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China Market-Wise | Asia Pacific

Green Fields Beyond the Woods; Raise Index Targets

MORGAN STANLEY ASIA LIMITED+
Laura Wang
Equity Strategist
Laura.Wang@morganstanley.com +852 2848-6853

MORGAN STANLEY ASIA (SINGAPORE) PTE.+
Jonathan F Garner
Equity Strategist
Jonathan.Garner@morganstanley.com +65 6834-8172

MORGAN STANLEY ASIA LIMITED+
Chloe Liu
Equity Strategist
Chloe.Liu1@morganstanley.com +852 2848-5497

We raise index targets for China again after signs of a 4Q24 earnings beat, upward revisions, and more upside for valuation on par with EM. Uncertainties linger: US tariffs and investment policies, as well as China's macro climate. We analyze market implications and positioning to hedge risks.

We raise our 2025 year-end index targets for Hang Seng, HSCEI, MSCI China, and CSI 300 to 25,800, 9,500, 83, and 4,220, respectively: They imply 9%, 9%, 9%, and 8% upside from the current market levels, following our prior upgrade of China in February. The increases are directly driven by moderately higher earnings growth forecasts (7% and 9% for 2025 and 2026, respectively, for MSCI China, and further re-rating upside for China to trade on par with MSCI EM by year-end (12.5x 12-month forward P/E).

MSCI China finally on its way – looking set for the first earnings beat after 13 consecutive quarterly misses, while earnings estimate reductions are approaching inflection: 4Q24 results so far are showing a solid 8% net beat for MSCI China on both number of companies (11% of index reported) and weighted earnings (50% of market cap reported) – the first time in three and a half years. Aggressive cuts to estimates, diligent corporate self-help efforts, and acceleration of tech/AI-related investment and adoption have all contributed to the change. China now boasts the second-best earnings beat result – a net 8% earnings beat by number of companies – among the major global equity markets, after only Japan (13%), with MSCI EM at 0.8% and the S&P 500 at 1.3%.

We believe MSCI China deserves a valuation on par with MSCI EM, cutting its long-standing discount: MSCI China's ROE recovery and geopolitical risk alleviation have led the initial round of re-rating YTD (from 10.2x to 11.6x 12-month forward P/E), compressing its discount to MSCI EM to 6%. We think the discount should disappear in due course because:

1. MSCI China's earnings results and consensus estimate revisions are on a much healthier trajectory than MSCI EM's.
2. MSCI China is relatively better positioned against potential further US tariff hikes vs. broad EM, on an incremental basis – current tariffs imposed by China on US imports suggest limited room for hiking based on Reciprocal Tariff Scheme, and MSCI China has merely a mere 3% revenue exposure to the US, the lowest among the US's 10 largest EM trading partners.

See the following section – Overview (cont'd)

Exhibit 1 : Our new 2025 year-end index targets for China – reflecting moderately improved outlook for earnings and valuations

	Index	Current Price	MS Target Price (Dec-2025)	*Prior MS Target (Dec-2025)*	MS Top-Down EPS YoY %		Consensus EPS Forecast YoY %		MS Target Fwd P/E Dec - 2025	Consensus 12m Fwd P/E Current
					Dec-25	Dec-26	Dec-25	Dec-26		
Base Case	Hang Seng	23,690	**25,800** *9%*	*24,000* *-9%*	2,155 *6%*	2,310 *7%*	2,198 *5%*	2,381 *8%*	11.1x	10.6x
	HSCEI	8,742	**9,500** *9%*	*8,600* *-9%*	899 *5%*	962 *7%*	910 *2%*	965 *6%*	9.9x	9.2x
	MSCI China	76	**83** *9%*	*77* *-7%*	6.2 *7%*	6.7 *9%*	6.5 *9%*	7.3 *12%*	12.5x	11.4x
	CSI300	3,915	**4,220** *8%*	*4,200* *2%*	282 *6%*	307 *9%*	297 *9%*	324 *9%*	13.7x	*13.0x*

Source: MSCI, IBES, RIMES, Morgan Stanley Research. Note: Data as of March 21, 2025.

Overview (cont'd)

Key market concerns and how to be positioned

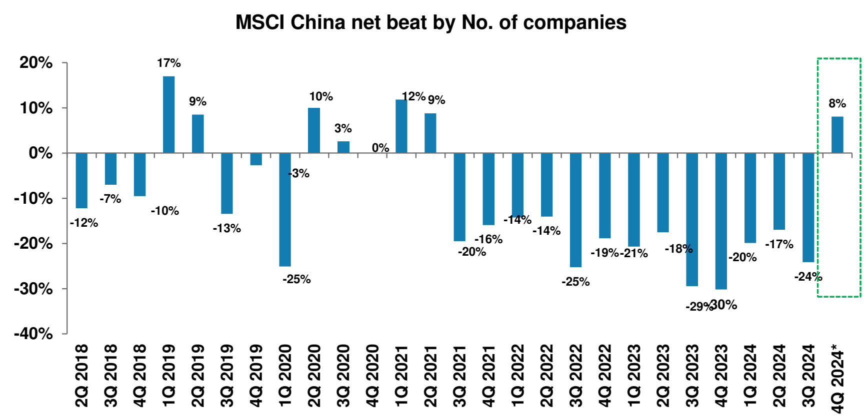
1. **Unexpected impact from escalations of US/China tension, particularly with equity investment restrictions:** While we think it is too early to expect such measures are a given, if they happen, we believe it could lead to a meaningful market setback. Accordingly, in the near term, we recommend being overweight A-shares in a Chinese portfolio, while for non-US investors we suggest buying on dips of high-quality stocks affected.
2. **Continuous macro/deflation drag:** So far ROE and earnings beats, as well as FAI data, all point towards much stronger and healthier momentum among technology/AI R&D and adoption-related sectors. We continue to recommend being overweight these sectors/stocks while waiting for broad-based improvement.

Early signs emerging of inflection in earnings estimate revisions – first time in three and a half years

This would be MSCI China's first quarterly earnings beat after 13 quarters, following its ROE trough and recovery

Reductions in MSCI China earnings estimates are finally showing signs of coming to an end, after 13 consecutive quarters of sizable earnings misses (Exhibit 2): China's equity markets have experienced the longest earnings disappointment period in our publishing history – since 2H2021 – with MSCI China missing consensus earnings estimates for 13 consecutive quarters. It started with tougher regulatory tightening against some New Economy sectors (Internet, Education, Healthcare, etc.) and against the property sector ("Three Red Lines") in 2021, then moved on to a macro slowdown as a result of supply chain disruptions arising from Covid-related measures in 2022, and eventually suffering from persistent deflation since mid-2023. 4Q24 so far has shown a net 8% earnings beat on both number of companies and by weighted earnings – the first time since 3Q21.

