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December 31, 2019

Dear Clients:

We are often asked why, after more than 30 years, we still travel around China when so much knowledge now resides online. Our first response is because the region continues to provide the most significant marginal corporate growth globally. Further, it is impossible to comprehend how a company operates successfully -- and sustainably -- in a far-off region of the globe with an entirely different economic system, as well as distinct social, political, and consumption characteristics, without a steady visitation schedule. Now more than ever necessitates this process of analysis.

As western investors, we have been talking about China's massive future potential for decades. But it has become clear that the future has arrived faster than expected. With a GDP level of $14 trillion vs the U.S. at $20 trillion, China will soon be the world's largest economy, having grown ~9.6% CAGR since 1989 and, since 2017, accounting for an estimated ~35% of global economic growth -- nearly double the U.S.

One of the most dramatic developments we have witnessed in the last thirty-plus years has been China's soaring consumption and its integration into global flows of trade, capital, and innovation. More recently, China has made the move from just participating in these flows to influencing their shape and direction.

A recent McKinsey report calculates that, by 2040 Asia is expected to account for 40% of total global consumption -- with China a disproportionate sum of that total. The report notes that "these trends represent a real shift in the world's center of gravity". Furthermore, as consumption overtakes exports as a percentage of GDP, more of what gets made in China will stay in China. In the decade ending in 2017, China tripled its production of labor-intensive goods (to $8.8 trillion) while at the same time the share of this output produced for export fell by half (to 8.3%). This points to a future China where, as they develop new capabilities and more sophisticated products, they will likely become less reliant on foreign imports.

China recently celebrated the 70th anniversary of the founding of the People's Republic with a spectacle meant to demonstrate its enormous growth in prosperity. Since 1949, average life expectancy has soared from 40 to 75; 21,000 people went to college that year while in 2018 that number was in excess of 7.5 million. Since 1990 alone, GDP per capita has climbed from less than $500 to more than $9,000, lifting hundreds of millions of people out of poverty. When you go from these statistics to this next one, the observation that the "future has arrived faster than expected" is illustrative: Chinese mobile payments spending exceeds the U.S. by a ratio of 50 to 1.

This is alarming for U.S. multinational profit potential. According to the "GDP accounts at the Federal Reserve" (we will spare you how that sausage is made), U.S. corporate profits rose $130 billion from the end of 2015 through 3Q 2019 with the entire gain accounted for by higher foreign earnings. However implausible as it seems, this means that domestic economic profits have gone nowhere in four years. This is not a ringing endorsement for the U.S.A. to attract companies needing to adjust capacity or supply lines while looking for low tariff, more predictable economic policies. This is a problem with no good solution.

But still we wonder if we ever see the other side of China's growth story. Just as it had an outsized effect on global GDP on the way up, it will likely be a major drag on the way down. With this thought in mind, and Q4'19 at its close, we launch into our observations and anecdotes obtained from this, our fourth and last quarterly trip **West of the Hudson**™ in 2019.

- China, Inc.

We tend to make this trip at the same time of year and happened to be in-country for the 2016 presidential election (and began our letter that year discussing the sudden apprehension borne of the outcome). One year later we noted that the unease of the year prior had metastasized into a more robust anxiety that persisted through the 2018 visit as well. It was notable that this sense of vulnerability and dependence is no longer apparent, and has progressed into a steely resolve that "we can do this".

This change in attitude was made apparent by our mainland-based acquaintances when we made the gaffe of seeking their thoughts on a "phase one" trade deal. The common refrain -- "*Soybeans? You think we care about the source of soybeans?*" -- made us realize that this first step towards detente had *nothing* to do with China and *everything* to do with the president's domestic agrarian vote. Raising the issue was treated as impolite as the scope of this deal is tantamount to having achieved nothing, and fails to address the real issues of tariffs, sovereignty, and a "seat at the table" of the rules-bound international order.

