Yardeni Research

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Morning Briefing

On Japan, France, Europe & S&P 500 Earnings

Check out the accompanying chart collection.

Executive Summary: Investors in Japan's stock and bond markets aren't likely to welcome the policies of Japan's probable new prime minister. William explains why. … Also: Political and fiscal crises in France are rocking that nation's financial markets as investors wonder about the need for an IMF bailout. … And: Melissa discusses the economic data that have been coming out of Europe, where the stock market has been forging ahead even as the overall economy limps along. … Finally, Joe has cheery news about the prospect for Q3 S&P 500 earnings beats.

Japanese Politics I: New Leader May Trigger Bond Vigilantes. In picking Sanae Takaichi as Japan's next prime minister, the Liberal Democratic Party (LDP) made as right-leaning a choice as it could have. The conservative firebrand makes her two political heroes—Japan's Shinzo Abe, prime minister from 2012 to 2020, and the UK's Margaret Thatcher—seem almost moderate.

With nicknames ranging from "Iron Lady" to "*Taliban Takaichi*," Japan's first female leader—assuming that she can build a governing coalition by October 15, a likely prospect—will be anything but boring. Yet the real excitement is likely to be what the Bond Vigilantes make of her pro-stimulus worldview.

Let's look at why Takaichi's policies might unnerve the financial markets:

(1) *Nationalist fervor*. Even the LDP's longtime coalition partner *Komeito is unnerved* by Takaichi's nationalism, anti-immigration rhetoric, and reputation for having some of Tokyo's sharpest elbows. These reservations pale in comparison to how Takaichi might shake world markets.

The yen's slide past *150 level* to the dollar is just the beginning. Like Abe, unfortunately, Takaichi is less about structural disruption than monetary and fiscal pump priming. The

"*Takaichi trade*" sent Nikkei 255 stocks to an all-time high of 48,150 on Monday (*Fig. 1*).

(2) *Stimulus over reform*. The late Abe did more during his reign to exacerbate Japan's addiction to free money and runaway debt than to revive its animal spirits.

"*Abenomics*" was a three-part plan. The monetary and fiscal arrows were deployed immediately. But Abe failed to fire the third and *most vital arrow*: Cutting bureaucracy, modernizing labor markets, and catalyzing a start-up boom remain in the quiver still.

Only by firing up these reforms can Japan compete in the artificial intelligence age. Yet Takaichi prioritizes policy measures over more substantive reforms—with a bias toward monetary easing that puts her at odds with the Bank of Japan (BOJ) and with fiscal stimulus plans.

Japanese Politics II: BOJ Tightening Cycle in Doubt. The BOJ will have an even *harder time* pursuing its tightening agenda under Takaichi (*Fig. 2*). Last year, she called BOJ rate hikes "*stupid*."

Here's more background:

(1) *BOJ uncertainty.* The price for winning opposition support to stay in power is likely to be tax cuts. Takaichi knows that lasting more than 12 months in power—*a rarity* in Japan—requires lightning-fast wins. This Thatcherite risks triggering a *Liz Truss moment* at a time when 20-year Japanese yields are near *1999 highs* (*Fig. 3*).

(2) *The Trump question*. Takaichi scored a surprise win in Saturday's LDP election by talking tough on China and hinting at a *renegotiation* of the US-Japan tariff deal. It's not clear what would have US President Donald Trump throwing ketchup at the White House walls faster: a sharply weaker yen or Tokyo's refusing to pay his $500 billion "*signing bonus*."

Where Japan goes from here—and where that takes the globe—definitely won't be boring.

French Politics: Parisian Chaos Shakes European Markets. The collapse of France's government is the definition of a "gray swan" moment. Unlike impossible-to-foresee "black swan" shocks, the gray kind are reasonably predictable events that jolt global financial markets anyway.

Monday's resignation by France's *fifth prime minister* in two years, Sebastien Lecornu—who lasted less than a month—was precipitated by the same failure that doomed his immediate predecessors: getting a wildly unpopular budget involving tax hikes and spending cuts through a fragmented parliament, where multiple parties claim the mandate to govern.

