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# China Economics

## AI Supercycle vs. Domestic Stagflation

**CITI'S TAKE**

China's K-shaped economy appears to be playing out through the contrast between an AI supercycle and domestic stagflation. AI is driving industrial production and exports, with high-tech IP reaching a five-year high. But domestic demand is faltering, as retail sales contracted for the first time since Covid and FAI decline deepened. Steady CPI and broader PPI suggest stagflation risks are on the rise for the domestic economy. We maintain our headline GDP forecast at 4.5%YoY for 26Q2E and 4.7%YoY for 2026E. On policies, we see an acceleration of targeted support for domestic demand but not broad-based stimulus ahead. Investment-stabilization measures such as the "Six Networks" initiative are underway. Consumption and household income growth could be a key focus of July's Politburo meeting. But an outright lift of budget deficit or government bond quota is not our base case, and monetary policy does not appear to be in the driver's seat.

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**AI supercycle vs. domestic stagflation is now the dominant force in China's K-shaped economy**, as mixed activities indicators for May revealed.

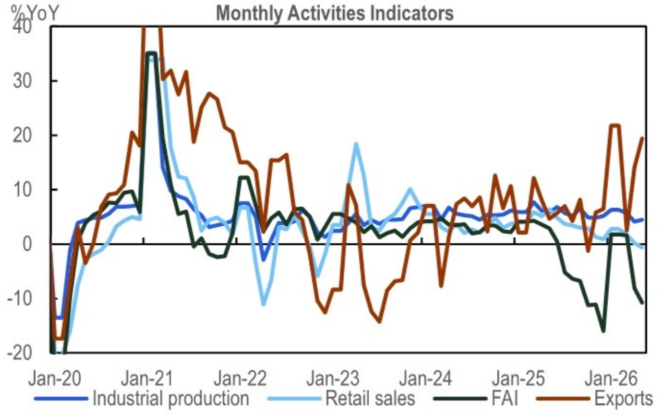
- **AI supercycle powers production and trade.** Industrial production rebounded to 4.5%YoY in May, in line with our above-consensus expectations (Citi/Mkt: 4.5/4.4%YoY). >50% of the growth came from high-tech sectors per our estimate, whose IP expanded at 15.1%YoY, a five-year high. Output of ICs, industrial robots, and NEVs all rose further, echoing earlier exports data. The AI supercycle generated investment only in selected sectors, with capex in telecom manufacturing growing at double-digit and investment in intellectual property rising 9.3%YoY Ytd.

- **Stagflation risks on the domestic side rise further.** Domestic demand indicators missed already subdued expectations. Retail sales contracted for the first time since Covid at -0.6%YoY (Citi/Mkt: 0.0/-0.2%YoY). Investment decline deepened to -4.1%YoY Ytd (Citi/Mkt: -2.5/-2.3%YoY Ytd), with the monthly rate estimated by us at -10.7%YoY, the lowest rate since 25Q4. Compounded with steady CPI and rising PPI, real growth of retail sales and FAI both turned negative and created new lows since Covid. The Middle East conflict may not be fully to blame: PPI reflation was more than energy prices in May, and the supply constraint from crude loosened with recovering petrochemical related outputs.

**Headline growth could remain steady despite the bifurcated nature.** With IP at 4.5%YoY and service output index up 4.4%YoY, monthly proxy for GDP could hover ~4.5%YoY, the lower end of this year's target. The sharpest slowdown is also likely behind us with a lower base starting to kick in from 26H2 and Middle East conflict resolution, although there is little visibility for a pickup ahead. We maintain our growth forecast unchanged at 4.5%YoY for 26Q2E and 4.7%YoY for 2026E as such.

**We see an acceleration of targeted support for domestic demand but not broad-based stimulus ahead.** Targeted measures such as the "Six Networks" initiative are underway, enabling AI transition and stabilizing investment. Consumption and household income growth could be a key focus of the July Politburo meeting (held on the 30th in 2025). We still think job market stress over the summer could prompt more targeted efforts. Having said that, steady headline GDP raises the bar for more significant policy adjustments. An outright lift of the budget deficit or government bond quota is not our base case. Although monetary policy is not in the driver's seat, we still keep our call for a symbolic 10bps cut in 26H2E, with risks skewed to earlier.

