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Morning Briefing

On China, Financial Stability & S&P 500 Earnings

Check out the accompanying chart collection.

Executive Summary: Hopes that China's deflation problem is ending are premature, William reports. He explains why deflation remains a clear and present danger to China's economy, and one that's exportable to its trading partners. … Also: The Fed's latest *Financial Stability Report* depicts a reassuringly resilient financial system. Melissa recaps the report's main points, including its positive assessments in four main risk categories. … And: Joe reports that six months of improved net earnings revisions data suggest a trend reversal from years of negative readings to positive ones. Historically, such speedy reversals have led to positive readings for the next two years. This supports the S&P 500's recent recovery to a record high.

Chinese Economy I: Deflation Troubles Deepen. The latest batch of Chinese economic data releases is fueling optimism that Asia's largest economy is leaving deflation behind. For example, the rate of decrease in producer prices eased in October, while consumer prices rose 0.2% y/y after falling 0.3% y/y in September (*Fig. 1*). In reality, though, China's deflation troubles are deepening—and crying out for a far more assertive government response.

The *October figures* were somewhat skewed by President Xi Jinping's campaign to stamp out excessive price competition. This so-called "*anti-involution*" campaign had regulators scouring the economy in recent months to halt the price race to the bottom. The campaign is gaining traction, the October inflation data suggest, which is masking the forces that are ingraining deflation more deeply in China's *$19 trillion economy*. Real GDP grew just 4.8% during Q3-2025, well below the 8.0% average over time (*Fig. 2*).

Let's look at why deflation remains a clear and present danger:

(1) *Chronic weakness*. A month of improved PPI and CPI readings doesn't change the fact that this is the third consecutive year that mainland price trends have been deflationary. Chronic weakness in domestic demand continues to cloud the outlook. So do the tariffs and

geopolitical tensions, which are negatively impacting external trade (*Fig. 3*).

Zhiwei Zhang at Pinpoint Asset Management speaks for many when he says: "It's too early to conclude the deflation is over" or that Chinese price trends have "*changed fundamentally*."

(2) *Glacial reforms*. What hasn't changed is that Xi's Communist Party has been treating the underlying causes of weak prices at a glacial pace; it's mostly been treating just the symptoms.

Among the main causes: a giant property crisis that's delaying construction, weak demand dating back to Xi's "zero-Covid" policies, high youth unemployment, an aging population, and a dearth of social safety nets that might encourage households to spend more and save less.

(3) *Beijing's denial*. This latter headwind is only intensifying. Chinese families feel more pressure to save for an uncertain future than to spend in the present. In 2024, household savings reached an all-time high of roughly *160 trillion yuan* ($22.5 trillion).

Team Xi's response smacks of denial about the severity of this problem that's hamstringing economic growth as 2026 approaches. Along with the occasional fiscal jolt and raising the ceiling for local government debt issuance, China has relied on consumption voucher programs, many aimed at household appliances and electronics. Yet the aggressive monetary easing that deflation warrants is conspicuously absent.

Chinese Economy II: Risking a Japan-Like Future. On October 19, the People's Bank of China left benchmark lending rates unchanged for the *fifth consecutive month.* One reason: concern that rate cuts might set back Xi's deleveraging efforts. Another: a falling yuan might enrage US President Donald Trump, resulting in higher tariffs.

For now, Shanghai stocks are *up 18%* this year (*Fig. 4*). Yet monetary stinginess might only prolong a deflationary cycle that's heading toward a fourth year. "And that's when *China becomes Japan*," Eeva Kerola, China expert at the Bank of Finland's emerging economies research department, told Bloomberg.

Here's more:

(1) *Avoiding Japan's troubles*. As Tokyo proved in the 1990s and 2000s, the longer

consumer prices are allowed to slide, the greater the risk that the economy will weaken in the years ahead. China's trajectory will make it even more challenging to achieve higher-income status—or, for that matter, surpass the US economy in GDP terms.

All this makes for quite the split-screen: On one screen, China appears to be on track to meet its 5% GDP growth target this year. On the other is the deflation problem that Logan Wright at Rhodium Group calls "*systemic*" amid a global trade war.

(2) *New economy versus old*. There's yet another split-screen worth considering. One depicts China's prowess in artificial intelligence (AI), semiconductors, electric vehicles, and robotics. The other shows a nation weighed down by rising debt, weak local government finances, and *aging demographics*.

What's more, with China's GDP deflator down for *10 consecutive quarters* now, the *longest streak* since at least 1993, headline figures may not be capturing how bad things are. China's National Bureau of Statistics isn't afforded the budget needed to *measure granular changes* in a lopsided economy of 1.4 billion people, divided by vast regional differences.

