



# All Along the Clocktower

## VOLUME II – SPECIAL REPORT



## China's Three Traps & Macro Trilemma

### Key Takeaways:

- China is trapped by three factors: geography, demographics, and a decelerating rate of GDP growth that is likely to leave it languishing in a Middle-Income Trap.
- The three traps will force China to remain far more addicted to export-led growth and increasingly dependent on foreign capital than is assumed.
- To alleviate the pressure from its “traps,” China is pivoting away from the US developmental model and embracing “Rhine capitalism” of Germany.
- The German model offers China the hope that it can resolve its traps, boost productivity, and counter the geopolitical challenge of the US.
- Sectors we expect to outperform given this new strategic push are Green China Inc., the semiconductor supply chain, and China's very own *Mittelstand* (SMEs).
- Will China's pivot to the German model succeed? We don't know. But we do know that a highly leveraged economy facing a demographic downturn and pivoting to advanced manufacturing is highly unlikely to engage in geopolitical adventurism.
- China will remain trapped by its macro trilemma for much of this decade.
- Therein lies the irony of investing in China: One must believe that Chinese policymakers will remain constrained from pursuing their geopolitical ambition by domestic factors in order to continue profiting from onshore growth and innovation.

The US-China geopolitical confrontation will remain the decade's premier geopolitical risk. But what if this is a decade colored by political rather than geopolitical risks? This is a thesis we articulated in our decade forecast<sup>1</sup> and one that we believe has driven all the major macro inflection points this cycle: from the extraordinarily unorthodox fiscal and monetary pandemic response in the US to the ongoing domestic volatility in China.

Why should investors focus on domestic politics rather than geopolitics in a decade that has the makings of the very beginnings of the epic US-China rivalry? Global multipolarity will constrain both actors by creating a high cost of alliance building, our thesis since 2019<sup>2</sup> that has thus far proven quite salient.<sup>3</sup> In a world where no one or two countries are head and shoulders above the rest, creating "coalitions of the willing" for containment will be difficult. Investors should take note that America's global Huawei ban has flopped ignominiously, while its latest AUKUS alliance – intended to challenge China in the vastness of Indo-Pacific – is comprised of two countries that are essentially each other's antipodes.<sup>4</sup>

The AUKUS alliance is Washington's mournful nod to the constraints it faces in a multipolar world. Instead of rallying Western democracies against China's alleged Machiavellian machinations with an updated Transatlantic alliance befitting the Cold War, Atlantic-spanning, NATO alliance, the US appears to be resigned to go against Beijing with a select group of Cricket powerhouses.<sup>5</sup>

A major flaw in our elegant geopolitical argument is Beijing's reaction function. China does have a mind of its own and President Xi Jinping has proven to be fond of an assertive foreign policy. A China that evolves from assertive to aggressive would do Washington's bidding by unifying the West against its geopolitical ambitions. Multipolarity would quickly dissipate as a diagnostic variable in the face of Chinese military expansion in its near abroad. This report, therefore, focuses on China's constraints. Namely what we refer to as the Three Traps: geography, demographics, and the middle-income. We conclude that China's traps have conspired and will continue to conspire to force it to tone down its geopolitical assertiveness and to focus inward over the course of the next decade. We also explore Beijing's strategic shift from the American development model to Germany's Rhine capitalism and its investment and macro implications.

## The Three Traps of China

The Three Traps of China represent material constraints to policymakers that cannot simply be wished away or resolved. While not exactly immutable – as they will evolve over time – these factors will force Beijing into the macro path of least resistance – the focus on "common prosperity" and shift away from the US developmental model – which we elucidate in the latter part of the report. Odds of a successful policy pivot are uncertain as China enters its dangerous, post-growth, phase.

### The Geography Trap

It has become fashionable to refer to the First and Second Island Chains when discussing China's geopolitical ambitions. This is somewhat anachronistic given that the "Island Chain Strategy" was a 1950s US strategic concept to constrain China and the Soviet Union by surrounding both with naval bases in the West Pacific.

<sup>1</sup> Please see Clocktower Group *All Along the Clocktower*, "The Rabid Twenties – A Decade Forecast," dated January 2020, available on request.

<sup>2</sup> Please see Clocktower Group, "Back to the Nineteenth Century," dated October 4, 2019, available on request.

<sup>3</sup> Please see Clocktower Group, *China Macro Watch*, "China-US Rivalry: The Strategic Ambiguity Risk," dated April 8, 2021, available on request.

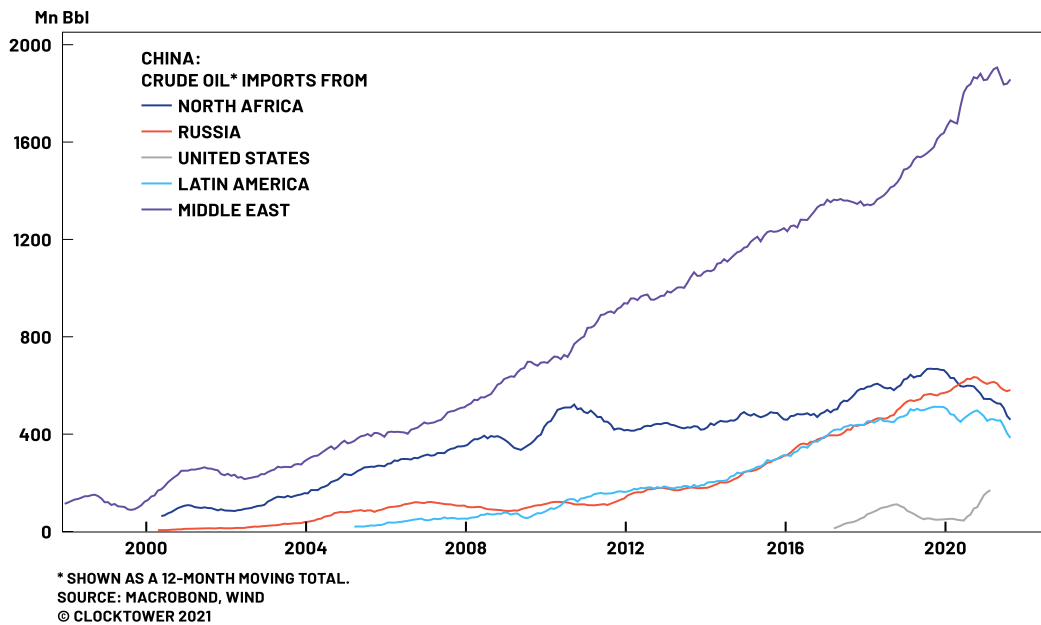
<sup>4</sup> As in as far from one another as geographically possible on planet Earth.

<sup>5</sup> We give AUKUS a bit of a break here with a nod to India's role in the "Quad."

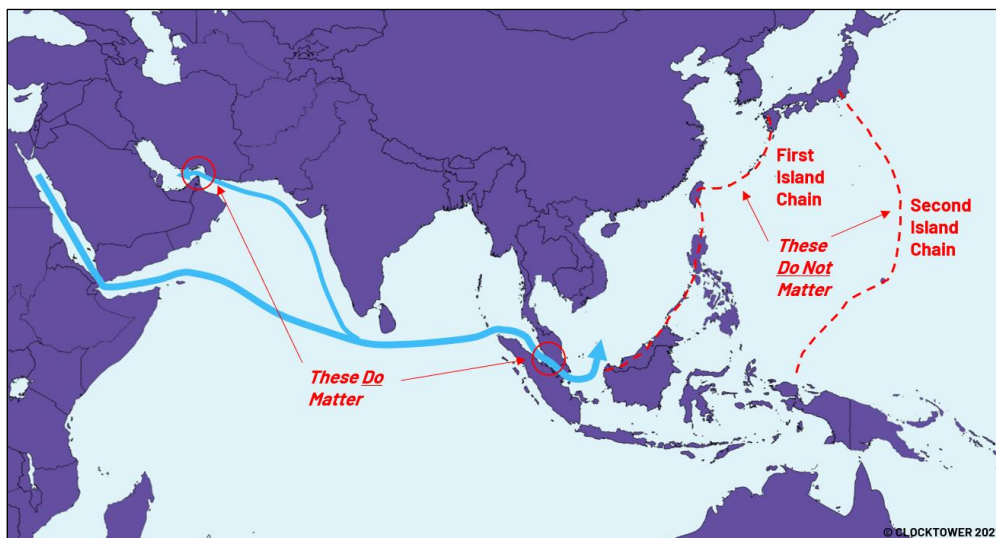
The truth is that neither the First Island Chain – running from the Kuril Islands to the island of Taiwan and ending with Borneo – nor the Second – from the Mariana Islands to Western New Guinea – are critical in constraining China. Its growing addiction to imported barrels of oil (**Chart 1**), carried on tankers through the Strait of Hormuz (and later the Malacca Strait) is Beijing's true geopolitical chokepoint (**Map 1**).

Even if China possesses the military capability to project power within the First and Second Island Chains, it does not have the necessary fuel reserves to do so for long. Over 90 percent of China's oil is imported via sea routes, mainly via the Hormuz and Malacca Straits where its "home court advantage" no longer applies. Its reserves limit it to just 100 days with which to enjoy its victory, were it to make a "go" for Taiwan or other geographies in its near abroad.

**CHART 1 | China's Greatest Geopolitical Risk Is a Growing Addiction to Middle East Oil**



**MAP 1 | Forget the Island Chains, China's Geographical Fulcrum Is in US Dominated Waters**



China's navy has superiority in smaller vessels and submarines, at least relative to the US naval presence in the Pacific today. Frigates and conventional submarines are great at disrupting shipping and harassing shipping lanes of other countries. However, they are far from being able to project power and protect convoys. To overcome its geography trap, China could build a navy to rival the US. However, it would likely have to double those ambitions to rival both the US and its regional allies (**Table 1**). On top of such an extraordinary defense buildup, China would also have to learn how to operate a large, multi-fleet navy in a region completely devoid of true allies – save for Pakistan, maybe Myanmar, and maybe Iran.

**TABLE 1 | China Would Need to Embark on an Epic Naval Build-Out to Protect its Fuel Supply**

		Naval Forces						US & Allies Total
		China	US	Japan	Korea	India	Australia	
Principal Surface Combatants	Aircraft carriers	2	11	4	0	1	0	16
	Destroyers	31	68	38	0	10	3	119
	Cruisers	1	24	3	0	0	0	27
	Frigates	46	21	6	2	17	8	54
<b>Total</b>		<b>80</b>	<b>124</b>	<b>51</b>	<b>2</b>	<b>28</b>	<b>11</b>	<b>216</b>
Submarines	Nuclear propulsion + nuclear armed	6	14	0	0	1	0	15
	Nuclear propulsion	6	54	0	0	1	0	55
	Conventional	29	0	11	71	14	6	102
	Air independent propulsion	18	0	10	0	0	0	10
	Lithium-ion battery propulsion	0	0	1	0	0	0	1
<b>Total</b>		<b>59</b>	<b>68</b>	<b>22</b>	<b>71</b>	<b>16</b>	<b>6</b>	<b>183</b>

Source: The Military Balance, 2021.

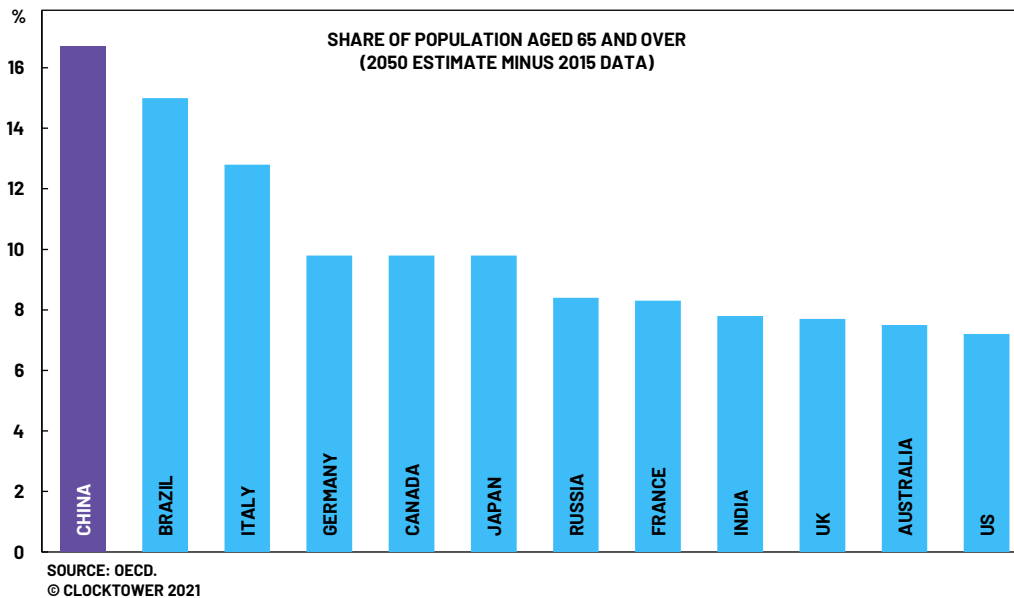
Alternatively, Beijing could simply focus on accelerating its already significant focus on EVs and green tech in order to reduce its reliance on imports of oil. We would bet on China following this “green” strategy, rather than a “deep blue” one for the remainder of the decade. However, between now and then (total energy independence), Beijing has a decade of vulnerability to the US. Any effort to project power in the First and Second Island Chains is therefore likely to fail as the US and its allies strangle China's oil supplies. For the next decade, at least, China remains trapped by its geography and addiction to Middle East oil.

This represents a stunning role reversal between the US and its primary geopolitical rival. Throughout the Cold War, the US – itself addicted to Middle East oil supplies – faced off against an energy independent Soviet Union. Moscow used this vulnerability to constantly try to destabilize the Middle East and America's access to the Persian Gulf. Today, the US is the (nearly) energy-independent superpower, while China is the one that depends on the Middle East for fuel. But unlike during the Cold War, it is the energy-independent superpower that has a chokehold, militarily speaking, on Middle East transportation routes. Imagine the course of the Cold War had Moscow had a nuclear-powered aircraft carrier parked in Bahrain and a massive air base in Qatar. It is no surprise, then, that Beijing has embarked on an ambitious plan to push EVs to resolve this balance of power dilemma. But even if it were able to meet its ambitious goals of 75% hybrid cars by 2030, China would remain vulnerable to oil disruptions given that aircraft carriers, fighter jets, and submarines don't run on electricity.

