Morgan Stanley

INVESTMENT MANAGEMENT

BIG PICTURE
Key Themes for 2026

The world is broadening economically, geopolitically, technologically and monetarily. As we move into 2026, we see a shift from concentrated sources of growth and returns to a greater dispersion and wider set of opportunities, both within the U.S. and across global markets. The investment environment is being shaped by the interest rate regime, widening gap between tariff rhetoric and reality, divergent technological architectures, monetary fragmentation and renewed interest in real assets.

The Age of Capped Real Rates

Last year we noted that rates were likely to be "higher for no longer" because two powerful forces were consistently underestimated: supply-side resilience and the debt-driven limits that cap how restrictive monetary policy can be. Excess Chinese manufacturing capacity, and its deflationary spillovers, kept global goods inflation anchored. The assumption that tariffs → inflation → higher rates ignored how supply chains adapt, absorb or reroute cost pressures, and how Asia's deflationary pull helps offset inflationary pressures elsewhere.

The deeper constraint is debt arithmetic. Global public debt has surged to levels historically associated with negative real rates. Across past episodes, from the U.S. Civil War to the World Wars, the Global Financial Crisis and the pandemic, high-debt environments have required negative or near-neutral real rates to stabilize (*Display 1*). Today, U.S. federal debt stands near 120% of GDP, double its 2000 level, with fiscal deficits projected at around 6% of GDP for the next decade. The October 2023 real-rate peak of 2.7% marked the upper boundary of what a high-debt system can absorb without destabilization.

The implication is clear: In a high-debt world, real rates cannot remain restrictive without triggering sovereign strain, fiscal accidents or recession. Market forces should cap real rates at neutral or negative.

Monetary policy may still tighten cyclically, but structurally, rates cannot rise above nominal growth without undermining the system they are meant to stabilize.

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Key Themes for 2026

End of One Money: The Rise of Many

Back in 2022, we wrote about China forming currency blocs and building alternative payment systems to challenge U.S. dollar (USD)-centric channels (*Big Picture – China's Geopolitical Aspirations and Challenges)*. Even then, countries were already making tactical yuan payments, such as India's largest cement producer paying in renminbi (RMB) for Russian coal, while yuan-ruble trades surged after the Russia-Ukraine conflict.

That architecture is now materially more developed. Asia's credit creation is increasingly dominated by RMB and local currency lending rather than by USD loans. More than 30% of China's trade is settled in RMB, lifting it into the top three currencies used in global trade finance. Offshore clearing banks have been established in 33 markets to facilitate yuan payments, while a growing number of countries, including India, UAE, Brazil and ASEAN economies, are settling trades in their domestic currencies.

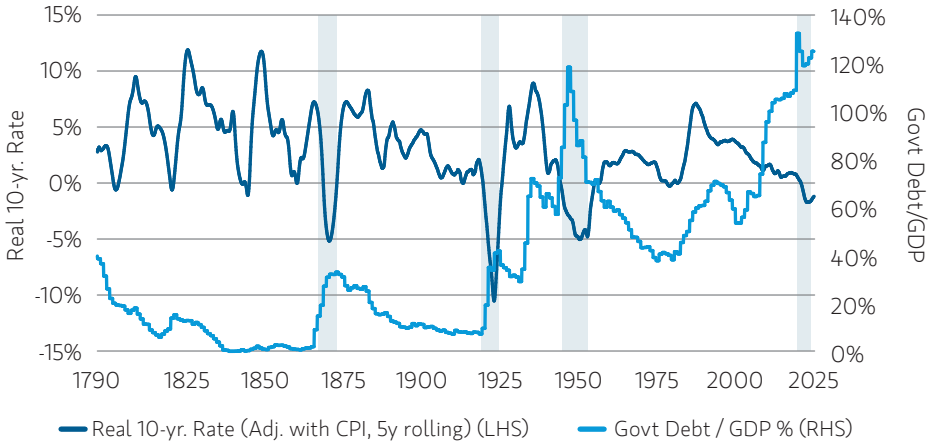
The U.S. dollar's share of international reserves has fallen from 58% in 2015 to 42% today, while gold's share has risen from 8% to 20%. We expect demand for non-dollar reserves to continue.

