Yardeni Research

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Morning Briefing

Japan's Rough Road,
China's Silk Road

Check out the accompanying chart collection.

Executive Summary: Fear of Trump's tariff impacts has already sapped the life out of Japan's consumer sector, raising the specter of stagflation and thwarting the Bank of Japan's tightening plans. If BOJ Governor Ueda fails to navigate the economy away from the shoals, he won't be the first BOJ head set rolling by the Tokyo political establishment. William takes a look at his conundrum. … Also: China is taking full advantage of what it didn't wish for, i.e., Trump's Tariff Turmoil. As heavily tariffed Southeast Asian nations disengage from the US, China has begun framing its Belt and Road initiative—designed to unify the region and expand China's power—as an alternative to US dependence.

YRI Weekly Webcast. Dr Ed is on vacation this week. He will be back for next Monday's webinar on June 23 at 11 a.m., EST. Replays of the weekly webcasts are available *here*.

Bank of Japan I: Tokyo's Rough Road in 2025. Any list of central bank chiefs who can't wait for 2025 to end would be a long one, with the Bank of Japan (BOJ)'s Kazuo Ueda right at the top. Yet Governor Ueda likely began the year pumped.

Back in January, the BOJ was well on track to exit Tokyo's deflationary era policy framework. That month, the BOJ hiked its benchmark interest rate from 0.25% to a *17-year high of 0.50%* (*Fig. 1*). Team Ueda also was reducing its ginormous government bond-buying program by *$2.8 billion each quarter* (*Fig. 2*).It was trimming its *80% share* of the exchange-traded-funds market.

Then came US President Donald Trump's trade war. The BOJ's January rate hike came the same week President Trump returned to the White House for a second time. Like most policymakers in Asia, the BOJ and the Ministry of Finance figured that Trump's threatened trade war might mean 10% tariffs here and there, but not much more.

Now the harsh reality of Trump's Tariff Turmoil (TTT) is hitting Japan even harder than it is

China, the real target of Trump's ire. This has the BOJ shelving its rate-hike cycle, which it will confirm by standing pat at this week's two-day monetary policy meeting.

Let's have a closer look at the economic escape room the BOJ finds itself trapped in:

(1) *Tariff pain galore*. Expectations for the tariff onslaught to come have chilled business and household spending enough to push Japan's Q1 GDP into the red, *contracting 0.2% y/y* (*Fig. 3*).

Q2 will likely see an even bigger drop. Trump's *30% China tariff* (down from 145%, but still prohibitively high) is disastrous for Japan. Many top companies—including Olympus, Panasonic, Sony, and Toshiba—sell parts that China Inc. uses to power its manufacturing industry. Japan also is grappling with a *25% auto tariff*, *50% tariff on steel* and aluminum, and a *24% "reciprocal" tariff* if Prime Minister Shigeru Ishiba doesn't offer loads of concessions in trade-deal talks.

Add to that Japan's *3.6% consumer price inflation rate* (*Fig. 4*). Until recently, taming upward price pressures topped Ueda's agenda. Now, stagflation risks abound. Ueda is caught between the BOJ's price-stability agenda and not wanting to be blamed for tipping Japan back into recession. This fear will be front and center at the BOJ's *June 16-17 meeting*.

(2) *Tightening cycle interrupted*. After all, if 2025 had gone according to plan, Ueda's board would be raising rates to 0.75% or even 1.00% this week and ending quantitative easing (QE) once and for all, while withdrawing *hundreds of billions* of dollars from the stock market.

Instead, Ueda is expected to hold rates steady this week despite an inflation rate nearly twice the BOJ's *2.0% y/y target*.

Bank of Japan II: Avoiding Blame. The blame game is actively played in BOJ leadership circles. It's the Tokyo political establishment's *modus operandi* to prod the BOJ into easing aggressively, then blame the central bank when things go bad.

In the late 1980s, at the end of Japan's "bubble economy" era, BOJ Governor *Satoshi Sumita* took the fall for years of corporate excess. His successor, *Yasushi Mieno*, was derided as *Japan's Paul Volcker* for tightening too much. Years later, it was *Toshihiko Fukui*'s turn in the political woodchipper.

Ueda's current predicament is all the more hellish given that it's not the first time a BOJ chief was excoriated for leading the economy astray with a monetary policy shift:

(1) *Lessons from the past*. Fukui is the one BOJ leader of the last 25 years who understands first-hand what Ueda is experiencing. By 2006, Fukui *ended the QE strategy* that the BOJ *pioneered in 2001*. He also was the first to step away from the zero-interest policy the BOJ implemented *in 1999*. In 2007, the Fukui-led BOJ managed to get rates up *to 0.5%*.

