May 2017

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HOW WOULD A KOREAN CRISIS IMPACT JAPAN?

Summary

- While highly unlikely, we examine the potential impact on Japan of a major crisis on the Korean Peninsula
- Two potential scenarios: Yen appreciation if Japan is not directly entangled; and yen depreciation if Japan becomes involved
- We would anticipate investment flows to regions of perceived safety like Europe, and opportunities around risk assets

The possibility of Japan becoming embroiled in any kind of escalation related to North Korea has changed from extremely unlikely to highly unlikely. Any pre-emptive strike by the US, pre-emptive political intervention by China, or large-scale nuclear test by North Korea could greatly ramp up geopolitical risk on the Korean Peninsula.

A direct pre-emptive strike by the US on North Korea brings an increased risk of a counterattack on Japan. This would also increase the risk of the 1953 Korean War Armistice Agreement collapsing. A successful political intervention by China that ensures a change to the political structure within North Korea represents less risk, and would be positive overall. Unfortunately, this remains unlikely. Lastly, although highly unlikely, North Korea performs a nuclear test. This would be crossing the red line set by the US. We believe this would raise the possibility that North Korea would be willing to inflict damage to US troops stationed in Korea or Japan, or even attempt a direct attack on the US mainland.

Japan's economy would be impacted directly, whether or not a conflict occurs, if air and sea routes in the areas between China and Japan were blockaded. If Japanese firms manufacturing electronics in China using Japan-made machinery and parts had to suspend production for several months, profits would be negatively impacted. Also, an attack on US troops stationed in Japan would affect production levels there. The issue is how long any disruption would last, as the extent of the impact on the economy would depend on the duration.

Any of the above scenarios could cause a rise in oil and other commodity prices. In a normal economic environment, subdued production decreases commodity prices due to a reduction in demand, but concerns over a potential blockage of supply routes and transport would drive prices up in the above scenarios. Moreover, a delay to US tax cuts due to increased military expenditure would increase the likelihood of a dampened US economic recovery, with the consequent depreciation of the US dollar boosting prices of commodities traded in US dollars.

Scenarios - yen appreciation if Japan not entangled; or yen depreciation if Japan involved

The yen often appreciates in times of crisis due to its reputation as a safe-haven asset, but this would not be the case if the crisis directly involved Japan.

Scenario A: Japan Not Involved

	Equities	Bonds (Price)	Currencies	Gold/Oil*
Japan	↓	↑	↑	→
US	↓	↑	↓	↑
Europe	↓	↑	↓	↑
Asia	↓	↑	↓	↑

Scenario B: Japan Involved

	Equities	Bonds (Price)	Currencies	Gold/Oil*
Japan	↓	↓	↓	↑
US	↓	↑	↑	→
Europe	↓	↑	↑	→
Asia	↓	↓	↓	↑

N.B. The above scenarios are the opinion of the author
* Price changes are in the currencies of the respective countries/regions

Let us consider scenarios A and B three months following a significant crisis. In scenario A, in broad terms equities would fall, bond prices would rise (yields would fall), the yen would strengthen against almost all other currencies, and gold and oil prices would rise in US dollar terms but stay more or less unchanged in yen terms. The increased uncertainty caused by this scenario would hamper global economic growth, but Japan would be unlikely to suffer economic harm (such as a production disruption of three months or longer). A slowdown in global economic growth would be likely to strengthen the yen, as it has long been considered a safe-haven asset. This was seen with the drop in US interest rates and appreciation in the yen when geopolitical risks flared up in mid-April. Market reactions in this scenario could actually be regarded as a sign of confidence in the Japanese currency and by extension its government.

In scenario B, it is likely that equity markets would sell off on risk aversion while Japanese and Asian bonds would fall in price (yields to rise) due to heightened credit risk. This is the worst scenario and is not currently expected by the market. Even the increased fear of damage from a missile attack aimed at US forces stationed in Japan could potentially depress production in Japan. Given that many Japanese firms use China as a production base, a blockade of air or sea routes alone would also likely significantly affect production. A production disruption of three months or longer would push down corporate profit estimates and eventually GDP growth.

Moreover, a reactive approach by the Japanese government could cause a simultaneous jump in government bond yields and a slump in the yen, which would raise refinancing costs for the government, putting pressure on its finances. Hyperinflation is also a possibility if confidence in Japan's government bonds and currency deteriorates. While this scenario is highly unlikely, it is appropriate for investors to consider even low-probability risks and anticipate how they would respond.

Investment may flee to regions like Europe; potential risk asset investment opportunities

Here I would like to stress once again that the likelihood of any significant crisis on the Korean Peninsula is extremely low. Moreover, if something does happen, it is likely that Japan – scenario A – avoids any direct involvement. While extremely improbable, scenario B in which Japan becomes involved, would likely lead to a fall in equities, bonds and the yen due to the changed risk outlook for Japan by the markets. Even in this case, it is unlikely that any crisis would last for a prolonged period of time - we would expect that the situation would resolve in a reasonable amount of time. Under such circumstances, investors are likely to look to US dollar-denominated bonds and gold as a temporary way of avoiding risk.

At the same time, if investor confidence in Japan is maintained, the yen would strengthen and therefore investment in assets like gold may not necessarily be the best way to avoid risk, while capital gains from foreign bonds could be offset by yen appreciation. Scenario A may actually be more of a challenge for investors than scenario B. If scenario A occurred and the yen strengthened, the euro would likely be at an advantage relative to the US dollar given Europe's remoteness from this particular geopolitical risk. Whatever the case, this would usher in a period in which investors move away from risk assets to areas of perceived safety.

At the risk of repeating myself, I would like to emphasise that both of the above scenarios are unlikely to occur and, even if either did, their impact would be doubtful to last very long. The best way of handling investment risk is anticipating all potential scenarios and considering how a long-term investor would respond. If the situation in North Korea significantly escalates, it could lead to investment opportunities in risk assets by those investors able to determine which of the anticipated scenarios applies and can calmly discern how long it will take for the turmoil to resolve.

From a global perspective

To put things in perspective, the global economy is improving as employment and wage increases gather momentum and consumption grows in the US – which finally appears to be on a firm path to normalisation from the financial crisis fallout, as indicated by the Fed's interest rate hikes. In addition, the Trump administration can still be expected to implement tax cuts and other stimulus policies. At the same time, President Trump stated in an interview following the China-US summit that he doesn't consider China to be a currency manipulator, and he does not appear to be ramping up his protectionist policies (although he is not reversing them either). While the pace of policy implementation in the US has decelerated somewhat, the administration's pro-growth stance is still intact and its protectionist tendencies are currently contained, giving us few reasons to doubt that the US economic recovery will ripple through the rest of the global economy.

At times like this, investors are encouraged to maintain an appropriate level of risk in their portfolios while at the same time preparing for the unexpected.