

Week of 7th June 2021

What's on our mind this week?

China's battle against imported inflation

At a time when every other economic article printed is about the surge of inflation and its impact on risk assets, China is protecting itself from imported inflation by letting its currency appreciate while cracking down on commodity traders piling on inventory, by raising transaction fees and at the same time telling currency speculators around the world that a rising RMB is not a one-way bet.

To understand the logic behind this move, one needs to remember how the regime came to power in October 1949 after the Nationalist Kuomintang had let the country fall into hyperinflation by printing massive amounts of money to pay for the civil war against forces led by Mao Zedong. Between September 1948 and May 1949, prices in China had gone up by 1.28 million times while the yuan's exchange rate against the US dollar had depreciated from 700:1 in January 1949 to 23,280,000:1 in May 1949.

Forty years later, in June 1989, the Chinese government faced another inflation-triggered crisis soon after China had abandoned in 1988 the food rationing coupon system that was common at that time to many communist countries. Food coupons were replaced by market economy, and price control started being lifted in August 1988. Inflation immediately rose from 7.3% in 1987 to 18.8% in 1988. It was a key factor behind the June 1989 unrest.

The Chinese government's fear of inflation is the reason why it has been so critical of western Central banks' monetary policies that started in 2009 after the fall of Lehman Brothers, namely quantitative easing through asset purchases. It is quite easy to draw a parallel between China and Germany as both countries saw their modern history set by hyperinflation (the Weimar Republic of the 1920s in the case of Germany) and as both governments remain highly critical of quantitative easing, Germany having surrendered its monetary policy to the European Central Bank. This is why People's Bank of China (PBoC) has been the only central bank to have refused to print money, and why it is now letting the RMB appreciate to protect the Chinese economy from the consequences of

western monetary policies, i.e. imported inflation. The subtle exercise is to let this gradual appreciation of the RMB happen without allowing currency speculators take control of the script, which is why the official message is that PBoC will not let the RMB appreciate in a disorderedly way and will not hesitate to step in to curtail any excessive move. This is what happened when PBoC announced on 31st May that the Required Reserve Ratio for foreign deposits will be raised on 15th June from 5% to 7%, reducing the amount of foreign currencies in the banking system that could be exchanged for RMB.

In our views, the Chinese government is intentionally blowing hot and cold air as it does not want to openly state that it is protecting the Chinese economy from imported inflation through a steady wave of currency appreciation that could become a one-way bet for currency traders, which in turn could trigger a snowball that would be detrimental to the trade balance.

This strategy seems to be working as the economy is showing no sign of a slowdown. Demand for Chinese goods is as high as it has ever been, Chinese exports accounting for a record 15.9% of world exports as at February 2021 according latest IMF data, up from 13.3% a year earlier. While the RMB appreciated by 1.6% in April against the US dollar, the headline Consumer Price Index (CPI) rose by 0.9% YoY and the core CPI by 0.7% YoY only. Prices at the factory gates moderated on a month-on-month basis: The Producer Price Index dropped from +1.6% MoM in March to +0.9% MoM in April, showing the muted impact imported commodities had on companies doing business in a rising RMB environment.

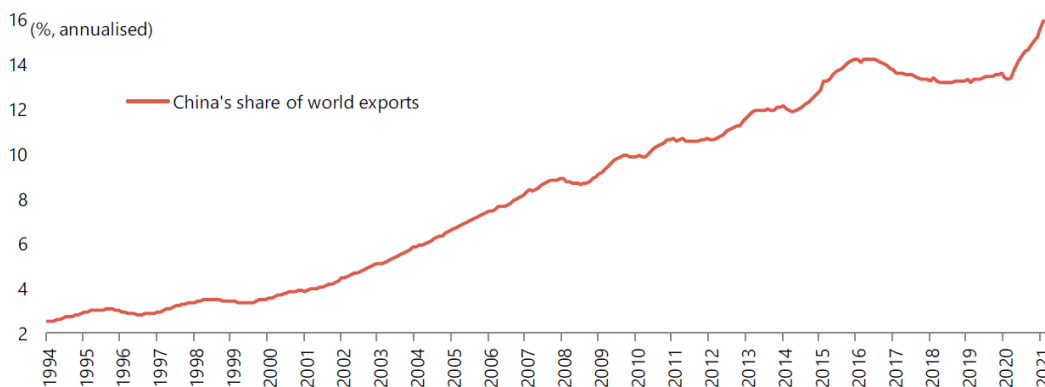
By comparison, CPI indices in the United States and in the euro area went up by 4.2% and 1.6% respectively in April.

