Chinese equities have been rocked by regulatory changes occurring simultaneously across key sectors like technology and real estate. While the situation may seem severe, it is common for policymakers in China to harden their approach to correct inefficiencies. In fact, they have a history of pulling regulatory levers in response to shifting priorities.

It might be tempting to characterize recent market turbulence as evidence that China is uninvestable, but we view the regulatory actions as a final stage in the country’s economic maturation.

This edition of Global Insights provides updates on developments in China’s technology and real estate sectors and examines the three main stages of its regulatory reforms. We also address China’s health care sector, which is likely the next industry to draw the scrutiny of policymaking bodies.
The popular Chinese proverb, "He who rides a tiger is afraid to dismount," warns against pursuing a path without reaching the end. As the market awaits direction, Chinese equities have been battered by regulatory changes enacted simultaneously across key sectors. The situation may seem severe but is not uncommon. In fact, China has a great deal of experience pulling regulatory levers in response to shifting priorities. Last year, China introduced a wave of regulations that spooked investors, who responded by dumping Chinese stocks. The MSCI China Index, which comprises A- and H-shares of large- and mid-cap Chinese companies, declined 30% in the one-year period ending Jan. 31 (see Exhibit 1). The market reaction was predictable, as, for many investors, the new regulations seemed to arrive without warning.

Many of China's recent regulatory actions are grounded in its "common prosperity" policy, which aims for a broader distribution of wealth. While it might be tempting to characterize the recent regulatory-related turbulence as evidence that China's financial markets are uninvestable, we consider the recent actions to be a final stage in the multidecade maturation of the country's economy. From our vantage point, Beijing's history of rulemaking has been linear, featuring three key steps: 1) Align government agencies with strategic initiatives, 2) Fine-tune intervention threshold and 3) Introduce new policies to mitigate financial risk, wherever it may live. We believe we are in the early innings of the final stage of policy reforms. Although we are positive on China's longer-term prospects, the latest moves remind us that investors must be aware of Chinese policymakers' iterative approach to guarding against what President Xi Jinping has referred to as "the disorderly expansion of capital."

Below, we highlight these three stages and consider developments in the technology and real estate sectors.

Finally, we examine China's health care sector, which will likely face additional scrutiny given Xi's commitment to reducing health care costs.

**Step 1: Align government agencies with strategic initiatives.** China's capital markets are experiencing a transformation. China started formal operations of its two major exchanges in the early 1990s. However, the China Securities Regulatory Commission (CSRC) did not become the sole regulator supervising nationwide securities markets until 1998, amid the Asian financial crisis (see Exhibit 2). Although China escaped the most adverse consequences of the crisis, it marked a turning point in the country's system of financial sector reforms, highlighting the need to centralize regulatory review and prioritize stability.

**Step 2: Fine-tune intervention threshold.** Beginning in March 2015, the Shanghai-Hong Kong Stock Connect granted foreign investors faster and broader access to the China A-share market. The China Securities Regulatory Commission's (CSRC) decision to ease government intervention in its capital markets illustrated the second stage of the multidecade maturation of the country's financial system.

**Step 3: Introduce new policies to mitigate financial risk, wherever it may live.** At the start of 2021, Xi announced the beginning of a new development stage for China. The 14th five-year plan shifted its focus toward quality-of-life concerns; as a result, a new set of regulatory tools was required.

**Technology.** In our Nov. 10, 2021 Global Insights, “China’s Tech Wreck,” we explored how China’s policymakers targeted the country's largest internet companies through the lens of national security, antitrust and social stability. We recommended that investors remain cautious on Chinese internet companies and look for evidence that regulators have shifted toward more dovish policies like the resumption of offshore initial public offerings (see Exhibit 3). Since we
published the report, Beijing has stepped up enforcement and introduced new tools.

In December 2021, for example, the Cyber Administration of China (CAC) fined a Chinese social media platform for repeatedly publishing illegal information. The 3 million yuan fine demonstrates that regulators will continue to pursue bad actors and suggests that additional fines are likely. Policymakers also recently drafted new rules to regulate how companies use algorithms. The rules, which have been described as focusing on minimizing harm to consumers, are set to take effect March 1. Finally, just this past month, policymakers proposed new laws banning cross-border brokerages, warning that information collected by these brokerages is a risk to national security. As the regulatory environment evolves, we reiterate that investors should remain vigilant.