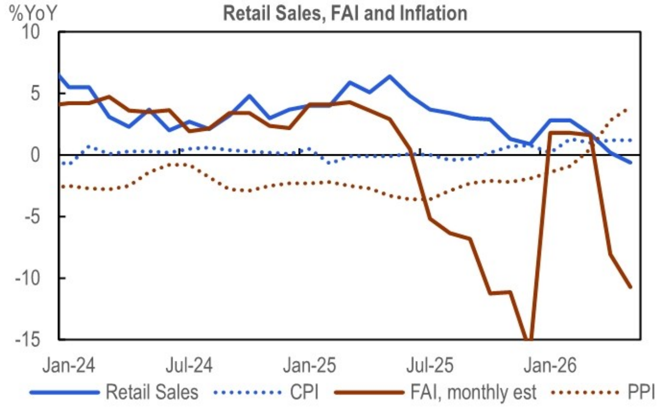
**Figure 1. China's K-shaped economy now showing through an AI supercycle vs. domestic stagflation**





Source: China Customs, NBS, Wind, Citi Research

**Figure 2. Stagflation risks on the domestic side rise with contractionary retail sales and investment in May**





Source: NBS, Wind, Citi Research

## Readthrough Monthly Indicators

**Monthly indicators came in mixed for May.** The supply side continued to outpace the demand side, with AI supercycle and domestic stagflation now two dominant forces in the K-shaped economy.

Industrial production rebounded to 4.5%YoY, in line with our above-consensus forecast (Citi/Mkt: 4.5/4.4%YoY). The AI supercycle appears to have helped.

- **AI supercycle powers ahead.** High-tech IP rose 15.1%YoY, up from previously 12.8%YoY and hitting a five-year high. With its share at ~17% in IP (NBS, Oct 20th, 2025), it could have contributed >50% of IP. Output of high-tech products rose further, with ICs at 22.9%YoY (vs. 22.1%YoY in April), industrial robots at 27.9%YoY (vs. 15.1%YoY), and NEVs at 17.8%YoY (vs. 3.8%YoY). Exports delivery remained steady at 10.1%YoY.

- **Impact from Middle East conflict faded.** Output of ethylene recovered to 2.1%YoY (vs. -4.1%YoY) and contraction narrowed for sulfuric acid to -1.6%YoY (-2.2%YoY). The resolution to the Middle East conflict could help further.

- **Old economy showed no sign of stabilization.** Crude steel output continued to contract -2.7%YoY (vs. -2.8%YoY), while cement output dropped -8.1%YoY (-10.8%YoY). The *Six Networks* investment could have just started and may take longer to shore up actual investment and production.

**Retail sales recorded the first negative reading since Covid.** The May reading came in at -0.6%YoY, below already subdued expectations (Citi/Mkt: 0.0/-0.2%YoY, Prior: 0.2%YoY). Steady CPI at 1.2%YoY in May could have sent real growth to ~1.8%YoY.

- **Trade-in subsidies remained a drag.** We estimate the drag at -2.2ppts in May vs. -2.0ppts in April, a marginal deterioration insufficient to address the further decline, in our view. Auto sales stayed soft at -16.1%YoY (vs. -15.3%YoY), while home appliances remained sluggish at -15.6%YoY (vs. -15.1%YoY. Telecom equipment sales slowed further to 0.7%YoY (vs. 6.2%YoY), which could be under a "double whammy" from reduced subsidies and price increases. The high-base from last year's trade-in subsidies could further kick in, and some easing in contraction could follow in 26H2.

- **Demand shock from Mideast conflict faded.** Energy & fuel sales dropped -3.2%YoY (vs. -6.5%YoY) and jewelry sales contracted -8.9%YoY (vs. -21.3%YoY), both narrowing from previous readings through remaining negative. Struggle of big retailers (annual sales >RMB5mn) continued, with their monthly sales at -5.2%YoY (vs. -4.9%YoY).