Exhibit 2: MSCI China quarterly earnings surprises by number of companies – first net beat after 13 consecutive quarterly misses



Note: *4Q 2024 is based on interim review, by number of companies, MSCI China has 11% companies reported.
Source: MSCI, Bloomberg, RIMES, Factset, Morgan Stanley Research. Data as of Mar 21, 2025.

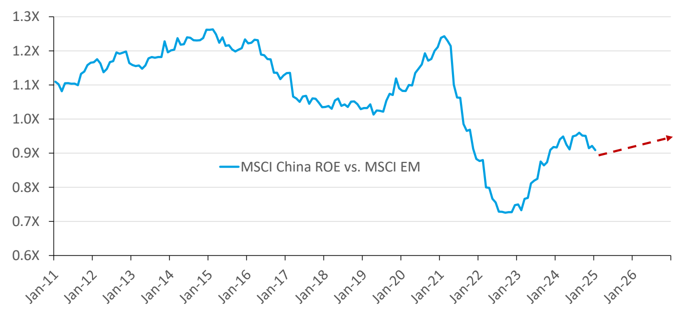
We believe this appearance of long overdue earnings inflection is the direct result of aggressive cuts to earnings estimates over the past several years...

...combined with diligent corporate self-help efforts to enhance earnings and shareholder returns (cost-cutting, overseas expansion, increasing dividend and share buybacks, etc.). It also coincided with the bottoming of MSCI China's ROE since 2H24 (Exhibit 3). Such self-help efforts as well as MSCI China's sustainable ROE improvements were the key reasons for our recent call to upgrade China to equal-weight – China Equity Strategy: Getting Out of the Woods (19 Feb 2025).

Exhibit 3: MSCI China 12-month forward ROE – China's ROE bottoming out and recovering since 2H24

Source: Bloomberg, Morgan Stanley Research. Data as of March 21 2025.

Exhibit 4: 12-month forward ROE (MSCI China ROE vs. MSCI EM) – we expect the convergence to continue through 2027

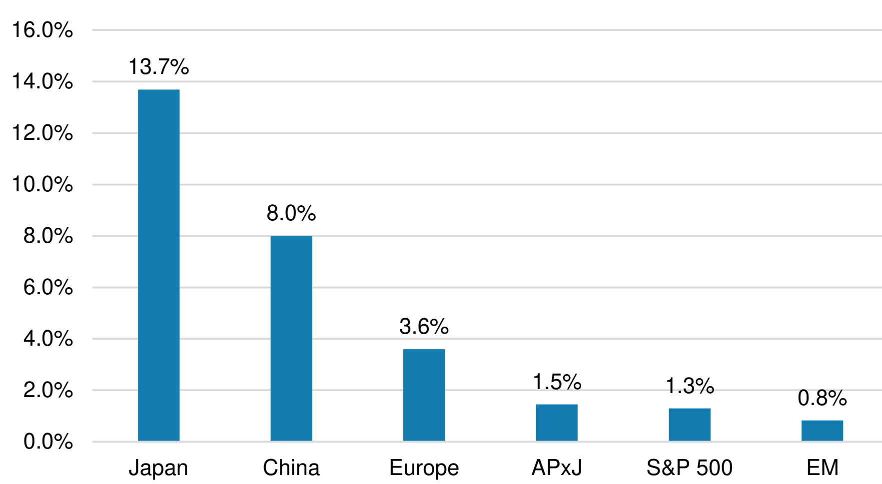


Source: Datastream, Morgan Stanley Research. Data as of end-Feb 2025.

MSCI China, together with MSCI Japan, is leading the global reporting season so far; sustainability bears watching from here

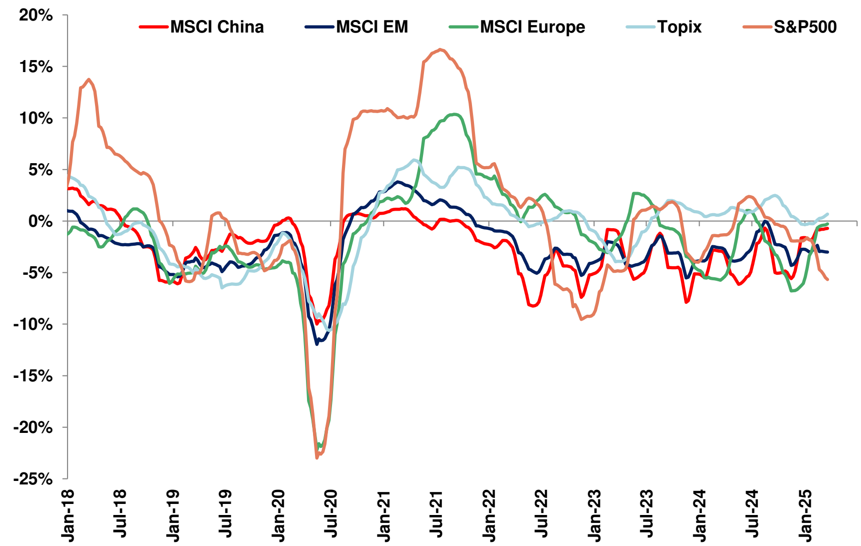
MSCI China's earnings beat so far for 4Q is not only impressive compared to its own track record of the past four years – it stands out on a global basis as well (Exhibit 5). So far, with all major global equity markets having more than 50% of their market cap reported, MSCI China ranks as a solid #2 with a net 8% earnings beat surprise, following MSCI Japan's 13.7%, while it is significantly exceeding Europe, the US, broad EM, and APxJ. Exhibit 6 also shows that MSCI China and MSCI Europe's earnings estimate revision breadth momentum is picking up rapidly, about to break even and lead to an uptrend, while the S&P 500 as well as broad MSCI EM are obviously struggling more at the moment.

Exhibit 5: Earnings surprises at the regional level in 4Q24 so far* – Japan and China leading the season



Source: MSCI, Bloomberg, RIMES, IBES, Morgan Stanley Research. Data as of Mar 21, 2025. * % of market cap reported: 49% of MSCI China, 98% for MSCI Japan, 75% for MSCI Europe, 74% for MSCI APxJ, 100% for S&P 500, 76% for EM

Exhibit 6: 12-month Forward ERB (Earnings Estimate Revision Breadth, 3MMA) – China and Europe are approaching positive territory while the US is trending downward significantly

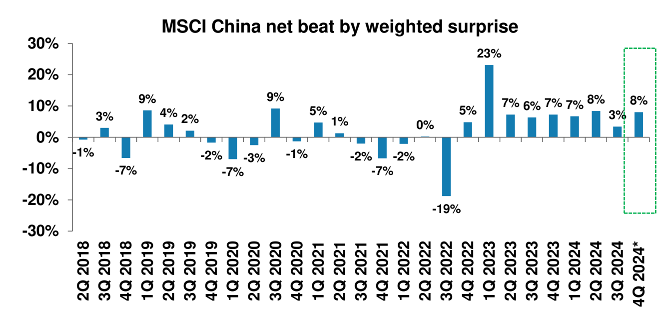


Source: IBES, DataStream, Morgan Stanley Research. Note: Monthly data as of March 17 2025.

