May 20, 2025

Morning Briefing

On China & Euro

Check out the accompanying chart collection.

Executive Summary: Intractable demographic problems are straining China's economic system and thwarting policymakers' attempts to battle deflation. Rapidly declining birthrates are providing fewer new consumers, and elderly Chinese are savers, not spenders. Amid these pressures, falling prices "take on a life of their own," William reports. No wonder China's annual GDP growth is projected to slow to 2% by the 2030s. … Also: A look at the complicated issue of China's fentanyl trade—including reasons China isn't keen on stopping it. … And: The dollar's recent weakness has revived predictions that the euro might usurp it as reserve currency to the world. But "King Dollar" remains hard to dethrone.

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

China I: Demographics Entrench Deflation. For a decade now, economists have been theorizing about how China's aging and shrinking population might affect its economic growth potential (*Fig. 1* and *Fig. 2*). Yet there's nothing conjectural about the ways demographics are now exacerbating the nation's deflation troubles.

As Japan's experience since the 1990s has highlighted, few Asians in their mid-60s and higher consume with gusto as twenty- and thirty-somethings do. They tend to buy fewer houses, cars, and appliances; to upgrade technology less frequently; and to splurge less on luxury dining and travel.

Let's explore how China's demographic trends are stacking the deck against policymakers as they battle deflation:

(1) *China's population drop is secular*. In 2024, the nation's population shrank for a third year, *falling* by 1.39 million y/y to 1.408 billion—an unprecedented trajectory since the country's founding in 1949. And pressures on the economic system come from both ends of the lifecycle: Elderly Chinese are living longer, straining their pensions, and the birthrate is falling, providing fewer new consumers.

The number of births has been *below 10 million* since 2022 (*Fig. 3*). The United Nations estimates that China's population will halve to 633 million by the end of the century. Over the next decade, China could lose the equivalent of South Korea's entire population—*50 million-plus*—according to Bloomberg Intelligence.

(2) *History catches up*. As economic own-goals go, Mao Zedong's draconian "*one-child policy*" is in a category of its own. At the end of the Cultural Revolution, in 1979, Mao's Communist Party worried that a rapidly growing population would be impossible to feed. Reducing birth rates became a national priority, executed with elaborate measures. By the time President Xi Jinping ended the policy in *2016*, it was too late: A policy that dictated the social order for generations has proven hard to overcome.

Today, Chinese households cite *rising living costs* and career uncertainty for why they're having fewer babies. Such concerns have younger mainlanders delaying marriage or eschewing it altogether.

A shrinking workforce is thwarting Xi's efforts to boost domestic demand. Since he took over 2012, China's working-age population—aged 16 to 59—*has been declining* (*Fig. 4*). It dropped by nearly 7 million last year to 858 million, *according to* the Bank of Finland.

(3) *It's all connected.* All this feeds into China's 3Ds problem: deflation, debt, and demographics. Falling prices that take on a life of their own, local governments facing multi-trillion dollar debt burdens, and a fast-aging population each are challenging enough. China's need to tackle them simultaneously explains why many see China growing *around 2%* at best by the 2030s.

Alicia García Herrero of investment bank Natixis warns China will "feel these effects more significantly after 2035," when the economic boost of urbanization ends.

(4) *So many men*. China's worsening sex ratio imbalance is another problem for population growth. A Mao-era side effect is a preference for having boys over girls. Because China lacks social safety nets, elderly parents move in with one of their sons' families. Having girls is likened to "watering your neighbor's garden" since wives end up caring for in-laws. In 2024, China's gender imbalance reached at least *104 men* to every 100 women.

China is already plagued by high youth unemployment. The social instability risks of whole generations of lonely young men are obvious enough.

All this means that falling prices risk deflating far more than just next year's GDP.

China II: Costly Fentanyl Addiction. If any economy understands the role of narcotics in driving geopolitics, it's China. The ways in which Britain went to war in the 19th century with what's now Asia's biggest economy are legion. For commercial gain, the British Empire flooded China with opium, a period recalled as the start of a "*Century of Humiliation*."

Xi Jinping hasn't been shy about referencing that period of national trauma to justify his push to restore China's place on the world stage. Might China finally be getting its revenge on the West by way of fentanyl?

Few Washington-Beijing issues are more contentious. Like the Biden administration before him, President Trump's team has confronted Xi's inner circle early and often over China's role in the estimated *80,391 people* in the US killed by the synthetic opioid in 2024.

Trump has gone further, making reduced illicit fentanyl shipments a key precondition for ending his China tariff, currently *at 30%*. The good news is that last year saw a nearly *27% drop* in US fentanyl fatalities last year. The bad news: Synthetic opioids, fentanyl mostly, continue to be involved in most overdose deaths.

It begs the question: Why does China continue to tolerate the thriving fentanyl trade given that the damage to its global standing outweighs the profit motive? The short answer: It's complicated, and wildly so.