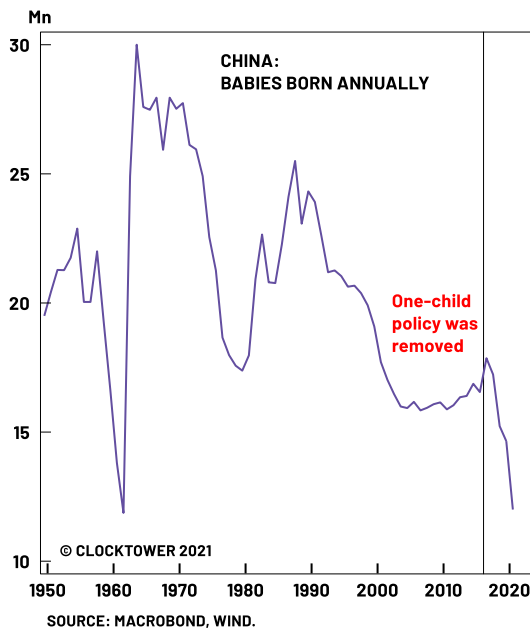
## The Demographic Trap

Volumes have been penned about China's challenging demographics. We will not add to this debate other than to point out that the situation is dire (**Chart 2**), unlikely to be resolved by policy (**Chart 3**), or migration (**Chart 4**).

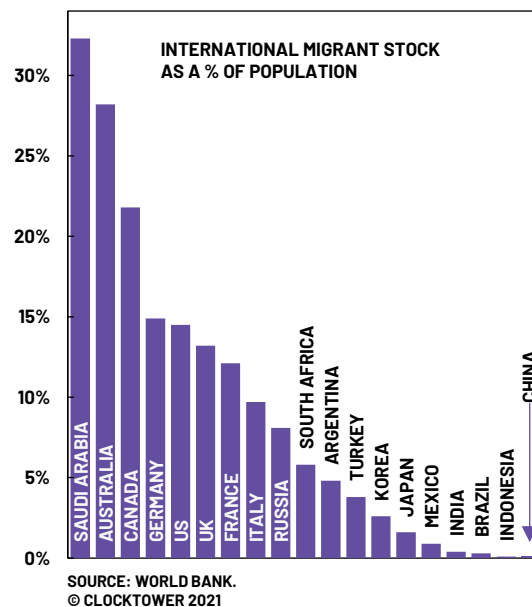
**CHART 2 | Chinese Population Will Age the Fastest Over the Next Three Decades**



**CHART 3 | China's Births Are Collapsing...**



**CHART 4 | ...With No Help from Immigration**

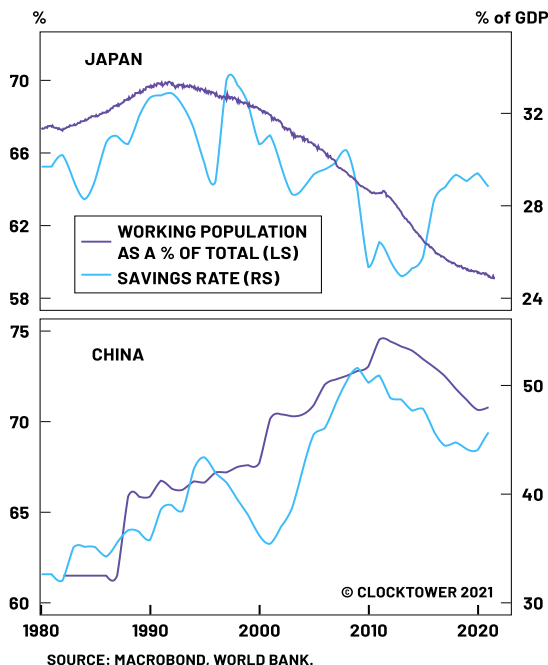
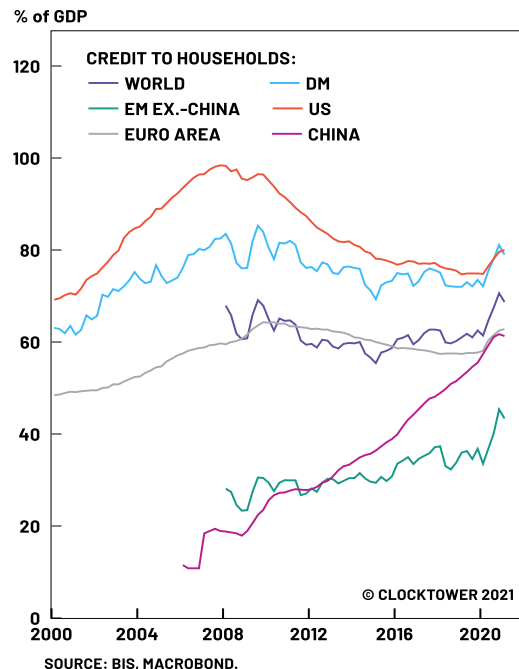


Given that China's savings rate is 44 percent of GDP, this seems a non-issue. China's savings rate will fall, but from a high enough level that it does not matter. However, China's investment rate is also high, given that investment accounts for roughly 43 percent of GDP. We know from basic macroeconomics that  $GDP(Y) = C + I + G + NX$ . Given that savings  $(S) = Y - (G + C)$ , we know that  $S - I = NX = CA$ . In other words, the difference between savings and investment roughly produces the current account (CA) balance.

What investors should focus on is what this means for the country's savings-investment balance and thus overall balance of payments. While demographics is not destiny, it is a gravitational force that affects many other macro factors. Working population and the savings rate share a close embrace (**Chart 5**). As the working share of population falls, the number of savers (workers in their prime years) relative to spenders falls, pulling the savings rate down with it.

For a wealthy country like Japan, this is not a problem. The lack of investment opportunities domestically has worked well to balance Japan's CA in a world where its savings rate has fallen due to demographics. With a GDP per capita of \$40,000, this is a non-issue. But for China, whose GDP per capita hovers around \$10,500 and which has just declared a war on income inequality, moving away from investment-led growth is going to be impossible.

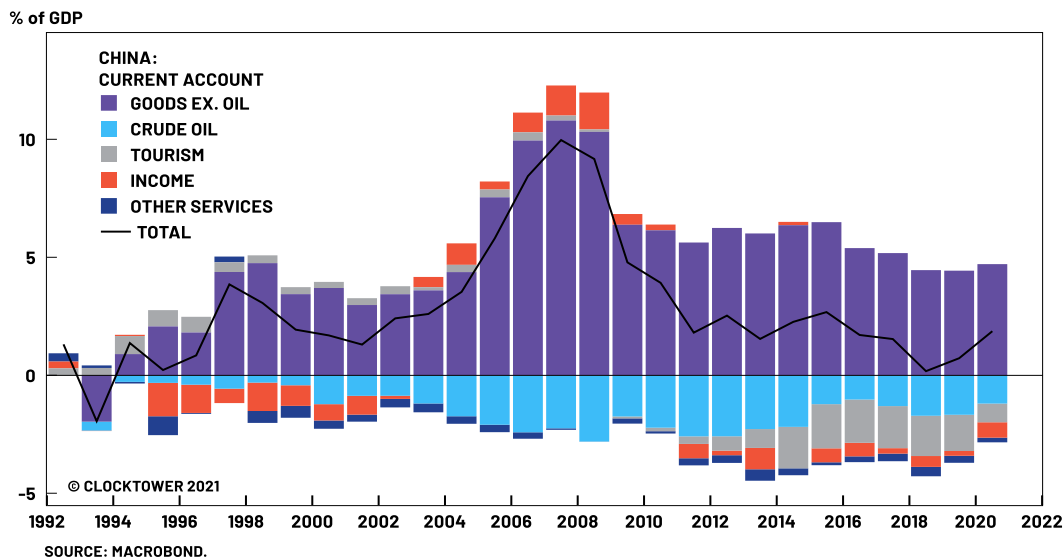
This is especially relevant as the country is also highly domestically leveraged (**Chart 6**). Much of today's ruminations about China's future policy – especially by national security hawks in the West – ignores this critical material constraint. Plans for “dual circulation” and “autarky” look great on government brochures, but a deeply leveraged economy has little to no chance of pivoting towards domestic demand, lest it is open to a long and painful – or sharp and disastrous – deleveraging campaign.

**CHART 5 | China's Savings Rate Will Decline**

**CHART 6 | Households Are Over-Leveraged**


The point is that China is likely to chronically flirt with CA deficits over the rest of the decade (**Chart 7**). It already did so in 2018, when it almost entered a deficit. It has since built back a robust surplus, thanks to the pandemic-induced exports orgy and an end to overseas tourism, a major form of “imports” from an accounting perspective.

Both are likely to be temporary. Furthermore, the cost of commodity imports is likely to continue to rise, given our macro view that this cycle is likely reflationary.<sup>6</sup>

### CHART 7 | China's Greatest Geopolitical Constraint this Decade Will Be a Reliance on Foreign Capital



From Beijing's perspective, a current account deficit is not a tragedy. Reserve currencies are built on a healthy CA deficit. As such, Chinese policymakers have been preparing for the future by making it easier for foreign capital to support a CA deficit. Even at the height of the trade war with the US, Beijing continued to ease controls on foreign capital (Table 2).

Chinese policymakers appear to be aware of their predicament and are therefore laying the groundwork for a day when foreign capital helps rebalance China's balance of payments. Can they also be so myopic to believe that this foreign capital would be indifferent to military aggression in China's near abroad? It could be. China hawks no doubt believe that the entire effort is a ruse sprung on unsuspecting foreign capital to "trap it" once the military reunification of Taiwan begins.

This may be the case, but it would require Chinese policymakers to be completely devoid of any understanding of macroeconomics. A country sporting a CA deficit experiences a "sudden stop" crisis when foreign capital dries up. In that scenario, policymakers must rebalance their balance of payments (BoP) with a collapse of imports, i.e., they need to engineer a recession. As such, the onus is on China hawks to convince the rest of us that Beijing is suddenly open to forcing a severe recession on its populace – with accompanying shortages of oil and other imports – in order to capture the First and Second Island Chains which hold very little strategic value given that the real geographical fulcrums are in the Indian Ocean.

Most members of the US national security establishment do not understand macroeconomics. Therein lies the irony. China's demographics will create a massive opportunity for the US to acquire a major lever over Beijing: its soon-to-be unbalanced current account. American policymakers ought to be encouraging foreign capital flows into China, not restraining them. These capital flows are not "feeding China's war machine," they are the Sword of Damocles that will constrain Beijing's geopolitical ambitions going forward.

<sup>6</sup> Please see Clocktower Group *All Along the Clocktower*, "An Expansion Like Any Other... Just Shorter," dated February 2021, Volume I, available on request.



**TABLE 2 | Beijing Remains Committed to Financial and Economic Opening**

DATE	CHINA OPENING-UP POLICIES
09.25.2020	CSRC, PBOC and SAFE officially released the Measures for the Administration of Domestic Securities and Futures Investment by QFII and RQFII ("the Measures"). The CSRC has consolidated the QFII and RQFII schemes into one through the New QFII Measures. This way, foreign institutions can make a one-time application for the new "Qualified Foreign Investor" status. The New QFII Measures have also expanded the investment scopes for QFIIs
2020.06.01	Beijing released a master plan for the Hainan FTP, with a thirty-year plan for implementation. By 2025: The plan is to have in place policies to facilitate trade and liberalize investment. The key pillar for both will be an independent customs regime on the island. By 2035: Policies would be in place to further support free trade, investment, cross-border capital flows, and free movement of people and data. By 2050: Hainan aims to become a full-fledged FTP with strong international influence and a high level of openness to the rest of the world.
2019.10.11	Removed limits on foreign ownership in: 1) Futures brokers on January 1, 2020; 2) Fund management companies on April 1, 2020; 3) Securities companies on December 1, 2020.
2019.09.10	Removed quotas on the QFII and RQFII, two major inbound investment schemes.
2019.07.20	11-Point plan to expand access to domestic financial markets. Allow foreign institutions who engage in credit ratings business in China to rate all types of bonds in the interbank and exchange-traded bond markets. Encourage offshore financial institutions to invest in domestic commercial banks' asset management subsidiaries. Allow offshore asset management firms and the subsidiaries of Chinese banks or insurers to jointly invest in and establish wealth management companies with the controlling shareholder being the foreign institutions.
2019.05.01	The China Banking and Insurance Regulatory Commission announced 12 measures to further open the financial system. Particularly, Beijing simultaneously cancelled the ceilings on equity holdings by a single Chinese-invested or a single foreign-invested bank in a Chinese commercial bank.
2019.03.15	National People's Congress passed a new Foreign Investment Law, scheduled to take effect on January 1, 2020. It replaces three previous laws, namely the Wholly Foreign-Owned Enterprises Law, the Sino-Foreign Equity Joint Ventures Law, and the Sino-Foreign Contractual Joint Ventures Law. In addition, China promises a "pre-establishment national treatment" plus "negative list management" system for foreign investment.

SOURCE: CHINESE GOVERNMENT WEBSITES.

## The Middle-Income Trap

The Middle-Income Trap is not a novel concept. It is one that Beijing policymakers themselves focused on for much of the past decade. Vice Premier Liu He was a driving force behind a report co-published between his Development Research Centre (DRC) and the World Bank titled "China 2030."<sup>7</sup> The report concluded that out of 101 countries that counted as middle-income in 1960, only 13 achieved high-income status by 2008. The others remained mired in a mix of economic malaise and domestic political risk.

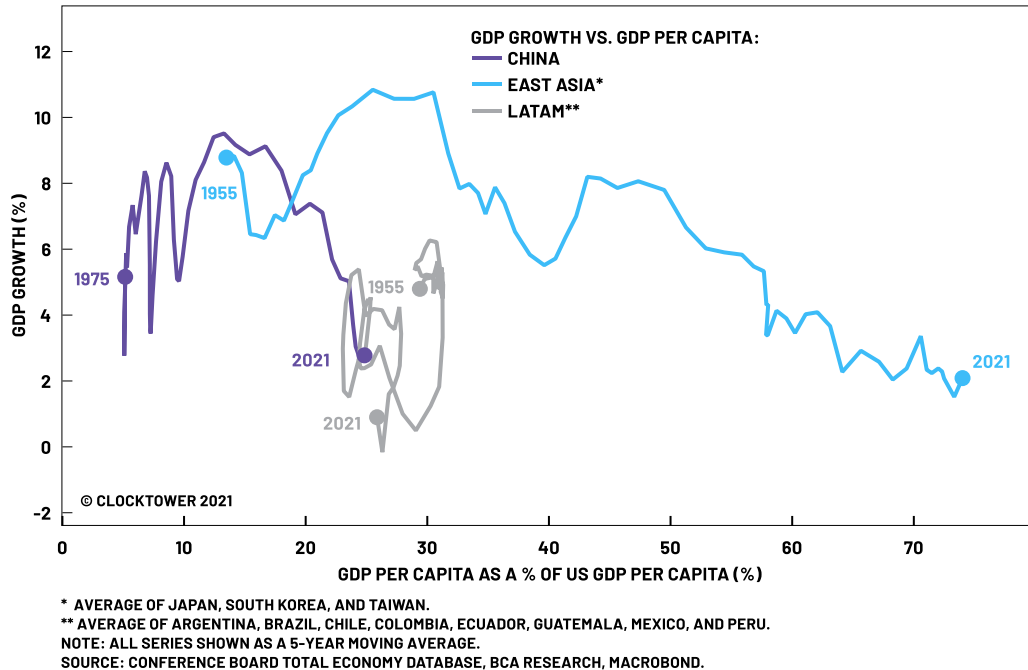
The 2012 report called for a slew of structural and supply side reforms to boost productivity in order to avoid the Middle-Income Trap. Given that potential GDP growth rate is a function of only two variables: labor force and productivity growth, China must put most of its eggs in the productivity basket. Its demographics are unlikely to change any time soon.

