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Morning Briefing

Trump's Tariffs Unsettle Japan & Latin America

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

Executive Summary: The potential for lower US interest rates, a weaker dollar, and Trump Tariff Turmoil have created one big headache for Bank of Japan Governor Kazuo Ueda. William explores how Japan's central bank will weigh the need to stimulate its economy to offset declining exports with the need to continue normalizing interest rates. If the Fed cuts rates and the BOJ hikes them, the yen-carry trade could be at risk. ... Latin America faces its own Trump Tariff Turmoil. Our southern neighbors are increasingly sending their exports to China and would suffer if tariffs trigger a global economic slowdown. Diversifying their export base could be part of the solution.

Japanese Economy I: Tariff Pain Intensifies. At least one global policymaker is sweating Jerome Powell's rate-cut pivot: Bank of Japan Governor Kazuo Ueda.

Federal Reserve Chair Powell's hint that a September easing move is in play triggered a global Fed Put rally in equities. At BOJ headquarters in Tokyo, though, the specter of lower US borrowing costs—and a weaker dollar—could make Ueda's job even harder ([Fig. 1](#)).

Last week, BOJ officials learned that exports sustained their steepest drop in more than four years as US tariffs slammed Asia's second-biggest economy. The [2.6% y/y drop](#) in July was the biggest since February 2021 amid the Covid-19 crisis ([Fig. 2](#)). It was led by cars, auto parts, and steel.

The data also suggest that, for now, exporters are absorbing most of President Donald Trump's tariffs, keeping prices steady and eating the tariffs to preserve market share. But with Japan's economy expected to grow all of [0.7% y/y](#) this fiscal year, it's hard to see Japan Inc. eating the trade-war pain for much longer ([Fig. 3](#)).

An added wrinkle: Japan's exports are declining to two of its major customers, the US and deflation-challenged China. Japan's exports to the US fell 10.1% in July y/y, the fourth straight month of declines. China-bound exports dropped 3.5% ([Fig. 4](#)).

Let's explore where all this leaves the BOJ:

(1) *Headwinds galore*. As headwinds from both of its top trading partners buffet Japan, Ueda's best laid plans to normalize the interest rate environment are unraveling in real time. In January, the Ueda BOJ managed to hike its benchmark to a [17-year high](#) of 0.5%. Then came Trump's tariffs.

Since then, the most promising tightening cycle since the late 1990s, when the BOJ first went to zero, has been in limbo. The tariffs, tepid domestic growth, and China's slowdown put the BOJ into a holding pattern.

(2) *Fed uncertainty remains*. Yet increasing odds of a [September 16-17](#) Fed rate cut reduce the chances of a BOJ tightening at its meeting that same week. The same is true for the BOJ's October and December meetings. A major concern: the yen might surge against the dollar as US and Japanese rates diverge, further undermining exports.

It hardly helps that Prime Minister Shigeru Ishiba is still struggling, over a month into the process, to discern what exactly his government agreed to as part of the US-Japan tariff deal. Other than a 15% levy, it's not entirely clear how tariffs will ultimately apply to key industries like autos, steel, and parts used to make electronics. Nor are the mechanics of the \$550 billion "[signing bonus](#)" that Trump World demanded from Tokyo clear.

Tokyo remains nervous that the US might renege on the overall deal, one that isn't exactly written down. Risks abound, too, should Trump decide Chinese President Xi Jinping is stringing him along. If Trump were to return China tariffs to the 145% range, Japan's export engine would take bigger hits as China's deflation troubles would worsen.

Ueda's balancing act is growing more daunting by the day. Push ahead with rate hikes and risk being blamed for Japan's next recession. Hit pause on tightening and miss the chance to be the hero who extricated Japan from the deflationary era that began more than two decades ago.

