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Morning Briefing

On China's Economy & S&P 500's Record Earnings

Check out the accompanying [chart collection](#).

Executive Summary: China's stock market has been strong, up 20% since April, as investors appear to be downplaying the potential consequences of the tariff war with the US. But with China's weak economic underpinnings, we're not so sure that's wise. William discusses the reasons Chinese stocks may be overvalued, the governmental decisions that led to China's economic predicament, and the challenges ahead for Team Xi. ... Also: "Stunning" is Joe's word for the degree by which S&P 500 companies that have reported Q2 results so far (most of them) collectively overshot analysts' earnings estimates: nearly 9%!

Chinese Economy I: Stock Rally Masks Underlying Cracks. Don't tell Donald Trump, but Chinese stocks are enjoying a celebratory rally at the US President's expense. This week, the Shanghai Stock Exchange Composite Index closed at its [highest level](#) in a decade on the belief that Trump's trade-war bark is much worse than his bite. It has risen 11.2% ytd and 20.0% since an April selloff.

But we think Trump's bite could be pretty bad: If Chinese leader Xi Jinping doesn't give Trump a splashy "grand bargain" trade deal, Asia's biggest economy could face tariffs far above the [current 30%](#).

The dubious assumption investors seem to be making plus the nation's underlying economic troubles could mean that China's stock market bulls are operating on borrowed time ([Fig. 1](#)). Let's explore why Chinese stocks may be getting ahead of themselves:

(1) *Faltering economy.* China's economy was sputtering across the board in July thanks to tariffs and a deepening property crisis. Retail sales in July grew at the slowest rate of any month since December, just [3.7% y/y](#). Factory output slumped to an eight-month low in July, rising 5.7% ([Fig. 2](#)). Fixed-asset investment has cratered as well, while [property investment](#) fell 12% during the first seven months of the year. The government's 5% GDP

growth target for this year is looking like a reach.

Moreover, [deflation](#) is making an ill-timed return ([Fig. 3](#)). China's 100 biggest developers saw new-home sales plunge by [more than 20%](#) for two consecutive months now, in June and July. Home prices have been deflating on a y/y basis fairly consistently since spring 2022 ([Fig. 4](#)). Also, China Evergrande Group is back in global headlines.

(2) *Japanization*. The developer that came to symbolize China's real estate bust will see its Hong Kong stock [delisted this month](#). Evergrande's 2021 [default](#) had Lehman Brothers overtones. The turmoil it represents has many worrying that China is headed for a Japan-like economic malaise ([Fig. 5](#)).

"The ongoing challenges in the real estate sector, though anticipated, are still concerning due to the sector's critical role in driving consumption through wealth effects, particularly as 60% of domestic household wealth is tied to [real estate](#)," says Carlos Casanova at Union Bancaire Privée.

(3) *Xi's fingerprints*. For all Xi's swagger on the world stage—including slow-walking a US trade deal—it's hard to argue that he has the solid economy to back it up. It's even harder to dismiss the view that so many of China's most pressing troubles bear Xi's fingerprints.

And in the past when Xi has let investors down, Chinese stocks have sunk like rocks. Here, the 2015 bookmark is worth considering: Though Shanghai stocks are having a bit of a meltup this week, August 2015 was a time of meltdown. Over a three-week period in July and August that year, mainland shares lost roughly [a third of their value](#) as investors realized that the "Big Bang" reforms Xi had promised two years earlier weren't happening.

Chinese Economy II: Time To Stop Skinny Dipping. That mini-crash in 2015 had Beijing circling the financial wagons. Over the decade that followed, Team Xi cut interest rates, loosened leverage rules, and slashed bank reserve requirements ([Fig. 6](#)). It stopped all [initial public offerings](#), halted trading in thousands of companies, and let households use apartments as collateral to buy shares out of patriotism.

The episode deadened the urgency to prioritize innovation over inefficient state-owned enterprises.

Had Xi moved faster to make the yuan fully convertible, strengthened capital markets, and increased corporate transparency, China's current stock rally might have more credibility. At

[18.2 times](#) forward earnings as of Tuesday's close, the Shanghai index isn't as richly valued as the Nikkei 225 Stock Average with a [forward P/E 20.3](#). But then again, Japan is no longer in the deflation zone ([Fig. 7](#)).

Consider the following:

(1) *Uninvestable China?* Xi has work to do to settle the debate on whether China is "[uninvestable](#)." Such questions have swirled since Xi's late 2020 clampdown on tech billionaires, starting with [Alibaba Group founder Jack Ma](#), and Xi's crackdown on the property sector in the name of reducing leverage.

Beijing also is scrambling to reverse a late 2024 policy that mainland economists call "[anti-involution](#)." This awkward term derives from the Chinese concept of *neijuan*, or rooting out excessive price competition ([Fig. 8](#)). The effort backfired, denting employment.

