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Eastern Promise: On the Road in Mainland China

A Path to Recovery 2025

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China Trip Report – October 2024

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The below is a report on our recent trip to China in partnership with FountainCap Research & Investment, our boutique China manager. Across an intensive five days, from Shanghai to Hong Kong via Zhu Ji and Hangzhou, we met with officials, bankers, private companies and consumers to try to gauge whether 'the dragon' is sleeping or on its death bed. I must also extend my thanks to both Steven Luk and Frank Ding for their tireless translating and chaperoning across the trip.

To reduce an information dense trip down to some salient points was not easy but I offer the below by way of summary:

What were the key concerns before the trip?

- **Consumption:** are we witnessing the 'Japanification' of China? An aging population, signs of deflation all kicked off by a property crisis. A conservatism that grips both consumers and corporate balance sheets.
- **Real Estate:** China watchers' 'Bête Noir' - a near constant thorn in the side for both government and investor. Despite my prior view that this was not a 2008-like even when it comes to systemic risk, concerns remain that diversifying the economy away from a sector responsible for 30% of GDP will be costly and protracted.
- **Regional Government:** concerns around both the general level of competence, but most importantly their indebtedness given reliance on land sales.
- **Social Contract:** The silent trade-off between government and people. The idea that if citizens can be ensured the opportunity to work hard and prosper beyond previous generations, then the government can pick off social freedoms at will.

And after...

1. **Consumption:** This feels far more behavioural than structural. Shanghai's main shopping streets were packed at 10pm on a Tuesday, predominantly with younger shoppers. Behavioural changes in consumers are nearly impossible to predict - both in terms of timing and scale. What is more predictable is the nature of the consumer and my anecdotal view is that the younger generation of consumers remain committed capitalists.
2. **Real Estate**: While our observations are limited to the provincial level (we met with local bankers and government officials) it strikes me that consensus opinion outside China is that issues in the sector are more blight than blip. While there are inventory and local government debt problems, this is not a price bubble and damage can be contained to the sector. The wider market and consumer are impacted by sentiment but balance sheets for both remain healthy. At a government-level, we feel this will drive better lending and investment practices and a shift away from a 'growth at all costs' mentality that has led local government finances to their current sorry state. The government is also moving to a very supportive policy position, despite their initial hesitancy.
3. **Innovation:** China is rapidly moving up the value chain with notable success in various strategic industries (aerospace, EVs, Green Tech etc.), where their primary advantages lie in vast state support coupled with cheap and plentiful labour. This in turn allows for meaningfully more competitive pricing and production. In the most advanced technologies however, those advantages count for less and state involvement is more hinderance than help. I make no predictions for the long term, but the US lead within AI, Biotech, Semiconductors and Quantum Computers feels safe in the medium term.

TLDR: What are the notable observations?

- It is essential for asset managers and investors to be 'on the ground' to identify opportunities and market inefficiencies.
- China is a patchwork of people, businesses and culture. Research process should reflect this.
- China's positive trajectory in 'upgrading manufacturing' has continued. Current powerhouses – Germany, Korea, Japan etc. – should be concerned.
- China remains a master replicator, but a weak innovator. Xi is betting the house on shifting this.
- Key issues of RE/Consumer are more behavioural than structural.
- Top-down subsidies can create a national champion but not a global winner (Semis, EVs etc.).
- China's advantages in manufacturing are not replicable, but the same is true of the West's advantages in innovation.
- The balance between political power and economic success/prosperity remains delicate in China.
- The luxury market will likely recover in China in the longer term. International luxury brands retain their prestige.
- Domestic brands are likely to continue to take market share from lower/mid-market international players. This is true from autos to healthcare to trainers.
- The young 'Gen X' Chinese consumer looks more like their Western counterparts than they ever have before.
- Power is far more devolved in China than one would imagine. Large local governments have plenty of autonomy beyond the framework set by Beijing.
- Local governments are reforming their lending/investment habits. Shifting from unsustainable growth to a focus on returns.
- Trade War 2.0 will look very different to 1.0. China has spent 5 years preparing for retaliation.
- US geopolitical aims have pushed China into building out a self-sustaining economy.

Introduction

To cover such a long trip sequentially feels like folly so I will stick to the areas of interest for readers and China watchers. It is worth noting that while the views below are in no way comprehensive in demonstrating where China is and its trajectory, the combination of cities (Tier 1 and Tier 4), key industries and sector visits, feels adequate to at the very least offer readers some genuine insights. I will tackle the following as the key focus areas of the trip:

- Consumption
- Real Estate
- Advanced Industry
- Local Government
- Geopolitics
- Quickfire: Further Thoughts

Consumption: Structural or Behavioural?

