



Market Commentary: What Is Going on in China?

August 2023

The China - US relationship used to be quite simple: China produced anything and everything we wanted, cheaply and well-made. And we, the US consumer, purchased it. China continued to focus on efficiencies to drive prices down even lower, employing a specialization approach where whole regions focused only on certain items. At the same time, the US policed global waters and created incredible global supply chains, allowing for lean inventories and, importantly, for everyone to get what they wanted, when they wanted it, for cheap. China moved its population from agrarian, poor areas into urban areas at record pace, increasing wealth for the country as a whole.

Shanghai port:



That simple story is no longer. China “borrowed” some intellectual property (IP) along its journey in an attempt to speed up and upgrade to more complex and value-add product. It militarized. Its GDP gave it heft, becoming a competitor to the US. China’s most recent anti-business decrees by Xi Jinping, China’s leader, have made it evident that China does not operate on the core tenets of capitalism and democracy. The story is now quite complex, with an obvious negative bias coursing through the US public.

Clocking in at 1.4 billion people and an ~\$18 trillion GDP, good for second globally, one cannot afford to ignore China.

With the above in mind:

- How should one think about investing in China?

¹ [10 Major Ports In China \(marineinsight.com\)](https://www.marineinsight.com)

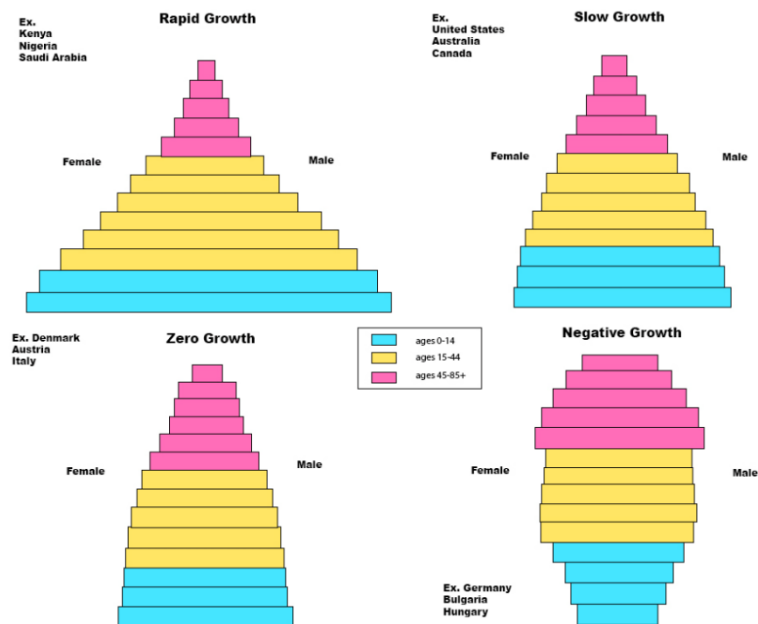




- How does China affect the global economy?
- Can China take the reins and dethrone the US as a global leader?

On a macro level, there are a number of warning signs to be aware of. China's demographics are scary, with its current fertility rate of 1.18², well below the necessary replacement levels. For context, the US has a fertility rate of ~1.8 and the general replacement rate is 2.1. Note that the US has the benefit of immigration in allowing it to surpass the replacement rate. China does not (currently). The UN middle of the road projection, which assumes that rate increases, is for its population to decline close to 10% over the next 25 years and 40% by 2100!³ This will place significant pressure on productivity, finances via a top-heavy population pyramid, and dire deflationary issues (e.g., housing). Its real estate sector continues to be under immense pressure due to some administrative reforms pushed through by Xi's administration and as evidenced by recent market concerns over potential defaults. And, due again to reforms by Xi's administration, the private technology sector has been decimated leading to a lack of faith in the country by entrepreneurs generally.

