Yardeni Research

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Morning Briefing

China, Retail & Hydrogen

Check out the accompanying chart collection.

Executive Summary: China has been getting back at the US for imposing sanctions by targeting easy marks: US companies that do business there. Jackie discusses the tit-for-tat cold war that's not likely to end soon and the companies, like Nvidia and PVH, caught in the middle. … Also: Two retailers catering to consumers at different ends of the income spectrum both reported underwhelming spending among US consumers last quarter. … And in our Disruptive Technologies segment: Hydrogen holds promise as an important new source of green energy, but realizing that promise has been a long, slow slog.

China: The Cold War Intensifies. US officials were sorely mistaken if they thought they could impose sanctions on China without eliciting a response. The Chinese government has been going toe-to-toe with the Biden administration, imposing their own restrictions and penalties on US companies and personnel in reaction to any restrictions or penalties the US government announces. This dance precedes the inauguration of President-elect Donald Trump, who has threatened to impose 60% tariffs on Chinese imports, and it's sure to continue.

China is taking on the US at a time when its economy remains sluggish. Even promises of additional stimulus resulted in a mixed response from the financial markets. The country's CSI 300 has rallied 16.3% ytd, but the yield on China's 10-year bond, at 1.85%, remains near a record low (*Fig. 1* and *Fig. 2*).

Here's a quick look at the ongoing China-US game of cat and mouse as well an update on some of China's recent economic data:

(1) *The US/China dance.* Nvidia is in the unenviable position of being caught between two squabbling superpowers. This week, China's State Administration for Market Regulation opened an investigation into whether Nvidia's $6.9 billion acquisition of Mellanox Technologies, an Israeli manufacturer of computer networking components, violated China's monopoly regulations. The deal was initially approved in April 2020 under the

condition that the companies would continue to supply GPUs and network equipment to China. Nvidia could face a $1 billion fine.

Why reexamine a four-year-old deal? The obvious motive is retaliation for US restrictions on sales to China of high-end GPU chips used in AI training—like those Nvidia makes—and high-bandwidth memory chips. The US added 140 Chinese entities to its trade blacklist, including large domestic chip toolmakers and semiconductor manufacturing plants.

In addition to investigating Nvidia's acquisition, China has banned exports to the US of gallium, germanium, antimony and other metals used in making semiconductors. Prior to the ban, the US imported almost all of its gallium, about half of its germanium, and 80% of its antimony, mostly from China.

PVH, which owns the Tommy Hilfiger and Calvin Klein brands, is also in a pickle. Western governments have banned or restricted the purchase of products from companies in the Chinese region of Xinjiang due to mass arrests and the forced labor of the Uyghurs. Last fall, China's Ministry of Commerce announced that it is investigating whether PVH took "discriminatory measures" against products from Xinjiang when it stopped buying garments and cotton from the region so that it wouldn't be subject to the Western ban.

If found guilty, the company could face a halt to its imports and exports from China, restrictions or bans on investments in China, restrictions or bans on PVH employees entering or working in China, or fines, a September 24 *NYT* article reported. Even before a decision has been made, influential personalities who had endorsed Tommy Hilfiger and Calvin Klein have stopped working for those brands. The potential impact is not small: In 2023, PVH generated about 6% of its revenue and 16% of its earnings before interest and taxes from China.

The tit-for-tatting has entered the military arena as well. After Taiwan President Lai Ching-te visited Hawaii and Guam, China launched military exercises that included nearly 100 Chinese warships and vessels in the waters surrounding Japan, South Korea, and Taiwan.

The diplomatic core is also involved. The US State Department said it would impose visa restrictions on officials involved with the jailing of 45 activists for subversion under Hong Kong's national security law. The activists were involved with an unofficial "primary" election in 2020, which was deemed to be a plot to overthrow the Hong Kong government. China responded by imposing visa restrictions on "US personnel who have behaved poorly on Hong Kong-related issues," a December 10 *South China Morning Post* article reported.

(2) *A game of endurance.* Looking ahead, the US is in a strong economic position to outlast China in this game of tit-for-tat. That said, China's population may be more willing than US consumers to deal with any inconveniences arising from this cold war.

China recently reported that its imports fell 3.9% y/y in November, the biggest drop in 14 months. Exports rose 6.7% y/y, but that's only around half of October's 12.7% y/y increase (*Fig. 3*).