Then, the backlash: Fukui was blamed for the *recession* that followed, which was exacerbated by the global financial crisis of 2008. Once Fukui's successor *Masaaki Shirakawa* arrived at BOJ headquarters in 2008, his first course of action was to cut rates back to zero and restore QE.

(2) *Ueda's conundrum*. Is Ueda about to suffer the same fate? A *Reuters poll* of 60 BOJ watchers finds most think that Ueda won't hike rates again in 2025 and that the BOJ will throttle back on its quantitative tightening.

One big possible tweak: Instead of trimming bond purchases by *400 billion yen* ($2.8 billion) per quarter as planned when the year began, the BOJ may pivot to cuts of just half that, or 200 billion ($1.4 billion) every three months.

Perhaps that move is Ueda's best gambit at this point?

Bank of Japan III: The Trump Unknowns & Preexisting Knowns. There are two big risks to Japan's economic trajectory this year: 1) Trump's next round of tariffs, and 2) the myriad preexisting conditions that Japan carried into the trade war.

The first risk remains something of an imponderable. Trump's claims of a framework for a detente with China fueled hopes that "Tariff Man" had learned his lesson on imposing crushing import taxes. Not so much, it appears: Trump says he'll set *unilateral tariff rates* in the next week or two.

Ishiba's ability to avoid the worst of Trump's wrath is also an open question. Trump seemed to view Japan as easy prey, figuring that he could conclude a deal with Tokyo first. Yet Ishiba has proven to be a *worthier sparring partner* than Trump World imagined.

The other concern is the structural economic weaknesses that Japan carried into 2025:

(1) *Stratospheric debt.* One of those weaknesses is the largest debt burden among developed nations—a GDP ratio of *roughly 260%*. That leaves limited fiscal space for Ishiba's Liberal Democratic Party to increase spending to support growth, particularly after Moody's Investors Service revoked Washington's last AAA rating.

This limited fiscal space is a problem, as "Japan's economy lacks a driver of growth given weakness in exports and consumption," says Yoshiki Shinke at Dai-ichi Life Research Institute. "It's very vulnerable to shocks," particularly Trump tariffs.

(2) *Shrinking real wages.* Japan also suffered from weak wage growth before Trump 2.0 arrived. A year ago, Japanese unions scored their biggest hikes in 33 years in annual "shunto" negotiations—*5.58%*. Yet in real terms, wages actually fell in 2024 for a third consecutive year. If CEOs were reluctant to fatten paychecks in pre-trade war 2023 or 2024, they're likely to be even less inclined now.

Add tariff fears to the financial planning calculus of consumers whose incomes don't stretch as far as they used to, and it's no wonder that tariffs and tariff threats aren't damaging just exports and industrial production, according to a *report* by Stefan Angrick of Moody's Analytics, but household spending as well. As we see in the US, expectations for further wage gains drive today's spending decisions. In Japan's case, many consumers are deciding to retrench.

China's New Silk Road I: On Track. As Trump's policies derail trade relationships virtually everywhere, Xi Jinping's China is keeping one of its top economic strategies on track—literally.

The reference here is to the "Belt and Road Initiative" that Xi unveiled at the start of his presidency *in 2013*. It aimed to create a *new Silk Road* of trade routes linking China with the rest of the globe. Financing infrastructure development, Xi believed, would buttress China's "soft power" by way of economic "hardware" projects.

The "belt" refers to ancient overland trade networks linking Asia and Europe. The "road" part of this juggernaut involving *150 countries* includes building road and rail links, ports, and energy and digital infrastructure.

Consider the following:

(1) *Railways paying off*. A dozen years on, Xi's ambitious infrastructure blitz is having a

moment. Exhibit A: how China's big bet on railways alone is beginning to pay off.

Take Southeast Asia, which in recent years has leapfrogged over the US and European Union to become China's top market. More than a decade ago, Xi's inner circle targeted the 10 members of the Association of Southeast Asian Nations (ASEAN) for a boom on next-generation high-speed railway infrastructure.

In 2015, Xi's Communist Party turned heads with a deal with Indonesia, which *chose China* over bullet-train-pioneer Japan. The *88-mile route* linking Jakarta and Bandung has been an economic game-changer. That same year, China signed a *deal with Laos* for a 260-mile railway linking the capital city Vientiane and the border town Boten to create a direct route to China's Yunnan province. Both lines have opened since.

Then came China-loan-driven projects in Malaysia, Thailand, and Vietnam.

