

GMO: Something's Fishy in China

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January 17, 2012



A wide gulf separates the two most prominent views regarding China's future. Faced with slowing economic growth, one side says its leaders will deftly navigate a soft landing, while the other claims it will face an implosion similar to those that befell Japan 20 years ago and the US in 2008. Count GMO, a firm that has built its reputation on its ability to identify a bubble about to pop, in the latter camp.

Edward Chancellor, who focuses on capital market research as a member of Grantham, Mayo, Van Otterloo's asset allocation team, laid out that negative forecast last week when he spoke in London at a research symposium hosted by Societe Generale.

Accusing the soft-landing camp of "uncritically accepting" China's growth story and placing an "overblown belief" in the authorities in Beijing, Chancellor listed 10 tell-tale traits of an economy on the verge of collapse.

China, according to Chancellor, meets that classic definition of a bubble.

Let's look at Chancellor's historical examples and how China fits into his paradigm.

Ten signs you know you are in a bubble

"Having looked about 300 years of financial history," Chancellor said, "I've been able to reduce it, for the sake of simplicity and storytelling, to 10 characteristics of a great mania."

First among them is a growth story that is uncritically accepted. Chancellor cited the dot-com era, when analysts routinely assumed that virtually every company would follow an s-shaped growth curve, where initial growth was tepid, as companies expanded into niche markets. Rapid market growth followed, as firms were assumed to possess a dominant strategy, as was followed by a leveling off of growth, as markets matured.

Chancellor related such uniformity of thinking to his experience working in Hong Kong, where he said that the dream of the typical businessman there was to sell a toothbrush (or other everyday goods) to every Chinese person, as a way to tap into its growing middle-class consumer demand.

But that dream has turned into a nightmare for most. Chancellor cited projections of a billion urban consumers in China's cities by 2030. Economists, however, "are not very good at predicting anything, much less demographics," he said. Migration to cities is a



pro-cyclical phenomenon, according to Chancellor, and once its economy slows, China's population will exit the cities. He cited similar patterns in the US, where Chicago's population grew during boom periods and shrank or stalled when the economy slowed.

Furthermore, China's population, which is set to contract in a few years, is even more reason to be skeptical about projections of a billion consumers, Chancellor said.

Chancellor's second sign was overconfidence in authorities. A clear example from the US experience was Bob Woodward's book, *Maestro*, a tribute to Alan Greenspan published at the peak of the dot-com bubble in 2001. Chancellor cited several similarly laudatory books about China's leaders, but he offered a starkly different take on China's braintrust. China's leaders "are not incompetent when it comes to lining their own pockets," he said, and through corruption "have made a great deal of money in recent years."

Third, easy money and credit expansion are precursors to a financial crisis, according to Chancellor, who cited data similar to that published by Reinhart and Rogoff showing that debt-to-GDP invariably rises rapidly before a crisis. Indeed, China's total debt-to-GDP has risen dramatically from approximately 135% in 2008 to 175% in September of 2011. A significant contributor, Chancellor said, has been "social financing," which is lending by non-bank entities partly controlled by Chinese authorities. He said those loans come close to being "Ponzi financing," since they are short-term, high-interest-rate loans that largely support real estate development.

An investment boom and a misallocation of capital are the fourth signal of a bubble. As an example, Chancellor cited the railway boom in Britain between 1820 and 1840, when the British Parliament authorized excess construction that led to duplicative railroads serving London and ultimately a low return-on-capital for the industry. Today, Chancellor sees signs of over-investment in luxury goods in China, an extreme example of which was the sale of a Tibetan Mastiff for 1 million UK pounds.

Fifth, Chancellor cited troubling "agency" issues. At the peak of the dot-com era, Chancellor said it was common for investment banks to hire brokers and analysts not based on their ability to understand businesses or their competitive strategies, but based on how well they understood the "game" of underwriting and how fees were allocated among, for example, trading, new issues and corporate finance. In China's case, he cited an index – created by GMO – of IPOs with the word "China" in the company name, stocks which he said were promoted by brokers telling you to "buy China," while ignoring the notion of a possible bubble. That index has already fallen nearly 60% in the last four years.

Collective irrationality and herd behavior were the sixth sign of a bubble that Chancellor discussed. As an example, he cited the Mississippi [bubble](#) of 1719, when investors poured money into a trading company based on an over-hyped value of properties in Louisiana. Signs of similar activity in China include excessive trading – in 2009, there



were days when the Shanghai exchange volume was greater than that of New York, London and Tokyo combined.

Fraud and Ponzi financing were the next indicators Chancellor cited, of which there is a long history in the US, including Enron and WorldCom. Chancellor showed examples from China today, including [Longtop](#) and [Sino-Forest](#), the latter of which ensnared the hedge fund investor John Paulson, who lost \$100 million when the company collapsed amid questions about its finances.

Ninth on Chancellor's list was conspicuous consumption, which in China has been most obvious in excess investment. He said China's fixed investment is roughly 50% of its GDP, a level that no other economy has sustained for a long period of time.

Real estate markets are the subject that most clearly separates the optimists from the pessimists in regard to China. Chancellor, as you might expect, said the market is vastly overbuilt, with empty apartments throughout the country. Moreover, work on much of the construction has been shoddy, he said, including the use of cement insufficiently strong to support buildings. Many apartments have no fixtures, electricity or bathrooms.

And the number 10 sign of a bubble...

Ultimately, what matters for investors are valuations, and Chancellor cited several examples of prices in China that increased by two or more standard deviations above their historical averages. The most prominent illustration is in housing, where the value of China's housing stock went from 200% to 350% of GDP from 1998 to today. By contrast, the corresponding increase in the U.S. was from 100% to just over 150% from 1998 to 2006, and ours is now back to nearly 100% of GDP.

China's housing bubble more closely parallels that of Ireland in 2004 and Japan in 1990; in both cases, a collapse in housing led to severe recessions.

Chancellor said that he discussed China's housing market with his boss, Jeremy Grantham. Acknowledging that China's empty apartments were primarily for trading and not for occupancy, Grantham said that they were like the sardines tins that California's gold miners exchanged in the 1850s. When a prospector was flush with money, they would buy a tin of sardines, and sell it when their fortunes had reversed.

One day, however, a miner opened a tin and found that the sardines were rotten – thus realizing that these tins were really for trading, not eating.

The sardine investor may still have been better off in those days than a Chinese real estate investor is today, since there was a secondary market for trading those little tins.

There is no secondary market for Chinese housing, Chancellor said.



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