Yardeni Research

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Morning Briefing

On China's Challenges & Global Debt

Check out the accompanying chart collection.

Executive Summary: China is on the losing end of President Trump's foreign policy moves in Venezuela, Iran, and Greenland—all strategically important to China's economy. How President Xi responds over the next few weeks will be critical to his legacy. William discusses the ten top challenges Team Xi must confront at the government's annual "Two Sessions" meeting this week. … Also: A look at the record-high global debt—what's driving it and the ramifications.

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

Chinese Economy: A Week of Mulling Challenges from GDP to Iran. He has led Asia's biggest economy for the past 13 years, but Chinese President Xi Jinping's reputation as a reformer will hinge on what happens in the next few weeks. The clock starts ticking on Wednesday as the annual "Two Sessions" meetings commence in Beijing.

Since Xi took the reins in March 2013, these Chinese Communist Party (CCP) meetings have come and gone in a flurry of GDP targets, policy pledges, slogans, and market signals hyping outcomes that rarely materialize. Mostly, the Xi era has talked big about retooling, but stayed the course with growth led by exports, huge waves of investment, and ginormous infrastructure projects.

This complacency is running into a Great Wall of challenges that's forcing Team Xi to get to work. Economic *long Covid* is colliding with President Donald Trump's tariffs and event-rich foreign policy. The last couple of months have been head-turning for Beijing as two of its biggest global investments—Venezuela and Iran—face US military action. China looks to be on the losing end of the escalating Middle East conflict, given that it's the destination for roughly *90% of Iran's oil*. Meanwhile, Trump's designs on Greenland imperil China's "*Polar Silk Road*" plan to access Arctic rare earths and add another dimension to Xi's Belt and Road Initiative (BRI).

On the economic front, the 4.8% y/y GDP growth rate last quarter could be the new normal for a political system that derives its legitimacy from world-beating growth (*Fig. 1*). If China stays at that rate in 2026, it would be the slowest annual expansion *since 1990*, the year after the Tiananmen Square protests.

This legitimacy dynamic is on display as Xi carries out the most sweeping military purge in generations. Ahead of the CCP's annual gathering, at least *19 officials*—nine from the military—were removed from Beijing's list of lawmakers, followed shortly by Xi's highest-ranking general, Zhang Youxia.

Trump's trade war is turning up the economic heat, which Xi's party no doubt is feeling, by exacerbating Chinese deflation, now in its fourth year (*Fig. 2*). The forces behind falling prices—including a multi-year property crisis—continue to slam business and household confidence (*Fig. 3* and *Fig. 4*). On top of that, Xi's risk-averse government can't seem to decide whether AI is friend or foe.

Let's look at the 10 biggest challenges Team Xi must address this week—not with vague talk but bold action:

(1) *Forget GDP targets*. These arbitrary annual goals warp incentives and sap political will to reform. Even so, Xi is expected to set an "*around 4.5%*" target. Instead, the CCP ought to devise a better model that shares the benefits of growth with the vast majority of China's *1.4 billion people*, not just urban dwellers. This requires leveling playing fields and vastly reducing the dominance of state-owned enterprises (SOEs) to make room for more startups. A startup boom would help create high-paying jobs from the ground up.

(2) *Jolt consumption*. For years now, Xi talked about persuading mainlanders to save less and spend more. With 70% of *household assets* tied up in real estate, it's vital to end the property crisis. Yet Beijing must create a national social safety net to alter consumer behavior. Any hope of ending deflation requires getting households to deploy more than *$22 trillion* in savings. This mountain of money is more than five times the *annual GDP* of Japan, whose lost decades taught Beijing the high cost of complacency.