And yet, it's hard not to see a relationship between the Chinese resolve we noted and how easily the U.S. capitulated on the issues central to its trade offensive (technology transfers, IP theft, limited market access, regulatory favoritism) and settled merely on farming products that China needs regardless. The administration's coercive strategy is also at play in this stiffening, confident posture. It's a policy which explicitly assumes that, if subjected to enough pressure, China will capitulate. But as career diplomat Ambassador Chas Freeman points out, "(the administration's) maximum pressure tactics have fostered recalcitrance and countermeasures rather than accommodation on the part of every country to which they have been applied". (*A World Dividing*, Quincy Brief, November 2019)

Chinese resolve is also borne of this fact: for all the noise about how the U.S. is "winning" the trade war, exports are a fraction of China's economy. Since 2015, domestic consumption contributed more than 60% of total GDP growth in 11 of 16 quarters. And, in 2017 and 2018, ~76% of GDP growth came from domestic consumption. Meanwhile, China has become the world's biggest market for online retail and represents more than 30% of global market in luxury goods, automobiles, consumer appliances, mobile phones, and spirits (McKinsey, The Chinese Luxury Consumer, August 2019).

Looking ahead, it's hard not to consider this confidence booster: in the two years since China announced its intent to lead the world in artificial intelligence (AI) by 2030, it has unleashed a formidable surge in research and discovery across biotech, smart manufacturing, autonomous and electric vehicles, and next-generation renewable energy**.** When it comes to emerging principals and applications of AI, as former Google chairman Eric Schmidt explained, "by 2020, China will have caught up (to the U.S.); by 2025, they will be better than us; and by 2030, they will dominate the industries of AI." This is no trivial matter. PricewaterhouseCoopers has projected AI's deployment will add ~$16 trillion to global GDP by 2030, with China projected to take home $7 trillion of that total and the U.S. closer to ~$4 trillion.

In a separate McKinsey analysis of 186 countries, China is the largest export destination for 33 countries and the largest source of imports for 65 other countries. And it has a disproportionately high impact on specific sectors, notably those with globally integrated technology chains and resource-exporting sectors. Concurrently, Chinese firms have attained global scale: as of 2018, there were 110 mainland China and Hong Kong companies on the Global Fortune 500 list, compared to 126 in the U.S. It is obvious that the relationship between China and the rest of the world is changing…and foreign businesses will need to adjust accordingly.

For now, a non-contentious, symbolic agreement has had the intended effect, which is to put a hold on further escalation, provide a modicum of *political* relief for both presidents, and *economic* relief for those caught in the crossfire (U.S. farmers lost income and Chinese consumers experienced soaring food inflation). However, given the risk of China being unable to live up to its considerable commitments and/or U.S. election season calculus to ratchet up the rhetoric, it will not mark the end of trade tensions

nor resolve the underlying drivers of the dispute, as they are incredibly complex and have yet to be truly addressed.

- The Substitution Effect

When evaluating Chinese economic growth, we tend to stick to local government data because it's at the provincial administration level that many of the of national economic policy mandates are implemented. These include leveraging state-owned enterprises (SOEs) to maintain stable employment; provide development stimulus; institute structural reforms; ensure credit gets to remote corners of the economy, etc. While multinational companies have their Beijing-based lobbyists, it is these local administrators that make the potential revenue growth available and represent the best route to new business.

The term substitution effect is classically applied to describe a decrease in sales for a product that can be attributed to consumers switching to cheaper alternatives when prices rise. In China the term is applicable to a switch to local alternatives -- not specifically because they are cheaper than foreign products and certainly not because they provide better products or services -- but simply because they are Chinese. We know this mentality as "Buy American".

Long before this trade war, China was pursuing policies with taglines including "indigenous innovation" and "civil-military fusion". Since the tariff conflict began, the Chinese president has made clear his desire to accelerate these efforts and make China self-sufficient, creating supply chains that are "autonomous, controllable, safe and effective". These marching orders are all the cover local governments need to make the trade down switch to local suppliers. We are not in a position to determine how widespread the practice has become but it will not likely subside -- which is significant as we shall see -- especially within the larger framework of a global slow-down in trade.

