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CAPITAL MANAGEMENT

ALTERNATIVE THINKING ABOUT INVESTMENTS

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,

A handwritten signature in black ink that reads "Mark W. Yusko". The signature is written in a cursive, flowing style.

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND¹

This is the last part of our five-series newsletter exploring China's dual circulation policy. The prior newsletters focused on China's economic transition to internal circulation. In this newsletter, we will analyze the impact of trade wars on China's international trade, and highlight China's strategy to ease global trade tensions.

China's high-tech import restrictions

China is the world's largest chip consuming market. It heavily relies on imported fabless chips designed in the US, and manufactured in foundries in Korea and Taiwan. Since 2017, Chinese companies in certain advanced industries have experienced various pressures from restrictions on accessing critical US technologies. It started with adding hundreds of Chinese tech companies into the 'Entity List' including Huawei, which resulted in a significant hit to its cellphone business due to chip shortages. However, from 2018 to 2022, about 70% of Chinese companies on the US export blacklist have been granted trading rights.² Huawei, one of the biggest firms, was also receiving approved licenses which was worth \$61 billion between Nov 2020 and Apr 2021.³

New trade restrictions were published in September 2022. China faced a US-led export ban that restricted access to 1) high-end AI chips; 2) US-made chip design software and 3) US-built semiconductor manufacturing equipment and its components.³ The new trade sanction focused on blocking the export of cutting edge AI chips to China. Nvidia and AMD are among a small set of AI chip designers in the world, which were ordered to stop selling the top performing chips to Chinese AI data centers.⁴ Nvidia has over \$5 billion in revenue generated by Chinese clients with 25% income exposure. To protect the business, they chose to keep providing another tailored product for China with a discount on computing speed, which is sufficient for data center operations in the short term.

In addition, to slowing down the Chinese chip design industries import substitution, the restrictions reduced China's access to US software that enables chip designers to create complicated blueprints and worldwide microchips manufactured by US equipment. The US needs to ensure that all of its allies including South Korea, Japan, and the EU countries are rowing in the same direction when it comes to limiting China's access to innovative semiconductor technology. It is now becoming a challenge for the US government to balance this with other countries' needs and to turn unilateral export controls into multilateral restrictions.

China's high-tech opportunities

While the sanctions dramatically raised the obstacles to China's production of an indigenous supply chain, China is not going to give up. Chinese tech companies incubated their own chip supply chain such as Huawei's HiSilicon, BYD's Bydmicro, and founded their own Corporate VC funds to nurse domestic start-ups. Huawei invested more than 25% of its revenue⁵ in R&D of chip design and equipment, and just claimed a breakthrough in creating electronic chip design tools and equipment needed to make semiconductors sized at 14 nanometers.⁶

China government also provided billions of dollars of investments to domestic IC start-ups. From 2021, many countries including Japan, Korea, the US, and the EU have invested huge amounts of money in the production of chips to ensure their supply chain safety. To catch up with advanced economies, the 14th Five-Year Plan (2021-2025) committed \$1,400 billion to accelerating China's innovation in wireless networks and artificial intelligence.

Date	Country	Name of Act	Committed (\$B)
May-21	China	The 14th Five-Year Plan	1,400
Nov-21	Japan	Act on Specified Advanced Information Communication Technologies	112
Jan-22	South Korea	K-chip Bill	431
Feb-22	EU	European Chips Act	48
Aug-22	US	CHIPS Act	280

*Table 1: Major economy's action on safeguarding the supply chain of chips*⁷

China has invested heavily in education to expand its skilled talent pool, increasing the number of college graduates from one million in 2000 to more than eight million in 2019. Five million of these graduates earned degrees in science, technology, engineering, and math. This increased number of graduates gives China more STEM graduates than India, the United States, Japan, Germany, France, Italy, the UK, and Canada combined.

As China begins to attract government-supported investments, graduate a larger engineering pool, and construct dozens of semiconductor fabless manufacturers, we believe that it has the opportunity to achieve the goal of 70% self-reliance in semiconductor production by 2025.

