Maybe elephants can dance: a contrarian take on China

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Keen readers of business books may recall one penned by Louis Gerstner in 2008 titled, *Who says elephants can't dance: leading a great enterprise through dramatic change*, recounting his turnaround of IBM.

A company that was once the embodiment of American business supremacy found itself struggling with a dated culture causing it to miss out on the technology boom its competitors were enjoying. IBM was thought to be too big to change, until Gerstner showed otherwise.

In that same vein, questions are now being raised about China as its decades-long fixed asset investment driven model appears to have reached its limits and another shot of old-school stimulus that pours more capital into real estate and infrastructure is not the remedy. This explains why Beijing has not opened the fiscal taps despite some observers waiting for it to do so.

Moreover, the Xi Jinping-led Chinese Communist Party (CCP) is far more ideological than the one led by his post-Deng Xiaoping era predecessors, encapsulated by the declaration at the CCP's 19th National Congress in October 2017: "Party, government, military, civilian, and academic; east, west, south, north, and center, the Party leads everything."[1]

The 2020 crackdown on technology companies, private tutoring businesses, and wealthy celebrities, was a case of putting severely into action, words of intent.

All this, and more, has caused many China watchers to pour cold water over previous assumptions about the inevitability of the Middle Kingdom surpassing the United States as the world's largest economy.

Like the old line about nothing in life being certain except death and taxes, there is nothing inevitable about China's future. Americans in the 1980s fretted about the Japanese economic juggernaut and we know how that played out!

Economy is better than feared

Our conclusion, for now, based on a research trip which included 33 company visits across China (as well as South Korea and Japan) is that the Chinese economy is better than feared. Admittedly, that is short of a ringing vote of confidence, but given the dominance of bearish views, it does go somewhat against the grain.

This note's focus is on structural themes and is thus not preoccupied with parsing every recent data point. Nevertheless, a few quick thoughts need to be voiced as they are consistent with our moderately against-the-grain conclusions.

The deep doldrums of China's residential property industry and potential knock-on effects have received a lot of media attention and so it is not insightful to just repeat well-worn headlines or namecheck embattled high profile property development companies.

Commercial housing sales in October fell a stunning 28.5% versus September, according to data from China's National Bureau of Statistics.[2] Despite thumping falls in sales volumes, Beijing has succeeded in engineering a soft-landing which has seen prices fall by around 5% (**Chart 1**, on next page) while managing to avoid a sector collapse, at least at this stage.

An upshot is the economy, measured by Gross Domestic Product, is likely to register around 5% growth over calendar 2023 and a touch above 4.5% over 2024[3] as policy makers seems to have pulled off a successful pivot from property to manufacturing with the automotive, shipbuilding and electronics industries faring far better, as well as consumer-related industries.

1 *The Party leads on everything. China's changing governance in Xi Jinping's new era.* Nis Grunberg, Katja Drinhausen, 24 September 2019, https://merics.org/en/report/party-leads-everything

2 *China's house of cards is falling and that might not be so bad for ASX iron ore.* Christian Edwards, 21 November 2023, https://stockhead.com.au/news/chinas-house-of-cards-is-falling-and-that-might-not-be-so-bad-for-asx-iron-ore/

3 *Move aside, China. India will drive Asia's growth in the next few years, S&P Global* says. Charmaine Jacob, 30 November 2023, https://www.cnbc.com/2023/12/01/india-not-china-will-lead-apac-growth-in-next-3-years-sp-global.html

Chart 1: Property bubble has been deflated, not smashed

Residential property prices for China

Source: Bank for International Settlements

That's the end of brief comments on the current state of the economy. On to the bigger picture.

Demographic winter is coming, but not for a while

There is no disputing that China faces profound structural headwinds with the demographic situation, arguably, topping the list. Recent studies, though, suggest the demographic winter is still a little way off. Until then, China will continue to possess a demographic advantage.

Associate Professor Qiao Jinzhong, a member of the Regional Education Branch of the Chinese Education Strategy Association, modelled the country's school age population with his work revealing that, "by at least 2035, six years after the peak of junior high school enrolment, there will still be a significant number of students entering the workforce."[4]

Today's labour supply is effectively set by birth rates 16 years ago and on that basis China's labour supply situation looks better than sometimes understood, at least to the end of this decade.