- **Services economy softened.** Cumulative retail services growth edged down to 5.4%YoY Ytd from previously 5.6%YoY for the first four months. Holiday economy related items were sluggish: restaurant revenue grew merely 0.6%YoY in May; beverage sales increased 6.1%YoY, and tobacco & liquor sales grew 4.8%YoY. The NBS attributed part the fluctuations to weather (SCIO, Jun 16th). Food deflation despite overall steady CPI could drive the nominal readings lower.

**Investment contraction deepened further.** Cumulative FAI growth dropped -4.1%YoY (Citi/Mkt: -2.5/-2.3%YoY Ytd), after turning negative at -1.6%YoY Ytd in April. The monthly reading could have deteriorated to -10.7%YoY per our estimate, the lowest reading since 25Q4.

- **Manufacturing investment** showed tentative signs of stabilization amid an overall worsening picture. Cumulative capex growth dropped to -0.4%YoY Ytd from previously +1.2%YoY, yet its monthly rate could have stabilized at -4.2%YoY (vs. -4.3%YoY) based on our estimate.

  - New economy led the stabilization. Investment in telecom mfg strengthened to 6.7%YoY Ytd from 5.4%YoY Ytd in April, and we estimate its monthly rate to pick up to 10.4%YoY. Investment in rail, ship and other transportation equipment stayed buoyant at 23.6%YoY Ytd. The new economy investment could also span more in intellectual property – its growth was solid at 9.3%YoY for Jan-May (NBS, Jun 16th).

  - PPI reflation beneficiaries showed little signs of capex, unsurprising amid anti-involution actions and Mideast conflict impact. Capex of chemicals dropped -12.2%YoY in the month, with its cumulative reading at -5.9%YoY.

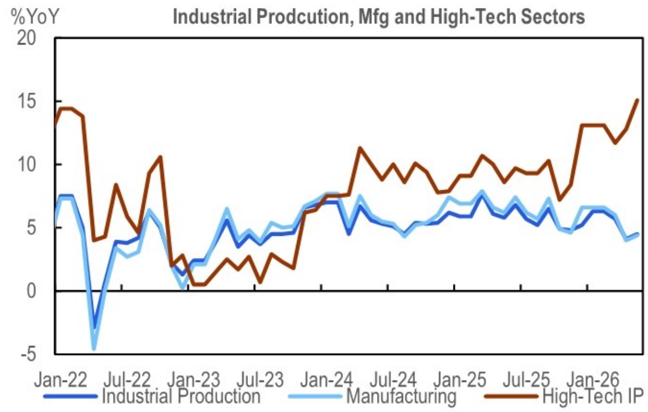
- **Infrastructure investment** dropped further to 0.6%YoY Ytd from previously 4.3%YoY Ytd. We estimate monthly contraction to have expanded to -9.1%YoY from -4.9%YoY, inching close to lowest readings excluding Covid disruptions. The Six Networks investment could have started but it may take longer to shore up FAI data. Weather disruptions into the summer could create more volatility.

- **Green shoots in the property sector** sustained, but not spreading. This is particularly the case for prices and second-hand sales in top-tier cities.

  - Second-hand prices rose another 0.4%MoM in Tier-1 cities, with its 3M/3M annualized rate now at 4.9%, the highest since mid-2023. Second-hand sales in cities such as Shanghai continued to trend above last year's level. The price momentum didn't spread: 10 cities out of the 70 cities surveyed by the NBS reported a sequential increase in second-hand prices, further down from 12 in April, and the contraction deepened in Tier-3 cities. National sales dropped -13.1%YoY in terms of floor space and -9.5%YoY in value terms.

  - Property investment contracted further. The cumulative reading dropped -16.2%YoY Ytd, with the monthly rate estimated at -24.3%YoY, and housing new starts remained in deep contraction of -24.6%YoY.

