

MORGAN CREEK

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,

Handwritten signature of Mark W. Yusko.

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND¹

This is the second part of our discussion on "Can China innovate." In the prior newsletter, we postulated about why China missed the industrial revolution and how the authorities today have learned lessons from the past and restructured its system to enable sustainable domestic innovation in the future. However, some have expressed skepticism about China's current institutional system being capable of fostering true technology innovation. Examples include:

- A recent *Wall Street Journal* article arguing communism is incapable of nurturing the curiosity that leads to innovation;
- A Lowy Institute (leading Western think tank) article claiming China would struggle to become an innovative nation due to its controlled society and education system that emphasizes rote learning and memorization
- The famous Harvard Business Review article succinctly titled " Why China can't innovate"

The mainstream narrative goes like this: political institutions are key to innovative success. Democracies allow free markets of all types, goods, services, money and ideas, which when coupled with private property rights and the rule of law, work to unlock human ingenuity and drive economic growth in a never-ending positive cycle. On the other end of the political spectrum are autocracies, which feature heavily controlled societies that are unable or disincentivized to experiment and grow, resulting in a persistent negative spiral of poverty.

This simple and appealing narrative saw the mass adoption of the democratic model globally. The spread happened in three waves, illustrated in the chart below.

3 Waves of Democratization Empowered Billions of World Population with Democratic Rights

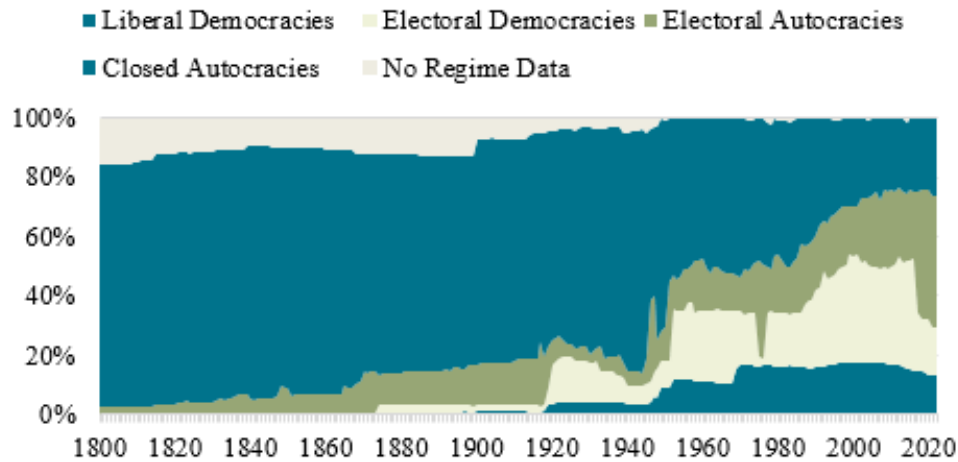


Figure 1: 200 years ago, everyone lacked democratic rights. Now, billions of people have them - Our World in Data

The first wave from the 1920s occurred mostly in Western Europe and North America. The second wave began post World War II and into the 1960s, comprising the conversion of Latin American (“Latam”) countries. The third wave took root in the 1970s with the Carnation Revolution in Portugal and Spain, which then spread to the rest of Latam and Asia Pacific in the 1980s, and Africa and Eastern Europe after the collapse of the Soviet Union in 1991. By the turn of the century, more than 53% of the world (a high watermark) lived under the umbrella of democracy.

However in hindsight it does not appear that the political transition succeeded in translating to proportionate levels of economic success for the masses. To date, there are only a handful of democratic countries that have managed to attain developed nation status. These countries include parts of Western Europe, the US, Japan and the Asian Tigers (South Korea, Taiwan, Singapore and Hong Kong). These countries make up only 1/7 of the world population. What can explain the disconnect?

