GMO Emerging Thoughts

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China – King Canute Holding Back the Waves?

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According to the 12th century legend, King Canute set his throne by the seashore and commanded the incoming tide to halt and not wet his feet and robes. Yet continuing to rise as usual, the tide dashed over his feet and legs without respect to his royal person. He then turned to his fawning entourage and rebuked them for ascribing supernatural powers to a mere mortal.[1]

CANUTE REBUKES HIS COURTIERS

The Chinese government is displaying no such humility as it attempts a similar feat with its free-falling stock market. In response to the recent market decline, the government forced brokers to collectively buy $20 billion of ETFs, drastically curtailed margin lending, and allowed 50% of listed companies to suspend trading in their stocks. On top of this, the stock market regulator banned major shareholders, corporate executives, and directors from selling stakes in listed companies for

[1] "Canute Rebukes His Courtiers," illustration by de Neuville, reproduced in Famous Men of the Middle Ages, John Henry Haaren and Addison B. Poland, American Book Company, 1904.

six months. Investors with stakes exceeding 5% must maintain their positions as well. Any new share issuance was also banned.

And all of this to stem a drop of 30% in a market that had risen 150% in the past 12 months.

So, what's going on? Why the panic?

In our opinion, the panic is just a plain, old-fashioned, rookie move by a government that is used to being able to execute policy as it sees fit and doesn't (yet) understand that the stock market doesn't follow administrative fiat. They do not seem to realize that their interventions are likely to be more damaging to their long-term plans than the stock market decline alone would have been.

This is because the stock market is a key part of the plan to rebalance the economy away from the investment-led model, which focused on state-owned enterprises, and toward a consumption-led model that emphasizes private ownership and capital. The plan was to have an effective "equity for debt" swap at a societal level by having companies raise capital in the stock market, thereby reducing the overemphasis on bank debt and its inherent vulnerability.

As the economy slowed and the real estate market started to show some cracks, the government served as a cheerleader for the stock market and played along in the hope that the wealth effect created by the rising market would ameliorate some of the effects of a slowing economy. However, it was inevitable that stocks could not continue to rise when valuations reached silly levels in the face of declining earnings.

We believe the sudden market drop will scare away retail investors (who took seven years after the last crash to return to the market), and ham-fisted government actions will make institutional investors wary, thus pushing rebalancing out into the future. In addition, the negative wealth effect may spill over into reduced consumer spending, which was the one bright spot in a slowing economy. Thus, one can see the economy slowing even faster than it has so far. If that is the case, it will be negative not only for China but for many emerging markets that serve as suppliers, as well as for the sales of multinationals within China.

As far as our strategies are concerned, both the Emerging Markets[2] and Emerging Domestic Opportunities Strategies[3] were underweight China going into June, primarily based on high valuations. In regards to our flagship strategy, the only area within China that we were overweight was the big four banks, which were cheap relative to global financials. However, given that actions taken by the government to stabilize the market may well force the banks to do what we call "national service" (i.e., bail out troubled asset holders), we are reassessing our holdings in Chinese banks.

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[2] As measured against the S&P/IFCI Composite.

[3] As measured against the MSCI Emerging Markets Index. The Emerging Domestic Opportunities Strategy does not have a benchmark. The Strategy has been compared to the MSCI Emerging Markets Index in an effort to compare and contrast the Strategy versus a broad emerging markets index.

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