Yardeni Research

**April 8, 2025**

# Morning Briefing

## Who Will Save The Day?

*Check out the accompanying chart collection.*

**Executive Summary:** Amid the recession fears heightened by Trump's Tariff Turmoil, we take a look at what usually causes recessions. Our Credit Crisis Cycle (CCC) theory posits that financial system crises, unmitigated by intervention, lead to credit crunches. No such crisis has occurred, yet the financial markets are acting as though one has. Their distress is high but not enough to warrant Fed intervention—yet. As it stands, this is a manufactured bear market that can be reversed. … Also: We chat with Jim Lucier of Capital Alpha Partners for a status update on how Trump 2.0's promised tax cuts are faring in Congress. Our assessment is that regardless of the end result, tax cuts are unlikely to offset tariffs—a tax hike—as they stand.

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

**Strategy I: Correlations Go to One.** The current bear market is very different from previous ones. This is perhaps the first manufactured US bear market in at least 100 years, in the sense that it was created by President Trump, in his obsession with tariffs, rather than caused by anything to do with the business cycle, overleverage, or financial contagions.

Let's review our Credit Crisis Cycle (CCC) theory for how bear markets typically form (and bottom). It was this theory that underpinned our bullishness on the US economy and stock market in recent years, as it discredits the commonly accepted "long-and-variable-lags" argument that tighter monetary policy drags down economic growth after some lag time. To review:

In our CCC, rising interest rates cause a recession only if they break something in the financial system. That rupture causes a credit crisis, which morphs into a credit crunch and then a recession. To be fair to the bears, that sequence nearly happened from the latest round of Federal Reserve tightening. The Fed, the Treasury, and the FDIC together stemmed the mini regional banking crisis in March 2023 by quickly providing a liquidity facility and insuring all depositors of the failed banks. So the economy was able to continue expanding without cuts in the federal funds rate (FFR).

The Fed is a much better firefighter of financial crises than it was in the past, having expanded its toolbelt since 2008. Based on our CCC, it makes sense that Fed Chair Jerome Powell has signaled restraint on further easing and suggested that FFR cuts aren't on the table just yet.

President Trump's Tariff Turmoil (TTT) has walloped the stock market and will likely hurt the real economy in the coming weeks and months. But with elevated services inflation and tariffs threatening to raise goods prices substantially, the Fed remains wary of easing for now. We think that would change only if TTT causes a financial crisis—which looks increasingly possible as global markets sell off in unison. In a crisis, all correlations go to one. There has been no financial system implosion—no bank has failed, no hedge fund has blown up, nor has a massive leveraged trade rapidly unwound—yet the global markets are experiencing all the symptoms of one.

Perhaps the selling is enough to trigger a crisis?

The CCC is aptly acronymic for "CCC"-rated junk debt. The spread of high-yield bond yields (anything lower rated than BB) over Treasury yields is our preferred market gauge for credit stress. It has surged to 4.45ppts as of Friday from as low as 2.62 on February 18, when the stock market peaked (*Fig. 1*). The current level is its highest since the mini regional banking crisis. Should it rise north of 6 points and toward 7, we believe the conditions for the Fed to act by using its powerful balance-sheet tools and slashing the FFR would likely be met (*Fig. 2*).

In these situations, the Treasury bond yield-curve bull steepens as the 10-year yield falls but not as deeply as the Fed cuts the FFR (*Fig. 3* and *Fig. 4*). So while long-term rates do in fact fall, that doesn't necessarily support stocks. The bottoming process for the stock market often takes much longer to play out. This time, it might take even longer than usual, as Fed rate cuts are a blunt tool that's not very effective at offsetting the effects of global trade war (*Fig. 5*).

Given the man-made nature of TTT, it could easily be reversed. If President Trump grows fed up with the reactions of financial markets and the real economy to his tariffs, he might shun the advisers who helped get him here for others. Enough calls from CEOs and Wall Street—or complaints from the GOP about the mid-term elections—could also spur a pivot.

Indeed, alarm bells have sounded. JPMorgan CEO Jamie Dimon wrote this in his annual *letter to shareholders*: "We are likely to see inflationary outcomes, not only on imported goods but on domestic prices, as input costs rise and demand increases on domestic products ... Whether or not the menu of tariffs causes a recession remains in question, but it will slow down growth."

And there's discord at the top: Elon Musk, in response to an interview clip of Trump's trade brain Peter Navarro, *wrote on X*: "A PhD in Econ from Harvard is a bad thing, not a good thing. Results in the ego/brains >>1 problem."