Japanese Economy II: BOJ at a Crossroads. The longer Ueda waits, the smaller his window for action might get. The last thing Ueda wants is to reprise the BOJ's [2006-2008 experience](#). At the time, the BOJ increased rates to current levels—only to cut them back toward zero when the economy hit a rough patch.

Looked at another way, the bigger mistake could be maintaining Japan's ultra-low-rate environment. A quarter century of free money did less to revive Japan than to deaden its animal spirits. The quantitative easing the BOJ [pioneered in 2001](#) took the onus off Tokyo to increase competitiveness and level the playing field. It reduced the urgency for companies to innovate, boost productivity, and take big risks.

(1) *Hard habit to break*. Kicking Japan's addiction to QE might be easier if Ishiba's Liberal Democratic Party (LDP) weren't on the ropes. Though the BOJ is technically independent, it's generally more susceptible to political pressure than the Fed has been historically.

Coming off a [dismal election result](#) in July, the LDP is barely clinging to power. It had to cobble together a governing coalition with opposition parties, many of which favor tax cuts. Concerns that fiscal loosening will swell the biggest debt load in the developed world have Japanese government bond (JGB) yields on the rise.

Last week, 20-year JGB yields jumped to the highest level since 1999, the same year Japan became the first Group of Seven nation to give zero interest rates a try. The [increase to 2.655%](#) followed another disappointing bond auction on August 19 ([Fig. 5](#)).

(2) *The Bond Vigilantes*. Difficulty selling JGBs has become something of a pattern. Weak auctions in [May and June](#) followed the mini-panic in the [US Treasury market](#) as Trump Tariff Turmoil triggered the Bond Vigilantes.

This, too, thickens the plot for Team Ueda. Rate hikes could destabilize Japan's bond market—and raise Tokyo's debt-servicing costs. So does the risk that the Powell Fed could make a costly mistake.

A Fed rate cut isn't a done deal. If the August employment report and/or inflation data overshoot expectations (which is more than possible), hopes for a rate cut could be dashed. Yet if a Fed rate cut angers the Bond Vigilantes, US yields could rise and drag JGB rates higher, too.

(3) *Collateral damage*. Though Trump's tariffs are really aimed at China, export-dependent Japan is right in the center of the collateral damage zone. One wild card: if the Fed cuts rates and the BOJ hikes them, it could raise havoc with the so-called yen-carry trade.

For decades, investment funds have [borrowed cheaply](#) in yen to bet on higher-yielding assets around the globe. As such, sudden yen moves can often slam markets virtually everywhere ([Fig. 6](#)). This is now one live risk of many as tariff pain intensifies.

Latin America I: Trade War Hits Keep Coming. Latin America, like Japan, knows its lost decades. From the 1980s debt crisis to Mexico's contagion-rich reckoning in the mid-1990s, the region has seen more than its fair share of financial crises and market volatility.

Yet little prepared Latin America for the firehose of tariffs coming from Washington. In just a few short months, President Donald Trump's trade war has upended US-Latin American trade relations. And the hits keep on coming as Trump's tariff trigger finger remains itchy and his [campaign against the Federal Reserve](#) keeps the region's governments on edge.

Latin America is one of the most dollarized regions anywhere. That means investors from São Paulo to Mexico City often care more about what Fed officials do in Washington than their own local central bankers. Trump's attacks on the Fed's independence and flirtations with a weaker dollar have Latin America on edge.

Let's look at how the tariffs are altering the region's outlook:

(1) *Darkening growth conditions.* By some measures, most Latin American nations can appear less vulnerable to fluctuations in trade, which tends to account for a smaller share of their GDP. Other than Mexico, US trade surpluses are common. In recent years, this included Brazil, Argentina, Colombia, and Peru. Trade accounts for [73% of Mexican GDP](#), versus 35% for Brazil, and 27% for Argentina.

Yet tariffs are darkening the global growth outlook. Tariffs on the region are comparatively high. Brazil faces a [China-topping 50%](#) tariff, while Mexico faces a [25% rate](#). These are markedly higher than the 15% levies on the European Union, Japan, and South Korea.