The economy's weakness continues to drag down prices. In November, China's consumer price index (CPI) rose 0.2% y/y. Excluding food & energy, it fell 0.3% (*Fig. 4*). Likewise, China's producer price index (PPI) fell 2.5% in November, following a 2.9% decline in October (*Fig. 5*).

China's purchasing managers indexes (PMIs) continue to show expansion (readings above 50.0) but barely. The manufacturing PMI was 50.3 in November, up by 0.2 from the October level, with new orders rising to 50.8. China's nonmanufacturing PMI, which represents service and construction activity, fell to 50.0 from 50.2 in October (*Fig. 6*).

But the government has enacted stimulus measures that are working, notably financial incentives that sent electric vehicle sales surging 52% in November, this *South China Morning Post* *article* reported.

China's Politburo said on Monday that it will "implement more proactive fiscal policy next year and focus on boosting domestic demand and consumption," a December 10 *WSJ* *article* reported. The country also plans to adopt a "moderately loose" monetary policy and to stabilize the housing market.

The news met with mixed reaction among investors: The Chinese stock market initially rallied on Monday but declined on Tuesday.

Consumer Discretionary: Not Very Cheery. Lululemon Athletica and Dollar General each serve different segments of society. Lululemon serves high-income fitness buffs as a retailer of premium athletic wear, while Dollar General caters to low-income shoppers hunting for deals in its dollar stores.

Lulu enjoyed a surge in international sales during its fiscal Q3 (ended October), but its US business was lifeless. Meanwhile, Dollar General's low-end consumer has been pinching pennies. Neither retailer seemed to expect a surge of US consumer spending over the holiday season.

Let’s take a look:

(1) *Exercising abroad.* Sales of Lululemon gear are taking off overseas. The company’s Q3 total revenue increased 9% y/y, bolstered by a 39% jump in mainland China, a 27% jump in the rest of the world (segmented as “Asia Pacific and Europe” and “Middle East and Africa”), but only 2% in the Americas. Within the Americas, US revenue growth was flat. Lulu plans to continue its international expansion by opening next year company-owned stores in Italy and franchising operations in Denmark, Belgium, Turkey, and the Czech Republic.

(2) *Strong dollar bites.* Lulu’s results may be pinched by the stronger dollar, reflecting the stronger US economy relative to mostly weak ones in the rest of the world. The US dollar index is up 2.2% y/y (*Fig. 7*). China’s yuan is 1.1% lower relative to the dollar y/y, and the euro is 0.2% lower (*Fig. 8* and *Fig. 9*).

When Lululemon gave its Q4 revenue forecast of $3.475 billion to $3.510 billion, an 8%-10% y/y increase, it noted that the range includes an incremental $20 million negative impact of foreign-exchange-rate fluctuations.

(3) *Talking tariffs.* Lululemon officials discussed the impact of Trump 2.0’s expected new tariffs. The company sources about 3% of goods from China, less than 1% from Mexico, and nothing from Canada. “If tariffs were levied on imports from all countries into the US, that would obviously have a more significant impact on our costs,” said CFO Megan Frank.

(4) *Tough times on the low end.* Dollar General executives described their core customer as remaining “financially constrained.” Consumers bought more consumables, items like food and necessities, and shied away from discretionary items like home, seasonal, and apparel goods. Sales of private-label goods did very well, and the best performing category was goods selling for $1.

While same-store sales were positive in each of the quarter’s three months, consumers spent more heavily in the first three weeks of both August and September. That implies budget pressure, observed CEO Todd Vasos on the company’s earnings *conference call*. Consumers, he said, “continue to face significant financial pressure, as they are less able to stretch their budgets [to] the end of the month.”

Despite the gloomy talk, Dollar General's net sales increased 5% in Q3 y/y to $10.2 billion, but Q3 operating profit declined 25.3% to $323.8 million, hurt by $32.7 million of hurricane-related costs, labor costs, and depreciation and amortization.

(5) *Shrink is shrinking.* While losses from shrink remain higher than Dollar General executives would like, shrink is approaching pre-pandemic levels. Shrink has gone from being a headwind to a tailwind.

(6) *A peek into holiday sales.* Executives at both companies gave brief comments regarding holiday sales. The Lululemon brass was optimistic that more "newness in its assortment" would boost growth in the US. "We're off to a good start to the holiday and happy with our regular price performance over the Thanksgiving weekend," said CEO Calvin McDonald on the company's earnings *conference call*.

