Yardeni Research

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Morning Briefing

More On China: Deflation & ‘Made In China 2025’

Check out the accompanying chart collection.

Executive Summary: China’s insidious deflation pressures are now evident in its producer and consumer price data. Government measures to stimulate the economy haven’t addressed the cause of the deflation problem—that the Chinese spend too little and save too much in the absence of adequate social safety nets. China needs to take decisive action in three areas, William explains. But a failure to see the urgency can be costly, as Japan learned the hard way; entrenched deflation can be difficult to root out. … Also: Does China’s ambition to dominate world tech markets pose a clear and present danger to Silicon Valley? Not quite yet.

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

China I: Deflation Clouds Darken. Over the weekend, as Treasury Secretary Scott Bessent engaged in trade talks in Geneva, his Chinese counterparts across the table received some alarming news from 5,100 miles away.

Factory-gate prices in China fell for the 31st consecutive month. The *2.7% y/y drop* in the April producer price index confirmed China’s slide toward deflation (*Fig. 1*). China’s falling-price trajectory is mild so far relative to Japan’s plight in the 1990s. But news on Saturday that Mainland consumer prices are now down y/y for *three straight months* should give pause to officials in both Beijing and Washington (*Fig. 2*).

For Chinese President Xi Jinping, this is a fork-in-the-road moment. There’s indeed a distinction between facing deflationary forces and experiencing outright deflation, which is hard to reverse. What Team Xi does next will determine which path Asia’s biggest economy takes.

For Trump World, this is a be-careful-what-you-wish-for moment. President Trump’s *tariffs* are a hurricane-force headwind that China hardly needs. Even if Trump’s claim that the

China tariff will be slashed considerably holds, a *30% import tax* is still no joke.

Pre-trade war, China was struggling with a property crisis, high *youth unemployment*, crushing local government debt, and weak domestic demand. Kicking China when it's down risks exacerbating deflation odds. The second-biggest economy exporting even more *deflation* is in no one's interest, considering that deflationary forces are already "persistent," notes Zhiwei Zhang, president of Pinpoint Asset Management.

So far, Xi has taken the road too often traveled by governments failing to grasp how deflation can take on a life of its own. Mostly, Xi's Communist Party has taken a page from Japan, circa 1995, throwing ever bigger mountains of cash at the problem.

Tokyo's top mistake back then was a decade-plus of treating the symptoms of its bad-loan crisis, not the underlying causes. Similarly, China has been rolling out bigger and bigger stimulus packages, rate cuts, and supplemental programs to support property, municipal finances, and the stock market. All the while, insidious deflationary pressures have been increasing under the surface (*Fig. 3*).

Now, as these deflationary pressures bubble above the surface, what we're seeing is more energetic effort to boost weak household and business confidence over the short run. *On May 7*, the People's Bank of China surprised global markets by cutting the seven-day reverse repurchase rate, the lever to its main benchmark interest rate, by *10 basis points to 1.4%*. Also lowered was the weighted average of the reserve requirement ratio, by *50 basis points to 6.2%* (*Fig. 4*).

Yet rate cuts don't address the underlying problems that have Chinese households saving too much and spending too little. Nor does this latest stimulus blast hasten the transition to a domestic-demand-led-growth model and away from exports and unproductive investment. Nor does it sideline the inefficient state sector once and for all.

To defeat inflation, Team Xi faces quite a to-do list. I asked William to explore three of the most immediate fixes China could make to increase domestic confidence:

(1) *China needs to encourage households to spend more.* By building bigger social safety nets, households would feel less need to hoard savings and would spend more. As of the start of 2024, the *International Monetary Fund* (IMF) calculated that China was home *to 28% of global savings*, a level more than 40% of Mainland GDP. Combined, the US and European Union economies held less than 33% of global savings.

To Lu Feng, an economist at Peking University, Beijing needs a fundamental change in the top-down allocation of resources, which historically favored the supply side over the demand side. That's key to increasing incomes in rural areas, where a critical mass of China's *1.4 billion people* live.

Current household consumption is driven by expected long-term income. As such, China's pension gap tells the story. Though good data are hard to come by, Lu noted that in 2022, the average annual pension for public servants was *73,198 yuan* ($10,113) versus 2,456 yuan ($340) for rural residents.

Oddly, to morph China itself into an upper-middle-income power driven by domestic consumption, Beijing may have to go more communist.

(2) *China needs to address its festering property crisis.* Though the real estate boom is over, the hangover is intensifying (*Fig. 5* and *Fig. 6*). Somehow, Japan comparisons seem inadequate considering the seizing up of a *$15 trillion sector*. This financial sinkhole is more than three and a half times the size of Japan's $4.2 trillion GDP.