Yi Wen, assistant vice president at the research division of the Federal Reserve Bank of St. Louis explored this very question in his [book](#), which he also summarized in a [presentation he made at the Fed](#). He studied the histories of all the successful economies mentioned above and made some observations:

- First, all these countries essentially followed the same path to development
- Second, there are three key stages to industrial development and they happen sequentially
- Lastly, only after industrialization has completed does any political system transition occur (if at all)

	Industrial Revolution 1.0	Industrial Revolution 1.5	Industrial Revolution 2.0
	Mass production (i.e Textiles)	Infrastructure buildup (i.e Railroads)	Mechanization of means of production
	1750-1830	1830-1850	1850-1920 Steel, chemicals
	1820-1860	1830-1870	1870-1940 Telegraph, automobiles
	1890-1920	1900-1930	1920-1980s Electronics, semis
	1988-1998	2008-present	2015-? EV's, PV's

Figure 2: China in the Early Innings of Industrial Revolution 2.0²

The first stage of the industrial revolution typically features labor-intensive mass production for the mass market. Interestingly, the textiles industry features very prominently across time and geography. Low cost, low skilled labor is the key input and, as such, a competitive advantage for countries that possess it at this stage of their development. The Chinese authorities were able to deliver this under its first two modern leaders, Mao and Deng:

Year	Life Span (Years)	Infant Mortality (%)	Extreme Poverty (%)	Literacy (%)
1949	Less than 35	Over 20.0	Over 90.0	20.0
1978	63	5.2	30.7	81.5
2021	78	0.5	0.0	97.3

Table 1: China’s Development from Mao (1949), Deng (1978) to Present³

Despite rising wages and geopolitics driving outsourcing of textiles production to other markets including South and South East Asia, China still currently retains a 41.4% share of the global textiles market due to its large, highly productive workforce.

The next stage of the revolution involves securing a steady supply of energy inputs and transportation networks to facilitate mass distribution. In the past four decades, China has built its infrastructure on a scale and timeline that the world has never seen.

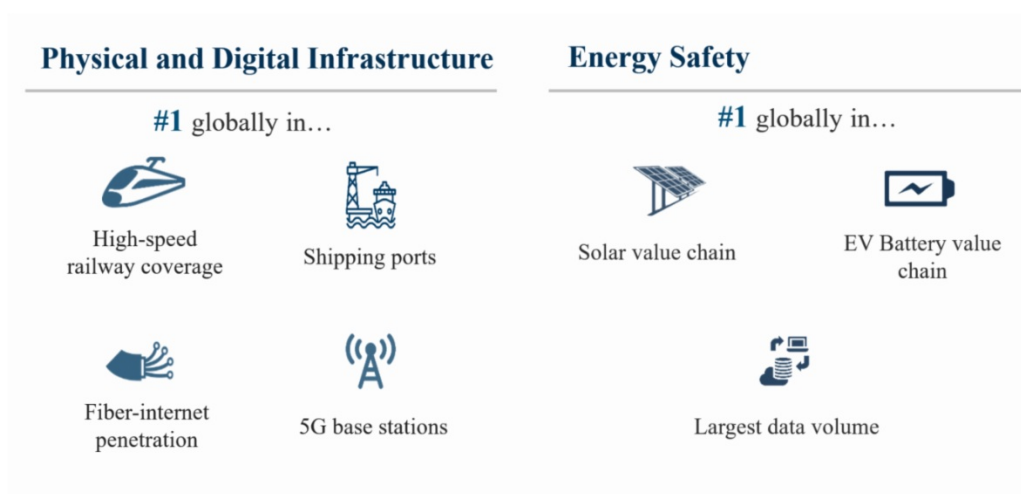


Figure 3: China’s Unrivaled Pace of Infrastructure Construction⁴

Due to the cost effectiveness and ease provided by China’s massive infrastructure, it is challenging to try to decouple from China even via “friendshoring” efforts. The chart below shows the similar pattern of importing from China and exporting to the United States in Vietnam, Mexico and India, implying that other developing countries are re-exporting goods from China and that it still makes economic sense to do so with local production elsewhere.

