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September 16, 2026 04:56 AM GMT

Investor Presentation | Asia Pacific

China Outlook Amid AI And The Next Industrial Super Cycle

MORGAN STANLEY ASIA LIMITED+

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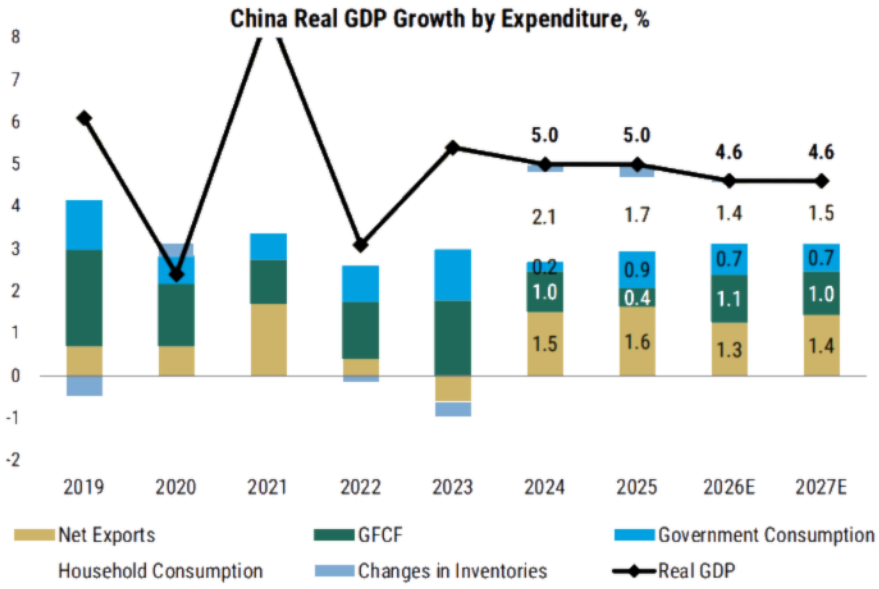
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For analyst certification and other important disclosures, refer to the Disclosure Section, located at the end of this report.

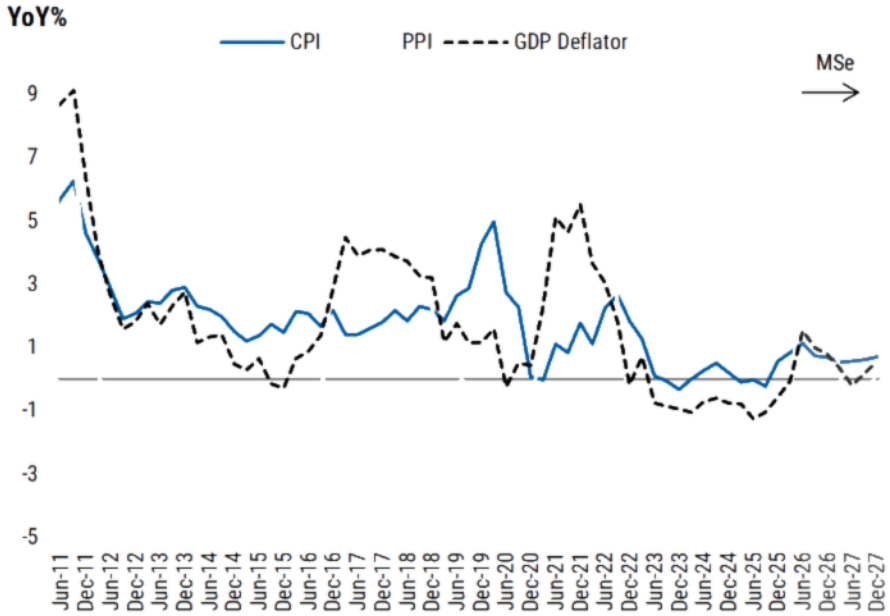
Economic Outlook

A Two-speed Economy

Subdued GDP growth amid resilient exports, yet weak investment and consumption



Better inflation, but reflation is narrow

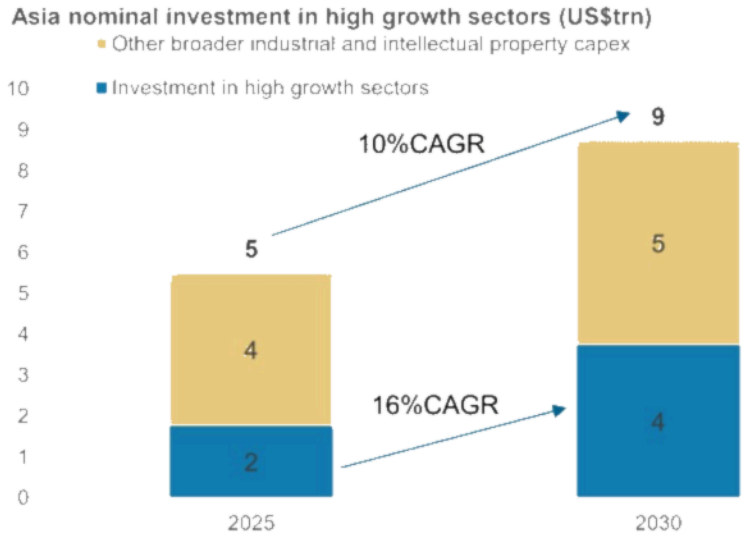


Source: CEIC, Morgan Stanley Research estimates.

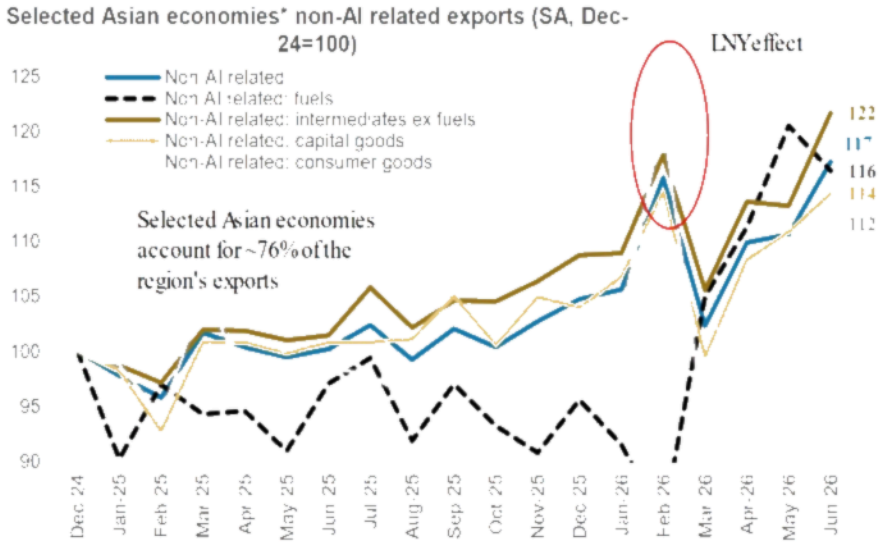
Economic Outlook

The Rising Asia Industrial Super Cycle

Asia is likely to enter its strongest industrial cycle since the mid-2000s, not just in AI/tech



The recovery in non-tech exports has been broad-based

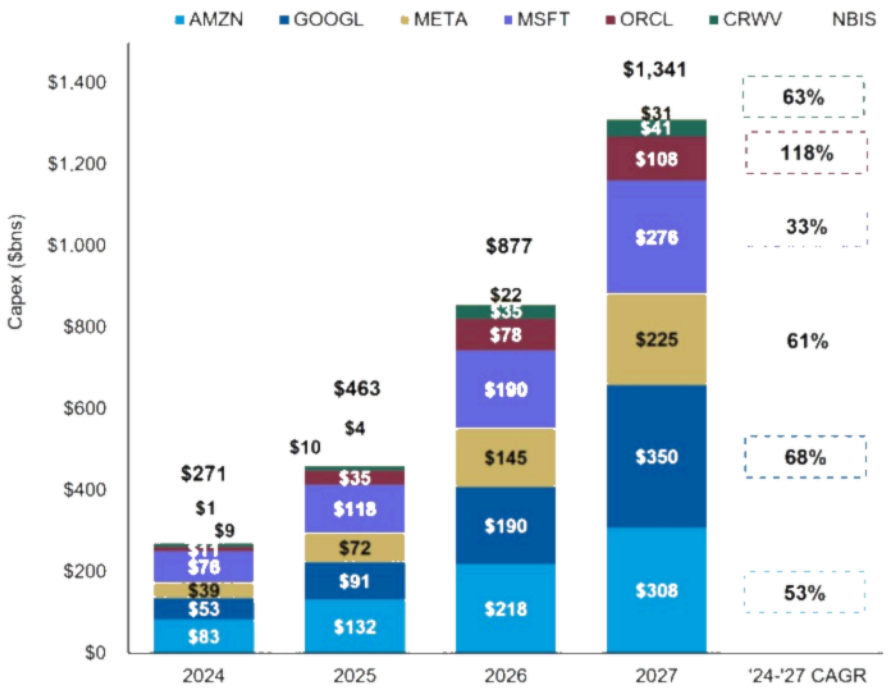


Source: Haver, Morgan Stanley Research estimates. *Asian economies include China, India, Indonesia, Korea, Taiwan, Australia, and Japan.

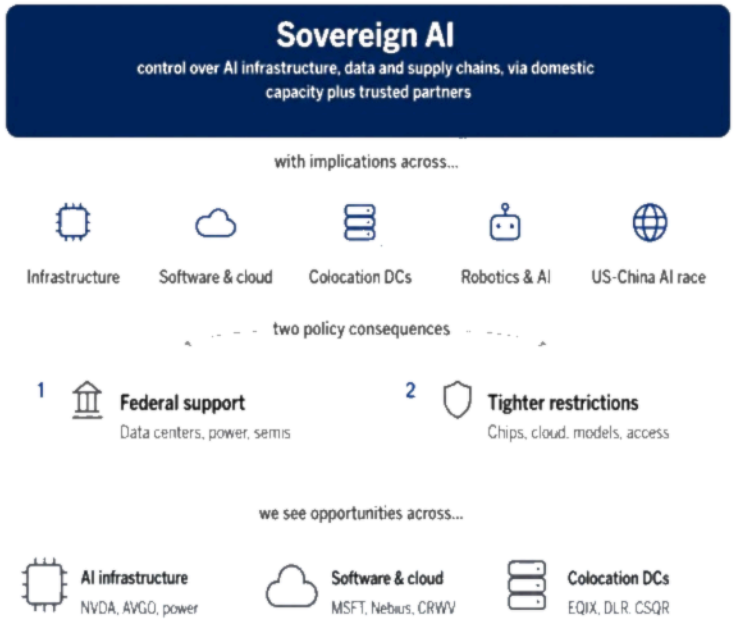
Economic Outlook

AI Is Just Part Of The Story

US hyperscaler and newcloud capex forecasts



AI sovereignty should further reinforce AI capex

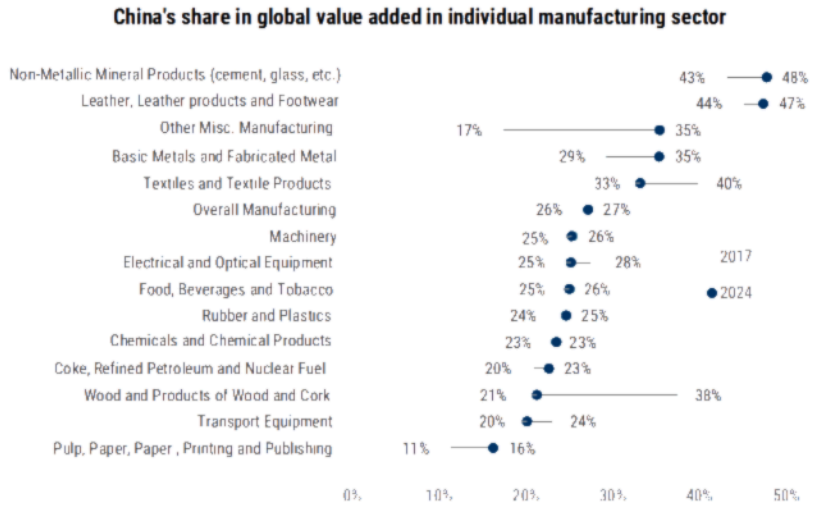


Source: CEIC, Morgan Stanley Research estimates. For more details on the LHS chart, kindly see Power Struggle: AI, Data Centers & Local Backlash (14 Jul 2026).