(2) *Pivoting to China.* US trade policies have many in the commodity-rich region pivoting to China. South America's largest economies, Brazil and Argentina, are major producers of soybeans and petroleum, and Brazil has been exporting more and more iron ore to China.

Brazil's turn toward China, now its largest export destination, dates back to the Trump 1.0 years. As Trump tariffed China, Xi's economy shifted sizable amounts of commodity purchases to Brazil. Along with soybeans, China is Brazil's top customer for beef, chicken, coffee, corn, orange juice, and sugar.

(3) *Commodities taking hits.* All this raises an added risk if Trump were to hit China with bigger tariffs once the recent [90-day extension](#) expires in November. Xi, as Trump World has surely noticed, seems in no hurry to hammer out a tariff deal. If Beijing plays hard to get, triggering bigger US levies, the global growth trajectory could worsen considerably. This could mean less demand for commodities.

In a [July 22 report](#), JP Morgan estimated that every 10 percentage points of increase in US tariffs on Brazilian exports reduces Brazil's GDP by 0.2% to 0.3%. If the full 50% tariff is implemented, the total impact could be 0.8% to 1.2%. The bank's GDP estimates for 2025 and 2026 remain at 2.3% and 1.2%, respectively, with more downside risks than before. Their estimates factor in the tariff increases to date and will be adjusted as the situation evolves.

(3) *Copper tariffs.* Adding to the disorientation, there's [confusion](#) in Brasilia whether Trump's definition of "reciprocal" includes the existing 50% levy on steel and aluminum.

Take copper. As of now, Trump's [50% tariff](#) is less draconian than feared. It only applies to manufactured goods containing copper, such as wires and cables, not unprocessed refined copper. Still, for economies like Chile, the world's largest copper producer, which [supplies 65%](#) of US purchases of refined copper, it's quite a blow.

Latin America II: Tariffs Are a Wakeup Call. The silver lining here is that the trade war is serving as a wake-up call for Latin American countries to get their acts together. This includes raising competitiveness, increasing innovation, productivity, and prioritizing other promising markets.

Here are some of the issues Latin American nations face:

(1) *Greater integration.* Washington's ever-shifting posture toward countries like Mexico and Colombia is a problem for Latin American leaders. Trump's penchant for characterizing Latin American countries as sources of runaway migration and crime has made it politically difficult for some leaders to work with his administration. Add in Trump's tariffs and the Latin American countries are looking beyond the US for trading partners.

In an August 14 interview with Reuters, economist Jose Manuel Salazar, head of the UN commission on Latin America, called on the region to step up efforts to [diversify its export and import markets](#) and deepen integration to limit the fallout from the tariffs. One initiative Salazar considers worth accelerating: a trade agreement between Mercosur—the free-trade bloc linking Argentina, Bolivia, Brazil, Paraguay, and Uruguay—and the European Union. The pact, two decades in the making, was finalized [in December](#).

(2) *Chronic deficits.* Mexican President Claudia Sheinbaum has drawn Trump's ire by pushing back against his trade policies. Trump has long railed against the US economy's chronic [trade deficit](#) with its southern neighbor since the 1994 North American Free Trade Agreement (NAFTA).

In 2020, Trump sought to repair what he's often referred to as "[the worst trade deal ever made](#)," replacing it with the US-Mexico-Canada Agreement. Yet the deficit remains. Trump is reportedly [drawing up attack plans](#) against drug cartels.

(3) *China's big play.* Xi clearly recognizes that all this presents China with a big opportunity. In late May, the Communist Party put out the welcome mat in Beijing for the leaders of dozens of Latin American and Caribbean countries. Xi unveiled a fresh [\\$9 billion of infrastructure investment](#) and credit lines. Beijing introduced a visa-free travel program with Argentina, Brazil, Chile, Peru, and Uruguay.