(2) *Good morning, Vietnam!* In February, when Vietnam raised its *GDP target* for 2025 to at least 8% y/y, it cited the multiplier effect from the *$8.3 billion rail project* to China. For an export-reliant economy keen on ramping up infrastructure investment to boost growth, this project is just the thing.

Contrast this dynamic with the cold shoulder ASEAN is getting from Trump World. Along with *30% tariffs* in China, Southeast Asia is grappling with the fallout from Trump's 50% tax on steel and aluminum and, in some cases, the threat of disproportionately high "reciprocal" tariffs.

China's New Silk Road II: Trump's Tariffs. *Trump hit* Cambodia with a 49% tariff on goods imported to the US, while Laos (48%), Vietnam (46%), Thailand (36%), and Indonesia (32%) were also slapped with higher levies than South Korea (25%) and Japan (24%). That was on "Liberation Day" April 2. On April 9, those tariffs were postponed for 90 days. Whether Trump will keep these levels or change them is still unclear, making it impossible for governments to devise growth policies.

China's Belt and Road project, a.k.a. its "new Silk Road," is about far more than infrastructure. Xi's vision was to develop a broad, interdependent market that China could harness to expand its political and economic power. Some view this as China's attempt to recreate the US's post-World War II Marshall Plan.

The enterprise also grew out of the 2008-09 global financial crisis. China, then under the leadership of Xi's predecessor, Hu Jintao, supported the economy with a *4 trillion yuan* ($558 billion) stimulus boom. It prioritized roads, bridges, airports, and especially railways.

Here's some background info:

(1) *Going global*. By the time Xi came to power, China's need for mega-projects was largely sated—hence, the pivot to exporting its economic model beyond China's borders. Along with tapping new markets, China pushes its surplus cement, steel, and technology, while securing minerals for high-tech products. Much of the work is done by mainland China companies employing Chinese labor and financing from Chinese banks, including the gigantic *Asian Infrastructure Investment Bank*.

Yet the initiative has come at a very high cost. As much as China benefits from Belt and Road, it has also caused serious reputational damage. Critics argue that Chinese companies, often state-owned entities, reap most of the benefits, while developing nations are forced to take on crushing debt loads.

(2) *Bumps in the Belt and Road.* "It hasn't all gone smoothly," writes James Guild, an expert on economic development in Southeast Asia in *an op-ed* for The Diplomat news site. "These projects have been plagued by delays and cost overruns. They have become intensely politicized and touched off debates about whether the economic value created is worth the debts being incurred." So, Guild concludes, "Chinese investment in Southeast Asian rail infrastructure clearly carries an array of risks."

Stephen Olsen at the Institute of Southeast Asian Studies notes that Beijing does itself no favors with the lack of transparency when signing project contracts, often with other opaque governments. This masks the "potential debt traps for participating countries" and the ways China uses "economic leverage" to exert political influence.

Many observers worry that Xi's Belt and Road push has increased corruption in places that can least afford it with projects that aren't ready for global prime time. Elaine Dezenski at the Washington-based Foundation for Defense of Democracies, says that *by 2023*, Belt and Road's 10th anniversary, Argentina, Ethiopia, Kenya, Malaysia, Montenegro, Pakistan, and Tanzania were "are all dealing with extreme debt-to-GDP ratios that force crippling decisions in order to service the debt."

Beijing's building boom also has environmentalists in a whirl. In a 2021 *report*, for example, the Council on Foreign Relations detailed how Xi's ambitious program had "sparked backlash over pollution, environmental damage, and population displacement concerns."

(3) *Xi doubles down*. But the upsides are getting renewed focus thanks to Trump's trade war. In mid-April, Xi took time out of his busy schedule sparring with Trump and deflation at home to *visit Southeast Asia*. It was hardly a coincidence that he stopped in Vietnam, Malaysia, and Cambodia, three economies particularly disillusioned by TTT.

"Economic disruption poses a major risk for trade-dependent Southeast Asian economies, stemming from Trump's use of tariff barriers against countries with trade surpluses, as well as a broader policy of decoupling from China," explains James Crabtree at the Asia Society Policy Institute. China is well positioned to exploit these countries' reduced US engagement, he says, by deepening its relationships with them through bilateral and multilateral initiatives, particularly investment deals and expanded BRICS—Brazil, Russia, India, China, South Africa—cooperation.

Also, Crabtree adds, "Trump's early decision to shut down the US Agency for International Development creates additional opportunities for Chinese influence."

China's New Silk Road III: Geopolitics Remade. The extent to which Belt and Road's reach worries Team Trump is apparent in how it pops up in diplomatic disputes. So worried was Panama about Trump's threat to retake the canal that it *ended its involvement* with Belt and Road in February. In May, Trump World slammed Colombia for *joining China's initiative*.