(3) *Sharing the pain*. China's deflation trajectory has Asia bracing for a tough 2026. "The correlation between China's export prices and other countries' import prices is high," argued Hua Cheng of AllianceBernstein in a recent *report.*

The correlation matters more than ever, from South Korea to Indonesia. "Lower import prices for Chinese goods can ripple through trading partners' economies," she said. "For example, low-priced Chinese SUVs in Thailand pressure local carmakers to cut prices, potentially triggering a deflationary cycle. China has diversified and expanded its overseas trade in recent years, including in response to US tariffs. As tariffs and deflation persist, we expect that expansion … to continue."

This increases the odds that China will share its deflation troubles with a global economy that's staggering out of 2025 and worried about what 2026 will bring.

The Fed: Financial System Stable. Investors concerned about risks to the financial system can find reassurance in the Federal Reserve's November 2025 *Financial Stability Report* (FSR). The FSR—which assesses vulnerabilities across the financial system—laid out far more strong areas than weak ones. It presents a financial system foundation that looks more durable than brittle.

Among the areas flagged to monitor were increased demand for higher-risk assets, elevated gross leverage among publicly traded firms, rising auto and credit card delinquencies, and leverage within hedge funds and life insurers.

In the FSR's survey of "novel uncertainties" that could deliver a systemic shock, the top three perceived risks increased since the last FSR, issued in *April 2025*: Policy uncertainty rose from 50% to 61%, geopolitical risks from 23% to 48%, and the risk of higher long-term rates from 9% to 43%. Inflation concerns remained steady near 40%.

AI-related risks were cited by roughly 30% of respondents surveyed—still moderate but notably higher than the 9% in the April report. Importantly, the report's discussion of AI is limited to its use in algorithmic trading, not addressing the economy-wide impacts of widespread AI adoption. The FSR's overall takeaway seemed to be that AI's use in trading is a trend to keep an eye on but not a big stability risk right now.

Despite elevated financial asset valuations, the perceived risk of asset prices declining declined! Only 30% of respondents cited it as a major vulnerability, down from 36% in the April report.

More good news is that the types of shock-amplifying vulnerabilities seen in past financial system crises appear to be absent. The housing sector is not positioned for the kind of downturn observed during the Great Financial Crisis of 2008; nor do banks exhibit the balance-sheet vulnerabilities that preceded that crisis. Likewise, the conditions for disorderly selloffs in equities, bonds, and real estate are not in place. Banks' capital positions remain sound, and household and business borrowing levels are broadly manageable relative to income. Liquidity strains are unlikely under current funding conditions.

While the November FSR found just a handful of reasons to worry, we count at least a dozen positive takes on financial stability in the Fed's four main risk categories:

(1) *Why elevated asset prices won't lead to outsized drops*. The FSR says that asset prices are high, but the conditions that can turn a market drop into a bigger problem—like weak bank balance sheets, heavy borrowing, and funding strains—aren't showing up right now. In other words, even if prices did fall, the financial system looks much better positioned to handle it than in past periods when stress spread quickly.

The report says that trading conditions in both the stock and Treasury bond markets have improved compared with the volatility and liquidity strains seen in 2022 and early 2023.

Credit markets also look calm, with borrowing costs for companies not showing signs of stress. While commercial real estate remains an area of close monitoring, the report notes signs that vacancy dynamics and rent growth patterns have begun to stabilize rather than deteriorate further.

(2) *Why business and household borrowing won't lead to distress.* The FSR underscores that household and nonfinancial corporate leverage remains manageable. Debt-to-GDP ratios are stable and notably below the levels recorded in the mid-2000s. Most publicly traded firms demonstrate the capacity to service debt. On the household side, debt is concentrated among borrowers with higher credit scores under post-crisis underwriting standards, and mortgage delinquency rates remain historically low. Credit card debt balances have stabilized.

(3) *Why financial sector leverage won't strain banks.* The banking system remains well capitalized. Regulatory capital ratios are near historically high levels, and the FSR emphasizes that banks are positioned to absorb sizable losses under unfavorable conditions. Supervisory stress test results continue to show that large banks could manage substantial credit, market, and trading losses while maintaining lending capacity.

(4) *Why funding risks are low.* Funding stress remains low across the system. Growth in government money market funds has supported stability in short-term funding markets, and the FSR reiterates that these funds make up the least fragile segment of the cash management universe. Banks maintain high levels of liquid assets, and reliance on uninsured deposits is historically low. This significantly reduces the likelihood of rapid deposit flight or disorderly funding withdrawals.

Strategy: Estimate Revisions Data Settling in Orbit. This week, LSEG released its November snapshot of the monthly consensus revenues and earnings estimate revision activity over the past month. In our *S&P 500 NRRI & NERI* report, we index this activity by the number of upward revisions less downward ones, expressed as a percentage of total forward estimates. A zero reading indicates that an equal number of estimates were raised as lowered over the past three months.