Talk about an own goal. The crisis began around 2021, when Xi's reform team moved to reduce the role of real estate—then generating about *25% of GDP*—in favor of technology-driven economic growth.

Xi had the right idea in tackling China's housing bubble and nose-bleed leverage levels among developers. But he used too much sledgehammer, not enough scalpel. Home prices *plunged about 30%* from their 2021 peak. The crash wiped out an amount of household wealth comparable to China's *nearly $18 trillion* of annual output.

The defaults that followed have China in global headlines for all the wrong reasons. The carnage has pushed municipalities to the brink.

(3) *China needs to tackle several trillions of dollars of local government debt*. During the Xi era that began in 2012, local governments made most of their money off property sales. With that business increasingly dead to them, China's 34 province-level administrative divisions are getting by with great walls of debt issuance.

In recent years, local officials found a way around Beijing's limit on bond sales: off-balance-sheet local government financing vehicles (LGFVs). At the start of 2024, the IMF reckoned that LGFV debt was nearly 48% of China's GDP. That *60.2 trillion yuan* ($8.3 trillion) is three times France's annual output.

Getting this debt off municipal balance sheets would empower authorities where most Chinese live to invest more in infrastructure, education, healthcare, and elder care. It would give local governments great scope to support startup companies, address declining birth rates, and create robust social safety nets. And of course, it would help China to avoid a Japan-like funk, the fears of which keep Xi's inner circle awake at night.

China II: 'Made in China 2025' Won't Kill Silicon Valley—Yet. Over the past six months, China served up three big surprises to global markets: 1) the success and sudden ubiquity of electric vehicle (EV) maker BYD; 2) DeepSeek's upending the artificial intelligence game; and 3) its continued pace of GDP growth at near 5% y/y despite the trade war.

Yet one man is anything but surprised: Chinese leader Xi Jinping, who a decade ago laid the groundwork for Asia's biggest economy to beat the odds in ways that Wall Street struggles to grasp.

The timing is no coincidence. Xi named the strategy he rolled out in 2015 "Made in China 2025" for a reason. It's now putting some big wins on the scoreboard, much to the chagrin of President Donald Trump, who's attempting to tariff China into submission. But in so doing, Trump is inadvertently enabling China to carry out its own decoupling from the West as it becomes more self-sufficient.

Yet for all the great press China is getting for wins here and there, Xi's signature effort to transform China from a low-cost manufacturing hub into a global leader in advanced technology and innovation is facing as many challenges as successes. That's particularly true as President Trump's trade war forces Xi's people to focus more on stabilizing a rigid and underdeveloped financial system than raising China's tech game.

Let's explore where Made in China 2025 is 10 years on and, more pointedly, where it's not. Spoiler: The Xi juggernaut remains far more an aspiration for the global domination of Chinese innovation than a reality.

In May 2015, Xi's Communist Party unveiled a new industrial policy to move beyond China's "world's factory" phase into high-value-added manufacturing on route to becoming a tech powerhouse. It targeted key technologies of tomorrow all at once: aerospace, semiconductors, AI, renewable energy, batteries, EVs, biotechnology, green infrastructure, robotics, quantum computing, and self-driving vehicles. In 2020, Beijing pledged to spend

$1.4 trillion on 5G networks alone.

The nation's *quantum computing* capabilities, meanwhile, are rapidly transitioning from the laboratory to practical applications. At the Mobile World Congress in March, Chinese robotics companies that few had ever heard of before wowed the crowd. Hangzhou-based Unitree Robotics showcased its line of humanoid robots. Shanghai-based robotics *startup Agibot* has Japan Inc. icon Olympus Corp. looking over its shoulder.

The point here is that "China has the potential to replicate its disruptive impact from the EV industry in the humanoid space," Reyk Knuhtsen of SemiAnalysis, *told CNBC*. "However, this time the disruption could extend far beyond a single industry, potentially transforming the labor force itself."

Could Nvidia CEO Jensen Huang—who in March *declared* that "the age of generalist robotics is here"—be humbled again by a Chinese upstart? Elon Musk has been: The Warren Buffett-backed Chinese automaker BYD *overshot* Musk's Tesla in both sales and revenue terms last year.

BYD serves as a microcosm for a broader phenomenon. Though founder Wang Chuanfu launched *BYD auto division* in 2003, it wasn't until 2015 that he set a course for world market domination—with help from the Chinese government. Likewise, DeepSeek's *creation* in 2023 wouldn't have been possible without Beijing's financing programs, regulatory pivots, and leveling of local playing fields.

The risks to the US from China's targeted subsidization in pursuit of global market leadership are numerous and arguably growing even faster now that Trump's tariff-heavy economic strategy is apparent.