(3) *Municipal finances*. Amid efforts to keep GDP growth near 5% and deepen control today, Team Xi often lacks the bandwidth to do long-term risk management. Under this banner falls strengthening the financial sector and local government balance sheets. This last problem is hitting a fever pitch: Local government financing vehicles total as much as *$12 trillion*, more than half of last year's GDP. This leaves less money to invest in local

economies, start-up ecosystems, and the "future industries" that are vital to revitalizing the 21 provinces outside Beijing. It's high time that Xi announced a strategy to write down this crushing debt.

(4) *Tech self-reliance*. For Xi, getting the greenlight from Trump to buy Nvidia's H200 chips was a major win for China's AI ambitions. Yet China must accelerate moves to strengthen its six critical "*chokepoints*" vis-à-vis the US: semiconductors, high-tech machine tools, industrial software, scientific instruments, advanced materials, and bio-manufacturing components. The "*Made in China* 2025" plan that Xi unveiled in 2015 paved the way for electric-vehicle maker BYD to *surpass* Elon Musk's Tesla. This week is Xi's chance to set China's tech sights on 2035.

(5) *Foreign investment*. China has moved past the "*uninvestable*" debate that raged on Wall Street in recent years. The key now is Team Xi strengthening the business environment for multinational companies, increasing transparency, and creating free trade zones. Such talk proved hollow in the past. It's time Beijing walked the walk. Too often, China thinks welcoming foreign capital inflows is a reform all its own. But being added to indexes such as MSCI and FTSE Russell does nothing to make China Inc. more competitive. That requires tangible upgrades.

(6) *Social stability*. Along with getting consumers to spend, reducing the sobering 16.5% *youth unemployment* rate, and addressing the *increase* in local protest activity, Xi must tend to worsening demographics. Case in point: the *record-low* birthrate in 2025. A wide gender gap is another problem. China has nearly *30 million more males* than females, a mismatch that augurs poorly for stability. Such challenges are now less academic as AI upends global playing fields.

(7) *Figuring out AI*. The last 12 months have seen China enter the AI race in a big way. The "*DeepSeek shock*" on January 2025 disoriented China Inc. as much as Silicon Valley. Since then, Team Xi has struggled to harness the most disruptive technology of our age without exacerbating domestic fissures. One fear Xi's government has is that AI will cause it to lose control over political narratives. Another is that AI adoption will exacerbate youth unemployment. A recent McKinsey report found that *36% of companies* in Greater China expect AI-driven workforce reductions. These concerns may explain why Shanghai's CSI 300 Index is *up just 2.1%* so far this year.

(8) *Keeping up with the world*. In January, the US military *grabbed* Venezuelan President Nicolás Maduro and seized the nation's oil. Between 2000 and 2023, Beijing provided *more*

than $100 billion to Venezuela for drilling infrastructure, power plants, railways, and other projects. The Iran attack, meanwhile, could almost be seen as *more about China* than the Middle East. It threatens a cornerstone of China's geopolitical and economic strategy—and a *25-year* strategic partnership. It also leaves China with an energy dilemma. How does China, which is still the globe's main factory floor, replace this oil supply on the fly?

(9) *Dealing with Trump*. All this comes at an awkward moment. Trump is due in Beijing in roughly one month (*if the trip is still on*). As the US seeks a "grand bargain" trade deal, might geopolitics get in the way? If Xi simply accepts the new global order that Washington is creating, the most powerful Chinese leader since Mao Zedong might appear feckless in CCP circles. But if Beijing pushes back too hard, it risks bigger retaliation. Paradoxically, Trump's "America First" foreign policy has been *more boon than hindrance* for the BRI. Washington's tariffs, cuts in global aid, and pivot away from multilateralism enable Xi to sell China as a premier source of infrastructure and development across the "Global South."

(10) *Acting boldly and rapidly*. Yet the big story domestically this week is that Xi is on the clock as never before. After 13 years of big talk, it's time to make good on his pledge to let market forces play a "decisive" role in decision-making—and to cut bureaucracy, increase transparency, create a world-class credit-rating system, curb corruption, fully tolerate yuan convertibility, and free the People's Bank of China to make its own rate decisions. Amid so much uncertainty, this is much is clear: From GDP to Iran, this year's Two Sessions meetings carry the highest stakes of any during the Xi era yet.