<sup>7</sup> Please see *The World Bank and Development Research Center of the State Council, the People's Republic of China, "China 2030: Building a Modern, Harmonious, and Creative Society,"* dated 2012, available at [www.worldbank.org](http://www.worldbank.org).



The fight against the Middle-Income Trap has informed and inspired Xi Jinping's rule more than probably any other concept. We can trace every single reform to this idea, from the anti-corruption campaign to the efforts to curb real estate sector speculation that has today birthed the Evergrande crisis. Regardless of these efforts, Chinese GDP growth rate has decelerated dangerously close to the level experienced by the unlucky emerging markets that never got out of the Middle-Income Trap (**Chart 8**).

**CHART 8 | The Middle-Income Trap Is a Quicksand for Many EM Political Regimes**



Deceleration of growth puts Chinese policymakers into a difficult bind. They can “liquidate everything” – to use Treasury Secretary Andrew Mellon’s 1931 words – and reset the system in an orgy of default and carnage. There is no country in the West with the sufficient political capital, today, to contemplate such a solution, let alone an authoritarian economy obsessed with not repeating the errors made by the Soviet Union.

The other option is to shove the Middle-Income Trap debate under the proverbial carpet and focus on income redistribution instead. If China is going to remain in the Middle-Income for the time being, it might as well get comfortable. In our view, the pivot towards “common prosperity” is therefore an attempt to reset expectations and live with the Middle-Income, at least until the system is slowly (“beautifully”?) deleveraged.

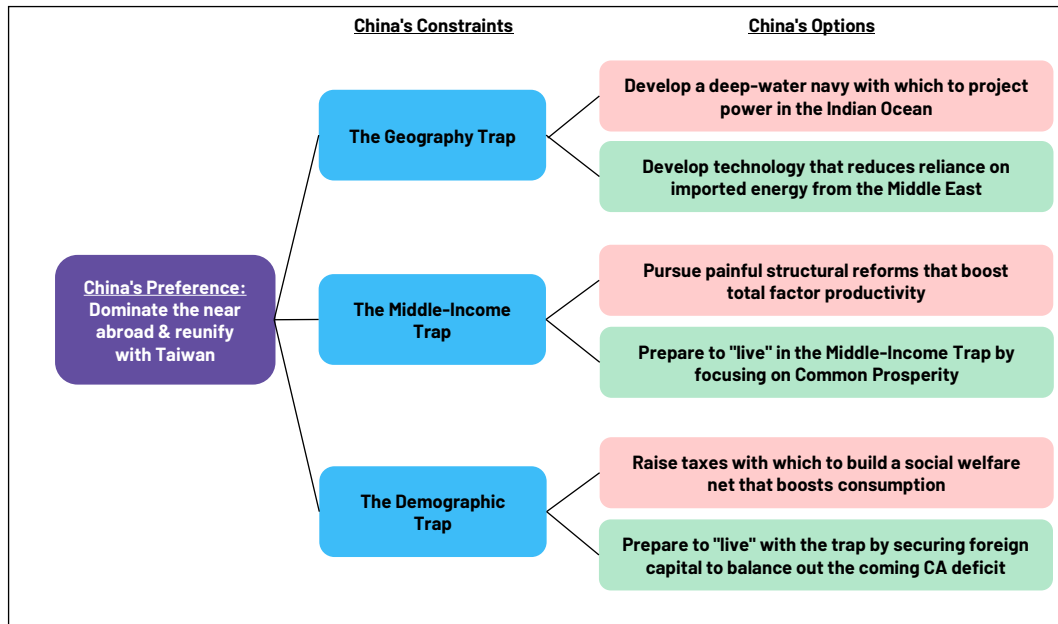
In the rest of this report, we focus on what this shift towards common prosperity really means, functionally speaking. But from the perspective of constraints, it means that China is abandoning – at least for the time being – the reform agenda originally intended to vault it out of the Middle-Income Trap. Its focus is now on maintaining life inside the trap and avoiding the political fate of many EM regimes that succumbed to it.

## Bottom Line: Putting the Traps Together

When we put all of China’s constraints together, we have a mosaic of a Great Power that is facing a challenging decade. Each trap has an exit strategy that would require considerable effort, colored **red** in our **Diagram 1** below. We think that policymakers will choose the path of least resistance instead, colored **green**.

Our diagram begins with a nod towards a claim by China hawks that Beijing wants to dominate the near abroad and unify with its wayward province of Taiwan. We share this view. Every Great Power has preferences that seek to maximize its security through the resolution of its longstanding security dilemmas. For China, that means the domination of East and South China Seas in the same way that, for the US, meant dominating the entire Western Hemisphere as stated in the 1823 Monroe Doctrine.

**DIAGRAM 1 | China's Constraints and Strategic Options**



SOURCE: CLOCKTOWER GROUP.  
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Those preferences, however, must be filtered through the prism of material constraints. The same constraints that made America's Monroe Doctrine an unrealized dream for more than 100 years will keep Beijing's preferences constrained for at least the rest of this decade. President Xi can desire whatever he wants, but the material constraints of geography, demographics, and subdued growth are insurmountable for the time being.

## The End of China's Americanization

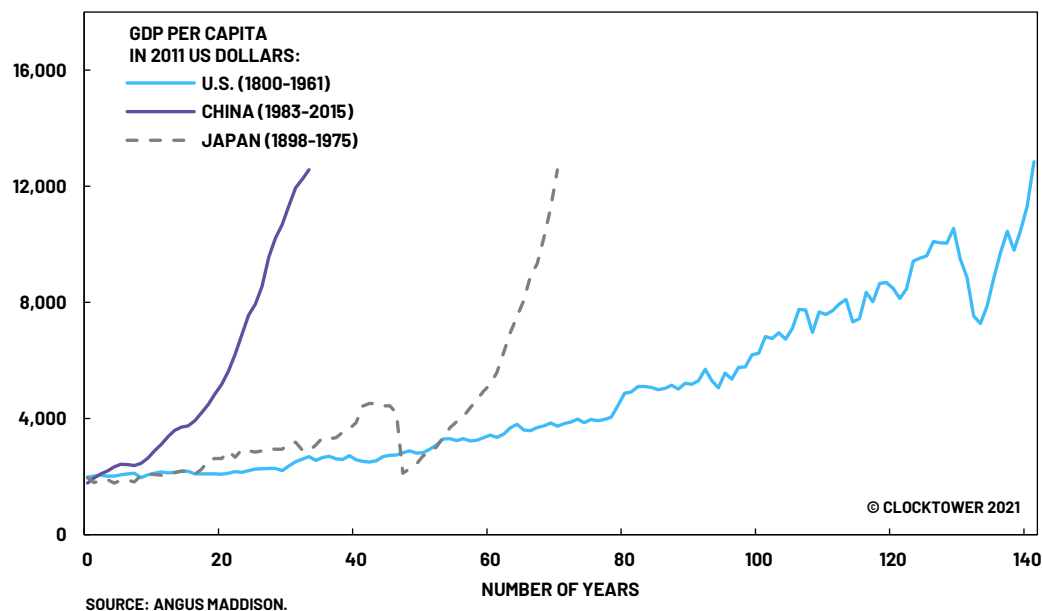
Beijing's sudden turn to the left on the economic policy spectrum has caught investors as well as domestic entrepreneurs off guard. However, to many savvy China watchers, there have been several signals since the second half of 2020 that should have alerted investors to the upcoming political pivot (**Chart 9**).

With the Chinese leadership starting to fixate on "common prosperity," a consensus has emerged among onshore investors that Beijing's basic state policy (基本国策) has shifted to promoting social equality from pursuing economic efficiency. In other words, China's "socialist market economy" will start to place more emphasis on the "socialist" rather than on the "market" aspect.

Ever since China's Reform and Opening Up back in 1978, Beijing has essentially adopted a development strategy that prioritizes economic efficiency over social equality. This strategy was neatly summarized by Deng Xiaoping as "let some people get rich first." As a result, several tailwinds conspired to produce China's economic miracle:

the Communist Party setting the “economic development as the central task of the government (以经济建设为中心),” the social consensus to “eat one’s fill and wear warm clothes (吃饱穿暖),” a demographic dividend, and rapid globalization as a result of America’s hegemonic stability (Chart 10).

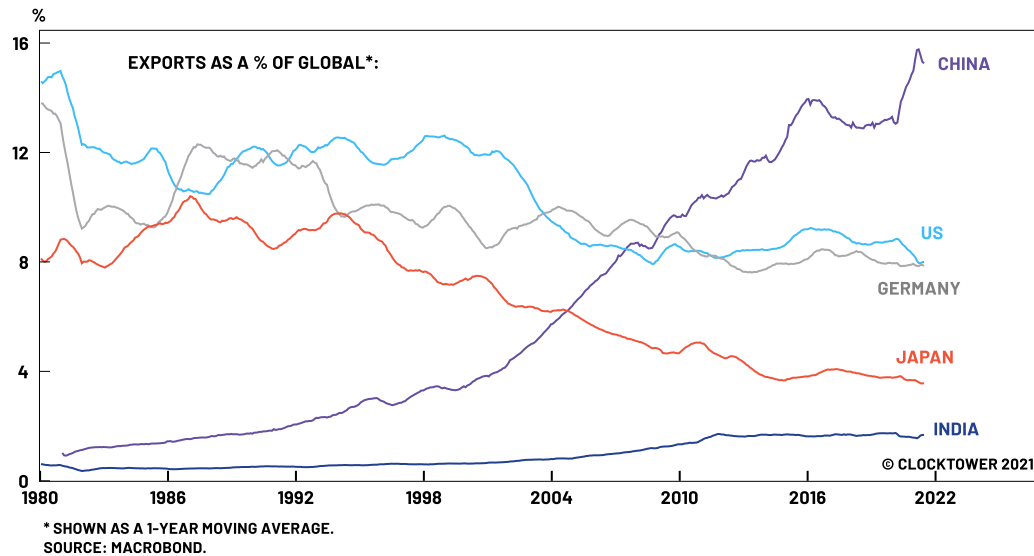
**CHART 9 | Beijing's Implicit "Forward Guidance"**

**CHART 10 | The Rise of China Is Unprecedented**


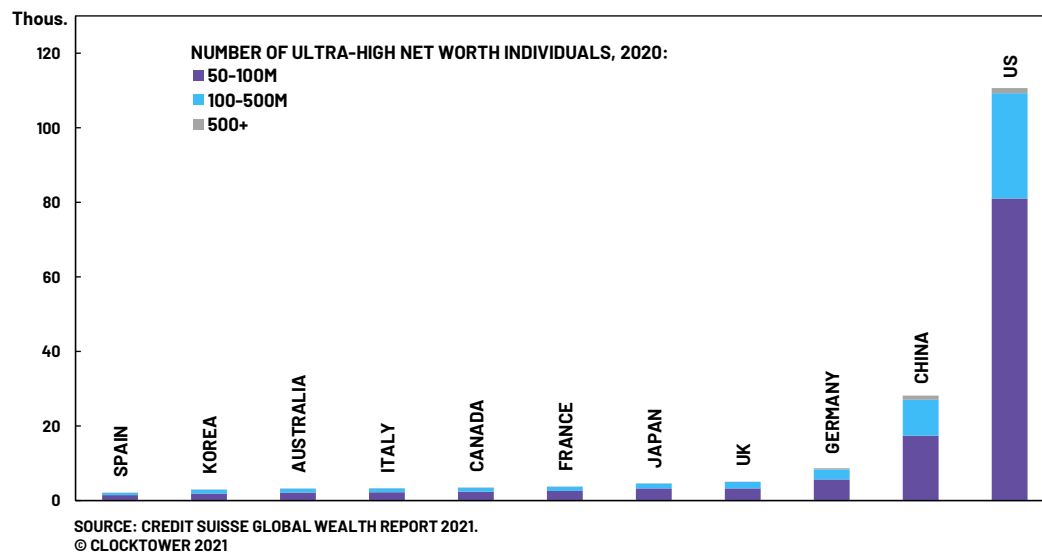
While Beijing has recently been fond of attacking the US for exporting “the American model” – namely liberal democracy and capitalism – there is little doubt among Chinese elites that their own country rapidly Americanized over the past four decades. China has become the most fervent supporter of economic globalization as it

developed into the largest trading nation on earth (**Chart 11**). China was also perhaps the firmest adopter of the Internet revolution outside of the US, with Alibaba, Tencent, and Baidu facing off against Amazon, Facebook, and Google, unlike Europe or Japan which have lagged in the tech revolution. In addition, it seems that the "American Dream" has found fertile ground in China, with nearly 30,000 people making their way to ultra-high net worth status in a short span of forty years, easily outpacing EU economies on the list (**Chart 12**).

**CHART 11 | China Has Become the Largest Trading Nation in 2010 and Has Not Looked Back Since**



**CHART 12 | "American Dream" Was Alive and Well in China**



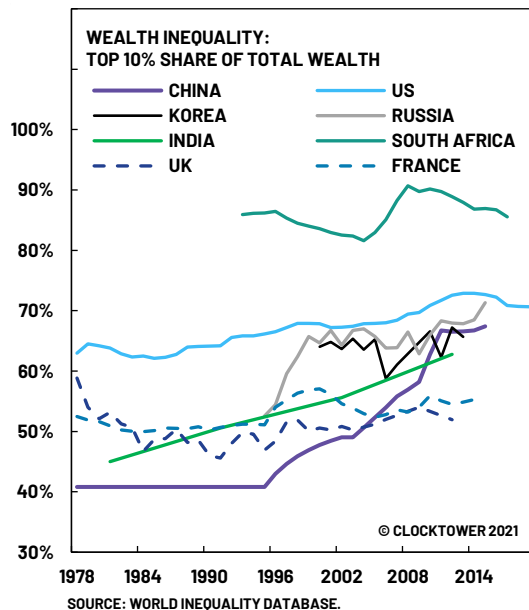
American capitalism and free market economy have undisputedly played a pivotal role in China's economic success. As Weijian Shan, the chairman of PAG and the author of *Out of the Gobi: My Story of China and America*, wrote, "Americans don't know how capitalist China is."<sup>8</sup>

<sup>8</sup> Please see Harvard Business Review, "[Americans Don't Know How Capitalist China Is](#)," dated May-June 2021, available at hbr.org.

