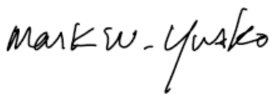
MORGAN CREEK
CAPITAL MANAGEMENT

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@morgancreekcap.com.*

Best Regards,



Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND[1]

In the prior newsletter, we postulated that China's economic transition is at the root of many challenges it is facing today - both externally in the form of increasingly choppy geopolitical waters and internally in the slowing domestic environment.

We discussed how China is following in the path of other major industrialized nations before it and how we believe it is currently at the last of the three stages of its industrial transformation. Specifically, China is innovating in the tools (*i.e*., equipment and machinery) that may allow it to continue its industrial development regardless of external pressures.

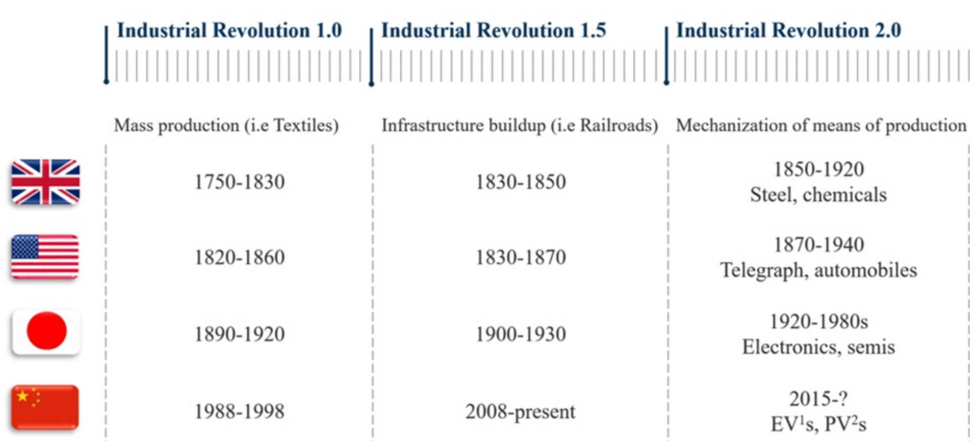


Figure 1 Chart of industrial development – US, UK, Japan, China

In this newsletter, we will examine the impact of this shift on China's internal economy.

China's old economic playbook of funding infrastructure no longer works

China's old playbook of infrastructure building (the mid stage of its industrial revolution as mentioned in our previous newsletter) was almost formulaic: the local governments zone a piece of undeveloped land, puts debt on it to fund the infrastructure build up, then use that developed area to attract new businesses to settle, via measures including tax incentives and subsidized rents to increase local GDP. Simultaneously, the local governments also sell neighboring parcels of land to property developers to develop residential units to house the new community. Because of the unique sources of revenue for central and local governments (where most of the taxes are due to the central government); local governments must fund most of these activities through debt or land sales.

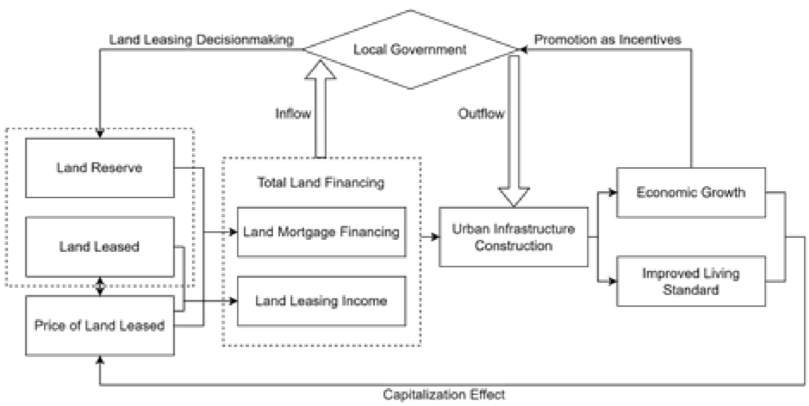


Figure 2 China's "land finance" playbook

This worked well in the beginning, but as China became more developed and an increasing amount of debt was added, diminishing marginal returns set in on additional debt earmarked for infrastructure building.