The earnings beat so far is more spread out across companies, based on market cap, reflecting a healthier recovery trend

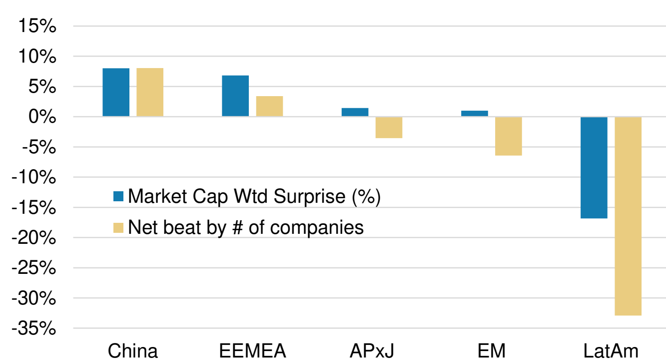
The challenging environment for earnings growth was more amplified for small- and mid-cap companies than for large-caps in the previous quarters – comparing Exhibit 2 and Exhibit 7 shows that earnings surprises have been much more negative for the past three and half years if measured by number of companies, than if measured by weighted earnings. The latest 4Q24 results are finally showing a similar magnitude of beat by both measures, suggesting more evenly distributed upside beats than before, across different company market caps. A comparison with other parts within the EM market also shows that so far, China's equity market (proxied by MSCI China) has shown a more balanced earnings beat across number of companies and market cap than EEMEA (Exhibit 8).

Exhibit 7: History of Chinese equity market earnings surprises by weighted surprise



Note: *4Q 2024 is based on interim review, by market cap, MSCI China has 49% companies reported.
Source: MSCI, Bloomberg, RIMES, Factset, Morgan Stanley Research. Data as of Mar 21, 2025.

Exhibit 8: 4Q24 earnings surprise by markets: China's earnings have outperformed EM/EEMEA so far*



Source: MSCI, Bloomberg, RIMES, IBES, Morgan Stanley Research. Data as of Mar 21, 2025. * % of market cap reported: 49% for MSCI China, 84% for EEMEA, 74% of APxJ, 77% for EM, and 95% for LatAm.

Valuation can trade higher now with green shoots for earnings finally in sight

ROE recovery and geopolitical risk alleviation have led the initial round of valuation re-rating

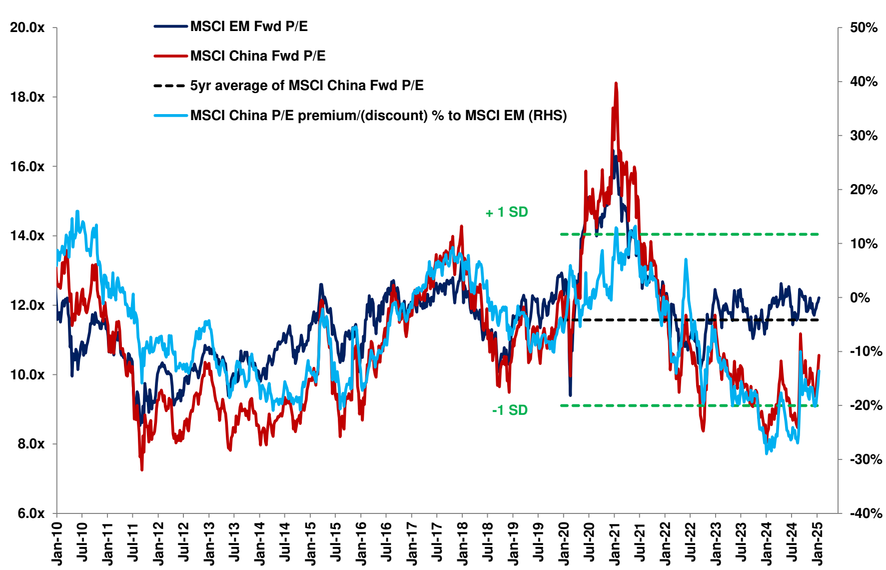
In our recent report upgrading China – China Equity Strategy: Getting Out of the Woods (19 Feb 2025) – we argued that MSCI China deserved a major upward shift in its structural valuation regime. given:

- ROE recovery trajectory and likelihood of converging with and surpassing MSCI EM's by 2027;
- Lessened global geopolitical concerns as a potential Russia/Ukraine ceasefire deal becomes more plausible, which reduces China's equity risk premium as a result;
- Reassessment of China's investability – despite macro challenges – upon DeepSeek's appearance, which has enhanced perceptions of China's ability not only to stay in the global technology competition but potentially lead it as well.

We argued that MSCI China's valuation discount vs. MSCI EM should compress to single digits from the previous 20-30% range as a result.

MSCI China's 12-month forward P/E has effectively recovered to 11.6x as of March 20, 2025, Meanwhile, its discount vs. MSCI EM has also been compressed to 6%.

Exhibit 9: MSCI China 12-month forward P/E vs. MSCI EM – MSCI China now trades at 11.6x with ~6% discount vs. MSCI EM



Source: Datastream, MSCI, Morgan Stanley Research. Data as of March 20, 2025.

We think MSCI China can trade on par with EM from here

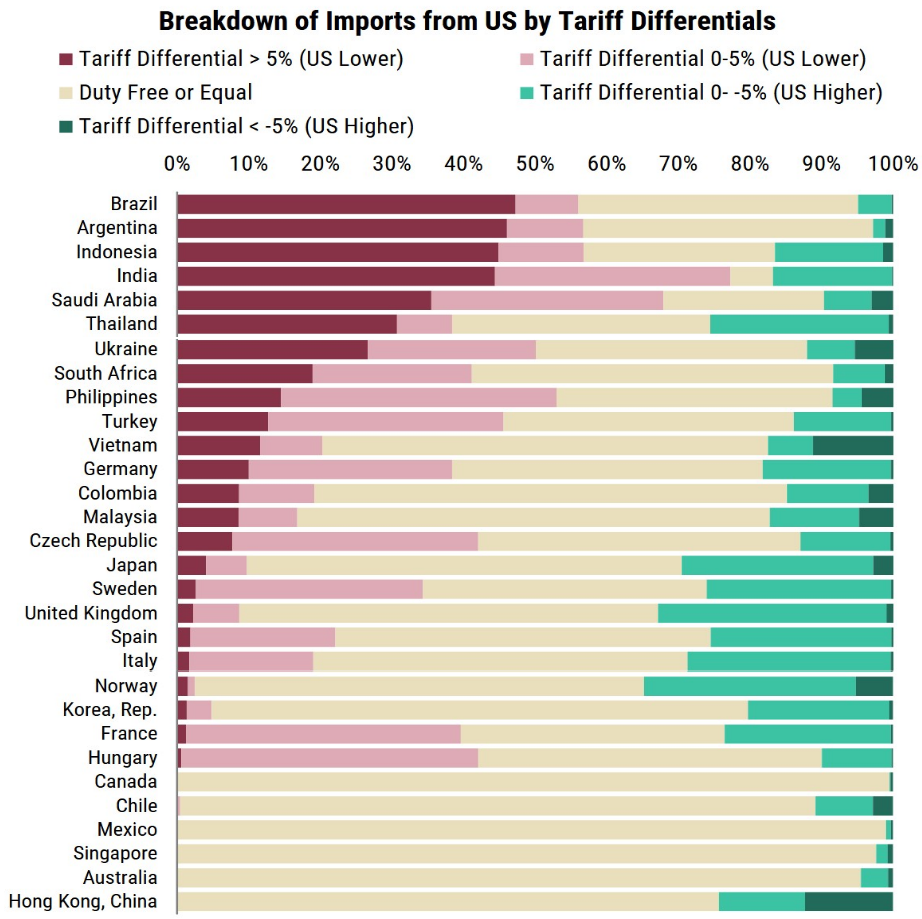
We believe MSCI China should not trade at a valuation discount relative to EM any more, given:

1) MSCI China's earnings results and consensus estimate revisions are on a healthier trajectory than MSCI EM's: We believe that MSCI China's relative valuation discount vs. MSCI EM should disappear at this stage given the much stronger earnings results so far recorded for 4Q24 and the more upward-trending consensus earnings estimate revisions (Exhibit 9), as discussed in the previous sections.

2) MSCI China is relatively better positioned against potential further US tariff hikes vs. broad EM equities, on an incremental basis: As the final date set for US Reciprocal Tariff implementation (April 2, 2025) approaches, investors are understandably getting more nervous about the disruptive impact on the equity market – particularly for China, given that it has been singled out since President Trump's election campaign as a major tariff hike target. However, we believe China, especially its equity market, is relatively better positioned than broad EM equities and some major EM economies to deal with further potential tariff hikes, particularly given that the market had rather pessimistic expectations towards tariff hikes against China since the beginning of the year.

- **Current tariffs imposed by China on US imports suggest limited room for tariff hikes by the US:** As far as the April 2 Reciprocal Tariff Scheme is concerned, Morgan Stanley's public policy team's work shows that current tariffs imposed by China against US imports into China/Hong Kong are already quite minimal (Exhibit 10). For more details, please visit US Public Policy & Global Economics: Tariffs: The Reciprocity Principle (19 Mar 2025).
- **Much broader set of countries/markets targeted by the Reciprocal Tariff Scheme:** Morgan Stanley's public policy team expects that the April 2 Reciprocal Tariff deadline could lead to broader targeted tariffs on countries that President Trump has called out specifically, or those with which the US currently has a trade deficit, including the European Union, Vietnam, Japan, and Brazil, in addition to gradually rising tariffs on China over the next year and a half (note: this does not represent a worsened scenario compared to the 60% universal tariff proposed by President Trump even before he got re-elected).

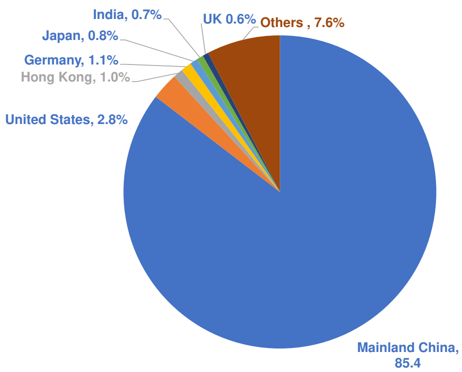
Exhibit 10: Imports from the US broken down by tariff differentials on a relative basis (2023 tariffs and trade data)



Source: UN TRAINS, WITS, UN Comtrade, Morgan Stanley Research; Note: This exercise is conducted at a HS6 level, and more details are discussed under "Product-level Reciprocal Tariff Methodology".

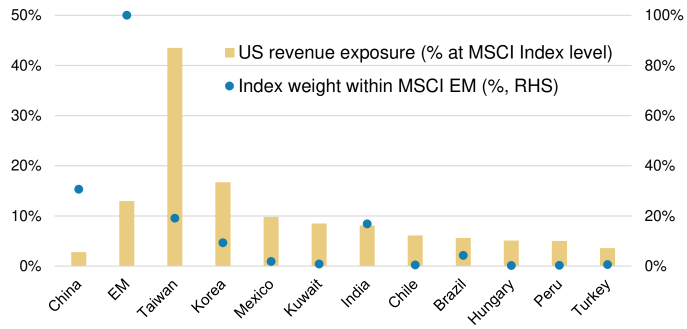
- **China's equity market is even more shielded from direct tariff impact, compared to China's economy:** Our analysis shows that MSCI China has less than 3% direct revenue exposure to the US, compared to broad MSCI EM's 13%, and other major EM markets (e.g., 44% for MSCI Taiwan, 17% for MSCI Korea, 10% for MSCI Mexico, etc.).

Exhibit 11: MSCI China LTM (last 12 months) revenue breakdown by country



Source: Factset, Morgan Stanley Research; data as of Mar 21, 2025.

Exhibit 12: US revenue exposure (% at MSCI Index level) and index weight within MSCI EM (%, RHS) for US' 10 largest EM trade partners



Source: Factset, Morgan Stanley Research; data as of Mar 24, 2025.

Raising index targets for China

We raise our 2025 year-end targets for the Chinese equity indices we cover – the Hang Seng Index, HSCEI, MSCI China, and CSI300 – to 25,800, 9,500, 83, and 4,220, respectively, implying 9%, 9%, 9%, and 8% upside vs. the current index levels.

The new and higher index price targets are driven by both moderate increases in earnings growth forecasts and higher valuation targets, as a result of a confluence of factors, including a more upbeat earnings estimate revision inflection, improved macro and FX outlook forecasts by Morgan Stanley's macro team for China, as well as further valuation convergence with the broad EM market.

