December 16, 2025

Morning Briefing

On Challenges For China & Europe

Check out the accompanying chart collection.

Executive Summary: It's not China's feared "Lehman moment." But the psychological impact of Chinese property developer Vanke's inability to pay its debt on time can't be overstated, writes William. The situation is rattling investors who recall the 2021 default of China Evergrande Group and catastrophic aftermath. Now Vanke's problems suggest the property sector's troubles are far from over, putting the government's GDP growth goals further from reach. Japan's lost decades hold lessons for China, if only President Xi would heed them. … Also: The European Central Bank may be about to start tightening, notwithstanding the global challenges. This has stirred global debate about the limits of monetary policy to fix what ails an economy.

Chinese Economy I: Deepening Property Crisis. As China approaches 2026, one of its two main economic engines is faltering, imperiling President Xi Jinping's ability to achieve a soft landing.

The engine doing most of the work—and getting the global attention—is the tech boom that Xi's been generating for a decade now. The success of artificial intelligence upstart *DeepSeek*, electric vehicle juggernaut BYD, and numerous renewable energy startups has put China Inc. in the global headlines for all the right reasons.

Yet as China's "new economy" narrative gains global traction—and now with added fuel from *Nvidia chips*—the old economy risks shutting down. A week ago, it was fair to argue China's all-important property sector—and real estate stocks tied to it—was sputtering (*Fig. 1*). Yesterday's news that *China Vanke Co.* may be crashing to earth means the property crisis may be worsening, making Xi's attempts to keep Asia's largest economy aloft more difficult.

Let's explore why Vanke's reckoning is so worrisome:

(1) *Default troubles continue*. The immediate focus on Vanke is its roughly *$50 billion* of

outstanding debt. So far, the company has failed to convince bondholders to extend by one year the repayment of an onshore bond due this week. Yet the effort to buy more time itself is still rattling markets, which remain triggered by the *2021 default* of China Evergrande Group.

Vanke is giving investors a clear case of deja vu. Since Evergrande's reckoning, investors have navigated around *$130 billion* in property developer defaults. As the crisis claimed developer after developer, Team Xi claimed bold efforts were afoot to repair the sector and halt deflation (*Fig. 2*). Now Vanke's troubles demonstrate that the rot continues to spread and deepen.

(2*) Psychological blow*. Shenzhen-based Vanke, with about *$160 billion* of assets, employs *127,000 people*. The skyline of the bustling metropolis—a roughly 20-minute train ride from Hong Kong—is crowded with Vanke projects: skyscrapers, high-end shopping districts, and sprawling residential blocks. It's not hard to extrapolate the local fallout on jobs and local businesses.

But arguably more impactful than the immediate economic fallout is the psychological fallout of Vanke's stumble. That is difficult to overstate. Whereas Evergrande, *Country Garden Holdings*, and others overleveraged with abandon, Vanke was viewed as the best run and most conservative developer. The last survivor of China's years-long property crunch was an industry exemplar.

Now, not so much. As economists count the knock-on effects to come, the exercise offers a timely microcosm of how China's old-economy troubles limit its tech ambitions.

(3) *China's 'Lehman moment' watch*. The only good news here is that Vanke might not represent the "Lehman moment" that China's financial markets have been fearing. If stumbles by much larger players like Evergrande and Country Garden didn't trigger systemic shocks that slammed global markets, Vanke probably won't upend Wall Street either.

Chinese Economy II: Failing To Heed Japan's Lessons. This new evidence of a deepening property crisis highlights how Xi has failed to heed the lessons from Japan's lost decades. Drip, drip, drip crises only delay the pain. And as Japan proves, taking on mountains of debt to paper over financial distress can cause even bigger problems.

In Japan's case, efforts to insulate the broader economy from the banking sector's bad-loan crisis shackled the government with the worst national debt in the developed world. That burden is a key reason why, 26 years after cutting rates to zero, Japanese borrowing costs remain there, effectively. If the Bank of Japan *tightens* its key interest rate by 25bps on Friday, as is widely expected, the move will bring the rate up to only 0.75%.

Given China's level of development, its *$19 trillion economy* can't afford a lost decade. And yet, the piecemeal, incrementalist way in which Xi is tackling the biggest economic challenge of his 12-year-plus reign is prolonging the damage. Side effects include near-record-high youth unemployment and chronically weak consumer demand (*Fig. 3*).