"The party's influence in the private sector is weak. Carry out the party's work and enhance its influence."

Xi Jinping at the National Propaganda and Ideology Work Conference on August 19, 2013

In a country of contradictions, the continued success and dominance of the private sector remains perhaps the largest. A contradictory capitalistic miracle in the world's largest anti-capitalist state. Perhaps we should be less surprised given the party's surrender to consumption has been instrumental in allowing its citizens to move from subsistence farming to queuing for iPhones in the space of 60 years.

FountainCap has long argued, and successfully bet on, the idea that the consumption theme has plenty more room to run.

Looking at the macro mechanism that has historically driven that shift, urbanisation, that conviction does not feel unwarranted. Despite the stringent Hukou system (a social policy designed to control immigration to cities) continuing, the flow of ambitious Chinese to the city in search of a fortune is historically unprecedented. The National Bureau of Statistics estimates that, as of the end of 2023, China now has over 670m people living in urban areas, versus 39m at the end of 1949. While the rate has slowed in percentage terms, the 14th Five Year Plan, set out in 2022, also offered a number of proposed changes to the Hukou systems which should enable continued growth. As will hopefully become clear across this report, what Beijing wants, Beijing usually gets!

At a more micro-level, my pre-trip views of consumer health in China were that it was in a death spiral, the 'Japanification' of the consumer was inevitable as savings piled up. It is hard to square these headlines with my anecdotal on-the - ground experience as the main Shanghai shopping street thronged with young people and domestic tour groups swarmed around central. Walking down the famous Bund, it is hard not to be swept up in a wave of flag-waving groups vying for the best selfie spots. These local observations were confirmed at a country-level by our visit to see Trip.com at their Shanghai HQ. Trip is Asia's largest online travel agent with domestic market share above 50%, they can provide a better view than most into the health of domestic tourism. Their read was positive with management noting that numbers were above pre-pandemic levels and would continue to grow slightly above GDP (6-9%). While outbound tourism numbers remain at only 74% of their 2019 numbers, forecasts have this reaching closer to 90% by the end of the year. The contrast between inbound/outbound travel feels representative of the wider shift in Chinese consumer behaviour. A broad 'downgrading', with that move inevitably favouring domestic experiences and brands over international.

The rise of this so called 'nationalist consumerism' is also worth touching on. I have doubts as to whether most of the youth buying Anta over Adidas are doing so out of a sense of national obligation; this does not feel like a Chinese 'MAGA'-style change. But we saw firsthand evidence of this across sectors. From the private hospital we visited, where international diagnostic and scanning machines are being replaced with more competitively priced domestic players, to the well documented struggles for Apple as the iPhone looks set to finally lose its throne to Huawei. The same trend looks to be true of QSR restaurants where local player Tastien (see below) is on track to open 3500 stores this year and is close to surpassing McDonald's as the second largest fast-food chain in the country. EV's are another category where domestic manufacturers BYD, Nio, Zeekr, Xiaomi and many others have reduced the European premium share significantly. This consumer shift has been borne out in the numbers as Mercedes announced EV sales had plummeted 30% in Q3 amidst Chinese competition. ***In short, the Chinese are buying Chinese.*** If I was to guess the primary reasons it feels like the powerful convergence of two opposing trends. Chinese consumers are *downgrading* their brand preferences, while domestic brands are *upgrading* their product, at a more competitive price.

I would be more cautious about applying the same lens to the luxury market. Again, the shorter-term numbers have been ugly across the board. LVMH, Kering, Hermes and others have all struggled against a weak Chinese macro backdrop. But as FountainCap has long argued; luxury and upmarket Western brands have a factor of non-replicability that provides them sufficient protection against China's typical consumer strategy of 'replicate and make it cheaper'. Throughout our trip, the prestige of historical western brands, be that Barbour, Hermes, Land Rover or even British public schools was evident. We visited Dulwich College International headquarters, from where they have now built a public-school empire in China. Despite charging dramatically more than rivals, the clamour for a British educational brand and all that entails, is enough to make it immune to the wider macro issues. As a broader rule of thumb, in a nation that has built an economy on replication, there are a select few factors that are non-replicable; prestige, status and history. **The dominant luxury**

brands have not lost their allure, only their marginal buyer. I expect the China market to remain a happy hunting ground for these brands when perceived 'normality' returns to the economy.

