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New China Perspectives



Welcome to the latest issue of Morgan Creek's **New China Perspectives**. This issue is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground" insights of our team together with

Morgan Creek's decades-long experience in covering the region. To learn more about our team and investment offerings, please email chinateam@morgancreekcip.com.

Best Regards,

Handwritten signature of Mark W. Yusko in black ink.

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND¹

Over the past 40 years, China has introduced a series of landmark market reforms to open trade routes and investment flows. We believe that ongoing issues such as world decoupling and China's demographic change will facilitate new reform among the major economic powers. China's reform emphasizes the strategy of 'Dual Circulation', introduced in 2020 to present a clear national strategy for the next decade. In this five-part newsletter series, we will explore dual circulation in depth, through segments including a model introduction, supply chain safety, productivity improvement, consumption stimulation, and international trade threats and opportunities. In this first newsletter, we will begin with an analysis on China's strengths over the past 40 years and its challenge to decouple its supply chain. Globalization shifted to a 'dual circulation' strategy, we will highlight the key reforms during the period.

On Dec 11th, 2001, China officially joined the World Trade Organization (WTO). Its achievements have been remarkable over two decades, surpassing Germany in 2009 and the U.S. in 2013 to become the world's largest goods exporter. China has become a 'global factory', with multinational companies relocating their supply chain within China to achieve efficiency and cost effectiveness.

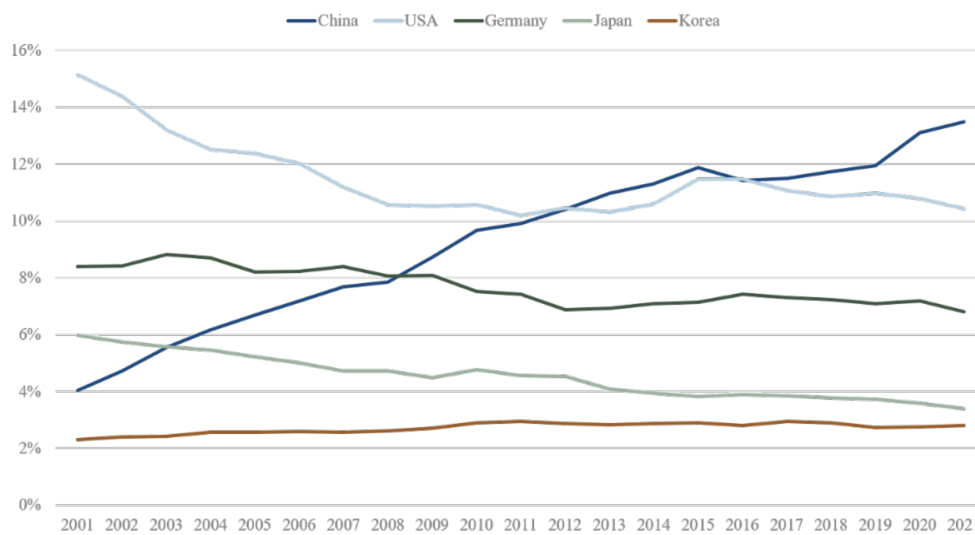


Figure 1: Shares of world trade (goods) - exports and imports on a USD basis ²

China's strengths

'The manufacturing industry is an indispensable sector to China at all times' ³

---President Xi

Today, China contributes 30% ⁴ of global manufacturing output and is at the center of the global supply chain. We believe that China's successful path to manufacturing superpower is attributed to three key elements: land reform, infrastructure development, and population size.

Land Reform

After China completed its 'Land Reform and Collectivization' in 1953, 100% of land in China became government owned. Despite mixed views on the movement itself, this movement played an essential role in allowing the government to develop robust infrastructure in a timely manner, which enabled China's success in manufacturing.

Infrastructure Development

In the 70 years since the land reform, China's infrastructure thrived. Today, the nation has the longest high-speed railway and highway coverage. It possesses seven out of the top ten largest ports in the world. China is building eight airports a year, more than any other country. ⁵ Its 5G base stations comprise over 60% of all installations around the world. ⁶ The benefits of robust infrastructure can be illustrated in the country's effective logistics industry: daily domestic courier volume reaches about three billion units per day while the average time required for the delivery is only two days.