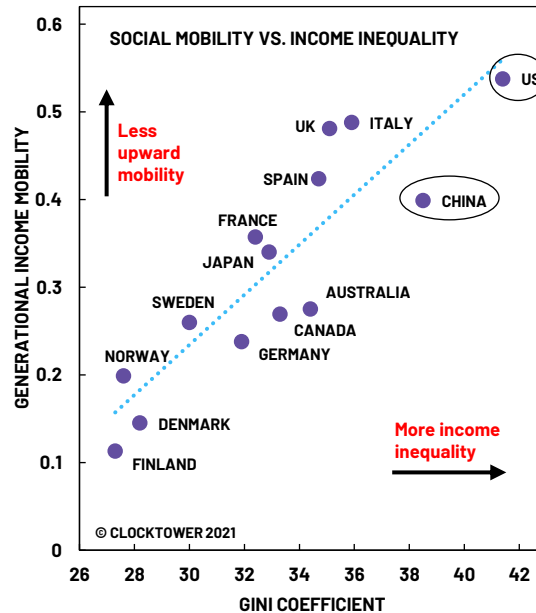
However, after running unchecked for the past four decades, China's capitalist reforms have produced negative externalities.

First, despite China's nominally socialist tenets, its level of wealth inequality is approaching that of the US (**Chart 13**). It was this widening wealth gap that partially motivated President Xi's anti-corruption campaign in 2013 and fully explained the poverty alleviation program between 2015 and 2020. Despite Beijing's efforts, the Chinese society remains staggeringly unequal. The average resident in Beijing and Shanghai is as rich as the average resident of Portugal (an OECD member state), whereas the average person living in Gansu or Heilongjiang Province is as poor as a resident of South Africa. While China's Americanization has brought many positives, the consequence of rising income inequality and declining social mobility have posed an obvious challenge to a government that promises common prosperity. To Beijing, sharing the same quadrant with the US on **Chart 14** is not a success story, particularly so in the wake of the 2020 US social justice protests and the January 6, 2021 storming of the Capitol, both of which shocked and left a deep impression on Chinese policymakers.

**CHART 13 | Widening Wealth Inequality...**



**CHART 14 | ...And Declining Social Mobility**

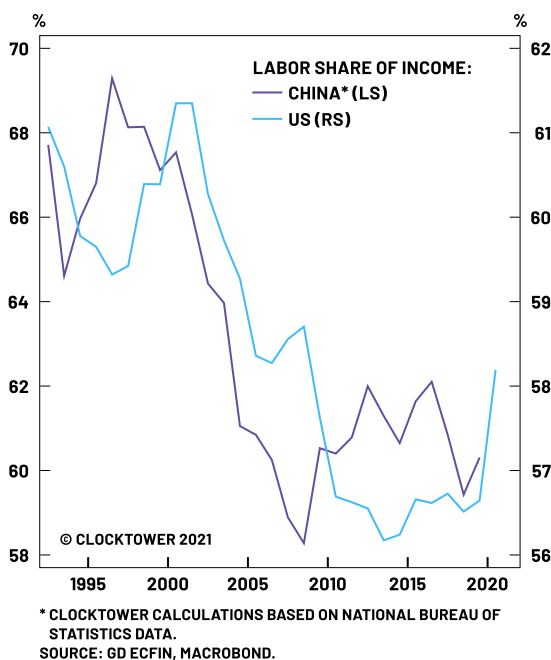
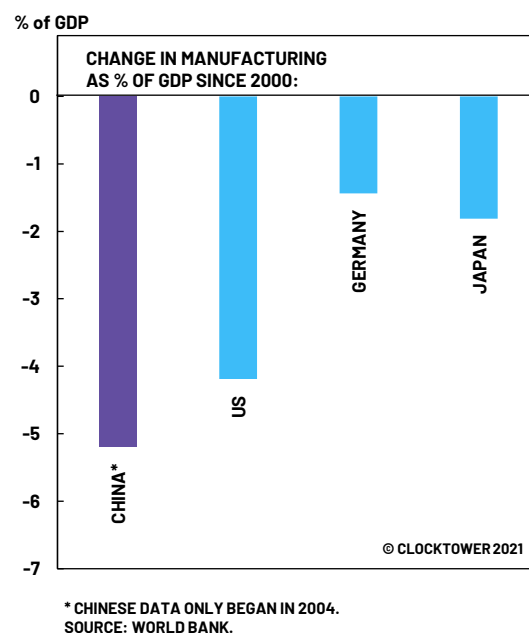


Second, the rapid economic growth has created a new elite that could potentially wield considerable political power. Much as in the US, the labor's share of the economy has been shrinking since the late 1990s (**Chart 15**). Instead, a group of corporate giants have seen their profits and market capitalization swell. The expansion of corporate power has increasingly become a threat to Beijing's political, economic, and social control. Critics of "Big Tech" in the US would argue that the same is the case across the Pacific, but Beijing has few domestic political and legal constraints and thus assumes that it can do something about it.

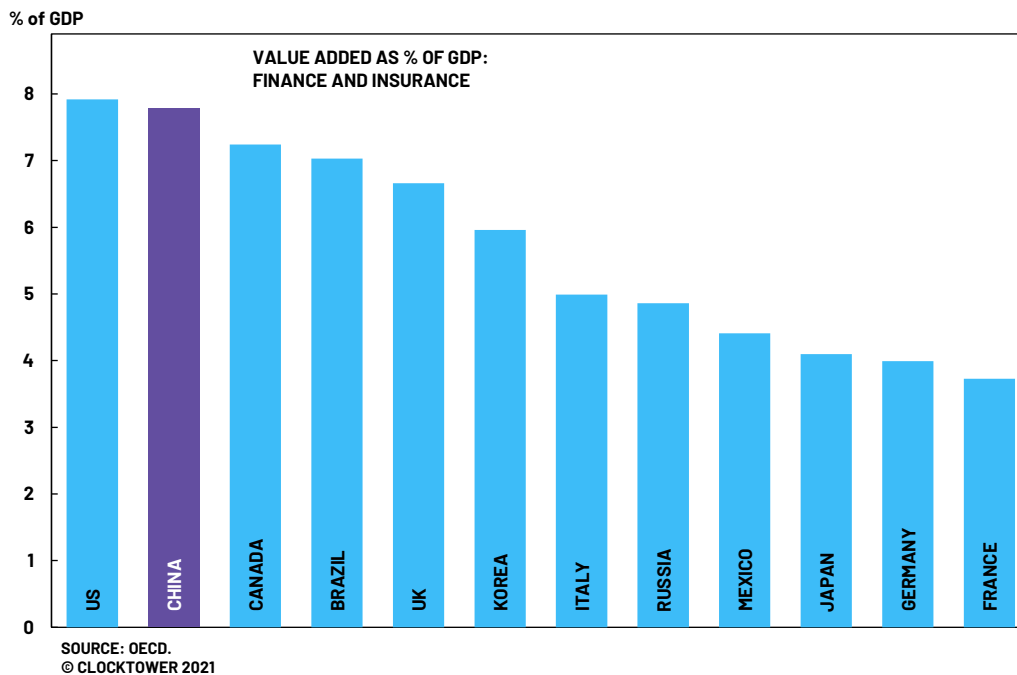
Beijing is also dealing with irresponsible corporate stewardship and governance, more akin to the 1980s Japan than the US. Whether it was Wanda and HNA's aggressive acquisitions overseas or Evergrande's relentless expansion domestically, Chinese corporates have increased the systemic risk in the economy and complicated Beijing's efforts to manage the ongoing economic transformation. Furthermore, the combination of massive

personal data and advanced algorithms has convinced policymakers that Big Tech platforms have gained sufficient power to influence, if not outright manipulate, public opinion. For a party that vows to represent the interests of the vast majority of the people, the excessive power possessed by “Russian oligarchs,” “Korean chaebols,” and “American tech billionaires” is intolerable.

Third, emulating the US development model has left China facing the same challenges of deindustrialization that plague large parts of the US. Somewhat counterintuitively, China has seen the largest decline in manufacturing as a share of GDP among major economies over the past decade, not unlike the US experience (Chart 16). With real capital – capital invested in physical means of production and workers – in retreat, “fictitious capital” has proliferated, helping the financial industry gain an excessively high share of national income. Although China is still a developing country that has not yet liberalized interest rates, the GDP share of its financial industry is close to that in the US and much higher than in other major economies (Chart 17). From Beijing’s perspective, this is folly. A strong manufacturing industry provides good job opportunities, increases productivity (at a faster pace relative to the service sector), and enhances China’s geopolitical prowess through innovation in technologies relevant to a military conflict. A strong leadership in soft tech and finance will not win a potential confrontation with the US, help overcome China’s geography trap, let alone help China escape the Middle-Income trap.

**CHART 15 | Labor Share of GDP Is Declining...**

**CHART 16 | ...Given Manufacturing Retreat**


**Bottom Line:** China’s love affair with the US style economic development has turned sour. Beijing is beginning to realize that it has made a critical error by leap-frogging an important stage of development: advanced manufacturing. Instead, it tried to emulate its geopolitical rival, the US, too soon by becoming overly financialized and obsessed with soft tech. Chinese policymakers and intellectuals have therefore shifted their eyes to the German model that appears to be a match-made-in-heaven – on paper at least – for China’s economic and social ills.

**CHART 17 | China's Financial Industry Dwarfs Other EM and DM Economies**

## China's Embrace of Rhine Capitalism

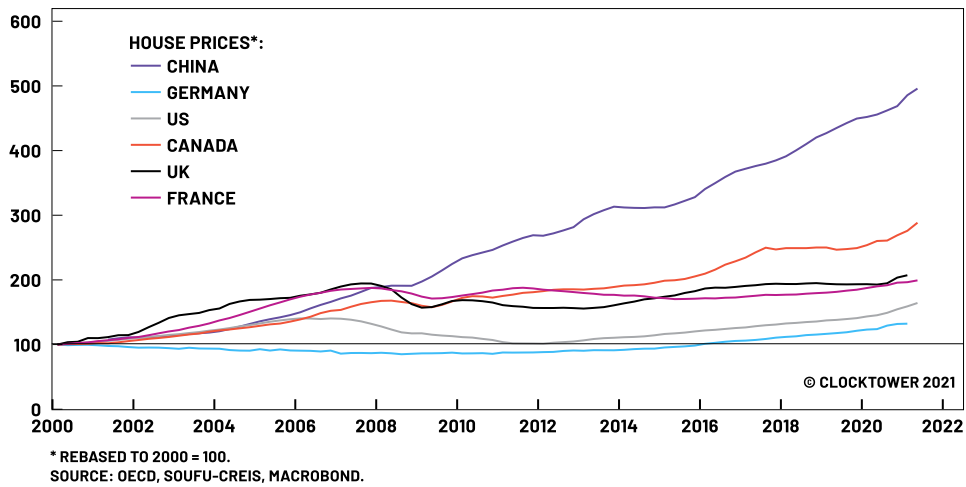
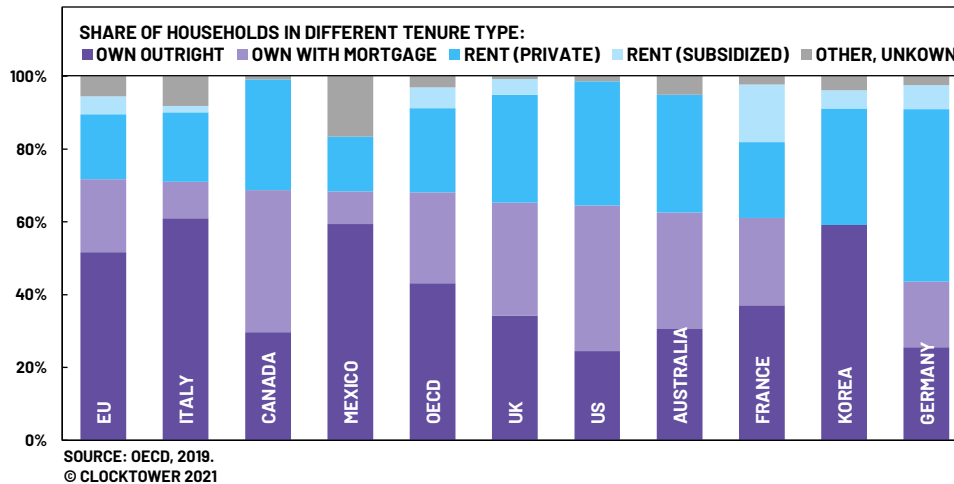
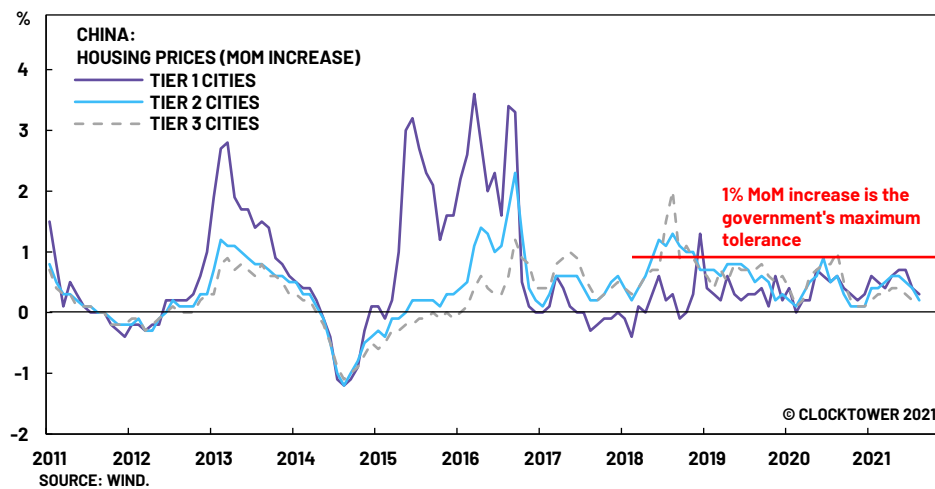
The German economic model is defined by "Rhine capitalism" or "a social market economy." China officially labels its own system as "the socialist market economy." The two countries therefore have a similar vision of capitalism, in rhetoric if not in practice, that imagines the state playing a pivotal role in ensuring fair competition, equal opportunities, and taking care of the weakest members of the society. There are several aspects of the German socioeconomic model that are particularly appealing to Beijing today.

Germany's exemplary record of affordable, stable housing is a solution to much of China's real estate problems. Over the past 20 years, property prices in Germany have largely remained flat thanks to effective policies that promote renting and discourage speculation (**Chart 18**). By strengthening renter protection and by incentivizing homeowners to rent out their properties, Berlin has managed to build a sophisticated rental market where households are comfortable to rent for long periods, if not their entire life. As a result, Germany's homeownership is one of the lowest among OECD countries (**Chart 19**).

