Yardeni Research

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Morning Briefing

All About China

Executive Summary: It's a start, maybe: China's President Xi Jinping finally has a plan to stabilize the property crisis that has hobbled the nation's economy since 2020. But it's limited in scope, William reports; more aggressive reforms are in order. And critics say it could backfire, exacerbating housing oversupply and homeowners' excessive leverage. … Also: Xi's opportunistic plan to strengthen the yuan as Trump's policies weaken the dollar likewise carries negatives. Xi envisions the yuan usurping the dollar's global dominance, but a strong yuan runs counter to China's need to combat deflation and overcapacity. … And: Insufficient "drip, drip" responses to China's daunting economic challenges suggest a "lost decade."

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Chinese Economy I: Xi Gets Serious About Property Crisis. Last week could be remembered as the point that China finally got serious about ending its giant property crisis.

China's reckoning was 20 years in the making. Developers built across Asia's biggest economy at extraordinary speed, fueled by urbanization and easy credit. Things hit a wall in 2020 amid the Covid-19 pandemic. As giant projects stopped, demand cratered, and prices plunged, developers were left with mountains of debt and *80 million* surplus homes.

The glacial response by President Xi Jinping's Communist Party has left China with deflation and fending off talk of a Japan-like lost decade. This context explains why last week's news that China is launching a new effort to *stabilize the market* could be a significant development.

Let's explore how this new property plan will work and whether it might succeed:

(1) *Reducing housing glut*. The pilot program targeting three large Shanghai districts aims to reduce the massive inventory of unsold homes using a "trade-in" mechanism. Residents of Pudong, Jing'an, and Xuhui will be able to sell their old homes to state-owned enterprises. The proceeds can be used to buy new homes, while the old homes will be converted into affordable rental housing units.

If implemented properly, the impact would be threefold. One, it would stabilize prices and enable developers to get back to work at idle construction sites. Two, it would help younger Chinese priced out of the housing market access more affordable rental options closer to urban areas where the jobs are located. Three, it would revive consumer demand, given that 70% of *household assets* are tied up in real estate.

(2) *Thinking bigger*. To be sure, there are many reasons to doubt the success of these efforts. One is the lack of clarity on the scale of the effort or a specific timetable. And why just the Shanghai area? Why not implement the trade-in scheme nationwide?

In a February 5 *report*, Morgan Stanley described it as a symbolic gesture with limited potential impact. The investment bank worries that, if implemented poorly, the plan could exacerbate the problem of excess housing supply in the long run. Also, since new-home prices are markedly higher in Shanghai and other core urban areas than prices for older trade-ins, overly leveraged homeowners might become even more so.

(3) *Mobilizing savings*. Still, as Edward Chan at S&P Global Ratings explains, purchasing secondary homes could "*provide liquidity* to existing homeowners. If those homeowners use such proceeds to buy primary homes, that will also help destock excess housing inventory. In our view, elevated housing supply is a major factor hindering China's property market recovery."

Also, Chan argues, the more success Xi's party has in increasing the "availability of social rental housing for those in need," the better the odds of increasing household confidence. This is vital to mobilizing China's 1.4 billion people to deploy their *$22 trillion* in savings to support Beijing's ability to grow the economy at close to 5% a year.

(4) *Stabilizing expectations*. Morgan Stanley's Robin Xing thinks it's time for massive mortgage subsidies to revive the housing sector. He estimates that roughly *$57 billion* of subsidies will be required per year to "stabilize expectations." Without them, Xing worries that the property sector might not bottom out until 2027—or maybe even later than that.

Along with lower mortgage rates, economists think Team Xi should consider reducing downpayment thresholds and reducing transaction fees for homebuyers. Land-use reforms are also needed to enable rural land to be traded more like urban land, thereby increasing supply and lowering prices.

Chinese Economy II: Can Yuan Capitalize on Dollar's Woes? The timing of Xi's housing plan seems connected to the other big news in China over the last 10 days: *Xi's push* to position the yuan as the reserve currency of choice, seeking to capitalize on the policy chaos in Washington.

Xi has been trying to internationalize the yuan since at least 2016, the year it was included in the International Monetary Fund's "special drawing rights" basket along with the dollar, euro, yen, and pound. It's been a slow grind, though. Ten years on, the yuan accounts for just 2% of foreign-exchange reserves compared with *57% for the dollar* and 20% for the euro.

On January 31, *Qiushi* magazine, the Communist Party's *flagship journal*, reported on a speech Xi delivered behind closed doors in 2024. Xi declared that China needs a "powerful currency" that's "widely used in international trade, investment and foreign exchange markets, holding the status of a global reserve currency." While the comments sound dated, the timing of the report—and its publication in the Politburo's chosen vehicle for announcing high-level policy shifts—caught the financial markets' attention.