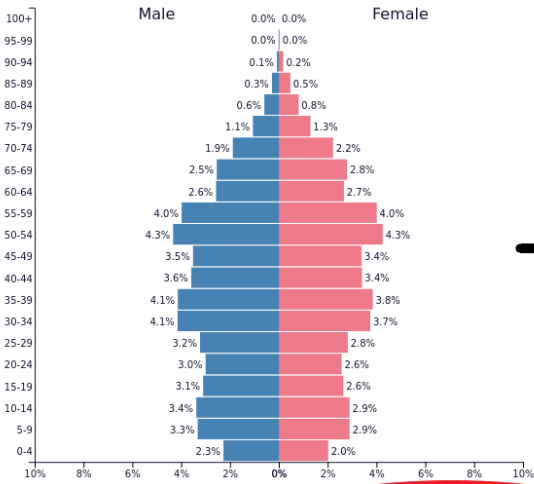
US is a "slow growth" pyramid while China is a Negative Growth one (note current and expected pyramid below) - which leads to additional resources necessary to support the elderly who are generally not productive (e.g., have jobs) or spending creating a stress on the smaller ratio of the working population and government.



² [Key facts about China's declining population | Pew Research Center](#)

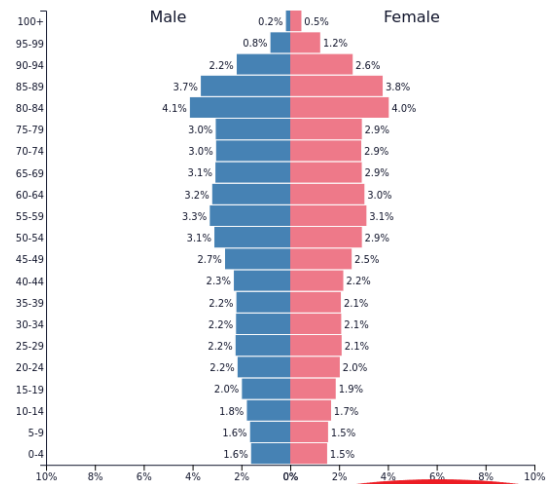
³ UN via Populationpyramids.net and Pew Research





PopulationPyramid.net

China - 2023
Population: **1,425,671,351**



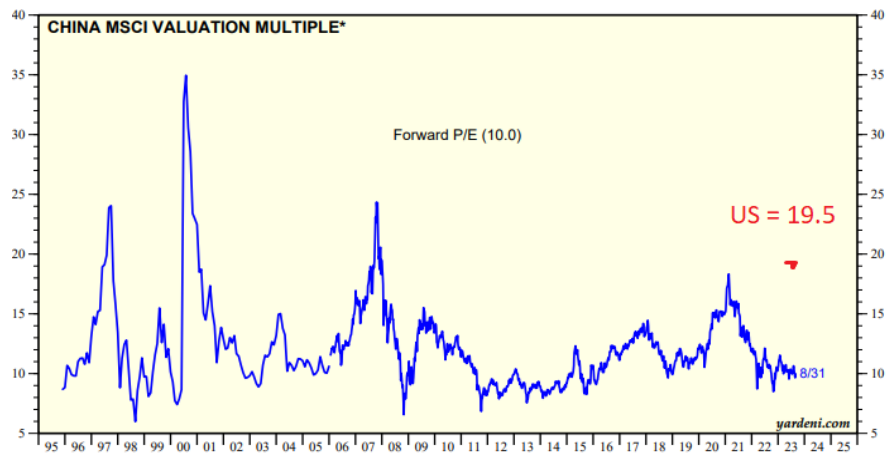
PopulationPyramid.net

China - 2100
Population: **766,673,270**

However, while the US economy is consumer driven, the Chinese economy is investment driven. And those investments have resulted in a clear lead in certain industries. For example, China spends 5x the US in renewable energy (2x the US and Europe combined), placing it in a good position to dominate energy for the foreseeable future⁴. It also has a train that can potentially go quicker than an airplane⁵. Clean, cheap energy and efficient transportation are great recipes for productivity and growth. Will China beat the US at innovation over the next 30 years?

Finally, from a valuation standpoint, China is as close to cheap as it gets. This is due to the macro stresses affecting it as summarized above, particularly when it comes to the heavy hand the government has taken with private business in certain sectors of the economy.

