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INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

# China Equity Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 31 DECEMBER 2019

## Performance Review

As the Fund is less than a year old we are constrained from commenting on its performance.

## Market Review

China equities finished 2019 on a strong note. The broad MSCI China Index returned 8.3% in December 2019, bringing the quarterly gain to 14.2%. For the full-year 2019, the MSCI China Index advanced 23.5%. Cyclical rotation continued into the year-end as real estate, materials and information technology (IT) sectors outperformed, while utilities and consumer staples lagged in December.

Easing geopolitical tensions were the main driver of equity performance, as the U.S. and China reached a phase-one trade deal that would avert new tariffs and lower existing ones. As part of the deal, China will significantly increase its agricultural purchases from the U.S., boost intellectual-property protection, curb forced technology transfers and further open up the domestic market. The deal marked the first tariff rollback since the inception of the trade war in July 2018 and helped remove some of the near-term downside risks to the market and the global economy.

Meanwhile, the latest macro data also came in upbeat, further buoying market sentiment. November industrial production growth accelerated to 6.2% year-over-year from 4.7% in October, while retail sales growth picked up to 8.0%, pointing to stabilization in overall economic momentum. Total social financing came in strong at 1,750 billion renminbi in November, beating market expectations. Consumer price index (CPI) inflation, however, edged higher to 4.5% year-over-year in November as pork prices remained elevated.

On the policy front, the authorities continued incremental easing. The People's Bank of China (PBoC) lowered the 14-day reverse repo auction rate by 5 basis points and announced a plan to replace the old benchmark lending rates with the loan prime rate in pricing outstanding floating-rate loans, which could lead to lower corporate loan rates. The government also front-loaded 1 trillion renminbi of the special local government bond quota by end-2019 to jump-start infrastructure investment projects. The annual Central Economic Work Conference set stability as the top priority for 2020, and the actual policy setting will likely be dynamic and pragmatic. Meantime, the long-awaited revision of the Securities Law was approved, which included provisions to expand registration-based initial public offerings, stricter information disclosure requirements and tougher penalties for market violations for the onshore A-share market.

The Hong Kong equity market rebounded in December, with the MSCI Hong Kong Index rising 4.0% for the month. The market gained 7.3% in the fourth quarter and finished the year 2019 up 10.3%. Hong Kong was battered by the months-long social unrest, which continued into year-end. Retail sales tumbled more than 20% year-over-year in October and November, and the overall economy remains in recession. The growth outlook appears gloomy given weak consumer confidence, subdued tourist arrivals and lingering political impasse. Real estate and utilities underperformed in the past quarter due to the weak local economy, while health care, consumer discretionary and IT outperformed.

## Portfolio Activity

There was no significant portfolio activity for the month of December.

## Strategy and Outlook

We are positive on China equities in the near term, which we expect to be supported by continuous earnings growth, potential further policy easing, a stabilized currency trend and improvement in trade talks/external conditions.

The Chinese economy is likely to stabilize and policy may remain supportive, with further reserve requirement ratio and/or interest rate cuts and increased local government bond issuance. We do not believe the recent CPI hike will trigger tighter monetary policy in view of subdued core CPI and continued Producer Price Index deflation. Our base-case scenario assumes a 'phase one' trade deal to be reached, which should help boost sentiment and private investment. Under this scenario, we also expect stabilization for yuan on a traded-weighted basis. From a bottom-up perspective, we expect sustained earnings growth for the MSCI China Index in 2020 to provide fundamental support to the equity market. Meanwhile, we think the current valuation level is reasonable given the expected improvement in external conditions.

Our medium-term view on the market hinges on whether the Chinese government can take the external pressure to further launch and implement long-term reform measures. We also expect global interest rates (and thus risk-free rates) to stay lower for longer. Against this macro backdrop, there are structural themes that will likely play out, including the ongoing industry consolidation and consumption upgrade. Many sectors have passed the rapidly rising penetration stage, and industry leaders with strong competitive advantages and financial strength should be able to gain market share and become even bigger and stronger. Thus, we continue to focus on industry consolidators with sustainable compounding growth. We expect the market appetite to resume for the so-called ‘New China’ companies as the growth expectation gets reset and the valuation levels find their support. We also expect the consumption upgrade to continue in the foreseeable future as household income rises and the middle-class population expands over time.

**For further information, please contact your Morgan Stanley Investment Management representative.**

### FUND FACTS

| Launch date | Base currency | Index |
|---|---|---|
| 01 August 2019 | U.S. dollars | MSCI China 10-40 Net Index |

**Past performance is not a reliable indicator of future results.** Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund’s other share classes.**

**The MS INVF China Equity Fund’s performance returns are benchmarked to the MSCI China 10/40 Net Total Return Index since inception, rather than the the MSCI China (Net) Index as originally announced.**

## Share Class Z Risk and Reward Profile

| Lower Risk | | | | | | Higher Risk |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | **6** | 7 |
| Potentially Lower Rewards | | | | | | Potentially Higher Rewards |

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The Fund is in this category because it invests in company shares and the fund's simulated and/or realised return has experienced high rises and falls historically.
- The Fund may be impacted by movements in the exchange rates between the Fund's currency and the currencies of the Fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The Fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the Fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the Fund's ability to buy or sell securities.
- Investment in China A-Shares via the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor’s reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 31 December 2019 and subject to change daily.

## INDEX INFORMATION

The **MSCI China 10/40 Equity Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and Pchips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective. The Index seeks to comply with the European Union's UCITS '5/10/40' diversification rule. This rule says that a maximum of 10 per cent of net assets may be invested in securities from a single issuer, and that investments of more than 5 per cent with a single issuer may not make up more than 40 per cent of the whole portfolio. UCITS stands for Undertakings for the Collective Investment in Transferable Securities.

The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective.

The **MSCI Hong Kong Index** measures the performance of the large- and mid-cap segments of the Hong Kong market.

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