China's export tensions

China exported approximately \$3.6 trillion with a 13% 4-year-CAGR from pre-Covid to 2022⁸, which was driven by the global demand rebound and inflation. China exports to its top three importers US, ASEAN⁹, the EU were \$582 billion, \$571 billion and \$562 billion, respectively, in 2022 with a growth rate of 1%, 18% and 8% year over year (YoY), respectively. The growth is due to the advantages of domestic epidemic prevention enabling China's supply chain to function properly. However, the epidemic slowed growth in domestic consumption and investment. Although global economic recession and the extra tariffs on China can threaten high export growth in the future, we believe that China still has a competitive advantage in exports compared with other countries.

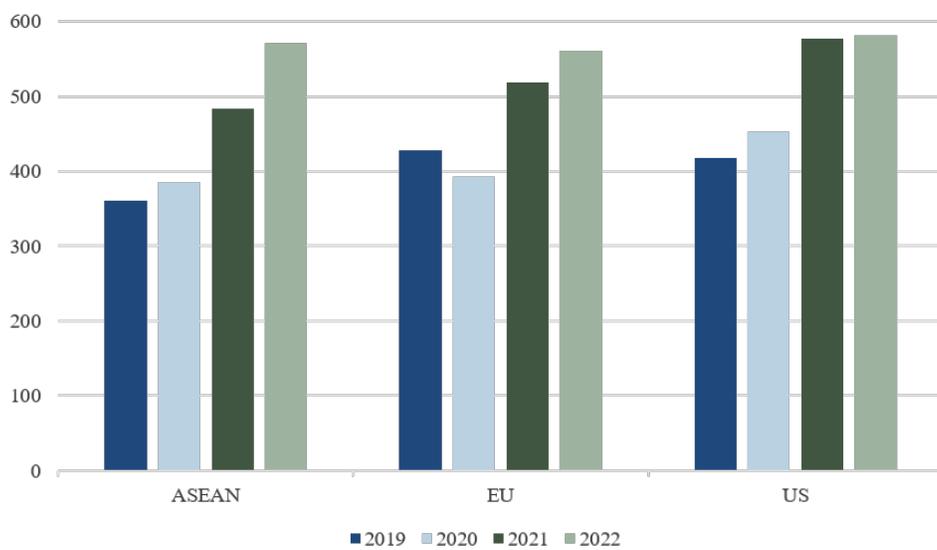


Figure 1: China exports to the top three regions from 2019 to 2022 (\$ billion)¹⁰

The US was previously one of the largest Chinese merchandise importers with 15% of China’s exports of goods. Beginning in July 2018, the Trump administration applied tariffs on 60% of imports from China. The Trump administration began by imposing tariffs of 25% on roughly \$250 billion worth of products including selected semiconductors, IT hardware, auto parts and furniture and 7.5% on other \$102 billion worth of products.¹¹ In 2022, China's exports to the US returned to pre-trade war levels. In comparison, current US imports from the rest of the world are 38% higher than pre-trade war levels, mostly due to price increases caused by heightened US demand, as opposed to increased volumes offsetting lost imports from China.

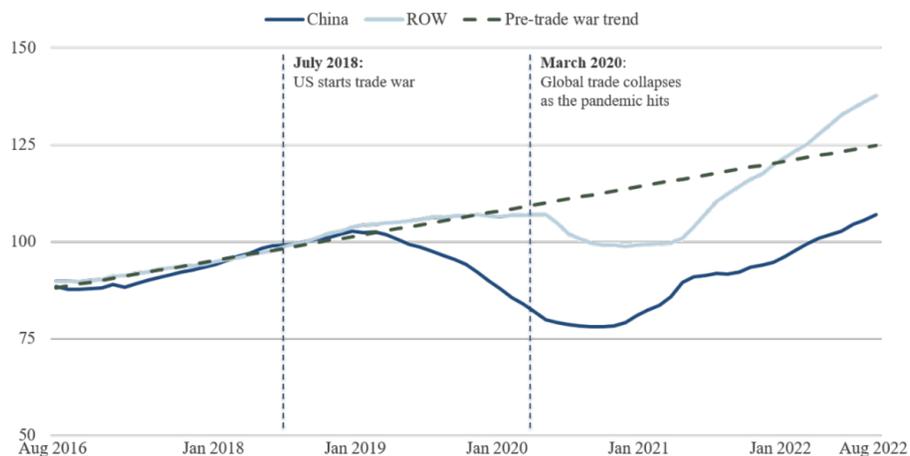


Figure 2: Value of US goods imports from China and the rest of the world (ROW) (June 2018 = 100)¹⁰

Semiconductors are the most telling example of product shortages driving price increases during the pandemic. Before the 25% tariffs, China has 47% of the US import market by volume. China’s foundries specialized in producing high volumes of low profit-margin ‘legacy’ chips. Other leading foundries firms like TSMC, Chinese Taipei Samsung from Korea and Intel from the US did not have the idle capacity or interest in switching to less profitable products. Here if the US does not want to import the legacy chips from China, who will produce them? Some companies were forced to either import from China with tariffs or spend to establish relationships with new suppliers elsewhere, which led to higher costs and exacerbating inflation pressure.

