Yardeni Research

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Morning Briefing

On European Auto Industry & The BOJ

Check out the accompanying chart collection.

Executive Summary: The reordering of global trade patterns stemming from Trump's Tariff Turmoil is having distinct ramifications for market players and policymakers the world over, as William explains today. Inexpensive Chinese imports flooding into Europe's auto markets are confounding the industry stalwarts and presenting policy conundrums. … Different policy conundrums have been dumped in the laps of central bankers in Japan and the US, and the decisions of each affect the other. Fed rate cuts could cause the BOJ to shift policy course, and simultaneous rate cuts by the two could shake financial markets worldwide.

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

China: Shaking Up Europe's Automakers. Europe's auto industry is having a decidedly rocky 2025. Donald Trump's trade war sure isn't helping. Nor are challenges ranging from global inflation to local battles with unions. But the real roadblock to European car companies' maintaining market share is China.

The threat from the low-cost-producer 4,700 miles away is a surprise to no one. What is surprising is how flat-footed Europe's auto titans have been revealed to be as Asia's biggest economy makes serious inroads into their *450-million-person-strong* market.

As of the end of 2024, the average new car price in Europe was $49,000, according to Asia-focused auto advisory *Dunne Insights*. The cost of the average vehicle exported from China: $18,000.

No wonder Volkswagen in late 2024 began *considering shuttering factories* in Germany for the first time in its 87-year history amid a 2.3% *decline in worldwide sales* last year. The "*challenging market environment*" that CEO Oliver Blume referred to in January reflected the rising flood of Chinese cars into Europe—particularly electric vehicles (EVs)—which has upended decades of stable market shares and profits for not just VW but Stellantis, Mercedes-Benz, BMW, and Renault too.

It's not just Chinese competition; the slowdown in European sales is partly a result of higher living costs. The phasing out of EV subsidies in certain countries, including Germany, is reducing demand for low-emission cars in favor of cheaper combustion-engine equivalents.

Yet China is turning the global EV market on its head, even making life difficult for the globe's richest person. In 2024, Shenzhen-based EV maker BYD *leapfrogged* over Elon Musk's Tesla in sales terms. What's more, Warren Buffett-backed BYD *just launched* a lower-priced alternative to Tesla's Model 3, long Musk's top seller in China.

So what are European car companies doing to regain their mojo versus China Inc.? Or, for that matter, versus Detroit and Nagoya? As far as Michael Dunne, CEO of Dunne Insights, can see, the answer is "not much."

While Chinese names like BYD, Chery Automobile Co., SAIC Motor's MG, Changan Automobile, and China FAW Group win business from VW, Chevrolet, and Toyota Motor, European, American, and Japanese auto giants "appear to have no response," Dunne argues. They are "confused and overwhelmed by the speed and strength of the Chinese offensive."

The problem, industry observers say, is one of increasing momentum. China's auto production soared from around 4.0 million units (saar) in 2006 to about 30.0 million currently (*Fig. 1*). China went from *one million auto exports in 2020* to *6.41 million* in 2024, a 493% increase.

Not surprisingly, the response from Trump is tariffs to head off China's EV ambitions, which his *25% tax* on foreign-made autos seemingly targeted. Europe is doing the same: Last October, the European Union announced a series of hyper-focused tariffs on China's EV upstarts on top of the pre-existing 10% car import tax.

BYD and Geely Group have EU tariffs of 17.0% and 18.8%, respectively, according to an EC *press release*. State-owned SAIC, by sharp contrast, received a 35.3% tariff. Other EV makers operating in China, including BMW and VW, are subject to a 20.7% levy. Tesla got away with just 7.8%.

Yet tariffs merely treat the symptoms of Europe's auto troubles, not the underlying causes.

Germany's extreme reversal of fortune tells the story. China, simply put, caught Europe's biggest economy napping. Besides German automakers, President Xi Jinping's economy is also threatening other sectors that Germany, on account of its prodigious global manufacturing leadership, took for granted, including chemicals and engineering. In a *January report* for the Center for European Reform, economists Sander Tordoir and Brad Setser warned that a five-year decline in German industrial production is a "source of profound angst in a country where manufacturing contributes around 5.5 million jobs and 20% of gross domestic product." Germany's auto production fell to 3.2 million (saar) during March (*Fig. 2*).