In peace talks with Ukraine last week, the US asked President Volodymyr Zelenskyy's government *not to allow China access* to its rare-earth-minerals market. The subtext: Russia's invasion, and resulting US sanctions, are helping to revive the so-called Middle Corridor route connecting China and Europe through Central Asia via Kazakhstan, Azerbaijan, Georgia, and Turkey.

China, not surprisingly, is rapidly increasing its footprint in Central Asia. In December, construction began on an *$8 billion* *railway linking China*, Kyrgyzstan, and Uzbekistan, a network aimed at creating a supply route to Europe.

As China recreates the Silk Road of old, with all railways leading to its export and supply-chain centers, Trump's mercantilist, tariffs-only Asia policy risks alienating the globe's most dynamic economic region.

Twelve months ago, the common narrative of Belt and Road was one of debt traps, carbon footprints, and China exporting its overcapacity. The extreme trade tensions of today have officials in Southeast Asia and beyond more interested in tapping into global value chains and production networks than picking sides between Beijing and Washington.

For better or worse, and for all the strings attached, China is offering a route to growth for developing nations bracing for the collateral impacts of US tariffs, one track at a time. If Trump 2.0 has a plan to counter China's global infrastructure ambitions, now seems like a good time to share it.

Calendars

US: Mon: NY Empire State Manufacturing Index -6.7; OPEC Monthly Market Report. **Tues:** Retail Sales Total & Ex Autos -0.5% & 0.1%; Industrial Production 0.1%; Capacity Utilization 77.7%; Business Inventories; NAHB Housing Market Index 35; Import & Export Prices -0.5% & -0.1%. (Source: FX Street)

Global: Mon: Eurozone Labor Cost 3.2%q/q; Italy CPI 0.0%m/m, 1.7%y/y; BoJ Interest Rate Decision; Nagel. **Tues:** Eurozone & Germany ZEW Economic Sentiment 23.5 & 34.5; Japan Machinery Orders -6.7%; BOJ Press Conference. (Source: FX Street)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index fell 0.5% during the June 13 week and weakened to 2.8% below its January 23 record high. That compares to a 0.1% gain for the AC World ex-US index, which has been hitting new record highs through Thursday since May 14—the longest streak of weekly record highs since June 15, 2021. The US MSCI has outperformed the AC World ex-US in just five of the past 20 weeks. EM Latin America was the best performing region last week, with a gain of 1.0%, ahead of EM Asia (0.8%), EM (0.6), and the AC World ex-US. EMEA and EMU were the worst performers, with declines of 0.9% last week, followed by Europe (-0.3) and EAFE (-0.2). The Taiwan MSCI index performed the best among country indexes last week, with a gain of 3.6%, ahead of Hong Kong (1.9), Korea (1.8), and Brazil (1.7). The Germany MSCI index was the worst performer w/w, with a drop of 2.0%, followed by India (-1.6), Sweden (-1.2), South Africa (-1.1), and Spain (-1.0). In terms of ytd performance rankings, the US MSCI index is up 1.7% ytd, but is the worst country performer and trails the 13.9% gain for the AC World ex-US. Among the regional indexes outperforming the AC World ex-US ytd, EMU now leads with a gain of 22.8%, followed by EM Latin America (22.6), Europe (19.6), EAFE (15.6), and the AC World ex-US. EMEA is the worst ytd performer, albeit with a gain of 9.3%, followed by EM Asia (9.9) and EM (10.7). Looking at the major selected country markets that we follow, Spain is the best ytd performer, with a gain of 37.6%, followed by Germany (28.1), Mexico (27.4), Korea (27.0), and South Africa (25.9). The worst performing countries ytd: the US (1.7), India (2.3), Taiwan (6.3), Japan (6.8), and Australia (9.2).

US Stock Indexes (*link*): Four of the 48 major US stock indexes that we follow rose during the week ended June 13, down from 46 indexes rising in the prior week and all 48 indexes the week before that. The S&P 600 SmallCap Pure Growth index was the best performer, with a gain of 1.0%, followed by the S&P 500 LargeCap Pure Value (0.8%), S&P 400 MidCap Pure Value (0.4), and Dow Jones 15 Utilities (0.3). The S&P 400 MidCap Pure Growth index, with a decline of 2.8%, was the worst performer, followed by S&P 400 MidCap Growth (-2.2), S&P 600 SmallCap Pure Growth (-2.2), S&P 500 LargeCap Pure Growth (-2.1), and Russell 2000 Growth (-2.1). Twenty-three of the 48 indexes are now higher so far in 2025, down from 30 rising ytd a week earlier and down from 47 in mid-February. With a gain of 5.5%, the Dow Jones 15 Utilities index is in the top spot as the best performer so far in 2025, ahead of Russell MidCap Growth (4.5), S&P 100 Equal Weighted (4.4), and S&P 500 LargeCap Pure Growth (4.1). The worst performing major US stock indexes ytd: S&P 600 SmallCap Value (-10.9), S&P 600 SmallCap Pure Value (-9.5), S&P 600 SmallCap Equal Weighted (-9.0), S&P 600 SmallCap (-8.1), and Dow Jones 20 Transports (-7.6).