Population Size

China has the largest labor force globally because of its high labor force participation rate, totaling 68% of the total population. This compares with only 34% in India, which has a similar population as China. ⁷ This has given China an edge in terms of affordable labor historically.

Decoupling supply chain

China, the U.S., and Germany are the three largest economies with the most influence on global trade. The Russia-Ukraine war has destabilized energy markets with Germany being hit hard due to its dependence on Russian energy. The German government is trying to diversify its natural gas supply sources by purchasing more gas from Norway and increasing imports via pipelines from Belgium and the Netherlands. ⁸

The ongoing U.S. and China confrontation is posing a threat to the world economy. In the short term, a motivating factor that may be spurring decoupling is for increased diversification of imports to make supply chains more resilient. In response to the COVID-19 pandemic and inflation, U.S. imports in 2022 were 38% higher than pre-trade war level. In comparison, U.S.'s import from China is only 16.5% of total U.S. goods imports, down from 21.2% at the onset of the trade war.⁹

We think that the policymakers foresee long-term benefits in disentangling the two economies. The U.S. has tried to convince multinational companies to return or establish manufacturing in the U.S. It takes time to reestablish, find, qualify and certify new suppliers in the U.S. The process could take as long as 12-18 months. In the meantime, if the U.S. must import parts or kits from China to support production. The U.S. will still pay penalty tariffs until it can source domestically. In 2022, the U.S. imports received from China remained high, showing that China's cost advantage built over the last two decades is not so easily replaced.

China depends heavily on imported crude oil and integrated circuits ("IC"s). To replace fossil fuel, China has opted for renewable energy to increase electricity coverage and support the Electric Vehicles (EV) industry development to replace traditional fuel vehicles as EVs powered by advanced semiconductor components are considered the new oil. The best semiconductor chips are designed in the U.S., manufactured in Taiwan or Korea with equipment made in Japan and the Netherlands, then finally assembled in China. To secure the domestic supply chains, China appears determined to make progress on import substitutions for self-sufficiency.

The forced reworking of already efficient supply chains via supply chain diversification, manufacturing reshoring and import substitution is time consuming and cost ineffective. Leaving China means additional construction costs, uncertainty in domestic infrastructure, and losing the economies of scale of the large market in China. While China maintains its manufacturing edge compared with its peers, its unsustainable reliance on advanced nations for low-cost demand and technology presents a challenge in what looks to become an increasingly decoupled world. To address these issues, China introduced its dual circulation strategy in its 14th five-year plan in early 2020.¹⁰

Dual Circulation

'Promoting high-standard opening-up, constructing the new development paradigm featuring dual circulation, in which domestic and overseas markets reinforce each other, with the domestic market as the mainstay'

-10th Congress Meeting¹¹



Figure 2: China's Dual Circulation Model

The strategy is to place a greater focus on the domestic market and less reliance on its external circulation. Dual circulation is China's plan to leverage its massive ecosystem to become self-reliant in both supply and demand. As the chart above illustrates, on the supply side, China plans to secure its upstream supply chain by reducing the consumption of raw materials it lacks and import substitutes using domestic alternatives for intermediate products. China also plans to increase the efficiency and productivity of its industrial machine through digitalization and automation to reduce wastage. On the demand side, China plans to increase domestic consumption by mobilizing its large middle class and diversifying its export markets through its one belt one road ("OBOR") initiative.

In the short term, China still has a cost advantage in global market driven by its comprehensive manufacturing supply chain and economies of scale. In the long term, China will try to shift its cost advantage to products with a high margin to solve global issues, such as the energy crisis. No matter what happens, we think China will never turn its back on the rest of the world. In our next few newsletters, we will seek to illustrate how the policy supports economic reform and highlight potential investment opportunities.