Finally, and at a broader level, from my observations on this trip, it feels as if a 'global consumer' profile has emerged in the last few years. During our trip on the high-speed rail, I sat next to a young girl who would not have looked out of place on a London commuter train. Adidas Sambas, a Starbucks coffee and doom scrolling make up tutorials on Douyin (China's TikTok) all on an iPhone. Youngsters meeting for coffees at the weekend, heads buried in their phones was a common site in central Shanghai. **I suspect that the complete dominance of social media within 'Gen X' has allowed Western trends, once siloed by geography and sluggish print media, to take hold in China in a matter of weeks**. What is trending in New York is now accessible instantaneously to someone sitting eight thousand miles away in Chongqing. How that affects the fortunes of foreign brands, particularly in the mid-market, will need close watching.

10pm on a Tuesday night on Shanghai's major shopping street.

High-end luxury brands have faced headwinds, but brand equity remains strong.

A smaller Tastien outlet in Shanghai. Tastien has rapidly established a strong market share vs. McDonald's and other Western offerings.

Domestic tour groups were everywhere in central Shanghai.

Real Estate: A House Built on Sand?

'Housing is for living in, not speculation'

President Xi, 2017

The messaging on property from Xi Jinping has been well established since the 'Three Red Lines' directive of 2020 was announced to try and de-leverage and de-risk the overheated property sector.

Property has felt like a poisoned chalice for the state over the last few decades. Essential in allowing urbanisation and subsequent prosperity, but also the genesis of rampant speculation and increasing inequality. Permissible under a more lenient regime, but now seen as capitalist aberrations by a more ideologically guided Xi. I do not need to repeat the well-known tale of China's property struggles, but I can share what we saw on the ground. Again, while our meetings were mainly at a provincial level, there are enough throughlines to Beijing to allow us to determine the direction of travel.

One thing that is immediately clear from landing in Shanghai, and periodically reinforced as we traversed around the country, is that China remains in thrall to construction. Besides the LED-adorned skyscrapers, the other dominant silhouettes across skylines from Hangzhou to Zhuji were cranes and scaffolding. Returning from the airport it is hard to avoid the question on our clients', and my own, mind: has Beijing's relentless focus on building metastasised into an addiction, helping prop up slowing GDP numbers with bridges to nowhere?

Speaking to developers in Zhu Ji was instructive as to where we are now. The headline figures remain ugly; prices have fallen by 30% across the board, with inventory stacking up and households sticking resolutely to cash. That said, according to locals, recent government stimulus has stemmed the bleeding with prices stabilizing and inventory finally starting to shift in some of the lower tier cities. Further green shoots are appearing in residential, as mortgage preferences are shifting from fixed rate to floating allowing speculators to bet on falling rates in the coming months.

The latter point is significant. While price drawdowns and inventory sitting idle have created the outlines of an issue in the sector, this has not been a leverage fuelled bubble that is remotely comparable to 2008. Household balance sheets are strong, and while many have bought property as the best route to a quick buck, the risk of contagion across sectors feels very low. The real, and unravelling risk from this, has been on the consumer psyche. The government taking the air out of a former gambler's paradise is likely of long-term benefit for the economy, but the unintended consequences of cutting off this route to riches seems to have knocked wider consumer confidence across the board.

Despite public proclamations against them, the irony is that the return of speculators might be just the tonic the market needs to start moving into a full recovery. **As with broader consumption trends, there is cash aplenty, and the prospect of making a quick dime, regardless of the political climate, may well be the Faustian bargain that Xi must strike to move consumers back to a spending vs. saving mentality.**

Postscript: As I edit this piece in December I wanted to add in and highlight Steven Luk's latest note from FountainCap. As he argues, the government is taking this seriously and it appears to be looking to incentivize home buyers once again. I highlight the salient lines below:

"Incremental policy supportive of the real estate sector continues to be announced in November ranging from tax cuts for home buyers to the Ministry of Finance frontloading nearly RMB 57bn to support urban affordable housing projects. Perhaps the strongest sign of a determined Beijing to tackle this issue came from a somewhat surprising politburo meeting chaired by President Xi that just took place this week. The official transcript from the meeting showed that Beijing is prioritizing the "stabilization of real estate and stock markets through extraordinary counter-cyclical adjustments and moderately loose monetary policy".

An unfinished development in central Shanghai.

Advanced Industry: Chasing Parity

"High-end science and technology is a national weapon in modern times."

