June 6, 2025

# Morning Briefing

## China's Currency & Japan's Stocks

*Check out the accompanying chart collection.*

**Executive Summary:** Trump's Tariff Turmoil has undermined the US's credit worthiness and unsteadied the dollar. For countries harboring currency-dominance aspirations, that's been a blessing in disguise. Today, William explains why China's aspirations for the yuan won't bear fruit anytime soon. … Also: The opportunity China is jumping on to recast itself as the world's protector of globalization. … And: Japan's stock market has been on a tear for the past decade. But whether spreading cracks in its foundation suggest overvaluation is a legitimate concern. Japan faces a stagflationary economic outlook, reform initiatives going nowhere, corporations struggling to reinvent themselves, anemic demand for Japanese bonds, and BOJ tightening plans now in limbo.

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**Chinese Currency: Ready To Rival Dollar?** As US President Donald Trump's sledgehammer approach to global trade undermines the dollar, China senses a unique opening to sell the yuan as a ready alternative.

So-called "yuan internationalization" has been a top Beijing priority during the Xi Jinping era. The push began *in 2016*, when the yuan secured a place in the International Monetary Fund's (IMF) "special drawing rights" basket. For developing China, scoring access to the reserve-currency club along with the dollar, euro, yen, and pound was momentous indeed.

Winning broad acceptance of the yuan, though, has been a real slog. Today, by IMF figures, the yuan accounts for *just 2.2%* of global foreign exchange reserves, a rounding error compared to the dollar's *nearly 58%* share and the *euro's 20%* (*Fig. 1*). Transaction network SWIFT says that, as of April, the yuan is involved in 3.5% of *global payments*. This *puts it fifth* among leading currencies.

Chinese officials think Trump's Tariff Turmoil of the last four-plus months could be a game changer. While the US turns inward with protectionist policies the likes of which have not been seen in *125 years*, China is stepping up efforts to elevate the international profile of the yuan.

How likely is it that the yuan will dislodge the dollar? Not very in the short run, but Washington takes for granted that the yuan will never rival the dollar at its own peril.

Let's look at what's standing in the yuan's immediate way:

(1) *Structural impediments abound*. One roadblock is that the Communist Party still prioritizes control over financial modernization. The yuan isn't fully convertible. The very lowest common denominator of reserve-currency status is that investors are able to move capital freely and instantaneously. Capital controls make the yuan an impractical currency for use by those who value liquidity most—from central banks to hedge funds.

"So far, China, with its closed capital account and politically uncertain investment climate, hasn't been able to significantly increase international use of its currency," notes Martin Mühleisen, an economist at the Atlantic Council.

Nor are China's opaque capital markets ready for international prime time. The Mainland's reliance on indirect financing, bank loans mostly, remains high (*Fig. 2*). China's futures and derivatives markets are works in progress, as are its hedging tools. The investor base in China is dominated by individual investors, who are less sophisticated than the institutional investors that move Western markets.

China also fails to clear the "*impossible trinity*" bar set by economists John Marcus Fleming and Robert Mundell in the 1960s: A truly world-class economy must simultaneously boast a stable currency, unfettered capital flows, and independent monetary policy.

(2) *China's trilemma.* Take the People's Bank of China (PBOC). Ostensibly, Governor Pan Gongsheng runs the central bank. But the PBOC has no autonomy over monetary policy calls or macroprudential tweaks. If Pan wants to cut the one-year loan rate, now 3%, it must be cleared with Team Xi, which cares more about political sensitivities than economic realities.

The effort to let market forces play a more "*decisive role*" in Beijing decision-making has Xi's men letting the yuan edge higher (*Fig. 3*). But market forces won't be able to do so with the other two constraints remaining in place.

China's reluctance to scrap capital controls smacks of fear. It limits which foreign financial institutions can do direct business in China. Team Xi worries that financially repressed households sitting on *$20 trillion of savings* might scramble to move cash abroad into more dynamic markets. A capital flight on that scale would challenge the yuan peg as never before.

(3) *Economic cracks abound*. Then there's China's underlying fundamentals. A property crisis that's *generating deflation* and "Japanification" talk are threats enough (*Fig. 4*). But China is also grappling with *high youth unemployment*, a fast-aging population, and local governments *burdened* by trillions of dollars in debt. The nation is plagued by weak consumer demand too, as households save considerably more than they consume owing to the lack of social safety nets (*Fig. 5*).