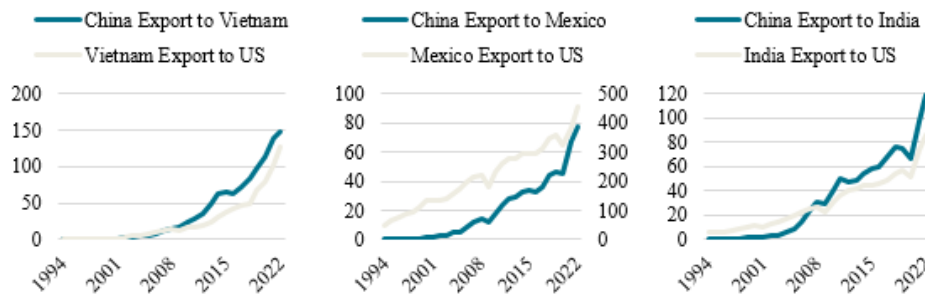


Figure 4: Vietnam, Mexico and India Re-exports from China to US⁵

The final stage features the mass production of the means of mass production. This includes intermediary inputs such as steel and equipment. Steel, for example, has always been a crucial component for industrialization. All advanced countries at one stage or another in their development had previously held the number one position in steel production. China is no exception, and in 1996, it attained the pole position in steel manufacturing. However, the scale of its dominance is new – the previous leader Japan at its peak accounted for 17.3% of global production in 1973; China’s production of 1.01 billion tons is higher than all the other countries combined, accounting for more than 50% of the global total in 2020.⁶ In other industries, China has also demonstrated its ability to close its production loop by manufacturing many important upstream components internally including high-speed trains where China independently developed both the permanent magnet traction power system and CTCS-3 control system, and in the electric vehicles space, where China dominates the battery supply chain. China is currently making efforts to advance in other sectors including semiconductors, where the country has made significant strides in the past few years.

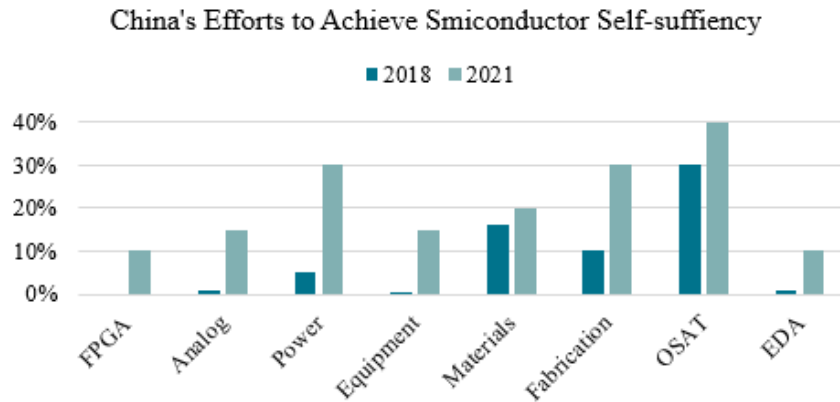


Figure 5: China's Domestic Market Share in Various Semiconductor Sectors⁷

It is only when countries have completed these three stages that they control their own economic destiny and attain advanced status. Yi Wen concludes that all prior countries who had made the successful transition towards that of a developed country had accomplished that under some form of authoritarian rule, and only after making the leap technologically did some of them evolve politically. See below observations related to the most recent countries to achieve industrialization.