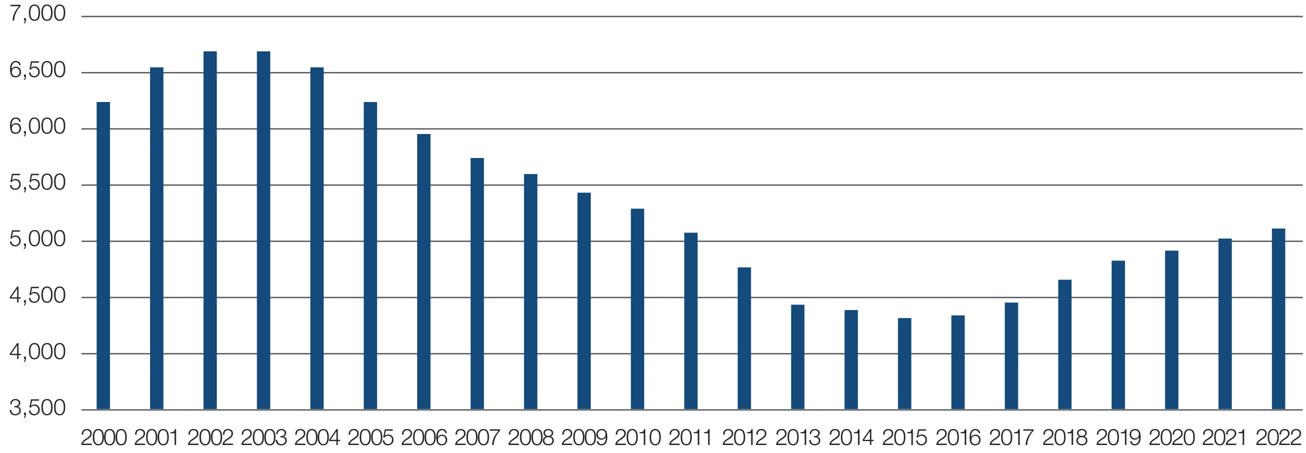
The number of junior high school students bottomed out in 2015, following a decade-long decline, and the numbers have picked up more recently, albeit below those in the first decade of the 21st century (**Chart 2**, on next page).

Finally, junior high school represents the final stage of China's nine-year compulsory education system and thus extrapolating from data leads to a conclusion of a workforce of rising numbers, at least over the next few years.

4 *Our contrarian view on China's demographics: the abundant supply of labor will help China maintain its low inflation advantage as wage costs drive prices higher in the developed world.* 13D Research and Strategy

Chart 2: High school population has been growing, again

Number of junior high school students in China (in ten thousand): 2000–2022



Source: Ministry of Education and 13D Research and Strategy

There has been quite a lot of commentary on the youth unemployment rate with recent analysis putting the number at 21.3%, the highest ever.[5] Unemployment is terrible for those looking for work, but the figures also imply that the inflation-driven labour shortages currently hitting Western countries is unlikely to be an issue in China, over the next few years.