Here's a look at why France's troubles are rocking Europe's financial markets:

(1) *Macron on the ropes.* President Emmanuel Macron faces *calls to resign* and/or call a parliamentary election. The problem is the not-so-gray area between France's dueling political and fiscal crises. The last thing the Eurozone needs amid a global trade war, China's export of deflation, and intrigue in Japan—the largest creditor nation—is investors' debating whether Europe's second-largest economy needs the International Monetary Fund's (IMF) assistance.

(2) *Debt market tremors*. Damage already has been done: *French stocks* and the euro have moved lower (*Fig. 4*). On Monday, yields on French 10-year notes *jumped to 3.58%*, the highest since January (*Fig. 5*). The borrowing premium on French debt over Germany's jumped to the *widest levels* since late 2024. French yields are higher than those of *Italy*, which the European Central Bank bailed out in 2012.

One reason the markets are so unnerved is that the latest French government lasted *just 14 hours*. If Macron names a sixth prime minister in two years and *that* government collapses too, the political volatility could play to the benefit of Marine Le Pen's far-right party.

France's annual *debt payments* are set to top 100 billion euros ($117 billion) by 2029 versus 59 billion euros in 2024. As the *sick-man-of-Europe* narrative makes headlines, IMF headquarters in Washington may be dreading a call from the *Élysée Palace* in Paris.

Between Japan and France, the Group of Seven is looking at a busy 2026. Not much gray area there.

Eurozone Economy: Limping Along. "Mixed" is the best way to describe the Eurozone's recent economic performance: Spain, a services and tourism driven economy, is growing nicely. Italy, France, and Germany—the bloc's manufacturing engine—continue to underperform, with sluggish growth.

Investors, however, haven't abandoned hope, with the EMU stock price index at a record high. Since the beginning of 2024, the analysts' forward earnings estimate for the MSCI

Eurozone has risen just 2.4%, while the region's forward P/E has expanded by 33% from 11.3 to 15.0 as of Monday's close (*Fig. 6*).

Stock investors may be hoping that fiscal policies will bolster the Eurozone's trajectory, but the political momentum behind them remains sluggish. Progress on the *competitiveness agenda* introduced one year ago by Mario Draghi—former prime minister of Italy and former president of the European Central Bank (ECB)—has been incremental at best. Its initiatives range from clean-tech investment and capital-markets integration to industrial coordination. Germany's deficit-financed infrastructure push risks being more *rhetorical* than real. Some *relief* from US tariffs on EU autos and parts has materialized, but the broader trade conflict—and its drag on US demand for Eurozone exports—is far from resolved.

Investors shouldn't expect much help from monetary policy either. The ECB held rates steady in September for the second consecutive meeting since the June 2025 cut. The financial markets took this as a signal that the rate-cutting cycle likely has run its course, as inflation hovers near the ECB's target. The bank's chief, Christine Lagarde, maintains that decisions will be made on a meeting-by-meeting basis, yet the ECB itself is bracing for a broader *shake-up* as several top policymakers—including Lagarde—near the end of their terms.

Here's more on the Eurozone's latest unenviable economic indicators:

(1) *Growth subdued*. Growth in the Eurozone is expected to remain tepid next year. The ECB *projects* real GDP growth in 2026 to fall to 1.0% after an estimated 1.2% in 2025. The bank expects weakness in the second half of 2025 to carry over into 2026.

Real GDP rose 1.5% y/y during Q2-2025 (*Fig. 7*). Germany remained the clear "sick man" of the Eurozone, growing just 0.2% y/y in Q2-2025. Spain's growth rose the fastest among the main Eurozone economies, up 3.1% y/y (*Fig. 8*).

Germany's IFO index is more volatile than real GDP, but the two series are highly correlated. September data show that German business confidence declined further into pessimistic territory, below a reading of 100, to 87.7 after increasing to a recent peak of 88.9 last month (*Fig. 9*).

(2) *Inflation moderating*. Consumer price inflation in Europe is holding just above the ECB's target of 2.0% y/y, and we see further moderation ahead given trends in compensation, a good predictor of services inflation.