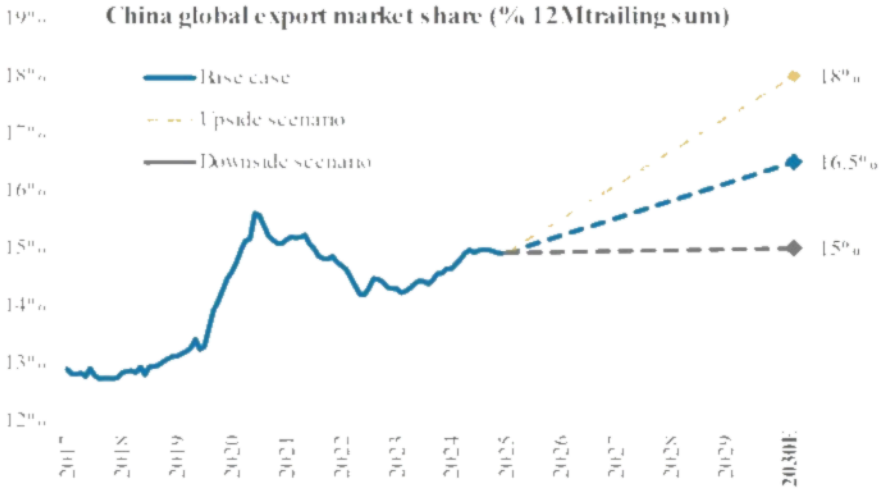
Economic Outlook

China's Exports To Benefit, Anchoring Growth Momentum

China has a dominant share in global value-added across manufacturing sectors



We expect China's global export market share to rise to 16.5% by 2030

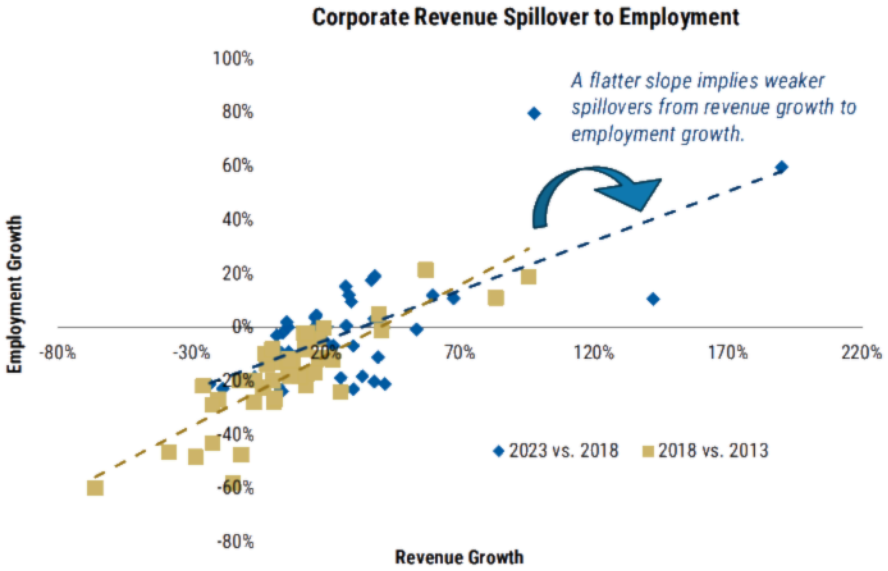


Source: CEIC, Morgan Stanley Research estimates. For more details, see Asia Economics: Why China will widen its lead in global manufacturing exports (7 Dec 2025).

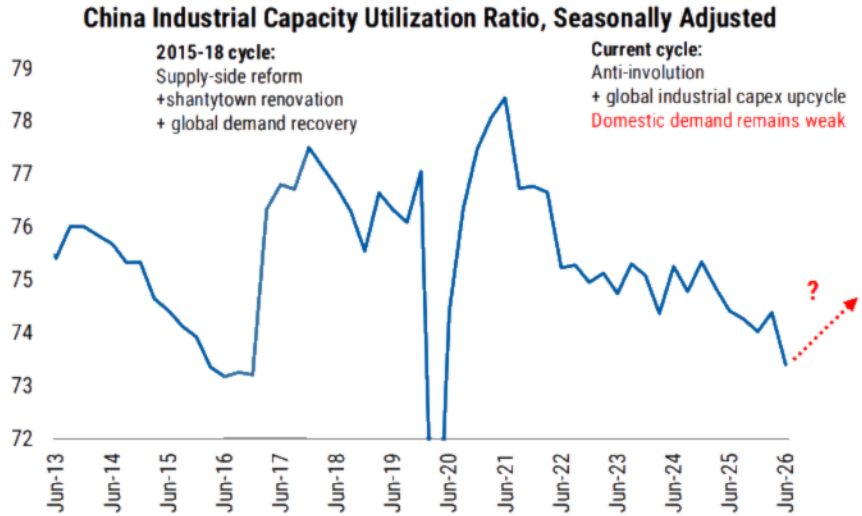
Economic Outlook

That Said, The Positive Spillover To The Broader Economy Could Be Milder This Time

Employment may get less boost as the industrial sector becomes more capital intensive and automated



Lingering excess capacity may slow the spillover of export strength to domestic demand

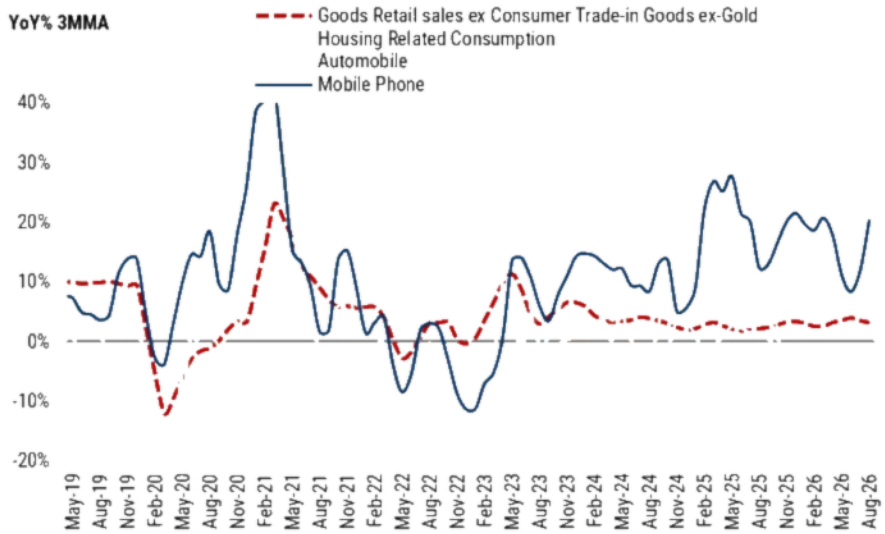


Source: NBS, Economic Census, Morgan Stanley Research. Note: RHS: 3-year rolling correlation.

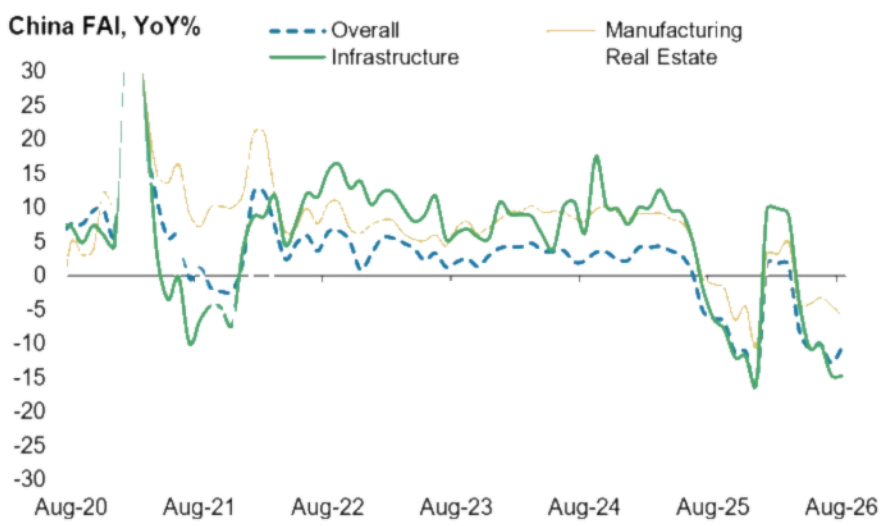
Economic Outlook

Domestic Demand Softened

Consumption weakened despite a low base



Broad-based decline in investment

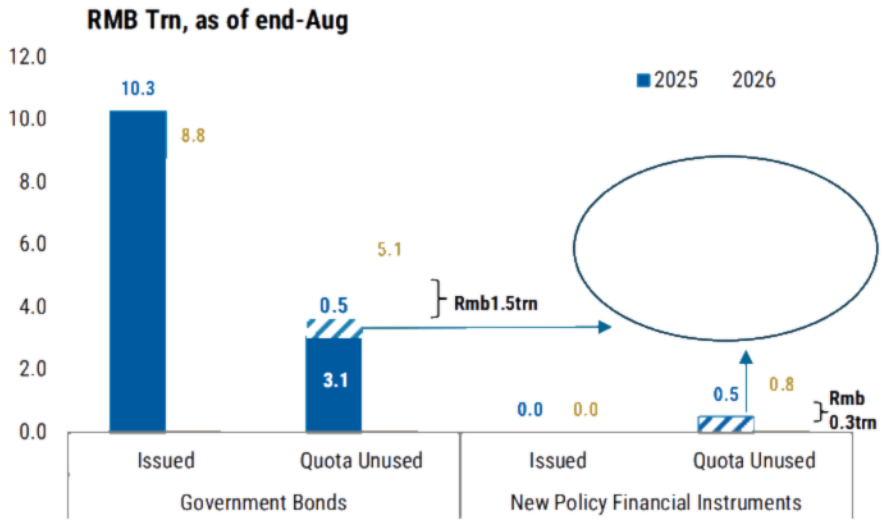


Source: CEIC, Morgan Stanley Research.

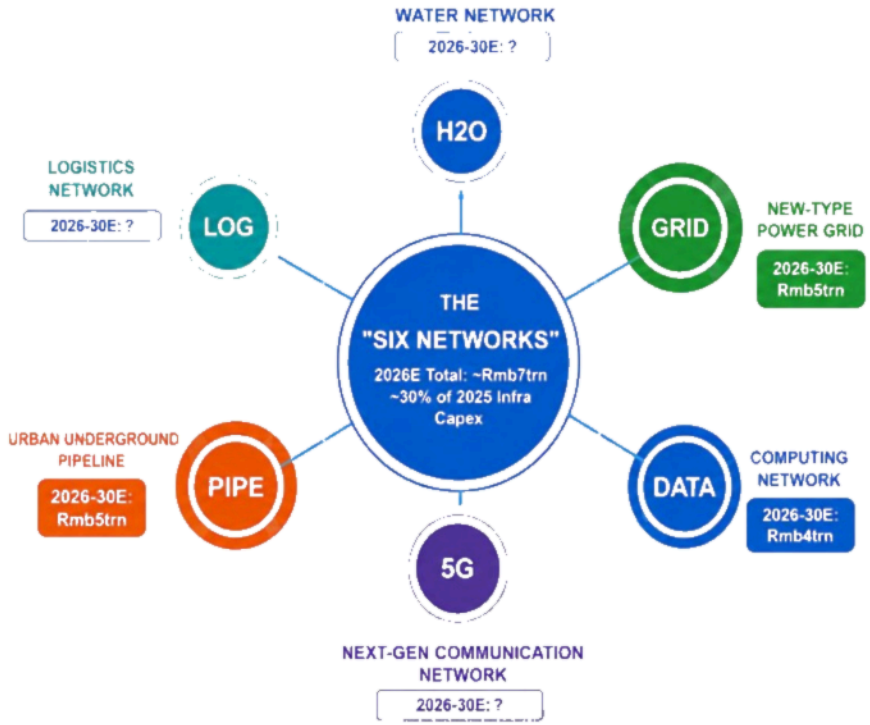
Near-term Policy Outlook

Policy: Supportive, But No Rush To Stimulate

The near-term priority should remain faster deployment of the roughly Rmb2trn of fiscal and quasi-fiscal impulse…



…with a continued supply-centric focus



Source: MoF, CEIC, Morgan Stanley Research. E = estimates from government website.

Near-term Policy Outlook

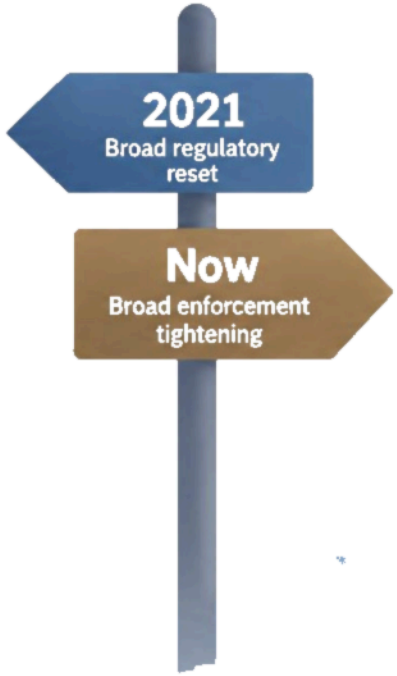
More Enforcement, Less Policy Reset

2021
Broad regulatory reset

New rules
Introduction of major new regulatory frameworks.

Policy objective
Shift in governance priorities.

Economic backdrop
Stronger growth momentum, more room for tight policy.



Now
Broad enforcement tightening

Stricter enforcement
Largely enforcement of existing rules and closing loopholes, rather than broad new restrictions.