Our resulting Net Revenues Revisions Index (NRRI) and Net Earnings Revisions Index (NERI) reflect three months of activity, encompassing an entire quarterly reporting cycle (since analysts' tendency to revise their estimates differs at different points in the cycle).

Joe's review of the November data found that revisions activity remains impressively strong among most of the S&P 500's 11 sectors, as it has since bottoming in May. More than a few sectors' data stand at or near multi-year highs. Some highlights:

(1) *S&P 500 NERI remains near four-year high.* The S&P 500's NERI was positive in November for a fourth straight month, having turned positive in August (for the first time in 11 months). While November's NERI fell 0.7pt m/m to 5.2% (from a 47-month high in October), it still was up sharply from a 28-month low of -7.8% in May (*Fig. 5*).

November's 5.2% NERI reading ranks in the top 13% of the 487 monthly observations since March 1985, when the data were first calculated, and is well above the average reading of -1.9% seen since. More impressively, the 13.1ppts jump in NERI over the six months since May is its biggest improvement since February 2021 and ranks 21st overall, or among the top 4% of the six-month changes since 1985.

NERI finally has broken out of its mostly negative range since June 2022 and settled well above its average historical readings.

The speedy NERI reversal began six months ago in June. Historically, when NERI has reversed trend this fast, positive readings followed for the next two years. That supports the S&P 500's recent recovery to a record high and suggests further above-trend gains ahead.

(2) *Many sectors have positive NERI.* Seven S&P 500 sectors recorded positive NERI for a third straight month in November, the most since August 2024 and up from five sectors in August. That's a notable improvement from May, when only Utilities' NERI was positive.

Though no new sectors joined in the positive NERI club this month, these two improved markedly on a m/m basis for a sixth straight month, to multi-year highs: Information Technology and Utilities (*Fig. 6* and *Fig. 7*). Utilities' 18-month positive NERI streak easily leads all 11 sectors, and its NERI is at a 58-month high. NERI is at a 48-month high for Information Technology and Health Care, followed by Financials at a 45-month high (*Fig. 8* and *Fig. 9*).

Here are the November NERI readings for the S&P 500's 11 sectors: Information Technology (12.8%, 48-month high), Financials (12.0, 45-month high), Communication Services (7.1), Health Care (5.9, 48-month high), S&P 500 (5.2), Utilities (4.4, 58-month high), Consumer Discretionary (3.0), Industrials (2.8), Real Estate (-1.3, 12 months negative), Consumer Staples (-2.6, 17 months negative), Materials (-4.8, 16 months negative), and Energy (-6.2, 16 months negative).

Calendars

US: Wed: MBA Mortgage Applications; OPEC Monthly Report; Williams; Bostic; Paulson; Waller; Miran; Collins. **Thurs:** Williams; Daly; Bostic; Kashkari; Musalem; Hammock. (Source: FX Street)

Global: Wed: Germany CPI 0.3%m/m, 2.3%y/y; Germany WPI 0.1%; Italy Industrial Production 1.5%; De Guindos; Schnabel. **Thurs:** Eurozone Industrial Production 0.8%m/m, 2.1%y/y; UK GDP 0.0%m/m, 0.2%q/q; UK Industrial Production -0.1%m/m, -0.2%y/y; Elderson; Greene. (Source: FX Street)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): The *Small Business Optimism Index* (SBOI) fell for the second straight month, though remains above its 52-year average of 98.0. The SBOI slipped to 98.2 in October, after climbing from 95.8 in April to a seven-month high of 100.8 by August. Meanwhile, the *Uncertainty Index* sank 12 points to 88—the lowest reading this year, though still historically high. A decrease in business owners reporting uncertainty about the expansion outlook accounted for most of the fall. During October, five of the 10 components of the SBOI fell: earnings trends (-9ppts to -25%), expect the economy to improve (-3 to 20), plans to increase inventories (-3 to -2), sales expectations (-2 to 6), and plans to increase employment (-1 to 15). Meanwhile, expected credit conditions (+4ppts to -3%), current inventory (+3 to -4), capital outlay plans (+2 to 23), and now is a good time to expand (+2 to 13) all contributed positively to October's SBOI, while current job openings was unchanged at 32%. Quality of labor (27%) was the *single most important problem for small business owners* in October—near its survey high of 29%—with taxes (16), inflation (12), and poor sales (10) among the highest percentages. The net percentage of owners *raising selling prices* fell to 21% from 24% in September, hovering around these percentages the past four months. It was at 32% in February—which was the highest percentage since May 2023. A net 30% of surveyed owners *plan price hikes* in the next three months, a tick below September's 31%. Turning to *compensation*, a net 26% reported raising compensation in October, down from 31% in September and 33% in June, while a net 19% plan to raise compensation in the next three months, unchanged from September's level; it peaked at 28% last November.

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