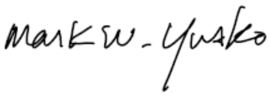
MORGAN CREEK
CAPITAL MANAGEMENT

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]

2023 began with high investor expectations for China. In January when China reopened its borders, many investors expected a big rebound in the Chinese economy, led by domestic revenge consumption. US-China geopolitics also appeared to be at a turning point after the Biden-Xi summit in Bali late last year, with a series of high-level official meetings arranged to occur in Q1 this year. Both these sentiments led the Chinese stock market higher, with CSI 300 indexes up 9.3%.

Two quarters later, neither of these expectations appear to be met, and China's internal economy is struggling in many reasons including:

- Aging population – India has overtaken China's population this year. [2]
- Youth unemployment of the population aged 16-24 has reached as high as 21.3%.
- Property sector is still recovering from the crackdown imposed in August 2020.
- Local government is experiencing a debt challenge with debt at an all-time high of $5.29 trillion.
- Exports are weak with June down 12.4% year-on-year.
- Consumer sentiment remains weak.

Externally, US-China dialogue was derailed by the "weather balloon" incident on February 1. While rhetoric has toned down somewhat, with the US insisting it is seeking to "de-risk", as opposed to "de-couple" with China, we see continued actions including that more stringent investment and export restrictions in high technology segments. For its part, China has begun to retaliate to the sanctions, banning sales of Micron's chips on May 21, followed by restricting exports of rare earths used in semiconductor manufacturing.

Given the weak internal and uncertain external environment, some investors are calling for China to provide significant stimulus, lest the economy begin a potential downward spiral.

In the next few newsletters, we will attempt to explain how we believe all the challenges mentioned above – internal and external – are linked to China's transitioning economy. In this newsletter, we will discuss how we think this is a natural evolution that every major developed country has gone through in completing its industrialization and one in which there are no short cuts.

China's economic transition is in the footsteps of its developed peers

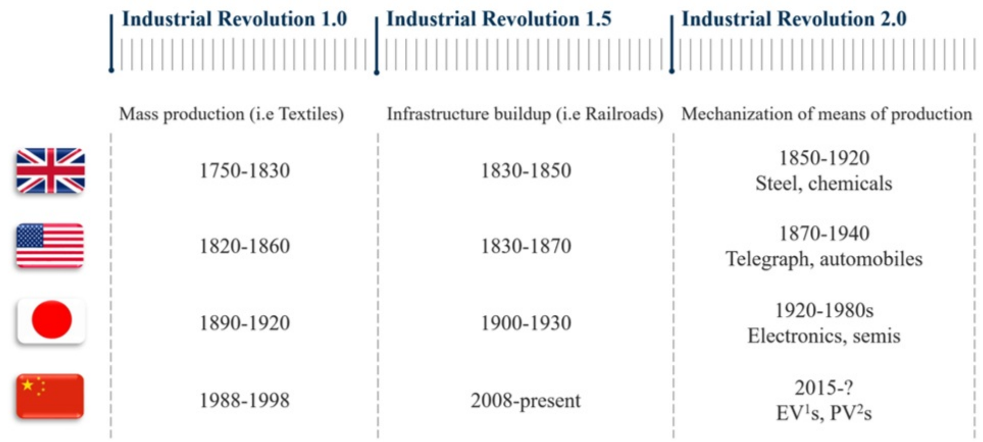


Figure 1 Chart of industrial development – US, UK, Japan, China

Developed countries have typically experienced three stages of industrialization:

- First, mass production of low-tech goods. This is where the country puts its abundant labor to use in manufacturing low tech, labor-intensive goods.
- Second, infrastructure building (roads, bridges, ports, etc.). This is important because it reduces the cost of transporting goods and makes production in a country globally competitive.
- Third, mass production of the means of mass production. This is the process of making the tools/equipment and the inputs that allow for continued industrialization.

