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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@morgancreekcap.com.*

Best Regards,

Mark W. Yusko
CEO & CIO

NOTES FROM THE BUND[1]

The cycle of centralization and decentralization of political power in China

China has experienced very significant changes in its regulatory environment in the past few years including changes in the below sectors:

- Education sector – for profit K-12 tutoring institutions banned
- Property sector – leverage reduction
- Tech sector – new anti-monopoly and data privacy regulations
- Covid-related lockdowns and stringent quarantine measures

The breadth, depth, speed and level of transparency in these policy decisions have concerned many investors. Some of this concern may be related to the perception of an authoritarian style of governance by President Xi. Specifically, foreign observers worry about the overconcentration of power in an individual and a potential reversion of China to the Communist ideology of its past.

The international mainstream narrative is as follows:

- China's years under Mao's leadership (i.e., authoritarian rule mixed with communist ideology) was disastrous for the country. Misguided socio-economic policies including the Great Leap Forward [1958-1960] and the Cultural Revolution [1966-1976] resulted in 36 million of deaths[2] [3] and stunted China's economic potential.

- Thankfully, Deng followed soon after with his pragmatic adoption of capitalism. Deng's policies were continued by succeeding presidents, and these policies helped revitalize the economy.
- The arrival of Xi and his preoccupation with accumulating political power threatens to undo the economic (and social) progress of China since Deng. Without a system of checks and balances, China is likely to regress.

We believe this mainstream perspective is incomplete. We will attempt to flesh out in more detail below the ingredients of China's political success thus far in driving its rapid economic growth, and why we believe it is by necessity and design that the leadership is evolving once again towards centralization.

China had flirted previously with industrialization post the Opium Wars under the Qing and later again under Sun Yat Sen's newly declared Republic of China. However, China was politically fractured, weak and bogged down in a series of civil wars under those two regimes, and neither regime made any memorable headway in progressing China forward technologically. It was only after Mao re-unified China in 1949 that the authorities were capable of aggregating resources to make a credible attempt at industrialization. The rest is history.

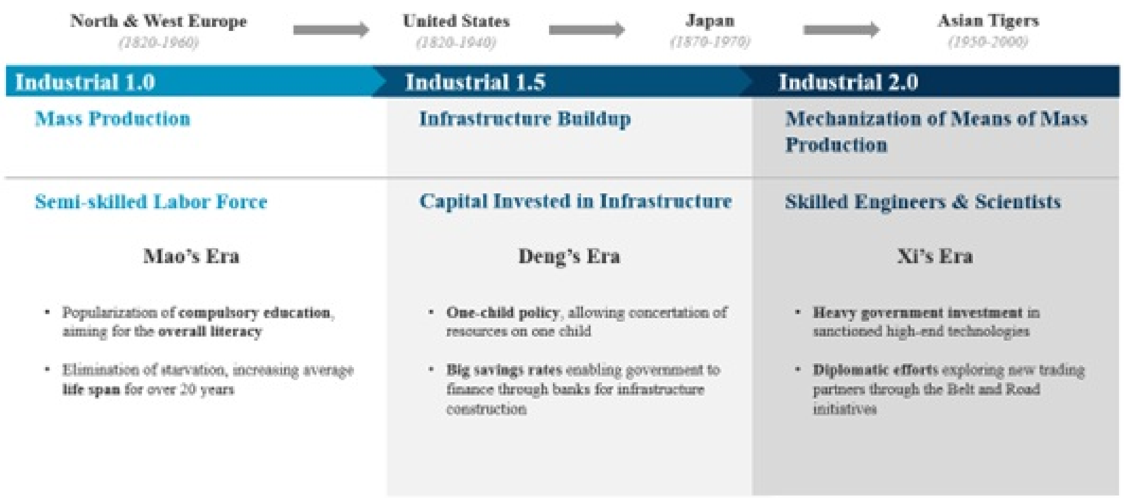

Figure 1: The path of industrialization is similar for every developed country thus far

Different approaches are required at different stages of development of economies. Strong control is necessary to induce paradigm changes at the beginning of each economic stage.

