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Dear Clients:

We recently made our annual sojourn to China's eastern shores, spending time in and around Shanghai, Hangzhou, Shenzhen, and Hong Kong. Whereas we had purposely planned last year's trip to coincide with the U.S. election (a communist backdrop is a wonderful way to celebrate democracy), this trip was planned without knowing the U.S. president would be making his first official state visit.

Considering the administration's stated position on bilateral trade with China, the coincidence was lucky. One year ago, the president's election roused local anxieties over the future of trade in this heavily mercantilist region of the world. But it is now one year later and the administration has not imposed changes, so the status quo remains and the apprehension has subsided. It is naïve to think we won't see activity on this front soon but China's economic engine is increasingly less reliant on foreign trade as domestic consumption expands. And, despite the initial emotion after the election the trade leverage the U.S. once held has lost some of its bite.

The timing of this state visit was curious and was scheduled to follow the "19th Party Congress" meeting where Chinese President Xi solidified his hold on power. The proceedings were a decisive validation of Xi's control that granted him a level of status and authority unmatched by *any* Chinese political figure since Chairman Mao himself. To be able to immediately project this authority to the Chinese people and the international community by having the world's most powerful leader at his side was astonishing. Every photo op was staged to look as if the president supported China's autocratic rule, underwriting Xi's narrative of an ascendant China. It was one of those "you had to see it to believe it" moments.

In his grand work on world history, philosopher Wilhelm Hegel described a China that lay "outside the world's history" and "appeared to have no connection with the outer world", a "provincial backwater, self-absorbed and primitive" (*Lectures on the Philosophy of History*, 1837). Today, just forty years after Mao's death, China is the world's second-largest economy and an economic force to be reckoned with. Western investors we interface with are skeptical and tend to focus on high-frequency economic minutia -- the explosion in debt, capital structure, outflows, slack regulation, etc. -- and deride China's economy as a house of cards. The U.S. government however is focused on the weighty and profound demand by China that it be treated as a "market economy" (under global trade rules set out in its 2001 admittance to the World Trade Organization (WTO)). The stakes are high as the U.S. can continue to impose high duties on Chinese imports on the theory that distortions from state intervention give Chinese producers an unfair advantage. State support is officially verboten and a breach of these same WTO rules. The charges, and the U.S. effort to address them and China to abide by them, are *decades*-old. But China's announced plans for total manufacturing domination within a decade (really) adds urgency and makes China's continued breach of fair competition impossible to ignore. How we manage this is critical.

Considering the expected protectionist environment and trade tit-for-tat, the results of this challenge are in focus. The conversations we had (typically) covered a wide range of subjects, but one dominated -- the shape of new rules governing trade. As we consider our observations and anecdotes from this last quarterly trip **West of the Hudson**™ of 2017, we cover the implications of China's rapid climb to the top, where they are headed in the coming years, and if/how the changing geopolitical backdrop impacts our multi-decades-long thesis on investing in China's growth through U.S.-domiciled companies.

- Yesterday: Decay and Fragmentation

In *The Grand Chessboard*, Zbigniew Brzezinski (U.S. national security adviser to President Carter) argued that the task of U.S. leaders is to manage the conflicts and relationships in Europe, Asia, and the Middle East "so that no rival superpower arises to threaten our interests or well-being". The relevant China passage is his succinct distillation of one thousand years of history where he describes China as "cycles of reunifications and expansions, followed by decay and fragmentations". This depiction captures the recurring struggle to unify a vast landmass the size of Europe under a centralized authority. Historically China took a narrow view of its "near-abroad" security. Its territory was immense and the four primary administrative zones were established by how many weeks it took a horse messenger to travel from the capital (Nanjing and later Beijing). Today, seventy years after its latest unification -- following more than two hundred and fifty years of fragmentation -- China has overcome its scale and emerged on the cusp of another period of expansion.