Global Debt: A Record $348 Trillion Level Even Before Iran Shock. As war in the Middle East puts the global financial system under strain, many major economies may find themselves with less of a buffer than they would need if conditions deteriorate. At issue: an ongoing explosion in government debt that, even before this latest geopolitical shock, added nearly $29 trillion to international stockpiles in 2025 alone.

That increase, according to the Institute of International Finance (IIF), brings overall debt to a *record $348 trillion*. The 2025 increase is equivalent to nearly *six German economies'* worth of debt in just 12 months. Though the binge is led by China, the US, and Europe, it's much broader than that. About two-thirds of the increase comes from mature markets as deficit spending hits new highs.

Let's look at what's driving this historic buildup of debt and its implications:

(1) *The root causes*. Behind it: governments' making the expedient choice of expanding

fiscal policy rather than implementing needed reforms and thus simplifying debt regulations; highly accommodative monetary conditions and global funding conditions; rising AI-related investment; and a broadening defense-spend push.

This latter dynamic is lifting the shares of *defense mainstays* Lockheed Martin, Northrop Grumman, and RTX (formerly Raytheon Technologies). Even before this weekend's events, Japan's leader Sanae Takaichi increased this fiscal year's defense budget to a record-breaking *$72.1 billion*. In Europe, even pre-Iran war, defense spending was set to lift the government debt-to-GDP ratio by over 18ppts *by 2035*.

(2) *The good news*. For one thing, easier financial conditions globally should support efforts to mobilize much-needed capital for national priorities, including defense finance, notes Emre Tiftik at IIF. For another, rumors of the US dollar's demise once again are proving *greatly exaggerated*.

As Tiftik notes, "the long-standing safe-haven status of US Treasuries continues despite concerns about weaknesses in US fiscal balances, as strong foreign demand for US assets—including Treasuries, equities, and corporate bonds—remains robust amid solid economic activity."

(3) *Dollar holding its own*. This, of course, stands in *sharp contrast* to the popular narratives of dedollarization and capital fleeing US markets. At the end of 2025, remember, foreigners held a record-high total of $9.3 trillion in US government IOUs.

"Outside of the brief resurgence of the 'Sell America' trade foreign appetite for US assets hasn't meaningfully changed," argues Kriti Gupta at JP Morgan Wealth Management. "Instead, *relative growth* and interest rates remain the main drivers of the dollar."

Meanwhile, Gupta notes, expectations for US growth remain resilient. "Interest rate differentials have already moved in favor of the US since the start of the year," Gupta explains. "This means the recent sentiment-driven bout of dollar weakness will likely be temporary and eventually stabilize as the US economy picks up steam throughout the year."

(4) *Potential landmines abound*. As IIF's Tiftik notes, "this government debt expansion is unfolding at a time when global growth remains broadly resilient, raising questions about whether the combined force of fiscal, monetary, and regulatory stimulus—together with capex-driven private borrowing—could eventually result in episodic overheating and stretched valuations in some areas."

International Monetary Fund head Kristalina Georgieva worries that the 3.3% global growth that her economists expect this year is “beautiful but not enough.” As she said *in Davos* in January: “Do not fall into complacency. Growth is not strong enough. And that is why the debt weighing on our shoulders, which is approaching 100% of GDP, will be a very heavy burden.”

The Organisation for Economic Co-operation and Development’s numbers are even higher for advanced nations, putting the average debt-to-GDP ratio at more than 110%. Other than the Covid-19 era, *The Economist* notes, this level was last reached during the *Napoleonic Wars*. Even if the global economy is growing and rates are manageable, war in the Middle East might be less concerning if the world's top economies had more fiscal space to respond.