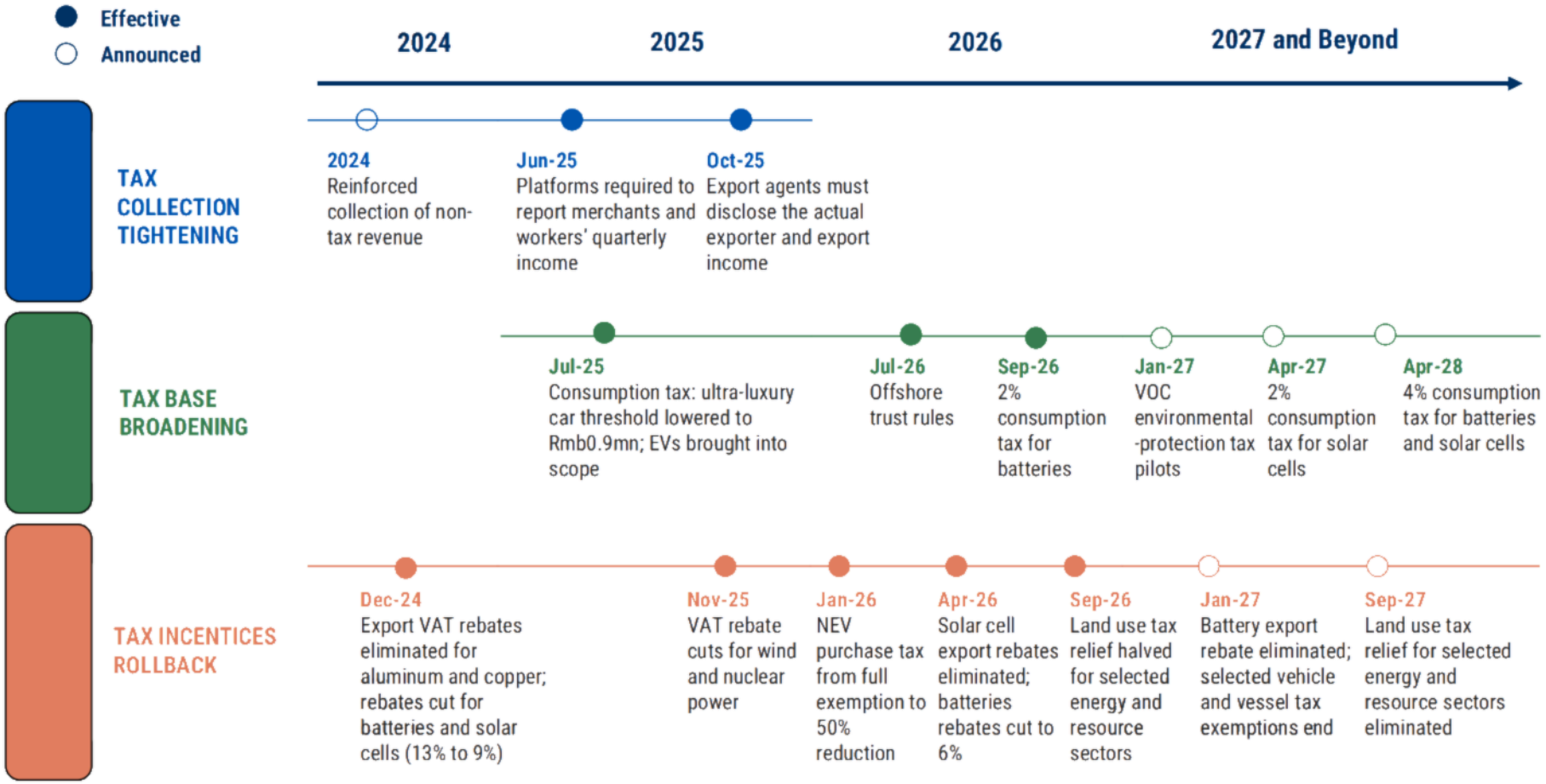
Policy objective
Financial stability, fiscal sustainability and regulatory compliance.

Economic backdrop
Weaker property market and deflation risks, which constrain the scope for aggressive tightening.

Source: Morgan Stanley Research.

Near-term Policy Outlook

Tax Enforcement: Closing Loopholes, Narrowing Tax Incentives For Selective Sectors



Source: Morgan Stanley Research.

Near-term Policy Outlook

Tighter Credit For Property Developers, Incremental Looser Mortgage Rules

Item		Previous Rules / Practice	New Rules (Aug-2026)
Property Developers	Financing model	Fragmented project financing	**Lead-bank system** introduced; one lead bank responsible for **closed-loop fund management** for each project
	Land acquisition loans	Prohibited (existing restriction)	Prohibited (explicitly retained)
	Developer loan tenor	No unified national standard	**Pre-sale projects:** normally **≤3 years**, maximum **5 years** **Completed projects**: normally **≤5 years**, maximum **7 years**
	Mortgage disbursement	**Pre-sale projects:** Released after the building's main structure was topped out **Completed-home projects:** Typically released after mortgage approval and registration	**Pre-sale projects:** Mortgage can only be disbursed **after project completion filing** **Completed-home projects:** Mortgage can only be released **after sales filing**
Households	Borrower affordability test	**Payment-to-income ratio:** ≤50% **Debt-to-income ratio:** ≤55%	**Payment-to-income ratio:** ≤50% **Debt-to-income ratio: ≤60%**
	Mortgage tenor	≤30 years	**≤40 years**

Source: Government website, Morgan Stanley Research.

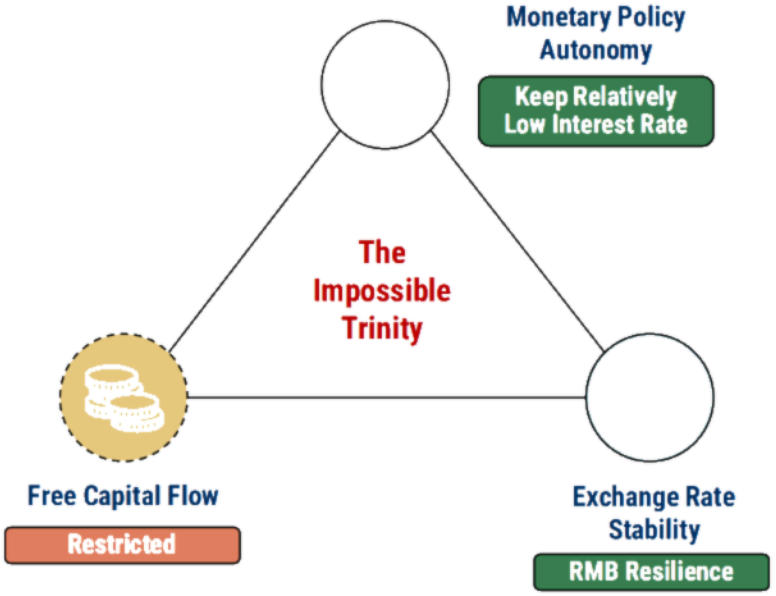
Near-term Policy Outlook

Outbound Investment: Rewiring, Not Shutting Down

The tightening is primarily aimed at redirecting private portfolio outflows into regulated channels…



…which also gives the PBoC greater room to navigate the "impossible trinity"



Source: CEIC, Morgan Stanley Research.

Near-term Policy Outlook

Gauging The Impact Of Recent Tax And Social Security Policy Tightening

1 Social security contribution tightening



- Stricter collection and enforcement of social security contributions
- Crack down on under-reporting of the contribution base

2 Export VAT rebate rollback



- Reduced export VAT rebates for selected products
- 249 products: rebate rate to 0% from 1 April 2026
- 22 battery products: 9% → 6% from 1 April 2026, and 6% → 0% from 1 January 2027

Implications

Direct fiscal / cash-flow impact



~1–2% of GDP

Indirect impact on sentiment



- Greater policy uncertainty
- Weaker private-sector confidence
- More cautious investment and hiring decisions

3 Offshore trust taxation



- 20% tax on legacy offshore trust assets with embedded capital gains
- Annual taxation of offshore trust income (e.g. dividends, interest)

4 Retrospective review of tax incentives



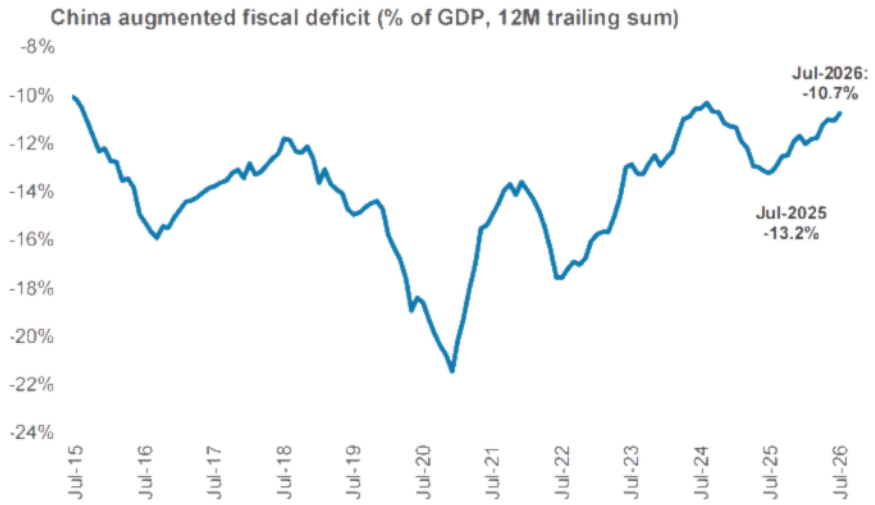
- Clawback of improperly claimed tax benefits (e.g. wrong classification into high-tech firms, R&D incentives, and other preferential policies)

Source: Government websites, Morgan Stanley Research estimates.

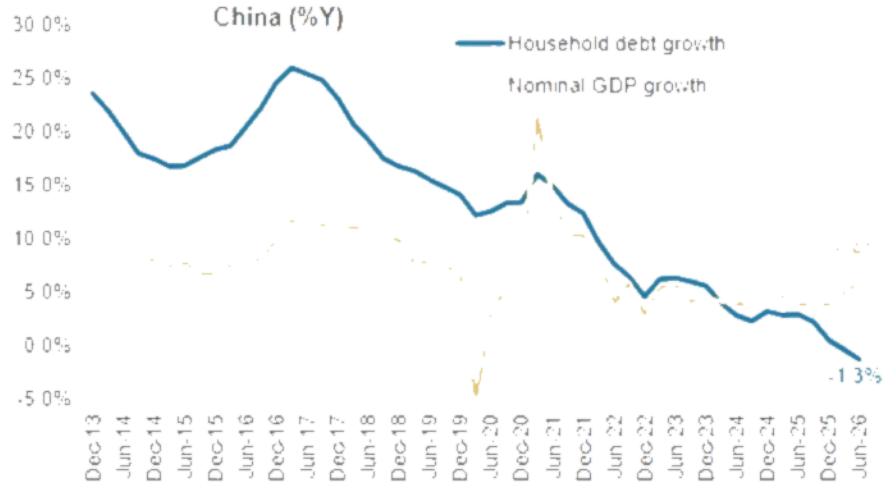
Near-term Policy Outlook

Pro-cyclical Fiscal Tightening A Key Risk To Watch

De facto fiscal tightening is underway…



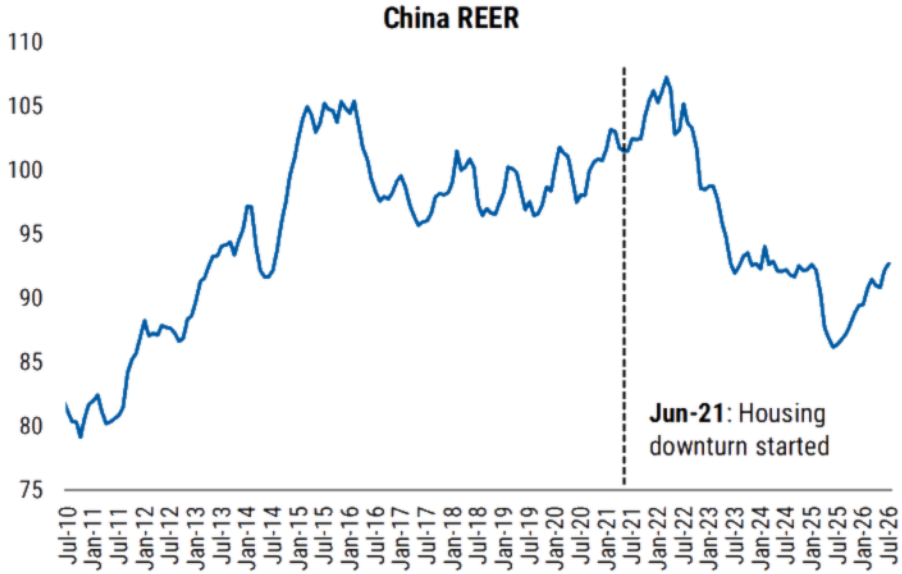
…when households are deleveraging



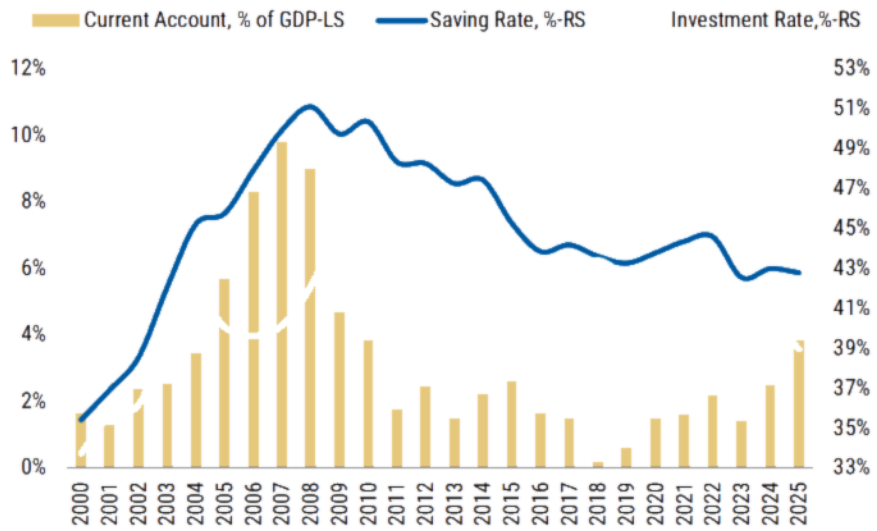
Source: CEIC, Wind, Morgan Stanley Research.