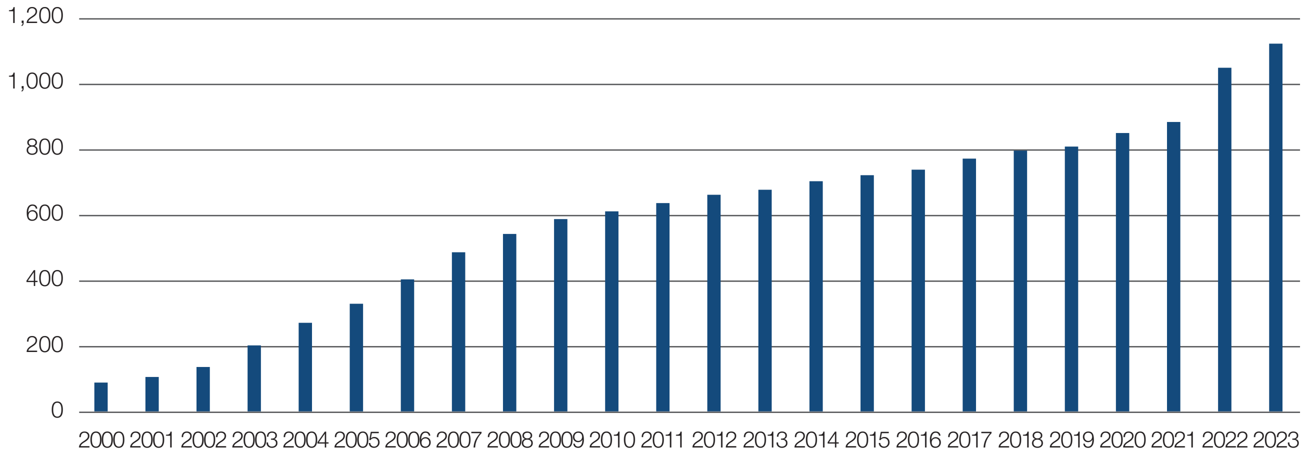
This should not be read as casually dismissing the human as well as political implications of such a level of youth unemployment. In fact, the government has become so perturbed it has stopped publishing official figures on the topic!

Leveraging growing university educated population

Alongside modestly growing high school student numbers are more upbeat trends on college graduates (**Chart 3**).

Chart 3: Rising number of college graduates

Number of college graduates (in ten thousand): 2000–2023



Source: Ministry of Education and 13D Research and Strategy

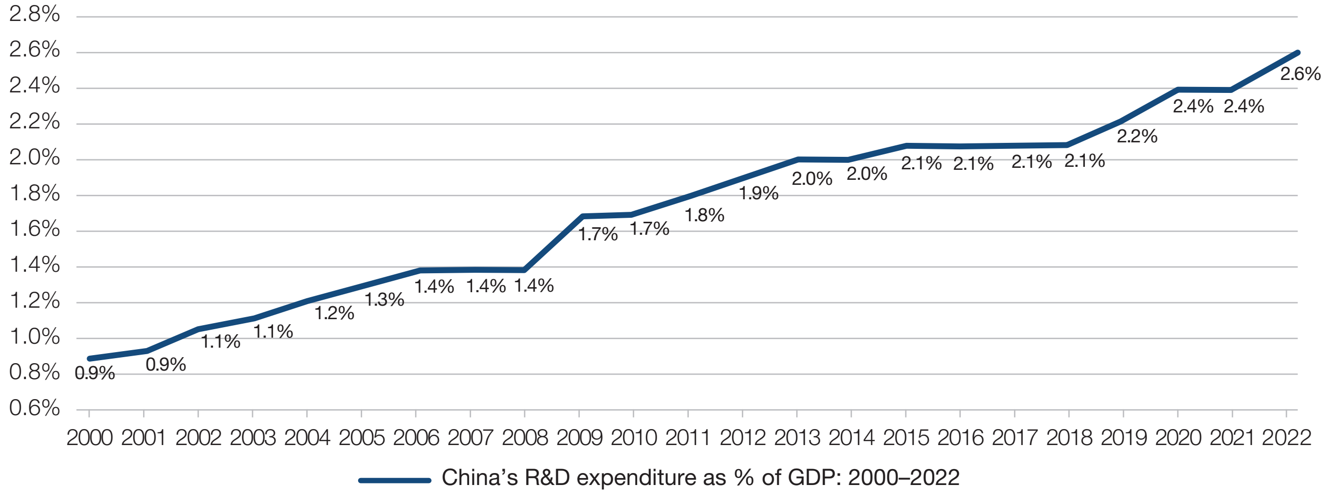
5 Ibid

The intellectual capital embodied by this well-educated cohort is obvious and Beijing is, amongst other things, leveraging this with a research and development (R&D) commitment that has grown steadily over the past two decades (**Chart 4**).

Unsurprisingly, China has the world's largest number of people devoted to R&D, an enviable human capital dividend that should potentially allow it to move up the global value chain.