All this is presenting an opportunity for China to accelerate efforts to displace the US as Latin America's main force for development and to expand Xi's signature "Belt and Road" infrastructure initiative.

Yet Latin America is especially vulnerable as "global trade becomes more fragmented and transactional," argue trade experts Antonio Ortiz-Mena and Diego Marroquín Bitar, in a June 16 *Americas Quarterly* [article](#). "Latin America will need to rethink its role in a world no longer governed by the principles of multilateralism. The coming years will be critical, as the region either adapts to this new reality or [risks being sidelined](#) in a global economy increasingly defined by U.S.-China tensions."

Calendars

US: Tues: Consumer Confidence 96.3; Headline & Core Durable Goods Orders -4.0%, 3.0%; Richmond Fed Manufacturing Index -17; Atlanta Fed GDPNow 2.3%; S&P/CS HPI 2.9%/y; Barkin. **Wed:** MBA Mortgage Applications; Barkin. (Source: FX Street)

Global: Tues: France Consumer Confidence 90; Japan Core CPI 2.4%/y; Mann; Macklem. **Wed:** Germany Gfk Consumer Confidence; Nakagawa. (Source: FX Street)

Strategy Indicators

S&P 500/400/600 Forward Earnings ([link](#)): During the August 22 week, forward earnings rose simultaneously for LargeCap and SmallCap for a 13th straight week, but MidCap's ticked down for the first time in eight weeks. LargeCap's forward earnings rose for a 14th straight week, its longest winning streak since it did so for 38 weeks through the September 13, 2024 week. MidCap's has dropped in just two of the 14 weeks since it bottomed during the May 16 week. SmallCap's has risen for 13 straight weeks since it bottomed during the May 23 week, and is now on the longest winning streak since it did so nearly four years ago for 15 weeks through the December 17, 2021 week. LargeCap's forward earnings rose 0.4% w/w to its 12th straight weekly record high. MidCap's edged down less than 0.1% w/w to a few pennies below its 19-week high a week earlier and is 0.3% below its record high during the April 4 week. SmallCap's rose 0.4% w/w to a 48-week high and is 10.3% below its June 2022 record. LargeCap's forward earnings has soared 28.8% from its 54-week low during the week of February 1, 2023; MidCap's is just 8.9% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and is up just 5.1% 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 Turmoil 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%, 10.2%, 13.3%), MidCap (0.4, 1.9, 17.5), and SmallCap (-10.2, 4.1, 17.8).

S&P 500/400/600 Valuation ([link](#)): Valuations were lower w/w for all three of these indexes during the August 22 week and at eight-week lows for LargeCap and MidCap. LargeCap's forward P/E dropped 0.4pt w/w to 21.9, and is 0.5pt below its four-year high of 22.4 during the July 25 week. It's now 4.9pts 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 dropped 0.2pt 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 fell 0.2pt w/w to 15.1, and is 0.5pt below its 20-week high of 15.6 during the July 4 week. It's 2.1pts above its 17-month low of 12.9 during the April 4 week and 4.5pts 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 a 28% discount to LargeCap's P/E, up from a 26-year low 29% discount several weeks earlier which matched its similar 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 31% discount the LargeCap's P/E, up from a 13-month-low 33% discount several weeks earlier. 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 just 3ppts 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, up from a 13-month low 6% discount several weeks earlier and 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