Global Imbalance: Look Beyond The RMB

The weak RMB is part of the post-housing equilibrium…



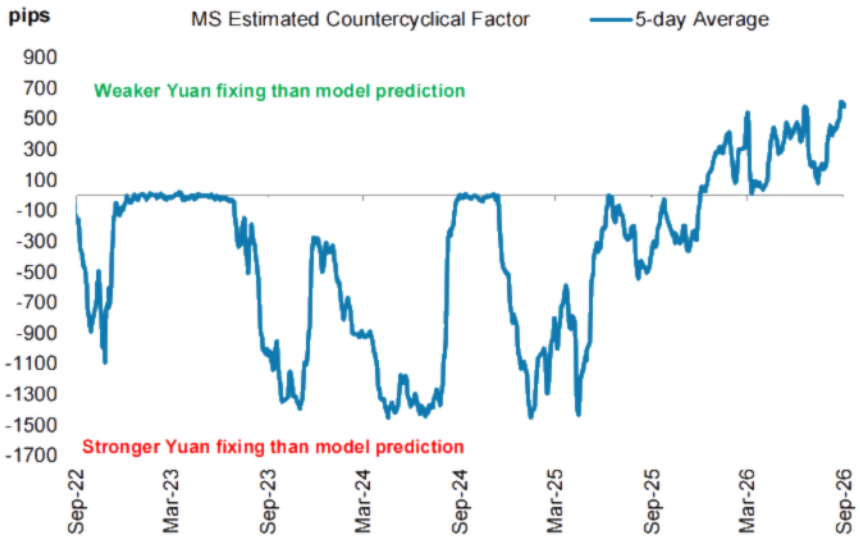
…with structurally high savings, weaker investment, and a lower equilibrium interest rate



Source: Haver, Morgan Stanley Research.

Recent Policy History Is Inconsistent With A Policy-driven Currency Undervaluation

RMB was defended by PBoC...



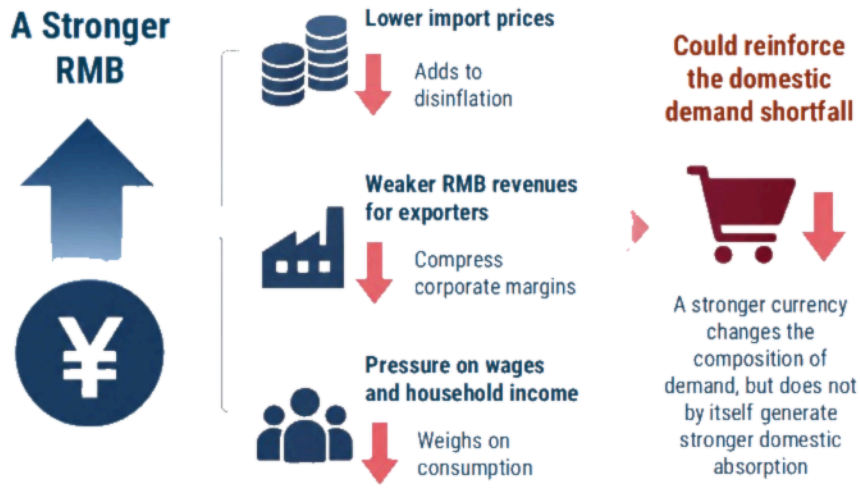
...before it was allowed to catch up partially



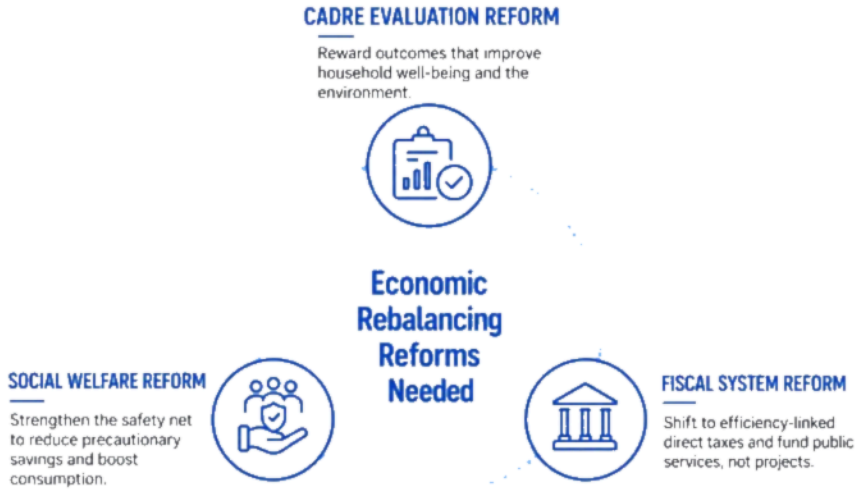
Source: CEIC, Bloomberg, Morgan Stanley Research.

A Stronger RMB Is Not The Rebalancing Policy

A stronger currency does not by itself create the stronger domestic absorption needed to narrow external surplus



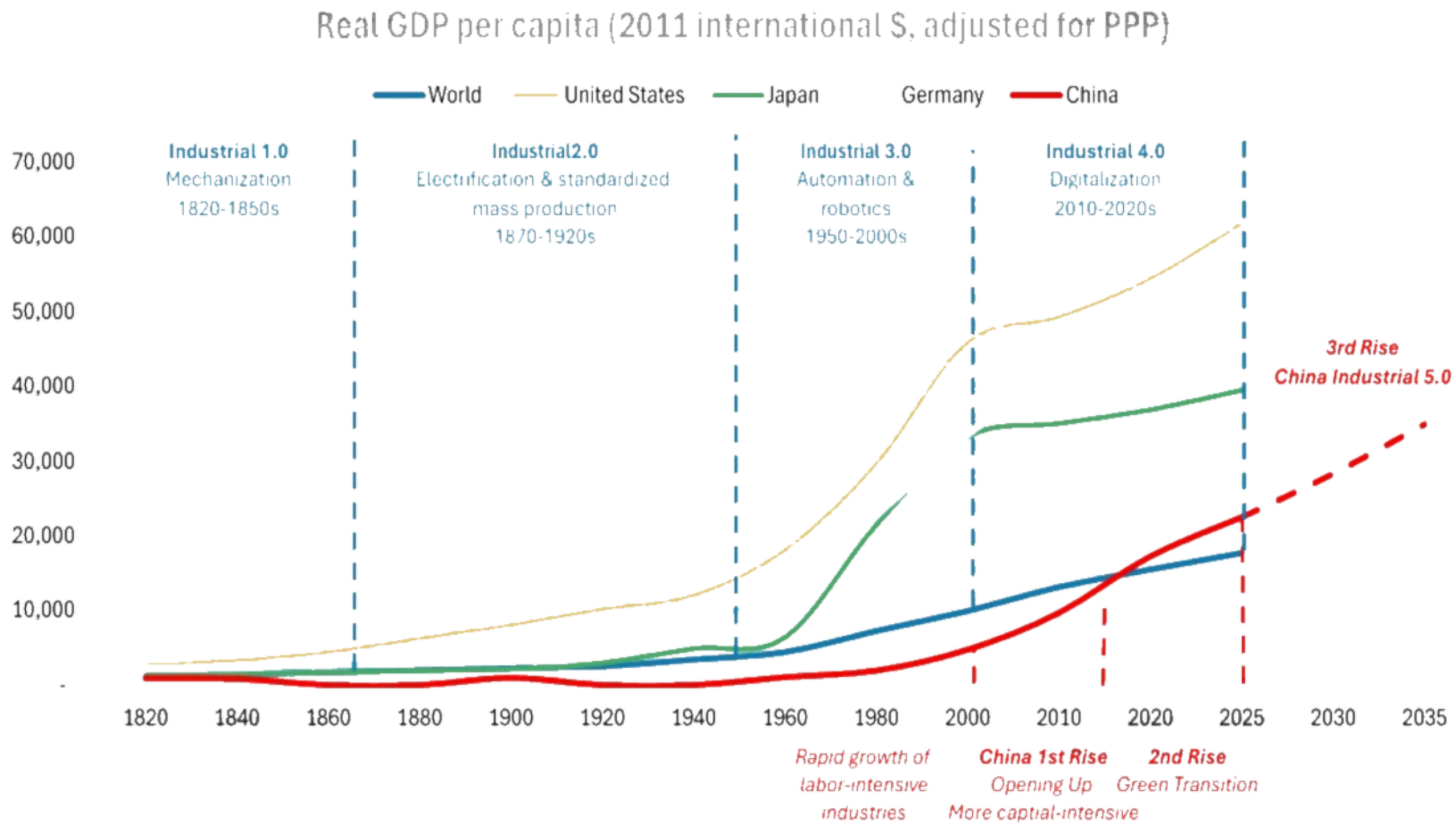
Rebalancing has to start within



Source: Morgan Stanley Research.

China Industry 5.0

China Appears Poised To Rise Again With Industry 5.0



Source: Madison Project Data, IMF, Morgan Stanley Research estimates.

China Industry 5.0

Manufacturing Workflow: From Automated To Adaptive





Why Is China Uniquely Positioned to Lead?

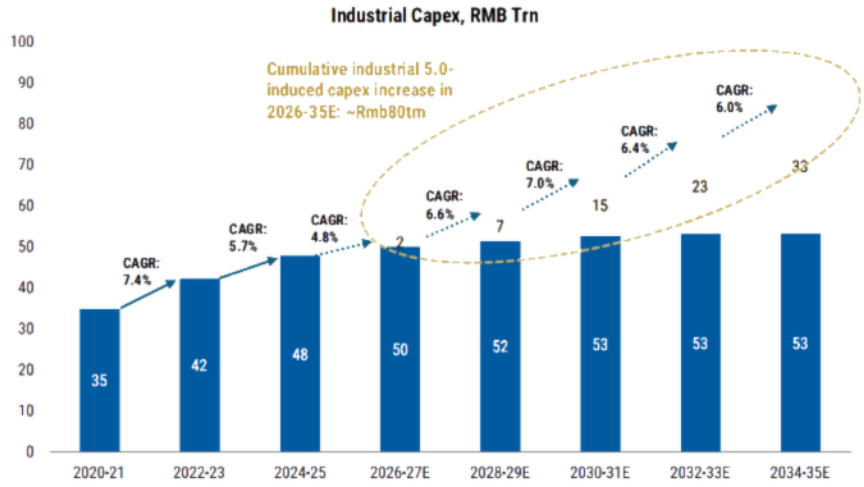
1	The largest addressable **manufacturing base**
2	A rapid **intelligent deployment base**
3	Policy is shifting from "digital factory" to "**industrial agent**"

Source: Morgan Stanley Research. For more details, see China's Emerging Frontiers: China's Next Industrial Revolution (9 Sep 2026).

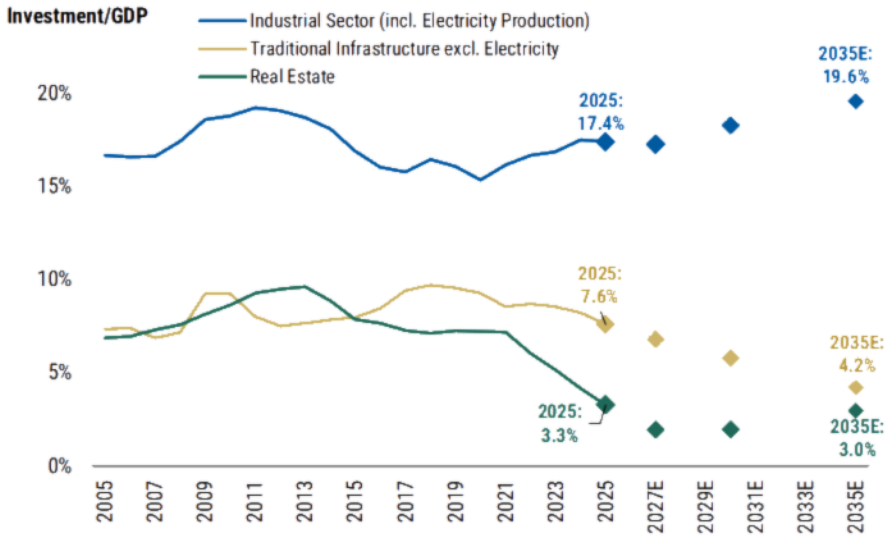
China Industry 5.0

Industry 5.0: A Long Capex Super Cycle

Unlocking US$12trn additional industrial capex over the next decade, although with a slow start…



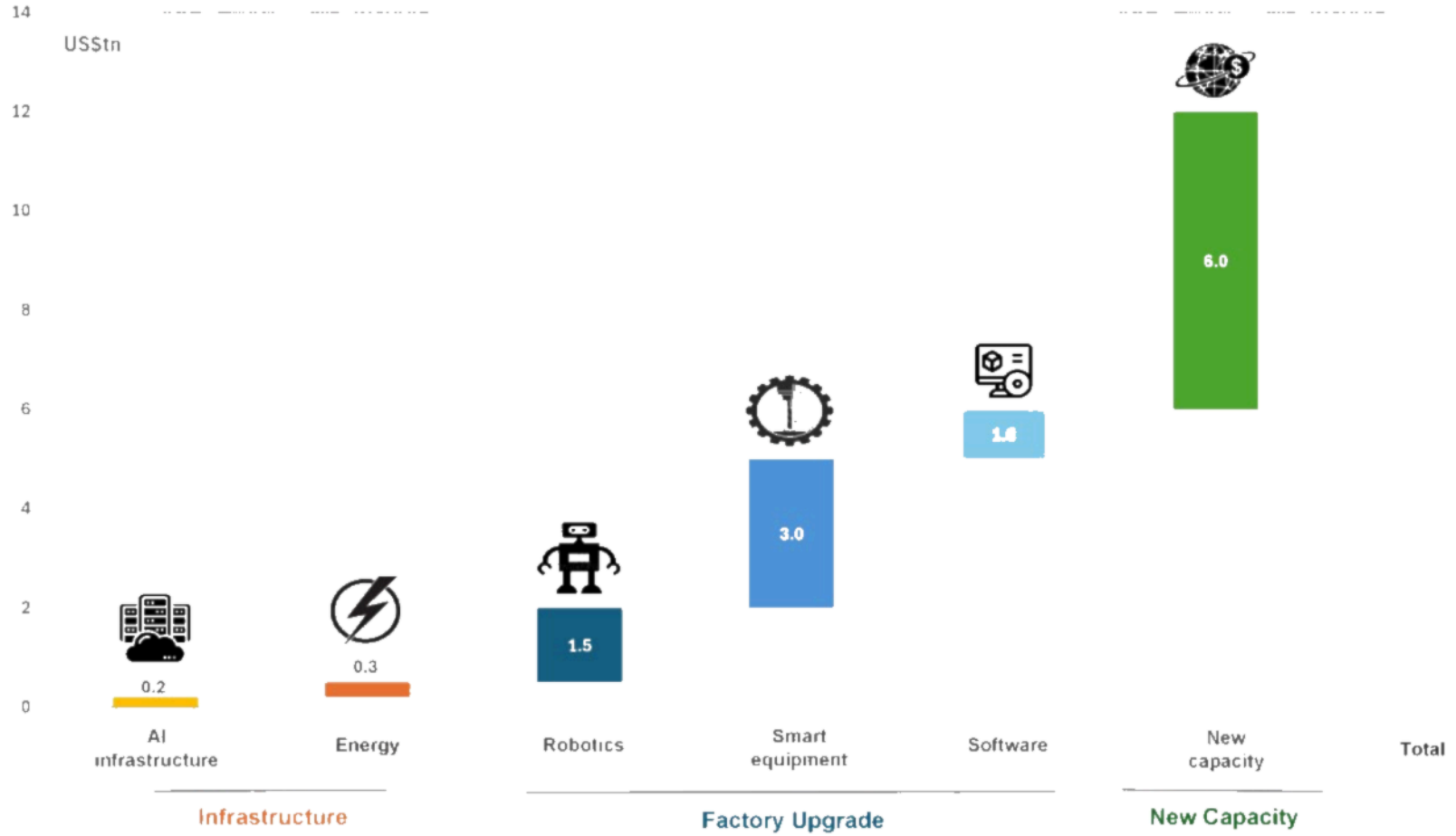
…which would partly offset slower structural capex in property and traditional infrastructure



Source: Haver, Morgan Stanley Research (E) estimates.

