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Morning Briefing

Less-Grand Bargain with China & The View from Abroad on Powell Mess

Check out the accompanying chart collection.

Executive Summary: President Donald Trump reversed course and allowed Nvidia to resume sales of its H20 chips into China. Could this change of heart indicate that the President is willing to bend on other trade matters as well? William explores whether the President might accept a "less-grand bargain" that can appease both US and Chinese politicians. … Meanwhile, foreign investors and analysts are growing uneasy about Trump's recent threats to fire Fed Chair Jerome Powell. Here's what folks on the outside looking into the US are saying. … We don't believe President Trump will fire Powell. But, just in case, we examine the credibility crisis that could ensue if he does.

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

China Trade Deal I: A Less-Grand Bargain. On any list of global executives experiencing the most serious case of 2025 whiplash, Nvidia chief Jensen Huang deserves a place at the very top.

First, in late January, Chinese artificial intelligence upstart DeepSeek seemed about to chop at least half a trillion dollars off the company's valuation (*Fig. 1*). Well, not so much. Now, the company Huang founded in 1993 finds itself at the center of US-China trade war turbulence. He's perhaps as surprised as anyone at President Donald Trump's abrupt U-turn to allow Nvidia to *resume China sales* of its H20 AI accelerator chips. The US Commerce Department gave Advanced Micro Devices *similar* assurances.

China hawks in Washington are *none too happy* about the reversal. But it's the strongest sign yet that Trump is pivoting away from blunt-force confrontation back to securing a "grand bargain" with Chinese leader Xi Jinping. As *The New York Times* reported on Sunday, Commerce Secretary Howard Lutnick's office is "*recruiting*" CEOs for a potential trade delegation, "setting off a competition over who will get to ride in Air Force One" if and when Trump heads to China for a meeting with Xi.

Let's explore what might be possible in terms of a trade deal—and what might not be:

(1) *The easy route*. Winding down the tech war with China may be the quickest and easiest way for Trump to prod China into joining the commercial ceasefire and to green light the return of vibrant business dealings between the two largest economies. This would give Xi political cover in Communist Party leadership circles to further dial back restrictions on rare earth minerals and other tech-related goods. A truce of sorts that can be spun as a victory on both sides would sound good to investors and corporate chieftains the world over.

(2) *Lowering our sights*. Even if Trump manages to get talks back on track, a central question looms in the background: What are the odds that a US-China trade deal that emerges from the fisticuffs of recent months fundamentally changes the most important economic relationship? They're not great at this point—for reasons on both sides.

The chances of an epochal reboot to the dynamics surrounding the *$438.9 billion of goods* the US imported from China in 2024 probably had its last gasp in April when Beijing was hit with a 145% tariff (Fig. 2). The US later throttled back. But tariffying China to such an extreme, while claiming to want to negotiate, probably cost the US the last bit of remaining trust in Beijing.

(3) *Troubled Chinese economy*. Yet it takes two to flub a bilateral deal. Clearly, Corporate America would prefer a genuine free-trade agreement providing deeper access across sectors to China's *nearly $18 trillion economy*. But with China struggling with deflation, a massive property crisis, and high youth unemployment, now seems an unlikely moment for Xi to lower the nation's trade barriers to increased competition (Fig. 3).

For all the chest-beating in Beijing about *China's 5% growth rate*, there's real disillusionment with the Xi era that began in 2012. The pride over DeepSeek's arrival and electric-vehicle maker BYD *overtaking Tesla* is checked by widening cracks in the economic foundations below.

The chronic weakness of Chinese domestic demand is not a Trump problem. It's a Xi problem, caused by the glacial pace of efforts to recalibrate growth engines. The lack of domestic demand has left Xi unable and/or unwilling to reign in state-owned enterprises, which are exporting their overcapacity around the world. It also hasn't made Xi particularly popular at home, perhaps giving him less latitude to make big concessions to a leader who, since 2016, has accused China of "*raping*" the US via unfair trade practices.