Regional M-PMIs ([link](#)): Three regional Fed banks so far have reported on manufacturing activity for August, *New York, Philadelphia, and Dallas*. The New York and Dallas regions showed increases in activity, while the Philadelphia region was at a standstill. *New York's headline general business activity index* rose from 5.5 in July to 11.9 in August—to its highest level since November 2024. *New orders* (to 15.4 from 2.0) accelerated this month, while *shipments* (12.2 from 11.5) continued to expand at a solid pace. Meanwhile, *delivery times* (17.4 from 8.3) lengthened significantly, and *supply availability* (-5.5 from -11.0) worsened a bit. *Employment* (4.4 from 9.2) climbed slightly higher, while the *average workweek* (0.2 from 4.2) held steady. As for pricing, the *prices-paid* (54.1 from 56.0) measure was little changed this month but remained elevated, while *prices-received* (22.9 from 25.7) showed moderate selling prices. *Turning to the Dallas region*, its *production index*—a key measure of state manufacturing conditions was 15.3 in August, down from July's 21.3, though still well above average. *New orders* (to 5.8 from -6.3) showed growth for the first time since January, while *shipments* (14.2 from 2.7) shot up to its highest reading in more than three years. *Capacity utilization* (13.7 from 17.3) eased a bit, though remained elevated. The *employment* (8.8 from 8.4) measure held fairly stable, while *hours worked* (15.0 from 7.7) climbed to its highest reading in more than three years. Turning to pricing, *prices paid for raw materials* (43.7 from 41.7) was well above its average reading of 27.4, while *prices received for finished goods* (15.1 from 11.1) was also at an elevated reading. The *Philadelphia survey's general business activity* (-0.3 from 15.9) measure was at a standstill in August. *New orders* (to -1.9 from 18.4) dipped into negative territory, while *shipments* (4.5 from 23.7) slowed considerably, though remained in positive territory. *Employment* (5.9 from 10.3) continued to register job gains, though at a slower pace, while the *average work week* (4.7 from 0.4) rose during the month. Turning to pricing, both measures remain elevated, though Philadelphia's *price-paid* (66.8 from 58.8) measure accelerated sharply—posting its highest reading since May 2022. *Prices-received* (36.1 from 34.8) accelerated, though was more subdued.

New Home Sales ([link](#)): New home sales (counted at the signing of a contract) fell in July, though there was a sharp upward revision to June sales. *New home sales* ticked down 0.6% last month to 652,000 units (saar), considerably above the consensus forecast of 630,000 units, while June home sales were revised up to 656,000 units from the initial estimate of 627,000 units. *Compared to a year ago*, sales were down 8.2%. The *estimate of new homes for sale* was 499,000 units at the end of July, representing a 9.2 months' supply at the current sales pace, unchanged from June, but up from June 2024's 7.9 months. *Regionally*, sales were mixed. The West (+11.7% to 153,000 units) was the only

region to report an increase in sales, while Northeast sales were flat at 26,000 units. Meanwhile, sales fell in the Midwest (-6.6% to 85,000 units, saar) and South (-3.5 to 388,000). Of the 652,000 *homes sold* during July, 340,000 were completed, 233,000 were under construction, and 79,000 weren't started. Of the 499,000 *homes for sale* during July, 121,000 had been completed, 267,000 were under construction, and 111,000 hadn't yet broken ground. The *inventory of unsold homes* fell to 499,000 in July, from down from 502,000 in June.

Global Economic Indicators

Germany Ifo Business Climate Index ([link](#)): Business sentiment continued to improve in August, climbing to a 15-month high. The *Ifo business climate index* increased for the seventh time in eight months, from 84.8 in December to 89.0 in August. The *expectations* component climbed from 84.7 to 91.6 over the comparable period to its highest reading since February 2022, while the *current conditions* component has been in a relative flat trend in recent months, hovering around 86.0. It was at 86.4 this month. *By sector*, *manufacturing* sentiment fell slightly in August, with companies somewhat less satisfied with current business, while their expectations were revised downward slightly. Meanwhile, there were still no signs of growth in orders. The *service sector* also saw its business climate deteriorate slightly in August. While the current situation was assessed as significantly better, expectations were subdued, with firms were more cautious about their future outlook. *Construction* showed a slight sign of weakness in August, after months of stability. Companies were concerned about current conditions, though their outlook about coming months improved. *Trade* weakened this month, reflecting a weak business performance, though expectations were slightly less pessimistic.

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