China Industry 5.0

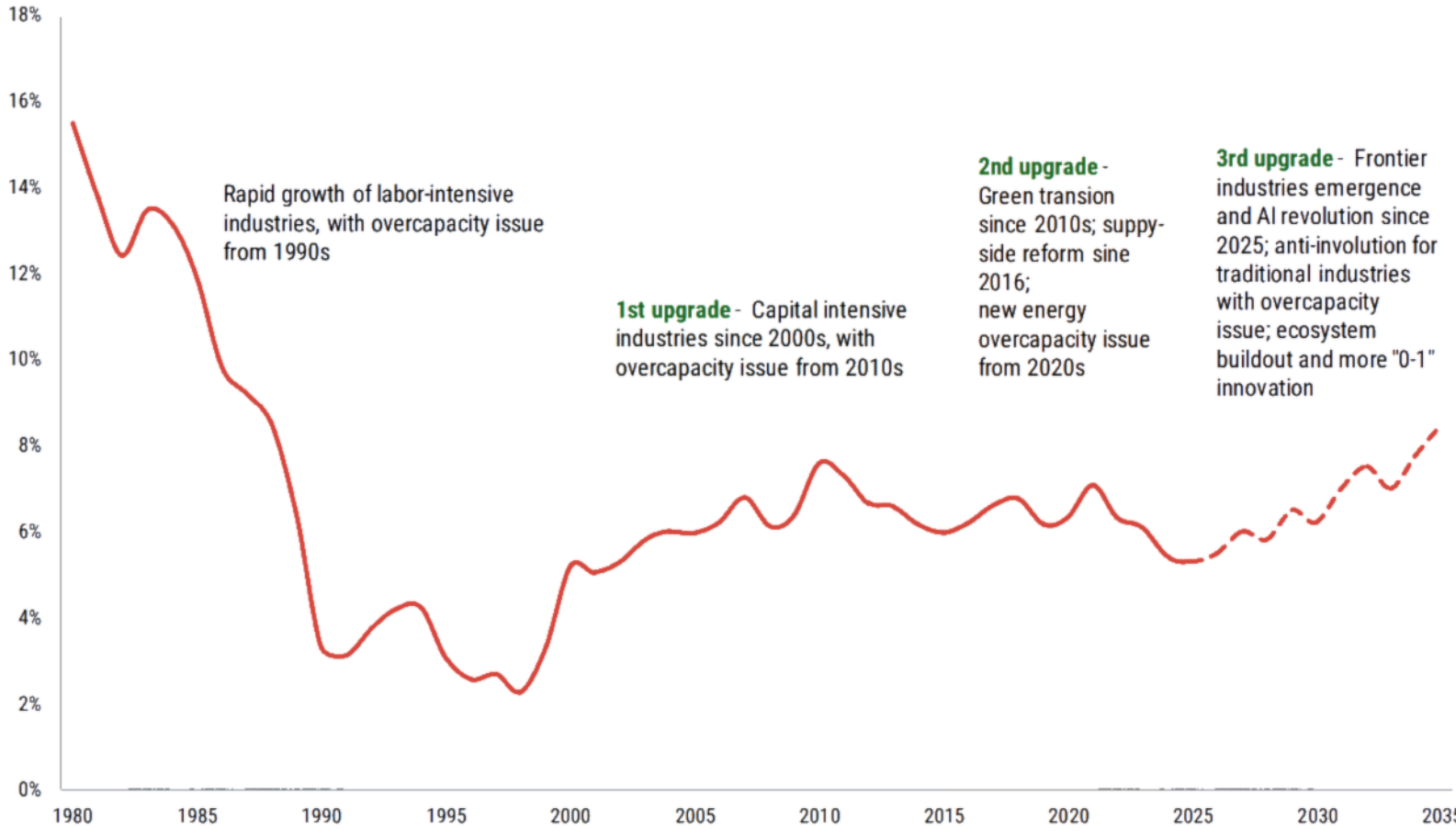
Where To Invest?



Source: Morgan Stanley Research estimates. For more details, kindly see China's Emerging Frontiers: China's Next Industrial Revolution (9 Sep 2026).

China Industry 5.0

How Could China Benefit #1: Industrial Margin And ROE Recovery

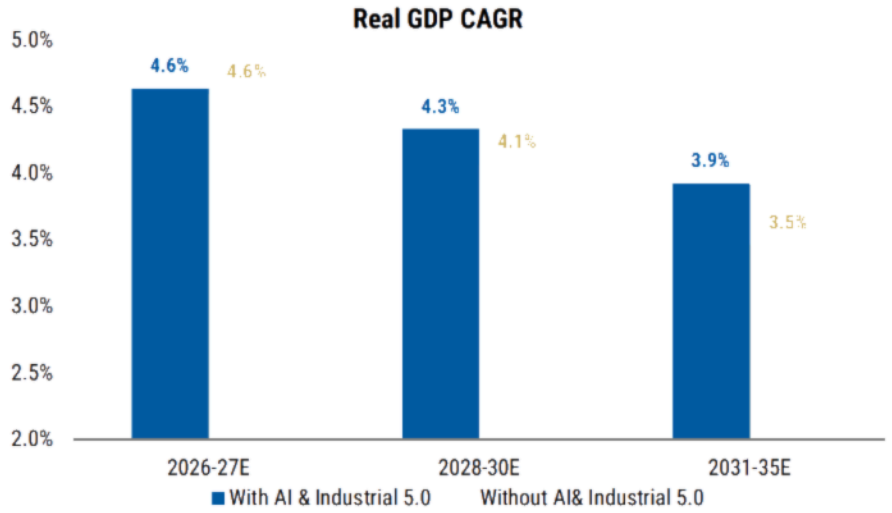


Source: NBS, Morgan Stanley Research estimates.

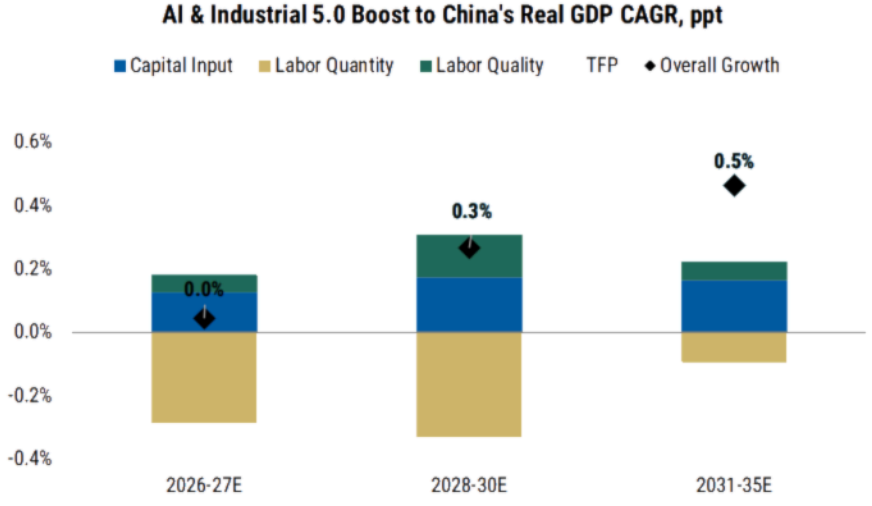
China Industry 5.0

How Could China Benefit #2: A Boost To Potential GDP

J-curve in AI & Industry 5.0's impact on China's potential GDP growth



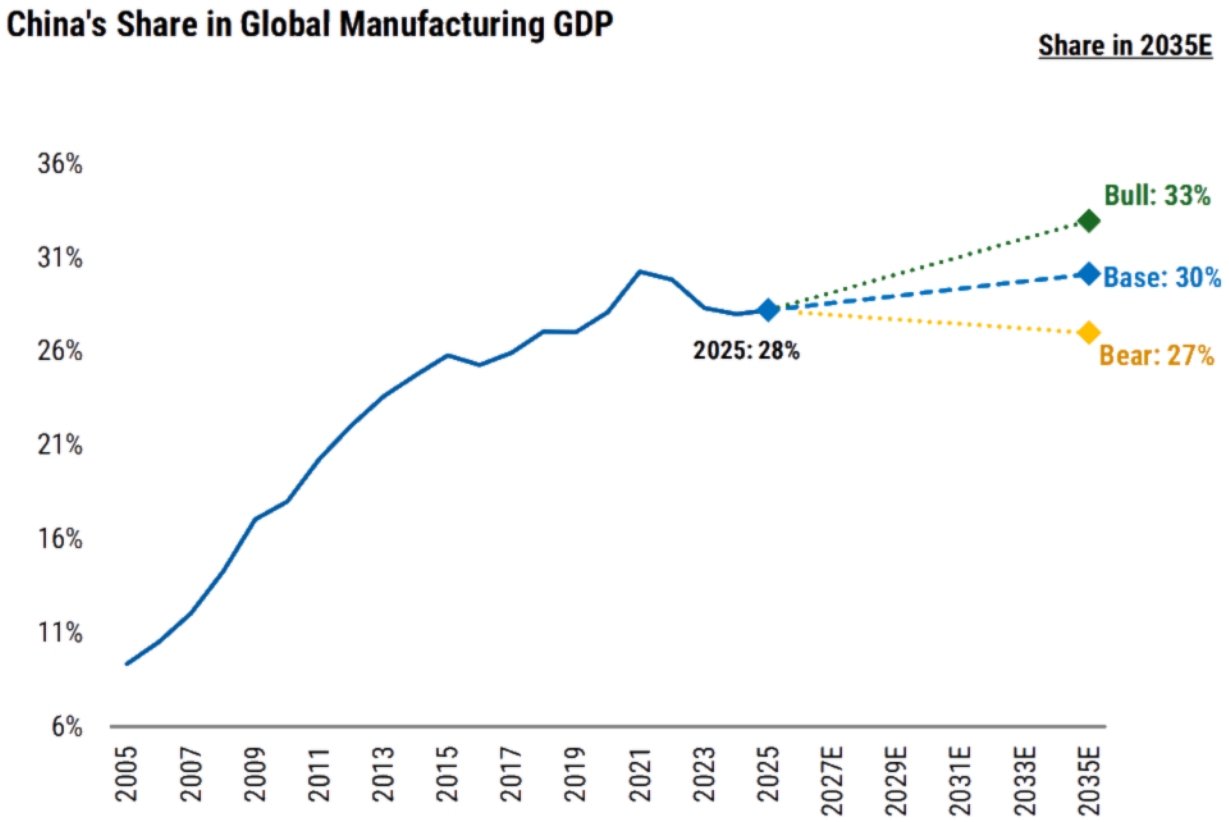
AI & Industry 5.0's boost to capex and productivity improvement to be more notable beyond the near term



Source: CEIC, Morgan Stanley Research (E) estimates.

China Industry 5.0

How Could China Benefit #3: Higher Global Manufacturing Share



Bull / Bear Assumptions

BULL CASE | 33%

- More decisive social welfare reforms to unlock household savings for consumption, lifting domestic demand
- Major industrial AI breakthroughs to widen China's edge in cost, speed, and flexibility

BEAR CASE | 27%

- More entrenched domestic deflation due to overly aggressive pro-cyclical fiscal consolidation and undisciplined AI/robotics build-out
- Broadened trade tensions vs. more trading partners, hampering transshipment

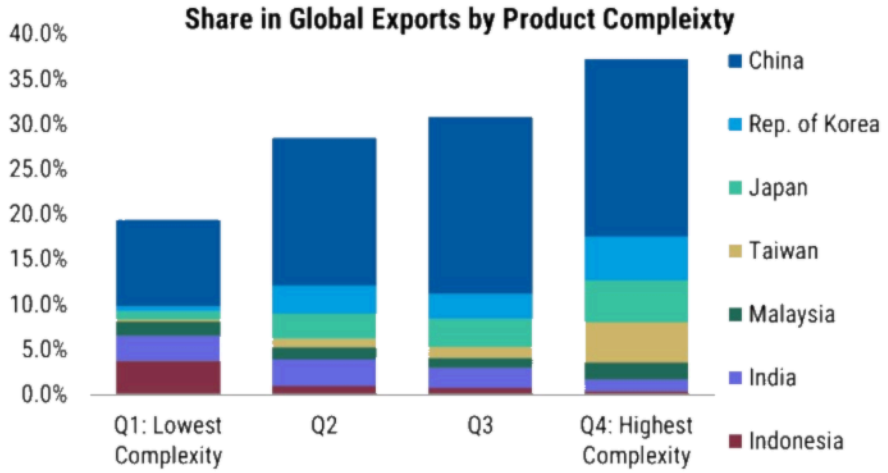
Source: Haver, Morgan Stanley Research (E) estimates.



