Myths vs Realities – Part I

Examining China Through The Top Headlines of 2023

MORGAN CREEK
CAPITAL MANAGEMENT

Part I

Introduction

The past four years have been arguably among the most challenging that China has had to navigate since Deng Xiaoping's market reforms opened the country to globalization four decades ago. Externally, it is engaged in heightened geopolitical competition with the United States (US); internally, it is experiencing growing pains in its industrial upgrading process; and all this while it has only recently emerged from one of the deadliest (and most disruptive) pandemics known to man. This murky macroenvironment has spooked foreign investors, with many questioning if this spells the end of the road for China's economy and if the country has become uninvestable.

Investors' concerns can be broken into three categories related to geopolitics, the economy and China's system of government and regulation. We will attempt to bridge the perception gap between international mainstream headlines, which we believe to be excessively pessimistic as of late, and the realities we experience on the ground. Lastly, we will try to draw conclusions on what all this might mean for investors.

We organize our discourse among the four most common media headlines about China, namely that:

- China is headed towards a Japan-style bust
- The era of China's miracle economy is over
- 40 years after reform and opening, China is now regressing politically
- China's regulatory framework is a blackbox

We believe that:

- China is currently on a different trajectory than Japan in the 1980s due to its massive scale and has benefited from heightened competition
- Despite its *absolute* growth rate declining steadily over the past few decades, China has been and should continue to be the single largest engine for global growth for the foreseeable future
- Centralization and decentralization are natural cycles which all political systems undergo; China is no different and early yet in its current phase of centralization
- China does have a regulatory system in place; and given where China is in its economic transition, we expect regulation going forward to be incremental.

In this whitepaper, the first portion of a two-part installment, we will share our views on the first two – geopolitics and economics.

Geopolitics

Since the world order was reset in 1945 after the second world war, the US has engaged in two great power contests with Japan and the Soviet Union. The US triumphed over both in the 1990s when the Soviets imploded and the Japanese capitulated. The world has been relatively unipolar ever since – until China's renaissance once again upset the balance.

Headline 1: China Is Headed Towards a Japan-style Bust

Of the two prior precedents, observers tend to favor drawing parallels with 1990s Japan because of what appear to be greater similarities including the heightening geopolitical competition, asset/property bubble and aging demographics.

While persuasive on the surface, there are two crucial differences: first, China's population and GDP is much larger than Japan was at a similar point in its development. China in 2018 was 11.5x and 5.9x[1] greater than Japan's in 1990, respectively. This scale means China has more policy options available and can leverage its massive internal markets for continued local innovation and consumption of its products or services the way Japan was unable to. Second, Japan was and continues to be dependent on the US for national security, further limiting its negotiating leverage.

Unlike Japan, China has benefited from geopolitical competition by developing its domestic industry

We believe the US contest with China officially began in 2018 with President Trump's trade tariffs and its scope has since expanded to include other dimensions including technology and capital. So far, it appears that domestic Chinese industry has been a net beneficiary of this contest in the mid-term.

Technology

Technology and talent ultimately follow capital. Capital chases profits and are in turn, correlated to the size of markets. Take the semiconductor sector. Sanctions imposed unleashed the huge internal chip market (30% of global demand) for new Chinese entrants, which began to flourish as illustrated in the chart below. This domestic value chain restructuring is being replicated across multiple industrial verticals creating potential opportunity for investors.

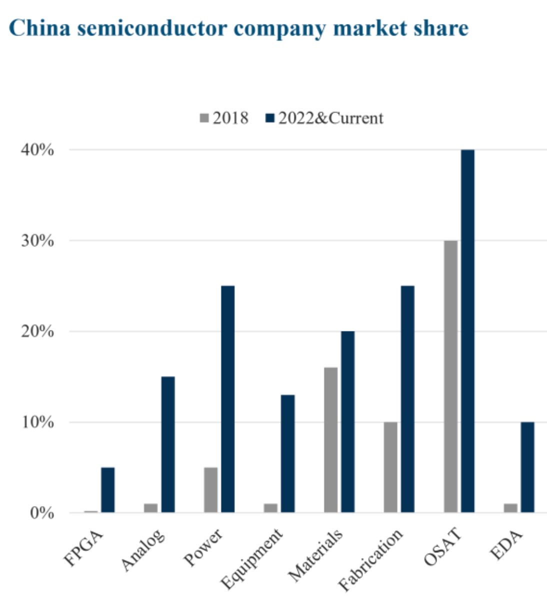


Figure 1: China's self-sufficiency rate[2] in key chip verticals have increased exponentially post restrictions[3]