China Trade Deal II: Art of the Win-Win. China's ruling party also worries that, unless Congress or the Supreme Court *check his power*, Trump tearing up a new trade deal is too great a risk. So, Xi's strategy has been to slow things down, hoping that Trump, increasingly anxious for a deal, will agree to some minor tweaks or a sizable Boeing order or two, and move on.

Trump being able to tout even a modest pact as a Big, Beautiful China Deal could be just the thing to cheer investors. Trump can declare victory and claim he's still got that art-of-the-deal magic. Xi could bask in the glow of China giving up very little to Trump World.

(1) *Red lines*. A deal that maintains much of the status quo is likely preferable to markets than Trump and Xi going to the proverbial mattresses. It might be a win-win for both sides. Even if the bargain is less grand, it may be preferable to not knowing if US tariffs will be 20% next month—or 200%.

Trump's about-face on Nvidia suggests previous US red lines on China are either falling away or negotiable. As Treasury Secretary Scott Bessent notes, it's "*all part of a mosaic*." Reports are that Trump's change of heart has rankled some administration officials who worry that once again granting licenses will only embolden China's tech champions (Fig. 4). Others argue that it's a necessary evil to enable Nvidia and its peers to compete with mainland giants like Huawei Technologies to win the broader AI war.

(2) *Bargaining chips.* There might be scope, too, to put some meat on the bones of the sticking points Bessent discussed in Geneva in May with Chinese Vice Premier He Lifeng. Ditto for the *trade framework* the US and China agreed to in late June. "A wide range of *bargaining chips* are on the table," including semiconductors, manufacturing equipment, rare earths, battery technology, AI chips, and mutual market access," Kevin Xu, founder of Interconnected Capital, told Bloomberg.

The good news is that, already, China's exports of rare earth magnets to the US surged 667% m/m in June—to *353 tons from 46 tons* (158% globally). Just a reminder that even a less grand deal between the globe's two economic superpowers could be quite a boon everywhere.

Firing Powell I: View From Abroad. Ever since Donald Trump rode down a New York escalator in 2015, folks overseas, too, have struggled to understand him given that what he says tomorrow is often not consistent with what he says today. His art-of-the-deal approach to communicating can be very confusing.

William reports that in Tokyo and Beijing, for example, officials fear that Trump trying to fire Jerome Powell is more of a "when" than an "if." Officials in Asia worry that everyone from the courts to Wall Street firms attempting to wave Trump off a drastic action often backfires.

Japan and China are the No. 1 and No. 3 *foreign holders* of US Treasuries (the UK is No. 2). That would put Japan and China directly on the frontlines if Trump were to attempt to remove Powell (*Fig. 5*).

Let's explore why governments and investors overseas are bracing for the worst where Trump and Powell are concerned:

(1) *Yield surge risk*. The worry for Asia is that the brawl over the most powerful central bank, the keeper of the global reserve currency, could send US yields skyward and the dollar sharply lower. Along with epic losses of state wealth — *$1.14 trillion for Japan* and just over $756 billion for China — Asia's two biggest economies would hit a wall.

(2) *US debt explosion*. Another concern overseas is that the years since COVID-19 have been especially bruising for Washington's fiscal health and, in turn, perhaps the dollar's Teflon-currency status. Between Trump 1.0, the Biden administration and now Trump 2.0's Big, Beautiful Bill, US marketable debt now exceeds $28 trillion (*Fig. 6*).

(3) S*howdown*. In a worst-case scenario, Trump would just fire Powell, perhaps setting the stage for a market-roiling legal showdown. An alternative would be naming a "shadow" Fed chair now in hopes it might cajole Powell to resign. Another idea making the rounds is essentially turning the Fed into the Bank of Japan, which gives the Ministry of Finance a voice in board meetings.

In a recent *CNBC interview*, Kevin Warsh, former Fed governor and a leading candidate to replace Powell, said: "We need a new Treasury-Fed accord, like we did in 1951 after another period where we built up our nation's debt and we were stuck with a central bank that was working at cross purposes with the Treasury."