The folks at Dollar General noted that November sales came in slightly above the midpoint of their expectations. For the full year, the retailer now expects diluted earnings per share of $5.50-$5.90, the top end trimmed from its previously announced $5.50-$6.20 range. The results include about $43 million in hurricane-related costs.

Disruptive Technologies: Has Hydrogen's Heyday Passed? There was a flurry of interest in hydrogen projects last year when the Biden administration earmarked billions in promised funding. But as is often the case, the initial excitement has faded. Funding has come in slower than expected, and costs are higher than expected. Some proposed projects are falling by the wayside, but the survival of the strongest projects is probably a good thing for the industry.

We're still optimistic that scientists and engineers will find an economical way to produce hydrogen from excess solar and wind energy, and that over time this new source of green energy will become an important element of the US energy mix.

Here are some details behind recent industry headlines:

(1) *Trump uncertainty weighs.* President Biden ushered in the Hydrogen Production Tax Credit, which includes a 10-year federal tax credit of up to $3 per kilogram for clean hydrogen produced after 2022 in facilities that begin construction prior to 2033. Under the Infrastructure Investment and Jobs Act, another $9.5 billion is earmarked to fund hydrogen projects, but the vast majority of those funds have not been distributed.

Now there's concern that the incoming Trump administration will reverse Biden's efforts to help develop the hydrogen industry. Any funding that hasn't been distributed could be reallocated through federal budget reconciliation by the new Trump administration, a November 27 *article* in *Environment Health News* reported. The new administration could also eliminate the hydrogen tax breaks. Conversely, Trump has promised to speed up permitting, which could help many of these large projects cut through red tape.

(2) *Hostility toward the hubs.* The Biden administration designated seven hubs to increase the production of hydrogen, and some are facing difficulties. In Pennsylvania, the Mid-Atlantic Clean Hydrogen Hub has encountered opposition from environmental groups, rising costs in producing green hydrogen, and a lack of certainty around Treasury Department rules on federal financial incentives for hydrogen production. Critics are also aggravated by the government's lack of transparency.

Some of the companies that committed to the Mid-Atlantic Hub have dropped out. Messer, a multinational industrial and medical gas company, backed out of plans to build electrolysis facilities in Delaware and Pennsylvania, while sHYp no longer plans to build an electrolysis facility in Wilmington, a December 6 *Inside Climate News* *article* reported. From the demand side, HRP Group, a real estate development company, has delayed plans to use hydrogen for power and steam generation in its new buildings.

(3) *Areas of growth remain.* Some hydrogen projects are moving ahead. Almost 20 US utilities have *proposed* mixing 20% hydrogen with 80% natural gas to reduce carbon emissions. In Texas, companies like Air Liquide are planning to use underground cavities that once held oil to store highly pressurized hydrogen. The company, however, uses the state's ample natural gas supplies to produce "grey" hydrogen. Environmentalists would hope companies would use the state's solar and wind power to produce green hydrogen instead.

Calendars

US: Thurs: Headline & Core PPI 0.3%m/m/2.5%y/y & 0.2%m/m/3.3%y/y; Jobless Claims 221k; Fed's Balance Sheet; 30-Year Bond Auction; IEA Monthly Report. **Fri:** Import Prices -0.2%; Baker-Hughes Oil Rig Count. (FXStreet estimates)

Global: Thurs: ECB Interest Rate Decision 3.15%; UK Gfk Consumer Confidence -18; Japan Industrial Production 3.0%; Japan Tankan Large Manufacturers & Non-