The top U.S. charge against China is the theft of intellectual property (IP). That China engages in rampant theft of intellectual property is a widely known fact we have discussed for years; however, despite White House protestations, IP theft is not a leading worry. In an article by journalist Fareed Zakaria, he cites a current survey of U.S. companies conducted by the US-China Business Council, which finds that IP protection ranks *sixth* on a list of pressing concerns (it was *second* in 2014) and that companies worry more about state funding of rival companies and delayed approval of product licenses. Why this shift from 2014? China created its first specialized courts to handle intellectual property cases in 2014 and, by 2015, foreign plaintiffs brought 63 cases to the Beijing Intellectual Property Court. The court ruled for the foreign firms in all 63. (*The New China Scare*, Foreign Affairs, January 2020)

So the question becomes, is China biased agianst to foreign companies? That's just one concern of those we spoke with. These aren't small companies, mind you, but large multinational companies -- a group once relied upon by China to attract capital and technology to bolster its growth. But it appears they are, incrementally, losing some leverage. The terms "challenging", "hesitant", "doubtful" were words used to describe the current environment. Substitution is not a new development (we discussed it's emergence in engineered products -- lower-value add companies -- in a 2015 letter), but that its been codified as a desired outcome by the Chinese president across the value-add chain is not a favorable policy turn for foreign operating companies. They (and we) can no longer assume foreign firms are favored simply because of their credentials, scale, or pedigree. This is not a minor development or passing trend.

- Decoupling

Walk through the aisle of any store in America while it may not be apparent, you're bound to see an array of products from companies that are moving U.S.-bound manufacturing out of China. Much of the components in Apple Air Pods, Google Pixel phones, and the Nintendo Switch are now made in Vietnam. Sony has moved operations to Thailand, while Samsung has shifted its production to Taiwan and Malaysia.

While some firms operating in China are transitioning to less contentious locales, most firms have not been stampeding for the exits. Among other sources of hesitation is a major uncertainty about where the president's ire might settle next. After all, China has not been the sole focus; the administration launched its trade war in 2018 with metals tariffs applied globally, and it's been ramping up pressure on dozens of countries since. The president's team claims that both the European Union and Vietnam are worse trade abusers than China, joining our neighbors, Canada and Mexico, as well as South Korea. We have recently revoked special trade privileges from Thailand -- similar to moves made against India and Turkey (threats against Indonesia and Kazakhstan remain). All told, the Peterson Institute estimates that we have imposed new restrictions on ~15% of U.S. international trade!

It really is no wonder relatively few firms are abandoning China as a manufacturing base altogether. Most companies that make things in China do so in part to ensure their ability to sell their products to Chinese consumers, who make up the world's second-largest consumer market. The reality is that moving operations is expensive, disruptive and time-consuming, and many firms are reluctant to do so without clear and lasting economic benefits. But even among those for whom relocating is worth the time and expense, there's still the issue of finding a suitable alternative to China, which is uniquely attractive as a well-oiled production machine.

We opened a letter in 2017 about the city of Shenzhen but we need to revisit it here. What was a fishing village just 40 years ago produces a mindboggling ~90% of the world's electronics today. Supercharged by hundreds of thousands of engineers, rapid prototyping technology, unparalleled supply chain flexibility, and sheer scale, Shenzhen is the go-to city for businesses building robots, drones, smart sensors, and wearable technology. As scientist and venture capitalist Dr. Kai-Fu Lee explains:

> Hardware entrepreneurs claim a week spent working in Shenzhen is equivalent to a month in the United States. With seemingly infinite electronic parts and manufacturing talent at ready disposal, hardware-based companies in Shenzhen have a remarkable advantage. Choose from thousands of versions of circuit boards, LEDs, microchips, sensors, mini cameras, microphones, and crystal oscillators, on the spot, at any of the city's countless electronics markets. Buyable in bulk and at extraordinarily low cost, engineering parts get turned into prototypes practically overnight, thanks to a force of world-class engineers unlike any other concentration of inventors on the planet. And with access to hundreds of factories capable of turning product batches from prototypes in a few days, startups in Shenzhen have a much higher iteration rate than their Western counterparts. This means innovating on an idea with significantly less delay.
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> -- *AI Superpower: China, Silicon Valley, and the New World Order*, 2018

As we note above, two years ago, China's government issued its plan to make China the global center of AI innovation. And as we also note, when the State Council speaks, *everyone listens*. Already there are 30 different cities and provinces investing in AI-driven city infrastructure and policy centered around autonomous vehicles, smart solar panel-embedded roads, and computer vision-geared infrastructure.

There is always a "yeah but" moment and this is it -- the Achilles heel of the "we can do this" resolve. In a word: semiconductors. China is the world's largest consumer of semiconductors, accounting for 60% of global demand. But it produces only about 16% of semiconductors used domestically, and only half of these are made by Chinese firms (Center for Strategic and International Studies, 2019). Beijing's goal to increase this to 40% by 2020 and to 70% by 2025 is not only difficult, but likely impossible to achieve. It will take many decades. China intends to end this dependence to be sure but, despite forty years of investment and espionage, it is unable to make advanced semiconductors. For now, they must remain dependent on foreign suppliers. How fast they are able to produce chips capable of handling today's workloads will determine how aggressively they can pursue their other interests on the world stage.

Given the concentration of global tech manufacturing expertise, the practicality of decoupling from China is hard to fathom in today's highly dependent and integrated world, and that benefits China's position.

And yet, given the barriers to entry that advanced semiconductor development and manufacturing present, China's timeline and resolve must be tempered.

- From Free-Trade to Managed-Trade

American policy toward international commerce has pivoted markedly over the past year with the administration forcing itself into a pivotal position as it seeks to cast aside existing trade agreements and take control of commercial cross-border transactions. The irony of course is they are imposing state-to-state procurement transactions, which is one of the *top charges* levied by the administration on China that has led to this point in time! Whether an arranged agricultural deal, or the demands made via the NAFTA 2.0 deal on American-made auto components, these actions reflect the president's aspiration for state control of the U.S. economy. Call it "Socialism with American characteristics".

Despite the president's demand that companies re-shore production and only hire American, it will not likely counter the powerful forces that underpin globalization. As we have already discussed, corporations with large fixed investments globally will not reconfigure their supply chains very quickly and will surely want to hedge their bets that any policy changes are durable and long-lasting. China's greatest advantage comes from its sheer size, and companies who want access and are willing to make concessions to get it.

The path forward is worrisome for the U.S. economy, businesses, and consumers. Despite the American origins of the World Trade Organization (WTO) and its role in reinforcing U.S. economic primacy, the administration rejects these institutions as constraints on its "America First" policies. This is a major blow to the so-called "rules-bound international order" that the U.S. spent the last century promoting, usually for its own gain. With the withdrawal of U.S. participation comes an erosion of U.S. primacy in the governance of international trade and finance. And ironically, it creates a vacuum that draws China in, allowing it to expand its role and elevate its status (file this under the laws on unintended consequences!).

In 2018, average U.S. tariffs on Chinese goods were 3%. They are now 21%. In response, China has raised tariffs on U.S. goods while lowering them on imports from America's competitors. Looking ahead, fake free-markets will cause the world's multinational corporations -- many of them American -- to protect themselves against government-imposed interruptions in trade or the sudden imposition of tariffs. This means they must produce or source each component for their products in more than one country -- and preferably more than two.