Fragmentation, however, is not just geopolitical, it is also technological. Money itself is becoming modular. Central bank digital currencies are scaling across major economies. Stablecoins now settle more value daily than major credit card networks. Tokenized treasuries and blockchain-based collateral systems compress settlement times and release trapped liquidity. China's digital currency, e-CNY, is advancing through regional pilots, while India's UPI, Brazil's PIX, Singapore's PayNow, and China's CIPS are evolving into influential payment ecosystems.

DISPLAY 1

High Debt Caps Real Rates

U.S. government debt as share of GDP against real 10-year rates



Source: Bloomberg, FactSet, Haver. As of September 30, 2025.

The U.S. dollar remains the world's anchor, but it now faces greater competition from alternative currencies, digital challengers and new payment infrastructures offering speed and regional liquidity. The direction of monetary multipolarity is clear, and these trends will help support compelling investment opportunities for years to come.

Tariffs: Illusion Versus Reality

As the global monetary system fragments, trade policy remains one of the few levers governments can still pull, often with misunderstood consequences.

The prevailing tariff playbook still assumes that trade can be reshaped neatly along national boundaries. In reality, the global economy is organized by sectors, not countries. Country-based tariffs raise costs for suppliers, businesses and consumers without meaningfully narrowing trade deficits. By contrast, sectoral tariffs have proven more effective in promoting strategic onshoring, generating trade revenues and reducing deficits.

The U.S. lacks the trained labor force and capital stock required to rapidly replace complex imports. Nearly half of its imports consist of intermediate goods that American factories need to produce finished products. Tariffs on these components undermine competitiveness rather than protect them, particularly in sectors such as pharmaceuticals, aerospace, automobiles, computers and machinery *(Display 2)*. Asia dominates electronics intermediate exports, while North American auto supply chains remain deeply integrated with Mexico and Canada, hence lowering tariff risk under the USMCA framework.

U.S. imports are no longer dominated by low-cost consumer goods. Machinery and electronics account for roughly 30% of imports, autos about 12% and pharmaceuticals around 5%, all categories that are difficult to reshore efficiently. By contrast, U.S. exports remain concentrated in lower-complexity commodities such as oil and

soybeans, which are easier to substitute. This asymmetry limits U.S. leverage in tariff disputes, particularly with China, which exports more complex goods to the U.S. than it imports in return.

The tariff debate remains framed around countries, but the economic reality is sectoral. Nowhere is the gap between tariff intent and economic reality clearer than in China.

Old to New China: The Manufacturing-Technology Pivot

Country-level tariffs have not derailed China's export engine. While the U.S. is experiencing an AI-led investment boom, China's growth is being driven by a resurgence in manufacturing and exports. China has transitioned from an economy once led by property and infrastructure towards one powered by high-value competitive manufacturing. This has produced a dual-track economy: "Old China" remains cyclically weak, while "New China" asserts growing global leadership.

Old China, rooted in real estate and low-cost manufacturing, faces excess capacity, deflationary pressures and a multi-year property correction that has weighed on private-sector confidence and nominal growth. In parallel, New China has undergone a technological and industrial transformation. China now accounts for 28% of global manufacturing output, up from just 5% in 2000, with a goods trade surplus exceeding a trillion dollars. As the U.S. share of China's exports has declined, shipments to emerging markets (EM) have risen to around 45% from 34% in 2016. This shift reflects a rerouting of goods previously destined for the U.S.