China’s new trading partners

The One Belt One Road (OBOR) initiative was announced in 2013 to open up and create new markets for Chinese goods. The project focused on improving connectivity and cooperation among multiple countries spread across Asia, Africa, and Europe by building a big network of infrastructure projects. To date, 147 countries accounting for 2/3 of the world's population have signed on to the projects.¹² The export value from China to countries in the OBOR initiative in 2022 amounted to approximately \$1.2 trillion, increasing 20% YoY.¹³

In addition, there has been significant growth of import value generated by ASEAN countries, which increased by nearly 60% from pre-Covid levels and was almost equal to US imports in 2022. Export to Vietnam jumped to \$139 billion in 2021, becoming the biggest trading partner among the ten ASEAN countries.¹⁴ Since 2018, many labor-intensive industries including 3C¹⁵ products assembly and clothing production have moved to Vietnam, which became a transfer station between US and China due to the tariffs.

Chinese exports of automobiles overseas were in excess of 3.1 million units in 2022, making it the world's second biggest exporter of cars, surpassing Germany, the United States and South Korea.¹⁶ Chinese brands are currently among the best selling in the Middle East and Latin America. Middle East countries increased imports 18% from China in 2022.¹⁷ Recently, Chinese President Xi Jinping visited Saudi Arabia in December 2022.¹⁸ China and Saudi Arabia signed 34 investment agreements covering several sectors in the fields of green energy, information technology, transportation, and medical industries. The most significant agreement for China was the Huawei Technologies agreement worth \$30 billion.¹⁹ In the future, we believe China's exports to Middle East countries will continue to grow, especially in high-margin products including lithium batteries and electronic vehicles.

In conclusion, the strong growth rate of exports proves that China's price advantage in the supply chain cannot be replaced by other countries easily. Tesla and Shien are still enjoying a cost advantage by manufacturing in China and selling to the global market. In 2022, Tesla's Shanghai factory produced more than its other three factories combined and Tesla expanded a new factory to make large-scale batteries.²⁰ In the end, by leveraging Chinese government support, a large educated talent pool and the scale of its domestic market, China has an opportunity to achieve breakthroughs in chip making and manufacturing upgrades, which can provide more cost-effective products to global customers.



Figure 3: China's Dual Circulation Model

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CHINA NEWS SPOTLIGHT

China Holds Lending Rates Steady; Market sees Reserve Ratio Cut as Next Move: China kept

its benchmark lending rates unchanged for the ninth month in May on Monday, matching market expectations, as a weakening yuan and widening yield differentials with the United States limited the scope for any substantial monetary easing. A raft of data over the past month or so, including April indicators last week, pointed to an economy losing momentum after the initial post-COVID bounce and lifted hopes of more easing measures. [Read More.](#)

China Continues to Raise Basic Pension Payments for Retirees: China announced Monday that it would raise the basic pension payments for retirees in 2023, marking 19th consecutive annual increase. The average monthly payment for pensioners of enterprises, government agencies and public institutions is set to be lifted by 3.8 percent from the 2022 level, according to a circular jointly issued by the Ministry of Human Resources and Social Security and the Ministry of Finance. [Read More.](#)

U.S. Apathy Paved the Way for China in Africa : In April 1997, toward the end of the protracted demise of the United States' longtime Cold War client Mobutu Sese Seko, the U.S. ambassador to the United Nations, Bill Richardson, flew to the capital of what was then called Zaire to try to persuade the besieged dictator to step down. As I stood outside the drawing room of the palace where Mobutu and Richardson met in the morning, an aide to Richardson sidled up to me and whispered an invitation in my ear. [Read More.](#)