Onshore RMB vs USD



Source: Bloomberg – June 2021

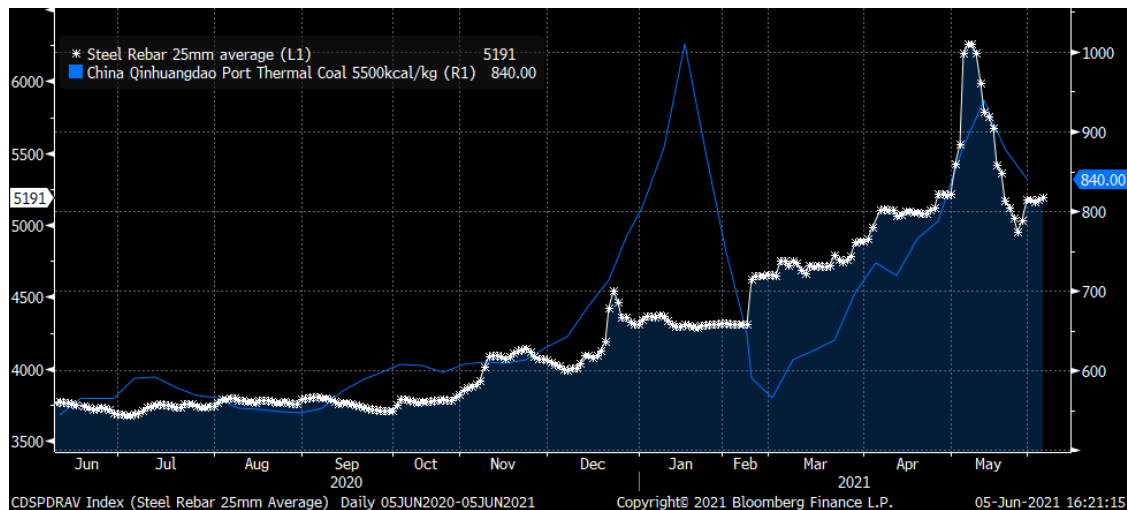
China's share of world exports



Sources: Jefferies, Datastream, IMF – Direction of Trade Statistics- June 2021

While PBoC is busy letting the RMB appreciate while being careful with the message it is conveying to the world, the National Development and Reform Commission (NDRC) is busy with its Department of Price taking actions to tame down local commodities prices. New taxes were recently imposed, transaction fees were raised, industry research on commodities are being censored and commodities producers are requested to sell their inventories. So far, these measures have been somewhat successful as the price for steel rebar dropped from its recent peak by 20%, and coal price by 10% (see chart below).

China's steel rebar and thermal coal prices



Source: Bloomberg- June 2021

In conclusion, our view is that the Chinese government is taking very seriously the inflationary threat coming from the western part of the world and is all-out to fight it. Even though the days of hyperinflation are long gone, managing inflation has always been on the top of the Chinese government's agenda as history has shown what social impact rising prices could have. As long as the macro picture remains good, we expect the Chinese government to let the RMB keep on appreciating against the US dollar even if the official message may be contradictory. As to commodities, the Chinese government is certainly hoping that the bout of inflation the west is currently going through will be temporary as administrative measures in China can only be temporary patches against a global rising tide of prices. The sandcastle cannot resist the rising tide for too long.

Nationalism in the semiconductor industry

Over the past few months an important change appears to have happened in the IT capex space: tangible assets are now favoured over intangibles, manufacturing is more popular than designing. This is happening across many sectors but in the semiconductor industry this trend suddenly became more apparent in light of the severe integrated circuits (IC) shortage that is currently hitting. Governments in the developed world have started to realise that owning factories to manufacture IC is important for their national security.