To many Sinologists, this effort suggests that Team Xi sees an opportunity, as President Donald Trump's tariffs and attacks on the Federal Reserve have prompted many global funds to question the stability of dollar assets and whether the White House even wants to preserve that stability given Trump's stated desire for a *weaker dollar*.

"Policymakers could think that it's … good timing right now because financial institutions have a strong consensus that the *dollar is weakening*," argues Xing Zhaopeng at Australia & New Zealand Banking Group.

Here's more:

(1) *Time for reforms*. Ending China's property crisis once and for all is a prerequisite to upping global trust in the yuan and its use in trade and finance. But myriad other needed reforms would bolster the case for the yuan too: scrapping strict capital controls, making the yuan fully convertible, increasing transparency, building globally trusted payment systems, strengthening institutional frameworks, creating a globally respected credit rating industry, and making the People's Bank of China (PBOC) independent.

So far, Xi's reform team has prioritized increasing access to Chinese government bonds and stocks over the supply-side upgrades needed to increase global trust in China's financial system.

(2) *Countervailing yuan needs*. The PBOC issue is particularly important given China's deflationary pressures (consumer price inflation was *essentially 0.0%* in 2025). Xi's broader priorities have constrained PBOC Governor Pan Gongsheng's ability to increase liquidity to help alleviate the deflationary pressures. For those purposes, a weaker yuan would be more beneficial.

Yet a weaker yuan might increase the odds that giant developers default on offshore debt. A lower exchange rate could prompt Trump to impose ever higher tariffs on China. In short, the liquidity that China needs to fight deflation would work at cross-purposes with Xi's "*strong yuan*" mission to achieve reserve-currency status.

Still, the optics of deflation and persistent manufacturing overcapacity do little to bolster China's position. Hence, Xi's renewed push to stabilize the property crisis. The problem is that far more aggressive policy measures are needed to avoid a *lost decade* of slow growth, akin to that experienced by Japan in the late 1990s through the early 2010s.

Possible responses include: a bolder effort to reduce housing inventories across China's 22 provinces, more aggressive state-led purchase programs, lower mortgage rates to increase affordability, moving away from the old high-leverage model of housing purchases, building a bigger social safety net to prod consumers to save less and spend more, and repairing local government balance sheets.

(3) *Off-balance-sheet liabilities*. China's municipal governments were hit especially hard by the post-Covid-19 housing crash. Prior to the pandemic, most financed operations with

property taxes and large-scale land sales. Since then, local governments have had to borrow heavily to fill the gap. As of the end of 2024, municipalities were sitting on *$9-trillion-plus* of local government financing vehicles (LGFVs), equivalent to roughly half of China's GDP.

These largely off-balance-sheet liabilities are rarely factored into economists' discussions of national debt levels. Yet these burdens are effectively paralyzing local leaders' ability to invest in infrastructure, human capital, and the cultivation of local startups. Xi needs to launch a bigger effort to reduce LGFV burdens, particularly in regions struggling to keep factories operating amid Trump's trade war.

Chinese Economy III: Taking Wrong Lessons from Japan. While Xi's Shanghai plan sounds promising, much more is needed. The drip, drip, drip response echoes Japan-like efforts to paper over financial cracks.

In a *December report*, Federal Reserve Bank of Dallas economists Scott Davis and Brendan Kelly found that in 2024, about 40% of China's bank loans to the real estate sector were made to companies with operating profits insufficient to cover interest obligations versus 6% in 2018.

"There's mounting evidence of 'zombie lending' in China—banks rolling over bad loans to unprofitable firms and allowing the status quo to continue rather than recognize losses." In many ways, they argue, "the current experience in China mirrors that of *Japan in the 1980s and 1990s*. Rapid growth in private sector debt—also fueled by domestic savings—was followed by the appearance of zombie lending. In Japan, that zombie lending led to the inefficient allocation of capital and decreased productivity, especially in sectors shielded from foreign competition."

A few related observations:

(1) *Uncertain world*. Chinese authorities, the economists point out, have introduced a high-profile "*anti-involution*" campaign against aggressive price competition in 10 leading manufacturing sectors. Its success will be important for limiting the share of zombie assets in the all-important manufacturing sector.

An added challenge for China is that the external sector could deteriorate. In 2025, Xi's government leveraged global trade to offset domestic headwinds. Despite the tariffs, China posted a record *$1.2 trillion* trade surplus. Maintaining overseas shipments at a healthy pace is becoming more difficult as US employment slows and European demand underwhelms.

One big "*gray swan*" risk is Trump's doubling down on tariffs. South Korea got an early taste last month when Trump suddenly *threatened to raise* the agreed-upon 15% levy on US imports from South Korea to 25%. Trump also threatened a *100% tariff* on imports from eight European countries that don't support his designs on Greenland.