**Chinese Currency II: Trump Makes Beijing's Case.** Yet Trump needn't make things so easy for China. His erratic foreign policy, retreat from international institutions, and trade broadsides against friend and foe alike are doing irreparable damage to Washington's credibility. His tariffs and chaotic policy style have destabilized the US Treasury market. This turmoil contributed to last month's move by Moody's Investors Service to revoke Washington's longstanding AAA credit rating.

Late last month, Deutsche Bank's George Saravelos warned that a "*dollar fiscal frown*" dynamic could trigger "a combined drop in US bonds and the dollar."

Other nations now are jockeying for advantage on the global trade playing field that Trump has upheaved. China, for example, has been trying to position itself as the protector of globalization and rules-based trade. In January, Xi addressed the crowd at Davos for the very first time, comparing protectionism to "locking oneself in a dark room," keeping out "light and air." Let's take a look:

(1) *Beijing makes its move.* As Trump shocks global markets on a daily basis, China has been able to position itself as a stable protector of globalization and rules-based trade—in ways both splashy and quiet.

For example, China is stepping up efforts to leverage the $6 trillion of foreign trade across more than 150 countries (*Fig. 6*). It's working behind the scenes to promote yuan settlement in exports, energy, infrastructure, and other key sectors. It's doing so via a multi-pronged strategy, including its SWIFT-rival Cross-Border Interbank Payment System (a.k.a. CIPS). This growing network of offshore yuan clearing institutions and currency-swap agreements eats away at reliance on the dollar in subterranean ways that Washington might miss.

(2) *De-dollarization isn't going away.* Brazil, a top US trading partner, is now settling bilateral Chinese trade in yuan. It's emblematic of the de-dollarization dynamic sweeping across the BRICS nations. These days, it's not just Brazil, Russia, India, and South Africa mulling dollar alternatives. It's also Saudi Arabia, Egypt, the United Arab Emirates, and Iran—and the list will include the broader "Global South" if Trump World isn't careful.

Again, dollar dependence is a very hard habit to break. The US is still the pre-eminent economy, backed by the deepest capital markets and most powerful military. The "exorbitant privilege" that allows Washington to pay a gravity-defying yield of 4.4% on 10-year bonds remains, even as the national debt races toward $37 trillion and yet Trump pushes for new tax cuts and toys with the Fed's independence. Foreigners held a record $9.0 trillion in US Treasuries in March (Fig. 7).

Yet members of Xi's inner circle probably can't believe their luck to see a US leader do so much so fast to amplify China's argument that the dollar's days might be numbered. It's quite the irony that Trump is making the odds of yuan internationalization great again.

**Japanese Stocks I: Economic Cracks Spread.** As Japan's bond market goes haywire, fresh questions are being asked about whether Tokyo stocks are trading at valuations too lofty relative to the risks (Fig. 8).

The Nikkei 225 Stock Average has been on a decade-long tear for three reasons: 1) ultra-aggressive monetary policies beginning in 2013 sent the yen lower and corporate profits higher; 2) legislative steps were taken in 2014 and 2015 to strengthen corporate governance, diversify boardrooms, and give shareholders a louder voice; and 3) Japanese markets became a post-Covid safe haven: A sleepy bond market, predictable politics, and unlimited quantitative easing returned Japan to its 1980s glory—with an assist from Warren Buffett's first-ever Japanese stakes in 2020 (Fig. 9).

The '80s indeed were back in one sense: In July 2024, the Nikkei surpassed its 1989 intraday high of 38,957 to hit 42,438. The index ended the year north of 40,000—only to face a Trump-triggered reckoning.

Like many major equity markets, Tokyo's April was a month of financial bedlam as US tariffs provoked one of history's greatest "risk off" trades.

Japanese officials have been shocked by the extent to which President Trump's tariffs came for their economy, too. Japan *shrank 0.7%* y/y during Q1, even before the worst of Trump's Tariff Turmoil (TTT) hit (*Fig. 10*). The current quarter could see Japan slip deeper into the red, and with fewer-than-usual escape hatches.

Even before Trump 2.0, the Bank of Japan was in the midst of a two-year effort to normalize a rate environment that's been at, or near, zero since 1999. In January, BOJ Governor Kazuo Ueda thought it was safe to raise rates to a *17-year high of 0.5%* and to taper a balance sheet bigger than Japan's *$4.2 trillion* economy (*Fig. 11*).