We believe that China has completed the first two stages becoming the factory of the world, overtaking the US as the #1 industrial power in 2010.[3] China is the world's largest investor in infrastructure, spending an average of 8.5 percent of GDP between 1992 and 2011 on the construction of roads and railways, as well as power and water facilities.[4] In fact, China used 6.5 gigatons of cement from 2011 to 2013, more than the US used in the *entire 20th century.*[5]

We think that China is now in the last stage of its development – innovating to control the technologies that allow its continued industrialization. Up until recently, China's progress could occur simply by importing and utilizing foreign equipment and technology.

China must upgrade its economy to survive

History shows that countries will be forced to upgrade their economies to survive after successfully completing stage one and two of their industrial revolutions. We believe this is both part of the natural evolution of economies and a necessity, for the reasons below:

- First, aging of the population begins to set in. As a result of better economic conditions, people begin to develop longer lifespans. On the other end of the spectrum, infant mortality drops and people no longer need to have many children to maximize their chances of survival to adulthood. In fact, fertility continues to fall as the cost of raising children increases. This is typically true of all developed countries (including the US, Europe and Japan) to varying degrees of severity.

- Second, due to better economic conditions, the workforce gradually becomes better educated and has higher job expectations, gradually giving up blue collar, manual labor and driving wages up across the board.

Both of these trends can have profound implications on a country's economic structure: an aging population and decrease in supply of manual labor results in increased wages, lower competitive advantages and outsourcing of the resulting low-tech jobs. We believe this trend is inevitable. To continue to progress, countries have no choice but to upgrade and move up the technology ladder.

China's upgrading means competition with advanced nations

However, China's upgrading means it is now competing in many of the same markets as their developed peers. The old economic framework was win-win and symbiotic: China imported the advanced nation's capital goods to manufacture/assemble low end products and sold those products globally. Now as China is beginning to lose the lower end segments of its manufacturing sector to outsourcing, it has to move upstream and innovate on its own machines and technologies, encroaching into the fields previously dominated by advanced economies. It is only natural that the inclination is for incumbents to enact measures to protect their economies:

- Japan faced a similar problem in the late 1980s, when it made such rapid progress in semiconductors that it almost put Intel out of business in the DRAM space, a field that Intel itself invented. It took a variety of US export restrictions and massive forced appreciation of the yen (+50% over 2 years) to end Japan's dominance in this space.
- Almost two centuries earlier at the outset of the Industrial Revolution, the UK forbade the export of machinery, manufacturing techniques and skilled workers to other countries[6] to maintain its technological edge.

Japan's failure to complete its industrial revolution in the '90s, and the UK's inability to ring-fence its technology comes down to the same factor: the size of their respective markets. In the case of the former, Japan was almost completely dependent on the US's continued patronage as its major export market.[7] In the case of the latter, the potential profits obtained from illegally exporting the technologies to the US (then a rapidly growing population and market) made it worthwhile.

From observing similar periods in the past, we postulate that:

- Size matters. History illustrates that market size attracts capital, and capital tends to bring with it technology and talent (whether through official channels or otherwise). Sanctions can distort the "invisible hand" of the markets in the short term, but it is impossible to deny the profit motive of markets over the long term. In terms of market size, few have the scale of China due to its massive population. In prior newsletters, we have given examples of how China has used its scale to dominate certain sectors, illustrating this phenomenon.
- The contest between the incumbent and the emerging contender can last decades before a new equilibrium is reached. We believe we are still in the early innings of China's transition. Thus, it is important to have a balanced and informed view as to how to position oneself in this changing world – and not succumb to overly optimistic or pessimistic sentiments based on the politics of the moment.

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CHINA NEWS SPOTLIGHT

Bolivia Challenges Global Dollar Dominance with Chinese Yuan, Russian Rouble: Bolivia's government is determined to curb dependence on the U.S. dollar for foreign trade, instead turning to the Chinese yuan, officials said, as Latin American support for alternative currencies grows.