[1] Calculating GDP using 2015 USD as a base year, at constant prices
[2] Calculate using the market share of China semi-conductor companies.
[3] Source: ACHI 2023 AGM material

Capital

Not too long ago, the US was once the most attractive listing destination for Chinese enterprises. At its peak in 2020, US exchanges raised $13.3 billion[4] for Chinese companies annually. Uncertain geopolitics has disrupted that flow. The most innovative businesses are now pursuing domestic listings instead, leading to a surge of IPOs in China. This has cultivated a virtuous feedback loop for domestic capital markets: more companies listed means greater analyst coverage, in turn attracting more capital and additional companies to float.

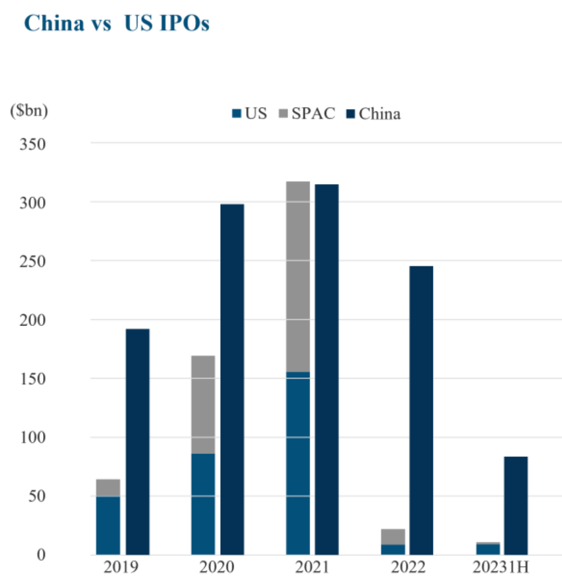


Figure 2: China has led the globe in IPOs over the past few years

Trade

China's exports, both with the US and the world more broadly, have continued to grow through the 2018 US tariffs and covid supply chain disruptions. While there have been international efforts to "de-risk" and reshape supply chains, this is a complicated and costly process that will likely take decades to achieve. In the meantime, China is expanding its trade in new markets, which has grown much faster than that with the US.

[4] Source: A Year After Audit Deal, Chinese IPOs in US Are Small and Rare; https://www.bloomberg.com; Dec. 14th, 2023