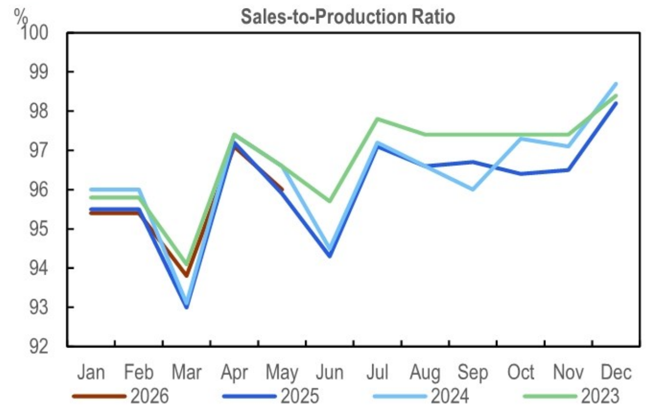
### Figure 3. Industrial production growth and major sectors





Source: NBS, Wind, Citi Research

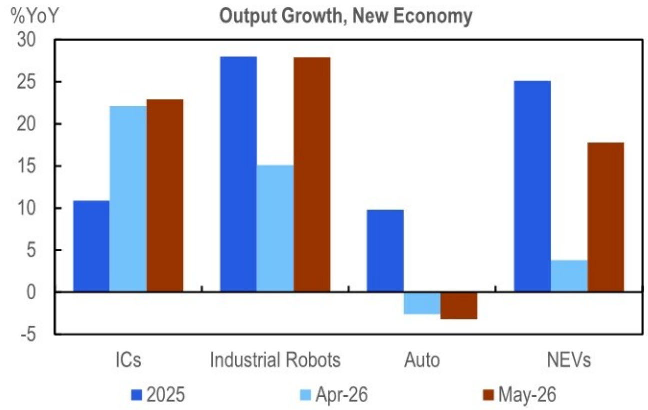
### Figure 4. Sales-to-production ratio by month





Source: NBS, Wind, Citi Research

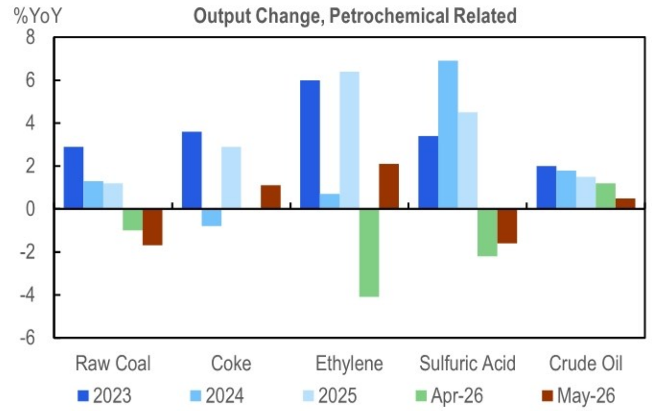
### Figure 5. Output growth of new-economy items





Source: NBS, Wind, Citi Research

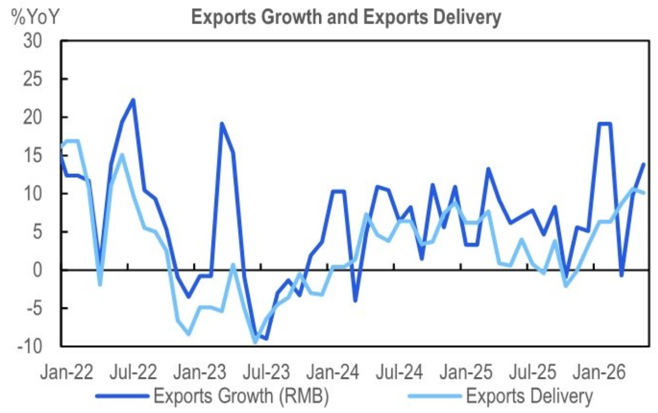
### Figure 6. Output growth petrochemical related products