Chart 4: A steadily growing R&D commitment

China's R&D expenditure as % of GDP: 2000–2022



Source: Ministry of Education and 13D Research and Strategy

A note of caution here: consistent with the conviction that very few things are inevitable, there is no guarantee the potential represented by this talent pool will be fully realised.

The danger of falling into the middle-income trap is real. According to the concept, a country in the middle-income trap loses its competitive edge in the export of manufactured goods owing to rising wages but is unable to keep up with developed economies in the high-value-added market.

Development economists would name Thailand, Malaysia and Argentina as countries shared by the middle-income trap while others like South Korea, Taiwan and Israel managed to progress from middle to high-income status.

A lot needs to go right in policy terms to make it into the ranks of the world's affluent nations and doubters may question whether China has the governance framework and institutions to facilitate the transition.

That said, the country's leadership does think truly long-term and is going to – in Australian vernacular – have a 'red hot go' within the context of a top-down, one-party state.

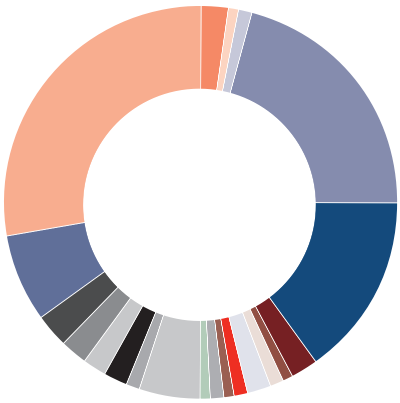
A high carbon dioxide emitter and renewable energy leader

Dominating the clean energy realm is one of China's economic ambitions. Success would mean high paying jobs for many more of its people as well as getting 'one over' the United States in a pivotal arena of 21st century economic competition with geo-strategic implications.

China emits about 28% of the world's carbon dioxide (CO^2), making it a leader in an activity no country wants to top: the United States is responsible for around 15% of global emissions (**Chart 5**).

Chart 5: By some distance the world's largest CO^2 emitter…

CO^2 emissions by country



Country	Percentage	Country	Percentage
China	28%	United Kingdom	1%
Indonesia	2%	Italy	1%
Australia	1%	Poland	1%
South Africa	1%	Russia	5%
Rest of World	21%	Turkey	1%
United States	15%	Iran	2%
Canada	2%	Saudi Arabia	2%
Mexico	1%	South Korea	2%
Brazil	1%	Japan	3%
Germany	2%	India	7%
France	1%		