China Imposes Sales Restrictions on Micron as it Escalates Tech Battle with Washington: US chip maker Micron says a ban on selling to Chinese companies working on key infrastructure projects could cost it as much as a “high single digit” percentage of its annual revenue. Beijing announced the sanctions on Sunday, in a major escalation of an ongoing battle between the world's top two economies over access to crucial technology. The Cyberspace Administration of China (CAC) said the company had failed to pass a cybersecurity review. [Read More.](#)

Huawei's HarmonyOS to Power Volkswagen Cars in China: According to Financial Times sources, Volkswagen is in talks with Huawei to bring HarmonyOS to its cars sold in China. In addition, given Chinese consumers' strong favor for homegrown technology and VW's software woes, it makes a lot more sense for VW to seek partnership with Huawei. In the opposite direction, Seres dropped HarmonyOS for Android Auto for its cars sold in Europe. [Read More.](#)

Wall Street Analysts are Bullish on Chinese Tech Firms, Even as Recovery is Uneven: Analysts are bullish on Chinese big tech firms even though recovery looks uneven across companies and their latest earnings. While search engine giant Baidu beat revenue and profit estimates for the first quarter of 2023 and Tencent bounced back to growth after consecutive negative and flat quarters, Alibaba missed first-quarter revenue expectations and its Hong Kong-listed shares slid almost 5% on Friday. [Read More.](#)

Chinese Phase 3 Trial of Roxadustat in Non-Myeloid Malignancies Meets Primary End Point: Roxadustat proved to be noninferior to recombinant erythropoietin alfa (Sepo) with regard to change in hemoglobin level from baseline to an average level during weeks 9 to 13 in patients receiving concurrent chemotherapy for non-myeloid malignancies in China, meeting the primary end point of an ongoing phase 3 trial (NCT05301517). [Read More.](#)

China's NMPA Accepts IND for SinoMab BioScience's SM17 to Treat Asthma: The Center for Drug Evaluation (CDE) of China's National Medical Products Administration (NMPA) has accepted an investigational new drug application (IND) for SinoMab BioScience's SM17 to treat asthma. SM17 is a humanized IgG4-k monoclonal antibody that targets IL-17RB to treat asthma, idiopathic pulmonary fibrosis (IPF), atopic dermatitis (AD) and other immunological disorders. [Read More.](#)

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: The US is still approving export licenses for blacklisted firms from China, including Huawei and SMIC <https://techwireasia.com>; Mar, 2023

³ Source: Choking off China's Access to the Future of AI <https://www.csis.org>; Oct 2022

⁴ Source: US orders Nvidia and AMD to stop selling AI chips to China <https://edition.cnn.com>; Sep2022

⁵ Source: Huawei annual report

⁶ China's chip industry will be 'reborn' under U.S. sanctions, Huawei says, claiming breakthrough <https://www.cnbc.com>; Mar 2023

⁷ Source: Who is most anxious? Who is the most radical? China, Japan, South Korea, the United States and Europe chip strategy competition, Auto Business Review, Feb 2022

⁸ Source: Statistic

⁹ Note: The ASEAN is an organization on the Southeast Asian region with 10 members: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar,

Philippines, Singapore, Thailand and Vietnam.

¹⁰ Source: Wind.

¹¹ Source: Four years into the trade war, are the US and China decoupling? <https://www.piee.com>; Oct, 2022

¹² Source: China's Massive Belt and Road Initiative; <https://www.cfr.org>; Feb, 2023

¹³ Source: Total export value of goods from China to countries along the Belt and Road Initiative (BRI) from 2016 to 2022 <https://www.statista.com>;

¹⁴ Source: China, Vietnam vow to bolster economic cooperation <https://www.ciiie.org>; Feb 2023

¹⁵ Note: 3C is an abbreviation for computer, communication and consumer electronic products

¹⁶ Source: China closes gap with Japan after 2022 car exports surpass Germany with 54.4 per cent surge to 3.11 million vehicles <https://www.scmp.com>;

Jan 2023

¹⁷ Source: https://www.sohu.com/a/636916773_99947734

¹⁸ Source: President Xi Jinping Arrives in Riyadh to Attend the First China-Arab States Summit <https://www.fmprc.gov.cn>; Dec'22

¹⁹ Source: Saudi Arabia and China sign series of deals worth \$30 billion <https://www.gulftoday.ae>; Dec'22

²⁰ Source: Elon Musk: Tesla to build new battery factory in Shanghai <https://www.bbc.com>; Apr'23

Important Disclosures

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