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ECONOMIC TALKING POINTS

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Match 15, 2011

A Time To Reassess

Global shocks are by definition uncommon. When one does erupt, the impact on the world economy is usually brief. Rarely is there any lasting consequence.

But the first two weeks of March has unleashed a fusillade of geopolitical and natural shocks the likes of which we haven’t seen since World War II. This time, the shocks will likely ripple through the world economy for years.

What has transpired so far this month is an outbreak of vertigo-inducing events that are certain to bring historic changes across Japan, North Africa and the Persian Gulf.

Japan

The Armageddon-like devastation in Japan and the ongoing threat of radioactive fallout will have a chronic impact on the country’s economy. While the country makes up only 10% of global GDP, the repercussions will be felt globally and force a rethinking of economic forecasts and asset allocation strategies.

It is, of course, impossible at this time to assess the full economic impact of the tri-cataclysms because the destruction in still ongoing. The country remains in the midst of a nuclear catastrophe, one that is ominously edging closer to the core explosion seen at Chernobyl. Japan’s Fukushima Daiichi nuclear power plants are sending out dangerous levels of radiation into the air. The winds have periodically shifted to the southwest which means the fallout can move closer to Tokyo with its population of 39 million.

Scientists have already detected elevated radiation levels in the capital city. Moreover, several new significant aftershocks were felt near Tokyo this morning, with one measuring 6.2 and the other 6.0. All told, we believe it will take decades for Japan to recover from the destruction wreaked by the multiple earthquakes, tsunami and the nuclear catastrophe.

What to make of it all?

Here are a couple of preliminary conclusions that can be made. The impact on the global economy has to be viewed in two different time frames.

Short run (next six months to a year): The quake-ravaged economy, the world's third largest, could lower economic activity in Japan as much as 1 percentage point, and shave off worldwide growth 0.2 percentage points in 2011.

• Japanese officials and business leaders are looking at a reconstruction bill that could amount to more than $200 billion, double the rebuilding cost after the Kobe earthquake in 1995.

• Japan's export infrastructure has been damaged, with producers of cars, home electronics, industrial equipment, steel, textiles and foods impacted the most.

• Then there is the need to finance all those repairs. Japanese sovereign debt is already higher than any other industrialized country relative to its economic size. The debt is expected to surge to 228% of GDP in 2011. This will heighten concerns among creditors of a default, especially if interest rates start to rise. It is true that Japanese investors hold more than 90% of the country's sovereign debt. But if foreign investors begin to sell off their holdings, will Japanese institutional bondholders be far behind?

• The looming specter of a growing debt crisis in Japan has led investors to exit out of domestic stocks. The Nikkei has fallen more than 10% this morning alone--- plummeting 1,000 points---and that helped spark a sell off in stock markets worldwide.

Medium term (1 to 5 yrs): We see a massive reconstruction effort underway in the earthquake-damaged countries of Japan ($200 billion plus), New Zealand ($12 billion), and Chile ($30 billion). In addition, Egypt, Australia, Iraq, Haiti will also be spending tens of billions of dollars rebuilding their economies as a result of either riots, earthquakes or biblical floods. On top of these efforts, demand for construction equipment and material will remain strong from the other healthier emerging countries, like Brazil and India. This will boost global economic growth and drive industrial commodity prices higher. We expect to see financial markets recover in the second half of this year as the prospects for global growth improves in 2012.

The Middle East

The other huge story, of course, are the multiple rebellions erupting across North Africa and the Persian Gulf. While Egypt and Tunisia have successfully overthrown their autocratic rulers, stability is far from assured in these countries because they still have no clue how to transition to a more open and democratic society.

As for Libya, soldiers loyal to Gadaffi are rushing to use all their military capabilities to recapture cities and oil depots from rebels --- just in case the UN prepares a vote on a no-fly zone over Libya. (Much to Gadaffi's relief, Security Council members have so far failed to agree on a no-fly zone, which means the odds have improves that he will maintain his rule. This actually raises an intriguing question. Could it be that the major Western oil importers quietly decided that a Gadaffi victory, while abhorrent, might actually take some steam out of the other rebellions that have spread across the oil-rich Persian Gulf nations where stability is really far more paramount? Remember, Saudi Arabia is a major supplier of oil to the West and the Saudi Kingdom is currently encircled by countries where violent protests are increasing. A Gadaffi victory could weaken the resolve of those demanding change in the more important oil exporting countries. Granted, it's purely Machiavellian…. but plausible in the world of realpolitiks.)

A word of caution

There is still a lot of uncertainty how bad the human and economic toll will be in Japan. The tragedy has certainly been horrific, and there is still no sense the nuclear crisis is over. Some experts believe Japan may face a meltdown in all six reactors.

As for the Persian Gulf, events in Bahrain have taken a more dangerous turn too. Saudi Arabia and other countries from the Gulf Cooperation Council (which also includes Kuwait, Oman, Qatar, UER) have sent 1,500 troops into Bahrain to quell the Shiite uprising, infuriating Iran. Deaths have already been reported this morning among the armed forces and protestors.

We advised clients in February to begin locking in capital gains on equities and increase their allocation of cash until there is greater clarity how the protests across North Africa and in the Persian Gulf play out. Given the carnage in Japan and the continuing threat of a nuclear meltdown, we see no reason to alter that recommendation.

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