Let's explore why:

(1) *China's says US is overreacting*. It's a truly globalized industry, Beijing claims—especially considering the central role played by Mexican drug cartels that synthesize the chemical precursors sourced from China and smuggle them into American cities. The US, Beijing counters, should do less "scapegoating" and work to limit booming demand at home.

(2) *It's a geopolitical tool*. China sees fentanyl as a tool to be wielded in negotiations. It's a trap into which the Brookings Institution's Vanda Felbab-Brown worries Washington has already fallen. As simplistic as it sounds, Beijing thinks it benefits from the fentanyl crisis because the crisis weakens and polarizes the US.

(3) *It's super-complicated*. The real reason that China is finding the fentanyl game nearly impossible to foil might be that its many moving parts prove all too nimble at circumventing

new countermeasures.

Policies to boost China's pharmaceutical industry, now the globe's second biggest, created a cottage industry of hundreds of thousands of small chemical plants. Along the way, a sprawling money-laundering industry thrives off the opacity inherent to China's banking system, savvy at using mobile phone apps and active in cryptocurrencies. Zongyuan Zoe Liu at the Council on Foreign Relations has called the fentanyl boom a study in how "regulatory effects can have unintended consequences."

Unfortunately, fentanyl could be China's Inc.'s most innovative sector. Trying to halt its production at its many sources is like playing a deadly game of Whac-A-Mole.

To further complicate the issue, Chinese provinces, desperate to create new jobs, ferociously woo pharmaceutical companies to build factories—often at the expense of Beijing's directives. This is yet another unintended side effect of China's deflation troubles.

Europe: Reserve-Currency Hopes Pinned on Euro. At the turn of this century, Europe launched a currency that many saw as destined to rival the dollar. Things didn't turn out that way. The euro's *20% weighting* in foreign exchange reserves has barely changed since 1999.

Until now, perhaps. With President Trump's trade war and unpredictability eroding trust in the dollar, the euro is on a bull run—*up 8.7%* so far this year. Moody's Investors Service's recent revoking of Washington's last AAA rating has further strengthened the euro's case for top safe-haven status.

The question is whether we're seeing a short-term rebalancing of dollar-heavy portfolios or the sharp pivot away from the US currency. At least for now, it's likely more the former than the latter.

Let's see consider why the euro is rising, then why it still faces headwinds:

(1) *The euro is having a moment*. This was true pre-Trump 2.0. By the third quarter of 2024, as the US national debt topped *$36 trillion*, the dollar's share of reserves was a *30-year low of 57.8%*. The International Monetary Fund says this marks a nearly *9-percentage-point drop* in just the last decade. Since January 20, though, euro bets have increased markedly.

(2) *The Trump factor*. Trump's penchant for retaliation worries the financial markets,

especially threats to fire Federal Reserve Chair Jerome Powell. There's also great optimism over fiscal-hawk Germany's "*debt brake*" reform. In March, the Parliament altered borrowing limits spelled out in the constitution. The specter of the Eurozone's top economy issuing 1 trillion euros of debt in short order is creating big buzz for the euro.

Count German Finance Minister *Joerg Kukies* and European Central Bank (ECB) President Christie Lagarde among those arguing that the Trumpian trauma spooking the globe is an opportunity for Europe.

(3) *Structural impediments*. One impediment is the role of the ECB, which succeeded in calming the financial markets amid the region's 2010-11 *debt crisis* and during Covid-19. While it's been more activist than the Bundesbank of old, after which the ECB was modeled, being a reliable lender of last resort is not in the ECB's DNA.

National lines divide Europe's overlapping banking systems. Capital markets are too small and fragmented to handle giant waves of safe-haven investment either washing in or receding as suddenly. Years of slow-walking a fiscal union or capital-market union continue to be the US market's gain. The same goes for the slow pace of devising a deep, single bond market for issuers with reliable liquidity.

(4) *Reforms needed*. The Eurozone has resisted calls for a clearer fiscal union. It has yet to harmonize business regulations and bankruptcy laws. Also, tensions remain among *higher debt nations* like France and Italy and fiscal conservatives Germany and the Netherlands.

The Eurozone is proving that it's getting its act together, while the US is dividing its allies. Still, "King Dollar" remains hard to dethrone, even as Trump's unpredictability has investors tempted to give the euro a try.

Calendars

US: Tues: Daly; Barkin; Bostic; Collins; Kugler; Hammack. **Wed:** MBA Mortgage Applications. (FXStreet estimates)

Global: Tues: Eurozone PPI -0.3%; Eurozone Consumer Confidence Flash -16; G7 Meeting; PBoC Interest Rate Decision 3.0%; RBA Interest Rate Decision 3.85%; Canada CPI 0.2%m/m, 1.6%y/y. **Wed:** UK Headline & Core CPI 3.3% & 3.6%y/y; Japan Core Machinery Orders -1.6%m/m, -2.2%y/y; ECB Financial Stability Review; Lane; Balz.

(FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the May 16 week, LargeCap's forward earnings fell after rising for two straight weeks, MidCap's dropped for a sixth straight week, and SmallCap's edged up a hair for the first time in six weeks. LargeCap's forward earnings dropped less than 0.1% w/w to 0.5% below its record high during the April 4 week. MidCap's declined 0.4% w/w to 3.2% below its record high, also during the April 4 week. SmallCap's remained steady w/w at 14.4% below its June 2022 record. LargeCap's forward earnings is still up 22.9% from its 54-week low during the week of February 1, 2023; MidCap's is just 5.6% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and is near the lowest level 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%, 8.7%, 13.6%), MidCap (0.4, 3.4, 17.1), and SmallCap (-10.2, 3.8, 17.8).

S&P 500/400/600 Valuation (*link*): Valuations rose to 11-week highs during the May 16 week for the LargeCap and SmallCap indexes, and MidCap's touched a 13-week high. LargeCap's forward P/E rose the most w/w in nearly three years, jumping 1.1pts higher to 21.5. It's now 0.8pts below its 43-month high of 22.3 during the December 6 week and 4.5pts 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 the most since the election during the November 8 week, gaining 0.8pt w/w to 15.9. It's now 1.2pts below its 40-month high of 17.1 during the November 29 week and 3.7pts 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 also had its best weekly gain since the election, rising 0.7pt w/w to 15.1. It's now 2.2pts above its 17-month low of 12.9 during the April 4 week and 3.3pts above its 14-year low of 10.6 in September 2022, but remains 2.0pts below its 41-month high of 17.1 during the November 29 week. 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, 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 30% discount to LargeCap's P/E, up from a nine-month-low 31% discount during the May 2 week. 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 4ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is at a 5% discount to MidCap's, 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

Leading Indicators (*link*): "Most components of the index deteriorated. Notably, consumer's expectations have become continuously more pessimistic each month since January 2025, while the contribution of building permits and average working hours in manufacturing turned negative in April," noted Justyna Zabinska-La Monica, senior manager of business cycle indicators at the Conference Board. She went on to say, "Widespread weaknesses were also present when looking at six-month trends among the LEI's components, resulting in a warning signal for growth." *Leading economic indicators (LEI)* fell for the fifth successive month in April, by 1.0% m/m and 2.3% over the period, posting its largest monthly decline since March 2023. The *LEI* has plunged 16.3% since December 2021's record high. The Conference Board notes that while the six-month growth rate fell deeper into negative territory, it didn't trigger the recession signal. In April, seven of the 10 components of the LEI contributed negatively, while only three contributed positively, though barely. The *biggest drags on the LEI* were consumer expectations for business conditions (-0.33pts), stock prices (-0.24), and ISM new orders index (-0.17), followed by building permits (-0.14), average weekly hours (-0.12), initial claims (-0.03) and the interest rate spread (-0.01). *Only three components contributed positively*, manufacturers' new orders for nondefense capital goods ex aircraft (+0.03), leading credit index (+0.02), and manufacturers' new orders for consumer goods & materials (+0.01).

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index rose for the fifth time in six months to yet another new record high, climbing 0.1% in April and 1.1% over the period. Three of the four components of April's CEI—personal income less transfer payments (+0.3%), manufacturing & trade sales (+0.2), and payroll employment (+0.1)—once again were positive contributors, while industrial production was flat during the month.

Global Economic Indicators

Eurozone CPI (*link*): The *Eurozone's CPI* was unchanged at 2.2% y/y in April, after slowing from 2.5% in January to 2.2% in March. It was at 1.7% last September—which was the lowest yearly rate since April 2021. Meanwhile, the core rate accelerated 2.7% last month after slowing the prior two months to 2.4%—the lowest since January 2022—after a string of 2.7% increases from September through January. The headline and core CPIs are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. *Looking at the components*, the *services* rate rose 4.0% y/y in April, after easing from 4.0% at the end of last year to 3.5% in March. The rate for *energy* prices fell deeper into negative territory in April (-3.6% y/y), after turning negative in March (-1.0); it had climbed from a recent low of -6.1% last September to 1.9% by January. Meanwhile, the rate for *food, alcohol & tobacco* accelerated for the third month to 3.0% in April, after easing from 2.9% in October to 2.3% at the start of this year. The rate for *non-energy industrial goods* held at 0.6% again in April, fluctuating in a narrow band between 0.5% and 0.6% since last October. Among the four *largest Eurozone countries*, April's yearly inflation rates were unchanged in both France and Spain, at 0.9% and 2.2%, respectively, while rates in both Germany (2.2 from 2.3) and Italy (2.0 from 2.1) ticked down.

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