Mao era [1949-1976]: Establishing the Foundation

The period under Mao, even after taking into account the calamity that was the Great Leap Forward and the Cultural Revolution, actually witnessed tremendous progress in the standard of living of China's citizenry.

Year	Life Span (Years)	Infant Mortality (%)	Extreme Poverty (%)	Illiteracy (%)
1949	<35	>20	No data	80.0
1978	63	5.2	30.7	18.5
2021	78	0.5	0.0	2.7

Table 1: China's Development in Mao's Term

India was at par with China in many areas during the period before Mao took over, with an average lifespan of 34 years old, infant mortality of 16.4% and illiteracy of 81.7% in 1950, but India fell behind significantly overtime. By 1980, India's average lifespan increased to only 48 years (15 years behind China's); its infant mortality fell incrementally to 11.5% (double China's); and illiteracy remained high at 56.4% (thrice of China's).[4] Two significant accomplishments of Mao's leadership include:

- Leading China out of World War II (mostly) territorially intact. This is in contrast with other countries including India which was partitioned along ethno-religious fault lines. The fracturing of what was once the British Raj continues to plague India's relationship with Pakistan today and serves as a distraction to the continued economic development of both countries. Post Partition, India has fought four wars with Pakistan over disputed borders (1947, 1965, 1971 and 1999).
- Establishing the foundation for China's rapid Industry 1.0 development: which trained a large, readily available semi-skilled workforce during that period. As an example, the number of middle schools in China increased almost 48x between 1949 and 1976. This compulsory basic education established a foundation allowing China to triple its industrial workforce over the same period, compared with a less than doubling of its agricultural workforce.[5]

Mao achieved all of this within three decades. One may postulate that China sans Mao might have realized its economic potential more quickly and with less collateral damage. While certainly possible, the reverse might also have occurred. Over three centuries after Great Britian invented the steam engine, only 20% of the world population live in countries that have successfully undergone the industrial revolution.

Deng era [1981-1989]: Unleashing Rapid Growth

On Mao's solid foundation, Deng helped unleash market forces to create the economic behemoth that we see today. However, the paradox was that he had to consolidate significant power to be able to push through many of his reforms, some of which were highly unpopular during those times. Among the most intrusive policies he introduced was the one child policy – which in the near term allowed China to concentrate its limited resources on a smaller population. There were two notable short/mid-term positive outcomes:

- Average Chinese expenditures were lower given smaller family units, resulting in higher savings in the bank. The authorities promptly channelled these excess savings into infrastructure building to assist it along its Industry 1.5 development.

- The resulting one child per family tended to receive most of the family's resources, leading to a highly educated talent pool for China to tap into as it is undergoing an upgrade to Industry 2.0. Specifically, Keyu Jin, a tenured professor of economics at LSE6 did research on twins[7], comparing them with single children in Chinese families, concluding that the average twin received far less support than the average only child after the age of 15, creating large disparity in education outcomes[8] between the two groups.

This policy of course, has also led to long-term adverse consequences on China's demographics which the authorities are facing and now beginning to address.

Having set the country on the gradual path of economic liberalization, Deng's priority was to ensure that no future leader could derail China's progress in decentralization. The economy was for the most part on "auto-pilot", and the government during this period of transition needed only to intervene in certain areas – for example, in continuing to build out infrastructure to accelerate the pace of economic development.

Jiang/Hu era [1990-2013]: Cruise control

During this stage of decentralization, further protections were installed including age and term limits. To further weaken the authority of successor general secretaries of the party (the highest political office in China), predecessors tended to stagger handover of the most critical appointments. Jiang Zemin, for instance, became general secretary of the party in 1989, but did not become president until 1993. Hu Jintao became general secretary in 2002, president in 2003 and received chairmanship of the military commission in 2004.

