Yardeni Research

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Morning Briefing

On Liquidity,
Tariffs & Earnings

Check out the accompanying chart collection.

Executive Summary: The Fed doesn't always make the right decisions. But there's next to no chance that it will mismanage liquidity and overly stress short-term funding markets, Eric explains. The Fed would end its quantitative tightening before that happened. … Also: Melissa delves into the motivations behind Trump 2.0's tariffs. The newly announced global steel and aluminum tariffs are matters of national security, seeking to promote US independence from foreign sources of these critical metals. Coming soon will be reciprocal tariffs that aim to level the playing field in global trade. … Also: Joe assesses how Q4 results are shaping up among S&P 500 and Mag-7 companies that have reported so far.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy: Lacking Liquidity? Fed watching is important insofar as we can generate alpha in identifying economic developments that Fed officials may be misinterpreting.

For instance, the Federal Open Market Committee's (FOMC) mistaken concern about last summer's labor market weakness led to 100bps of rate cuts. Whether due to confirmation bias, institutional groupthink, or simply a desire to avoid a recession at any cost, we believed the Fed wasn't acting appropriately based on the economic fundamentals. Economic growth was strong, and inflation remained sticky, leading us to grow increasingly bearish on long-term bonds as the rate cutting cycle proceeded last year (*Fig. 1*).

But one ball that the Fed is not likely to take its eyes off is liquidity. For all the hoo-ha about the ill effects of quantitative tightening (QT) and balance-sheet rundown, there's next to no chance that the Fed will endanger market liquidity and let short-term interest rates spike. Some commentators have pointed to the nearly drained Overnight Reverse Repurchase Facility (RRP)—with $76 billion in it as of Tuesday—as evidence that a malfunctioning of short-term funding markets is imminent, which will make the financial markets go haywire (*Fig. 2*). Such episodes have cascaded into broader financial markets and sparked volatility across asset classes before. We are confident that this won't be the case this time around.

Here's why:

(1) *QT refresher*. The Fed's balance sheet has shrunk from a peak of around $8.9 trillion in 2022 to $6.5 trillion of Treasuries and mortgage-backed securities today (*Fig. 3*). However, bank reserves have barely budged, remaining around $3.2 trillion or roughly double pre-pandemic levels (*Fig. 4*). One reason reserves have remained elevated is that the RRP drained as opposed to bank reserves.

(2) *Will reserves start to drain?* Yes, but probably not much. The Fed is likely to end QT later this year, or as soon as repo markets exhibit any signs of potential stress.

Frankly, there are more tailwinds to liquidity than headwinds. Fed Governor Michelle Bowman, who may be tapped as the Fed's next vice chair of Supervision, recently *highlighted* several bank regulations that need to be relaxed. Included were measures that will make it easier for large banks to absorb Treasury supply. That's a good thing considering that we don't see Treasury supply slowing anytime soon (*Fig. 5*). We also believe the Fed will start to *reinvest* maturing mortgage-backed securities into Treasuries, another positive for Treasury market functioning.

(3) *Money supply*. The Fed's lowering the federal funds rate by 100bps and banks' easing of lending conditions in response have led to a pop in M2 money supply, which was up 3.9% y/y as of December (*Fig. 6*). In fact, M2 is rising in nearly every region and country globally, with the notable exception of China, which is firing several stimulus salvos as we write.

The theme of this story is to not sweat QT, as that's one area the Fed is on top of.

Global Trade I: National Security—Steel Matters. On Sunday, Trump announced global tariffs of 25% on steel and aluminum, with no countries exempted. These followed earlier threats of 25% tariffs on most Canadian and Mexican goods and 10% on all Chinese imports. The tariffs on Canada and Mexico were postponed for 30 days as Trump worked out a deal with both countries to tighten border security, limiting the flow of immigrants and drugs into the US.

The broad tariffs on Canada and Mexico imports were likely a negotiating tactic, aimed at increased border security versus tit-for-tat tariffs. However, we think the new steel and aluminum tariffs reflect a different approach that prioritizes domestic industry and rebalancing trade. Boosting US steel production and prohibiting Chinese dumping practices are priorities of their own, and thus we believe these tariffs may stand longer than the initial Canadian and Mexican proposals. This comes with the usual caveat that everything in Trump World remains negotiable.

It's important to understand why steel gets extra attention from this administration:

(1) *Peter Navarro's intentions.* Peter Navarro, Trump's senior trade advisor, emphasized that the tariffs are not just about trade. "It's about ensuring America never has to rely on foreign nations for critical industries like steel and aluminum," he recently *told* reporters. The tariffs aim to end foreign dumping, boost domestic production, and secure the steel industry as vital to both economic and national security, he added. Under Trump 1.0, Navarro dismissed concerns about modest inflationary effects from eliminating unfair trade practices.

(2) *A familiar story*. In January 2018, Trump 1.0 imposed tariffs on steel and aluminum following a US Department of Commerce Section 232 *report*. It concluded that steel is critical to national security, expanding that to include industries beyond defense.