Germany continues to learn the hard way that the "Made in China 2025" strategic plan that Xi launched in 2015 produced Mainland auto, clean technology, and civil aviation sectors that are upending its industrial interests. The answer is greater innovation, disruption, and adapting to new global economic realities, not tariffs that can work at cross purposes with the EU's goals.

One of the "knock-on effects" from having fewer Chinese EV imports "would slow the growth" of EVs in the 27-economy market and "run counter to the European Commission's tougher carbon dioxide reduction targets," warned Ian Fletcher, auto analyst at S&P Global.

It's a real Catch 22. Industry executives like Ola Källenius, CEO of Mercedes-Benz, have long argued that strict EU regulations are a big disadvantage that China is exploiting. At present, the EU's policy is for 100% of all new cars purchased to be EVs by 2035. Support for deregulation is increasing in the name of competitiveness.

So far, EU leaders have been noncommittal on assertive deregulation. In January, the EU announced an "*unprecedented simplification effort*" to boost innovation and slash regulations to keep up with China. This came four months after Mario Draghi, former Italian prime minister, warned of a "*slow and agonizing decline"* if Europe doesn't raise its innovation game.

Separately, tariffs carry a host of unintended consequences. Scores of basic materials and parts used for EV batteries and computers come from China. As Trump tries to end what he calls a "transition to hell" with import taxes, cars everywhere could become more expensive. Chinese automakers don't rely on the US market for significant revenue, but automakers everywhere else do—and they'll all be hurt.

Tariffs alone aren't likely to derail China's auto trajectory. In 2023, China wrested the title of “world’s top automaker” away from Japan. To be sure, tariffs from Washington and Brussels may trigger a wave of industry consolidation in China. “But incumbent carmakers shouldn’t celebrate too much—even with slower export growth,” analysts Gregor Sebastian and Endeavour Tian at the Rhodium Group argue in a *recent report*. “Chinese carmakers are transforming into formidable global competitors in the auto market.”

One problem for governments putting tariffs ahead of innovation and R&D is China’s ability to navigate around tariffs. Among the *top destinations* for Chinese EVs are Brazil, Russia, Saudi Arabia, and the United Arab Emirates. As the West wages trade wars, China is busily pivoting to new markets among “Global South” economies.

All this puts Europe’s auto industry at a major inflection point. Europe, argue Tordoir and Setser, “cannot be complacent. If it does not act to counter Chinese policies, its current advantages in other sectors will go the same way as those in EV batteries and solar panels.”

The analysts add that “EU industrial policy support would undoubtedly benefit Germany, and it should.” The EU, they conclude, “should target its scarce industrial policy funds to maximize competitiveness. This means supporting value chains—and regions—with strong potential, many of which are centered in Germany. Germany would be a primary beneficiary of a significant European funding program for decarbonizing industry or expanding chip production, for example.”

The China threat won’t take care of itself. It’s high time Europe adjusted policies and strategies for a global marketplace being reordered a world away.

Japan: Staring Contest Between Fed & BOJ. As trade war fallout jeopardizes global growth and markets, it’s an open question who’s hating 2025 more—Federal Reserve Chair Jerome Powell or Bank of Japan (BOJ) Governor Kazuo Ueda.

Powell and Ueda share a common problem: Trump 2.0. Powell is caught between President Donald Trump’s demands for sharply lower rates and a US economy that just won’t quit. Ueda’s two-year campaign to “normalize” the BOJ’s deflation-era monetary landscape is in peril as Trump’s tariffs send giant headwinds Asia’s way. As 2025 unfolds, the policies of two of the globe’s most powerful central bankers might be on a collision course.

For Powell, Friday’s employment report only complicates the Fed’s road ahead. Trump is ratcheting up pressure on the Fed to ease immediately and assertively. But the justification to do so, the imminent recession argument, is dented by the US's adding an expectations-defying *177,000 jobs in April*—and with an unchanged 4.2% jobless rate at that.

Indeed, regional and national business surveys suggest that tariff-induced inflationary pressures are more pronounced than risks of economic weakness. Only Trump can say how far he'll take his crusade to fire Powell, whether there's "cause" or not.