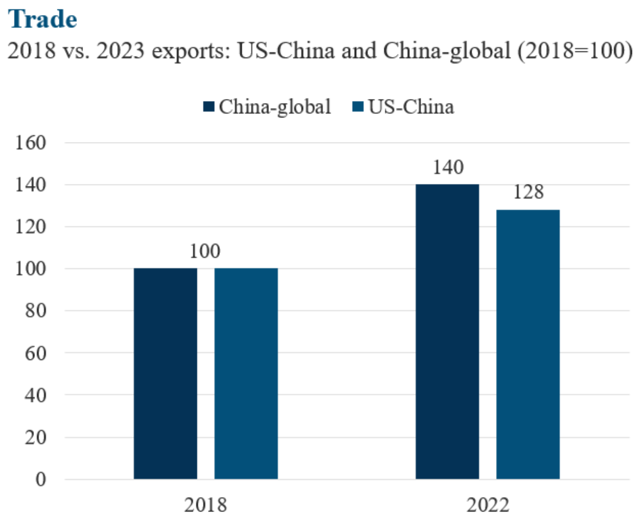


Figure 3: China trade exports have continued to grow

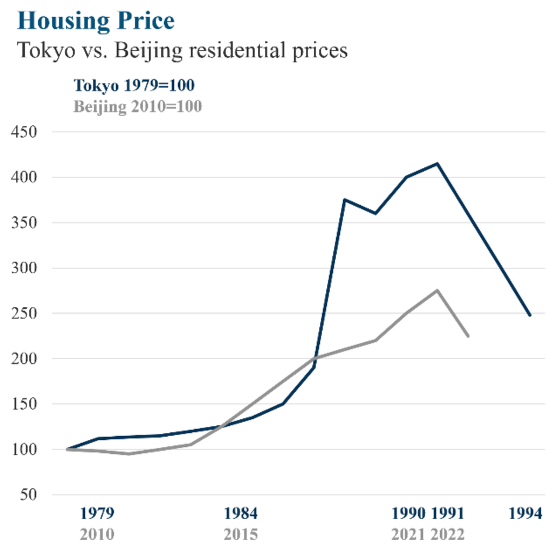
The nature of the asset bubbles in Japan and China are very different

The root cause, impact and remedy for the asset bubble which Japan underwent is very different from China:

- Japan's asset inflation was triggered by the Plaza Accords, which forced a rapid appreciation of the yen[5].
- This compelled Japan's central bank to keep its interest rates artificially low, fueling a massive asset bubble – in property, financial assets and the banking system, which made loans based on (in hindsight) inflated asset values.
- When the bubble ultimately burst, Japanese authorities adopted "extend and pretend" policies, continually pumping greater amounts of stimulus into the system, exacerbating the issue.

China's property bubble was driven by an oversupply of residential units in the lower tier markets and is relatively insulated from other financial assets. Valuations of Chinese assets have never reached the lofty levels seen in their Japanese counterparts, as shown below. Learning from the Japanese example, the Chinese regulators have also been reticent to apply a blanket stimulus which could worsen the problem down the line.

[5] The yen appreciated from a pre-accord level of 240 to the dollar to 200 in a matter of months, and to below 80 by 1995. [Source: Milestones in the yen's history; https://www.reuters.com;](https://www.reuters.com) Oct. 27th, 2008



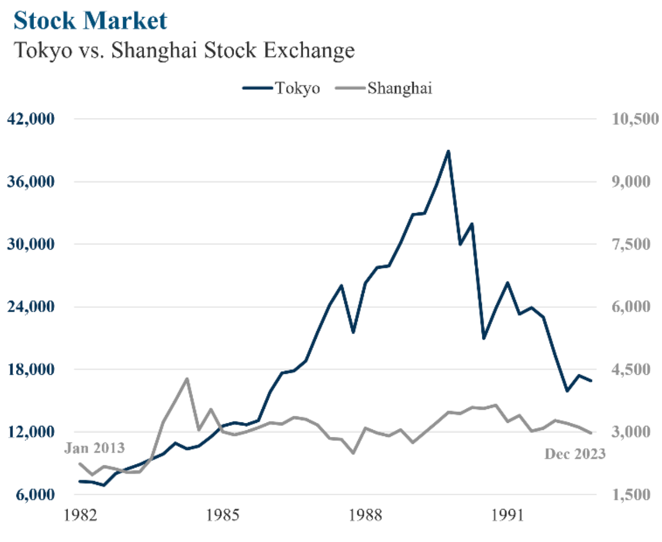


Figure 4: Tokyo vs. Beijing Residential Prices[6]

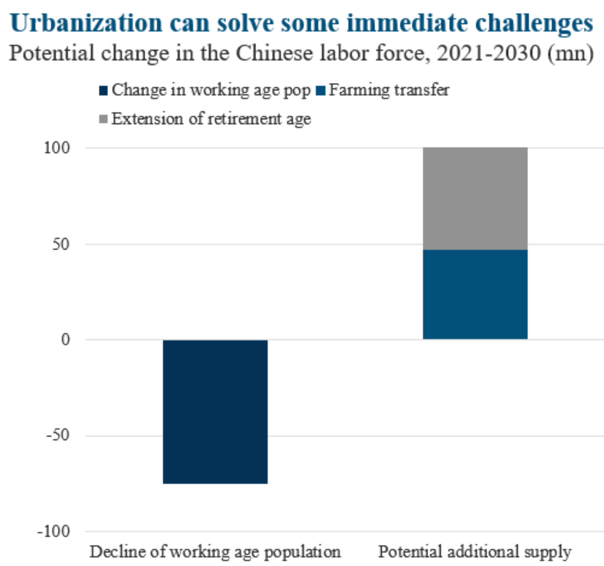
Figure 5: Tokyo vs Shanghai Stock Exchange