(2) *Naked truths.* The trade war is perhaps the ultimate manifestation of Warren Buffett's famous observation that "only when the tide goes out do you discover who's been swimming naked." A decade-plus of Team Xi's skinny dipping—i.e., providing large stimulus bursts in lieu of devising a more productive economy—is now catching up with China.

It's an open question how Xi will respond to the challenges of economic malaise at a critical point in the trade war. Rate cuts by the People's Bank of China (PBOC) to bolster the economy could send the yuan tumbling. The quickest path back to a 145% tariff is any perception in Trump World that Xi is manipulating exchange rates for trade advantage ([Fig. 9](#)).

It's clear, too, that recent fiscal jolts didn't do the trick. The PBOC's [2024 move](#) to prod state-owned companies to buy up vacant properties didn't get much traction. Bloomberg Economics estimates that China had [60 million unsold apartments](#) even before the tariffs.

China's weak July performance has investors expecting a burst of stimulus. It's a balancing act, though. Team Xi is reluctant to roll out large-scale spending packages because it might set back efforts to deleverage the economy. That's why, "in the short run, the cost of addressing overcapacity and deflation could be [even weaker growth](#)," notes Rob Subbaraman at Nomura. "Beijing will very likely rush to roll out a new round of supportive measures in the second half."

Yet even though Xi's Communist Party is growing more confident that it can strike a tariff

deal with Trump that, like Japan, changes very little about the bilateral trade relationship, the tariffs are starting to bite. The 90-day extension in US talks helps China Inc., but the extreme uncertainty is hitting the economy on both ends.

On the one hand, the front-loading factory boom that lifted Chinese growth to a [5.3% y/y pace](#) in the first half of the year is losing steam. There's less reason for multinational companies to get ahead of sharply higher tariffs if Trump keeps delaying them. On the other hand, domestic companies don't know whether to hire, fire, invest, or retrench. Hence, the [5.3% y/y plunge](#) in fixed-asset investment in July, the worst reading since the early Covid-19 days in January-February of 2020.

Even so, many investors think that China's so far avoiding the worst of Trump's wrath is a buy signal. "We're confident that this rally has legs," Wang Huan of Shanghai Zige Investment Management [told Bloomberg](#), citing steady PBOC liquidity and coming government stimulus measures.

The risk-on spirit is spreading to Hong Kong, too. On Friday, mainland China-based traders bought a record [\\$4.6 billion worth](#) of stocks in the city.

Yet risks abound, likely making this a buyer-beware moment. While China stock bulls should be wary of the tariff risks on the horizon, the bigger, more immediate problem may be the worsening economic troubles with the potential to undermine companies' earnings growth prospects and render current elevated valuations unsustainable.

Strategy: S&P 500 Q2 EPS at a Record High! With 92% of the S&P 500 companies having reported June-quarter results through Tuesday's market open, their aggregate "blended" quarterly EPS—a mix of actual EPS for companies that have reported and consensus estimates for those that haven't—is \$66.79 ([Fig. 10](#)). That's a new record high for the S&P 500. For perspective, it's 2.8% above the prior record high of \$65.00 in Q4-2024 and 5.9% above Q1's \$63.07, which marked a three-quarter low. (See our [web pub](#) "S&P 500 Quarterly Metrics.")

Moreover, the degree by which the S&P 500 companies collectively beat analysts' Q2 earnings expectations was no less than stunning—8.8%. That's among the strongest earnings surprise in the 39 years we've been tracking these data, ranks 12th best in the 154 earnings seasons since Q1-1987, and represents an acceleration from Q1's 7.1% beat ([Fig. 11](#)).

Also up were Q2's blended EPS relative to analysts' expectations at the end of June before reporting season began; at that point, their consensus estimates implied EPS of just \$62.64 ([Fig. 12](#)).

As for Q2's y/y growth, that's in the double digits yet again. With 8% of the companies left to report, the S&P 500's blended y/y earnings growth rate for Q2 is 10.6%, marking the eighth straight quarter of positive y/y earnings growth for the S&P 500. That also matches the prior lengthiest streak since the eight quarters through Q3-2022 ([Fig. 13](#)).

However, Q2's y/y growth rate is down sequentially for a second quarter from Q4's rate, when growth peaked at 12-quarter high of 13.7% y/y ([Fig. 14](#)). Viewing growth through a different lens, S&P 500 earnings rose 12.9% y/y in Q2 on a proforma same-company basis. That also marked a slight slowdown from a 12-quarter high of 17.1% in Q4-2024 ([Fig. 15](#)).

How did the S&P 500's 11 sectors, the Magnificent-7 stocks, and the remaining S&P 493 do last quarter? Below, Joe puts their aggregate Q2 earnings results under his analytical lens:

(1) *Few sectors drove S&P 500's earnings growth.* During Q2, eight of the 11 S&P 500 sectors delivered rising earnings y/y, but just three sectors recorded stronger y/y growth than the S&P 500 ([Fig. 16](#)). Furthermore, Communication Services was the only sector to post record-high EPS.