Figure 1 Per capita GDP (purchasing power parity) of selected economies during period of most rapid growth index = 100 at starting point

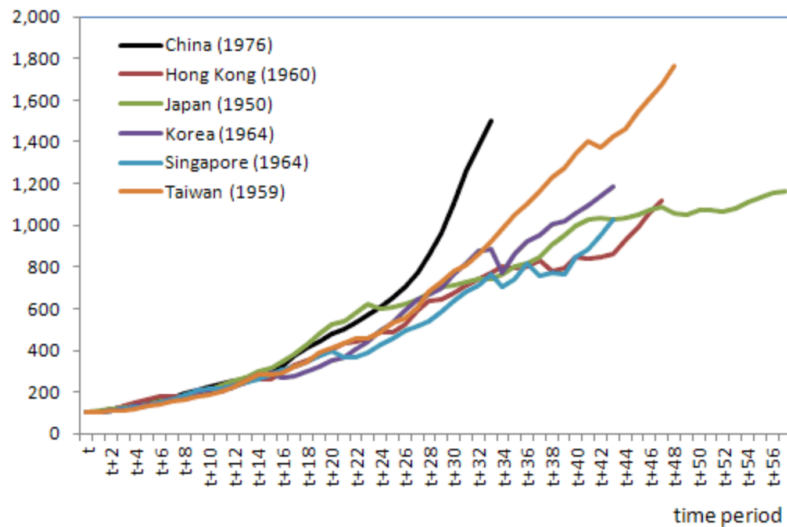


Figure 6: Major Asian Economies Achieving Industrialization⁸

- The Meiji Restoration in 1868 restored control of Japan to the Emperor from a military government and under this centralized leadership, Japan began its rapid industrialization. Japan's general election law, which allowed all males above 25 to vote for the first time, passed in 1925; the law changed to allow women to vote in 1945.
- Hong Kong's economy was the first of the Asian Tigers to undergo industrialization in the 1950s, starting with textiles. Hong Kong is an interesting case among these since it was run by a British colonial administration.
- South Korea's economic takeoff occurred in the 1960s – 1980s under a dictatorship after its April Revolution. The first direct presidential elections took place only in 1987.
- Taiwan's economic miracle occurred in the late 1950s, similarly under a dictatorship that set the direction for the economy. Taiwan held its first direct presidential election in 1996.
- Singapore began its period of rapid economic growth in 1959 after Lee Kuan Yew came into power. Many Western observers, while giving him and his government due credit for the successful economic transformation of the country, would not label him as a democrat.

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CHINA NEWS SPOTLIGHT

Hong Kong Taking Lead Role in Globalization of Renminbi with Expansion of Bilateral Trading and New Products - Finance Chief: Hong Kong is seeking to expand bilateral trading of the renminbi and launch new products to take a leading role in internationalizing the currency, according to the city's finance minister. Revealing that talks were also under way with mainland Chinese authorities to launch yuan Treasury bond futures locally, Financial Secretary Paul Chan Mo-po on Sunday said Hong Kong had stepped up efforts to help diversify the renminbi to not only globalize it but mitigate risks arising from worldwide political and economic changes. [Read More.](#)

Tech war: China to Host First Supply Chain Expo to Bolster Global Position Amid US 'de-risking': The inaugural China International Supply Chain Expo is set to kick off in Beijing on November 28, as the world's second-largest economy seeks to protect its key role in global manufacturing amid intensified trade restrictions imposed by the United States and its allies. The five-day event, which is themed "connecting the world for a shared future",

aims to “help Chinese firms participate more deeply in the global industrial division of labor” and “promote the building of resilient global supply chains”, said Ren Hongbin, chairman of the state-backed China Council for the Promotion of International Trade (CCPIT), the expo’s organizer. [Read More.](#)

Sequoia China Goes Solo Under HongShan Brand, a Sign that the Bromance Between US Funds and China Tech Start-ups is Over: The separation of Sequoia China, the poster child for the financial bromance between the US and China over the last 18 years, from its US parent is a watershed moment in China’s venture capital industry, as American capitalists divorce themselves from Chinese entrepreneurs, industry insiders said. Few institutions have played such an important role as Sequoia China, which was founded by Yale-educated Neil Shen Nanpeng, to connect US funding with China’s tech start-ups, but the rising acrimony between Beijing and Washington has made it hard for intermediaries like Sequoia China to align interests across the Pacific. [Read More.](#)