That said, there is an adverse impact to China's economy as construction and real estate related industries (cement, steel, renovation) experience a slowdown. Many economists have accounted for this negative contribution in their China GDP growth projections of 5%, which we address further below.

China has some time yet to find solutions for its aging demographics

In 2022, China registered its first population decline since the Great Famine. In the near and mid-term, we believe this problem to be manageable for China given continued urbanization and productivity increase. Japan is today almost 92% urbanized[7]. While Japan's overall population has been consistently declining since its 2009 peak, Tokyo's population continues to increase every year[8]. China's urbanization rate is currently only 65%[9], significantly below that of the developed world (~80%)[10]. At the same time, there is also further scope for older age participation rates to increase in urban areas due to government policy and better health capacity.

[6] Source: China is no 1990s Japan - but it could have been; https://think.ing.com; Aug. 3rd, 2023
[7] Source: Japan: Degree of urbanization from 2011 to 2021; https://www.statista.com; May 2023
[8] Source: Population of Tokyo; https://www.metro.tokyo.lg.jp
[9] Source: Degree of urbanization in China in 2022, by province or region; https://www.statista.com; Oct 2023
[10] Source: Total and urban population; https://hbs.unctad.org



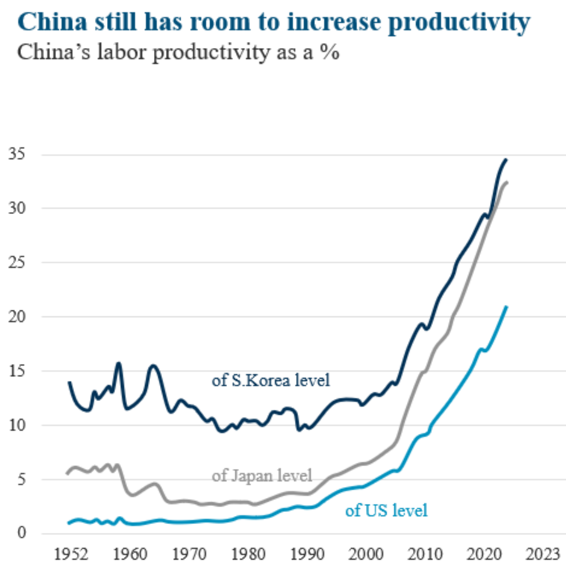


Figure 6&7: China can offset labor force decrease in the near term

More importantly, China's labor force productivity has grown exponentially in the past decade, supported by higher rates of technology adoption[11] and an educated young work force[12].

In the long term, China has attempted to increase its population by abolishing its one-child policy, loosening some of its immigration policies to attract high-end talent[13] and continuing to invest heavily in automation technologies. While the jury is still out on its future success in reversing its demographic trend over the very long term (Japan has not been successful in either by increasing its fertility rate or societal opposition towards immigration), we believe the economic damage due to aging will be muted in China for the next few decades, buying the authorities time to experiment on various policies.

Economics

Headline 2: China's Miracle Economy Is Over

Despite a projected slowdown in China's growth rate given its transitioning economy, China is expected to remain the main engine for global growth over the foreseeable future. Over the past decade, China has consistently represented more than a third of global growth[14]. The chart below illustrates that even in 2023 – a relatively difficult year for China, this trend will remain unchanged.