Those counts for Q2 are unchanged from Q1's readings. But they represent a downshift from 10 sectors rising y/y in Q4, when four outpaced the S&P 500 and two posted record-high EPS (Communication Services and Information Technology).

Just three sectors recorded double-digit percentage y/y earnings growth in Q2, down from four in Q1 and a big downshift from seven sectors in Q4. Among Q2's laggards, Energy's earnings fell at a double-digit percentage rate for a fourth quarter and the sixth time in seven quarters. Materials' earnings growth turned negative again in Q2 following Q1's first positive reading in 10 quarters. Utilities' was down y/y for the first time in nine quarters.

On the bright side, Information Technology's earnings rose y/y for a ninth straight quarter and grew at a double-digit percentage rate for an eighth quarter. Consumer Discretionary and Financials both marked their 10th straight quarter of positive y/y earnings growth. Communication Services posted a fourth straight quarter of double-digit y/y percentage growth and its ninth quarter of rising earnings.

Here's how the sectors' y/y earnings growth rates for Q2 have stacked up so far on a proforma basis: Communication Services (48.8%), Information Technology (23.0), Financials (13.9), S&P 500 (12.9), Health Care (8.6), Consumer Discretionary (6.6), Industrials (4.5), Real Estate (1.6), Consumer Staples (0.8), Materials (-1.5), Utilities (-1.8), and Energy (-18.5).

(2) *Magnificent-6 performed magnificently.* Through Tuesday's open, six of the Magnificent-7, all but Nvidia, have reported results so far. The "Magnificent-6's" aggregate Q2 earnings surprise was 11.8%, and its y/y earnings growth of 23.1% was more than double the consensus' 10.1% forecast—all well above the S&P 500's measures ([Fig. 17](#)).

Two of the six had double-digit percentage earnings surprises, and five had double-digit y/y earnings growth. Here are the Q2 earnings surprises and y/y earnings growth rates for the Magnificent-6: Amazon (26.4% earnings surprise, 33.3% y/y earnings growth), Meta (20.7, 38.4), Apple (9.5, 12.1), Microsoft (8.3, 23.7), Alphabet (5.7, 22.2), and Tesla (-6.7, -23.1).

(3) *S&P 493 logged another decent quarter.* The S&P 493 delivered positive y/y earnings growth in Q2 for a sixth straight quarter but slowed from a double-digit rate in the prior two quarters. While earnings growth slowed to 8.2% y/y from 10.3% in Q1 and a 12-quarter high of 13.2% in Q4-2024, it was well above the consensus forecast of just 1.0% growth. The S&P 493's aggregate Q2 earnings results beat the consensus forecast by 7.9%, behind the Magnificent-7's stellar earnings beat of 11.8%.

Calendars

US: Wed: Mortgage Applications; FOMC Minutes; Waller; Bostic; Jackson Hole Symposium. **Thurs:** Leading Indicators -0.1%; Initial Claims 227k; Philadelphia Fed Manufacturing Index 5.9; Existing Home Sales 3.92mu; S&P Global M-PMI & NM-PMI 40.9 & 53.3; Bostic. (Source: FX Street)

Global: Wed: Eurozone Headline & Core CPIs 2.0% & 2.3% y/y; Germany PPI 0.1%/m/m, -1.3%/y/y; UK Headline CPI -0.1%/m/m, 3.7%/y/y; Lagarde. **Thurs:** Eurozone, Germany & France HBOC M-PMIs 49.6, 48.8 & 48.5; Eurozone, Germany & France NM-PMI 50.8, 50.5 & 48.6; Eurozone Consumer Confidence -15.0; UK M-PMI & NM-PMI 48.2 & 51.9; UK Gfk Consumer Confidence -19; Buba Monthly Report. (Source: FX Street)

US Economic Indicators

Housing Starts & Building Permits ([link](#)): Housing starts in July were a surprise on the upside, but building permits slumped during the month. Total housing starts jumped 5.2% to a five-month high of 1.428mu (saar) in July, building on June's upwardly revised gain of 5.9% to 1.358mu. July starts beat consensus expectations of a drop to 1.297mu. July's gain was led by an 11.6% jump in multi-family starts of five units or more to 470,000 units (saar), while single-family starts climbed 2.8% to 939,000 units. Versus a year ago, total starts climbed 12.9%, with single-family starts up 7.8%, while multi-unit starts were 27.4% above a year ago. Regionally, housing starts in the Midwest (33.3% m/m & 40.8% y/y) and South (19.2 & 29.5) both posted double-digit gains on a monthly and yearly basis, while starts in the Northeast (-26.0 & -35.5) and West (-27.5 & -14.4) both fell at double-digit rates. Building permits, an indicator of future construction, fell 2.8% to 1.354mu (saar) in July, led by a 9.9% slump in units with five units or more to 430,000 units, while single-family permits edged up 0.5% to 870,000 units.

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