Xi Jinping, Inspection of the Chinese Academy of Sciences, July 17, 2013

With Donald Trump making a return to the White House in January, so too are the economic ideas associated with his MAGA dream, protectionism, re-shoring, re-industrialisation, state support for strategic sectors, de-risking supply chains. The irony of Trump following a similar playbook to that employed under Xi has not been lost on policy makers in Beijing. The flagship of China's efforts to drive its development of key industries dates to 2015, with the announcement of 'Made in China 2025' (MIC2025) which put forward several benchmarks which I summarise below:

- ***Develop self-reliance in key technologies.***
- ***Upgrade Industry and manufacturing across industries. Quality> Quantity.***
- ***State support for 10 key industries: 1) New advanced information technology; 2) Automated machine tools & robotics; 3) Aerospace and aeronautical equipment; 4) Maritime equipment and high-tech shipping; 5) Modern rail transport equipment; 6) New-energy vehicles and equipment; 7) Power equipment; 8) Agricultural equipment; 9) New materials; and 10) Biopharma and advanced medical products.***

Our trip led us to the very heart of these efforts with a visit to the G60 innovation park outside of Shanghai. The park we visited forms part of a network of centres that form an "innovation corridor through the Yangtze River Delta, with a core focus on advanced manufacturing covering all the sectors associated with MIC2025. As with anything China-related, the headline numbers are fairly staggering in their scale; 76 thousand sq. KM covered, 45 thousand enterprises, nine participating cities and over 100 companies listed on the STAR exchange. We were granted a full tour of the exhibition centre (pictures below) which I will caveat was extremely stage-managed and leaned heavily on success stories, but it was hard not to be impressed by the focus and resources behind the technology shown. This included everything from novel AI dashboards designed to replace mirrors in clothes shops right the way through to the early stages of a Starlink competitor and Chinese spacesuit manufacture utilizing an entirely new material. Beyond the performance, the clear message is that China is all-in on Xi's dream to move industry up the value chain.

Semiconductors, the keystone on which China hopes to build its future technology - both civilian and military, feel harder to place in the winner's circle. We had lunch with a former SMIC executive who offered some insights into what remains a secretive industry. Despite strong rhetorical bluster to the opposite end, China has continued to ship more mature nodes to the US than pre-Covid. The same is also true on the US side where the major semiconductor manufacturing equipment providers have seen their China revenues grow despite export controls. He was also exceptionally bullish on the idea that China can and would catch up over the course of a few years on all key aspects of the chip supply chain; foundry, design and assembly. Given his standing as a career employee of a state-owned semiconductor firm, I remain a little sceptical to how close China is on the most technical elements including lithography and design/fabrication of high-end chips below 7nm. Despite Huawei's surprise breakthrough with its own advanced AI chip last year, yields remain below those of TSMC and American competitors. Where China will take further share is in the legacy/mature node market where chips are primarily used for less advanced tasks, predominantly in cars, whitegoods and other household appliances. A combination of brutal work ethic (our lunch guest informed us SMIC is running on a 24/7 production schedule), near-unlimited government support and substantially lower production cost leaves global peers little room to compete in the long term. The nuance often missing when talking about US export controls is that two contradictory end results can be true at the same time. Firstly, at the very least, US pressure has forced Chinese leadership to take seriously the independence of its advanced technology sectors and rapidly re-route subsidies and policies to address these flaws. Secondly, where policy and cash flows have been redirected, Chinese domestic efforts have still struggled to get close to the most sophisticated efforts coming from the US and Taiwan.

Beyond that, and the most visible of MIC2025 success is the explosion of the EV sector. From minnow to giant, China has come to dominate the sector. And while this is the most tangible area that we see the payoff of this strategy, any expert in the more technical domains can speak to the fact that several historically Western-dominated industries - Advanced Materials, Aerospace, Biotech, Drones, Green Tech - have seen China claw back ground on the West.

Construction continues on another G60 innovation park.

A domestically produced flight simulator for China's new airliner produced by a company under the G60 umbrella. An example of upgrading domestic manufacturing capabilities

Inspecting Huawei's latest top of the range saloon. All yours for under $40k.

Local Government (Zhu Ji)

As has been a common theme in this report, the scale of mainland China is perhaps the starkest departure from the West. FountainCap was keen for us to see China beyond the major cities and Zhu Ji was a convenient opportunity, located a 90-minute burst on the HSR south of Shanghai. Despite being considered a Tier 4 (or even 5 by some measures) city, it remains home to over a million residents.