Such diversification poses severe management challenges: it inflicts undue costs and adds to the complexity of supply chains, most likely impacting profits (which are often derived from leveraging the comparative advantages of its sourcing). As companies diversify their supply chains, they will favor countries that offer low/no tariffs and more predictable economic policies. The U.S. is currently not doing any of these things and, as a result, companies are not relocating production here. The president intends to cripple the WTO. In time, this is likely to drive countries that remain devoted to free trade to organize their own collectively sponsored parallel version of the WTO -- a body in which the U.S. cannot block the majority -- raising the prospects of a global trade body from which the U.S. has excluded itself.

- Hong Kong

At the risk of running a little long, Hong Kong is near and dear to our hearts and we couldn't wrap this letter up without comment because without the courage of our friends, we would not have made the trip. To begin, it is inescapable that what we think of as Hong Kong's trifecta of optimism, opportunity, and outlook as *the* Asian financial center -- has irrevocably been lost. Life goes on despite the unrest, and our acquaintances and their families go about their daily lives without incident. But what was a collective kumbaya moment of millions was lost as a small minority of protesters turned violent, as anti-China sentiment increased, mainlanders physically attacked, and China-linked businesses repeatedly vandalized.

Across the city, ATMs are boarded up, traffic lights broken and the always remarkable and reliable MTR subway a little less so. Social outings are curtailed, special events canceled, and plans shelved. Some weeks, schools have closed. Retail and food/beverages workers have lost jobs to dying nightlife and slowing commerce. And, perhaps familiar to westerners lately, political arguments darken family dinners. As one friend opined, “the underlying situation is deeply distressing and it is hard to see an imminent resolution to what is only partly an economic problem. The social fissures are just too wide, and the sovereign's instincts are not good”.

According to the latest figures released by the Hong Kong Tourism Board, visitors -- the lifeblood of the city’s GDP, has declined 56% YoY. Retail sales have plummeted, with brands reporting sales declines of up to 45%. Luxury sales in Hong Kong are driven mainly by international travelers, and visitors from China alone account for up to 70% of purchases. Mainlanders are no longer visiting.

For many luxury brands, Hong Kong represents over 5% of global sales, which is a significant portion. One person we spoke with said that if the situation doesn’t improve, and if Chinese tourists shun the city in favor of other destinations, Hong Kong risks becoming “just like any other second or third-tier city in China” (for those with a score card, Hangzhou, Wuhan, and Chengdu are considered second-tier cities while Fuzhou, Harbin, and Zhengzhou are designated as third-tier cities). That was, until recently, *inconceivable*.

While Hong Kong’s economic importance to the mainland has gradually diminished with the rise of special economic zones like Shenzhen and Shanghai, Hong Kong will remain an indispensable gateway for international capital inflows, attaching steep costs to any move by Beijing that erodes Hong Kong’s reputation as a relatively stable and transparent place to do business. But uncertainty prevails.

- Conclusion

The U.S. is in competition with China -- that is a fact and will remain so for many years to come. The issue is whether the U.S. should compete within the stable international framework we established to our benefit and continue to work to integrate China, or attempt to isolate it at all costs. A fractured, bifurcated international order, marked by government restrictions and taxes on trade, technology, and travel, would result in diminished prosperity, and persistent geopolitical instability.

Regardless of where this trade road terminates, we end with what we believe is a most disturbing bullet-point: the hard-earned, unquestioned faith in America as a reliable and trustworthy partner has been quickly turned on its head. The new terms applied by our Chinese hosts to describe the relationship with the U.S. have flipped to “unreliable” and “untrustworthy” -- signifying how quickly seventy-plus years of statesmanship have been wrecked. For anyone not perturbed by this change in discourse has not been paying attention to what made America great.

The U.S. is acting as though it can win a competition with China by keeping China down, rather than raising its own game. It turns out that trade wars are not “easy to win”. Like other wars, their outcomes are uncertain. Nor are they without long-term consequences and casualties.

From our families to yours, we wish you all a peaceful and prosperous 2020.

Yours truly,

Hirschel B. Abelson
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