The US government plans to invest USD 49.5bn in the semiconductor industry of which USD 39bn will be spent to boost manufacturing capabilities in the US. The Japanese press also reported that their government is reviewing a USD 9bn investment to build advanced semiconductor factories in Japan and is working to bring TSMC and Sony into this investment plan. Also, the EU industry chief, Thierry Breton, recently met with senior executives from TSMC and Intel to convince them to set up manufacturing facilities in the European Union. Finally, it is also well known that State-driven-economies like China or Korea have been investing in the IC manufacturing industry for years already. Just this week it was announced that China Resources and a state fund will set up a joint venture which will invest RMB 7.55bn in a semiconductor wafer production line. The state fund will own a 33% stake in the venture, according to a statement made to the Shanghai stock exchange.

What may this state driven investment spree mean for Asian players? Are they at risk of losing their competitive advantage? Probably not in the short term. Our base case is still that companies like TSMC and Samsung will be the main beneficiaries of the trend in the next 3 to 5 years, as they are the companies invited to build factories in the developed world. However, in the longer term, governments in the developed world are likely to naturally favour their local champions: Intel in the US, Sony in Japan, or ST Micro in the EU. This is the main purpose of this government funding spree: to build domestic production powerhouses managed by local players.

However, state-planned investments often lead to inefficiencies and oversupplies. Currently the global semiconductor supply chain is very efficiently set up: the US designs the core digital chips, the EU designs and manufactures the analog chips, Korea manufactures the memory chips, and Taiwan manufactures the logic chips. The economies of scale of each sub-sectors and the high- expertise knowledge they each require has led to this regional clustering.

Even within each region, one can find local clusters such as the small area of Hsinchu in Taiwan, and Suwon in Korea, where the supply chains including material, parts, and equipment suppliers are clustered together with the foundries. If state-driven investments lead to new clusters appearing in each region, it will definitely bring inefficiencies over the longer term. It is not a new story in Asia: the investments made in the MEMS sensor industry that had been piloted by the Korean government 15 years ago, the logic IC

investments made by local Chinese governments 10 years ago are all good examples of how such policies can turn into massive failures.

Although our view is pessimistic in the longer term, it will be beneficial for Asian companies as their cost of funding will drop, and as equipment makers will face unprecedented demand growth. This trend will continue for several years. Asian IC manufacturers from Taiwan and Korea have strong operational technology and customer relationships. They will certainly benefit from this trend.

However going back to the original question, what should companies and governments in Asia do to maintain their leadership? The answer lies in what the Asian IC industry is lacking: chip design capability and equipment technology.

Looking at chip design, leadership is mostly dependent on having ownership of the end users by being irreplaceable, more so than proficiency in assembly language. China definitely has the market to support a local chip design. Chinese chip designers are well positioned to keep enhancing their chip design capability faster and better thanks to a strong pool of captive customers such as device makers Xiaomi, Oppo, Lenovo, Hikvision, TCL or DJI, the drone company. Companies like Will Semi are poised to become major chip designers for China. Once they are, the risk of seeing their leadership shift away from Asia will be limited.

Looking at manufacturing technology, it is important to understand that the TSMCs of the world are not the ones that actually own the technology they use: the equipment companies who supply them are the ones. Without Dutch company ASML, TSMC would have never been able to surpass Intel's manufacturing leadership. Currently, 80% to 90% of the manufacturing equipment needed by the foundries is produced in the US, in the EU or in Japan. This is how President Trump managed to cut the equipment suppliers from the leading Chinese IC manufacturer SMIC.

Asian countries need strong local equipment makers to provide local foundries with state-of-the-art manufacturing technology if they want to succeed in building a local and sustainable leadership. Korea has several strong equipment makers. In China, we are witnessing significant progress in this field as well.

If Asian governments understand well enough the industry, they should not invest in chip manufacturers (i.e. foundries) like some of them have done in the past, but rather focus

on growing their equipment makers which are the companies that will bring long-term stability to the semiconductor industry across the region. Time will tell if they have such vision and avoid making the same mistakes once again.

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