Those plans are now in flux as the Bond Vigilantes stalk Tokyo's debt auctions. A May 20 sale of *20-year bonds* drew the weakest demand since 2012. Roughly a week later, a sale of *40-year bonds* was a dud, too, adding pressure on Tokyo to reduce issuance of longer-dated securities.

**Japanese Stocks II: Changing Calculus for Valuations.** There are valid reasons to worry that Japan's underlying fundamentals aren't keeping pace with investors' optimism toward Japan Inc.

Granted, the Japan MSCI forward P/E ratio, at 14.2, is lower than the US MSCI forward P/E of 21.7 as of Friday's close (*Fig. 12*). Yet Japanese stock valuations have been warped for a decade by the BOJ's aggressive stock purchases via exchange-traded funds. The BOJ started buying ETFs in 2010 to stimulate the economy, but turbocharged purchases after 2013. Now, as the BOJ tries to exit its roughly 80% share of the ETF market—*¥37 trillion yen* ($257 billion)—the Nikkei is losing its biggest benefactor, forcing the market to stand on its own (*Fig. 13*).

Inflation is racing far ahead of Japanese growth. Core consumer prices rose *3.6% y/y* in May, nearly twice the BOJ's 2.0% target (*Fig. 14*). This makes Japan a far more likely candidate for stagflation than the US economy.

(1) *It's the politics, stupid.* The power vacuum of the last decade is catching up with the markets. It's been 4,542 days since the Liberal Democratic Party returned to power on December 26, 2012 under the leadership of then-Prime Minister Shinzo Abe. That should have been enough time to reduce bureaucracy, rekindle innovation, and catalyze a startup boom, as "Abenomics" said it would.

Meanwhile, 149 months should've been ample time to devise a more meritocratic labor market, increase productivity, empower women, and put out the welcome mat for top global talent. It should've been enough time to address an aging-population conundrum that's limiting potential growth. In 2024, the number of bankruptcies caused by labor shortages *rose 32%* y/y, says research firm Teikoku Databank.

(2) *Credit where it's due*. No doubt, Japan's effort to raise its corporate game gained real traction. It prodded Japan Inc. to increase transparency on governance structures, increase accountability among top executives, appoint more independent directors on boards, and become more accessible to shareholders.

Later this month, as companies hold their annual general meetings, notes Hidenori Yoshikawa at the Daiwa Institute of Research, the pace at which shareholder proposals are stacking up "is faster, and the number of proposals for the year may exceed the record high."

(3) *More talk than action.* Yet there's been no real effort in recent years to buttress the 2013-14 reforms. Amid all the talk of change, Japan Inc. too often hasn't been walking the walk on epochal change. Nicholas Smith at CLSA Japan notes that 1,674 Japanese companies are due to hold shareholders' meetings over a period of just four days—25% of the meetings are on a single day, and 83% of them take place during a single week. "The aim is to make it difficult for their owners to attend," Smith explains.

Granted, this is an improvement over years past. But it's well out of sync with global norms.

(4) *A bubble in buybacks?* Some worry, too, that companies are using stock buybacks, a relatively new phenomenon in Japan, to deflect attention from their limited success in increasing innovation and restructuring. The worriers include Prime Minister Shigeru Ishiba's government, which is urging corporate chieftains to devise better ways to use money—particularly investing in R&D—than buying back their own companies' shares.

Mizuho Securities' Masatoshi Kikuchi says it's likely an attempt to prod private firms to spend more on semiconductors and other areas to boost Japanese competitiveness—or, as Kikuchi tells Bloomberg, to "revive its industry policies."

(5) *Animal spirits needed.* The magnitude of Japan Inc.'s task can be seen in the recently announced layoffs by *Nissan Motor* (20,000 workers) and *Panasonic* (10,000). In Nissan's case, the problem isn't just an aging fleet of models or spending more time searching for a

financial savior than restructuring. It's China's BYD, whose electric vehicles are lapping Nissan's.

This situation is a microcosm of how the last 10-plus years of turbocharged BOJ easing and a weak yen deadened Japan's Inc.'s animal spirits.

