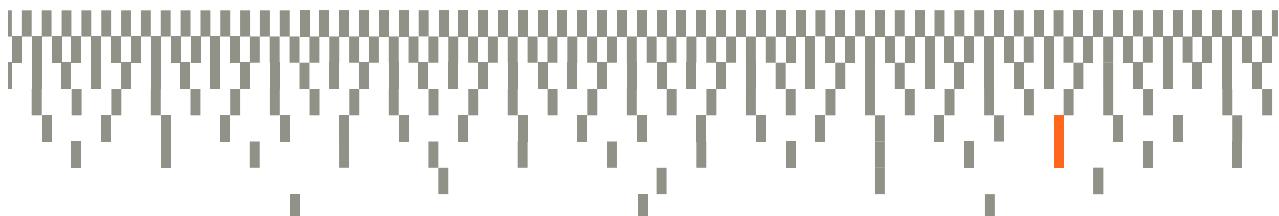




China beyond manufacturing: Automation and the rise of services



China update

In late 2025, Chinese equities completed a full cyclical transition, moving from a period of volatile consolidation and policy support to a pre-New Year rally. The A-share market came under pressure in November before rebounding. Investor sentiment weakened amid debates around the sustainability of the AI narrative and a marginal tightening in liquidity conditions, prompting a rotation into defensive sectors such as banking and pharmaceuticals.

- **The MSCI China A Onshore Index outperformed significantly in December (+4.8%).**
- **The MSCI China Index dipped (-1.5%) while the China All Shares Index remained flat (+0.4%).**
- **On a full-year basis, all three indices delivered strong double-digit growth: MSCI China (+28.1%), MSCI China A Onshore (+27.0%), and MSCI China All Shares (+25.9%).**

As December began, the Chinese central bank increased liquidity injections, easing market interest rates, after which A-shares stabilised before hitting a strong rally. The Shanghai Composite Index recorded an 11-day winning streak, closing at 3968.84, its highest level in 18 years.

Small and mid-cap stocks outperformed, with "tracks" such as semiconductors and lithium batteries leading gains. Materials, Information Technology, and Industrials posted strong gains, while Healthcare and Real Estate continued to lag. Over the full year, more than 40% of individual stocks rose by more than 30%, with Technology, AI, and Aerospace among the standout performers. Trading activity also surged, with annual turnover rising over 60% year-on-year, to a record high.

The Hong Kong market consolidated in November but showed signs of fatigue by December. Although trading activity remained elevated, market style shifted toward value stocks. Select themes such as commercial aerospace remained attractive, while low-valuation sectors such as non-ferrous metals and machinery outperformed growth stocks.

Performance among large technology companies diverged amid earnings uncertainty and intensifying competition, weighing on index returns. Despite the year-end cooling in trading, full-year Southbound capital net flows (from the mainland to Hong Kong) reached a record HK\$1.38 trillion. Toward year-end, however, Southbound capital showed signs of profit-taking, with allocations shifting toward high-dividend sectors like banking and insurance.

Chinese ADRs staged a notable recovery from late November, supported by rising expectations of US Federal Reserve rate cuts and improved China-US relations.



Liquidity support sparks year-end rally



Onshore small- and mid-caps lead gains



Capital inflows hit multi-year highs



Policy clarity accelerates structural shift

On the macro level, the Central Economic Work Conference underscored "Innovation-Driven Development" and the "AI+" strategy as core policy priorities providing a clearer medium-to-long-term direction for markets.

Capital flow data showed that Northbound capital net inflows in December reached a three-year high for the period, with significant additions to semiconductors and AI computing power. Meanwhile, public mutual funds continued to favour manufacturing, resources, and technology themes.

Overall, with clearer year-end policy signals and sustained domestic and foreign capital inflows, Chinese equities appear to have moved beyond a phase of risk release and structural repair, establishing a firmer foundation heading into 2026.

Accelerating beyond manufacturing

Against this backdrop, this edition continues our exploration of China's evolving role in the global economy, drawing on insights from a presentation by Professor Richard Baldwin, Professor of International Economics at IMD Business School in Lausanne and a leading authority on international trade and globalisation.

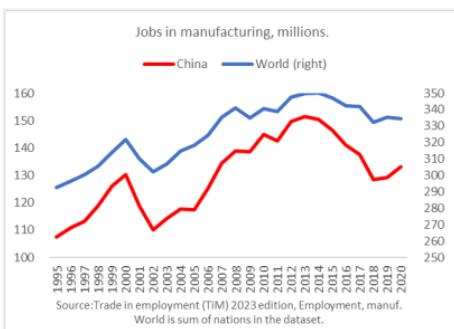
In last month's newsletter, we examined China's manufacturing scale, supply-chain centrality, and role as a global value chain builder. The focus now shifts to what comes next: automation, services, and the structural transition now underway.

Automation and the future of manufacturing

Automation is increasingly reshaping global manufacturing, narrowing the labour-cost advantages that historically differentiated China from its peers.

Chinese equities completed a full cyclical transition in late 2025, culminating in a decisive pre-New Year rally.

Advances in robotics, AI, and digital technologies are reshaping global production and reducing the traditional reliance on low-cost labour. While this trend gradually erodes the labour-cost advantage that underpinned China's early manufacturing success, China's rapid adoption of automation is now helping it offset rising wages and a declining working-age population.



At the same time, automation carries important implications for employment, wage growth, and the broader structure of the Chinese economy.

Managing this transition will require continued investment in workforce retraining and the reallocation of labour toward higher-value roles in engineering, equipment maintenance, and digital operations. If navigated effectively, automation has the potential to support the next phase of China's industrial upgrading rather than act as a constraint on growth.

The next frontier: high-value services

While global goods trade has expanded steadily over time, (albeit with periods of volatility), services trade has grown more rapidly, driven by advances in digital technology, the globalisation of knowledge-based work, and the rising importance of intangible assets. For China, narrowing the productivity gap in services could yield far greater economic benefits than incremental improvements in manufacturing efficiency.



Automation reshapes jobs and wages.



Retraining supports industrial upgrading.



Services drive next productivity gains.



Engineering becomes a core value-add.

Technological advances are increasingly lowering barriers to entry in global services markets. As highlighted by Professor Richard Baldwin, breakthroughs in areas such as real-time speech translation could prove transformative, enabling Chinese service providers to compete globally despite language barriers. At the same time, the growing global pool of engineers and digital talent continues to reduce the cost of delivering complex, high-value services across borders.

Engineering value-add: the evolving core of manufacturing

Even within manufacturing, China's value creation is shifting away from pure assembly and towards engineering-led services. Companies such as Apple rely heavily on their Chinese suppliers not just for manufacturing, but for design optimisation, materials engineering, and component innovation. This embedded engineering capability has become a critical competitive advantage, and a key reason China remains deeply integrated within global supply chains.

Conclusion

China's evolution from manufacturing powerhouse to global supply-chain architect and, potentially, a leader in high-value services, is reshaping the global economic landscape. While near-term challenges remain, the country's capacity for structural transformation is substantial. For investors, understanding these shifts will be essential to assessing China's long-term growth trajectory.

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