Zhu Ji is both a good and bad example of a lower tier city. In most measures, it remains atypical. The city is globally dominant in not one, but two subsectors. Its nickname: 'Pearl City' is well earned, with 90% of global freshwater pearls originating there, although it can also claim to be 'Sock City', being responsible for nearly 40% of global sock production. Outside of industry, it is also atypical in its behaviour and economics at the local government level. We were treated to a long working lunch China-style. This is not London so claret or pints are replaced by Moutai or 'Chinese Wine'. Do not be fooled by the name, a bottle of Moutai at lunch is more likely to lead to a visit to Zhu Ji A&E than promises of a new business deal. Food, as I highlight below, is also a stark departure from London. Putting some distance between a big city also invited a more…. exotic offering. Dog, Turtle, raw crab and sea cucumber soup (surprisingly nice) were all on the menu. Our audience - bankers from China Merchants Bank, local officials and real estate developers- were nearly as eclectic as our food. To my earlier point on Zhu Ji's atypical nature, this is also true of its governance. To summarise:

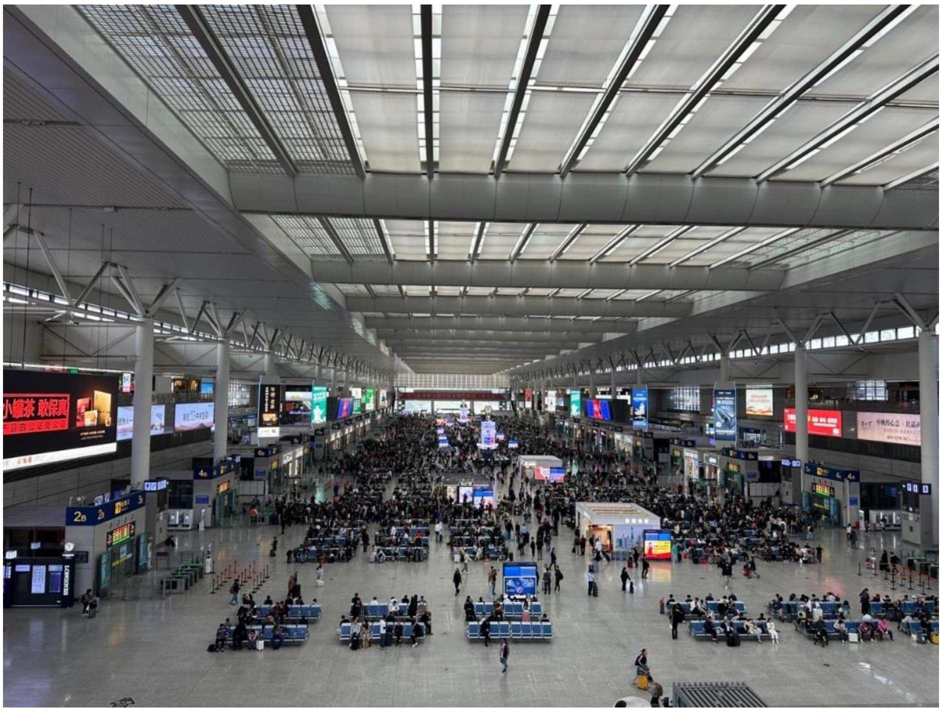
- Zhu Ji has seen a strong rebound and new highs for its wider industrial output. This has been netted out by the corresponding decline in the RE sector.
- Land Sales (60% of traditional revenue) have been stopped. Most local governments have struggled as their tax base cannot make up the shortfall.
- Zhu Ji has always ranked in the top 20 for growth. It is near 80% private sector as an economy - this has led to more durability in lean times and sustainable growth in boom times.
- ***A rule of thumb to follow - the closer to power (Beijing), the more a local government's revenue mix leans SOE vs. Private Sector***
- Zhu Ji's balance sheet is healthy relative to other provinces - largely due to higher share of private sector.
- Many local governments Reliance on the central government's balance sheet has only increased post-covid.
- ***Bankers noted near record levels of savings from HNW clients. In October, there was a shift to equity from fixed deposit products - traditionally the bedrock of Chinese savings.***
- Bank and local government incentives/KPIs have shifted - focus on sustainable growth, not growth at all costs.
- Beijing has asked local governments to concentrate lending efforts on SMEs and private sector.
- NPL is very low across consumer and household lending given saving-levels.
- Local developers have begun to clear inventory and stopped land purchases.
- Mortgage blend has moved from fixed to floating as speculators return in anticipation of falling rates.