- Today: Expansion

Every five years, China holds an assembly where leaders of the vast Communist Party gather and debate policy direction (although as one of our friends notes, "to call it a *debate* is technically incorrect -- it is a forum for the leadership to dictate what it thinks, and what everyone else must do"). Just prior to our arrival, the "19th Party Congress" laid out the blueprint for the next five years.

Since taking power in 2012, President Xi has steadily consolidated his power over China's political, economic and military affairs. The head of the world's largest authoritarian state walks with swagger. His grip on China is tighter than any leader's since Mao and, whereas Chairman Mao's China was chaotic and miserably poor, Xi's China is both a dominant force and a top beneficiary of globalization. China is big and getting bigger. With a GDP of US$11.2 trillion, it is the world's second-largest economy, has the second-largest stock market, and will also soon have the world's largest middle class (McKinsey & Co., November 2017). Its policy goals are well known: reduce its reliance on exports; increase domestic consumption; boost its service industries and move up the value-added chain. They are well on their way, as domestic economic output has surpassed export manufacturing output and consumption has exploded. We are told to expect household consumption to grow *exponentially* as the country's high savings ratio (a whopping ~45% of GDP) is drawn down, fueling expansion across all areas including basic goods, housing, education, healthcare, technology, travel and tourism (The Churchouse Letter, November 2017).

The growing scale of the domestic economy is only part of the expansion. Another aspect is its full embrace of globalization and the slow economic absorption of its neighbors. With its much-publicized "One Belt One Road" industrial initiative, China is currently developing infrastructure across SIXTY countries, with strategic interests across huge swathes of Africa, Central Asia and Eastern Europe. Collectively, these "OBOR" relationships account for one-third of global GDP and ~60% of the global population (Stansberry Research, November 2017). Literally hundreds of billions of dollars of Chinese money are being spent on foreign railways, ports, power stations and other infrastructure that buy them long-term access to these markets and, importantly, a high degree of inoculation from western influence.

It was stressed to us that the scale of this infrastructure outreach and attendant influence has not been seen since the U.S. brought the Marshall Plan to Western Europe in the 1940s. And, these investments are unfolding just as the U.S. turns inward, so China's economic heft and reach are becoming ever more central to the world economy. We will return to the scale and implications of China's game plan in a moment, but first a word on trade -- as the trade charges levied by the U.S. are legitimate, even if the message has become overtaken by the messenger.

- Rules and Principles of Trade

Chinese expansionism is state policy and is not occurring in a vacuum. It is ambitious and dictates that its economy move on from serving as the world's low-value-add "factory floor" to building the world's most advanced, competitive, high value-add economy *within a decade*. The industrial policy roadmap -- *Made in China 2025* -- targets virtually all high-tech industries: automotive, aviation, machinery, robotics, maritime, railway, electric vehicles, medical devices and information technology. This is more than a proverbial shot

across the bow and challenges the primacy of Western economies and corporations. It is a formidable agenda…one that the U.S. insists cannot be achieved if China obeys the rules of trade.

Thinking back over the years we have visited U.S. business operations in China, the anecdotes detailing intellectual property transfers are the most memorable because they are frequent and egregious. The U.S. position on Chinese trade practices spans decades and maintains that China "does not abide by the principles and rules of open markets and fair competition." This includes "the forced transfer of technology and intellectual property from foreign corporations seeking market access"; "local policies that make it difficult for foreign corporations to establish market-based terms"; "domestic access to state funds to acquire foreign assets to gain technology and intellectual property"; and "state-sponsored cyber-theft of intellectual property and trade secrets." These charges are established and well-documented and it is hard to imagine that the WTO grants China the desired, tariff-busting, "market economy" designation under the prevailing conditions.