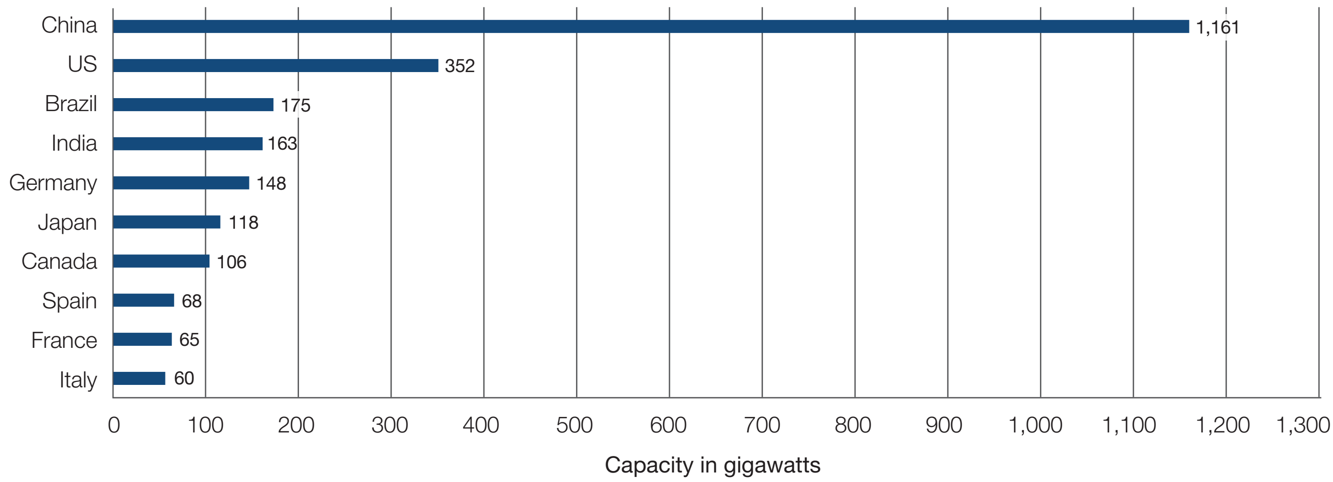
10 July 2023

Source: 8Billiontrees.com

However, China is not standing still and accepting the status quo. In fact, it is taking serious action to transition from the unwanted status of the world's CO^2 laggard to a renewable energy superpower with the country accounting for around 50% of the world's installed renewable energy capacity (**Chart 6**).

Chart 6: …but also a renewable energy leader

Installed renewable energy capacity worldwide, in gigawatts: 2022



Source: https://www.statista.com/statistics/267233/renewable-energy-capacity-worldwide-by-country

Furthermore, China is on to track to meet its 33% electricity consumption target from renewables by 2025 and may even exceed it amid ongoing efforts to debottleneck the power grid to accommodate more renewables.[6]

6 *China could exceed renewables generation target of 33% by 2025.* Ivy Yin, Eric Yep, S&P Global Commodity Insights, https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/energy-transition/092322-china-could-exceed-renewables-generation-target-of-33-by-2025

Dominating the clean-energy value chain

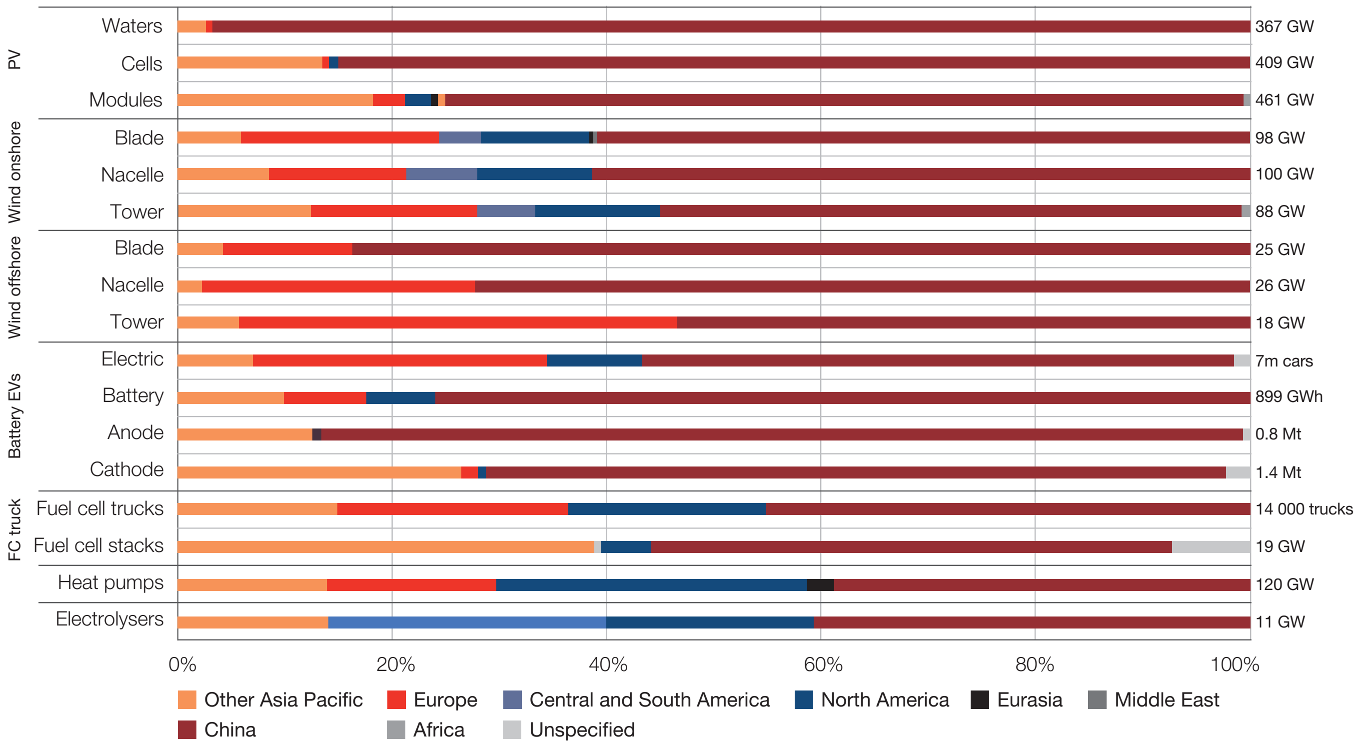
China's clean-energy heavyweight status is amplified by its dominance of value chains (**Chart 7**). The country accounts for around 60% of rare earth elements (REE) production and a towering 90% of refining of REEs.[7] In the solar industry, China is expected to hold more than more than 80% of the world's polysilicon, wafer, cell, and module manufacturing capacity from 2023 to 2026, according to Wood Mackenzie.[8]