(2) *Beeline to Beijing*. Xi's government sees a window to position China as a more stable and reliable partner in trade and geopolitics than Trump's America. The past two months

saw the leaders of Canada, Finland, France, Ireland, Korea, the UK—and soon German Chancellor Friedrich Merz—*make a beeline* to Beijing to tighten trade ties with China.

The global unpopularity of Trump's ever-shifting tariff policies is enabling Xi to recast China as a place open for business. Trump's efforts to commandeer the role of the Fed, for example, have stoked worries among investors and governments alike about the sanctity of the dollar and US Treasuries at the center of the global financial system.

(3) *Policy volatility*. The surge in the price of gold to a *record $5,500* per ounce last month spoke to the level of alarm. Yet to make the most of the policy volatility in Washington, Xi's reform team must do considerable heavy lifting at home. This means ending the property crisis and streamlining China's capital markets.

A consistent misstep of Xi's government is to view increased capital inflows as a reform all their own. The inclusion of Chinese stocks in MSCI indexes and of Chinese government bonds in Bloomberg, FTSE Russell, and JPMorgan indices has solidified the mainland's status as a core investment destination. But China's opacity, heavy-handed regulatory interventions, deflation, and geopolitical uncertainties surrounding issues like Taiwan limit China's overall appeal.

In 2025, foreign direct investment (FDI) in China *fell 9.5%* y/y despite the economy's reaching its 5% growth target. That followed a much deeper *27.1% drop* in 2024. The fact that FDI remains in the red suggests that drag from China's property troubles has global capital treading carefully.

(4) *Clock is ticking*. This suggests that time isn't on Xi's side. "Without at least a partial recovery in the real estate market, the Chinese government will be hard-pressed to make *meaningful progress* on its much-trumpeted goal of boosting domestic demand," argues Jeremy Mark at the Atlantic Council. Even once the shockwaves from China's collapsed property bubble recede, Mark notes, "the task of rebuilding will be daunting. It requires not only replacing a major pillar of Chinese economic dynamism, but also the revitalization of homeowners' deeply damaged sense of financial security."

Xi's Shanghai pilot program is a promising start—and a welcome sign of renewed urgency. But moving a *$19 trillion economy* beyond a giant real estate slump now in its fifth year will require a far more assertive policy response. Without it, Xi's reserve currency ambitions may suffer, too.

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the February 6 week, forward earnings rose for LargeCap and SmallCap, but four company changes within the MidCap index bumped theirs down for the first time in 11 weeks. LargeCap's forward earnings rose for a 38th straight week, its longest winning streak since it did so for 39 weeks through the June 23, 2011 week. MidCap's recovery has two-step backed at times due to index changes, but has risen in 32 of the 38 weeks since it bottomed during the May 16 week. SmallCap's has risen in 34 of the 37 weeks since it bottomed during the May 23 week. LargeCap's forward earnings rose 0.7% w/w to its 36th straight weekly record high. MidCap's re-adjusted 0.5% lower from a record high, but has recorded 13 new highs in the past 15 weeks. SmallCap's jumped 1.5% w/w to a 40-month high and improved to 3.0% below its June 2022 record. Forward earnings had bottomed in early 2023 for these three indexes following big Tech's year of cost-cutting in 2022. Since then, LargeCap's forward earnings has soared 41.6% from its 54-week low during the week of February 1, 2023; MidCap's has slowly gained 14.4% from its 55-week low during the week of March 10, 2023; and SmallCap's has quickly rebounded 13.6% from its 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 Tariff 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 2025, 2026, and 2027: LargeCap (12.7%, 14.9%, 15.5%), MidCap (-1.6, 19.1, 14.7), and SmallCap (9.1, 13.1, 15.1).

S&P 500/400/600 Valuation (*link*): SMidCaps' valuations rose to multi-month highs during the February 6 week, but LargeCap's bucked the trend and ticked 0.1ppt lower. LargeCap's forward P/E of 21.7 is now 1.2pts below its 25-year high of 22.8 during the October 31 week. It's up 4.7pts 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. MidCap's forward P/E rose 0.8pt w/w to a 54-month high of 17.1 and is now 4.9pts 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 rose 0.4pt w/w to a 14-month high of 16.2. It's 3.3pts above its 17-month low of 12.9 during the April 4 week and 5.6pts above its 14-year low of 10.6 in September 2022, but remains 0.9pt below its 41-month high of 17.1 during the November 29, 2024 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 improved swiftly w/w to a three-year high 22% discount to LargeCap's P/E from 25% a week earlier, and has improved markedly from a 26-year-low 30% discount during the October 31 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 improved to a 13-month high 26% discount to LargeCap's P/E, up sharply up from a 25-year-low 34% discount during the November 20 week. That compares to a 23% discount during the November 29, 2024 week, which was its best reading since the March 2, 2023 week. SmallCap's P/E relative to MidCaps' slipped w/w to a 5% discount to MidCap's, up from an 18-month-low 7% discount during the November 20 week and above its 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.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
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