Maintaining the ground rules of trade is commonsense -- the U.S. is in the crosshairs of Chinese ambitions and it is an absolute imperative that we work to level the playing field for market access amidst the mounting competition. But the worry of businesses we visited is two-fold: 1) that the rules may damage their existing business activities and supply chains, and 2) that they may be cut off and no longer have a voice in trade relations. The delay in new rules is an understandable source of frustration. The administration has scrambled to square their stated policy objective on trade agreements (America First) against the economic facts supporting world trade. Rather than simply argue the case for fair and open trade they have chosen instead to promote the idea that, despite the immense benefit global trade has provided the U.S. economy, we "should have done better." Should 2018 bring robust, punitive, actionable rules against China specifically and our other large trade partners in general (Canada, Mexico), calculating the enormity of the value at stake over time is near impossible. As a reminder, when China joined the WTO in 2001, U.S. GDP was $10.7 trillion. U.S. GDP is now $19.5 trillion -- 82% larger -- with a population roughly the same size. This trade relationship with China is nevertheless described as a "menace" to American prosperity.

China's model has indeed been to subsidize its growth. And the U.S. is right to argue that it needs to play fair. But the thesis that a decline in U.S. manufacturing and China's ascension are two sides of the same coin is tired and dogmatic. If there is one overarching reason for the imbalance in trade, it's that China's heavy investment in its "factory floor" initiative has led to gross overcapacity in manufacturing that inevitably devalued whatever its workers produced. There are hundreds of millions of Chinese workers who are approaching a similar level of productivity as their Western counterparts. This phenomenon has dampened wages, prolonged the deflationary pull, and pressured governments to "do something".

One person provided a comment that perfectly summarized his anxious view of trade relations: "your president has never been accused of running a surplus in predictability". The problem is that global companies care less about what the rules are than whether the rules are stable and predictable. While no strategic direction was offered, the president did deliver a new term -- *Indo-Pacific* -- which vaguely indicates a broadening of the traditional *Asia-Pacific*. Arthur Kroeber described the term as "second-hand rhetoric wrapped around a strategic vacuum…the phrase is disconnected from any proposed policy or institutional architecture". (GaveKal, 7 November 2017). For global companies seeking to divine what the new trade rules might be, ambiguity has become a seemingly permanent state of affairs.

- Consumption with Chinese Characteristics

For those of you who wonder why hundreds of international companies would bend over backwards to gain a foothold in China despite the barriers to entry, this is for you. Just over the border from Hong Kong is Shenzhen, a city we have frequented over the years that continues to get bigger and more cosmopolitan. Our host on this excursion mentioned that just 30 years ago Shenzhen was a minor outpost with a few hundred thousand people. Like the rest of China, they wore traditional Chairman Mao suits and bicycles were the primary means of transportation. Today, Shenzhen is a city of twelve million people and the epi-center of a vast manufacturing zone. Mao suits have given way to designer gear, and bicycles have been replaced by BMWs. Like many Chinese cities, Shenzhen is the result of the most significant trend of all -- a great migration -- as millions of people rise up to join the middle class, they're packing up from the fields, moving into cities, gaining steady work, and growing their savings as well as their disposable income.

According to one consumer-facing investor we saw, not so many years ago China was a country where just 18% of the people lived in cities. Today 58% of the people do. China then was a country where less than 3% of urban dwellers could be described as middle class. Today, 76% of urban dwellers fit that category. Digging in deeper, at the end of 2015, China's middle class was around 150 million people (11% of the population) -- larger than the U.S. middle class population (120 million). But in just three years from now, approximately 200 million *more* Chinese will have been elevated into the middle class (26% of its population) (McKinsey & Co., November 2017). Just think about that...think about the forces of demand that 350 million people represent. Now try and imagine this: by 2022 the Chinese middle class will have shot up *again* - accommodating around 550 million people (40% of its population). Putting this in context, the Credit Suisse 2017 Global Wealth Report forecasts that by 2022 the total middle-income population of the world will be about 1.1 billion people. If so, this means that in just a few years' time, 50% of the world's middle class will be Chinese.