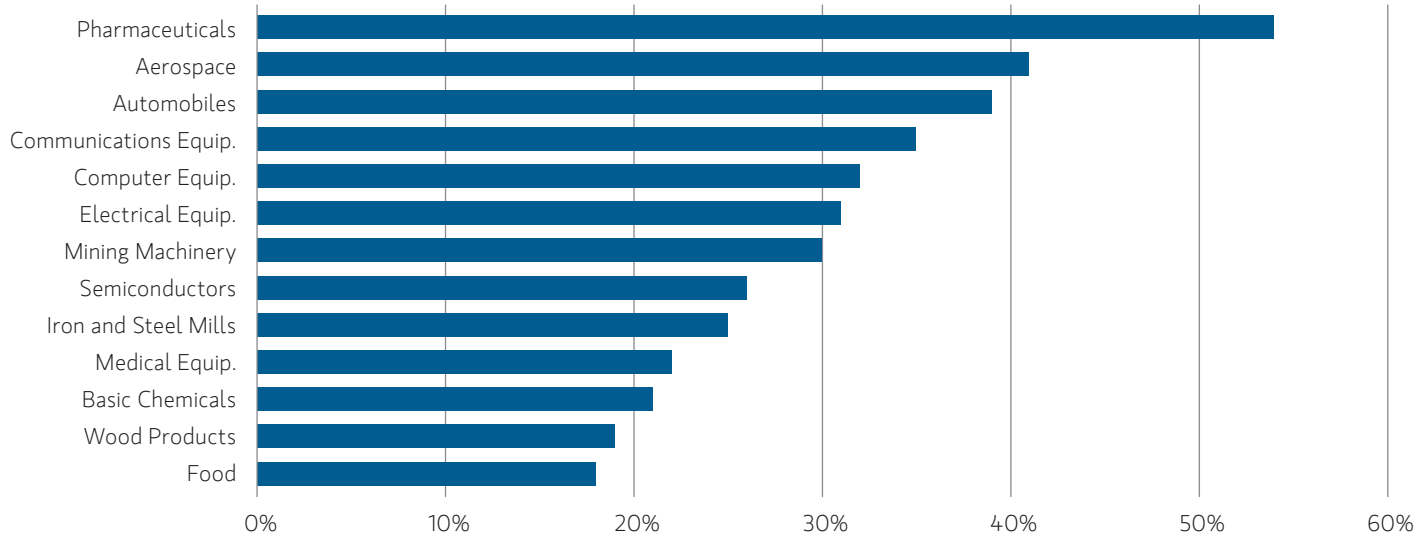
China has also increased investment and offshore production in several emerging markets, moving up the value chain in clean energy, electric vehicles (EVs), batteries, robotics, biotechnology and AI. A pivotal moment was the 2018 U.S. semiconductor export restrictions, which exposed China's strategic vulnerabilities. Beijing responded by accelerating the de-Westernization of supply chains, directing capital toward priority industries while tightening leverage in property markets. This produced a dual shock: weakening domestic demand from real estate alongside a surge in capacity across advanced manufacturing. Export composition adjusted accordingly: batteries, EVs, solar products, ships and industrial robots now account for nearly half of the increase in China's trade surplus over the past seven years. China's structural advantages in electricity and 12 million annual STEM (Science, Technology, Engineering and Mathematics) graduates are difficult to replicate. Europe, Japan and Korea have ceded global market share across autos, chemicals, solar and industrial machinery. Its growing role in technology is also reflected in the release of DeepSeek's model in early 2025.

China's shift from low-cost manufacturing to advanced industrial capability sets the stage for the next frontier of global competition: artificial intelligence.

DISPLAY 2

The Hidden Import Dependence of U.S. Manufacturing

Import share of intermediate goods (%)



Source: MSIM, Bureau of Economic Analysis, Federal Reserve. As of December 31, 2019.

AI: The Boom, the Cracks, the Opportunity

Three years after the launch of ChatGPT, AI has reached adoption levels that are exceptional by historical standards. Nearly 800 million people have interacted with generative AI, a scale of engagement that took the internet more than a decade to achieve. At the same time, hyperscalers are committing substantial capital to support this expansion across GPUs (Graphics Processing Units), data centers, power infrastructure and networking. Beneath this spending, the technology itself continues to advance: task complexity is doubling roughly every seven months, multimodal use is increasing token intensity and unit token costs are falling at close to a ten-fold annual pace, creating favorable conditions for application development.

But cracks are appearing. Monetization continues to trail adoption, and many enterprise users remain in an experimental phase as they seek clearer productivity gains and return on investment. Physical constraints are also emerging. Power availability and networking bottlenecks are limiting utilization, leaving expensive computing capacity idle for significant portions of time. In addition, the growing use of leases, vendor financing and private credit introduces layers of opacity into the funding structure that warrants careful monitoring.

At the same time, the countervailing forces are equally powerful. While capital intensity is rising, the largest platforms continue to generate substantial cash flow, allowing them to fund investment internally rather than through balance-sheet stress. History provides useful context. Previous infrastructure cycles, from telegraphy to telecommunications to the internet, were marked by periods of overbuilding that ultimately proved constructive. Excess capacity reduced costs, accelerated adoption and eventually led to productivity gains.