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the February 26 week, forward earnings rose simultaneously for all three of these indexes for the tenth time in 12 weeks. LargeCap posted another record high, and MidCap’s improved to just 0.1% below its January record. SmallCap’s forward earnings (1.2% below its record high in June 2022) has soared 13.8% y/y and is improving at its fastest rate in 40 months. That’s double MidCap’s slowed gain of 6.0% y/y (still a 12-month high) and compares to LargeCap’s strengthened gain of 17.0% y/y (43-month high).

LargeCap’s rose for a 41st straight week, its longest string of weekly gains in nearly 15 years! LargeCap’s next milestone is the 46-week streak following the Great Financial Crisis (GFC) through the March 25, 2010 week. The SMidCap’s forward earnings are also on solid uptrends too, with both indexes missing just a few of the w/w gains since Liberation Day last April.

LargeCap’s forward earnings rose 0.5% w/w to its 39th straight weekly record high. MidCap’s ticked up 0.2% w/w to 0.1% from its January 29 record high, which that index has posted in 13 of the past 18 weeks. During March 2025, MidCap re-entered the record-high-forward-earnings club, for just three weeks, for the first time in 33 months before tariffs sidelined the index for six months. SmallCap’s was up a hair w/w to just 1.2% below its June 2022 record. SmallCap’s absence from the record-high-forward-earnings club has lasted longer than its post-GFC drought, 43 months now versus 36 months then.

These three indexes' forward earnings downtrends from mid-2022 to early 2023 during Big Tech's year of cost-cutting 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 GFC. Powered by stellar growth from the Magnificent-7, LargeCap's forward earnings has soared 43.4% from its 54-week low during the week of February 1, 2023; MidCap's has slowly gained 14.8% from its 55-week low during the week of March 10, 2023; and SmallCap's has quickly rebounded 15.7% from its recent 42-month low during the May 23 week.

Analysts currently expect all three of these indexes to post double-digit percentage earnings growth in 2026 and 2027. Here are the latest consensus earnings growth rates for 2025, 2026, and 2027: LargeCap (12.9%, 15.1%, 15.9%), MidCap (-0.7, 17.4, 15.4), and SmallCap (10.4, 12.5, 17.4).

S&P 500/400/600 Valuation (*link*): Valuations fell 0.2pt across the board for all three S&P market-cap-style indexes during the February 27 week. While forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018, they've been improving since October 31 and are closing the gap as LargeCap's weakens. LargeCap's forward P/E dropped 0.2pt w/w to an eight-month low of 21.2.

LargeCap's P/E of 21.2 remains 4.2pts 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. It's now down 1.6pts from a 25-year high of 22.8 during the October 31 week.

MidCap's forward P/E fell 0.2pt w/w to 16.9 from a 64-week high of 17.1 and is now 4.7pts above the 12-month low of 12.2 in October 2023. That compares to an 11-year low of 10.7 in March 2020 and a record high of 22.9 in June 2020 (when forward earnings was depressed).

SmallCap's forward P/E dropped 0.2pt w/w to 15.7, just 0.5pt below its 14-month high of 16.2 during the February 6 week. It's 2.8pts above its 17-month low of 12.9 during the April 4 week and 5.1pts above its 14-year low of 10.6 in September 2022, but is now 1.4pts below its 41-month high of 17.1 during the November 29, 2024 week following Trump's election. 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 GFC.

MidCap's P/E was steady w/w at a three-year-high 20% discount relative to LargeCap's

P/E. That's up markedly from a 26-year-low 30% discount during the October 31 week. MidCap had been at a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021.

SmallCap's P/E was steady w/w at a 13-month-high 26% discount to LargeCap's P/E. That's well above its 25-year-low 34% discount during the November 20 week. SmallCap had been at 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 MidCap's was also steady w/w, but at a 7% discount that matches the 18-month-low discount during the November 20 week. That remains well 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.

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