There is probably a lesson in amongst all that information. On the investment side, it really hammers home the point that China is best viewed and analysed as a collection of unique provinces with vastly different economic drivers and outcomes. It also suggests that the manager willing to do the work on the ground will increase their odds of success as a lack of broker coverage and the sheer scale of China combine to create exceptional inefficiency and therefore opportunity.

There is also a lesson for the Party in there, although evidence of them admitting, let alone learning from mistakes is scant if non-existent. Simply put, competent local government, combined with a stronger private sector revenue mix and more prudent investment criteria is clearly the equation that works. The question I am left with is, can the Zhu Ji model become less of an anomaly?

Not your typical European working lunch. Roasted turtle served with a shot of Moutai.

Sea Cucumber soup. Despite appearances this tasted remarkably like Miso soup.



Shanghai Hongqiao railway station. Closer to an airport than UK train station!

Geopolitics: Trade War 2.0

"Globalization is inevitable"

Shanghai Party Official

A quotation that would feel more familiar coming from the campaign trail of George W. Bush than from the mouth of a senior party official. Welcome to 2024 in China. Amongst the often dry and scripted remarks dished out by party officials on our trip, a long banquet complimented by what felt like endless Moutai toasts, offered us a rare glimpse into the Party machine. As we have noted elsewhere in this letter, CCP leadership has long performed the equivalent of alchemy in political economy; balancing bottom-up market forces (and often animal spirits) with top-down state control. For investors, it has always paid to understand this balance and in which direction the pendulum is swinging.

Former Australian Prime Minister Kevin Rudd, a keen Sinologist, has argued that Xi marks a return to the Marxist-Leninist ideology that the party was founded on. Viewed under this lens, economic liberties and the 'reopening' of the Chinese economy that was started under Deng and accelerated under Hu Jintao are aberrations to the longer-term ideological goals of Xi. Rudd's point was emphatically demonstrated as Hu Jintao was escorted from his seat at the 2022 National Congress, without even a cursory glance up from Xi. Beijing's messaging on its wider geopolitical aims has been similarly assertive. From the South China Sea to its 'Wolf Warrior' diplomacy, the desire to reshape the international, Western-led order to China's interests has not been subtle. And yet below the sabre rattling from the top table, there was a stark contrast to the more nuanced and reserved views of officials we met. Their belief, that 'globalization is inevitable' and trade will continue to flow between China and the world can bring investors some comfort. They are correct about globalization in one way - the world's two largest economies have become impossibly intertwined across many industries. In blunt terms, China is one of the largest export markets for US goods and services and the US is the top export market for China. And while there is justification for the US to try and reshape the balance of that trade, it is not a relationship that is going to collapse overnight. Any journey to complete independence would likely prove too politically costly for either Trump or Xi. No industry offers a better view of the battle between rhetoric and reality than semiconductors, the most sensitive of all, and yet outside of the most advanced chips, trade in both directions has only increased since US export controls were announced. Investors should be well served following the money, not the headlines.

It is also worth noting that the definition of what constitutes a 'critical sector' remains in the eye of the beholder. As officials reminded us, the UK's position on EVs remains at odds with that of the US and Germany: and why should it not? The UK has no domestic auto champion and again pointed out by our hosts; UK consumers continue to benefit from Chinese taxpayer-driven subsidies on EV production. Beyond national security concerns, there are few sectors where it is viable for European countries to prioritise allegiance with the US over the health of their fragile economies.

This new geopolitical chessboard will require pragmatism from all sides, including investors. This was substantiated by our final meeting of the trip with members of the British trade delegation in Hong Kong. They emphasised that Britain would continue to attempt to thread the needle between the US and Europe, taking a utilitarian, selective approach to critical industries and national security risks. If the early months of the Starmer are anything to go by, that may be trickier than anticipated!

That said, investors could do worse than to follow the UK lead. What was once unpredictable and reactionary policy making from Beijing in 2016 has evolved into something more studied since Trump last held office. Without wishing to talk up our own book, FountainCap's approach here; focus on critical, but not sensitive, components - has allowed it to avoid the glare of domestic regulators in Beijing and trade hawks in Washington.