Huawei Launches GaussDB, another Breakthrough Made amid US Crackdown: Chinese technology giant Huawei launched the GaussDB database on Wednesday, featuring a major comprehensive upgrade. This marks another breakthrough for domestically developed databases amidst the ongoing US crackdown. Zhang Pingan, Huawei’s executive director and CEO of Huawei Cloud Computing Technologies, announced the launch of the GaussDB at the Huawei Intelligent Finance Summit 2023. [Read More.](#)

China's BYD Announces New Fang Cheng Bao Brand of Energy Vehicles: BYD announced on Friday a new brand of electric vehicles (EV) ranging from off-road to sports cars as the company looks to meet more diversified consumer demand. The new brand is called Fang Cheng Bao, which translates from Chinese literally as "Formula" and "Leopard". The Chinese EV giant is expected to launch the first model this year - an SUV identified for now internally as SF, BYD said in a statement. [Read More.](#)

Tech War: Chinese Manufacturers Brace for the Impact of Japan’s Semiconductor Export Curbs: Chinese companies are scrambling to seek local substitutes to cut reliance on Japanese suppliers as they brace for the impact of Tokyo’s export curbs on semiconductor equipment and materials, according to corporate statements and analysts. Under tightened export restrictions unveiled by Japan’s Ministry of Economy, Trade and Industry (METI), Japanese suppliers of 23 types of semiconductor equipment are required to obtain prior export licenses to sell to China starting from July. This follows an agreement by the US, Japan and the Netherlands to limit the export of advanced chip-making equipment to China. [Read More.](#)

Harbour Ships Phase 3 Data to Take Lead Over Argenx, J&J and UCB in Chinese Autoimmune Race: Harbour BioMed has taken the lead in the Chinese leg of a competitive autoimmune race, becoming the first company to show an anti-FcRn drug improves outcomes in generalized myasthenia gravis (gMG) in the country. The result is a boost for Immunovant, which has rights to the drug in several major markets. The drug candidate, batoclimab, is one of a clutch of anti-FcRn molecules in development in gMG and a number of other diseases. Argenx is leading the way in the West, having won approval for Vyvgart in the U.S. and the EU, and companies including Johnson & Johnson and UCB are giving chase. In China, Harbour’s anti-FcRn monoclonal antibody has a shot at beating its rivals to market. [Read More.](#)

ITabMed Announces the IND Approval from NMPA for A-337, a CD3-activating Bispecific Antibody Targeting EpCAM to Treat Solid Tumors: TabMed Ltd., a clinical-stage biotech company in China, announced the IND approval from China National Medical Products Administration (NMPA) for A-337, a CD3-activating bi-specific antibody targeting EpCAM. This is a “Phase I, Open-label, Dose-escalation Study to Evaluate the Safety and Pharmacokinetics of A-337 in patients with advanced solid tumors”. EpCAM is one of the earliest identified tumor-associated antigens (TAA) and up-regulated and over-expressed in many solid tumors. [Read More.](#)

¹The 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.

²Source: Federal Reserve Bank of ST.Louis (Nov'15).

³Source: Wind Economic Database.

⁴Sources: Wind Economic Database, CSET (Aug'21), RankingRoyals (2022), World's Top Exports (2021), Statista (Mar'23), WITS (2021), GPs' AGM material in Dec'22, Digital Economy Report (United Nations, 2021).

⁵Wind Economic Database.

⁶Source: Nikkei Asia - <https://asia.nikkei.com/Business/Business-deals/China-steel-industry-faces-growing-pressure-to-consolidate#:~:text=China%20is%20the%20world%27s%20largest,all%2Dtime%20high%20in%202020.>

⁷Source: GPs' AGM material in Mar'23.

⁸Source: PIIE. <https://www.piie.com/commentary/op-eds/learning-chinese-mercantilism>, 2011/1/25.

Important Disclosures

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