Exhibit 13: Our new 2025 year-end index targets for China – reflecting moderately improved outlook for earnings and valuation

	Index	Current Price	MS Target Price (Dec-2025)	MS Top-Down EPS YoY %		Consensus EPS Forecast YoY %		MS Target Fwd P/E Dec - 2025	Consensus 12m Fwd P/E Current
				Dec-25	Dec-26	Dec-25	Dec-26		
Base Case	Hang Seng	23,690	**25,800** *9%*	2,155 *6%*	2,310 *7%*	2,198 *5%*	2,381 *8%*	11.1x	10.6x
Base Case	HSCEI	8,742	**9,500** *9%*	899 *5%*	962 *7%*	910 *2%*	965 *6%*	9.9x	9.2x
Base Case	MSCI China	76	**83** *9%*	6.2 *7%*	6.7 *9%*	6.5 *9%*	7.3 *12%*	12.5x	11.4x
Base Case	CSI300	3,915	**4,220** *8%*	282 *6%*	307 *9%*	297 *9%*	324 *9%*	13.7x	*13.0x*
Bull Case	Hang Seng	23,690	**31,900** *35%*	2274 *10%*	2541 *12%*	2198 *5%*	2381 *8%*	12.5x	10.6x
Bull Case	HSCEI	8,742	**11,800** *35%*	948 *10%*	1058 *12%*	910 *2%*	965 *6%*	11.1x	9.2x
Bull Case	MSCI China	76	**103** *36%*	6 *10%*	7 *12%*	7 *9%*	7 *12%*	14.4x	11.4x
Bull Case	CSI300	3,915	**5,020** *28%*	296 *11%*	332 *12%*	297 *9%*	324 *9%*	15.1x	13.0x
Bear Case	Hang Seng	23,690	**17,400** *-27%*	2004 *-1%*	2082 *4%*	2198 *5%*	2381 *8%*	8.3x	10.6x
Bear Case	HSCEI	8,742	**6,490** *-26%*	863 *2%*	895 *4%*	910 *2%*	965 *6%*	7.2x	9.2x
Bear Case	MSCI China	76	**56** *-26%*	6 *4%*	6 *6%*	7 *9%*	7 *12%*	9.0x	11.4x
Bear Case	CSI300	3,915	**3,140** *-20%*	276 *3%*	286 *3%*	297 *9%*	324 *9%*	11.0x	13.0x

Source: MSCI, IBES, RIMES, Morgan Stanley Research. Note: Data as of March 21, 2025.

Moderately higher earnings growth forecasts given green shoots in earnings estimate revisions and Morgan Stanley's improved macro and FX views

We raise our 2025 and 2026 earnings growth forecasts for MSCI China to 7% and 9%, respectively, a moderate raise from 6% and 9%. The key drivers behind this change are:

Stronger earnings beats and revisions inflection: We have extensively discussed in the previous section how both MSCI China's earnings results for 4Q24 so far and the consensus estimate revisions trend are showing an approaching inflection point of earnings growth re-acceleration.

Improved outlook for GDP and CNY strength: Moreover, Morgan Stanley's economics team for China has also just raised its 2025 real GDP forecast for China and USDCNY forecast on March 21.

- It marked to market and raised its GDP growth forecast for 2025 to 4.5% from 4.0%, reflecting a stronger-than-expected 1Q and solid capex momentum.
- Meanwhile, the team now expects USDCNY to reach 7.35 by mid-2025 (vs. 7.5 previously) and 7.50 by end-2025 (vs. 7.60 previously), factoring in the PBoC's interim policy trade-off that prioritizes currency stability (against the dollar) over domestic economic objectives. We have always made the point that currency strength serves as an important factor for Chinese equities, especially for the offshore market. This is because foreign investors' funding costs are usually in USD terms, which means a relatively stronger or less weak currency should be a positive catalyst from an asset allocation perspective.

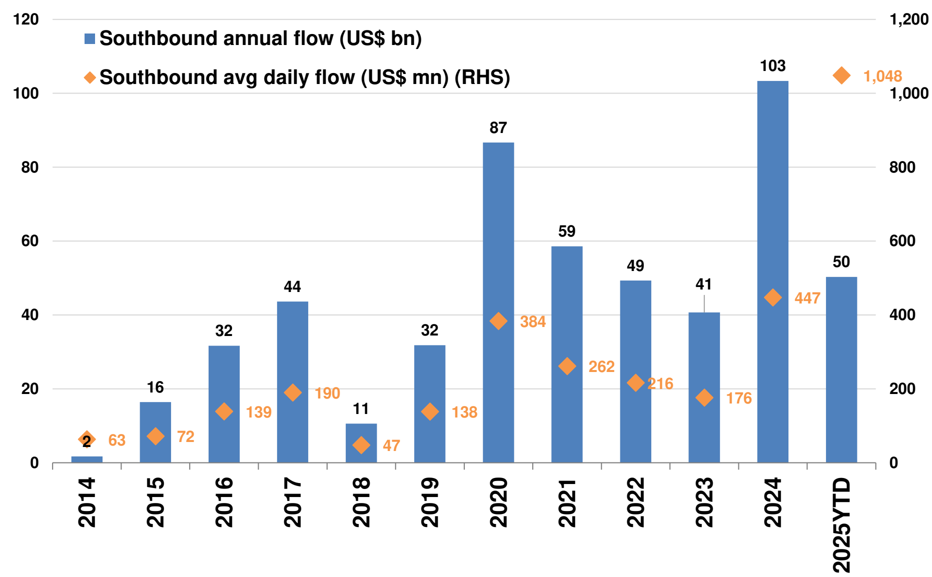
MSCI China to trade at a valuation on par with MSCI EM, eliminating a long-standing discount

We raise our year-end 2025 12-month forward P/E forecast for MSCI China to 12.5x, the same as our forecast for the MSCI EM index, completely closing its persistent discount vs. MSCI EM since 2022. We believe this is justified given MSCI China's better earnings beats and earnings estimate revision breadth trajectories, relative to broad EM, and MSCI China's limited exposure to the upcoming US Reciprocal Tariff scheme, compared to other markets within EM and globally. For more details, please refer to Valuation can trade higher now with green shoots for earnings finally in sight .

Southbound flow to continue supporting Hong Kong's liquidity, with Beijing's endorsement

Southbound flow has been a solid net buyer of Hong Kong's equity market since the Stock Connect program's launch (Exhibit 14). We saw a meaningful pickup of its inflow momentum last year – it reached a record-high annual net inflow of over US$100bn. YTD, the momentum has been even stronger, already receiving net inflow of US$50bn in less than three months, with average daily net inflow hitting US$1.0bn, more than double 2024's record of US$0.5bn/day.

Exhibit 14: Annual and average daily Southbound net flows – Southbound momentum has stayed strong compared to history



Source: CEIC, Wind, Morgan Stanley Research. Data as of March 20, 2025.

We are confident that Southbound flow could remain an important liquidity source exclusively available for the Hong Kong market, given:

1) Clear, strong signals from the Chinese government to support a stabilized and prosperous Hong Kong capital market with direct funding support from Beijing: At the beginning of this year, on January 13, the PBOC announced a series of measures to reinforce Hong Kong's status as an international financial center, including orderly expansion of the scope of investors and increasing the number of custodian banks, supporting more high-quality enterprises to list and issue bonds in Hong Kong, as well as increasing the proportion of national foreign exchange reserves allocated in Hong Kong.

2) Larger exposure to Internet and tech in the Hong Kong market: The A-share market does not have Internet exposure for historical reasons, making the Hong Kong market through Stock Connect a more straightforward option for those who look for AI and technology innovation and adoption plays.

What are the upside and downside risks?

We leave our bull and base case forecasts unchanged at this point.