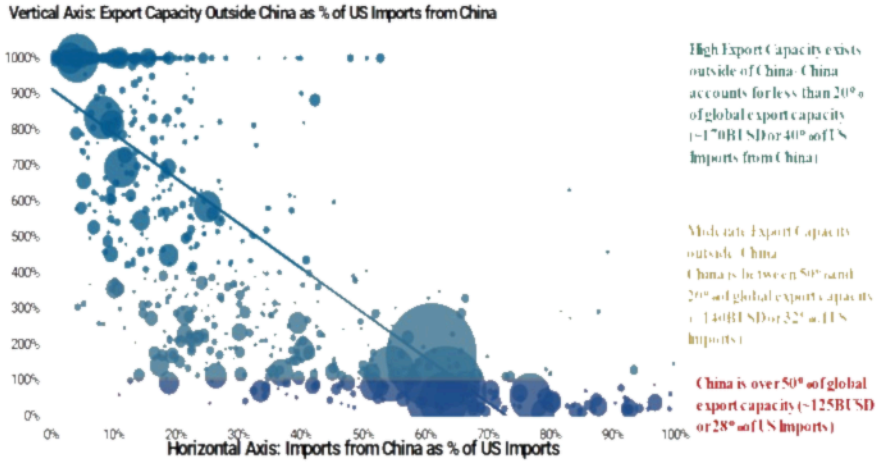
China Industry 5.0

Supply Chain Diversification Should Not Derail China's Manufacturing Share Gains

China has greater export capacity in high-complexity goods than all other major Asian economies combined



Less than half of US imports from China have alternative production capacity

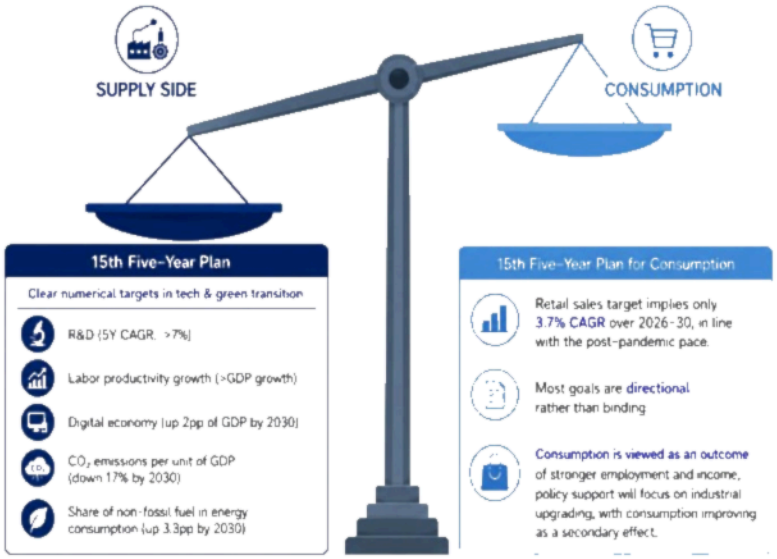


Source: UN Comtrade, Growth Lab at Harvard University, USITC, Morgan Stanley Research.

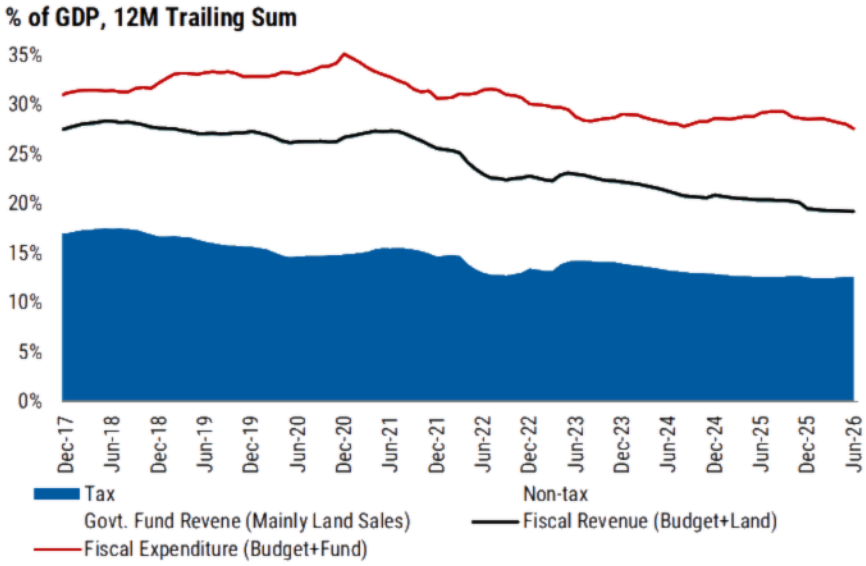
China Industry 5.0

Policy-driven Economic Rebalancing Remains Calibrated

Overall policy framework to remain supply-centric



Structurally weaker fiscal revenue constrains meaningful counter-cyclical demand support



Source: Government website, MoF, Morgan Stanley Research.

China Industry 5.0

Gradual Shift To Lowflation Possible From 2028, But Decisive Reflation Remains Unlikely

1 Housing market stabilizes in tier 1–2 cities from 2H27

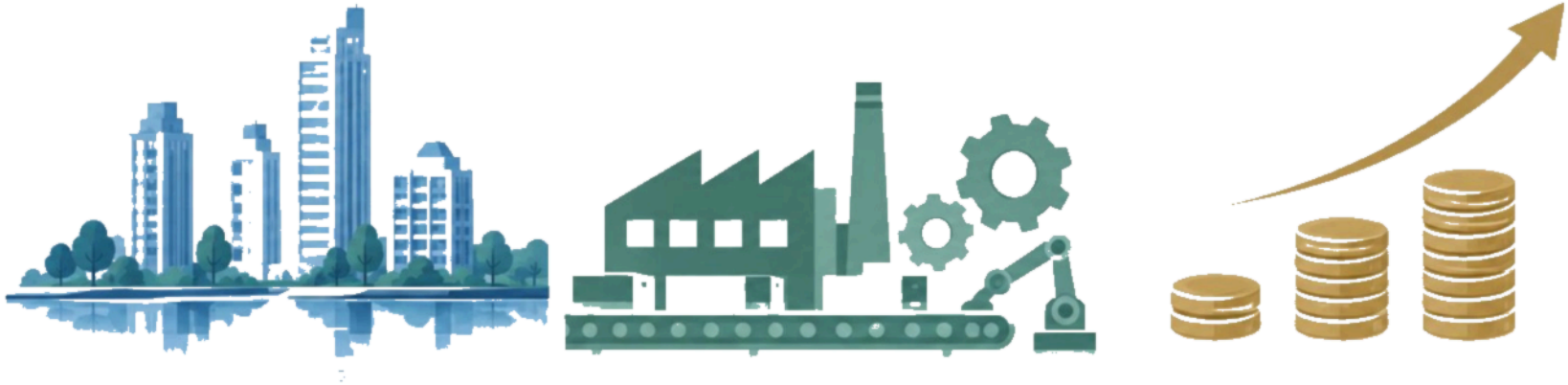
As supply contraction and demand adjustment run their course – ceasing to be a deflationary drag rather than becoming a growth driver.

2 Industrial capacity utilization returns to healthier levels

In the next 2–3 years, but the recovery is likely to be much longer and more gradual than the 2016–17 cycle, given limited consumption/housing stimulus and more pervasive overcapacity problems.

3 Industrial profit margin improves over the medium term

We expect margins to climb toward ~8% by 2035 from ~5% in 2025, driven by a rotation up the value chain, globalization of competitive Chinese leaders, and an economy-wide productivity lift from Industry 5.0.



Source: CEIC, CRIC, Morgan Stanley Research. For more details, kindly see China's Emerging Frontiers: China's Next Industrial Revolution (9 Sep 2026).

China Industry 5.0

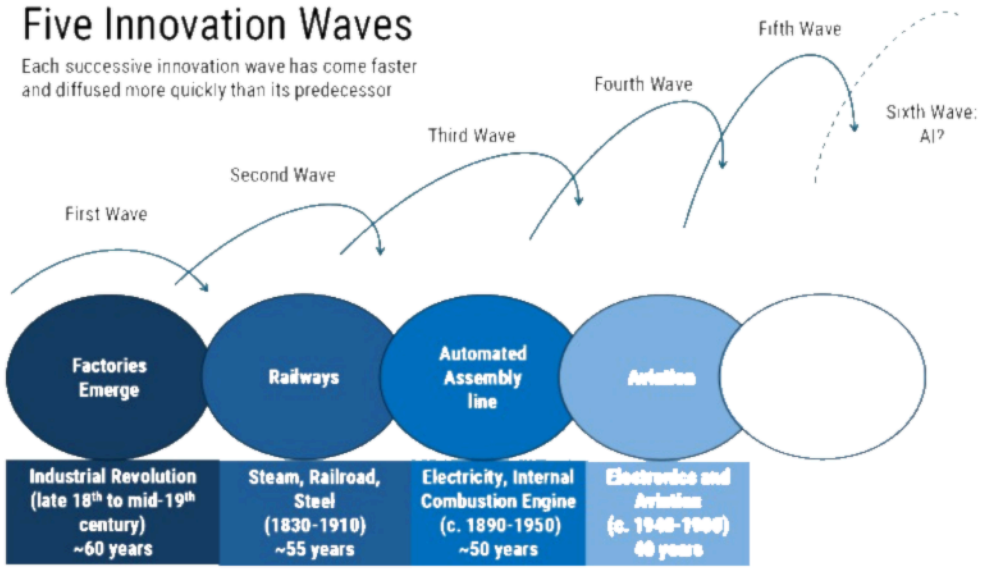
Base/Bull/Bear Summary

Scenario	Real GDP Growth (% p.a.)	Inflation	Share in Global Manufacturing GDP, 2035E
Base Case Calibrated rebalancing, continued low-flation • China enters Industry 5.0 era, powered by policy support + global capex supercycle. • AI & Industry 5.0 to boost capex and productivity, outweighing AI-induced labor disruptions.	4.6% (2026-27E) 4.3% (2028-30E) 3.9% (2031-35E)	**Low-flation persists** • GDP deflator to slip from 0.8% in 2026 to 0.2% in 2027 with oil price normalization, but would grind to **0.5–1.0% from 2028** on housing stabilization, reduced excess capacity, and margin improvement under Industrial 5.0.	30%
Bull Case Decisive rebalancing, healthy reflation • Industrial-AI breakthroughs widen China's edge. • Stronger domestic demand lift imports, helping ease risk of broader trade tensions.	4.7% (2026-27E) 4.5% (2028-30E) 4.2% (2031-35E)	**A healthy reflation** • Decisive economic rebalancing to lift GDP deflator from lowflation in 2026–27 toward **1.5–2% over the medium term,** easing debt-deflation pressures and reinforcing private-sector balance-sheet repair.	~33%
Bear Case More entrenched deflation • Pro-cyclical fiscal tightening and undisciplined AI / robotics overbuild. • Broader trade frictions with non-US trade partners, given China's increased overcapacity problems and prolonged OFDI restrictions.	4.4% (2026-27E) 4.0% (2028-30E) 3.5% (2031-35E)	**Entrenched deflation** • Premature fiscal consolidation, undisciplined industrial investment and weaker external market access would reinforce a demand-deflation overcapacity loop, sending GDP deflator to outright deflation from 2027, which would stay at **-0.5% to -1.0% over the medium term.**	~27%

Source: CEIC, Morgan Stanley Research (E) estimates.

AI Diffusion

AI Impact: Lessons From The Five Innovation Waves



01 Productivity gains are likely

02 Labor Displacement Is Transitional

03 Boom-Bust Cycles Are Probable

04 Inequality Risks Are Elevated

05 Education and Re-skilling Will Be Decisive

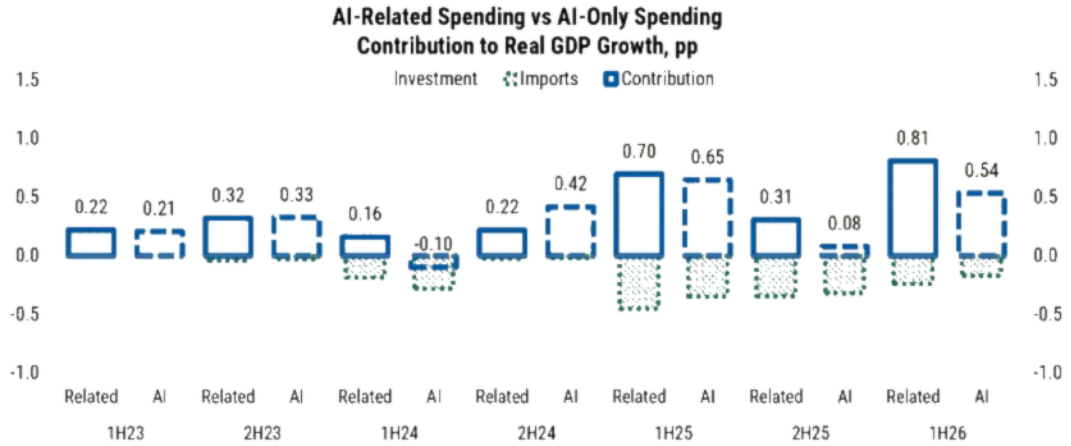
06 Policy Matters

Source: Morgan Stanley Research. For more details, kindly see Lessons from the Five Innovation Waves That Preceded AI (6 April 2026).