Already, the Bond Vigilantes are in a whirl over Trump's broadsides against Fed independence. They might push US 10-year Treasury bond yields well above the current 4.3%. Foreign exchange traders might short a dollar that Trump has long wanted to push lower to help exporters.

Welcome to Ueda's hell year. Back in January, Ueda was destined to be the hero of modern Japanese economics, the policymaker who restored monetary sanity to the third-biggest economy. That month, the BOJ hiked its benchmark interest rate to a 17-year high of 0.5%.

Ueda was on track to hike rates to 0.75%, a move that, until very recently, investors thought would come *on May 1* (*Fig. 3*). That would've bested Toshihiko Fukui's 2006-07 effort to extricate Japan from the zero-rate gambit *launched in 1999*.

At the time, BOJ Governor Fukui made global headlines for finally ending the quantitative easing (QE) experiment that the BOJ *pioneered in 2001* to defeat deflation. Then came the 2008 "*Lehman shock*," as the Japanese call it. Zero rates and QE returned in short order.

Now, Ueda faces a similar fate. The collateral-damage risks posed by Trump's Tariff Turmoil are the worst that Asia has encountered since 2008. Raising the stakes is how Trump is attempting to kneecap China, the economy at the center of Asian supply chains, with a *145% import tax*.

Trump's preferences for a more subservient Fed and a weaker dollar are also limiting Ueda's latitude to hike rates. With the yen already *up nearly 9%* this year, Japan Inc. is bracing for slower economic growth and lower profits (*Fig. 4*). Foreign funds that pushed the Nikkei 225 Stock Average to *all-time highs* in 2024 are having buyer's remorse as Japan flirts with stagflation.

The interplay between the dollar and yen is arguably the foreign exchange market's best risk-on/risk-off gauge. If the Fed were to start cutting rates suddenly, the BOJ might have to abandon its yield-curve-control strategy, boosting the yen. Already, the Nikkei's volatility is ramping up, a reflection of the tension between Fed and BOJ policies in states of flux (*Fig. 5*).

Though the status of Trump's tariffs is unclear, Japan is unhappy that his team is standing firm on *25% auto tariffs*, regardless of what concessions Tokyo makes. The same goes for Trump's levies on steel and aluminum. The inflationary impacts of Trump's tariffs are mounting just as the corresponding headwinds imperil Japanese demand.

Though some see stagflation as a risk for the US economy, it may be a more immediate problem for Japan. Prior to this, Japan was stuck in a deflationary funk for more than 20 years. Now the problem is too much inflation. Yet one of the less understood dynamics in Japan is that QE hasn't defeated deflation so much as Vladimir Putin has. In 2022, Japan imported oil and food at elevated prices because of Russia's Ukraine invasion, which boosted commodities prices. That drove Japan's consumer price inflation rate above the *BOJ's 2% target*. In March, prices rose at a *3.6% y/y rate* (*Fig. 6*).

Now Japan's economic trajectory is subject to the whims of a Trump White House that has long viewed Asia as stealing American jobs and wealth. Though China is his current obsession, Trump has nursed anger against Japan since the 1980s. Trump declared back then that Japan had "*systematically sucked the blood out of America*" and "*gotten away with murder*." And when Trump muses about a "Mar-a-Lago Accord," he's riffing on the 1985 Plaza Accord to weaken the dollar versus the yen, forged at a New York hotel he once owned.

Then there's the so-called "yen carry-trade" that's now at risk. Twenty-six years of near-zero interest rates—and *24 years* in the QE zone—made Japan into the top creditor nation. Some investors routinely borrowed cheaply in yen to bet on higher-yielding assets around the globe. Yet yen liquidity, keeping aloft financial assets of all kinds, can leave faster than it arrived. The yen carry-trade's blowing up suddenly is one of hedge fund managers' biggest fears.

If it turns out that the BOJ's next move is to lower rates, not raise them, everything that traders thought they knew about interest-rate differentials in the second half of 2025 goes out the window. The Fed and BOJ easing simultaneously could provoke a race to the bottom on exchange rates, a tug of war that could shake markets worldwide.