The 2018 report noted that steel imports were harming the US steel industry. To sustain it, mills need to operate at 80% or more of their capacity, which requires reducing imports via quotas or tariffs. US steel production capacity utilization was 74.6% in September 2024, *according* to the International Trade Administration.

(3) *No exceptions this time*. Back under Trump 1.0, Canada, Mexico, and Australia were exempt from the tariffs. South Korea, Brazil, and Argentina agreed to quotas. In April 2022, President Joe Biden then replaced European and Japanese tariffs with quotas as well. These exemptions ultimately weakened the impact of the broader tariffs on the US steel industry, the current administration believes.

(4) *Economic consequences in 2018*. In Trump's view, sustaining these domestic industries is worth the economic costs. When these tariffs were last imposed, they raised prices for consumers and reduced domestic growth, according to a May 2024 *Tax Foundation* *report*. The US International Trade Commission found that steel and aluminum prices increased by 2.4% and 1.6%, respectively, following the 2018 tariffs. Removing these tariffs would have led to a modest increase in real GDP growth of 0.02% y/y.

Given steel's importance in construction (e.g., rebar) and auto manufacturing, it's a critical commodity in the reshoring efforts.

(5) *Targeting Chinese dumping*. These tariffs also aim to undermine China's steel industry, which is plagued by overproduction. China's share of global steel production exceeds 50%, while the US accounts for just 5%.

While China's steel isn't a top US import, it impacts global prices. Price differentials between US steel and the world remain elevated at $762 per metric ton as of September 2024 versus the world at $480 and Chinese prices at $376, according to the US International Trade Commission's *data*.

China is the world's largest steel producer, and its steel exports have been on the rise, further pressuring domestic US producers. Exports from China are expected to top 100 million tons in 2024, the highest since 2016. Only 1.0% of Chinese steel mills are profitable, according to a Chinese consultancy *quoted* in the *Financial Times*.

(6) *Canada's major role.* Canada, though not a major global producer of steel, supplies the largest portion of US imports in the world. It accounted for 22.5% of US imports through September 2024. Canada also imposed tariffs on Chinese steel in October 2024 to protect its domestic industry from China's oversupply, though China's prices remain competitive even with the added tax.

We've suggested before that Trump's desire to incorporate Canada into the US is driven by energy security. We believe US steel industry security is also a part of Trump's short list of reasons to bring Canada into the US.

Global Trade II: Required Reading on Reciprocal Tariffs. Along with the 25% steel and aluminum tariffs, Trump hinted at imposing reciprocal tariffs on more countries and imports soon. To understand this, we return to our March 8, 2018 *Morning Briefing*, in which we analyzed Peter Navarro's views on reciprocal tariffs. Navarro repeatedly has championed the idea of "free, fair, reciprocal trade," aiming to level the playing field in global trade.

Here's more:

(1) *Navarro's identity crisis*. Navarro believes trade deficits are harmful because they must be offset by foreign investment. This investment could benefit US investors, increasing demand for financial assets and pushing US interest rates down. But protectionists like Navarro see this as problematic, fearing increased foreign control over US assets.

(2) *Conquest by purchase*. Navarro's primary concern is "conquest by purchase," whereby large trade deficits allow foreign rivals to buy US companies, technologies, and farmland. This, he argues, could ultimately affect national security if these entities control critical industries.

(3) *Focus on trade in goods*. Navarro emphasizes that the US must rebuild its manufacturing base to secure national defense. Only one company in the US can repair Navy submarine propellers, and no US company can produce certain critical military technology, he argued in 2018.

(4) *Fast forward to 2025*. For those interested in a deeper dive into US trade deficits with specific countries and the dynamics of reciprocal tariffs, Navarro's chapter in the Heritage Foundation's *Project 2025 Mandate For Leadership* (starting on page 765) offers valuable insights. This section, which outlines a comprehensive vision for US trade policy, aligns closely with what is unfolding in the Trump 2.0 trade agenda.

Strategy: Q4's Earnings Hook Has Arrived. Through midday Tuesday, 65% of the S&P 500's companies have reported December-quarter earnings. Among the 325 reporters so far, the aggregate revenue and earnings beats relative to analysts' consensus estimates are 0.7% and 6.7%, respectively (*Fig. 7* and *Fig. 8*). Below, Joe shares data on how these S&P 500 and the six Magnificent-7 reporters to date fared last quarter:

(1) *S&P 500 looks bound for record-high quarterly EPS yet again.* The S&P 500's blended Q4 EPS (i.e., estimates blended with actual results reported so far) jumped $2.32 to $64.71 from $62.39 a week earlier (*Fig. 9*). That boost is typical of past quarters, when earnings "hooks" in the charted blended data appeared after companies reported results that beat expectations. The current blended EPS of $64.71 is on track for the index to post its third straight quarter of record-high EPS (*Fig. 10*).

The Q4 quarterly EPS growth rate soared 4.1ppts w/w to 13.3% from 9.2% (*Fig. 11*). That's ahead of the forecasted 11.8% at the beginning of the quarter and 8.2% at end of the quarter. It's also the highest y/y quarterly earnings growth rate since Q4-2021, when growth was winding down from the fast-paced recovery that followed pandemic lockdowns (*Fig. 12*).