It's unclear how much of the damage from TTT will be long-lasting. Indeed, some confidence in the US, at least from a stability perspective, has been lost. But given the resilience that the US economy has displayed in recent years and its strong footing entering this year (relative to both history and the rest of the world), any pivot away from TTT would likely spark a limit-up stock market rally.

How little it would take to trigger a relief rally was showcased Monday morning, when CNBC misquoted National Economic Council director Kevin Hassett and ran a headline suggesting that Trump was contemplating a 90-day delay on tariffs (excluding China). The S&P 500 jumped to a more than 1% gain, just an hour after it opened down more than 3%. The rally faded after a White House X account called it "fake news." Still, the one-minute relief rally underscored that all it would take is one Trump statement to erase a lot of losses.

Aside from paring back on TTT, it's worth revisiting the policy proposals that made the business world, the financial markets, and observers like us bullish on Trump 2.0. Deregulation is a key pillar, but one that takes time. A major source of optimism was tax cuts, which we believe(d) could help accelerate the productivity growth boom and expand corporate profit margins.

**Strategy II: Tax Cuts Amid Tax Hikes.** Tariffs are ultimately a tax. Whether consumers bear the full brunt of them is up for debate, but someone must pay the tax. It will be some combination of importers (US businesses), exporters (foreign businesses), and consumers (foreign and domestic amid retaliation). Taxes weigh on economic growth. So what about those tax cuts promised by Trump on the campaign trail?

They are being discussed in Congress as we speak, in both houses. They are still at the budget phase; no concrete proposals have been made yet. Unfortunately, collaboration between the chambers seems to be quite low. We chatted with our friend Jim Lucier at *Capital Alpha Partners* to get the inside scoop on the budget machinations and what tax cuts may be coming down the pipeline. By our estimation, everything being discussed is not enough to offset the TTT tax hike. But they are something. Consider some of the takeaways from our conversation with Jim:

(1) *Are these really cuts?* No, they are mostly extensions of the 2017 TJCA (Tax Cuts and Jobs Act) tax cuts. The big kahuna, the corporate tax cut from 35% to 21%, is permanent and unlikely to change. Mostly, the extension avoids a big tax hike to the pre-2017 baseline, which affects budget scoring but not real economic activity.

(2) *Some meat on the bones*. That's not to say it will be a complete nothing burger. The prospects of no taxes on tips, overtime, and Social Security benefits are on the table, and would be a boost for consumers and small businesses. An interest expense deduction for loans to buy new cars (which are likely to be more expensive) has also been floated. Jim believes that only no tax on tips is likely to make it through the legislative gauntlet into law.

Companies stand to benefit from restoration of some expired accounting rules, such as 100% bonus depreciation, 30% of EBITDA (earnings before income taxes, depreciation, and amortization) interest expense deduction, and the expensing of research & development costs. Expensing for structures broadly, instead of for just property, plant & equipment, is also possible and could facilitate factory building.

(3) *House versus Senate*. According to Jim, Republicans in the House of Representatives believe they can extend the TCJA for seven or eight years, allow expensing for structures, and maybe secure no tax on tips on a temporary basis.

Senate Republicans have said they can assent to permanent expensing for structures and implement Trump's promises for individuals, like no tax on tips, permanently. Of course, neither of these plans helps reduce the federal budget deficit. A recession, of course, would make the deficit situation even worse by lowering revenues and expanding entitlement spending (*Fig. 6*).

The House budget resolution passed on February 25 would allow the national debt to increase by $3.3 trillion over ten years. When accounting for the additional interest expense from the bonds needed to finance that deficit spending, it could reach $4 trillion. The Senate said that the budget resolution it passed last week increases the national debt by $1.5 trillion; but when adding in the cost of a permanent TCJA extension and interest costs, the total cost of the package is around $6.0-$7.0 trillion.

Jim says the House is much more focused on the national debt and prefers not to follow the

Senate's lead in not counting the impacts of the TCJA extension because it is the current status quo. The Senate budget does include limits that would prevent a complete deficit blowout, however.

It remains to be seen how the House and Senate will reconcile their two resolutions—which may hinge on how members manage their constituencies and lobbyists as the tariffs start to bite. Apparently, the House is not on board with TTT. Hopefully, its voices grow loud enough in DC.