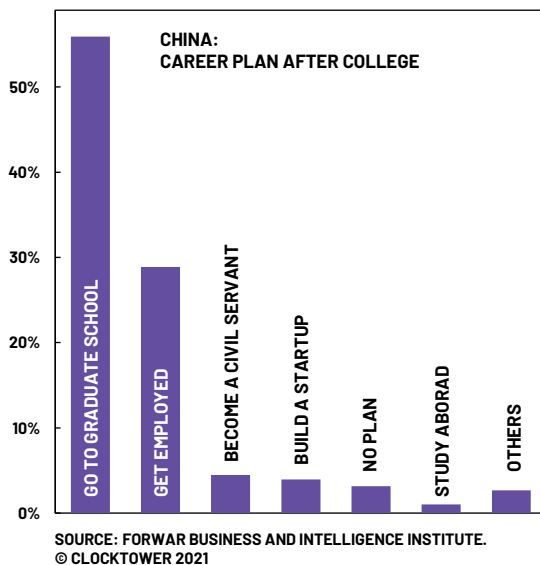
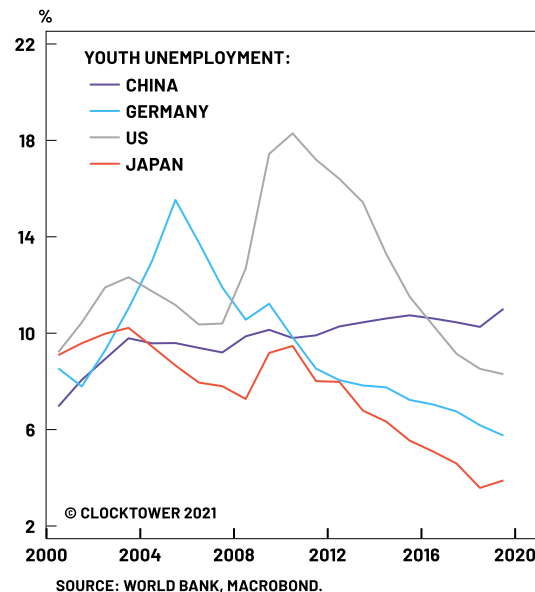
A stable and affordable housing market is seen as a panacea for all of China's macro problems. It would reduce systemic risk in the economy, unleash household consumption demand, and lower the risk of a social unrest akin to the Hong Kong protests in 2019. Onshore commentators widely believe that President Xi's famous words "Housing is for living, not for speculation" essentially marked China's Germanization in housing policy. Much as with Germany's price control in the 1990s, there has been an implicit rule in China since 2017 that the month-over-month increase in property prices should not surpass 1% (**Chart 20**). In addition, Beijing has pledged policy support to develop the rental market by offering tax breaks for rental operators and a potential exit channel through REITs.<sup>9</sup>

<sup>9</sup> Please see Reuters, "[Global investors bet on China's rental property amid shifting political winds](#)," dated August 12, 2021, available at [reuters.com](#).



**CHART 18 | Beijing Admires Berlin's Ability to Maintain an Affordable Housing Market****CHART 19 | Germany Has One of the Lowest Home Ownerships Among OECD Economies****CHART 20 | There Is an Implicit Ceiling on Real Estate Prices**

Germany's highly effective work-based vocational education and training (VET) system has also become a model for China's education reforms. One of the main reasons for Beijing's recent crackdown on after-school tutoring enterprises is that they have exacerbated educational inequality and imposed tremendous financial burden on middle-class families. However, the high demand for tutoring services is fundamentally caused by the belief that it must take a college degree to get a good job – a very much American assumption – even though there has been a widening gap between the instruction at universities and what is needed by employers (**Chart 21**). China's education system is simply not oriented towards career development, complicating Beijing's efforts to stabilize employment and making further progress in labor productivity more difficult. The growing deficiency of the education system explains, at least in part, rising unemployment among youth, in contrast to the falling trend in most major economies (**Chart 22**).

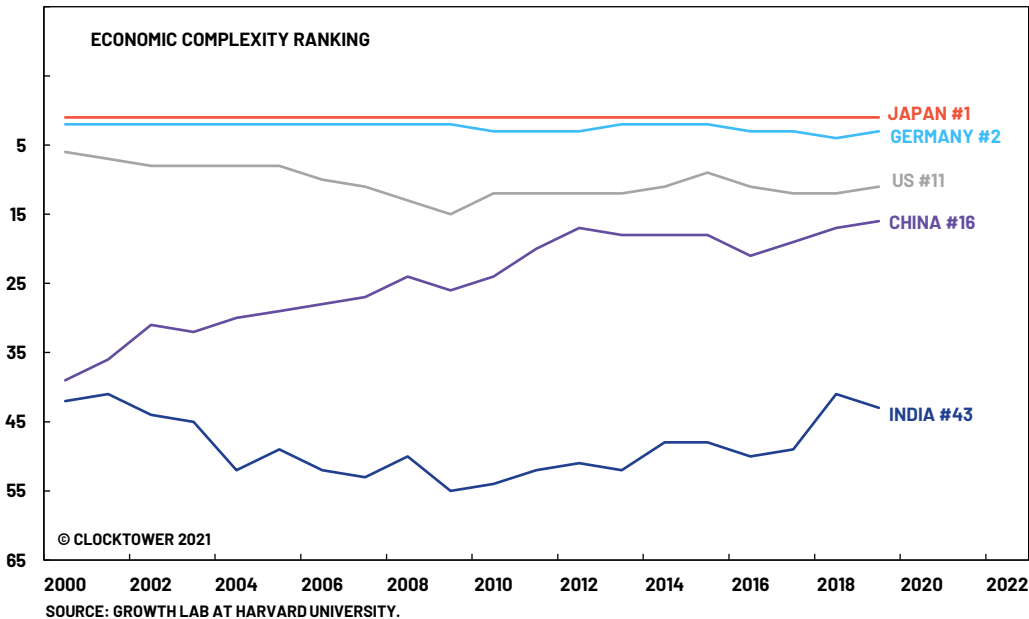
**CHART 21 | Inefficient Labor Training...****CHART 22 | ...Leads to Youth Unemployment**

With nearly half of the population holding a formal vocational qualification, Germany has managed to maintain one of the lowest levels of youth unemployment in the world. As a result, Chinese policymakers have adopted several measures to boost vocational education that take inspiration from Germany. For example, many cities have introduced policies that only allow 50% of middle-school graduates to continue regular high-school education, with the rest being streamlined to vocational training programs. Seems harsh? In Germany, only about a third of all students attend the most elite secondary school system, the Gymnasium, which is considered the preparatory stage for university and college attendance.

Most importantly, Germany's strong industrial capability (or edge in the "atom" sector) is appealing to Beijing as China concentrates on upgrading its manufacturing prowess. Unlike the concerning trend of deindustrialization in the US, Germany has largely kept its manufacturing as a share of GDP stable. Thanks to maintaining a large manufacturing sector – which has superior productivity gains relative to the service sector – Germany's labor productivity is one of the highest in the world. This is an important lesson for China, given the aforementioned demographic and middle-income traps. In addition, while China has become the largest exporter since 2010, it still lags other manufacturing superpowers, such as Japan and Germany, in terms of export complexity and technology-intensiveness (**Chart 23**). Therefore, the strategy of adopting the German model would allow China to continue to move up the global value chain, raise labor productivity, and prevent the hollowing out of its manufacturing industry.

**Bottom Line:** To overcome its three traps, counter the challenge from the US, and resolve domestic socioeconomic challenges, Beijing intends to shift its economic developmental model from the American to the German. The transition will be fraught with difficulty and is unlikely to produce a Rhine China. However, investors should not doubt Beijing's commitment to emulate Berlin, an important market signal for the near future.

**CHART 23 | China Still Lags in Export Complexity and Tech Intensiveness**



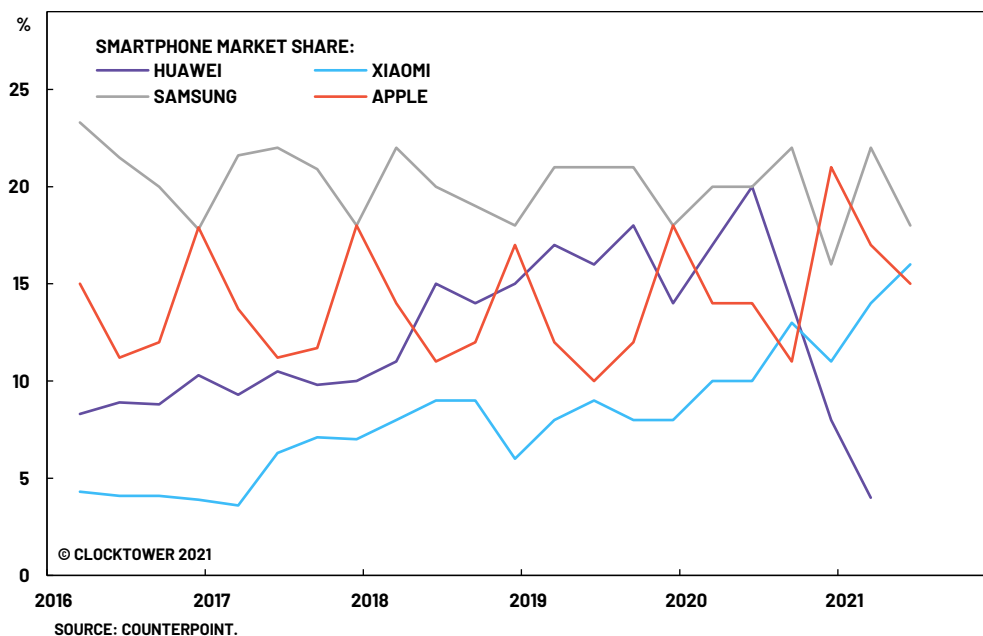
## The Transition from the American to the German Model

There is a growing consensus among onshore investors that Beijing is strategically shifting away from the American model that prioritizes economic efficiency and the development of the service sector, to the German model that places more emphasis on social equality and advanced manufacturing. Compared with the structural motivations behind the shift, there are three tactical forces that lie at the core of Beijing's efforts to reshape China's economic and social system.

The first force are the rising US-China geopolitical tensions since 2018. The US-China trade war was a wake-up call to Beijing, forcing it to realize how vulnerable Chinese tech industry was, and still is, in the face of US sanctions and export controls. Despite a booming Internet industry worth trillions of dollars, China controls few of the core technologies that underpin the modern economy, especially the knowhow to make advanced semiconductors.

When Washington expanded its sanctions in May 2020 to require foreign chip makers that use US technology to apply for a license to sell chips to Huawei, the Chinese telecom giant was instantly crippled. Given its inability to access high-end semiconductors, Huawei had to sell its Honor budget smartphone business to a consortium of over 30 entities. As a result, Huawei's global smartphone market share has plummeted from 20% to just 4% in less than a year (Chart 24).<sup>10</sup>

<sup>10</sup> Although it is notable that neither Samsung nor Apple ate into Huawei's share. Rather, it was another Chinese tech giant, Xiaomi, that has benefited from Huawei's decline, yet again revealing the constraints on US from pivoting global trade away from China.

**CHART 24 | US Sanctions Crushed Huawei**

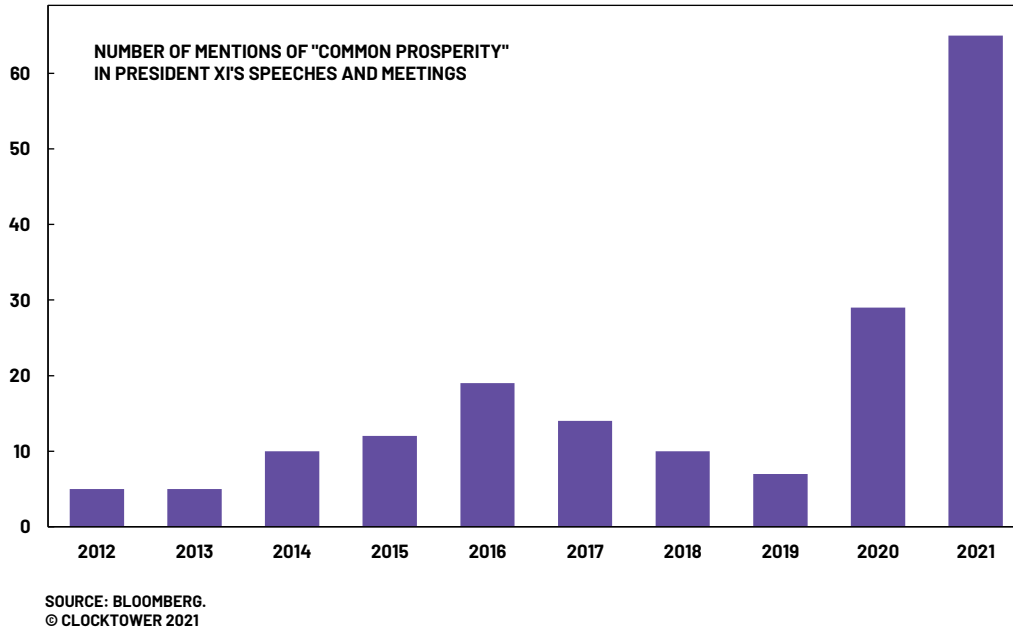
The humbling of Huawei, a national champion, has intensified Beijing's fear of being strangled by Washington's technology blockade and has hardened the political will to achieve technological self-sufficiency. It was with this goal that Beijing has determined to shift resources away from business model innovations (i.e. the Internet sector where companies profit by innovating through digitization on already existing business models – as in: Uber) to hard technological innovations (i.e. advanced manufacturing). This strategic shift is the key reason why Beijing established the Science and Innovation Technology Board exchange (STAR) in June 2019, with the intention of fast-tracking IPOs of hard-tech companies, while keeping the door closed for soft-tech companies.

Germany, again, offers a counterpoint for Beijing to emulate. The country has not manufactured a serious cell phone in decades. Nokia closed its manufacturing facilities in the country last decade and a recent “Made in Germany” handset – the Gigaset – is a novelty. Its consumer electronics exports have suffered, with names like Grundig and Telefunken all but a distant memory of the 1980s. And yet, Germany can manufacture almost every single weapon system required to project power and deny area access in a modern war, from fifth generation fighter jets (Eurofighter Typhoon), extremely advanced main battle tanks (the Leopard 2A7+), to super quiet diesel-electric submarines (Type 212 and 214). And if Berlin ever really got motivated to remilitarize with gusto, there is no doubt on any serious military analyst's mind that it would quickly leapfrog its neighbors France, Russia, and the UK in military tech, if not also the US. Berlin's inability to emulate iTunes seems vacuous in the grand scheme of things.

