Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

China Equity Portfolio

EMERGING MARKETS TEAM | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 0.30% (net of fees)[1], while the benchmark returned 2.27%.

For the quarter ending June 30, 2021, our stock selection in financials and information technology, along with our underweight to real estate and overweight to consumer staples, contributed to returns. Our stock selection in consumer discretionary and communication services and our underweight in health care detracted.

At the stock level, our overweight allocations to TAL Education and New Oriental Education were the biggest detractors from returns due to China's crackdown on after-school tutoring (1.1% and 1.2% of the portfolio).[2] Our overweight to Tencent also detracted given weak sentiment on the internet sector amid increased regulatory scrutiny (19.3% of the portfolio).[2] On the other hand, our overweights to textile and sportswear makers Shenzhou International and Li Ning contributed most to returns (4.5% and 2.0% of the portfolio).[2] Our overweights to staple names China Resources Beer and Kweichow Moutai also contributed (2.8% and 6.8% of the portfolio).[2]

Market Review

China equities traded largely sideways in the second quarter as the market struggled to find direction amid heightened uncertainties on inflation, growth and policy outlook. The MSCI China Index closed the quarter up 2.27%, trailing the broader emerging markets, which gained 5.05% (MSCI Emerging Markets Index). Despite strong corporate earnings, sentiment remained cautious amid China's ongoing antitrust campaign, tighter internet sector regulations and surging commodity prices. Health care, information technology and energy sectors outperformed during the quarter, while real estate, financials and communication services lagged.

Following the 18.3% year-over-year rebound in real gross domestic product growth in the first quarter, the Chinese economy continued to expand in the second quarter, albeit with moderating momentum. The latest official manufacturing purchasing managers' index edged down to 50.9 in June from 51.0 in May, with the production sub-index leading the weakness.[3] Export orders also showed signs of tapering, suggesting pandemic-induced global demand for Chinese goods is waning. Indeed, China's export growth moderated to 27.9% year-over-year in May from 32.3% in April, with weaker growth in personal protective equipment and electronic products.[3] Meanwhile, economic recovery remained uneven, with the consumption and service sectors still lagging, likely due to lingering social distancing and weaker consumer purchasing power. While domestic tourist visits during the Labor Day and Dragon Boat Festival long holidays reached new highs, tourism revenue was still far below pre-pandemic levels. The soft spending trend was echoed by broader household consumption data, as retail sales growth missed market expectations in April and May.

Commodity prices surged going into the second quarter amid tight supply, prompting inflation and policy tightening concerns and triggering equity market sell-offs. While China's consumer price index (CPI) inflation remained muted at 1.3% year-over-year in May, producer price index (PPI) inflation jumped further to 9.0%, driven by upstream raw material prices.[3] The price surge was met with repeated verbal guidance from the Chinese government, which expressed concerns about "irrational' price movement

[1] Source: Morgan Stanley Investment Management. Data as of June 30, 2021.
[2] Holdings data as of June 30, 2021.
[3] Source: National Bureau of Statistics of China (NBS)

and pledged targeted measures to curb speculative trading. The government also announced the release of national reserves of copper, aluminum, zinc and other industrial metals to meet market demand and tame prices. Policymakers have also downplayed the inflation threat, citing limited pass-through from PPI to CPI. While commodity prices stabilized later in the quarter, PPI inflation could remain elevated in the coming months before trending down toward the end of the year as the base effect normalizes.

On the policy front, as the economy recovers from the pandemic, Beijing has shifted its policy focus away from growth stimulus to longer-term structural issues such as anti-monopoly, financial stability and housing market speculation, as well as the dual-circulation strategy. At its second quarter 2021 monetary policy committee meeting, the People's Bank of China (PBoC) maintained its commitment to make "no sharp policy shift" and reiterated that the prudent monetary policy will be flexible, pinpointed and appropriate. The central bank vowed to maintain the stability of macro leverage and keep credit growth largely in line with nominal gross domestic product growth. Separately, the PBoC revised the mechanism for setting commercial banks' deposit rate cap from "base rate x multiple" to "base rate + basis points," another move to lower China's deposit and lending rates to support the real economy. China's total social financing growth slowed further to 11.0% year-over-year in May from 11.7% in April, due to a further slowdown in corporate bond financing and shrinking shadow bank financing.[4] Given the front-loaded regulatory tightening and back-loaded local government bond issuance this year, the pace of credit deceleration is likely to moderate in the third quarter and stabilize in the fourth quarter, in our view.

