because I believe in times such as this, level heads prevail. At the same time, I do have a list of companies that I'm monitoring, and I will take advantage of opportunities to increase our holdings of new or existing companies where I believe the market pricing is overly pessimistic.

With the Japanese stock market down sharply, I'm keeping my ears to the ground and working diligently with analysts to re-evaluate the investment thesis for each of the fund's current holdings. I think it's important to maintain a long-term view, particularly for businesses that I believe are benefiting from secular trends. For example, some e-commerce companies have been severely punished by the market sell-off, but I don't think this price decline represents a shift in the long-term trend of Japanese investors purchasing more goods online (as opposed to shopping at brick-and-mortar stores). This is a secular trend that is going on not only in Japan, but in other areas of the developed world.

This unfortunate event is a terrible tragedy that has caused significant loss of life and damage, but I believe the resilience of the Japanese people is impressive. While the Japanese stock market may experience greater near-term volatility, there are opportunities in many companies that have the potential to reward shareholders over the long term.

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*Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.*  
Investing involves risk, including risk of loss.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest-rate, currency-exchange rate, economic, and political risks, all of which are magnified in emerging markets.

Indices are unmanaged and you cannot invest directly in an index.

**Past performance is no guarantee of future results.**

[i] Source: Japan Ministry of Economy, Trade, and Industry, Haver Analytics, FMRCo (MARE) as of 2/28/11.

[ii] The Bank of Japan indicated on 3/14/11 that it would increase its Asset Purchase Program, mainly of risky assets, by about 10 trillion yen to about 40 trillion yen in total and made 21.8 trillion yen available to financial institutions. Source: Bank of Japan, FMRCo. (MARE) as of 3/14/11.

[iii] According to the International Monetary Fund (IMF), Japan's estimated budget deficit and debt is estimated to be 8.9% and 234%, respectively. Source: IMF, FMRCo. (MARE) as of 2/28/11.

[iv] The Nikkei 225 Index fell 6.2% on 3/14/11. Source: FactSet, FMRCo. (MARE) as of 3/14/11.

The MSCI Japan Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in Japan.

The Nikkei 225 Index is a price-weighted index of the 225 most important stocks on the Tokyo Stock Exchange.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges, and expenses. For this and other information, call or write Fidelity for a free prospectus or if available, a summary prospectus. Read it carefully before you invest.

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