The second catalyst for the shift away from the US developmental model is a political one. China's leadership transition is scheduled to take place next year at the 20th Party Congress, where President Xi is widely expected to continue for a third term. While President Xi has successfully consolidated power since 2013, the momentous break with the decade-old rule of two-term limit has still produced dissent within the party. Unlike the common perception in the West that Xi is omnipotent, he still needs to run an “election” and win enough support both within the party and from the wider public in order to get “re-elected.” There is an old saying in China that “whoever wins the heart of the people wins the world (得民心者得天下).” President Xi has been heeding this adage by focusing on the concerns at the top of mind of most Chinese citizens. As such, the anti-corruption campaign, poverty alleviation program, and the war on pollution have been carried out by the Xi administration over the last nine years

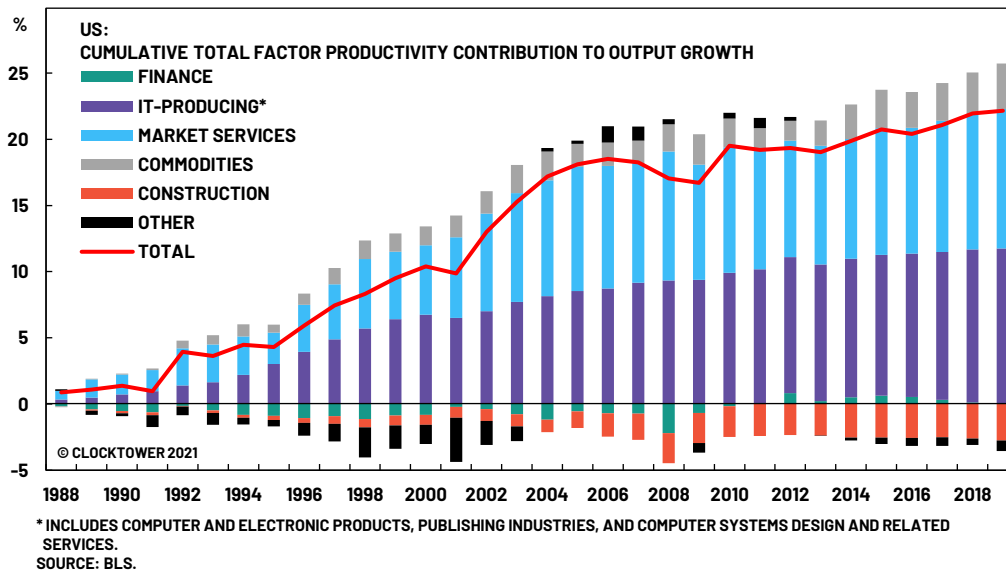
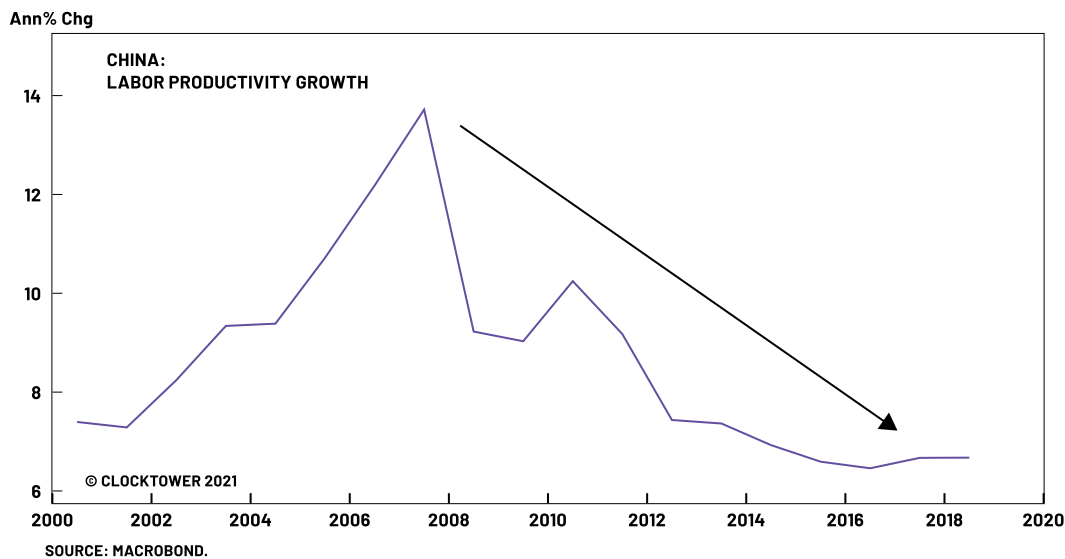
with the “median voter” preferences in mind. To further boost public support, President Xi has shifted his attention to the “three mountains” weighing on households – elevated costs of housing, healthcare, and education – and doubled down on the narrative of “common prosperity (Chart 25).”

**CHART 25 | Xi's Pivot to Common Prosperity**



There is also an economic catalyst. While China’s demographic deterioration is not a new thing, the collapse of birth rates in recent years has clearly caught policymakers off guard. For a country with scant to non-existent labor force growth, the only way to continue growing the economy – and thus create escape velocity out of the middle-income trap – is to rely on productivity growth. The prospect of becoming dominated by soft tech Internet companies does not bode well for China’s economic future for two reasons. First, the evidence that software boosts productivity has been scant in recent years. The most earth-shattering innovation in software was implemented by businesses by the mid-2000s. Since 2010, I.T.’s contribution to productivity growth in the US has been paltry (Chart 26). Second, China’s own experience has shown that the expansion of the Internet sector over the past ten years did little in boosting its productivity growth (Chart 27). Given Beijing’s lofty goal to double its GDP by 2035, a declining working age population requires labor productivity growth to stay above 5% over the next 14 years. This is an extremely difficult job to accomplish if Beijing does not change its current development strategy.

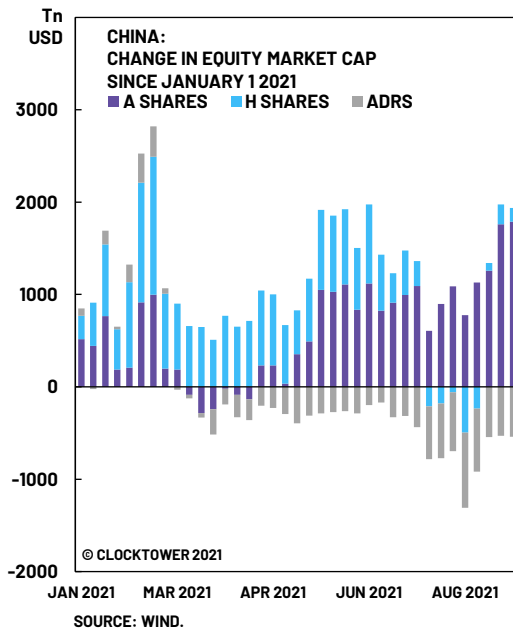
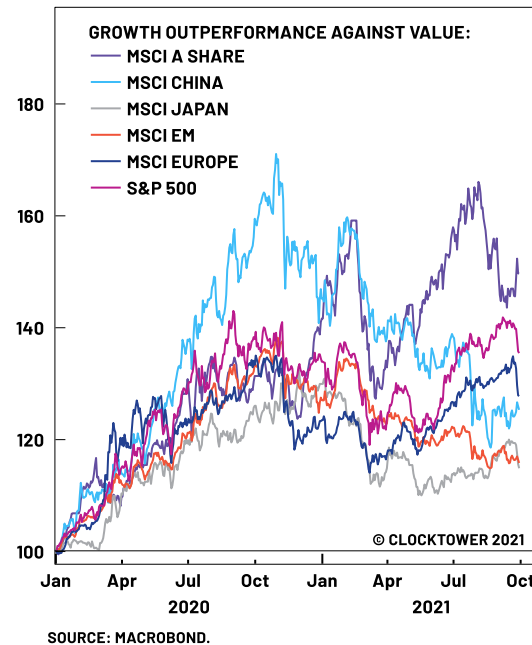
**Bottom Line:** The demographic decline has driven Beijing to launch the three-child policy in May 2021. The effectiveness of that policy will hinge on whether policymakers can successfully lower the cost of living for middle-class families. On the other hand, reversing the downward trend in productivity growth requires a strategic shift from “bits” to “atoms.” The combination of both goals requires Beijing to limit the profitability of the service sectors – housing, education, healthcare, etc. – while encouraging the development of advanced manufacturing that increases China’s technological competitiveness. To respond to its three traps, Beijing has decided to emulate Germany, not America.

**CHART 26 | The Evidence that Software Boosts Productivity Has Been Scant in Recent Years****CHART 27 | The Expansion of Big Tech Has Failed to Raise China's Labor Productivity Growth**

## Investment Opportunities of China's "Rhein Turn"

Over the past decade, the "China growth story" has primarily focused on the Internet, healthcare, and consumer sectors. With consumer names losing steam in recent months due to domestic demand weakness – which we believe is secular trend due to extreme household leverage – Beijing's *volte-face* on Big Tech platforms and potential crackdown on healthcare companies have become the straw that broke the camel's back. Given the sharp selloff in Chinese equities, there is a rising chorus that China's growth story has likely ended and that investors should shift their focus to a different geography.

We believe that China's growth story is shifting away from the offshore, Internet sector to the onshore, hard-tech manufacturing industry (**Chart 28**). While offshore growth stocks underperformed value in recent months, the outperformance of onshore growth stocks has been one of the largest globally (**Chart 29**). The three themes that should be particularly enticing are Green China, Inc., import substitution in semiconductors, and golden era for the Chinese *Mittelstand*.

**CHART 28 | Money Is Flowing into A Shares****CHART 29 | Onshore Growth Outperformance**

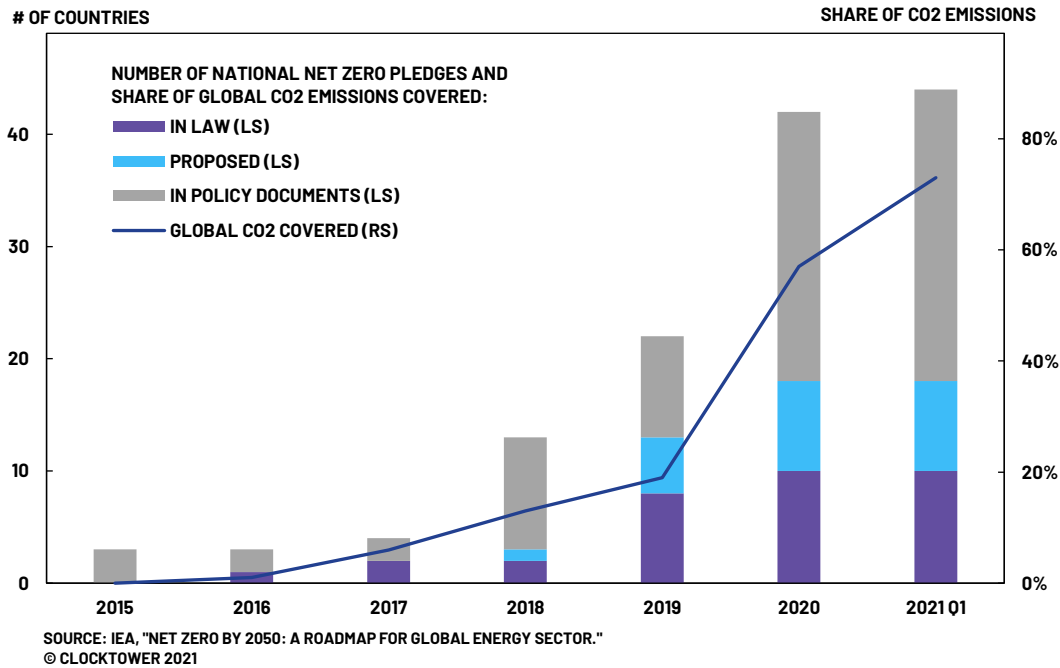
**The Green China, Inc.** As we posited in a special report in February 2021, China has undergone a phenomenal transformation from a climate laggard to a green leader over the past decade.<sup>11</sup> As the world's largest producer, exporter, and installer of solar panels, batteries, and electric vehicles (EVs), China is at the forefront of the global *Race to Zero*, a decade-defining investment theme.<sup>12</sup> The renewable development allows Beijing to kill three birds with one stone – increase export competitiveness, address air pollution, and enhance energy security by reducing its Geography Trap. With an increasing number of countries pledging their commitments to carbon neutrality, the total addressable market (TAM) has vastly expanded for China's renewable products (**Chart 30**). For example, the export of Chinese solar products has surged since July 2020. As a result, onshore solar stocks have staged an exuberant rally, dwarfing that in the US despite President Biden's focus on fighting climate change (**Chart 31**).

The domestic EV penetration continues to surprise to the upside. EV's share in new vehicles sold has already surpassed 10%, and the government's target is 20% by 2025. The rapid EV transformation has created booming demand for batteries and relevant raw materials, such as lithium, cobalt, and graphite. Over the past few months, the most popular investment theme in the onshore community was jokingly titled "a Decisive Battle Against the Periodic Table of Elements." In other words, investors have been binge buying A-share companies that own critical resources used in the EV and other renewable sectors. The surging demand for several chemical products – particularly LiPF<sub>6</sub>, VC, and PVDF – has brought several insolvent chemical companies back to life.

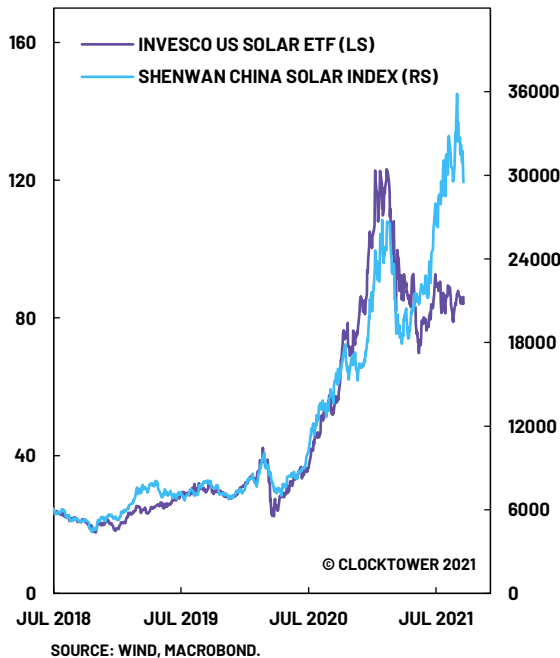
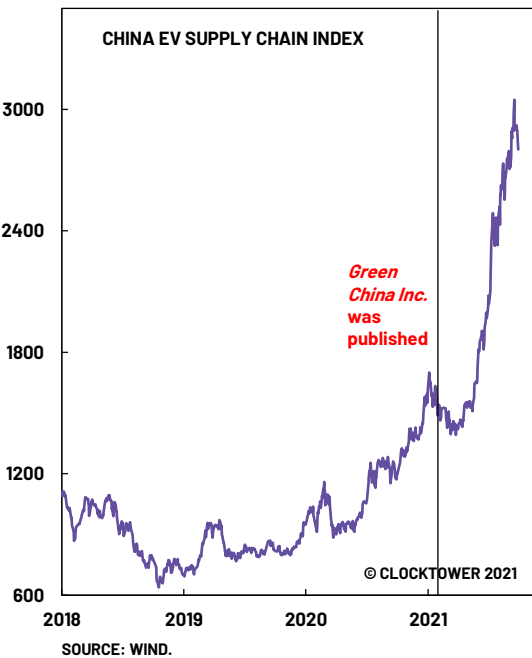
<sup>11</sup> Please see Clocktower Group *All Along the Clocktower*, "The Green China, Inc.," dated February 2021, Volume II, available on request.