Specifically, Eurozone headline inflation rose to 2.2% y/y in September, up from 2.0% in August. Core inflation (ex-energy, ex-food) was unchanged at 2.3% in September (*Fig. 10*).

Energy prices, a source of major upward inflation pressure in 2022-23, are now deflating by -0.4% y/y in September, as the region's natural gas reserves are *well stocked* (*Fig. 11*). Services inflation remains sticky, rising 3.2% y/y in September, though off a recent peak (*Fig. 12*).

Spain—with its heavy services exposure—posted inflation of 2.9% y/y in September (the highest among the four big economies). Germany, despite its weaker growth, saw inflation near 2.4% y/y, likely reflecting tariff pass-throughs (*Fig. 13*).

After a period when inflation outpaced wage gains, the balance recently reversed. In Q2-2025, compensation per employee rose by nearly 4.0% y/y across the Eurozone, but that was down from a recent peak of nearly 6.0% during Q2-2023. The ECB's *wage growth trackers* for late 2025 and into 2026 point to further deceleration, suggesting that services inflation may continue to moderate as well (*Fig. 14*).

(3) *Services sector steady, manufacturing contracting.* The Eurozone's non-manufacturing purchasing managers index (NM-PMI) hovered near 50 in September, signaling that domestic demand for services remains firm enough to sustain lingering price pressures. The services PMI, still above the manufacturing gauge, eased to 51.3, pointing to cooling momentum rather than outright contraction. Spain's NM-PMI continues to lead the pack at 54.3, while Germany's, at 51.5, has just edged back into expansion. France's services sector, by contrast, slipped into mild contraction, at 48.5 (*Fig. 15*).

Soft M-PMIs reinforce expectations for weaker growth. The Eurozone M-PMI dropped below 50, to 49.8, indicating a mild contraction in September. That was also true for the individual M-PMIs of Germany, France, and Italy. Spain's M-PMI fell too, though barely avoided a contraction (*Fig. 16*).

(5) *Productivity limping along*. Low productivity growth has *long* been a structural weak spot in the Eurozone, and the numbers remain uninspiring. Labor productivity grew just 0.8% in Q2-2025—consistent with a broader decade-plus pattern of sub-2% gains (*Fig. 17*).

Can Mario Draghi—a man known for doing "*whatever it takes*"—save the day and revive Eurozone competitiveness? The clock is ticking.

US Strategy: Q3 Earnings Surprises on Tap. Joe has been tracking the quarterly reporting seasons for S&P 500 companies collectively since Q1-1994. Typically, analysts cut estimates gradually until the quarter's last month, when some companies warn of weaker results. The combination of falling forecasts for them, steady forecasts for others, and few estimate increases just before the report date lowers the collective expectations. When reported earnings come in stronger, the blended estimate/actual data series forms an "earnings hook" pattern—indicating a positive earnings surprise.

The Q3-2025 estimate revisions data suggest another big earnings surprise is on tap, but probably not as large as that of Q2, when analysts curtailed their expectations amid managements' tariff uncertainty. Analysts expect S&P 500 earnings will rise 8.8% y/y in Q3 on a proforma "same-company" basis, down from 13.8% in Q2 (*Fig. 18*). Q3's earnings hook could see the S&P 500 record a fourth straight quarter of double-digit percentage earnings growth, the longest streak since the five quarters through Q1-2022.

Here's how expectations for Q3 relative to Q2 have shaped up for the S&P 500, the Magnificent-7, and the S&P 493:

(1) *MegaCaps still growing earnings faster than the S&P 500 and S&P 493.* The analysts expect the Magnificent-7 group of stocks to record Q3 earnings growth of 14.2% y/y, just around half the group's Q2 growth rate of 26.4% y/y (*Fig. 19*). That Q2 growth rate represented a magnificent beat, 12.3ppts, relative to the 14.1% forecast. We anticipate another big earnings beat for Q3.

For perspective, the analysts' 14.2% expectation would be the group's slowest rate of y/y growth since the 5.9% recorded in Q1-2023, when five of the Mag-7 posted double-digit percentage declines.