Firing Powell II: Unprecedented Credibility Crisis. There are also signs that Team Trump might go after Powell for the renovation of Fed headquarters running over budget. One irony is that the Fed's main building is named after the last chairman caught in political harm's way in anything approaching this moment: *Marriner Eccles*, who resigned in 1948.

Eccles irked then-President Harry Truman by not being more willing to finance the Korean War. Eccles *stayed on the board* until 1951, though, raising questions today about whether Powell could remain Fed governor even if he's removed from the chairmanship. Yet firing Powell would be unprecedented.

(1) *Losing US 'specialness.'* Again, context matters. The timing of Trump's monetary policy adventurism comes at a sensitive moment from a dollar credibility standpoint. Central banks

around the globe are *hoarding gold* at the dollar's expense. The drip, drip, drip of hints Powell might get axed only adds to the sense of disorientation.

The "US 'specialness' would be severely tested by meddling with the Fed," warns Derek Holt at Scotiabank. Besides, he adds, "US monetary policy is about right," whereas the *Fed slashing rates to 1%*, as Trump desires, would be "crisis territory" for the US at a moment of full employment. We agree.

(2) *Inflation risks abound*. At the moment, the *2.7% y/y* US consumer price inflation rate is above the Fed's preferred price stability neighborhood of around 2%. If central banks holding Treasuries worry about inflation now, imagine the discussion when global markets factor in a US president dictating rate policy.

(3) *Worried central banks*. Much of this shattering could be felt by central banks holding the most US Treasuries. In theory, at least. For now, many of the top foreign holders of US government debt aren't selling in a panic. In fact, foreign Treasuries holdings jumped $32.4 billion in May m/m to $9.05 trillion as we discussed yesterday (Fig. 7).

Japan, by far Washington's top financier, added $500 million to its stockpile in May. The UK added $1.7 billion, bringing London's holdings to a total of $809.4 billion. But Canada was the real whale, buying $65.8 billion of net US debt to boost its holdings to a record $430 billion.

Since no president has directly fired a Fed chairman before, it's impossible to game things out. For all the concerns about the federal deficit and Trump axing Powell, JPMorgan's Priya Misra, tells Bloomberg, there really is "no alternative for the depth and liquidity of the Treasury market." We agree.

Yet firing Powell might be the quickest way to incentivize central banks to find one.

For now, Trump's latest word is that he won't fire Powell. On July 16, Trump stated it was "highly unlikely" he would fire Federal Reserve Chair Jerome Powell, despite earlier discussions with Republican lawmakers about the possibility. This came after reports that Trump had asked House Republicans if he should sack Powell, with some indicating support. Trump clarified, "We're not planning on doing it," but added, "I don't rule out anything," citing potential fraud as a condition for removal. This followed his ongoing criticism of Powell for not lowering interest rates, with Trump calling him a "knucklehead" and claiming he was "doing a lousy job." Markets recovered after Trump's denial of imminent plans to fire Powell, reflecting the sensitivity to such statements.

We don’t think Trump will fire Powell. We also still think that the dollar will weather this storm and that its 10% selloff so far this year is a correction rather than the beginning of a long-term bear market in the greenback (Fig. 8). But we certainly can understand why both foreign and domestic investors might be worrying about the Fed’s independence and the value of the dollar.

Then again, in yesterday’s *Morning Briefing*, we reviewed the latest Treasury International Capital System data which showed that foreign investors remain significant buyers of US Treasuries and other bonds (Fig. 9). They also purchased a record $597 billion of US equities over the past 12 months. Go figure (Fig. 10)!