Quickfire: Further Thoughts

EVs: Shanghai is the largest supporter of EVs in China, and that is made clear upon leaving the airport terminal, the taxi rank a sea of green number plates. The traffic jams are the same, and I was shocked at the sheer variety of makes and models from Chinese manufacturers. Its hard not to envisage a wave of consolidation to come. Prestige western brands are still seen, but given subsidies, locals can pick up a brand-new, lower range offering for less than $15k. Officials also proudly boasted that this price advantage is a built-in tariff defence. Even at a 100% tariff, low-end Chinese EVs are significantly cheaper than western equivalents. As one official told us: "The UK has capitulated on Chinese EVs." Whether Europe follows suit is another question.

Sustainability: It's hard to square the circle in China when it comes to sustainability. A city like Shanghai teeming with EVs and ESG signs adorning lampposts. Green technologies being heavily supported and invested in by the state. The world's dominant solar cell manufacturer and solar power generator. Yet China is building 95% of the worlds new coal-fired power plants. Sustainability has long been one of the remaining consensus and positive-sum policy areas between the US and China. One has to fear that it will likely be a victim of Trade War 2.0 as Washington turns away from its commitments and China looks to power its growth – whatever the cost.

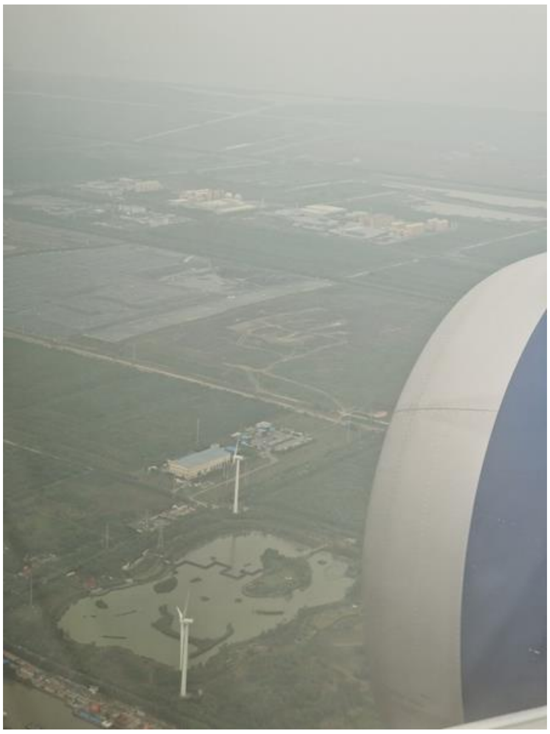
Innovation: As I have mentioned elsewhere in this report, China's attempts at moving up the value chain and 'upgrading consumption' have been a success when we judge them on their 2014 aims. That said, innovation is not static and that is particularly true in semiconductors and AI. China can and will close the gap in these technologies, but surpassing the US feels hindered by the rigidity of the top-down governance structure. The near collapse of the venture ecosystem will be a further drag.

Infrastructure As a British train-user, a delegation might need to be sent to study the Shanghai HSR network. Efficient as it is sprawling, with Shanghai to Beijing capable in under 5 hours and over 4,000km of track laid this year alone.

Mobile Phone as Utility: The phone is mightier than the sword? Certainly, the case in China where nearly every meaningful daily process has been digitalized. My initial taxi journey into Shanghai was an early sign. The driver using three phones simultaneously across payments, GPS and a live translation app to quiz me on the Premier League!

SMEs: Issues for mega cap companies in China have been well documented as the government moves against monopoly businesses. Our trip made me more bullish on the smaller end of the market. Alongside the government sponsored tailwinds of increased and eased borrowing access and a plethora of tax incentives via innovation parks, there is also a vast pool of cheap and educated human capital waiting to be hired. In many instances, including a VR company we visited (below), many US-educated PHDs are returning to build their tech businesses domestically as developer talent is less than half the price.

Youth Struggles: China's youth have not had an easy ride in the last decade. Youth unemployment remains stubbornly high (>30% by some estimates). The government removing the figure from regular release is perhaps all we need to know confirm the numbers are as bad as estimates suggest. Our discussions also demonstrated that things are not great for those who do have jobs. The '996' (9am-9pm, 6 days a week) culture still features for younger technology and factory workers alike.



A land of contradiction. Greeted by wind turbines and smog.

Manual assembly still makes economic sense for SME manufacturers.

Conclusion

You must enter the Tiger's den to catch his cubs.