(2) *Don't fear falling growth expectations for Q1-2025.* This is always a busy time of year for analysts as company managements share their expectations for the year ahead. This year,

it’s been even busier as Trump 2.0 plans have come to light.

Adjustments to analysts’ models for news on tariffs and dollar impacts have lowered the S&P 500’s Q1-2025 earnings estimate by 2.5% since the start of the quarter (*Fig. 13*). We’re not worried since that’s less than the average 4.2% decline seen for Q1s since 1995. The consensus now expects S&P 500 earnings to rise 8.3% y/y in Q1-2025 (*Fig. 14*). That’s down from 9.8% a week earlier and 11.1% at the start of the quarter six weeks ago. The most affected S&P 500 sectors have been Financials (due to California fires) and Consumer Discretionary (Tesla).

For the rest of the 2025, analysts are expecting y/y earnings growth of 9.8% for Q2, 11.9% in Q3, and 12.6% in Q4. The 4.1ppts decline w/w in Q4-2025’s growth forecast to 12.6% from 16.7% turns out to be a nothing-burger. All of the change in the growth rate this week was due to higher base period earnings from Q4-2024.

(3) *Mag-7 results*. Among the Magnificent-7 companies, only Nvidia has yet to cross the Q4 reporting finish line. Tesla undershot estimates on both the top and bottom lines, and Alphabet missed on the top line. The six companies mostly recorded double-digit percentage revenues and earnings growth. Tesla managed to eke out single-digit y/y percent gains in both those measures. Also underperforming the group on both measures was Apple, which posted earnings growth of just 10.1% on a revenue gain of 4.0%.

Tesla’s weakness dragged down the Mag-7’s aggregate surprise and y/y growth numbers, causing the group to be a negative contributor to the overall S&P 500’s revenue surprise metrics among reporters so far. However, the Mag-7 remains a net positive contributor to the S&P 500’s y/y growth rates in revenues and earnings and the aggregate earnings surprise.

Excluding the Mag-7’s December-quarter results from the S&P 500’s improves the revenue surprise to 0.7% (from 0.6%), lowers the earnings surprise to 6.5% (from 6.7%), and drops revenues growth and earnings growth to 3.5% y/y (from 4.5%) and to 10.8% y/y (from 14.9%). The Mag-7’s six reporters to date posted a collective 0.2% revenue surprise, 7.2% earnings surprise, 9.8% y/y revenues growth, and 26.6% y/y earnings growth.

Calendars

US: Wed: Headline & Core CPI 0.3%m/m, 2.9%y/y & 0.3%m/m, 3.1%y/y; Monthly Budget

Statement -$79.8; MBA Mortgage Applications; EIA Crude Oil Inventories & Gasoline Production; Powell Testimony; Bostic; Waller. **Thurs:** Headline & Core PPI 0.3%m/m, 0.3%m/m; Initial Claims 216k; Fed Balance Sheet. (FXStreet estimates)

Global: **Wed:** Italy Industrial Production -0.2%; Japan PPI 0.3%m/m, 4.0%y/y; Elderson; Mauderer; Nagel; Green. **Thurs:** Eurozone Industrial Production -0.6%m/m, -3.1%y/y; Germany CPI -0.2%m/m, 2.3%y/y; UK GDP 0.1%m/m, -0.1%q/q, 1.1%y/y; UK Headline & Manufacturing Industrial Production 0.3% & 0.0%m/m, -2.0% & -1.8%y/y; ECB Economic Bulletin; European Commission Winter Forecasts; Nagel; Cipollone. (FXStreet estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Optimism Remains but Uncertainty Grows" is the heading of January's NFIB Small Business Survey. The *Small Business Optimism Index (SBOI)* fell in January for the first time in five months, declining to 102.8 after climbing from 91.5 in August to 105.1 in December. This marks the third successive month the index has held below its historical average of 97.9. January's reading fell short of the consensus estimate of 104.6. Meanwhile, the *Uncertainty Index* rose 14 points in January to 100—the third highest reading on record, following two months of decline. In January, seven of the 10 *components of the SBOI* fell, with the biggest declines occurring in capital outlay plans (-7ppts to 20%), plans to increase inventories (-6 to 0), and expect economy to improve (-5 to 47), followed by now is a good time to expand (-3 to 17), sales expectations (-2 to 20), expected credit conditions (-2 to 4), and plans to increase employment (-1 to 18). Meanwhile, earnings trends (+1ppt to -25%) was the only component in the plus column, while current job openings and current inventory were unchanged at 35% and -1%, respectively. Inflation (18%) remained the *single most important problem* for small business owners in January, though quality of labor (18), joined them at the top last month, followed by taxes (17), government regulations (10), cost of labor (9), and poor sales (9). The net percentage of owners *raising selling prices* slipped to 22% in January from 24% in November and December, while a net 26% plan price hikes in the next three months, down from 28% in both November and December; it was at a recent low of 24% in July. Turning to *compensation*, a net 33% reported raising compensation in January, the highest since August and up from 29% in December, while a net 20% plans to raise compensation in the next three months, down from 28% in November but near 2024's low for the year of 18%.

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