

## CHINA



- Chinese stocks have surged in recent weeks. The MSCI China Index is up 26.5% as of 21 Feb 2025 from its January low and has gained nearly 18% this year. What is behind this lift, and where is it headed?

**The Catalysts**

- The biggest impact on the market came from DeepSeek's breakthrough in late January.
- The innovative techniques implemented by the company provided important cost reductions in AI model training while also improving performance. DeepSeek managed to rival OpenAI's o1 model using inferior chips acquired prior to export controls and high-end chips obtained by exploiting loopholes in those regulations. They also leveraged on distillation techniques, which allows training of a smaller model with by asking larger models such as ChatGPT questions.
- This reversed the bearish sentiment on the Chinese technology sector as it showed that, despite the numerous trade restrictions implemented by the US on semiconductors exports to China, the country was still able to adapt and improvise to develop AI models that could rival those in the US.
- Following DeepSeek's R1 release, the Bank of China announced its AI Industry Development Action Plan, pledging \$137B over the next 5 years with the aim to achieve self-reliance in science and technology.
- Stocks rose after President Xi held a meeting with prominent entrepreneurs, such as Jack Ma, where he promised to abolish unreasonable fines against private firms. This contrasts with the crackdown in recent times on leaders in the private sector.
- This led to a re-rating of the Chinese tech giants. The KraneShares CSI China Internet ETF is up 25.9% YTD as of 21 Feb 2025. Meanwhile, Alibaba's ADR listed on the

NYSE was up 48% since the start of the year prior to its latest quarterly report.

- Adding to the bullishness of the markets, President Trump announced tariffs of only 10%, significantly lower than the 60% he was quoting during his campaign. He qualified his relationship with President Xi as "great" and mentioned that he expected him to visit the US. He also stated that there is the possibility that the US and China will sign a new trade deal.

**What's ahead**

- DeepSeek would need significantly more computing power to catch up to o3, OpenAI's latest model. The company's CEO stated that "Our challenge has never been money; it's the embargo on high-end chips." In January 2025, Trump signed an executive order for the administration to "identify and eliminate loopholes in existing export controls" to enhance national "industrial and technological advantages." Thus, given US firms' continuous outsized investments in AI, it is likely that the US' lead will widen.
- China is likely to continue to play an important role in AI development. It is possible that China will position itself as a low-cost provider for low/middle income countries. DeepSeek is currently charging \$2.19 per million tokens for R1 while OpenAI charges \$60. Alibaba – which made DeepSeek models available on its cloud platform - announced that it would invest \$52Bn in AI and Cloud over the next 3 years, which is more than what it had invested over the past decade.
- Bloomberg recently reported an interesting development in the property sector. Chinese state-backed developers are buying land at a 20% premium to prop up the property market and as a bet on the market bottoming.
- The outlook of investment banks for Chinese equities, following the recent surge, is mixed. Morgan Stanley ended its bearish view on China but still forecasted only a 4% upside on 19 Feb 2025. UBS was also neutral, stating that tariff risks remained and that domestic issues have not yet been fully resolved. They nevertheless expect the internet sector to outperform as the multi-year crackdown appears to be over. Goldman Sachs shares the same optimism, seeing a 14.9% as they expect latest developments in AI to change the narrative about Chinese technology and re-rate investor's optimism about the growth and the economic benefits from AI.

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