According to the MSCI All Cap World Index, a balanced global equity exposure to China is currently ~3%, a far cry from the country's actual place in the global economy. Regardless of how one feels about an investment in China, it is a mistake not to keep tabs on the second largest economy as well as the second most populous country in the world.



* Price divided by forward consensus expected earnings per share. Monthly data through December 2005, weekly thereafter. Source: I/B/E/S data by Refinitiv.

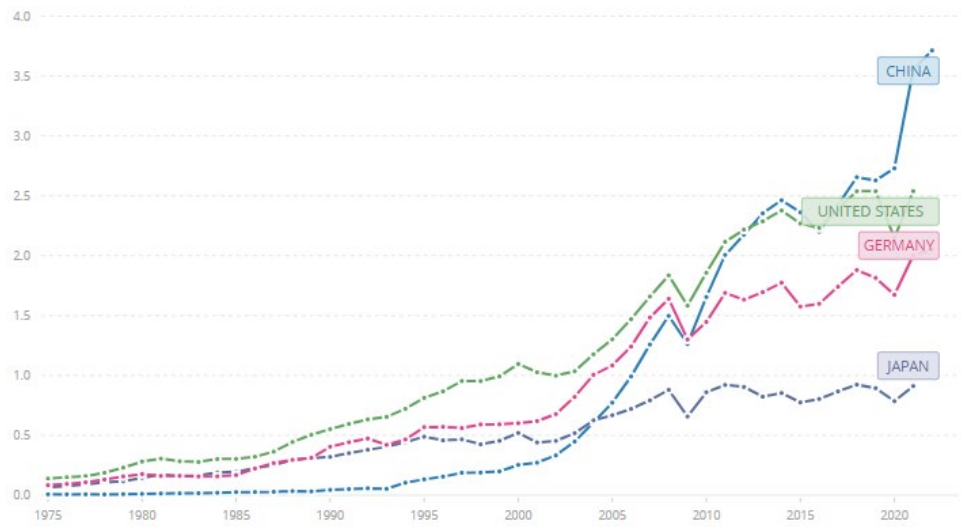
⁴ Ones and Tooze Podcast: China's Economic Crisis

⁵ [China debuts world's fastest Maglev train | CNN](https://www.cnn.com/2022/08/01/asia/china-maglev-train/index.html)





China continues to be the world's largest exporter of goods and services, with an export value of \$3.55 trillion in 2021 as compared to a US value of ~\$2.5 trillion⁶. While China continues to be the world's factory, the US has lowered their reliance on them as evident by both Canada and Mexico surpassing China in trade with the US in 2022⁷. We expect this trend to continue due to both the geopolitical environment as well as the lessons learned by international business during Covid, including a move away from simple efficiency to redundancy and risk mitigation.



Furthermore, China continues to innovate, resulting in the opportunity to export higher value products to the world. This sets up the potential for further friction with the US, which tends to focus on the higher end market from a complexity / specialization standpoint. For example, can China's EV production come to dominate the globe, placing pressure on both the US and German car manufacturing sectors? Or will all the investment China has made generally in renewable energy simply be a boon to world markets via cheaper access to energy than is currently feasible via oil and gas?

Geopolitically, China has embraced a different governing philosophy from the US since the Chinese Communist Revolution in 1949. They currently have a leader who is widely viewed as a strongman; have gone through a few especially tough years with respect to Covid; and have experienced a forced slowing of their real estate market and a crackdown of sorts on private technology companies. Unemployment among China's youth is likely above 20%,⁹ and its demographics, as mentioned, are stressed. China is at a crossroads. How the US and the Western world react to China and how China navigates both its own issues at home and its relationship abroad will have a material impact on world economies and markets.

⁶ The World Bank - [Data.worldbank.org](https://data.worldbank.org)

⁷ [Mexico seeks to solidify rank as top U.S. trade partner, push further past China - Dallasfed.org](https://dallasfed.org)

⁸ [Data.worldbank.org](https://data.worldbank.org)

⁹ [Charted: Youth Unemployment in the OECD and China \(visualcapitalist.com\)](https://visualcapitalist.com) - China has discontinued providing this statistic..



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