Today, two distinct AI ecosystems are emerging. The U.S. model is a *high-cost innovation engine*, fueled by massive capital expenditure, premium GPUs and broad commercial experimentation. Constrained by export controls, the Chinese model has evolved into a *low-cost efficiency system*, innovating around scarcity and achieving competitive benchmark performance at just 18% of U.S. hyperscaler expenditure. Its open-source ecosystem and deep partnerships across EM foundries, servers, memory and networking underpin a parallel AI supply chain. China's highly digitized economy is enabling even faster adoption and applications. The result is not one global AI future, but two architectures with different cost curves, capabilities and geopolitical implications.

AI remains a long-duration theme, but index-level exposure will increasingly mask widening dispersion. The next phase of value creation lies in vertical applications, particularly in some sectors such as health care, where AI is reshaping research and operations.

Code Meets Cell: The Birth of the Bio-Economy

Biology is becoming programmable. AI applications are embedded across both health care delivery and drug discovery, and the industry is deploying AI at more than twice the rate of the broader economy.

Early deployment has focused on workflows: clinical documentation, billing automation and patient engagement, all designed to reduce physician burnout, improve efficiency and deliver measurable productivity gains in a system under persistent cost pressure.

Beyond care delivery, AI is rewiring the entire life sciences value chain. AI is increasingly used to design proteins, discover drugs, edit genes and engineer cells in much the same way software engineers write code. What was once a sequential, labor-intensive process is becoming iterative, data-driven and computational, reducing development timelines from years to months.

The convergence of AI and biology is enabling advances in personalized medicine, gene therapies, bio-manufactured materials and next-generation agriculture. Faster drug discovery, new methods of producing food and chemicals and the emergence of "bio-factories" that complement or replace traditional manufacturing models are no longer theoretical. Longevity research is also becoming investable at scale.

As with previous technological revolutions, value will accrue not only to end products but to the enablers like data infrastructure, lab automation, sequencing technologies and bio-manufacturing capacity.

The shift from "code-to-cell" is emerging as a strategic priority with clear implications for health care systems, national competitiveness and capital allocation. For asset owners, it represents a potentially durable, long-duration investment theme.

DISPLAY 3

The Autonomy Stack

Factory Floors, Airspace, Space

The Autonomy Stack: From Factory Floors to Airspace to Space

NVIDIA's CEO Jensen Huang has remarked that "everything that moves will be autonomous someday." This means machines are no longer tools awaiting instruction, but systems capable of independent action across physical environments *(Display 3)*.

It began on the factory floor. Early, industrial robots, such as Unimates introduced in the 1950s, were rigid machines designed for repetitive tasks. By 2023, more than four million industrial robots were in operation worldwide, yet most still depended on fixed programming and oversight. AI removes that constraint. It allows machines to interpret their surroundings, adjust behavior and coordinate with both humans and other machines.

Amazon's deployment of more than 750,000 robots reflects not only incremental efficiency gains, but is a rethink of how labor is organized at scale. Emerging humanoid platforms, including those developed by Figure AI and Tesla, suggest that autonomy is moving beyond specialized tasks toward more general physical capabilities.

Above the factory lies the low-altitude economy. Drones are increasingly used for logistics, infrastructure monitoring and agriculture. These applications are most valuable where labor is scarce, geography is challenging or traditional infrastructure is costly, conditions common across many EMs.

Beyond airspace sits space, where autonomy is not optional, but essential. Satellites, launch systems and space exploration vehicles operate in environments where human intervention is impossible. This is helping space systems develop into strategic capabilities.

The broader economic impact is substantial. Autonomous systems influence safety, cost structures and productivity in ways that software alone cannot.

Autonomy is not a niche vertical, it is a horizontal layer spanning hardware, software, sensors and power systems. It marks the moment when AI stops analyzing the economy and starts operating it: on the ground, in the air and in space.

Artificial, but Surprisingly Empathetic

AI is also reconfiguring human connections.

When New York State introduced a pilot program for seniors that provided AI companions, in the form of a robot capable of chatting about the news, telling jokes and reminding users to take their medication, the results were striking: a 95% reduction in loneliness alongside measurable improvements in well-being. What once sounded like science fiction is rapidly becoming everyday reality with AI companions, ranging from romantic chatbots to robotic pets.