On exchange rates, the PBoC raised the reserve requirement ratio for foreign currency deposits from 5% to 7%, effective June 15. The increase would help discourage foreign capital inflows and therefore dampen renminbi appreciation pressure. The move came after the rapid renminbi appreciation since April, which has sent the renminbi trade-weighted exchange rate to the highest level since 2016.

China's once-in-a-decade census revealed that its total population reached 1.412 billion in 2020, but the number of annual new births dropped further to 12 million, marking an 18% decline from a year earlier and extending the descent to a near six-decade low.[3] The data pointed to daunting demographic challenges facing China, as its fertility rate dropped to 1.3 children per woman – below the replacement level of 2.1 – and its population aging deepened.[3] Meanwhile, population quality has improved with better education attainment. Compared with 2010, the number of people with university education went up from 8.93 to 15.47 per 100 persons, and the average years of schooling for people aged 15 and above increased from 9.08 years to 9.91 years.[3] The urbanization rate has also gone up from 49.7% 10 years ago to 63.9% in 2020.[3] As part of the effort to boost the fertility rate, the government announced it will allow all married couples to have three children, further relaxing its birth-control policy introduced 40 years ago. In 2016, Beijing abolished the one-child policy and allowed all families to have two children. In view of the population aging, the government also decided earlier this year to raise the retirement age by a few months every year going forward.

Geopolitical tensions remained. The U.S. Department of Commerce added seven Chinese supercomputing entities to the Entity List for activities that "are contrary to the national security or foreign policy interests of the United States." U.S. President Joe Biden also signed an executive order amending a ban on U.S. investment in Chinese companies initiated under his predecessor, blacklisting 59 firms with ties to China's military or in the surveillance industry. Meanwhile, Biden revoked executive orders targeting the TikTok and WeChat apps signed by former President Donald Trump, but signed a new order directing the U.S. Department of Commerce to evaluate software applications connected with foreign adversaries under recent U.S. supply-chain security rules and take action as appropriate. The Biden administration also banned imports of a key solar panel material from a Chinese-based silicon company over forced labor allegations. Separately, the European Parliament halted ratification of an investment pact with China until Beijing lifts sanctions on European Union (EU) politicians over the Xinjiang human rights dispute, deepening the tensions in Sino-European relations and denying EU companies greater access to China.

In Hong Kong, the economic recovery continued in the second quarter as the local COVID-19 situation is kept under control, but the progress is uneven across sectors. The labor market improved, with the unemployment rate falling by another 0.4 percentage points to 6.0% for the three months ending May.[5] Employment across major labor-intensive sectors posted positive year-on-year growth for the first time since 2019 as the economy reopens gradually. Consumption remained soft, as May retail sales volume came in 29% lower than that of May 2019.[5] Investment also remained weak given lackluster business sentiment and continued border closure.

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3 Source: National Bureau of Statistics of China (NBS)
4 Source: The People's Bank of China
5 Source: Hong Kong Special Administrative Region Census and Statistics Department

Portfolio Activity

We initiated a position in Jiangsu Hengli Hydraulic (1.4% of the portfolio).[2] We expect the company's hydraulic pump and valve segments can continue to grow rapidly and boost margins. Expansion into the industrial (non-construction machinery) space will likely be a medium-term growth driver.

We initiated a position in Innovent Biologics (0.5% of the portfolio).[2] Innovent Biologics is China's leading biotech pharma company, with a strong pipeline and distribution and an established global strategy.

