

Thought for the Week: Monday, March 14th, 2011

Japan & DIAS

First and foremost, **our 'Thoughts' go to the people of Japan**. A stark reminder of the power of Mother Nature and our relative position in the grand scheme of things.

From the moment the disaster hit, we have been discussing the potential economic effects. **The world's third largest economy has suffered a devastating blow** and now faces an uncertain period.

In most events of this nature, **the people who stay the course come out ahead of the panic sellers**. We feel this is the case with the Japanese nuclear and earthquake related problems.

On September 17th, 2001 (the first date you could buy or sell a stock on the S&P 500 following the 9/11 tragedy) the S&P 500 closed at 1,038. By October 3rd, 2011 the index was back to 1,072.

In the short-term, **supply chains will be affected**; industrial production around the world will suffer from shortages of components produced in Japan. About 20% of global semiconductors and 40% of flash memory chips are made in Japan. The price of NAND flash chips - critical for smart phones and tablet computers – jumped by 20% on Monday. A similar situation exists in the Auto industry with many components, mainly electronic, being sourced in Japan.

The **Nuclear and Insurance industries are taking a big hit**. Modern corporations are globally entwined. Insurance companies with direct exposure to Japan will have hedged their risks through the reinsurance markets; therefore, expect aftershocks amongst many indirect insurers.

Japan is the world's third biggest consumer; for example it accounts for approximately 13% of Coca Cola's profits. It is estimated that the earthquake could cost \$200 Billion in reconstruction and knock and additional \$100 Billion off Japan's GDP, significant figures for world economic growth.

The earthquake and collateral damage are exerting a terrible toll on life. However, Japan is a highly organized society and the negative effects should be short-term.

What Happens when the Faucet is Turned Off?

Bond and Stock prices have been raised by the U.S. Federal Bank's expansion of money supply and its injection into securities markets.

The big question is: **How much has this elevated the level of Bond and Stock 'buckets'?** With Quantitative Easing 2 scheduled to end in June 2011, markets are already looking ahead to what comes next.



The Federal Open Market Committee (FOMC) meets this week. Markets will hope for some clear direction regarding the end of Q.E.2.

It will be a brave FOMC that decides the financial 'bucket' can maintain current levels without Federal top-ups!



In DIAS Portfolios

DIAS investors have benefitted from our confidence in U.S. equity markets for two years; we were already in the early stages of a process of reallocating equity exposure based on the data we currently see.

Specifically, we **had reduced our exposure to Asian Equity and Debt** markets in all portfolios. In the medium term, the disaster may have positive economic effects for the region, but in the short-term we see no reason to change our bias away from Asian emerging markets.

Our equity-based portfolios had reallocated defensively before last week; **Active Alpha recently held 13% cash**, for example.

In light of Far East, and recurring Middle East, events we repeat the Thought of a few weeks ago: **“We do not see any reason to treat current stock market valuation drops as a reason to buy the dip”**. After the 9/11 World Trade Center attack, we bought the dip; this time we are keeping our powder dry. We currently plan to remain defensive, monitoring a number of areas for attractive valuation.

Interestingly, **tragedies such as Japan can create opportunities for patient investors**. Those companies that fit into our **“ICE-T” theme – Infrastructure, Commodities, Energy and Technology** – being some of our favorite areas to potentially benefit. For this reason, we are not looking at large allocation changes.

We were overweight Energy and see **opportunities for any energy source and commodities that can replace nuclear power** in the short-, medium- and long-term. We also hope to see increased demand for Natural Gas, one of our long term bull commodities.

Although the initial investor ‘knee jerk’ reaction was to reduce the value of many commodity and inflation-related assets, **the net effect of the catastrophe may be rising inflation**. Japan is fundamental in the supply of many items; this supply will be reduced. When supply reduces and demand stays constant, prices normally rise. We have no doubt that suppliers around the world will quickly react to fill supply shortages; however, many will charge higher prices to fill the gaps.

We are making changes to address current events and suggest investors stay where they are at this time.

In Summary

The Rising Sun will be obscured for a while which will cool many areas of global economic activity. But the Japanese people are far too industrious; their systems too well organized to stay in the shade for too long.

The sun has not been extinguished; it will rise again and quicker than many people would think.

In the meantime, this is **another impediment to continued market appreciation**; the list keeps growing.