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Update on the Impact of the Tohoku Pacific Offshore Earthquake

March 23, 2011

Economic Impact

1. Supply constraints

- Damages in capital stock in the Tohoku region

Some analysts predict the damage in capital stock in the Tohoku region to be around JPY15 trillion. This equates to around 25% of the combined capital stock of Iwate, Miyagi and Fukushima prefectures. The combined gross domestic product (GDP) of the three prefectures accounts for approximately 4% of Japan's GDP. The GDP of the 3 prefectures is estimated to contract by 20% from the damage to capital stock. Though the standard of living in the area will recover gradually from reconstruction, Japan's annual GDP growth rate is likely to contract by 0.5% in fiscal year (FY) 2011.

- Power shortages in the Kanto (East) region

Assuming the electricity supply shortages will continue until the end of April, the GDP of the Kanto region is likely to shrink by 10%. The Kanto region encompasses seven prefectures, including Tokyo, and accounts for 40% of Japan's GDP. We believe this will reduce the nationwide annual GDP growth rate by 0.4%. While we expect electricity supply shortage to resolve temporarily in May, the shortage is likely to recur in the summer periods. The maximum capacity of electricity supplied by TEPCO (Tokyo Electric Power Company) in the summer is around 50 million kW/h. Typically, demand for electricity reaches its peak in the summer, at somewhere between 55 million to 60 million kW/h. As such, concerns regarding electricity supply shortages may resurface in the summer.

There is also concern that the disruption to the supply chain in the Northeast or Kanto region will spread to other regions. However, shifting the production base from the affected areas to the western

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region of Japan or overseas may help to offset this negative impact, and thus mitigate the impact on the overall economy.

2. Reconstruction demand

Judging from the estimated figure of the decline in capital stock and the estimated size of the extra budget, reconstruction demand for FY2011 is expected to be around JPY5 trillion (more than 1% of Japan's GDP)

3. Psychological effect

● Personal consumption

Consumer spending has been declining as a whole. While spending on consumer discretionary goods has risen on the back of food and gas hoarding, spending on luxury goods and leisure services have declined, partly due to the psychological effect from recent events. It is hard to quantify the impact of the nuclear problems on personal consumption at this point in time.

● Appreciation of the yen

We expect repatriation of foreign assets held by insurance companies and other companies to be minimal and the impact on the foreign exchange market to be limited. Taking into account both the negative effect from supply constraints and the positive effect from reconstruction demand, we estimate economic growth rate of the April – June quarter to be negative, but to turn positive from the July – September period. The Japanese economy is estimated to grow approximately 1.5% in FY2011 ending March 2012 and to increase to nearly 3% in FY2012, underpinned by easing of supply constraints and reconstruction demand. Nevertheless, the following risks remain: power shortages, negative psychological impact on consumers/businesses and the appreciation of the yen.

Global Investment Climate

1. Weaker U.S. Dollar (USD) and rising commodity prices

The USD has not appreciated against many of the major currencies despite the rising geopolitical risks in North Africa and the Middle East, earthquakes in Japan and improving economic conditions

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in the U.S. In the short term, concerns regarding the divestment of foreign assets by Japanese companies and differences in monetary policies between the Federal Reserve Bank (monetary easing) and European Central Bank (monetary tightening) are likely to undermine the USD. In the mid-to-long-term, we expect the USD to be weaker against currencies of emerging economies. The basic mechanism is that the weaker USD and increasing demand from emerging economies will push commodity prices higher. In this regard, the weaker USD and rising commodity prices are inextricably linked.

2. Signs of accelerated inflation

Higher commodity prices are likely to have limited impact on inflation in developed economies compared to emerging economies. Although commodity prices are an important component of inflation, the Services sector accounts for a significant portion of developed countries' economies and is therefore a relatively greater component of their inflation indices. In addition, it is difficult to see an increase in wages given the high unemployment rates in recent years. On the contrary, food accounts for a large portion of household spending in emerging economies while the Services sector is a relatively small portion of these economies. In addition, the labor market tends to be tighter in these countries, and there is pressure on wages. Governments in these countries may have to accept higher wages to placate the low income earners in order to avoid political unrest, which may accelerate inflation. Hence, it is noteworthy that emerging economies are more vulnerable to inflation caused by rising commodity prices.

Implication for the Japanese Financial Markets

1. Foreign Exchange Market

We believe the likelihood of Japanese investors selling significant amounts of foreign assets to be relatively small. However, Japanese investors may reduce new investments into foreign assets. Taking into account the general trend of the weaker USD, the yen may continue to appreciate against the USD. The Bank of Japan has committed to continue to supply ample liquidity into the foreign exchange markets while the Japanese government is likely to take measures to curb the appreciation of the yen with coordinated intervention.

2. Fixed Income

In the fixed income markets, government bond issuance is likely to rise as public spending is boosted for reconstruction efforts. For the Private sector, we expect companies to increase capital expenditure; housing construction is also expected to rise. The effect on interest rates will be closely watched. However, given that the Bank of Japan has assured the markets of ample liquidity, a spike in interest rates is likely to be avoided.

3. Equity Market

We expect the stock market to recover, assuming that the Japanese economy is on track to recovery on the back of the easing of supply constraints and rising demand for reconstruction. Nevertheless, problems at the Fukushima Daiichi Nuclear Power Plant remain a concern, and electricity supply shortages may resurface in the summer. While it is true that the direct impact of higher crude oil prices on Japanese businesses may not be significant, monetary tightening in the emerging economies on the back of inflationary pressures may result in slower economic growth. Moreover, higher crude oil prices, which entail depreciation of the USD, may lead to further appreciation of the yen.

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