China's massive domestic market, in concert with an unequivocal desire to dominate the clean-energy value chain means it enjoys economies of scale that will be very difficult for others to match with its solar manufacturing expansion driven by high margins for polysilicon, technology upgrades and for developing local manufacturing in overseas markets.[9] This dominance should enable it to widen the technology and cost gap with competitors.

Admittedly, governments in other geographies have been putting in place policies to increase local solar manufacturing, but they are still not cost-competitive compared to Chinese supply. A module made in China is 50% cheaper than one produced in Europe and 65% cheaper than the US.[10]

Chart 7: China's renewable energy dominance is clear

Regional shares of manufacturing capacity for selected mass-manufactured clean energy technologies and components: 2021



Source: International Energy Agency (IEA)

7 *Clean energy supply chains vulnerabilities: energy technology perspectives 2023*. https://www.iea.org/reports/energy-technology-perspectives-2023/clean-energy-supply-chains-vulnerabilities
8 *China to hold over 80% of global solar manufacturing capacity from 2023-26*. Wood Mackenzie news release, 7 November 2023, https://www.woodmac.com/press-releases/china-dominance-on-global-solar-supply-chain/
9 Ibid
10 Ibid

A word about electric vehicles

No discussion on the clean energy economy would be complete without commenting on the electric vehicle (EV) market.

In our view, the rapid progress of China's EV industry is very much the execution of a 'leapfrog strategy.'

China could have taken the long road against legacy automakers by mass-producing cost-competitive vehicles with incremental improvements in internal combustion engine efficiency and performance and move up the price-ladder over decades.

Instead, the emergence of EV and related battery technology is enabling Chinese automakers to compress the competitive timeline.

Back in 2009 Beijing gave EV adoption a leg-up by providing subsidies for buyers, encouraging local governments to purchase electric fleets, helping build charging infrastructure, and essentially creating a mass market years ahead of Europe or the United States.

At the same time, China quickly made itself the decisive player in EV-related raw materials markets, such as, lithium, cobalt, and manganese, leveraging that into a battery industry dominance that latecomers will struggle to replicate. We estimate that batteries account for around 15–25% of the cost of an EV, and so it does beg the question as to whether the game is almost over for legacy automakers.

The upshot, as summarised in a recent Morgan Stanley report, is that 90% of the EV battery supply chain relies on China.[11]

China is the world's electric vehicle leader, with 64% of total production and 59% of global EV sales in 2022, according to the World Economic Forum.[12] Additionally, one of its biggest EV producers, BYD, seems to be on track to displace Tesla as the world's top seller of electric cars.