By company, here are their y/y earnings growth comparisons: Nvidia (51.6% in Q3-2025, 52.4% in Q2-2025), Microsoft (10.9, 23.5), Amazon (10.1, 34.6), Alphabet (6.7, 19.3), Apple (5.0, 9.2), and Tesla (-28.1, -22.2).

S&P 500 earnings excluding the fast growing Mag-7—a.k.a. "the S&P 493"—are expected to be positive again, rising a projected 6.5% in Q3—below Q2's 8.6% and down from double-digit rates in the prior two quarters (their best in three years). On the bright side, Q2's final growth rate of 8.6% was a whopping 650ppts above the consensus forecast of 2.1%. The bigger beats trend is likely to repeat again in Q3, and we think the S&P 493 will return to double-digit percentage growth.

(2) *Profit margin expansion to new record highs?* Looking back at the final results for Q2-2025, the S&P 500's quarterly profit margin rose 0.2ppts q/q to a 15-quarter high of 13.6%. That well exceeded the analysts' forecasts of 12.9%. For Q3-2025, they expect the quarterly profit margin to edge down 0.1ppt q/q to 13.5% (*Fig. 20*). We think the surprise hook will cause Q3's margin to finally exceed the record-high 13.5%-13.8% of Q2- to Q4-2021.

The collective profit margin of the S&P 493 rose to an 11-quarter high of 12.1% during Q2, 0.6ppt ahead of the 11.6% forecast. Analysts currently expect the profit margin to drop by 0.1ppt to 11.9% in Q3-2025. For the surprise hook to push it above the 12.9% record high of H2-2021 would be a stretch, as many sectors are in a profit margin recession (e.g., Consumer Staples, Energy, Health Care, Materials, and Real Estate).

The Mag-7's collective margin is expected to drop q/q for a second straight quarter to 25.4% in Q3. That's down 0.6ppt q/q and 1.1ppts below its record-high 26.5% in Q1. If Q2's surprise hook of 1.2ppts is matched in Q3, that would mark a new record high. Here are the margin comparisons by company: Nvidia (55.7% in Q3-2025, 55.1% in Q2-2025), Meta (34.8, 38.6), Microsoft (36.3, 35.6), Alphabet (28.2, 29.2), Apple (25.8, 25.0), Amazon (9.5, 10.8), and Tesla (7.0, 6.3).

Calendars

US: Wed: MBA Mortgage Applications; Minutes of September FOMC Meeting; Barr; Kashkari; Goolsbee; Musalem. **Thurs:** Powell; Barr; Daly; Bowman. (Source: FX Street)

Global: Wed: Germany Industrial Production -1.0%; Germany Buba Monthly Report; BoE FPC Meeting Minutes; Lagarde; Elderson; Pill. **Thurs:** Eurogroup Meetings; ECB Publishes Account of Monetary Policy Meeting; Lane; Balz; Mann. (Source: FX Street)

Global Economic Indicators

Germany Factory Orders (*link*): German factory orders fell 0.8% in August, the fourth straight monthly decline, missing the consensus forecasts of a 1.4% gain. July orders recorded a 2.7% shortfall. *Foreign* demand contracted 4.1% in August, with orders from *outside the Eurozone* contracting 5.0%, while orders from *within the Eurozone* sank 2.9%.

Meanwhile, *domestic orders* jumped 4.7%, driven by a jump in the defense sector. The less volatile *three-month on three-month comparison* showed factory orders were 2.3% lower than the prior three-month period; *versus a year ago*, factory orders were up 1.5%. The drop in August orders was driven by a slump in the automotive sector (-6.4%), while demand for data processing & optical products (-11.5%) and pharmaceuticals (-13.5) orders also tumbled during the month. By contrast, orders for both metal products (15.4) and other transportation (17.1) posted double-digit gains during the month, while electrical equipment (7.2) billings also moved higher. *Excluding large-scale orders*, billings dropped 3.3%. *By sector*, consumer (-10.3) and capital (-1.5) goods orders were in the red during August, while intermediate (3.0) goods orders rose.

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