<sup>12</sup> Please see Clocktower Group *All Along the Clocktower*, "The Race to Zero," dated January 2021, available on request.



**CHART 30 | Global Commitment to Fighting Climate Change Will Benefit Chinese Renewable Industry**

Despite the heightened valuation concerns in the near-term, long-term investors should stick with our Green China Inc. theme (Chart 32) while waiting for a correction to increase exposure. Chinese solar companies, battery producers, and EV manufacturers remain our top picks for global investors.

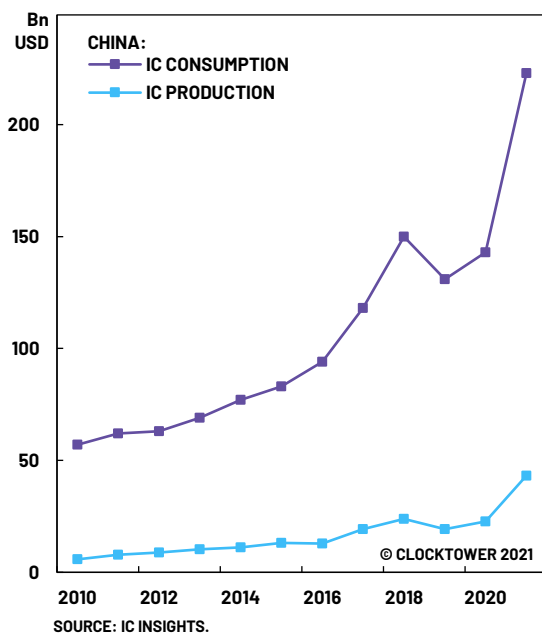
**CHART 31 | Chinese Solar and EV Companies...****CHART 32 | ...Are Our Top Investment Picks**

**Import Substitution in Semiconductors.** China's inability to produce advanced chips was a key factor catalyzing Beijing's strategic pivot from a focus on services to hard-tech manufacturing. Unlike the renewables industry whose TAM expanded in the wake of global concerns over climate change, the semiconductor sector has become a growth story because Beijing's national security concerns opened the domestic market for local products.

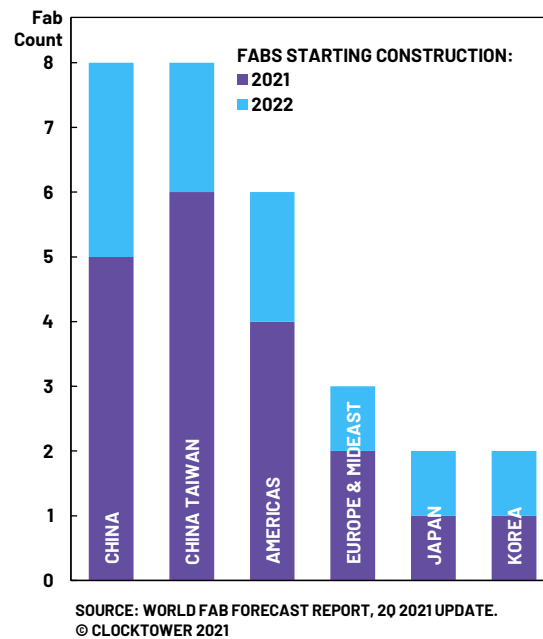
Semiconductors replaced crude oil as China's largest import in 2015. While China is the largest semi market globally, only about 15% of its semi consumption was supplied by domestic production (**Chart 33**). More importantly, of the \$22.7 billion worth of semis manufactured last year, China-headquartered companies produced only \$8.3 billion, accounting for only 5.9% of the country's total semi consumption. In the upstream sector – semi equipment, materials, and EDA – the self-sufficiency rate is even lower than 5%. Given the threat of some future US technological blockade, accelerating semi import substitution has become a top priority for Beijing. China has set an objective of expanding its domestic production of semiconductors (including from foreign firms in China) to meet 80% of domestic demand by 2030, as part of its Made in China 2025 industrial strategy.<sup>13</sup> As such, if Beijing succeeds in raising its semi self-sufficiency rate to even 50% in the next decade, it will mean a market of 10X revenue opportunity for local semi players, while also hurting foreign producers' market share in China.

Over the past few years, the Chinese government – both central and local – has established more than 15 state-owned integrated circuit investment funds, channeling over \$500 billion yuan (\$75 billion) in support of the domestic industry. Subsequently, domestic semi capex spending has surged and China is now leading the global fabs construction (**Chart 34**), supporting our multi-year theme of investing in semi capex stocks globally. This has created tremendous growth opportunities especially for Chinese semi equipment makers and material providers. Going forward, investors should consider overweighting Chinese semi players relative to their global peers. Our top investment recommendation since 2019 – to overweight global semi capex plays relative to semi producers themselves – remains salient as well.

**CHART 33 | Extremely Low Self-Sufficiency...**



**CHART 34 | ...Forced Beijing to Invest**



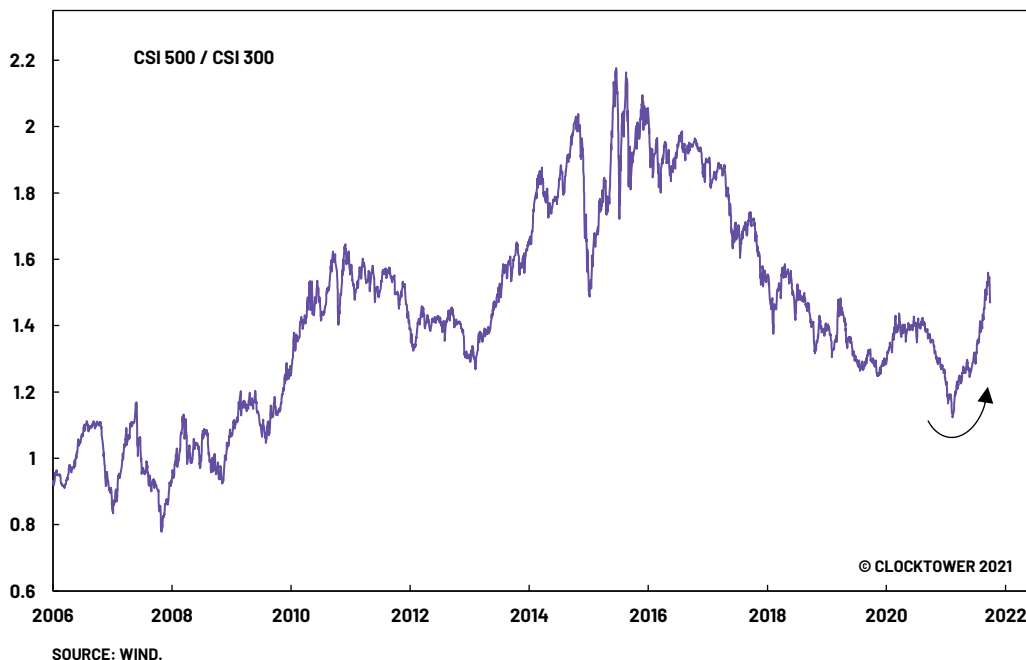
<sup>13</sup> Please see Congressional Research Service, "[China's New Semiconductor Policies: Issues for Congress](https://www.crsreports.congress.gov)," dated April 20, 2021, available at [crsreports.congress.gov](https://www.crsreports.congress.gov).

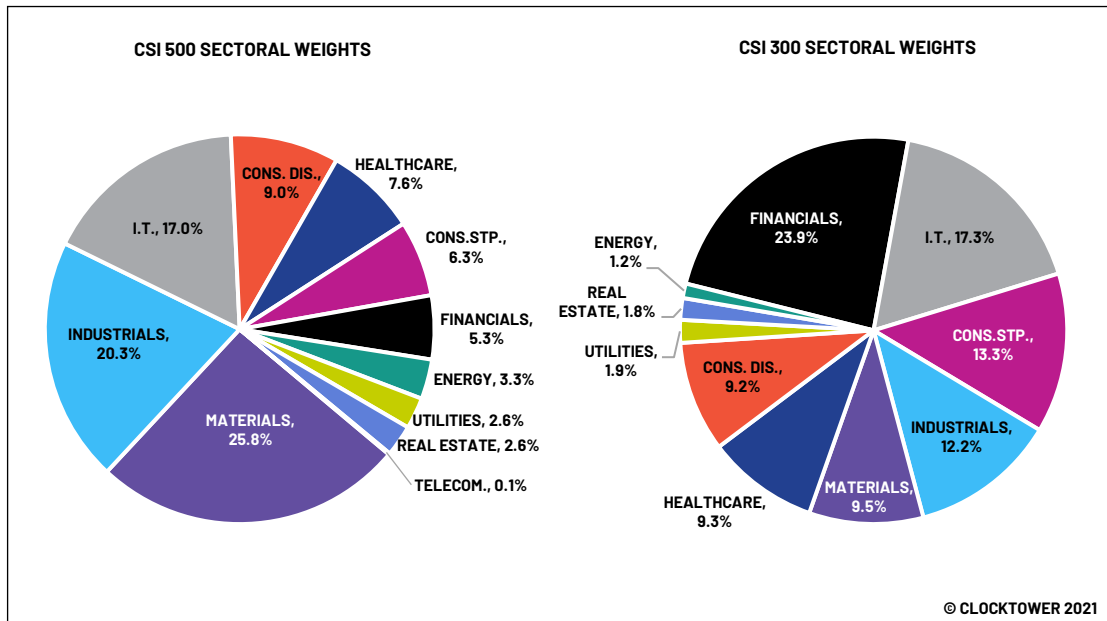
**Rise of the Chinese *Mittelstand*.** Beijing's anti-trust regulation against rising corporate power is likely to create a golden era for small and medium-sized companies (SMEs). While Big Tech platforms and after-school tutoring businesses were suffering a carnage, Vice Premier Liu He on July 27 publicly announced Beijing's strategic pivot to supporting technologically advanced SMEs, which have been dubbed in China the "little giants." According to the Ministry of Industry and Information Technology, "little giant" companies refer to leading SMEs that specialize in niche sectors, command a high market share, boast strong innovative capacity, and focus on core technologies. In many ways, Chinese "little giants" are comparable to the "hidden champions" of Germany – small-and medium sized leaders in highly specialized global markets that are known as the *Mittelstand*. Given Beijing's focus on solving technological bottlenecks, Chinese "little giants" are likely to emerge as a major winner in this new paradigm given ample government support and a regulatory crackdown against their larger corporate peers.

We would recommend investors to go long mid-cap CSI 500 index relative to large-cap heavy A50 or CSI 300 index as a strategic play (**Chart 35**). Unlike the CSI 300, whose sectoral weight concentrates more on financials and I.T., CSI 500 is oriented more towards hard-tech manufacturing, with materials and industrials possessing the largest weights (**Chart 36**). In addition, the revenue of companies in the CSI 500 index is more closely linked to external demand than that of CSI 300 (**Chart 37**).

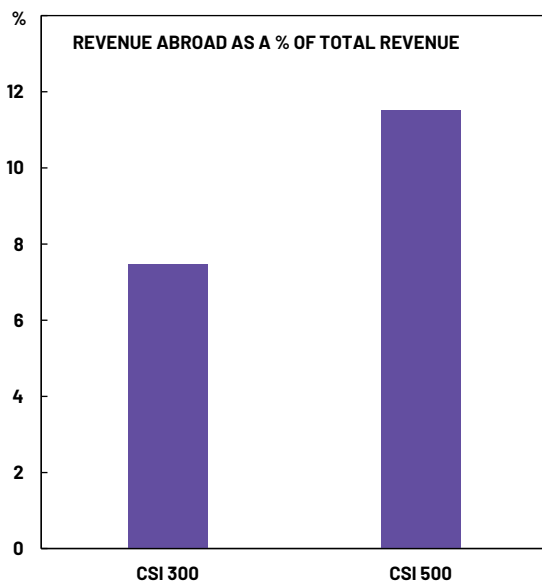
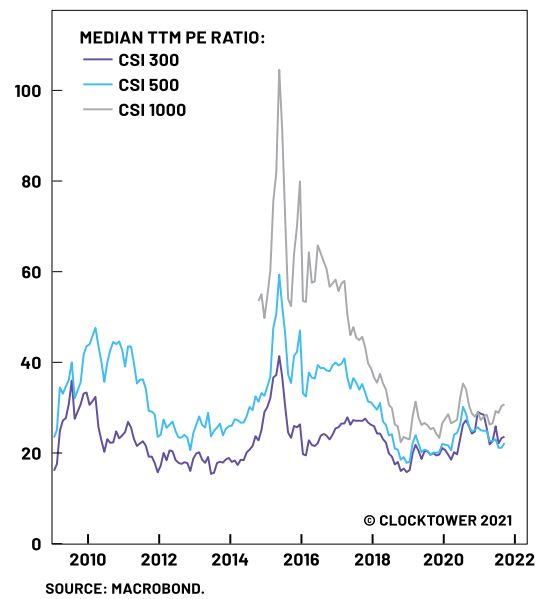
If our prediction is correct that China's traps will force it to tone down its geopolitical assertiveness, Beijing's fixation on manufacturing will only increase its addiction to exports. With Chinese hard-tech companies evolving to become global champions in highly specialized markets, the earning capability of CSI 500 companies is likely to surprise to the upside. Finally, despite the strong rally in recent weeks, the median TTM PE valuation of CSI 500 remains below that of CSI 300, which has rarely been the case in the past given a higher risk premium associated with smaller cap stocks (**Chart 38**). This valuation anomaly thus provides an attractive entry point for global investors who believe in our thesis that Chinese *Mittelstand* is entering its golden era.

**CHART 35 | Chinese *Mittelstand* Is Entering Its Golden Era**



**Chart 36 | CSI 500 Is More Oriented Towards Hard-Tech Manufacturing**

SOURCE: WIND.

**CHART 37 | CSI 500 Is More Linked to Exports**SOURCE: DUNHE ASSET MANAGEMENT.  
© CLOCKTOWER 2021**CHART 38 | Attractive Entry Point in CSI 500**

SOURCE: MACROBOND.