Loneliness is not a fringe issue. Roughly half of adults globally report feeling lonely at least some of the time, driven by aging populations, declining fertility rates and the rise of single-person households (*Display 4*). AI companions are emerging as a non-judgmental response to this structural challenge. Nursing homes that once relied on therapy dogs now see residents lining up to hold a $6,000 robotic seal, a scene that is both touching and revealing. For younger consumers, comfort tech is making solo living easier and more appealing, turning independence into a lifestyle choice rather than a compromise, as getting married and having children is not the norm for the younger generation.

Dedicated AI companion apps have surpassed 220 million downloads globally, growing nearly 90% year-on-year. The companion robot market, worth about $11 billion today, is projected to exceed $90 billion by 2034. In Japan, demand for premium companion robots, equipped with advanced emotional interaction, has outpaced supply, even with price tags approaching $3,000 per unit. Robot pets offer affection without the hassle: no walks, no vet bills and no mess.

From pets to pixels, AI is proving to be more tender and adaptive than we ever imagined. Beyond companionship, AI helps users practice job interviews, navigate social situations and manage stress. The booming comfort-tech economy is anchored in one of humanity's most enduring needs: connection. And if nothing else, your AI companion will never forget your birthday or chew the furniture.

DISPLAY 4

AI Companions for All Generations

The EM Comeback Was Just the Beginning

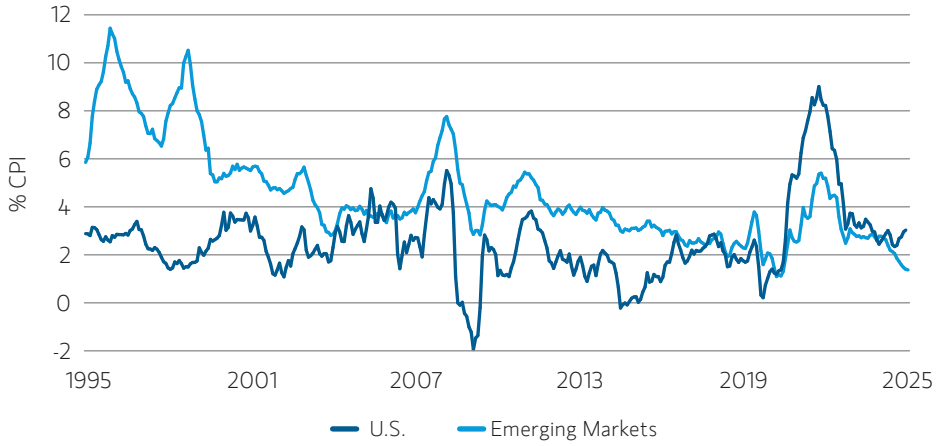
In last year's *Key Themes*, we wrote that a set of structural forces was finally aligning in favor of EM: shifting supply chains, a revitalized financial sector, AI-driven demand for semiconductors, electrification and reform momentum across frontier markets. That thesis is now playing out. While the U.S. has leaned further into protectionism and tariffs, many EMs restored credibility through reforms, balanced budgets and tighter monetary discipline.

Fiscal and monetary credibility is now a competitive advantage. EMs carry substantially lower debt burdens than their developed peers, giving them greater room to manage external shocks. EM central banks also tightened policy preemptively during the inflation cycle, then eased only cautiously.

DISPLAY 5

Reversal in Inflation Fortunes

Inflation in emerging markets is now lower than in the U.S.



Source: Bloomberg, Federal Reserve. As of September 30, 2025.

Tariffs act as a supply-side shock in developed markets, but largely as a demand-side shock for EM, which is easier to navigate. As U.S. tariffs ripple through global prices, EM inflation remains more subdued *(Display 5)*, helped by softer food and energy costs, and by China's continued export of deflation. As a result, several EM central banks now have the runway to ease, supporting domestic demand and credit growth.

EM growth will most likely be powered by digitalization, improving credit cycles, physical infrastructure, a commodity revival and AI supply chain investment. North Asia continues to benefit from demand for semiconductors, datacenters and electrification. China's launch of DeepSeek and its hyper-digitized economy should accelerate consumer-facing AI adoption and its Belt and Road capital outflows remain a stabilizing force for partner economies.

While governments across Korea, China and Japan are actively supporting shareholder value creation through various measures, Mexico, Malaysia and Vietnam continue to gain share of global trade.