S&P 500 Sectors Performance (*link*): Four of the 11 S&P 500 sectors rose during the week ending June 13, but six were ahead of the S&P 500's 0.4% decline. That compares to eight S&P 500 sectors rising a week earlier, when only three sectors were ahead of the S&P 500's 1.5% gain. The outperformers last week: Energy (5.7%), Health Care (1.2), Utilities (0.2), Consumer Discretionary (0.1), Information Technology (-0.1), and Real Estate (-0.12). The underperformers last week: Financials (-2.6), Industrials (-1.6), Consumer Staples (-1.1), Communication Services (-0.8), and Materials (-0.5). The S&P 500 is now up 1.6% ytd, with nine of the 11 sectors positive ytd and eight ahead of the index. Industrials still wears the crown as the best ytd performer, with a gain of 8.0%, ahead of Utilities (6.8), Communication Services (5.6), Consumer Staples (4.6), Materials (3.8), Financials (3.1), Real Estate (2.2), and Energy (2.2). These three sectors are lagging the S&P 500 so far in 2025: Consumer Discretionary (-6.7), Health Care (-1.4), and Information Technology (1.0).

US Economic Indicators

Producer Price Index (*link*): The PPI was tame again in May, with both the headline and core measures ticking up just 0.1%, below expectations of 0.2% and 0.3%, respectively. The yearly percent change for the headline rate matched the consensus estimate of 2.6%, little changed from April's 2.5% and down from its recent peak of 3.8% at the start of this year. Prices for *final demand less foods, energy, and trade services* ticked up 0.1%, slower than the 0.4% gains during the first two months of this year. The *yearly rate* fell below 3.0% for the second month, easing to 2.7% in May, after fluctuating in a relative flat trend bouncing above 3.0% since last April. The PPI for *personal consumption* slowed for the fourth month to 2.6% in May after accelerating from a recent low of 2.1% in September to 3.9% by January, while the yearly rate for *personal consumption excluding food and energy* also eased for a fourth month in May, to 3.0%, after climbing from 2.7% last July to 3.9% by January.

Consumer Sentiment Index (*link*): Consumer sentiment improved in mid-June, climbing for the first time in six months, up 16% from May's level but still roughly 20% below that of December 2024—when sentiment showed a post-election bump. *Consumer sentiment* jumped to 60.5 in mid-June after plunging from 74.0 in December to 52.2 in May. The *current conditions* component climbed to 63.7 after falling from 75.1 in January to 58.9 in May, while the *expectations* component rose for the second month, to 58.4, after sliding from 76.9 in November to 47.3 by April. *Turning to inflation*, year-ahead inflation plunged to 5.1% in mid-June from 6.6% in May, while long-run inflation expectations fell for the second month from 4.4% in April to 4.1% in June—with both inflation rates at three-month lows. The report noted, "Consumers' fear about the potential impact of tariffs on future inflation have softened somewhat in June. Still, inflation expectations remain above readings seen throughout the second half of 2024, reflecting widespread beliefs that trade policy may still contribute to an increase in inflation in the year ahead."

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production sank 2.4% in April, on widespread weakness, following a three-month climb of 4.2%. Output of consumer nondurable goods posted the largest decline in April, sliding 3.0%, followed by energy (-1.6), capital goods (-1.1), intermediate goods (-0.7), and consumer durable goods (-0.2) output. *Compared to a year ago*, production rose 0.8%, slowing from March's 3.7%, with only consumer nondurable goods production (6.1% y/y) in the plus column. Output of intermediate goods (-1.0) posted the largest yearly decline, followed by capital goods (-0.6) and energy (-0.1)—with consumer durable goods production flat with a year ago. Looking at the *largest Eurozone economies*, data are available for the top four economies: Italy (1.0% m/m & -2.7% y/y), Spain (-0.9 & 0.5), France (-1.4 & -2.1), and Germany (-1.9 & -2.4). *On a monthly basis*, only Italy showed a gain in April, while Germany and France reported sharp declines. *On a year-over-year basis*, Spain posted a small gain, while Italy, Germany, and France were in the red.

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