If you are looking for evidence that these Chinese consumers are confident, look no further than the one-day online-sales phenomenon known as Singles Day, which falls annually on November 11 (hence 11-11). The idea has morphed from a day dedicated to lonely singles to the world's largest e-commerce event. With $25 billion in sales, Singles Day 2017 easily bested last year's sales by close to 40% -- larger than Black Friday and Cyber Monday combined. This phenomenon underlines the trend (one we are able to quantify in our research on consumer goods and healthcare products) that increasingly, consumers are earning more money and are spending that money on a wider variety of higher-quality and pricier goods than ever before.

The past decade has been defined by Chinese consumers' strong taste for iconic Western brands including Nike, Rolex, Louis Vuitton, McDonalds, Starbucks, and Disney. While many of these Western brands have continued to adapt, grow, and maintain their importance (the lines at Starbucks and the latest Marvel movies are immense), we learned that today's consumer brings an increasingly organized approach to consumption that is "a sure sign of the maturation and shopper savvy" (as one person noted).

What is notable -- and it astounds us to write this after so many years -- is that Chinese brands have become credible, dependable competitors. After years of minimal local competition, Western brands must now fight for shelf space. This is incredibly relevant -- the U.S. consumer packaged goods sector was never going to compete on price but they brought the quality and dependability that defines Western aspirational brands and that was enough. Local producers have caught up in certain industries and, with the headwinds of state favoritism, the path to the checkout line is no longer wide open for Western brands.

- Tomorrow: Made in China 2025

China is unique in the scale and breadth of its industrial policy. The government spent years focused on modernizing what it considered nine traditional industries, including shipbuilding, steelmaking and chemicals. Then in 2010, seven additional strategic industries were added, including alternative energy and biotechnology. China broadened further its strategic playbook in 2015 -- via its *Made in China 2025* policy -- stressing ten additional sectors including aerospace, new materials, and agricultural equipment.

China's industrial masterplan aims to turn the country into a manufacturing superpower within a decade and, as we have noted, the policy challenges the economic primacy of Western economies and corporations. According to the mammoth *Mercator Institute for China Studies* report (2017), the strategy stresses terms like "indigenous innovations" and "self-sufficiency" and intends to increase the domestic market share of Chinese suppliers for "basic core components and core materials" to 70%. These include benchmarks for certain industries including 40% of mobile phone chips, 70% of industrial robots, and 80% of renewable energy equipment.

These announced targets are far-beyond Chinese manufacturers' current market share and begs the question *how* exactly China will gap up from here? This logically steers us back to the dispute over trade practices and the degree of government involvement. What exactly does "state support" look like? A good example was provided as we traveled by rail from Shanghai to Hangzhou. China holds the record for the fastest long-distance bullet train (220mph between Beijing and Shanghai). We are told this is a "triumph of engineering"

but the real answer is closer to "industrial policy". China's high-speed train program is only a decade old and yet the country has built 12,500 miles of track -- more than the rest of the world combined. This system could not have been built without a strong government, which is said to have provided funds for land and rail, subsidies for equipment-makers, and *incentives* for foreign companies to share commercial secrets (France's Alstom was absolutely fleeced). Setting aside the notion of "fairness", rail is a prime example of the government's prowess at identifying priority industries and deploying money and policy tools to nurture them.

China has emerged as a formidable industrial competitor and, while we might show disdain for its methodologies, the "America First" tagline does little to address China's plans to simultaneously ascend to positions of dominance in multiple strategic industries.

- Taking the Lead on Going Green

This would normally be included in the above discussion but China is well known to have a major ecological problem -- a disaster really – and deserved its own section. While the results on the ground (and in the sea and air) remain catastrophic, environmental regulation emerged as one of the first targets in Xi's campaign to assert his authority. Skipping ahead a few years, a September 2017 headline from The Economist, "*China Moves Towards Banning the Internal Combustion Engine*", was met with widespread derision. But Xi has put the environment near the top of the list of state priorities (the Ministry of Environmental Protection is now a national agency). In contrast to the U.S. administration's dissenting positions on all environmental issues, environmental controls and improvements have become *core policy* initiatives -- phasing out internal combustion vehicles, boosting production of electric cars and trucks, focusing on clean water, green energy/wind/solar/hydro, air pollution controls, waste treatment/management, food safety and security. No timeline for a combustion engine ban has been given, but that's beside the point -- China is simply far too big to lose out on. If China says no more fossil-fuel powered cars, global carmakers must follow. This initiative is not only testament to the critical mass the Chinese domestic market has attained, but is also another illustration of how they are stepping into the vacuum to assume global leadership.