There's another wildcard here: Tokyo's status as the largest holder of US Treasury securities, with *$1.13 trillion*. Given the recent volatility in the bond market, Tokyo surely understands the leverage it wields over Washington. Any whiff that Japan or China—with its *$760 billion* of US Treasuries—is selling could send shockwaves around the globe.

On May 2, Japanese Finance Minister Katsunobu Kato told local media that Tokyo's Treasuries are a "*card on the table*" in trade talks. Such comments come as Washington's national debt is *approaching $37 trillion* and amid worries that tariffs and policy chaos just 105 days into the Trump 2.0 era are imperiling the dollar's reserve-currency status.

As these crosscurrents upend global market dynamics, no two policymakers are more squarely on the frontlines than Powell and Ueda. Or, for that matter, more dependent on the other for success.

Calendars

US: Tues: Goods & Services Trade Balance -$129b. **Wed:** Fed Interest Rate Decision 4.50%; Consumer Credit Change $9.9b; MBA Mortgage Applications. (FXStreet estimates)

Global: Tues: Eurozone PPI -1.1%; Eurozone, Germany & France C-PMIs 50.1, 49.7 & 47.3; Eurozone, Germany & France NM-PMIs 49.7, 48.8 & 46.8; France Industrial Production 0.2%; UK C-PMI & NM-PMI 48.2 & 48.9; China Caixin NM-PMI. **Wed:** Eurozone Retail Sales -0.1%; Italy Retail Sales 0.2%. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the May 2 week, the SMidCap's forward earnings dropped for a fourth straight week, but LargeCap's rose for the first time in four weeks. LargeCap's w/w gain can be attributed largely to the Q1 earnings surprise hook from Communication Services, which outweighed the broad declines in the consensus' forecasts for Q2 to Q4. LargeCap's forward earnings rose 0.2% w/w to 0.7% below its record high during the April 4 week. MidCap's dropped 0.2% to 1.5% below its record high, also during the April 4 week. SmallCap's fell 0.4% w/w to 13.9% below its June 2022 record. LargeCap's forward earnings remains 22.7% above its 54-week low during the week of February 1, 2023; MidCap's is 7.6% above its 55-week low during the week of March 10, 2023; but SmallCap's has now slipped under 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%, 9.0%, 13.7%), MidCap (0.4, 6.3, 16.0), and SmallCap (-10.2, 4.6, 19.1).

S&P 500/400/600 Valuation (*link*): Valuations rose to four-week highs last week for all three of these indexes. LargeCap's forward P/E rose 0.5pt w/w to 20.5. It's now 1.8pts below its 43-month high of 22.3 during the December 6 week and 3.5pts 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 rose 0.5pt w/w to 14.8. It's now 2.3pts below its 40-month high of 17.1 during the November 29 week and 2.6pts 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 rose 0.5pt w/w to 14.3 and is just 1.4pt above its 17-month low of 12.9 during the April 4 week. It's now 2.8pts below its 41-month high of 17.1 during the November 29 week and 3.2pts 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 28% discount to LargeCap's P/E, not much 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 nine-month-low 31% discount to LargeCap's P/E, which compares to a 23% discount during the November 29 week, its best reading since the March 2, 2023 week. It's 3ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E was steady at a 4% 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.

US Economic Indicators

US Non-Manufacturing PMI (*link*): The US service sector expanded for the 10th successive month in April, beating expectations, while inflation pressures continued to accelerate due to tariffs. The *ISM NM-PMI* climbed to 51.6 in April from March's nine-month low of 50.8—coming in ahead of the consensus estimate of 50.2. April's index indicated expansion for the 56th time in 59 months since recovering from the coronavirus pandemic-induced recession that began in June 2020. (ISM associates a PMI reading of 49 over time with growth in the overall economy.) It peaked recently at 55.8 last October. April’s report was a mixed bag, with *new orders* (52.3 from 50.4) showing a slight pickup in activity, while the *employment* (to 49.0 from 46.2) measure showed a slowing in jobs cuts as the index moves closer to expansion territory. Meanwhile, the *business activity/production* (53.7 from 55.9) measure slowed in April, though did record a 59th successive month of expansion. *Supplier deliveries* (51.3 from 50.6) deteriorated last month—a reading above 50 indicates slower deliveries. On the *inflation* front, the price index (to 65.1 from 60.9) posted its highest level in more than two years.

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