As shown in Exhibit 13 , our bull and bear cases feature a wide range of upside and downside outcomes (for MSCI China from bear -26% to bull +36%), with the risk/reward profile slightly tilted towards the upside: This wide range reflects the nature of uncertainties associated with multiple moving parts (macro, liquidity, geopolitical tension, tariffs, etc.) and they could reinforce or offset each other in reality.

Our bull case would entail a much sooner turnaround of the persistent deflation as well as stabilization or even further de-escalation of geopolitical tension, particularly between the US and China: The faster improvement in macro conditions could be triggered by either:

1. A major step-up of fiscal policy pivot targeting consumption and the housing market, which could effectively boost private consumption and/or excess inventory clear-out for the primary new housing market; or
2. A strong boost to capex, hiring, and consumption driven by activities related to tech innovation and adoption related, combined with improved wealth effect thanks to a more prosperous equity market. We expect MSCI China's earnings growth to recover to double digits as a result.

For de-escalation of geopolitical tension, more framework and roadmap towards stabilized or even tariffs would be ideal. In our bull case, we expect MSCI China to regain its long-lost valuation premium vs. MSCI EM.

Our bear case scenario would feature the opposite to the bull case, which means a short-lived earnings recovery cycle and major escalation of US/China tension: The deterioration in earnings recovery would result from sharp slowdown of macro growth from 2Q onwards, owing to pressure from much higher than expected tariff hikes, along with other macro pressure. Meanwhile, broader investment bans against major Chinese listed companies, as a result of the America First Investment Memorandum, would instantly send the market much lower (as discussed in the following section, Key investor concerns and how to position). In this case, MSCI China would trade back to the valuation level before the September/October 2024 rally, with global long-term money leaving the market in large scale again.

Key investor concerns and how to position

In this report, we discuss events that could cause a major reversal of incremental positive catalysts. In addition, we noted structural improvements in our previous upgrade report, China Equity Strategy: Getting Out of the Woods (19 Feb 2025). These could cause the following:

- Derailing of increases to earnings estimates and ROE improvement.
- Sudden rise of China's equity risk premium vs. other major equity markets in the world.

We list below the major risks/investor concerns, as well asour thoughts regarding their likely paths and implications for China's equity market.

1. Unexpected impacts from escalation of US/China tensions.
2. Macro slowdown and deflation concerns.

Concern #1: Unexpected impacts from escalation of US/China tensions – more than just tariffs

This could come in various forms, including but not limited to a major tariff spike against Chinese exports, broad-based technology restrictions, as well as further investment restrictions or even prohibition, based on the recently signed America First Investment Memorandum.

a) On tariffs and related trade:

Key dates/events to monitor:

- **Reciprocal Tariff Scheme** to be announced on April 2, 2025.
- **Maritime and shipbuilding-related Section 301 investigation** against China – initiated on April 2024, public hearing to be held on March 24-25, no final conclusions yet.
- **Semiconductor-related Section 301 investigation** against China – initiated on December 23, 2024; public hearing held on March 11-12, 2025, no final conclusions yet.
- **The "America First Investment Memorandum"** – signed by President Trump on February 21, 2025; it does not include specific regulatory requirements but instructs several government agencies to begin formulating rules and procedures for implementation, no final conclusions yet.

We expect manageable impact on equity markets from the Reciprocal Tariff: As discussed in detail in Valuation can trade higher now with green shoots for earnings finally in sight , we do not expect China's equity market to be affected as much by the upcoming Reciprocal Tariff Scheme as the broad Chinese economy. Meanwhile, China's economy has become much better prepared over the years against potential tariff hikes, as illustrated in the report by Morgan Stanley's economics team for China: Reflation, Tariffs and Tech (11 Mar 2025).

In the scenario of targeted tariff hikes beyond the Reciprocal Tariff Scheme, a deal is not out of the question but could be challenging: We acknowledge that across Asia, China remains the most exposed to tariff risks given the wide scope of issues in the bilateral trade relationship that the US could use as avenues to hike tariffs. Aside from trade, the US is also concerned about strategic competition and has national security-related concerns. For a potential deal, China could offer to step up purchases of US goods, although the scale of the trade surplus still presents a challenge. Moreover, there are limited product segments in which the US will be ready to export immediately, and for the segments in which the US can step up (for instance, energy), there are supply constraints in the next two to three years.

China could offer to take more steps to assuage the concerns of the US in the context of the flow of precursor chemicals used in the production of fentanyl – a request that has been made by the Trump administration.

Finally, China could also offer to take on a more active role in helping to resolve geopolitical issues – both bilaterally and multilaterally.

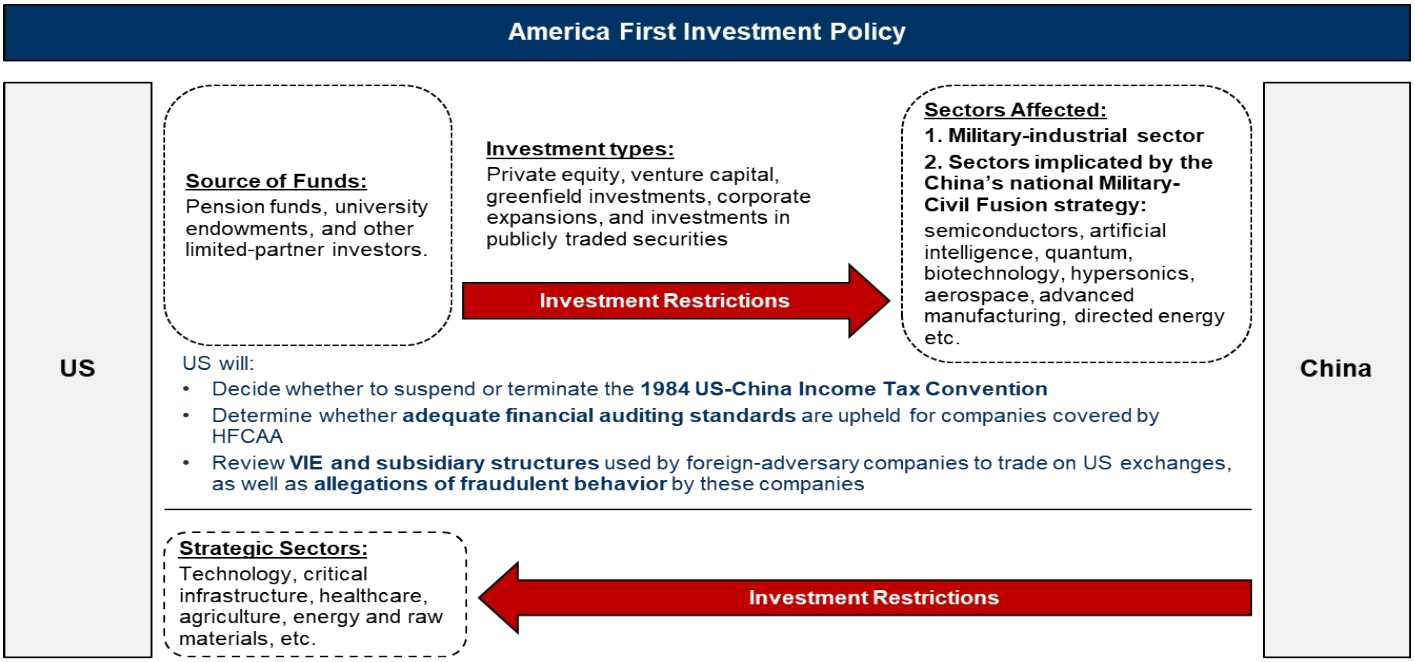
For more details please visit Asia Economics: The Viewpoint: Tariffs or Deals – What Will Prevail? (19 Feb 2025).