Eventually, the central government decided to move away from this model of development with the three red lines policy in 2020 which sought to reduce developer's leverage, lower risk in the financial sector and make homes more affordable. This policy resulted in meeting the central government's goal of cooling home prices, but also had knock-on consequences on overly levered developers (and local governments) whose collateral was for the first time beginning to lose value, precipitating the headlines we see in the papers today.

Some market participants are calling for the authorities to swoop in to "save the day" with large stimulus packages. Thus far – and we think rightly so – the government has been circumspect.

China's oversupply of highly educated youth can help it complete its economic transition

In June, official numbers show that the jobless rate of 16 to 24 year olds in urban areas rose to 21.3%[2], or approximately 1.4% of the potential workforce in China's urban areas. While still manageable, this number is almost certain to increase with a record 11.6 million university graduates expected to enter the job market in the coming months.

We believe unemployment in this age group is high for several reasons:

- Young people are highly educated and have higher expectations about their future careers.

China does not lack for jobs in traditional industries – most of the workers in factories around the country are in their 40s and 50s[3]; the situation in construction is even more dire with some work sites in Shenzhen, for instance, employing workers over 50 years old.[4] Many of these are jobs that are not yet capable of being automated in a cost-effective manner.

- Young people are in a better position to "hold out" for their dream jobs given the better economic position of their parents compared to the generations prior. In fact, some have opted out of the job market altogether, deciding instead to *tang ping*, or "lie flat", rejecting societal pressures to over-work and over-achieve.

China has always been a believer of the "build it and they will come" philosophy. They deliberately over-invested in many industries that enabled them to build world class infrastructure:

- Cement. Cement is the backbone of modern cities used to build safe, strong and efficient infrastructure. China over-invested in cement, experienced painful cement gluts in 2006 and 2009[5] but emerged as the world's largest producer of cement. In 2022, China's cement production was larger than the rest of world's *combined.*[6]
- Shipbuilding. China is the largest trading nation in the world, with 60% of its trade in value traveling by sea.[7] Being capable of building ships to transport those goods are critical. China over-invested in shipyards, experiencing huge overcapacity in 2009 and 2012.[8] Today, China is the world's largest shipbuilder: in 2022, one in every two new ships orders worldwide is being made in China.[9]

The same pattern is true when you look through other strategically important industries critical for China's physical and energy infrastructure development such as high-speed rail, various ports, renewable energy technologies, etc.

For China's next stage of development, we believe its most important resource is talent, and there may be an adjustment required for market forces to fully employ these resources appropriately. In the meantime, the transition will undoubtedly be painful as there are limits around what the authorities can do to accelerate or ease the process.

Increased economic uncertainty in near term drags on consumer sentiment

China's economic growth – historically formulaic and driven by credit growth – is no longer as predictable in this new phase. Government and businesses in China are investing significantly in R&D, but the payout is longer (compared to infrastructure investments) and not "guaranteed". It is important, though to put this in perspective. When Japan, for instance, was going through its last stage of industrialization from 1980-1988 and dominating high tech industries globally, its GDP growth was 4.1% annualized, down significantly from its "miracle" years of double-digit growth. This is not too far from China's current 3-5% target, which we think is a good outcome for China's new normal. It will take time, however, for the Chinese to get oriented in this new period before confidence returns.

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CHINA NEWS SPOTLIGHT

China Extends Tax Relief Measures to Support Small Businesses: China's finance ministry on Wednesday unveiled measures to help the nation's struggling small businesses as the economy's post-Covid-19 recovery loses steam. The ministry said the tax measures implemented in January, which were supposed to expire at the end of the year, would be extended by four years to end-2027. *Read More.*

Chinese Property Stocks Surge after Central Bank Vows More Support for Private Businesses: Chinese property stocks surged on Friday after the People's Bank of China vowed to pledge more financial resources to support the private economy. Hong Kong-listed shares of real estate developers like Country Garden Holdings, Longfor Group Holdings, and China Resources Land were some of the top gainers on the Hang Seng index. Longfor gained as much as 8.19% and Country Garden Holdings surged 6.2%, before paring some gains. *Read More.*

China Asks Some Banks to Reduce or Delay Dollar Buying, Sources Say : China's currency regulators are asking some commercial banks to reduce or postpone their purchases of U.S. dollars in order to slow the yuan's depreciation, two people with direct knowledge of the matter said. The informal instruction, or the so-called window guidance, is the latest in a series of steps taken by authorities this year to bolster a currency that has been hit by China's faltering post-pandemic economic recovery and rising yields for the U.S. dollar and other major currencies.
Read More.