Calendars

US: Tues: Richmond Fed Manufacturing Index -4; Powell; Bowman. **Wed:** Existing Home Sales 4.01mu; MBA Mortgage Applications. (Source: FX Street)

Global: Tues: ECB Bank Lending Survey; Lagarde. **Wed:** Eurozone Consumer Confidence -15.0; Japan Core CPI 2.6%y/y; Japan M-PMI 50.2; Bullock. (Source: FX Street)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the July 18 week, forward earnings rose simultaneously for all three of these indexes for the seventh time in the eight weeks since May 30. LargeCap’s forward earnings rose for a ninth straight week in its longest winning streak since December, and has posted gains in 11 of the 12 weeks since it bottomed during the April 25 week. MidCap’s rose for the eighth time in the nine weeks since it bottomed during the May 16 week. SmallCap’s has risen for eight straight weeks since it bottomed during the May 23 week, and is now on the longest winning streak since it rose for nine straight weeks though June 17, 2022. LargeCap’s forward earnings rose 0.4% w/w to its seventh straight record high. MidCap’s rose 0.3% w/w to an 11-week high and is 1.6% below its record high during the April 4 week. SmallCap’s rose 0.4% w/w to a 13-week high and is 13.0% below its June 2022 record. LargeCap’s forward earnings has soared 25.9% from its 54-week low during the week of February 1, 2023; MidCap’s is just 7.4% above its 55-week low during the week of March 10, 2023; but SmallCap’s has lagged considerably and is up just 1.9% from a very recent 42-month low during the May 23 week. These three indexes’ forward earnings downtrends from mid-2022 to early 2023 and again during

Trump's Tarriff Tantrum were 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%, 14.0%), MidCap (0.4, 1.8, 17.9), and SmallCap (-10.2, 2.1, 18.7).

S&P 500/400/600 Valuation (*link*): Valuations were mostly unchanged w/w for these three indexes during the July 18 week. LargeCap's forward P/E was steady at 22.1, down from a 30-week high of 22.2 during the July 4 week. It's now 0.2pt below its 43-month high of 22.3 during the December 6 week and 5.1pts 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 was unchanged w/w at 16.1, down from a 23-week high of 16.3 during the July 4 week. It's now 1.0pt below its 40-month high of 17.1 during the November 29 week and 3.9pts 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 dropped 0.2pt w/w to 15.3, and is 0.3pt below its 20-week high of 15.6 during the July 4 week. It's 2.4pts above its 17-month low of 12.9 during the April 4 week and 4.7pts above its 14-year low of 10.6 in September 2022, but remains 1.8pts 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 a 27% discount to LargeCap's P/E, up from 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 at a 30% discount to LargeCap's P/E, up from its nine-month-low 32% discount during the April 10 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 now at a 4% discount to MidCap's, up from a 20-year low 10% discount in late 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*): Leading indicators in June fell more than expected, not posting a gain since November. The *Leading Economic Indicators* (LEI) fell 0.3% in June, following by no change in May (first reported down 0.1%), and a 1.4% drop in April. The LEI has plunged 17.8% since December 2021's record high. The LEI's six-month growth rate weakened, falling 2.8% over the first half of this year, more than double the 1.3% drop over the second half of 2024. The Conference Board notes the *diffusion index* remained below 50, triggering a recession warning for the third successive month, though the Conference Board noted, "it does not forecast a recession, although growth is expected to slow substantially in 2025 compared to 2024." In June, five of the 10 components of the LEI contributed positively, while three contributed negatively and two were unchanged—manufacturers' new orders for consumer goods & materials and average weekly hours. *Five components contributed positively*, with stock prices (+0.15) once again leading the pack, followed by small contributions from the leading credit index (+0.03), interest rate spread (+0.01), building permits (+0.01), and nondefense capital goods ex aircraft (+0.01). The *biggest drags on the LEI* in June were the same three recorded in May—consumer expectations for business conditions (-0.22pts), followed by ISM new orders index (-0.19), and initial claims (-0.04).

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index climbed to a new record high in June. The CEI advanced 0.3% last month, after taking a slight breather in April and May, showing no change over those two months. All four components of June's CEI—personal income less transfer payments, manufacturing & trade sales, payroll employment, and industrial production were in the plus column in June. The CEI climbed 0.8% over the first half of this year, slightly below the 1.0.% gain over the prior six-month period.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Senior Global Investment Strategist, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
William Pesek, Contributing Editor, 516-277-2432
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102