b) On the America First Investment Memo:

The Trump administration signed an American First Investment Policy memo on February 21, 2025, requiring CFIUS to consider new or expanded restrictions on US outbound investment to China in sectors such as semiconductors, artificial intelligence, quantum, biotechnology, hypersonics, aerospace, advanced manufacturing, directed energy, and other areas implicated by the PRC's national Military-Civil Fusion strategy. It will consider applying restrictions on investment types including private equity, venture capital, greenfield investments, corporate expansions, and investments in publicly traded securities, from sources including pension funds, university endowments, and other limited-partner investors.

We think it is too early to jump to the conclusion that the language in the document implies a major escalation from what's already been put in place, especially for public market equity investment: But it could hold some US investors off for now until more clarity comes, and any major investment restriction could put China's equity risk premium under pressure.

Exhibit 15: Summary of America First Investment Policy

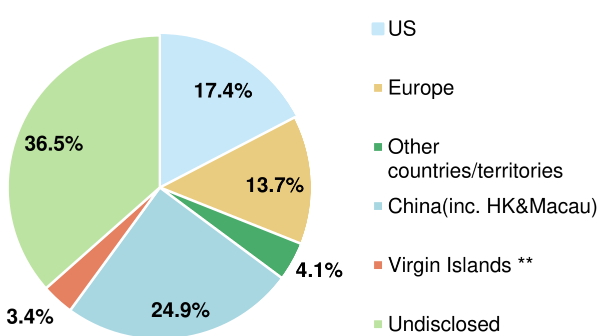


Source: White House, Morgan Stanley Research.

Our thoughts regarding the scenario of major investment ban involving public equities:

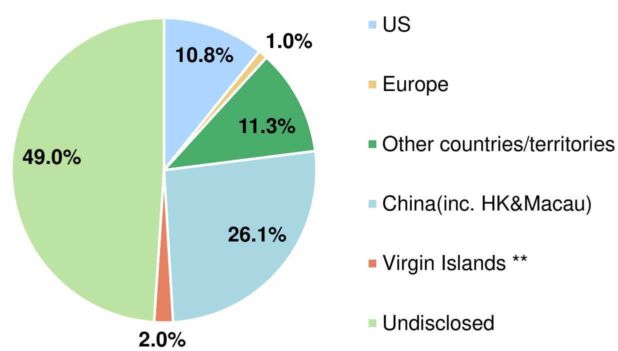
- **We would expect a sizable setback to MSCI China – up to a low-teens (ppt) level.** Such an event would signal major escalation of US/China tensions.
  - **We recommend being overweight A-shares within a Chinese portfolio allocation:** The A-share market tends to be less sensitive to geopolitical events.
- **US investor pricing power is decreasing over time:** US investor positions in China have already become much lighter over the past few years (Exhibit 16 Exhibit 17), suggesting less impact on China's market than previously. Southbound's strong momentum (Exhibit 18) also should help smooth out the Hong Kong market volatility seen YTD.

Exhibit 16: MSCI China constituents – foreign ownership in 2018



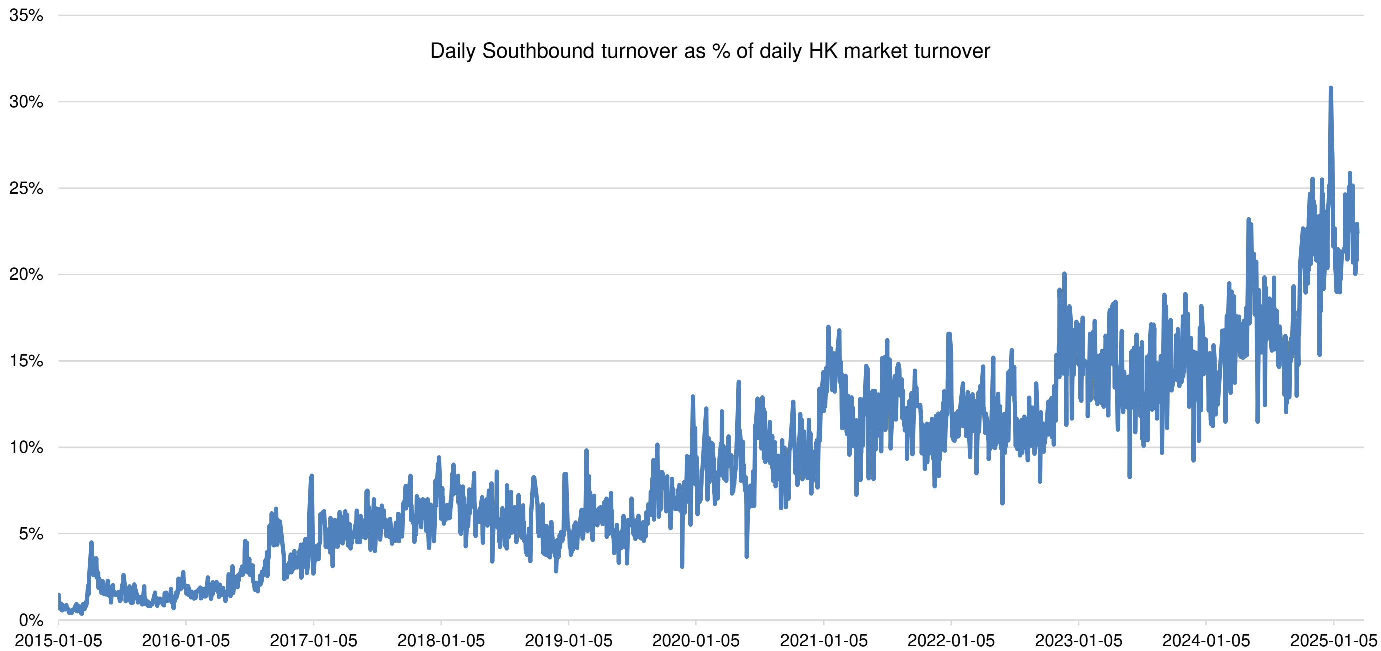
Source: Refinitiv, Factset, Morgan Stanley Research; Data as of end-2018.