At a congressional hearing in early February, just two weeks into the Trump 2.0 era, Liza Tobin of Garnaut Global, *warned*: "We risk losing the next industrial revolution, which is unfolding as AI converges with physical industry to transform how things are made."

At the moment, Trump's America and Xi's China can make for quite a split screen. On one, China, for all its flaws, is investing in areas where it thinks the global economy is heading in 2035. On the other, Trump seems to be bent on making America great by battling its challenges of 1985. His tariff policy rationale is ripped from the '80s, when a handful of industrialized nations held vast sway over global economic dynamics.

The bad news for Xi is how his top-down, power-obsessed government isn't exactly creating the Darwinian global economy that the Party seems to think it is. By prioritizing control over change and championing the state sector over private-sector development, Xi has created a bifurcated economic system.

It's one that tolerates disruption in certain strategic sectors that advance the ruling party's agenda—EVs, AI, and renewable energy—but squashes innovative disruption in others. Ask Alibaba's Jack Ma, China's most globally famous tech founder, how the last five years have gone for him. Ma's sin: *chiding Xi's regulators* in 2020 for stifling innovation—that and trying to take public his *Ant Group* fintech startup, which would've threatened the state-owned banking giants.

Add to that picture the backdrop of a shaky underlying financial system. The cracks in China's "old economy," until repaired, will undermine the potential of the "new" one that Made in China 2025 seeks to build.

China excels at slogans and spin. Hence, the splashy effort to frame its push to encourage "new quality productive forces" as some Silicon Valley killer that boosts productivity growth across sectors.

"But these sectors alone cannot compensate for weaknesses in other industries," write Rhodium Group economists in a May 5 *report*. "More fundamentally, the only way for China's economic growth to exceed growth in the rest of the world while pursuing an export-led development strategy would be to grab additional export market share, risking even more serious trade defenses in response. … Beijing's emphasis on industrial policy has also contributed to a stall in broader economic reforms, straining relations with key trading partners."

Unless Xi throttles back on the ginormous state subsidies that these policies entail, two woeful outcomes may transpire: Posterity might recall last weekend's talks in Geneva as a nice dining experience between trade negotiators that did nothing to alter either country's most important trade relationship. And China's days of 5% annual GDP growth could soon be over.

Calendars

US: Tues: Headline & Core CPI 0.3%m/m, 2.3%y/y & 0.3%m/m, 2.8%y/y; NFIB Small

Business Optimism Index 95.0. **Wed:** MBA Mortgage Applications; OPEC Monthly Market Report; Daly; Waller; Jefferson. (FXStreet estimates)

Global: Tues: Germany ZEW Economic Sentiment 9.8; UK Average Hourly Earnings Index Plus Bonus 5.2%; UK Claimant Count 22.3k; UK Unemployment Rate 4.5%; Japan PPI 0.2%m/m, 4.0%y/y; ECOFIN Meetings; Pill; Balz; Bailey. **Wed:** Germany CPI 0.4%m/m, 2.1%y/y; Spain CPI 0.6%m/m, 2.2%y/y; Cipollone; Nagel; Escriva; Breeden. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the May 9 week, the SMidCap's forward earnings dropped for a fifth straight week, but LargeCap's earnings rose for a second straight week. LargeCap's forward earnings rose 0.2% w/w to 0.5% below its record high during the April 4 week. MidCap's posted its biggest decline in 31 months, tumbling 1.4% w/w to 2.8% below its record high, also during the April 4 week. SmallCap's fell 0.5% w/w to 14.4% below its June 2022 record. LargeCap's forward earnings is still up 23.0% from its 54-week low during the week of February 1, 2023; MidCap's is just 6.1% above its 55-week low during the week of March 10, 2023; but SmallCap's is now the lowest since October 2021 (a 42-month low). 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%, 13.6%), MidCap (0.4, 4.2, 17.0), and SmallCap (-10.2, 3.8, 18.8).

S&P 500/400/600 Valuation (*link*): VValuations rose to four-week highs last week for all three of these indexes. LargeCap's forward P/E fell 0.1pt w/w to 20.4. It's now 1.9pts below its 43-month high of 22.3 during the December 6 week and 3.4pts 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 0.3pt w/w to 15.1. It's now 2.0pts below its 40-month high of 17.1 during the November 29 week and 2.9pts 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 0.1pt w/w to 14.4 and is just 1.5pt above its 17-month low of 12.9 during the April 4 week. It's now 2.7pts below its 41-month high of 17.1 during the November 29 week and 3.3pts 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 26% discount to LargeCap's P/E, up from a 28% discount a week earlier and 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 29% discount to LargeCap's P/E, up from a nine-month-low 31% discount a week earlier. That compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 5ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E was dropped to a 5% 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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