[11] Half of all global robot installations occurred in China in 2022. Source: China leads the way; https://www.universal-robots.com; Oct. 6th, 2023
[12] China possesses the world's largest higher education system with 240 million people receiving tertiary education. Source: China establishes world's largest higher education system with 240 million college graduates; https://www.globaltimes.cn; May. 17th, 2023
[13] Source: Shanghai Relaxes Permanent Residence Criteria for Applicants with PhD Degree; https://www.china-briefing.com; Sep. 20th, 2023
[14] Source: IMF, State Council of China

China growth still accounts for >30% of global GDP growth

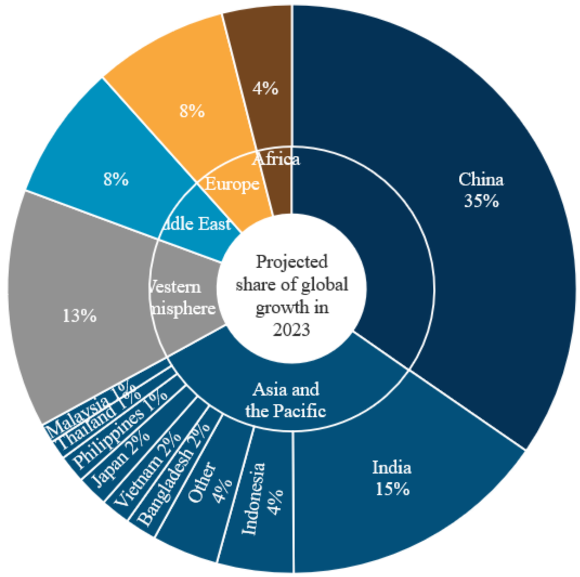


Figure 8: China continues to be largest contributor to global growth in 2023

Indeed, a recent McKinsey Report[15] concluded that for investors looking for scale and growth, the "next China is [still] China". Their conclusion is simple arithmetic: while breakneck growth of 8 to 10% going forward is highly unlikely for China's economy, growing between 2 and 5% is still likely achievable. Assuming for the next decade that China grows:

- At 5%, its incremental GDP would be equivalent to India, Japan and Indonesia combined in 2021
- At 2%, its incremental GDP would be equivalent to India in 2021.

Conclusion

At 18% of world population[16], 28% of manufacturing output[17] and 35% of global growth[18], China is too large a market to ignore. Its scale has brought with it increased scrutiny (and competition) from incumbent world powers, but we believe it will also be the key to its continued resilience and progress. Indeed, China has so far managed to benefit from difficult geopolitical headwinds and experienced tremendous advancements in economic competition – specifically in trade, technology and capital markets. Aging is a more worrying issue that the Chinese authorities need to find solutions for longer term. That said, the government has ample lead time to find solutions. More importantly, these challenges also bring potentially large opportunities for investors to domesticate supply chains and to invest in productivity and automation technologies.

[15] Source: How multinationals can capture the Chinese growth opportunity; https://www.mckinsey.com; Apr. 17th, 2023
[16] Source: China Population; https://www.worldometers.info; Jan. 9th, 2024
[17] Source: Top 10 manufacturing countries in 2023; https://www.safeguardglobal.com; Sep. 16th, 2023
[18] Source: IMF (May'23), State Council of China (Sep'22)

About Morgan Creek
Morgan Creek Capital Management, LLC is a SEC-registered investment adviser providing investment management services to institutional and qualifying clients such as pension plans, endowments, foundations, and family offices. Morgan Creek was founded in July 2004 by Mark W. Yusko, former Chief Investment Officer ("CIO") of the University of North Carolina ("UNC") Endowment. Our offerings include customized advisory solutions to funds of funds, to hybrid funds utilizing external managers and direct investments to funds focusing solely on direct investments in public and private investment opportunities.

Morgan Creek has been investing in China, and Asia more broadly since its founding, deploying over $903 million in private equity fund commitments and co-investments since 2004 across the region[19]. Morgan Creek has an on the ground presence since 2008, with a local office and investment professionals based in Shanghai since 2011. Over that period, our team has navigated and invested across multiple market cycles.

For further information on Morgan Creek's activities in the region, including our newsletters, webinars, research whitepapers and/or product offerings, please contact us at asiateam@morgancreekcap.com.

[19] Data as of March 2023