Economy Minister Marcelo Montenegro said the Andean country was following "a pattern at the level of international trade, that is generating a progressive increase in the use of the yuan in foreign trade," during a press conference on Thursday in La Paz. *Read More.*

Tech Bulls Lift JD.com, Alibaba as Hang Seng Index Retakes 20,000-level before more China Support Measures: Hong Kong stocks gained, lifting the market to near a three-month high as tech leaders surged amid further signs of state support. A government report showed manufacturing in China stabilized in July while traders await more measures from Beijing to spur consumer spending. The Hang Seng Index jumped 0.8 per cent to 20,078.94 at the close of Monday trading, the highest level since May 8. The Tech Index surged 1.9 per cent, while the Shanghai Composite Index climbed 0.5 per cent.
Read More.

TikTok to Launch E-commerce Program to Bring Chinese Goods to the US: TikTok plans to launch a program in August to help Chinese merchants sell goods globally, and will officially roll it out first to consumers in the United States, a person familiar with the matter said. Seeking to replicate the success shopping platforms like Shein and PDD Holdings' (PDD.O) Temu have had in the U.S., the Chinese-owned short-video platform will provide a suite of services ranging from storage to shipping to merchants in China to help them sell in the U.S., said the person, who declined to be named because the information is not public. *Read More.*

Ant IPO Unlikely in the Short Term, Chinese State Media Says: Ant Group is unlikely to proceed with a market listing in the near future, Chinese state media said on Saturday, discounting reports from earlier this week that the Jack Ma-backed conglomerate was working up to a Hong Kong initial public offering (IPO). Ant will need to assess internal and overall market conditions and will also need to ensure that any attempted listing is legal and in keeping with regulations, state-run China Daily reported, citing a person with knowledge of the matter. *Read More.*

Volkswagen Invests $700 million in Chinese EV Maker Xpeng to Boost Sluggish Sales: Volkswagen has bought nearly 5% of Chinese electric vehicle maker Xpeng for $700 million and agreed a strategic partnership to develop two new models as it attempts to reverse a decline in sales in the world's biggest car market. Subject to final agreement, the companies will join forces to develop two mid-sized VW-branded EVs for the Chinese market, to be rolled out in 2026, Volkswagen said in a statement.
Read More.

Biogen, Amid Layoffs, Ponies Up $7.3B for Rare Disease Specialist Reata and Potential Blockbuster Skyclarys: On Monday during a quarterly earnings call, when Biogen CEO Chris Viehbacher was asked about the company's potential to execute M&A, he randomly offered "we've got, I think, about $7.3 billion in cash?". Four days later, Biogen has revealed a proposal to acquire Reata Pharmaceuticals. The Massachusetts biotech will pay $172.50 per share for the Plano, Texas-based rare disease specialist in a deal that comes to—you guessed it—$7.3 billion. *Read More.*

China's Innovent Eyeing IPO this Year—and could List in U.S.: Chinese biotech Innovent Biologics is considering a $200 million IPO later this year that could take place in the U.S., according to media reports. A Bloomberg article suggested that Shanghai-based Innovent is on the verge of another private investment round ahead of the IPO that could involve U.S. asset manager Capital Group, which has been looking out for opportunities to fund startups in emerging markets. Innovent is also considering listing in Hong Kong, it said. *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] India overtakes China to become world's most populous country | The Guardian (theguardian.com)

[3] China's Rise from Agrarian Society to Industrial Power | St. Louis Fed (stlouisfed.org)

[4] How China uses infrastructure as a means of control | World Finance

[5] China used more cement in 3 years than the U.S. used during the entire 20th Century | Equipment World

[6] THE INDUSTRIAL REVOLUTION (historyhaven.com)

[7] Japan's reliance was exacerbated by the fact that it had no defense capabilities.

Important Disclosures

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Creek") as of the date it is written and, as such, all such opinions are subject to change. No representation or warranty, express or implied, is given by Morgan Creek as to the accuracy of such opinions and no liability is accepted by such persons for the accuracy or completeness of any such opinions. Further, Morgan Creek does not warrant the accuracy, adequacy, completeness, timeliness or availability of any information provided by non-Morgan Creek sources.

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