## Macro and Geopolitical Implications

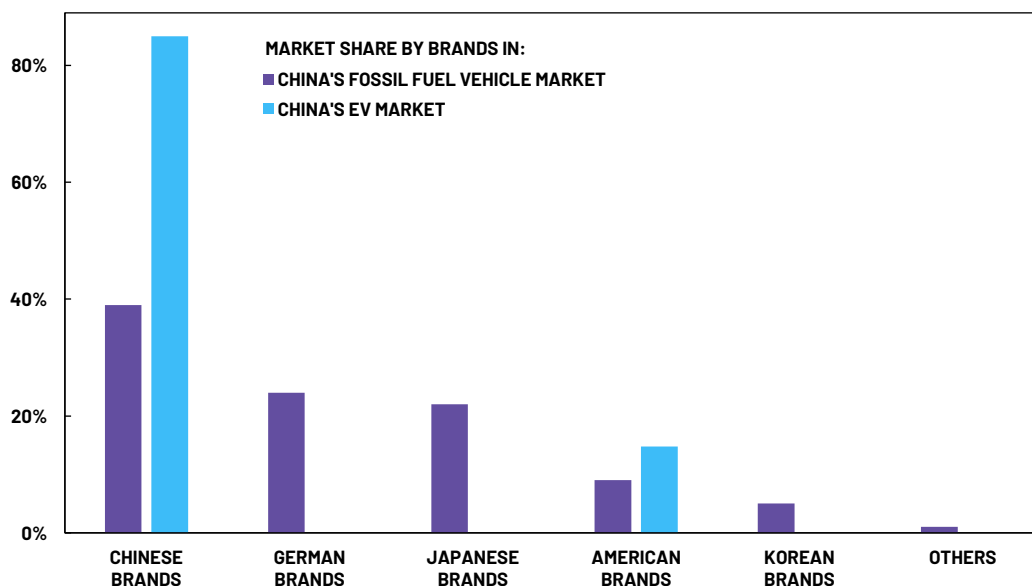
Faced with growing domestic pressures exacerbated by its Three Traps, China has chosen to shift from US to “Rhine capitalism.” There are three immediate risks to China from this shift.

**Risk #1 – The decisive shift towards advanced manufacturing may eventually pit China against Germany and Japan, two nominal US allies that have – thus far – presented a more ambiguous front to countering Beijing’s global ambitions.**

China’s mercantilist/autarkic shift – represented by the import substitution model of “Dual Circulation” – stands at odds with its goal of emulating Rhine Capitalism. A manufacturing-heavy economy tends to overproduce manufactured goods beyond its ability to consume them. As such, manufacturing-heavy economies tend to export some, if not most, of their finished goods. Both Japan and Germany are pacifist. For China, this reality will be exacerbated by its high level of household leverage and the overarching constraint of demographics. An aging, overindebted, society is not going to binge on manufactured goods. As such, Beijing will have to make nice with its export markets, taking care to not anger trade partners with mercantilist policies. This is not all too dissimilar from how both Germany and Japan have adopted manufacturing-heavy developmental models that ended up neutering both geopolitically.

The likely first iteration of this coming conundrum will be the EV transformation and the rise of domestic brands. European and Japanese auto makers have all but seen their dominance in Chinese market collapse in the EV era (Chart 39). Beijing’s move to strengthen China’s national security via hard-tech manufacturing may ironically weaken its geostrategic position. And yet, given that demographics and private sector leverage guarantee China’s addiction to export-led growth, Beijing will find itself between a rock and a hard place.

**CHART 39 | China's EV Transformation Does Not Bode Well for European and Japanese Auto Makers**



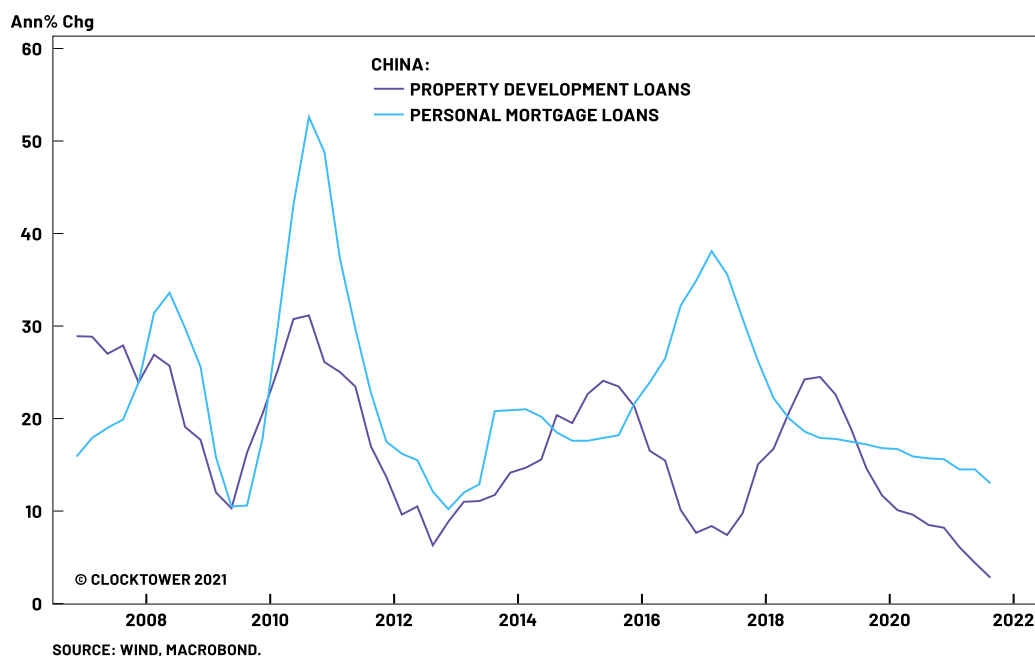
SOURCE: AUTOINFO, NATIONAL PASSENGER CAR INFORMATION EXCHANGE ASSOCIATION.  
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**Risk #2 –Beijing’s political will to address wealth inequality becomes overly strong, dampening the animal spirits of private entrepreneurs, scaring away investors, and even inducing a housing market crash.**

With a per-capita GDP of \$10,500, China is struggling to escape the middle-income trap. Given the demographic decline, continuous economic progress must be based on innovations and more effective investment, none of which are likely to happen if private entrepreneurs lose faith in the system. Given a series of high-profile CEO step-downs – including Richard Liu of JD.com, Zhang Yiming of Byte Dance, and Huang Zheng of PDD – Beijing’s regulatory push may have already gone too far in the near-term.

To narrow China’s wealth inequality, Beijing is widely expected to accelerate the introduction of capital gain tax, inheritance tax, and property tax. The housing market will bear the brunt of the three major taxes as they increase the cost of property holding, transaction, and transfer. In addition, increasing evidence suggests that the magnitude of Beijing’s latest crackdown on the housing market is unprecedented, with both property development loans and personal mortgage loans recording the lowest growth in history (**Chart 40**). As such, despite the good intention to increase housing affordability, a policy mistake (e.g. an imprudent introduction of nationwide property tax) is likely to cause a full-blown housing market crisis that destroys the savings of middle-class families.

**CHART 40 | Beijing’s Latest Crackdown on the Housing Market Is Unprecedented**

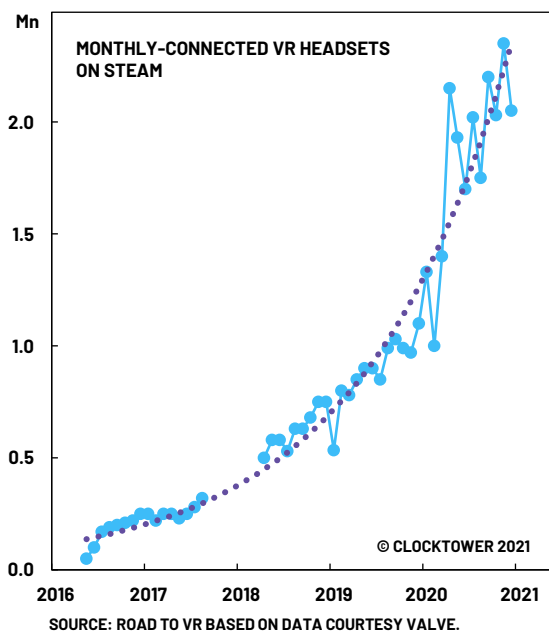


Of course, there is a smooth path to redistributing wealth. Instead of introducing real estate taxes that cripple the economy and increase odds of political risk, Chinese policymakers may simply retain a high degree of investment-led growth in the economy. This is a conundrum facing Beijing as depending on investment-led growth is also likely to exacerbate bubbles. While Beijing may pivot away from real estate investment towards more productive endeavors such as green/semiconductor/infrastructure investment, centrally planned and executed investment efforts are unlikely to end well in the future.

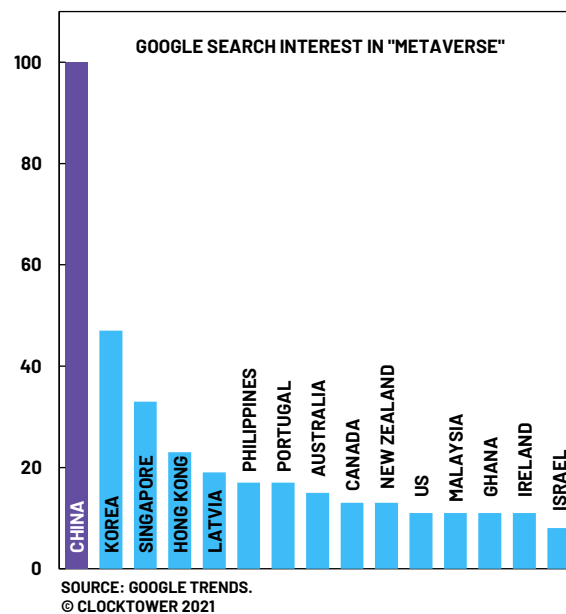
**Risk #3 – Beijing’s sudden hostility to “bits” sectors (Internet and gaming companies particularly), if unchecked, may deprive China of the opportunity to take a leading role in the Metaverse development.**

The formation of Metaverse is likely to surprise to the upside given the Covid-accelerated digital transformation and the fact that the VR industry is getting closer to an inflection point (**Chart 41**).<sup>14</sup> A more interesting observation is that China is the country that has the most enthusiasm towards the concept of Metaverse, at least according to Google Trends (**Chart 42**). China’s vast Internet user base, booming gaming industry, and large blockchain/crypto community have laid a strong foundation for its TMT companies to compete with leading US firms, such as Facebook and Epic Games, in the race towards the Metaverse. But if the regulatory reset overkills the bits sector for the sake of advanced manufacturing, Beijing may find itself missing a strategic opportunity to seize the commanding height in the Metaverse economy.

**CHART 41 | VR Industry at An Inflection Point**



**CHART 42 | Metaverse Enthusiasm in China**



For foreign investors, these are all concerns worthy of monitoring. Our analysis of China’s future growth prospects is riddled with potential pitfalls. Beijing’s ability to pivot its developmental growth model amidst geopolitical tensions with the US, a demographic decline, and the potential bursting of its own Debt Supercycle is greatly in question. We would not bet on China replicating the past two decades of extraordinary growth.

At the same time, China remains an investment opportunity, albeit one fraught with risks, precisely because of its faults. If we had a high conviction view that Beijing would resolve its domestic constraints and challenge the US for global hegemony, we would be – as investors domiciled in the West – highly skeptical of continued access to Chinese markets. A bullish view of China, in the absolute sense, would require a bearish view of one’s investment opportunities as an unconstrained Beijing would ultimately pursue its geopolitical imperatives and foreign policy preferences. Therein lies the irony of investing in China. One must believe that Chinese policymakers will remain constrained from pursuing their geopolitical ambition by domestic factors in order to continue profiting from onshore growth and innovation.

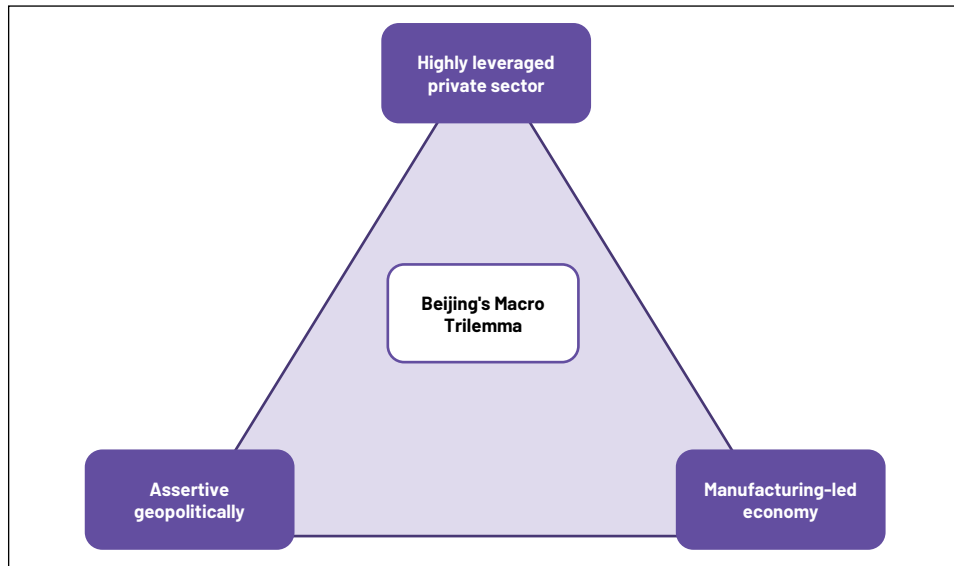
<sup>14</sup> Please see Clocktower Group *All Along the Clocktower*, “Enter the Metaverse,” dated August 2021, Volume II, available on request.



Our view is that Chinese policymakers will increasingly face a Macro Trilemma (Diagram 2). Over the next decade, Beijing will be able to exist in two out of the following three macro contexts:

- A highly leveraged private sector;
- A highly aggressive geopolitical posture;
- A pivot to a manufacturing-led economy.

DIAGRAM 2 | Beijing's Macro Trilemma



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A German economic model is only possible if China either tones down its geopolitical ambitions and focuses on export markets or if it resolves its domestic leverage to unleash domestic demand. Given that the latter would require an epic “cleansing” of leverage that would make Friedrich Hayek blush with excitement, we are confident that Beijing will have to tone down its ambitions instead.

The fact of the matter is that China is already stuck with extreme private sector leverage and a demographic crisis. It therefore must decide whether to be assertive geopolitically or shift towards a manufacturing-led economy. We think that the choice is obvious and only confusing to the most zealous China hawks (or... hawks *in* China!). China has the luxury of delaying its geopolitical ambitions one more decade. It does not have the luxury of staying in the middle-income trap forever. Emerging markets are littered with graveyards of authoritarian regimes that failed to transition out of the middle-income. The Trilemma therefore is no dilemma. It’s yet another trap. China will have to abate its geopolitical ambitions or face utter economic collapse.

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