Signs that China's economy is headed in the wrong direction have been mounting:

(1) *Drip, drip, drip*. On Monday, China reported that the years-long decline in home prices, which Xi has promised to halt numerous times, continues unabated. In China's 70 biggest cities, new-home prices, excluding state-subsidized housing, fell 2.4% y/y on average in November (*Fig. 4*). In October, they fell 0.45% m/m, the biggest decline in a year. The value of resale homes fell 0.66% m/m in November, roughly the same drop as in October.

Had Beijing acted more quickly to stop the bleeding and expand social safety nets to encourage households to save less and spend more, economists might be more optimistic about 2026. Never mind the tariffs and where President Donald Trump might take his trade war next year.

(2) *When good news is bad.* On the surface, it sounds grand that China's trade surplus topped $1 trillion in November for the first time (*Fig. 5*). It was a reminder of how China is navigating the 47.5% US tariff. Yet the surplus is also a reminder of the weakness of domestic demand as imports lag. While exports *rose 5.9% y/y* in November, imports increased just 1.9% y/y. Export strength is simply masking the increasing weakness of household consumption.

(3) *Negative wealth effect*. Most of these dots can be connected to the property crisis. This includes a powerful negative wealth effect that this year's *15% rise* in Shanghai stocks can't offset (*Fig. 6*). As the construction sector, which employs about *51 million people*, grinds to a halt, domestic demand seems unlikely to improve. Local governments, meanwhile, can no longer rely on land sales to developers to support their public spending.

To date, municipalities have issued increasing amounts of debt to make up the difference and toyed with housing incentives. The national government has relied on trade-in programs for household electronics. Yet bold, creative steps to end the property nightmare are conspicuously absent, adding to consumer pessimism.

(4) *Deflation deepens*. Though reliable data are hard to find, the ratio of Chinese household debt to per-capita disposable income was about *145% as of 2023* versus 97% in the US.

Since then, as deflation took hold, the People's Bank of China (PBOC) has been a bit too restrained about cutting borrowing costs or going further to reduce bank reserve requirement ratios. Lacking independence, the PBOC has bowed to political priorities. One reason: A weaker yuan might increase the odds of more defaults on overseas debt. Another: a falling exchange rate might anger Trump World.

Yet this restraint is allowing deflation to deepen. This is fueling "Japanization" chatter as Chinese and Japanese 10-year government bond yields converge at a moment when Xi is accelerating China's global tech ambitions (*Fig. 7*). It's hard to become a self-reliant tech superpower with a rickety financial system.

European Economy: ECB Decision in Global Footlights. As the European Central Bank (ECB) prepares to meet on Thursday, economists seem uniquely uninterested in the proceedings. That's because the drama has already shifted to 2026, when ECB watchers wonder if a rate hike is in store.

The specter of a tightening move isn't the conventional wisdom of just a few weeks ago. Since June 2024, the ECB has been a reliable rate cutter, slashing borrowing costs by *200 bps* over the 12 months ended June 2025 (*Fig. 8*). It then paused the easing cycle, with ECB President Christine Lagarde arguing that monetary policy is in a "good place" after inflation returned to the preferred target around 2.0% y/y (*Fig. 9*).

Almost universally, observers had been expecting the ECB to stand pat when it meets this week. But a recent *Bloomberg poll* suggests a recent shift: More than 60% of ECB watchers surveyed now consider the next move most likely to be a rate hike, up from one-third of respondents in October. In a *Bloomberg interview* last week, Isabel Schnabel, an influential ECB board member, said they're not wrong—catalyzing international debate.

The ECB may be done easing primarily because the Eurozone's GDP growth is performing well. GDP has been growing at a nearly *1.5% y/y rate* for the past two quarters (*Fig. 10*). Many expect the ECB to *raise its 2026 forecast*; that optimism has helped the Europe MSCI equity index climb 15.1% this year in local currency (*Fig. 11*).

The debate that Schnabel sparked has been making global headlines for two reasons: (1) It suggests that a major economic region might be in for a more robust 2026 than expected. If the ECB is preparing for a potentially stronger 2026 for Eurozone economies despite the formidable global risks, that augurs well for US economic growth. (2) It scratches at a question bedeviling central bankers from Washington to Tokyo: Which dynamics can monetary policy reasonably address at a moment of such chaotic transition for the global economy?

Here's more:

(1) *Global intrigue*. Schnabel could be considered the ECB's counterpart to Federal Reserve Governor Stephen Miran. It's hardly an ideal comparison. But Schnabel, the prominent ECB hawk, and Miran, the standout dove on the Federal Open Market Committee, hold opposing views on the same debate.