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CHINA NEWS SPOTLIGHT

Li Qiang Meets with French President Emmanuel Macron: On the morning of April 6, 2023, at the Great Hall of the People, Premier Li Qiang of the State Council met with French President Emmanuel Macron who is on a state visit to China. Li Qiang said that both China and France are countries with profound cultural heritage and a strong spirit of independence. Under the strategic guidance of President Xi Jinping and President Emmanuel Macron, China-France relations have enjoyed sustained and sound development, injecting precious stability and certainty into a changing, volatile world. [Read More.](#)

Surging Chinese Stock Market Turnover Fuels Optimism that Long-awaited Bull Run is on the Horizon: Mainland Chinese stocks that have been lagging behind their offshore peers are starting to regain their luster, with turnover at a 10-month high fueling optimism that a long-awaited bull market may finally be around the corner. The combined trading value in the domestic market has topped 1 trillion yuan (US\$150 billion) for three consecutive days so far this month, after intermittently hitting that level in late March, according to Bloomberg data. [Read More.](#)

China's First Batch of Shares Under New IPO System Surge in Debut : Some shares among the first batch of stocks to list under China's registration-based initial public offering (IPO) system more than tripled in their debut on Monday despite tepidness in the broader market. The listing of the 10 companies on the main boards in Shanghai and Shenzhen marks the full roll-out of China's new U.S.-style IPO mechanism, designed to make public share sales more market oriented. [Read More.](#)

Alibaba Unveils ChatGPT Alternative Tongyi Qianwen Under Cloud Services after Baidu's High-profile Ernie Bot Launch: Alibaba Group Holding is the latest Chinese Big Tech firm to unveil its anticipated answer to ChatGPT, as the race to produce a home-grown rival to the hit chatbot from Microsoft-backed OpenAI continues to draw resources and widespread attention. Alibaba Cloud unveiled the service, called Tongyi Qianwen, on Friday through its official WeChat account, and has opened the chatbot to invite-only beta testing for corporate clients. [Read More.](#)

Tesla to Build Shanghai Factory to Make Megapack Batteries: Tesla Inc (TSLA.O) is opening a factory in Shanghai, capable of producing ten thousand Megapack energy product per year, to supplement output of the Megapack factory in California, the company said in a tweet on Sunday. The news was first reported by Chinese state media outlet Xinhua. Elon Musk's automaker will break ground on the plant in the third quarter and start production in the second quarter of 2024, Xinhua reported from a signing ceremony in Shanghai. [Read More.](#)

China's Lithium-ion Battery Sector Expands in First Two Months: China's lithium-ion battery sector maintained growth momentum in the first two months of this year, official data showed. Total output of lithium-ion batteries exceeded 102 gigawatt-hours (GWh) in the period, jumping 24 percent year on year, according to the Ministry of Industry and Information Technology. The output of lithium-ion batteries for power storage surpassed 15 GWh. The installed capacity of power batteries for new energy vehicles came in at about 38 GWh. [Read More.](#)

Drug Giant AstraZeneca Teams Up with Hong Kong Science Park to Drive Biotech, Medical Research Growth: AstraZeneca, one of the world's leading pharmaceutical companies, has signed a second collaboration agreement with Hong Kong Science and Technology Parks (HKSTP) as the city moves to position itself as a trailblazer in life science innovation. Along with the wider Greater Bay Area, Hong Kong aims to attract the best health talent and drive growth in the fields of medical research, drug development, and clinical trials. [Read More.](#)

Life Science Property Investors in China Expect Steady Growth as R&D Spending Spurs Demand for Lab Space: Life science property investors in China expect the sector to grow steadily in 2023 despite a plunge in biotech financing last year that has weakened leasing activity. Their confidence is underlined by the resilient rental performance of life science real estate and companies' solid spending on research and development (R&D), which is likely to drive demand for better laboratory facilities in industry parks. [Read More.](#)

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¹ The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.

² Source: World Bank

³ Source: Manufacturing industry indispensable to China at all times: Xi <https://english.news.cn/special/2023lh/index.html>, Mar 6th, 2023

⁴ Source: China accounts for 30% of global manufacturing output in 202 <http://english.scio.gov.cn/index.htm>, Jun 14th, 2022

⁵ Source: Number of civil airports in mainland China from 2000 to 202 <https://www.statista.com/>

⁶ Source: LVC AGM material in 2022

⁷ Source: Wind, World Bank

⁸ Source: Germany inaugurates 1st LNG terminal in push to diversify energy supply <https://www.aa.com.tr>; Dec, 2022

⁹ Source: Statistic; U.S. import of trade goods from China 2022

¹⁰ Source: What is China's dual circulation economic strategy and why is it important? www.scmp.com; Nov, 2020

¹¹ Source: www.gov.cn

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