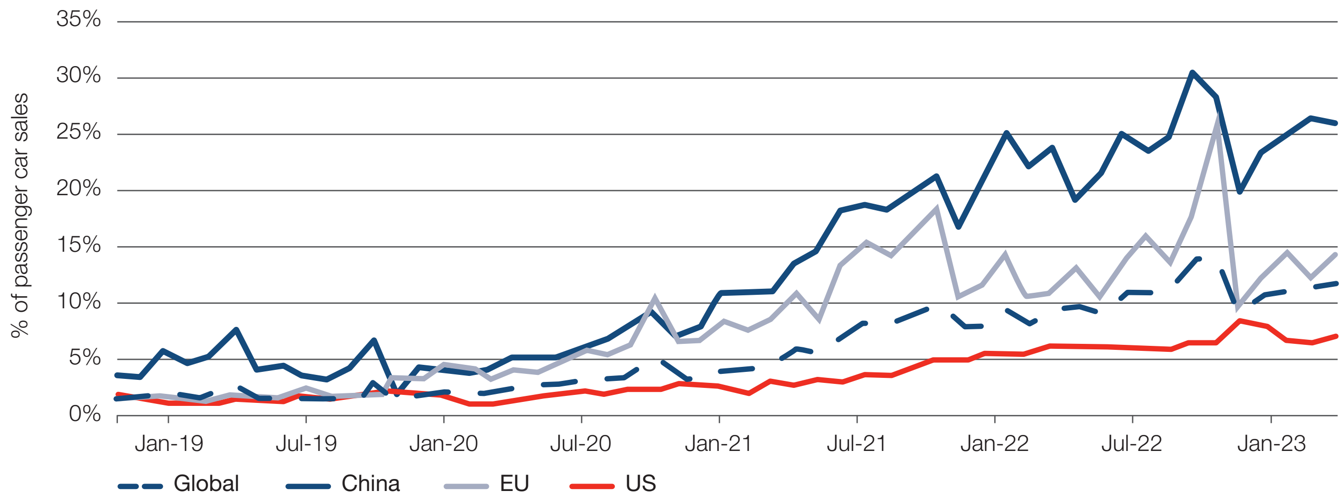
Incidentally, the late Charlie Munger, vice chairman of Berkshire Hathaway, the investment conglomerate controlled by Warren Buffet, described BYD's CEO Wang Chuanfu as "…a combination of Thomas Edison and Bill Gates."[13]

Electric vehicle sales in China as a percentage of all cars sold are some of the highest in the world at around 25% versus around 15% in Europe, 7% in the US, and around 12% globally (**Chart 8**). China ended its subsidy scheme for EV purchases in 2022 but some local authorities have continued to offer aid or tax rebates to attract investments as well as subsidies for consumers.

It also has an enviable EV-supporting ecosystem evidenced by the country having the world's largest charging infrastructure network with high-powered chargers roughly every 50 kilometres along major highways, helping drivers overcome 'range anxiety.'

Figure 8: EV penetration in China is higher than in Europe and US

Regional monthly battery EV penetration



Source: CPCA, Autodata, SMMT, KBA, OFV/insideEVs, CCFA, UNRAE, EU-Evs, Wood Mackenzie, data compiled by Goldman Sachs Investment Research

11 *Rewiring the supply chain for electric vehicle batteries*. Morgan Stanley Research, 7 July https://www.morganstanley.com/ideas/ev-battery-lithium-supply
12 *Electric vehicle sales leapt 55% in 2022 - here's where that growth was strongest*. Stefan Ellerbeck, World Economic Forum, 11 May 2023 https://www.weforum.org/agenda/2023/05/electric-vehicles-ev-sales-growth-2022/
13 *Warren Buffett Says These 4 CEOs Are Among the Best (Which Is Why He's Investing in Them)* https://byd-forklifts.com/inc-warren-buffett-says-these-4-ceos-are-among-the-best-which-is-why-hes-investing-in-them/

Early thoughts on investment implications

At first blush, our thoughts are that a number of Australian industries that have thrived on the back of strong China relationships and demand will continue to do so. Education services, agriculture, and food generally, as well as commodities pivotal to the clean energy transition, like copper, will likely remain highly sought after.

If that sounds a bit like 'the more things change, the more they stay the same', that's partly right. Investment themes don't usually 'turn on a dime' so it is unlikely we will see investors dropping assets related to every proven China-related industry and rushing to buy new ones.

Having said that, we do expect to see investors make gradual changes on the basis that China will remain a renewable energy leader. We will share our thinking in the months and years ahead as our China-related investment thesis evolves.

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