Four decades of party evolution would ultimately witness the rise of two competing factions who decided to share power, with each faction taking turns on recommending President and Premier candidates and splitting the various committees. By the time Xi began rising through the ranks, decentralization was already overwhelmingly successful, with local official fiefdoms belonging to either one of the two competing factions deeply entrenched throughout the Chinese political landscape. Many articles, including this Time article, "Hu You Calling a Lame Duck" highlights the gradual loss of central authority over the decades, all by design.

Since time immemorial, people tend to form interest groups to game a political or economic system for their advantage.

Human nature is such that a minority group (whether it be autocrats and their allies, or interest/lobby groups) may tend to create/bend rules to benefit themselves at the expense of the broader population.

The dangers of autocrats are obvious. What is less appreciated is the challenges presented by a system with two parties. We believe duopolies can actually end up even more anti-competitive (and therefore damaging to broader society) than a monopoly. Without walking through the mathematics, it is not difficult to envision collusion and the formation of a cartel amongst the top players. A monopoly might have to factor in potential societal backlashes and resulting regulation as the only provider of the product/service/idea; but a duopoly could potentially operate under the illusion and cover of legitimacy since there is already a "competitor" to supposedly moderate its worst impulses. This was the political quagmire China found itself in when Xi came into power, which we will discuss in the next newsletter.

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CHINA NEWS SPOTLIGHT

China Keeps Lending Benchmark Rates Unchanged, as Expected: China left benchmark lending rates unchanged at a monthly fixing on Monday, matching expectations, as a weaker yuan continued to limit further monetary easing and policymakers waited to see the effects of previous stimulus on credit demand. Recent data shows the recovery in the world's second-largest economy remains patchy with industrial output and retail sales surprising on the upside but deflation gathering pace and few signs the struggling property market will bounce back any time soon. *Read More.*

China Powers Global NEV Manufacturing: In an automotive factory spanning an area equivalent to 16 soccer fields in Hefei, capital of East China's Anhui province, more than 800 robots work collaboratively to assemble six different models of new energy vehicles. The mega factory is part of Volkswagen's new NEV production facility, designed to address the swiftly increasing demand in the country amid formidable local competition. While Chinese electric vehicle manufacturers and suppliers made a strong presence at the bustling showrooms of this year's International Motor Show in Munich, Germany, VW reiterated its commitment to establishing a localized supply chain in the Chinese market. *Read More.*

Jack Ma Positive on Alibaba, Will Continue to Hold Shares - South China Morning Post :

Alibaba co-founder Jack Ma is "very positive" about the company and will continue to hold its shares, the South China Morning Post reported on Friday, citing a communiqué from his office. The comments from Ma's office come a day after a regulatory filing showed that his family trust was set to sell 10 million American Depository Shares of Alibaba Group Holdings (9988.HK), for about $871 million. The phased sale is part of a long-standing "preset conditional plan to do a partial sell-down for the future" that was adopted in August, but "not a single share has been sold," the publication quoted Ma's office as saying. *Read More.*

China's Carbon Emissions set for 'Structural Decline' in 2024 with Fresh Renewable Capacity Despite Third-Quarter Rise: China's carbon dioxide emissions are expected to fall in 2024 as a result of record growth in new low-carbon energy sources, according to a new report, even as emissions continue to spike this year following the end of strict zero-Covid policies. China is expected to add 210 gigawatts (GW) of solar, 70GW of wind, 7GW of hydro and 3GW of nuclear power generation capacity in 2023, nearly doubling the 152GW of renewable energy capacity it added in 2022, according to a new analysis from the Helsinki-based research organization Centre for Research on Energy and Clean Air (CREA) on Monday. *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: Tombstone: The Great Chinese Famine, 1958–1962

[3] Source: CCP History Research Center

[4] Source: Census 2011: Literacy Rate and Sex Ratio in India Since 1901 to 2011;https://www.jagranjosh.com; Oct.17th, 2016

[5] Source: National Bureau of Statistics

[6] Source: The London School of Economics and Political Science

[7] Source: Twins were selected as a point for comparison in this research because they were excepted from the one child policy and thus could be used as a substitute for a household with multi-children.

[8] Source: Two children will be better than one for China's economy; https://www.scmp.com/; Jan. 8th, 2016

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