Japan boasts a bevy of innovative corporate standouts working to reinvent themselves, including SoftBank, Toyota, Denso, Hitachi, Sony, Toshiba, Fast Retailing, Nintendo, and Fujifilm. But stagflation poses more of a disruptive threat to the operating environment than CEOs or government officials do, and cracks in the foundation of the equity market may spread as bond yields and the yen surge. At that point, Japanese stocks could get the cold shoulder.

## Calendars

**US: Tues:** JOLTS Job Openings; Factory Orders -3.1%; Total Vehicle Sales 16.3mu; Goolsbee; Logan. **Wed:** ADP Employment Change 115k; MBA Mortgage Applications; Beige Book; Cook; Bostic. (FXStreet estimates)

**Global: Tues:** Eurozone Headline & Core CPI 2.1% & 2.5%y/y; Eurozone Unemployment Rate 6.2%; Italy Unemployment Rate 6.1%; China Caixin M-PMI 50.6. **Wed:** Eurozone, Germany & France C-PMIs 49.5, 48.6 & 48.0; Eurozone, Germany & France NM-PMIs 48.9, 47.2 & 47.4; UK C-PMI & NM-PMI 49.4 & 50.2; China Caixin NM-PMI 51.1; Lagarde. (FXStreet estimates)

## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): During the May 30 week, forward earnings rose simultaneously for all three of these indexes for the first time in eight weeks. LargeCap's forward earnings rose for a fourth time in five weeks, and SmallCap's and MidCap's both rose for the second time in eight weeks. LargeCap's forward earnings rose 0.3% w/w to 0.1% below its record high during the April 4 week. MidCap's gained 0.1% w/w to 3.0% below its record high, also during the April 4 week. SmallCap's rose 0.1% w/w to 14.6% below its June 2022 record. LargeCap's forward earnings is up 23.4% from its 54-week low during the week of February 1, 2023; MidCap's is just 5.9% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and remains 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%, 8.6%, 13.6%), MidCap (0.4, 2.9, 17.2), and SmallCap (-10.2, 2.6, 18.6).

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## US Economic Indicators

**US Manufacturing PMI** (*link*): The ISM M-PMI contracted for the third straight month in May after expanding the first two months of the year. May's *M-PMI* fell steadily from 50.9 in January to a six-month low of 48.5 in May. It was at a recent low of 46.9 in October—which was the lowest level since December 2023. According to ISM, the *overall economy* continued its expansion for the 61st month after a one-month contraction in April 2020. (A manufacturing PMI above 42.5 over a period of time generally indicates an expansion of the overall economy.) *New orders* (to 47.6 from 47.2) contracted for the fourth successive month, following three straight months of expansion, though May's measure showed it fell at a slightly slower pace than April's. The *production* (45.4 from 44.0) gauge contracted for the third month, following two months of expansion, though May's reading was above April's, which was the lowest since May 2020. Prior to January's 52.5 reading, the production measure was in contraction territory, below 50.0, for eight straight months. Companies liquidated *inventories* (46.7 from 50.8) last month, while *suppliers' deliveries* (56.1 from

55.2) continued to show a slowing in deliveries (a reading above 50 indicates slower deliveries). The employment (46.8 from 46.5) measure continued to show jobs cuts, though the index ticked up slightly. Meanwhile, *prices* (69.4 to 69.8) remain in expansion (or increasing) territory.

**Construction Spending** (*link*): Construction spending unexpectedly fell again in April, as higher borrowing costs, increasing input prices due to import tariffs, and growing inventories impeded building. *Total construction* spending dropped 0.4% in April, versus the consensus estimate of a 0.3% gain, following March's decline of 0.8%—first reported as a 0.5% loss. *Private construction* investment fell 0.7%, with both residential (-0.9%) and nonresidential (-0.5) investment reporting declines again. The decrease in residential construction in April was led by a 1.1% drop in single-family building, with multi-family construction ticking down 0.1%. The shortfall in nonresidential construction was led by declines in religious (-2.6), commercial (-1.0), power (-0.7), lodging (-0.6), and manufacturing (-0.6) building. *Versus a year ago*, total construction spending was 0.5% below a year ago, with private construction investment down 2.2%, reflecting a decline in residential (-4.8) residential investment, while nonresidential (1.0) investment was above year-ago levels. Meanwhile, public construction building edged up 0.4% in April, led by nonresidential investment, with commercial (3.8), health care (3.3), and office (1.2) construction leading gains. Public construction investment was 5.5% above a year ago.

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