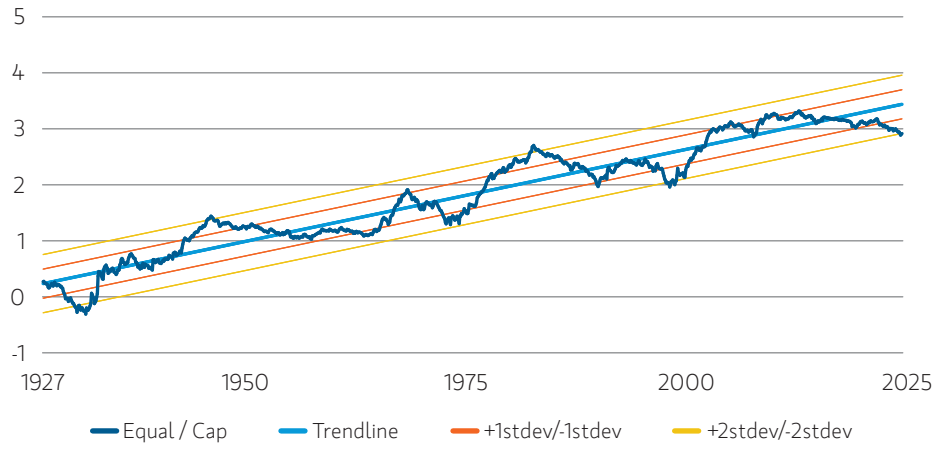
Years of underinvestment in resources benefit commodity-driven economies in Latin America, now supported by a political shift to the right. Even historically fragile markets such as Argentina, Egypt, Nigeria and Pakistan have undergone significant post-crisis repair, with currency devaluations, inflation suppression, deficit reduction and balance-of-payments rebuilding.

EM market infrastructure has matured as well: Deeper local currency funding, larger domestic investor bases and flexible FX regimes create resilient equity markets and more durable cycles.

DISPLAY 6

2026 Will Be More Than Just the Magnificent 7 in the U.S.

S&P equal-weight versus capitalization-weight index performance



Source: MSIM, Bloomberg, Haver. As of December 1, 2025. The Magnificent 7 are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.

The Great Broadening of 2026

Last year, we highlighted a shift away from a decade of U.S. concentration towards a broader international opportunity set *(Big Picture: The International Rebalance)*. That move is now clearly visible. EMs, Europe and Japan all outperformed the U.S. (USD terms) in 2025, confirming the early stages of rebalancing. We expect this broadening of performance to deepen in 2026, both within the U.S. and across international markets. The era of narrow winners is giving way to a wider, more globally distributed opportunity set.

A critical macro tailwind is that we are entering the age of capped rates. With public debt at multi-decade highs, real rates simply cannot remain structurally restrictive without destabilizing sovereign balance sheets. This implicit ceiling on rates improves liquidity conditions, supports duration and broadens risk appetite. EM central banks, having tightened early and decisively, now have room to ease.

AI development is migrating from model building toward horizontal platforms, vertical solutions and application layers, where monetization and productivity gains will be realized. The emergence of two distinct AI systems, a U.S. high-cost innovation engine and a Chinese low-cost efficiency model, ensure the AI cycle will not be monolithic. Dispersion, not direction, will define returns across companies and geographies.

Credit dynamics globally further reinforce the broadening theme. Years of margin compression, higher rates and tighter cost discipline are restoring profitability for European financials. As Europe and Japan emerge from deleveraging and EMs enjoy flush domestic liquidity, the conditions are falling into place for a new credit-fueled growth cycle.

Tariff fears remain more illusion than reality. Countries that have export overlap with China, namely Korea, Taiwan and Vietnam, should stand to benefit as preferred suppliers to the U.S., particularly in defense, shipbuilding and the AI supply chain.

Commodities are entering a multi-year tightening phase as reserve diversification, AI power demands and manufacturing revival collide with years of chronic underinvestment. In parallel, AI intelligent systems, like autonomy on factory floors, air and space and programmable biology, should unlock new investment opportunities. Even consumer behavior is evolving as digital companions reshape how people interact with technology.

Taken together, these shifts should define The Great Broadening of 2026 across the U.S., international markets, technologies and asset classes. Leadership is shifting from narrow dependence on mega-caps to a wider global opportunity set. To capture it, portfolios must broaden too.

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