Source: NBS, Wind, Citi Research

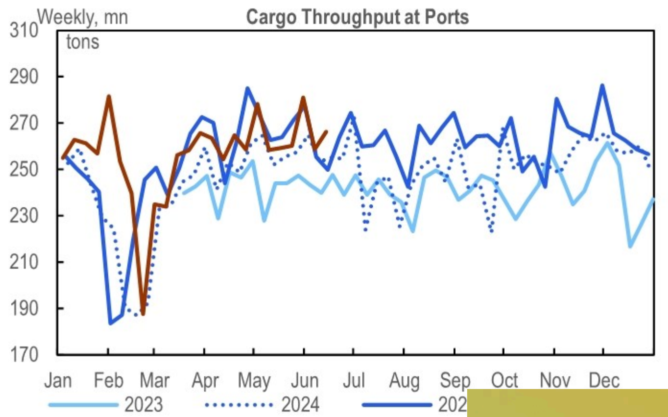
### Figure 7. Exports growth and exports delivery growth





Source: NBS, Wind, Citi Research

### Figure 8. Cargo throughput at ports





Source: MoT, Wind, Citi Research

**Figure 9. Retail sales growth by major categories**

| (%YoY) | | 2024 | 2025 | 25Q4 | 26Q1 | Apr 2026 | May 2026 |
|---|---|---|---|---|---|---|---|
| **Retail Sales** | | **3.5** | **3.7** | **1.7** | **2.4** | **0.2** | **-0.6** |
| Trade-in Subsidies | Auto | -0.5 | -1.5 | -6.5 | -9.0 | -15.3 | -16.1 |
| | Home Appliances | 12.3 | 11.0 | -17.7 | 0.0 | -15.1 | -15.6 |
| | Telecom Equipment | 9.9 | 20.9 | 21.6 | 20.8 | 6.2 | 0.7 |
| | Furniture | 3.6 | 14.6 | 0.6 | -5.2 | -10.4 | -8.7 |
| | Cultural & Office | -0.3 | 17.3 | 11.5 | 9.3 | -6.9 | -1.5 |
| Holiday Economy | Beverage | 2.1 | 1.0 | 3.9 | 6.7 | 3.6 | 6.1 |
| | Tobacco & Liquor | 5.7 | 2.7 | -1.0 | 16.0 | 11.7 | 4.8 |
| | Restaurants' Revenue | 5.3 | 3.2 | 3.0 | 4.2 | 2.2 | 0.6 |
| Global Prices | Energy & Fuel | 0.3 | -5.7 | -8.3 | -6.4 | -6.5 | -3.2 |
| | Jewelry | -3.1 | 12.8 | 16.7 | 12.6 | -21.3 | -8.9 |
| Staples | Grains & Food | 9.9 | 9.3 | 6.2 | 10.0 | 4.1 | 1.9 |
| | Daily Necessities | 3.0 | 6.3 | 3.3 | 5.9 | 3.5 | 1.6 |
| Other Discretionary | Apparel & Footwear | 0.3 | 3.2 | 3.3 | 9.3 | 3.6 | 3.8 |
| | Sport & Recreation | 11.1 | 15.7 | 6.3 | 1.9 | -8.0 | -8.0 |
| | Cosmetics | -1.1 | 5.1 | 8.2 | 5.9 | 4.7 | 2.5 |
| | Home Decoration | -2.0 | -2.7 | -12.5 | -4.7 | -13.8 | -13.6 |
| **Retail Services Sales** | | **6.2** | **5.5** | | | **5.6** | **5.4** |