In Europe's case, Schnabel has a point: The ECB has no real say over the structural challenges that limit the Eurozone's potential growth rate. Team Lagarde has zero influence over excessive bureaucracy, weak productivity, labor shortages, costly energy, and the ways in which intensifying competition from China are eating away at European manufacturing. For example, look no further than Chinese auto production, which is at record highs (*Fig. 12*). Another 25bps of ECB easing won't save the *German auto industry* from China Inc.

(2) *Structural crisis*. As *Schnabel said* back in February: "Interest-rate cuts can mitigate the economic weakness, but they can't solve the structural crisis." ECB Chief Economist Philip Lane has acknowledged that Europe requires *structural reforms* from national governments to achieve more robust growth. And as he noted in a *Reuters interview* last month, China's economic scale and global ambitions mean the time for standing still, reform-wise, is over. "The comparative advantage pattern in the world has turned," Lane said.

Lagarde, too, has been speaking out about governments' responsibility to implement supply-side reforms. On December 10, she *warned* of the urgent need for increased innovation, productivity, and investment across the Eurozone. She cited ECB estimates that internal trade barriers amount to an effective tariff of 110% on services and 60% on goods traded between European Union member states, levels she terms "staggering."

At Davos last January, Lagarde warned that Europe faces an "existential crisis" as global trade dynamics shift around it. As she put it then: "We are now getting this huge, big push, because another big player in the *global economy* is organizing things in a different way, and is threatening some of the partners and the players with which that country used to operate."

(3) *Geopolitical stress test*. When Lagarde & Co. claims that ECB policy is in a good place, it's not in denial about global risks. On December 12, the ECB announced it's canvasing the Eurozone's 110 biggest banks to see which potential geopolitical shocks worry them most. This "*reverse stress test*," as the ECB calls it, also asks for details on how institutions plan to minimize associated risks.

The list of potential 2026 spoilers is a daunting one: escalating US-China tensions that slam trade, energy costs and supply chains, an expansion of Russia's war in Ukraine, US military action in Venezuela or elsewhere, increased trade protectionism between the US and the EU, any sudden loss of faith in the dollar, and fiscal strains among EU members as defense spending spikes.

(4) *Musical chairs*. The rate-hike debate Schnabel has sparked is gaining traction as markets buzz about who might replace Lagarde when her term ends in *October 2027*. Schnabel said she'd be *willing to replace* Lagarde. This is fueling a musical-chairs debate over what the 1992 Maastricht Treaty and subsequent European agreements stipulate regarding ECB succession. Many believe an ECB executive board member who has served a full term can't ascend to the presidency.

Calendars

US: Tues: Nonfarm Payroll Employment 40k; Unemployment Rate 4.4%; Retail Sales & Control Group 0.2%, 0.3%; Business Inventories 0.2%. **Wed:** MBA Mortgage Applications; Waller. (Source: FX Street)

Global: Tues: Germany & France HCOB M-PMIs 48.5 & 48.2; Germany & France NM-PMIs 52.8 & 51.3; Italy CPI -0.2%m/m,1.2%y/y; UK M-PMI & M-PMI 50.2 & 51.5; Japan Machinery Orders -2.3%mm, 3.6%y/y. **Wed:** Eurozone Headline & Core CPI 2.2, 2.4; IFO Business Climate Index, Current Conditions & Expectations 88.2, 85.7 & 90.5; UK CPI 0.0%; UK PPI 0.2%. (Source: FX Street)

Strategy Indicators

S&P 500 Weekly Forward Earnings & Valuation (*link*): During the December 12 week, LargeCap's forward earnings rose for a 30th straight week, its longest winning streak since it did so for 38 weeks through the September 13, 2024 week. Forward earnings gained 0.3% w/w to its 28th straight weekly record high. The forward earnings downtrend during Trump's Tariff Turmoil in early 2025 was relatively modest compared to the deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Since its nine-week low during the April 25 week, forward earnings has soared 11.6%. Here are LargeCap's latest consensus annual earnings growth rates: 9.7% (2024) , 12.1% (2025), and 14.0% (2026). LargeCap's forward P/E fell 0.3pt w/w to a three-week low of 22.1 and is now 0.7pt below its 25-year high of 22.8 during the October 31 week. It's up 5.1pts from a 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.

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