Exhibit 17: MSCI China constituents – foreign ownership in 2024



Source: Refinitiv, Factset, Morgan Stanley Research; Data as of end-2024.

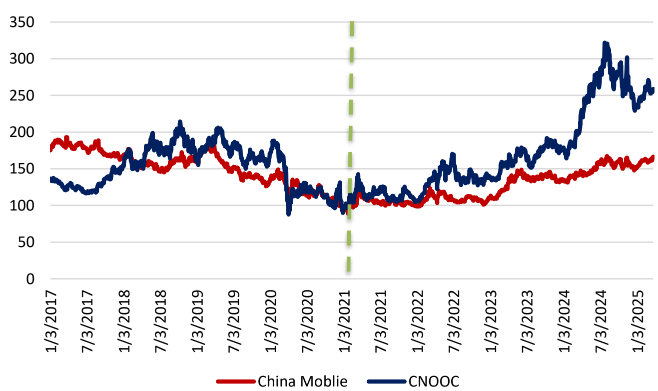
Exhibit 18:
Daily Southbound turnover as a percentage of HK market turnover – Southbound flows gradually taking over pricing power in the Hong Kong market



Source: Wind, CEIC, Morgan Stanley Research; data as of March 20, 2025.

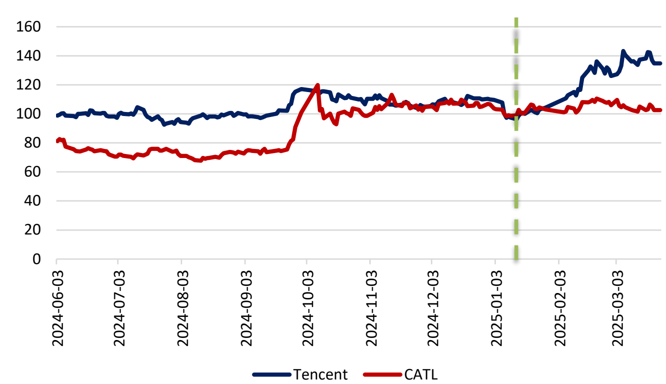
For non-US investors, this could be an opportunity to focus on bottom-up stock picking and to buy dips: Analysis of previous events of stocks being restricted from US investors, – i.e., China Mobile and CNOOC were part of the Executive Order that was effective from January 11, 2021 (see Implications of Index Providers' Response to US Executive Order) or put on a preliminary entity list (Tencent and CATL were on a US Department of Defense entity list published on January 6, 2025) – shows that despite temporary disruption, eventually these companies' stock prices would have a chance to recover and reward investors as long as the fundamentals stayed strong (Exhibit 19 , Exhibit 20).

Exhibit 19: China Mobile and CNOOC stock price from 2017 to now (rebased to 100 on January 12, 2021)



Source: Wind, Factset, Morgan Stanley Research; data as of Mar 21, 2025.

Exhibit 20: Tencent and CATL stock price from June 2024 to now (rebased to 100 on January 7, 2025)



Source: Wind, Factset, Morgan Stanley Research; data as of Mar 21, 2025.

Concern #2: Gloomy macro climate persists for longer – entrenched deflation?

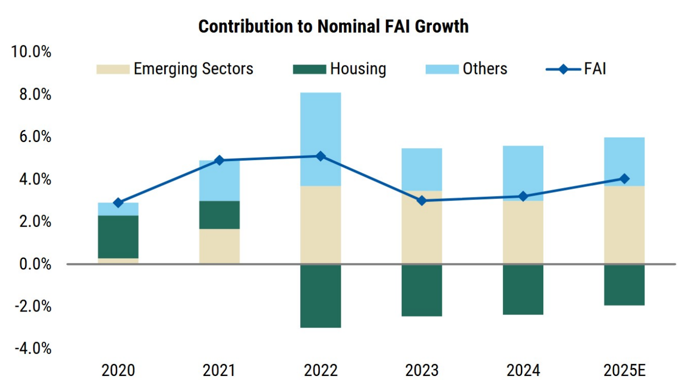
Despite its latest upgrade of China's real GDP and FX outlook for 2025, our economics team for China expects a softening, albeit shallower, quarterly trajectory from 2Q25, reflecting the impact of higher US tariffs, payback from policy front-loading, and a reactive policy stance, rather than proactive stimulus. As a result, gradual reflation remains the team's base case with its below-consensus GDP deflator forecast at 0.9% YoY for 2025, suggesting a mere 3.6% nominal GDP growth in 2025 for China. It expects mild reflation from 2026 amid fading tariff impact, phased stabilization in the housing market in different regions, and continued gradual social welfare reforms.

We have been highlighting the ROE divergence between technology/AI R&D and adoption-related sectors and those heavily dragged down by macro pressures in our recent China upgrade report (Getting Out of the Woods).

We are glad to see that these trends have been echoed by China's latest nominal FAI data and 4Q24 earnings beat breakdown: A similar trend now is also observed with capex investment, where we see higher contribution to capital formation to GDP growth supported by AI adoption initiatives (Exhibit 21). We have also observed that Internet, Financials, high-end manufacturing in Industrials, and IT have led the latest earnings beats (Exhibit 22).

New index targets feature only a moderate earnings growth lift to reflect such divergence: We have raised our earnings growth forecasts for 2025 and 2026 only moderately as a result, and we will monitor for clearer signs of earnings/growth momentum broadening to more sectors. We continue to recommend overweight-rated sectors given their stronger estimate earnings revision momentum and their under-owned status currently by global investors. For more detail regarding our latest sector allocation and stock focus list recommendations, please refer to Rotating from Defensive to Tech Adoption.

Exhibit 21: We expect higher investment growth in 2025, supported by emerging sectors amid AI adoption and policy support



Source: CEIC, Morgan Stanley Research estimates. *Emerging sectors include high-end manufacturing, new energy utilities, IT, and scientific research.

Exhibit 22: 2024 4Q average earnings beat/miss at company level by sector - Internet, financials, high-end manufacturing in industrials, and IT are leading

Sector	Earnings beat/company (Simple average)	Earnings beat/company (Weighted average)
Communication Services	8%	0.02%
Consumer Discretionary	18%	0.03%
Consumer Staples	-34%	-0.02%
Financials	48%	0.01%
Health Care	-5%	-0.01%
Industrials	15%	0.00%
Information Technology	-24%	0.02%
Materials	-45%	0.00%
Real Estate	-28%	-0.01%

Source: MSCI, Bloomberg, RIMES, Factset, Morgan Stanley Research. .

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1496	39%	378	45%	25%	695	40%
Equal-weight/Hold	1694	45%	370	45%	22%	810	47%
Not-Rated/Hold	3	0%	0	0%	0%	0	0%
Underweight/Sell	601	16%	83	10%	14%	230	13%
Total	3,794		831			1735	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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