Exhibit 3: Chinese IPOs in the US Dried Up in the Second Half of Last Year

<table>
<thead>
<tr>
<th>Year</th>
<th>First Half $ Billion</th>
<th>Second Half $ Billion</th>
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</thead>
<tbody>
<tr>
<td>2021</td>
<td>12.74</td>
<td>0.36</td>
</tr>
<tr>
<td>2020</td>
<td>2.82</td>
<td>10.85</td>
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<td>0.31</td>
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</tr>
<tr>
<td>2016</td>
<td>0.34</td>
<td>1.86</td>
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Source: The South China Morning Post, S&P Global Ratings, Morgan Stanley Wealth Management Global Investment Office as of November 2020

Real Estate Developers. In 2021, China’s largest property developers came under pressure. Since the industry opened to private investors, developers in China’s property sector have amassed trillions of dollars in debt. Beijing has sought to reduce real estate developers’ reliance on debt over the last few years over fears of financial instability and contagion. Specifically, in August 2020, the People’s Bank of China (PBOC) and the Ministry of Housing and Urban-Rural Development held a meeting with the 12 largest property developers to discuss mechanisms to reduce debt and curb borrowing. As a result of this meeting, developers will be subject to the "three red lines" policy restriction.

The three red lines policy requires property developers to meet three criteria in order to apply for financing: 1) liabilities should not be more than 70% of assets, 2) net debt should not exceed equity and 3) cash must be at least equal to short-term borrowings. China’s largest property developer failed the test, resulting in it defaulting on more than $1.2 billion in overseas bonds. In fact, 100% of CCC rated developers do not comply with the three red lines policy (see Exhibit 4). Given real estate’s contribution to China’s economy, we expect Beijing to maintain its tight lending policies in the near term.

Health Care. We think that China’s health care system will be the next sector to draw the scrutiny of policymaking bodies. In the same way that regulators have targeted inefficiencies in technology and real estate, health care, which is a strategic priority for Beijing, is due for an overhaul. According to the Organization for Economic Cooperation and Development (OECD), out-of-pocket expenditures are roughly 35% of total health care spending. The health care industry is key to Xi’s "common prosperity" goals. Last year’s 14th five-year plan featured a medical security plan designed to deepen health care reform, which should ultimately benefit the consumer given that market-based measures of pricing will become limited. Although the health care sector has seen some weakness, it is broadly in line with the MSCI China Index over the past year (see Exhibit 5). As Beijing’s focus shifts, we anticipate more downside for the sector.

Exhibit 4: “Three Red Lines” Policy Creates Headwinds for China’s Real Estate Sector

Exhibit 5: China Health Care Regulation Faces Uncertain Future, Could See More Price Decline

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2022
Investment Implications

China is following a playbook, and we don’t expect its regulatory actions to moderate in 2022. Recent regulatory actions suggest that policymakers are responding to perceived inefficiencies. As a result, the technology and real estate sectors will likely face near-term pressure. The health care sector, a strategic priority for policymakers, has not yet fallen victim to indiscriminate selling. As a result, the sector would be partially vulnerable if policymakers rewarded a more hawkish stance than markets have currently priced.
Charts You Can't Miss

Exhibit 6: Strong Venture Capital Flows Into China Health Care Sector


Exhibit 7: China’s Economy Is Shifting From a Focus on Manufacturing to Services

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2022

Exhibit 8: China Likely to Achieve Total Market Cap of $27 Trillion by 2027

Source: Morgan Stanley Research, Morgan Stanley Wealth Management Global Investment Office as of Feb. 11, 2019

Exhibit 9: Housing Is a Large Share of Overall Chinese Assets


Please refer to important information, disclosures and qualifications at the end of this material.
Current Readings From Our Quantitative Framework

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<th></th>
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Levels: Favorable, Neutral, Unfavorable
Changes: Improving, Unchanged, Deteriorating


Ongoing Development Spotlight

The International Monetary Fund recently cut Chinese growth estimates for 2022 from 5.7% to 4.8%. This cut has largely been attributed to continued state intervention in the economy. While growth last year was strong, at 8.1%, it came primarily from state-sector investments, as opposed to higher quality consumption-led growth. Since the beginning of 2021, this has resulted in outperformance by state-owned enterprises relative to more independent firms and the broader market. Equity return leadership of these firms underlines the phenomenon of government resources crowding out private investment. This is especially detrimental to long-term growth because these firms tend to be only 80% as productive as private counterparts. Capital flows toward less effective means will continue to weigh on growth and make the transition to a more mature consumer-driven economy more difficult.

- Brad Fulton

Exhibit 10: China’s State-Owned Enterprises Remain Largely Unscathed by Regulatory Crackdown

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 28, 2022
Disclosure Section

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

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RSN644370575491 02/2022