Chinese Proverb

Strolling down the famous Bund in Shanghai is a quick lesson in Chinese history. The city was a rare beast in the mid-19th Century, with the great trading powers of the time, the British, French and Japanese, operating within stone's throw of each other. Much has changed in the 150 years since. Once bustling hubs of commerce, they are now nameless shells dedicated to unknown government departments. Western capitalist influence remains, albeit in the less ambitious form of a Subway and KFC feeding hungry office workers just across the road. There is more contrast and contradiction looking over the river to the soaring Pudong skyline. An unintentional monument to the country's progress, built from Chinese steel and labour, and yet it is the familiar names of Western financial institutions that peak out of the smog. It feels too perfect a metaphor that this contrast and contradiction should be sitting within the centre of the China's commercial capital. My perhaps blunt views from London are now decidedly different. The most important realisation: China is a patchwork, not a homogenous whole. That is true of its cities, cuisine, people and politics. What may be true in Shanghai and Beijing might not be in Hangzhou and Shenzhen. Investors think they are looking through a spyglass, but it is closer to a kaleidoscope.

So, what does this mean for China investors?

Firstly, that an active local fund manager is the most effective way to play the inefficiencies these differences create. This has been borne out in the most recent 5 year numbers of active China managers, with just under 75% of managers beating their benchmarks. I would argue that an active manager beating a benchmark in China over longer time horizons is table stakes given the low-quality composition of the index. The real value of a local presence is an ability to manage the risk of investing in a country where the government can collapse a sector in a day (see education, online gaming etc.). A manager who understands the nuances of the regional tapestry and is willing to travel its length looking for and investigating ideas, can prosper. Despite the popular association, China, be that food or investing, is best approached with the help of a connoisseur, not a buffet. That is not to say that they can avoid significant risk that the Chinese system creates, but I believe that deep on-the-ground diligence informing careful sector selection can help investors avoid the depth charges periodically laid by the government.

Secondly, that headlines and reality can meaningfully depart from one another. A cursory glance at the FT, rock-bottom investor sentiment and generationally cheap valuations were suggestive that the world's second largest economy was going out of business. On the contrary, and as I have noted above, three essential levers of China's 30-year transformation remain intact:

1. **Consumption** Covered in Section 1 above.
2. **Industrialization** China's industrial growth remains robust, and well above the global average in 2024. With a dominant foothold in scale, China is moving up the value chain across industries to generate the next leg of growth.
3. **Urbanization** As with consumption, despite the demographic skew, urbanization reached 67% in 2023 and will likely continue to 75% by 2035 according to estimates. The effects on economic growth of moving workers from rural to urban living are substantial and persistent.

The trip also demonstrated that each thread has significant issues, but they look far more behavioural than structural when investigated in-person. On that basis, the image of 'Japanification' is credible from afar; aging population, deflation and property troubles are all commonalities. But when challenged up-close, the differences are stark. For one, while growth has slowed, China's latest figures still have GDP growth north of 4%. To quell the sceptic of those numbers (myself included), its property issues are controllable and fixable. This is not a 1989 Japan-style property bubble, nor a credit-fuelled crisis like 2008. There will be casualties within the property segment, but contagion feels limited.

Like the dragon emblazoned across Chinese folklore, mythmaking exists on both sides of the bull/bear spectrum. And like most things in life, the truth lies somewhere between the most negative headlines and the government's unwillingness to lose face. Ultimately, the future trajectory of Chinese equity markets is impossible to predict, but there will surely be far more conviction afforded to those views, be that positive or negative, that are confirmed on-the-ground. For those who remain positive, I will leave them with the prescient words of Jack Ma:

Today is difficult. Tomorrow is much more difficult. But the day after tomorrow is beautiful.

If by some miracle you have read this far then we will be back in China in 2025 alongside FountainCap and clients to show them the real China. Dates and details to be confirmed but spaces will be limited so please register any early interest with your relevant Aravis contact.

A traditional banquet setup.

The Pudong skyline with China's tallest building, the Shanghai Tower, escaping into the smog.

Further Reading

- Dan Wang is one of the best essayist's covering China. His archived letters are available via his website: https://danwang.co/2023-letter/
- Kevin Rudd discussing Xi Jinping Thought: https://www.youtube.com/watch?v=aGq-A6Ap8oI
- A primer on 'Made in China 2025' : https://www.csis.org/analysis/made-china-2025
- Japanification and China | Robeco : https://www.robeco.com/en-int/insights/2024/09/japanification-of-china
- Michael Pettis is my favourite source for all things China economics: https://x.com/michaelxpettis
- An excellent report from the Centre of Strategic Studies covering the effect of US export controls on the Chinese semiconductor industry: https://www.csis.org/analysis/true-impact-allied-export-controls-us-and-chinese-semiconductor-manufacturing-equipment