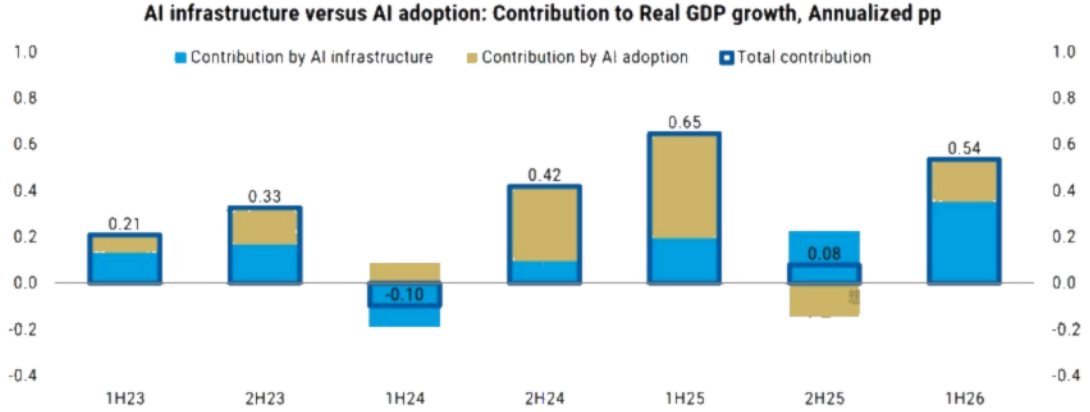
AI Diffusion

AI Investment Contribution To US GDP Growth

Contribution of AI-related spending to GDP growth



Decomposing the contribution of AI-only spending to growth into its infrastructure and adoption subcomponent

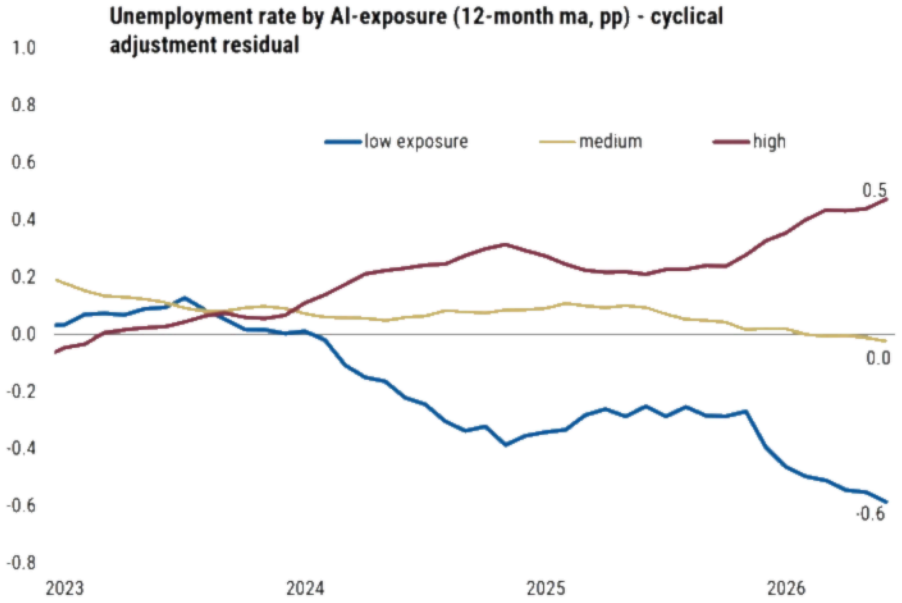


Source: BEA, Haver, Morgan Stanley Research. For more details, kindly see Building a better mousetrap: AI spending and its contribution to US GDP growth (7 Sep 2026).

AI Diffusion

AI Labor Disruption: Still Modest, But Increasingly Visible

AI-related labor market disruption is becoming harder to ignore at the occupation level



High AI-exposed workers remain unemployed for longer

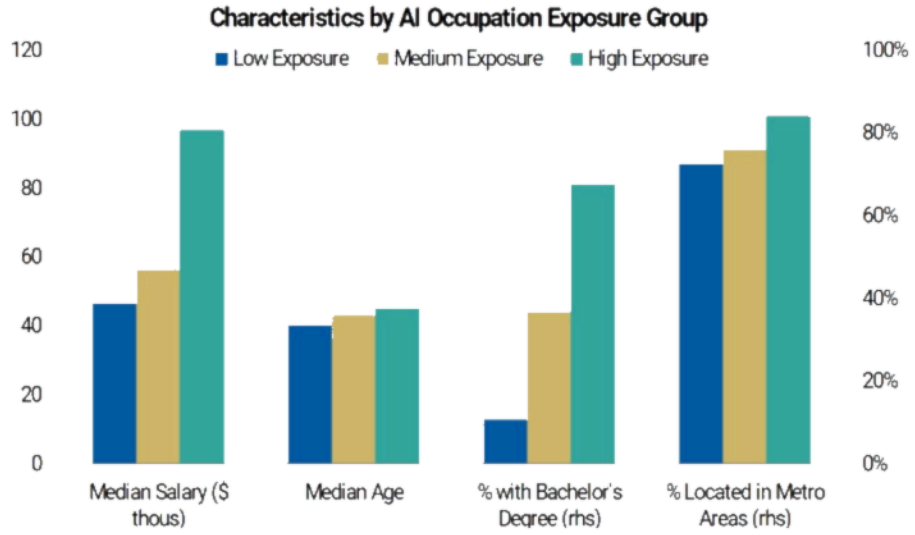


Source: IPUMS CPS (University of Minnesota), Morgan Stanley Research. For more details, kindly see AI Labor Disruption: Still Modest, but Increasingly Visible (3 Aug 2026).

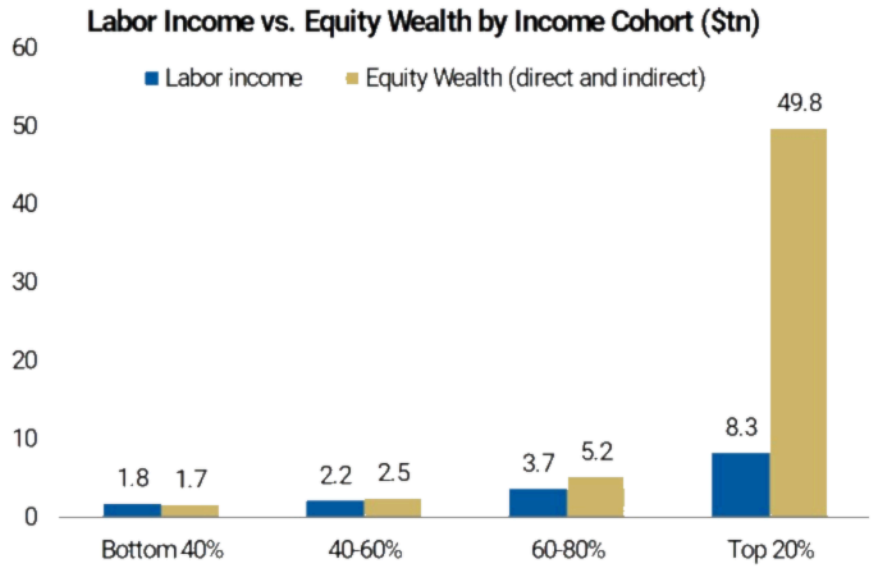
AI Diffusion

Affluent Consumers May Be Safer Than Advertised

High-income and college-educated urban households are most exposed to AI displacement…



…as well as to potential AI gains: productivity-driven wage growth, task creation, and wealth effects



Source: BLS, Federal Reserve Board, Haver, Morgan Stanley Research. For more details, kindly see Dispelling an AI Myth: Why Affluent Consumers May Be Safer Than Advertised (8 Sep 2026).

AI Diffusion

What To Expect On Policy Mitigation

1. GUIDING PRINCIPLE



Balance technological progress with labor-market stability

2. POLICY TILT



Higher-end, knowledge work

Greater labor flexibility to accelerate AI adoption



Labor-intensive service sectors

More cautious approach to protect employment

3. POSSIBLE MITIGATING MEASURES



Upskilling & vocational training support



New high-tech & service jobs creation



Stronger social protection (unemployment, healthcare, pension for gig workers)



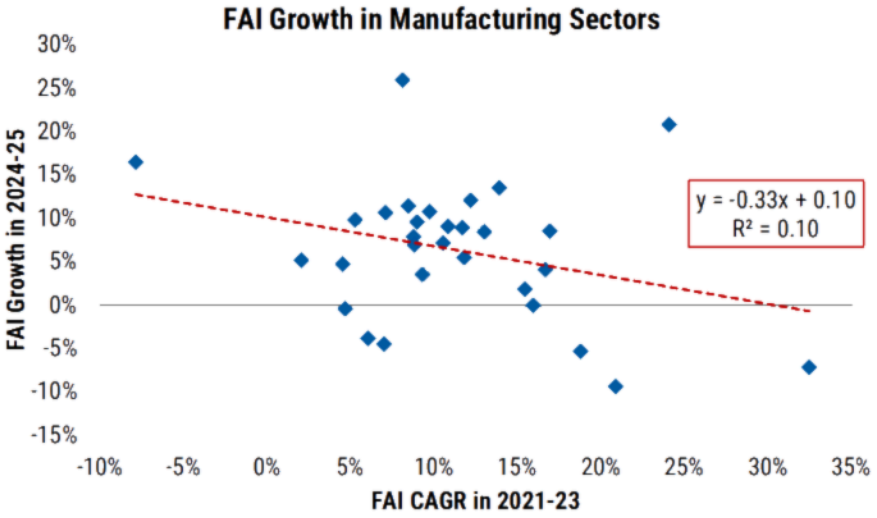
More calibrated automation in labor-intensive services

Source: Morgan Stanley Research.

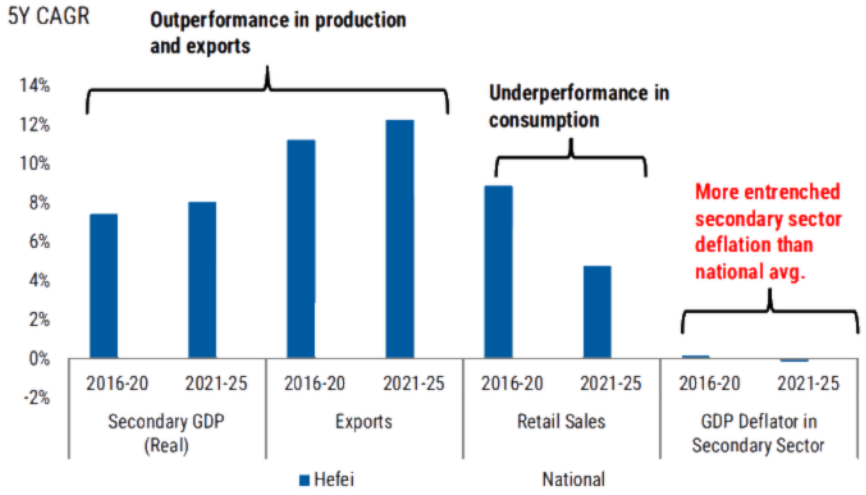
Gradual Rebalancing

Smarter Industrial Policy Alone May Not Narrow Supply-Demand Imbalances

Investment is rotating toward less oversupplied sectors…



…but even a successful model like Hefei is not immune to overcapacity and deflation



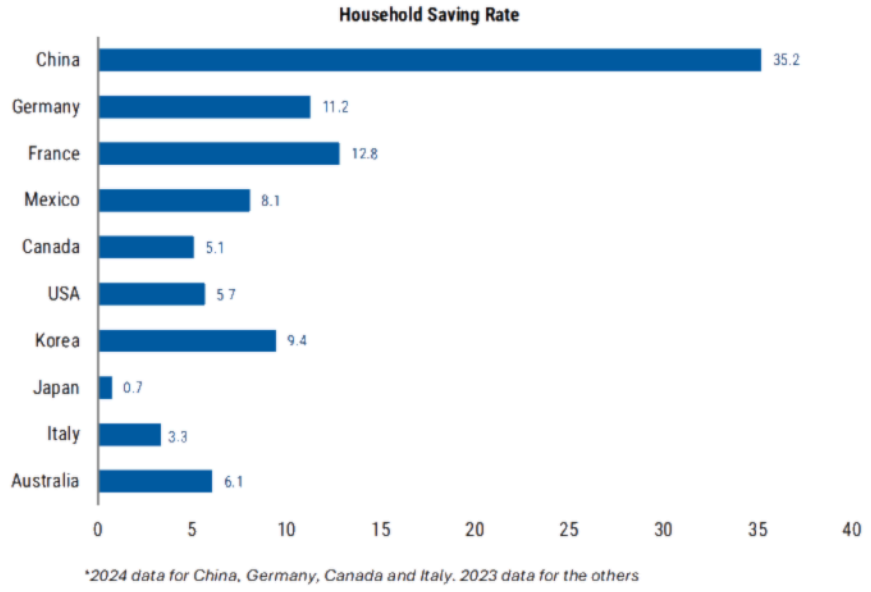
If many regions imitate the same surface tools – large upfront government seed capital and buildup of industrial parks, and focus on the same frontier sectors, it may compound the overcapacity problem nationwide

Source: CEIC, Morgan Stanley Research estimates.