We initiated a position in KE Holdings (1.5% of the portfolio),[2] China's leading real estate agent. With its unique agent cooperation network model, we believe the company is set to consolidate the market and gain market share. Decoration and financing businesses are likely to be medium-term growth drivers.

We initiated a position in Gree Electric Appliances (1.5% of the portfolio),[2] China's leading air conditioner maker with a strong brand and manufacturing capability. The air conditioner market is set to recover this year on low inventory, resilient property sales and average selling price rises. Distribution channel reform is underway, and we think this has been discounted in its low valuation.

We exited a position in Pharmaron to consolidate our position in the pharmaceutical contract research organization segment.

We exited our position in Longi Green Energy as the upstream silicon price hikes could weigh on the company's margins. We also exited our position in China Resources Land given rising margin pressure and tightening housing policies.

We exited our position in Geely Automobile given the company's lackluster shipment and profit margin pressure.

We exited our position in Hua Hong Semiconductor as we believe its lofty valuation has already priced in the tight semiconductor supply, while limited advanced node capability is likely to limit its long-term growth outlook.

We exited our position in Baidu as its core search business is set to see slower growth, while its artificial intelligence and autopilot initiatives will still take a long time to make a profit.

Outlook

The Chinese economy is expected to continue to recover in 2021 as coronavirus infections remain under control. For the longer-term implications of the pandemic, we believe surviving companies with strong balance sheets and cash flow could become market share consolidators afterward, and thus likely long-term winners. In addition, the pandemic is likely to foster digital trends on both the consumer and enterprise sides, favoring companies that embrace and enable the digital transformation.

Our China portfolio has always been focused on long-term fundamentals, and the impact of coronavirus on near-term market sentiment will not change our long-term investment philosophy. We continue to position for structural growth opportunities in China.

Our medium-term view of the market hinges on whether the Chinese government can take the external pressure to further launch and implement long-term reform measures. While the economic growth rate may slow down over time, reforms could help enhance the quality and sustainability of the economy, which in turn could help boost China's corporate return on equity and valuation multiple. There are also structural themes that will likely play out, including the ongoing industry consolidation and consumption upgrade. We expect "new economy" companies to deliver superior growth and attract market interest as the Chinese economy becomes increasingly innovation-driven. Against the macro backdrop of slower growth and lower global interest rates, we believe high quality stocks with secular growth trends will likely continue to enjoy a valuation premium and outperform the market in the longer run. As such, we believe bottom-up stock selection is important to generate alpha by identifying companies with structural growth, competitive advantages, strong governance and financial strength.

FUND FACTS

Launch date	Base currency	Index
October 31, 2019	U.S. dollars	MSCI China (Net) Index

[2] Holdings data as of June 30, 2021.

Performance (%)

As of June 30, 2021 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF China Equity Portfolio - I Shares	-0.23	0.30	-3.83	14.99	--	--	--	19.62
MSCI China (Net) Index	0.10	2.27	1.83	27.39	--	--	--	25.27

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

The gross expense ratio is 3.20% for Class I shares and the net expense ratio is 1.20%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus. The minimum initial investment is $5,000,000.

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I shares. Performance for other share classes will vary.

RISK CONSIDERATIONS

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to **market risk,** which is the possibility that the market values of securities owned by the Portfolio will decline and that the value of Portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equity securities'**values also fluctuate in response to activities specific to a company. Investments in **securities of Chinese issuers,** including A-shares, H-shares, B-shares and red chip shares, involve risks and special considerations not typically associated with investments in the U.S. securities markets or foreign developed markets, such as heightened market, political and liquidity risk. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. The risks of investing in **emerging market countries**are greater than the risks generally associated with investments in foreign developed countries. By investing in **investment company securities,** the portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Non-diversified** portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

INDEX INFORMATION

The **MSCI China (Net) 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 Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

IMPORTANT INFORMATION

The views and opinions expressed are those of the investment team at the time of writing and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings and sectors/region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced.

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Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

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