Source: NBS, Wind, Citi Research

**Figure 10. Retail sales, goods and restaurants' revenue**



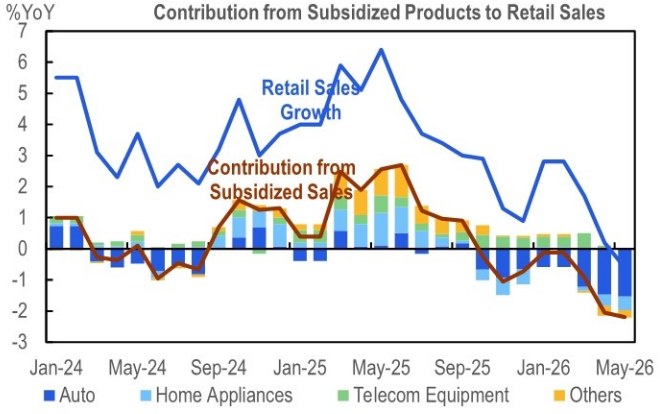
Source: NBS, Wind, Citi Research

**Figure 11. Retail sales, by size of retailers**



Source: NBS, Wind, Citi Research

**Figure 12. Contribution from trade-in related items**





Source: NBS, Wind, Citi Research

**Figure 13. Contribution from austerity rule related items**



Source: NBS, Wind, Citi Research

**Figure 14. Second-hand property prices**



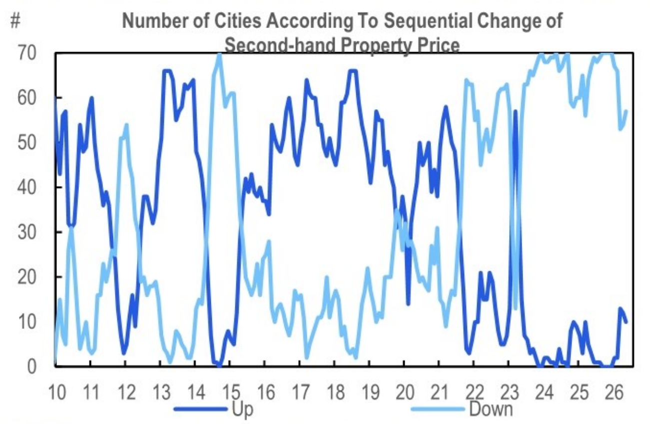
Source: NBS, Wind, Citi Research

**Figure 15. New home prices**



Source: NBS, Wind, Citi Research

**Figure 16. Counts of cities by change in second-hand prices**





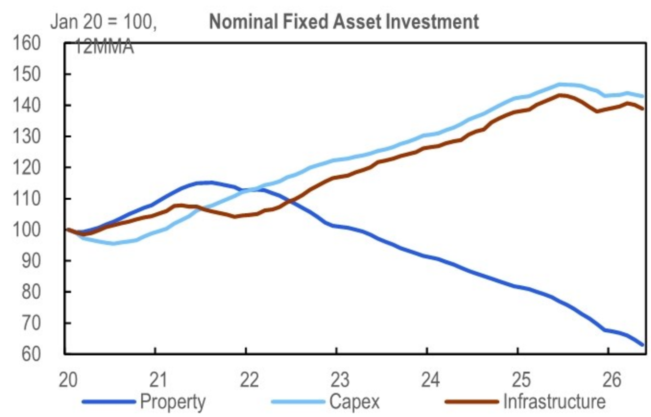
Source: NBS, Wind, Citi Research

**Figure 17. Second-hand home sales in Shanghai**



Source: Shanghai housing office, Wind, Citi Research

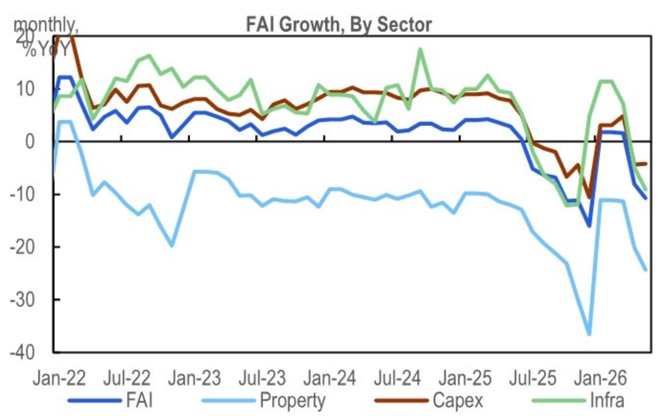
**Figure 18. Fixed asset investment indices**





Source: NBS, Wind, Citi Research

**Figure 19. Growth of FAI growth by major sectors**





Source: NBS, Wind, Citi Research

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# Appendix A-1

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