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## Calendars

**US:** **Tues:** NFIB Optimism Index 101.3; EIA Short-Term Energy Outlook; Daly. **Wed:** MBA Mortgage Applications; Wholesale Inventories 0.3%; Crude Oil Inventories; FOMC Minutes; Barkin. (FXStreet estimates)

**Global:** **Tues:** De Guindos. **Wed:** UK FPC Meeting Minutes; BoE Quarterly Bulletin; Japan Machine Tool Orders; Japan Consumer Confidence 34.7; Japan PPI 3.9%y/y; China CPI & PPI 0.1% & -2.3%y/y; Cipollone; Ueda; Balz. (FXStreet estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): During the April 4 week, forward earnings rose for all of these three indexes for the first time in 10 weeks and was at record highs for LargeCap and MidCap. The script is sure to flip in the coming weeks as analysts digest the implications of Trump's Tariff Tantrum (TTT). LargeCap's forward earnings was up 0.2% w/w, and MidCap's rose 0.1%, to record highs for both indexes. MidCap's record highs of the past three weeks are its first in 33 months. SmallCap's rose for a second week, gaining 0.2%. It's now up 1.9% since its 40-month low in mid-March, primarily due to index changes. However, it remains 12.5% below its June 2022 record. LargeCap's forward earnings has soared 23.6% from its 54-week low during the week of February 1, 2023; MidCap's is 9.2% above its 55-week low during the week of March 10, 2023; and SmallCap's is only 1.3% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (9.7%, 10.8%, 14.2%), MidCap (0.4, 9.1, 16.0), and SmallCap (-10.2, 7.6, 19.9).

**S&P 500/400/600 Valuation** (*link*): Valuations had their worst week in five years and ended the week at their lowest levels since November 2023. LargeCap's forward P/E of 18.2 was below 20 for the first time in a year, tumbling 1.8pts w/w to a 17-month low. It's now 4.1pts below its 43-month high of 22.3 during the December 6 week and just 1.2pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. MidCap's forward P/E tumbled 1.4pts w/w to a 17-month low of 13.2. It's now 3.9pts below its 40-month high of 17.1 during the November 29 week and just 1.0pt above the 12-month low of 12.2 in October 2023. That compares to a record high of 22.9 in June 2020 when forward earnings was depressed, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was down 1.3pts w/w to a 17-month low of 12.9. It's now 4.2pts below its 41-month high of 17.1 during the November 29 week and just 2.3pts above its 14-year low of 10.6 in September 2022. That compares to a record high of 26.7 in early June 2020, when forward earnings was depressed, and a record low of 10.2 in November 2009 during the Great Financial Crisis. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E is at an eight-month-low 28% discount to LargeCap's P/E, barely above its 25-year-low 29% discount during the July 5, 2024 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is now at a 30% discount to LargeCap's P/E, which compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's 4ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E weakened to a 3% discount to MidCap's, but that remains among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

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## Global Economic Indicators

**Eurozone Retail Sales** (*link*): Eurozone retail sales in February rose for the first time since September. *Headline retail sales* were 0.3% higher during February, after showing no growth from November through January, following last October's 0.3% decline. The *components of retail sales* all show small upticks during the month: Spending on *food, drinks, and tobacco* posted back-to-back gains in February, rising 0.3% m/m and 0.8% over the period. *Non-food products* climbed for the second time in three months, by 0.3% in February, following a 0.2% downtick and a 0.4% uptick the previous two months.

*Automotive fuels* spending has been volatile the past four months, though posted a 0.2% increase in February and a 0.7% gain over the period. *On a year-over-year basis*, total retail sales rose 2.3%, with non-food products ex fuel (2.5%), food, drinks, and tobacco (1.9), and automotive fuels (0.7) all in the plus column. February data are available for *all of the Eurozone's four largest economies*, with Spain (1.3% m/m & 3.8% y/y) posting the biggest monthly gain, followed by Germany (0.7% & 4.8), while France (0.2 & 2.3) posted a slight uptick and Italy (-0.1% & -1.1) a slight downtick. *On a year-over-year basis*, Germany (4.8% y/y) led the pack, followed by Spain (3.8) and France (2.3), while Italy (-1.1) was in the red over the 12-month period.

**Germany Industrial Production** (*link*): German industrial production fell back into contraction in February on tariff concerns. Germany's *industrial production*, which includes construction, sank 1.3% in February, steeper than the consensus estimate of -1.0% and erasing a big portion of January's 2.0% gain. The decline in February's industrial production was mainly due to construction (-3.2%) and energy (-3.3) production, which dragged output lower. Meanwhile, electrical equipment (3.3) output helped to offset some of the decline. *Production excluding energy and construction* was down 0.5% during the month. *By sector, consumer* (-3.0%) and *intermediate* (-0.4) goods production declined during the month, while *capital* (0.2) goods output posted a small decline. *Versus a year ago*, industrial production dropped 4.0%, widening from January's 1.6% shortfall. German production remains about 10% below its pre-pandemic levels.

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