Gradual Rebalancing

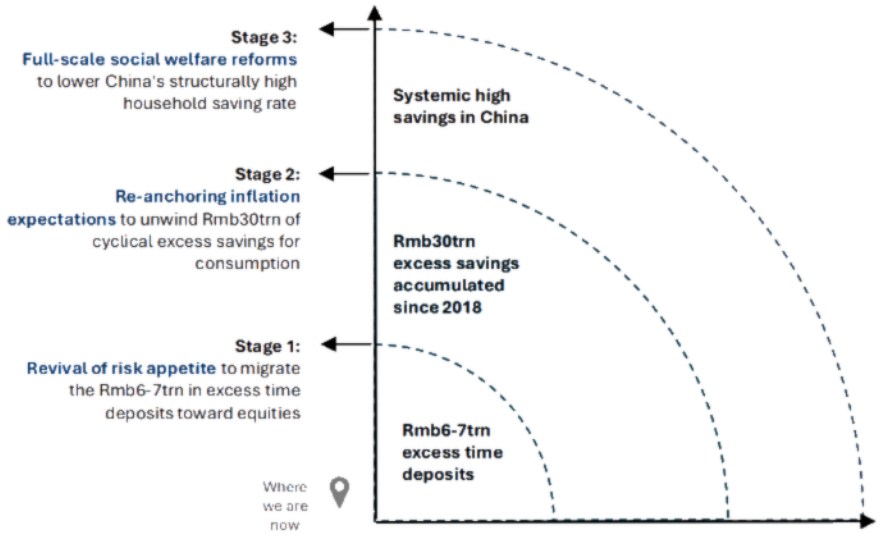
Pathway To Rebalancing: Unlock China's Household Savings…

China's household saving rate remains elevated



**2024 data for China, Germany, Canada and Italy. 2023 data for the others*

A three-stage roadmap to unwind household savings

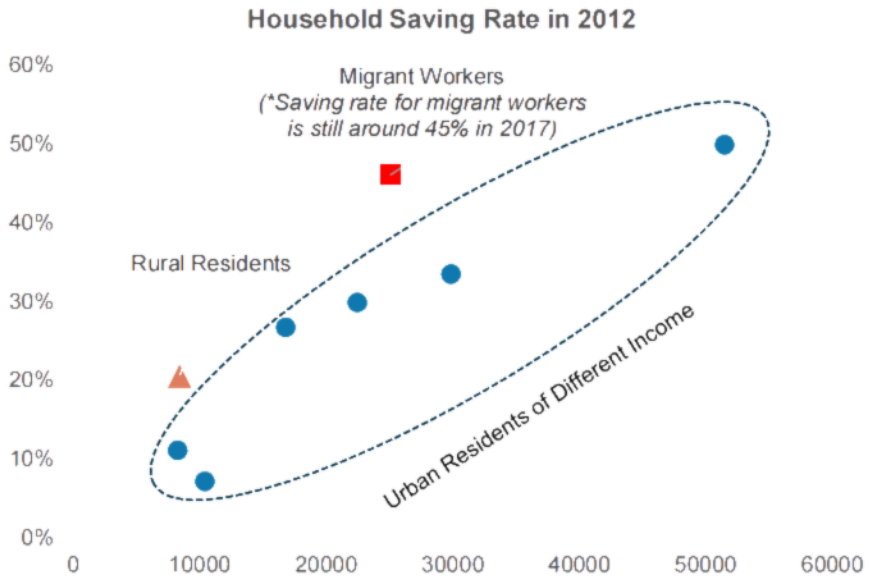


Source: Haver, OECD, Morgan Stanley Research.

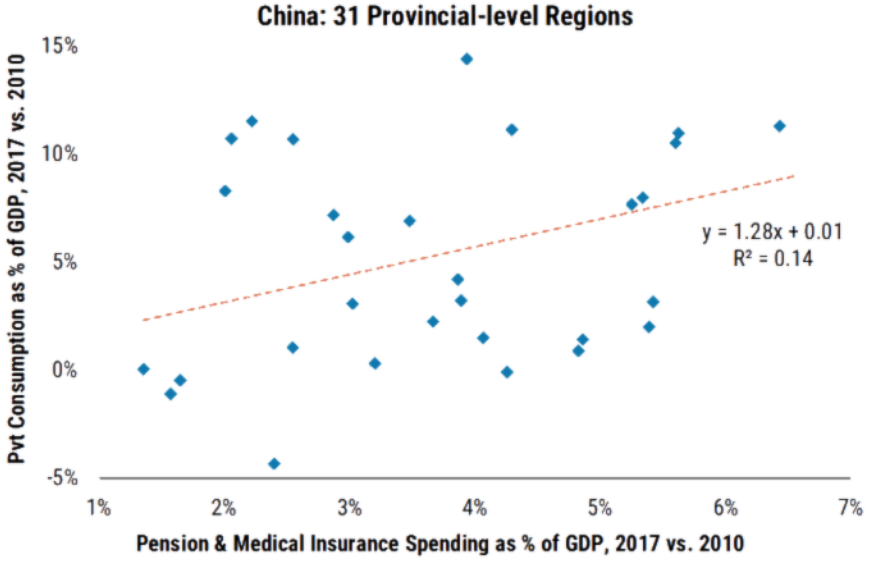
Gradual Rebalancing

…Through Social Welfare Reform

Income redistribution toward lower-income households that exhibit a higher marginal propensity to consume



Provincial data show rising social welfare spending associated with higher consumption share in GDP

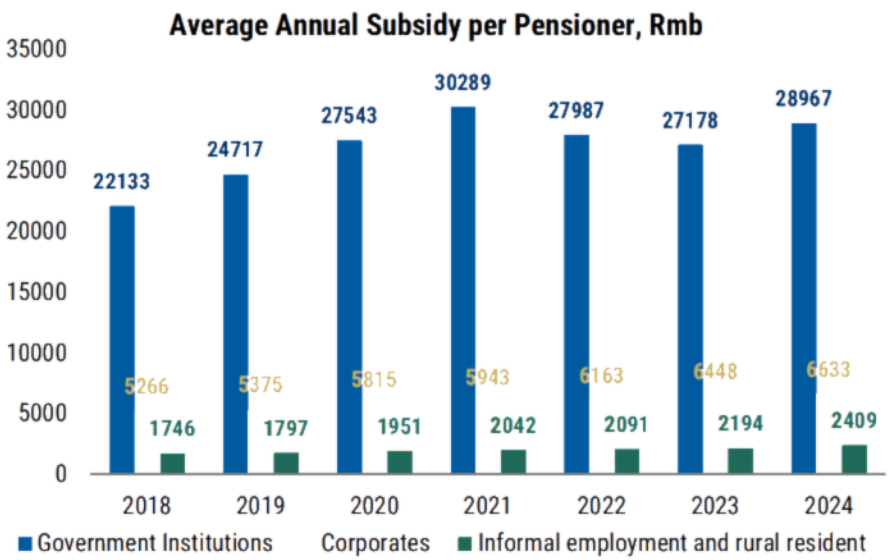


Source: CEIC, Morgan Stanley Research.

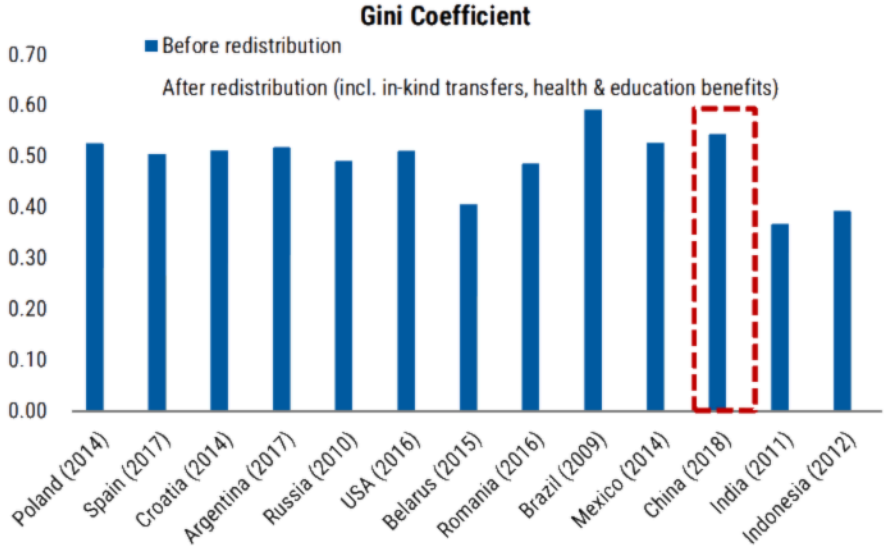
Gradual Rebalancing

Fragmented Social Welfare System

Wide benefit gaps across social groups



Inequality reduced, yet redistributive power lags peers

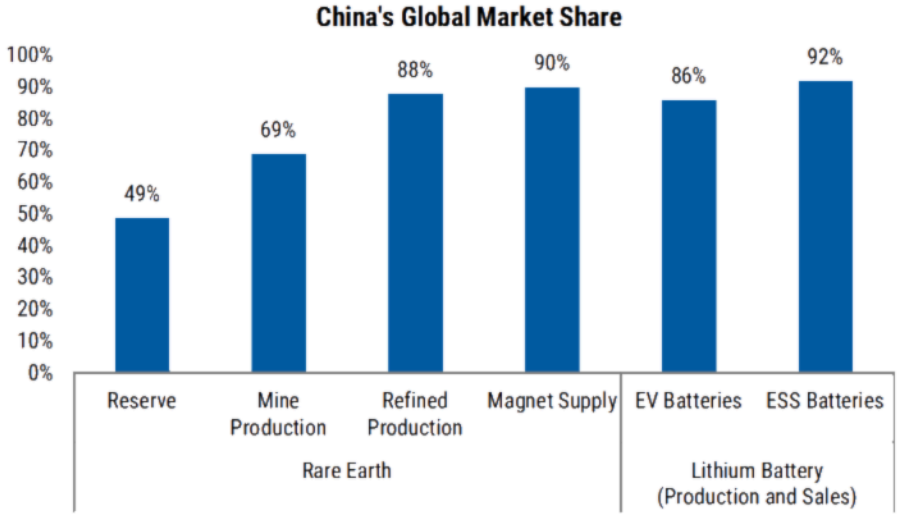


Source: CEIC, World Bank, CEQ Institute, Morgan Stanley Research.

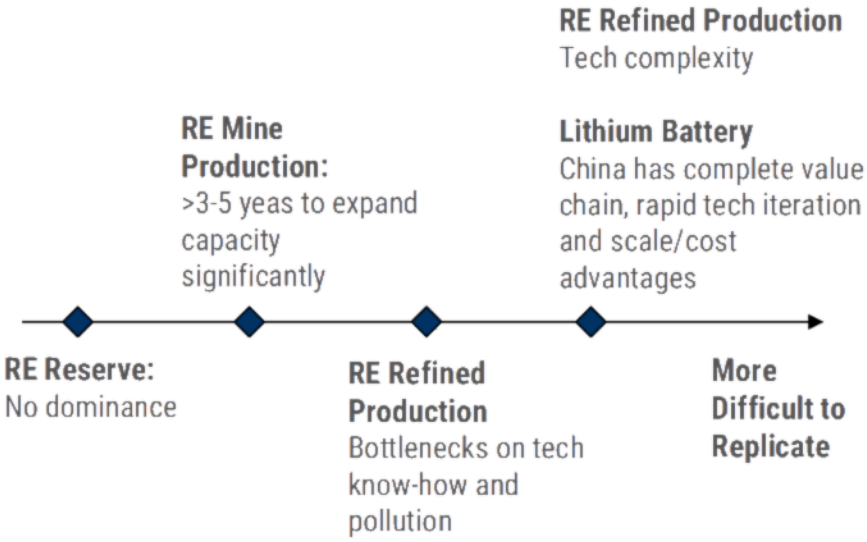
Geopolitics: China-US

Strategic Stability Underpinned By Chips/Rare Earths Equilibrium

China's global dominance in rare earths and lithium batteries



How durable is China's dominance?

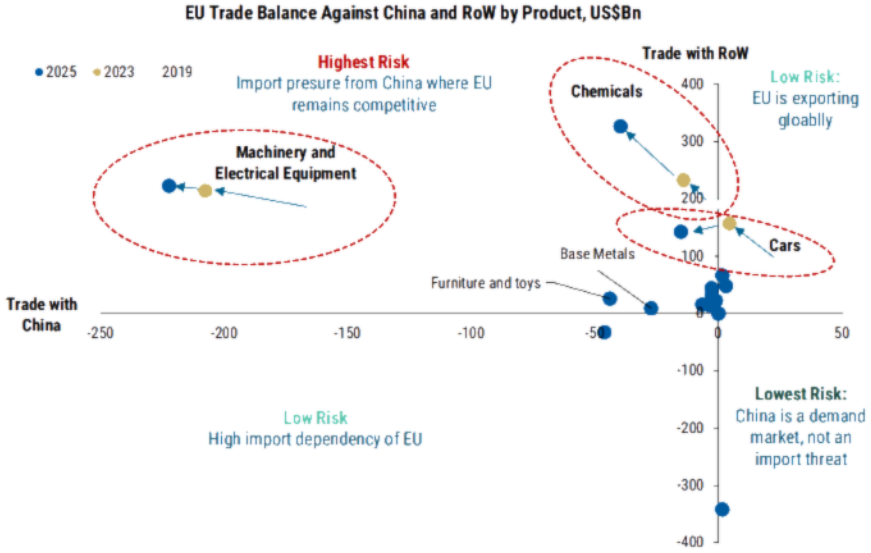


Source: US Department of Energy, company data, EV tank, SNE, Morgan Stanley Research.

Geopolitics: China-EU

Future Path: Navigating Preferences, Dependencies, And Choke Points

Potential China-EU trade pressure points



Trade barriers may reshape China's export routes, but not derail its momentum



Source: CEIC, UN Comtrade, Morgan Stanley Research.

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