China Leads World in Automobile Exports, Surpasses Japan: China has become the leading exporter of automobiles in the first six months of 2023, topping Japan within half a year as Chinese electric cars witnessed an increase in sales worldwide, according to a report by Nikkei Asia. The report mentioned that major Chinese automakers exported 2.14 million vehicles from January to June. *Read More.*

China's Huawei's Handset Business Making a Comeback, Executive Says: Huawei Technologies' handset business is "on the road to a comeback" the head of the company's consumer business Richard Yu said in his keynote at the company's annual developer conference in the southern city of Dongguan on Friday. Huawei's share of the domestic smartphone market share grew by 76.1% in the second quarter, and took second spot in the high-end sector, Yu said. The company held 11.3% of the overall China market in the second quarter, behind five competitors led by Vivo and Apple, according to Counterpoint Research .*Read More.*

Hua Hong, China's Second-largest Chip Maker, in Strong Debut on Shanghai's Nasdaq-style Star Market: Hua Hong Semiconductor, which made the world's second-largest initial public offering (IPO) this year, made a stellar debut on mainland China's Star Market despite being issued at twice the price of its Hong Kong-listed shares, buoyed by mainland investors' zeal for the country's chip self-sufficiency. The mainland's second-largest semiconductor maker opened at 58.88 yuan in Shanghai on Monday, 13 per cent higher than the offer price of 52 yuan. *Read More.*

FDA Approves IND Application for Nanjing Leads Biolabs' Bispecific Antibody: US Food and Drug Administration (FDA) and China's National Medical Products Administration (NMPA) have approved the Investigational New Drug (IND) applications for Nanjing Leads Biolabs' LBL-034 bispecific antibody for treating relapsed/refractory (R/R) multiple myeloma. LBL-034 is an IgG1 bispecific antibody that targets G protein-coupled receptor, class C, group 5, member D (GPRC5D) transmembrane receptor protein and cluster of differentiation 3 (CD3) T cell co-receptor protein. *Read More.*

Bristol Myers, BeiGene End Legacy Celgene Deal with Settlement Years after China Ban: ack in 2020, a surprise manufacturing shortfall led to an import ban of Bristol Myers Squibb's Abraxane, sold by BeiGene, in China. Legal finger-pointing ensued, and, now, the companies have decided to scrap their three-drug partnership altogether. BMS and BeiGene on Tuesday agreed to end a China licensing deal that BeiGene signed with Celgene back in 2017 before its acquisition by Bristol, a securities filing shows. In the original deal, Celgene essentially sold its China business, including local rights to cancer drugs Revlimid, Abraxane and Vidaza. *Read More.*

China NMPA Accepts Astellas' Monoclonal Antibody Zolbetuximab BLA: The Center for Drug Evaluation (CDE) of the China National Medical Products Administration (NMPA) has accepted Astellas Pharma's biologics licence application (BLA) for the investigational Claudin 18.2 (CLDN18.2)-targeted monoclonal antibody, zolbetuximab. Zolbetuximab is intended for treating patients with HER2-negative gastric or gastroesophageal junction (GEJ) adenocarcinoma whose tumours are CLDN18.2-positive. *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] China youth unemployment hits high as recovery falters - BBC News

[3] As China's population ages, the world's factory struggles to recruit young migrant workers | South China Morning Post (scmp.com)
[4] China's ageing construction workers and the urgent need for an industry overhaul | China Labour Bulletin (clb.org.hk)
[5] China's cement industry in supply glut (chinadaily.com.cn)
[6] Cement: production ranking top countries 2022 | Statista
[7] How Much Trade Transits the South China Sea? | ChinaPower Project (csis.org)
[8] China Shipyards Falter as Glut Triggers 49% Slump in Orders - Bloomberg
[9] Chinese shipbuilding sector tops world market in 2022 - Global Times

Important Disclosures

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