- Investing Into a 2025 World

The scale of China's industrial plans will create enormous demand for smart manufacturing products like industrial robots, sensors, radio frequency identification chips, and wireless networks. And yet this transformation requires advanced technologies that Chinese suppliers are not yet able to provide. Some of the companies we saw were understandably excited because, in the short term, China's industrial upgrading should keep open the door to another leg of growth for the multinational companies.

However, we were warned that *Made in China 2025* is not an open-ended opportunity. China's modus operandi is to systematically intervene in its market and elevate local businesses. According to a few skeptics we know, the policy assumes that Chinese products are almost good enough to act as *substitutes* to foreign components. So in many industrial sectors and industries, foreign competition will continue to face barriers to market access and is therefore safe to assume that as its manufacturing capabilities mature, China could well *increase* its restrictions on market access.

- Conclusion

The 2025 timeline for Chinese domination seems *extremely* aggressive and, with America's long history of innovation and disruptive technologies; we remain well-positioned to ensure that China *does not* have free rein. But American leadership is focused elsewhere, choosing instead to polarize, attack the independence of democratic institutions, and dismiss international treaties. This reflects the choice of the voting American electorate but will likely 1) *slow* U.S. economic expansion and 2) *bolster* Chinese efforts to deepen its influence. It is hard to imagine economic prosperity as the cost of goods spirals.

A thousand years of data lend support to trade as a foundation of a nation's growth. China has taken this to heart and made clear that it is willing and able to replace the U.S. in potential trade arrangements (most notably the Trans-Pacific Partnership, but also two other proposed trade deals, the Regional Comprehensive

Economic Partnership and the Free Trade Area of the Asia-Pacific). These agreements will bind greater Asia tightly together -- only with China, not the U.S., as the glue.

In the aftermath of WWII, the American economy was the proverbial shining city on a hill. For seventy years, America has had one of the largest and most powerful economies -- largely by elevating an entire generation into the middle class, buttressed by the values and alliances that have underpinned American hegemony. China clearly sees this middle class roadmap as a means to supplant the U.S. Its remarkable economic transformation, and its trajectory from here, is simply impossible to ignore.

The question is; will U.S. companies remain in a position to participate in this phenomenal consumer expansion? The results, we think, are mixed. China has dictated which industries it champions, so the barriers to entry for those companies proffering the latest, emerging value-added products -- technology (consumer and industrial), biotechnology, electric transport, artificial intelligence, etc. -- will have a steep hill to climb. Those lower down the value-added chain already established in-country with the hard-won understanding to navigate the changing landscape (mostly but not entirely consumer-facing) have a longer runway for success.

Our multi-decade investment in the expansion of Chinese consumption remains intact. However, based on the developments in policy and rising barriers to entry, investors hoping to ride the formerly broad and vast wave of growth via U.S. domiciled corporations will find the opportunities to be fewer. Stock selection will require greater nuance on industry niche, value-added, competitive forces…and politicians.

We don't have a solution to Chinese trade practices nor the U.S. rejection of free trade. Simply demanding greater access to foreign markets does not address the vast technological advances that have strengthened the nation at the expense of those basic industries that have propped up America's middle class for so long. Further, levying punitive threats at U.S. corporations who do not commit "enough" capital to the economy -- with its lackluster growth, low productivity, and anemic wage growth -- is not inspiring. U.S. multinationals are the largest employers in the United States and are in the lead when it comes to investing in their businesses, and participating and promoting the American brand abroad. Putting these businesses -- employees and investors -- at risk through retributive coercion or trade threats has no good end.

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

Yours truly,

Hirschel B. Abelson
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