THIRD WAVE SOLUTIONS

Outlook: Impact of the Japanese Reconstruction

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In the immediate aftermath of the recent triple-disaster in Japan (Earthquake, Tsunami, Nuclear Meltdown), equity indices around the world took a minor setback. They seem to have stabilized now with the apparent logic being that Japan seems to be weathering the disaster quite well and will soon be on its way to recovery. However, prior experience has taught that the impact of such tectonic changes (quite literally in this case) rarely get priced in correctly in the immediate few weeks after the change. Dynamics emerge which seem to take the markets by surprise. Even after they start becoming evident, in fact, they are often dismissed as immaterial. But the basic rules of economics rarely change and the best strategy is to go with what plain economic logic would suggest. Therefore, here is how I think things will unfold over the months to come. (A lot of the reasoning here is not my own but a summary of the opinions, amongst the multitude being expressed, that I think are correct).

Impact on global asset prices:

It is being estimated that the total cost of reconstruction in Japan will end up being close to $300B. Assuming that the Japanese Govt. will foot half the bill, insurance companies will still be left to fund about $150B worth of reconstruction. Japanese insurance companies, like any good insurance company, have investments widely distributed around the globe. To meet the inevitable demand for cash, they will be forced to liquidate part of their portfolios creating substantial supply in markets everywhere. Despite the ample liquidity being pumped into the system by central banks of developed countries, this is bound to put a significant downward pressure on prices for financial assets. In the worst case, it could trigger a spiral of selling as margin calls are generated on leveraged positions. This latter is only a remote possibility though, as leverage is probably at much lower levels today than the pre-recession days. In general, however, financial markets are likely to remain subdued while Japanese insurance companies liquidate their portfolios to pay for the reconstruction.

Impact on currency:

After a disaster of the magnitude that hit Japan, the natural first thought would be that the Japanese Yen would see significant weakening as exports are disrupted and the Bank of Japan is forced to keep interest rates low to ease the pain. However, the opposite happened as the Yen hit a 16 year high before the Bank of Japan stepped in to halt the appreciation of the currency. The reason for this was the phenomenon just explained above – Japanese insurance companies unwinding investments around the world and repatriating the cash back to Japan. As this process intensified, carry traders (people who borrow Yen at cheap rates to invest in other parts of the world) probably panicked and rushed to cover their Yen shorts driving it even higher.

However, this effect is not likely to persist as the cash that has been repatriated will soon start leaving Japan as imports of building material build up. The disruption of nuclear power facilities also means that Japan's demand for LNG will go up substantially. This would also entail higher outgo (although this will partially be offset by reduced outgo for nuclear material). In general, though there will certainly be higher volatility, I doubt the Yen will strengthen substantially over the next few months.

Impact on commodities:

The most obvious impact I expect to see is on steel prices. We should see a strong surge in demand for steel as Japan recovers from the 'fire-fighting' operations and starts the long and painful process of rebuilding the infrastructure that was washed away or otherwise destroyed in the wake of the earthquake and the tsunami. This is bound to drive up both the prices of finished steel as well as iron ore. Therefore I don't anticipate significant margin improvements for steel manufacturers. Top-line growth (and consequential bottom-line growth) might be seen though, for manufacturers operating below capacity currently. Iron-ore miners and bulk carriers in the shipping space should see improving fundamentals.

There are increasing reports of food contamination with nuclear radiation and I expect a double-whammy in terms of food demand. Not only will food export from Japan suffer a major setback (sea-food most of all), Japan is likely to end up increasing food imports to meet the deficit created by the destruction of their own production capacities. If the rice crop is affected significantly, we could see a sustained upward pressure on the price of rice which is the staple food for a large number of people across the world.

LNG prices are likely to see a spike-up too as Japan increases imports to cover the power deficit created by the outage of their nuclear power-generation capacity. Given the sensitivity of these plants, they might not be brought on-line for several months or even over a year. Coupled with the escalating crisis in the middle-east and north Africa (MENA), LNG prices are likely to remain high. Russia, which derives a large part of its revenues from crude oil and natural gas resources is likely to be the biggest beneficiary from this.

Indian Equities:

Overall, as pointed out before, the equity market is likely to remain subdued subject to liquidation by Japanese insurers (and even corporates). This may not be a big issue on its own but coupled with projected rise in steel, LNG (and crude oil) prices it could have a substantial impact.

I expect shares of mining companies to remain buoyant as ore prices rise on demand. Shipping companies with bulk carrier and gas tanker capacity could see improved valuations. Pharmaceutical companies would likely benefit as demand for drugs of a wide variety spikes – drugs ranging from treatment for radiation exposure to psycho-somatic medication are likely to be in heavy demand. Even though Ranbaxy is currently on a downward trajectory, its access to the Japanese market through parent company Daiichi-Sankyo should help boost sales.

Capital goods and domestic construction, on the other hand, could face pressure on account on rising input costs. Manufacturers dependent on parts imports from Japan are likely to face difficulties as manufacturing capacity in Japan is disrupted and inventories dwindle. Maruti could be one of the more visibly affected companies.

Conclusion:

Overall, with no significant improvement in the global economic situation worldwide, unrest in the middle east, natural calamities (and consequent human calamities) in the far east and uneasy political situation at home, my outlook remains bearish to neutral in the medium term for Indian equities. Specific industries could do well in the near term on account of the natural demand as outlined above. This is an opportunity to spend time identifying long-term plays and to build positions at current valuations or slightly more attractive valuations that I expect in the coming months.