Manufacturers Indexes 13 & 28; Lagarde. **Fri:** Eurozone industrial Production -0.1%m/m/-2.0%y/y; Germany WPI -0.6%; France CPI -0.1%m/m/1.7%y/y; Spain CPI 0.0%m/m/2.4%y/y; UK GDP 0.1%m/m/0.3%3m/3m; UK Headline & Manufacturing Industrial Production 0.3%/0.2%; China M2 7.6%y/y. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* fell to 3.80 this week, after rising the prior four weeks, from 2.61 to 3.91, which matched its highest reading since late July. *Bullish sentiment* edged down to 62.3% this week, after climbing the prior two weeks from 60.0% to 62.9%—which was the most bulls since late July, when the report noted seven consecutive weeks with bulls over 60%, ending at 64.2%. This week's reading remains in the high-risk danger zone above 55.0% for the ninth straight week, according to the report. Meanwhile, *bearish sentiment* rose to 16.4% this week, following a five-week drop of 5.9ppts (to 16.1% from 22.0%), which was the fewest bears since late July, when it dropped to 14.9%. The *correction count* ticked up to 21.3% from 21.0% in each of the previous two weeks; it has been hovering around 20% for the past nine weeks—with recent readings down significantly from the 33.9% in early September. In the AAII Sentiment Survey (as of December 5), both neutral and bearish sentiment among individual investors about the short-term outlook for stocks fell during the latest week, while bullish sentiment rose. *Bullish sentiment* soared 11.3 ppts to 48.3%, an unusually high reading, and above its historical average of 37.5% for the 55th time in 57 weeks. Bullish sentiment was just below its historical average during Thanksgiving week. *Bearish sentiment* sank 8.0 ppts to 30.7%, below its historical average of 31.5% for the first time in three weeks. *Neutral sentiment* dropped 3.3ppts to 21.0%, below its historical average of 31.5% for the 21st time in 22 weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose 0.1ppt w/w to a new record high of 13.4% during the December 5 week. It is now 3.2ppts above its seven-year low of 10.3% during April 2020. Forward revenues and earnings both also rose w/w to new record highs. The consensus expectations for forward revenues growth was unchanged w/w at 5.5%, and is just 0.3ppt below its 23-month high of 5.8% during the August 1 week. It has gained 3.2ppts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast rose 0.3ppt w/w to a 38-month high of 14.3%. It's now 11.0ppts above its 31-month low of 3.3% during the

February 16, 2023 week. That's down from its 23.9% reading at the end of April 2021, which was boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.8% in 2024 (unchanged w/w) and 5.5% in 2025 (up 0.1ppt w/w) compared to a revenues gain of 2.1% in 2023. They expect an earnings gain of 9.9% in 2024 (down 0.1ppt w/w) and a 14.4% rise in 2025 (up 0.1ppt w/w) compared to an earnings gain of 2.4% in 2023. Analysts expect the profit margin to rise 0.5ppt y/y to 12.4% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.1ppts y/y to 13.5% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.1pt w/w to a 43-month high of 22.4. It's up 2.7pts from a 14-week low of 19.7 during the August 8 week and 7.1pts from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.02pt w/w to a record high of 3.02. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): During the December 5 week, forward revenues rose for all but the Energy sector, and forward earnings rose for all 11 S&P 500 sectors. This led to rising forward profit margins w/w for all 11 sectors. Eight of the 11 sectors posted record-high forward revenues this week. Industrials' forward revenues improved to 2.4% below its early September record. Energy and Materials are the biggest laggards at 6.0% and 14.9% below, respectively. These five sectors had record-high forward earnings this week: Communication Services, Consumer Discretionary, Financials, Information Technology, and Utilities. These four sectors have improved to less than 1.5% below their recent records: Consumer Staples, Health Care, Industrials, and Real Estate. Forward earnings remains depressed for Energy and Materials, which are stabilizing in recent weeks at 32.5% and 21.4% below their respective post-pandemic highs. Looking at the forward profit margin, these three sectors had record- or post-pandemic highs this week: Communication Services. Consumer Discretionary, and Financials. In recent weeks, the Industrials and Information Technology sectors were in that club. Among the laggards, Energy's forward margin was steady w/w at 9.5%, up 0.1ppt from a 33-month low of 9.4% in mid-November, but that's down 1.4ppts since its six-month high of 10.9% in mid-June; Consumer Staples' rose 0.1ppt w/w to 6.9%, and is just 0.2ppt above its seven-year low in March 2023; and Health Care's 8.7% is only 0.2ppt above its record low in April. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.9%, up 0.1ppt w/w and down from its 27.6% record high in September), Financials (19.6, up 0.1ppt w/w and down from its 19.8 record high in in August 2021), Communication Services (18.6, up 0.1ppt w/w to a new record high this week), Real Estate (17.2, down from its 19.2 record high in 2016), Utilities (14.3, down from its 14.8 record high in April 2021), S&P 500 (13.5, up 0.1ppt w/w to a new record high this week and in 13 of the past 14 weeks), Materials (11.3, up 0.1ppt w/w and down from a 20-month high of 11.6 in July and a 13.6 record high in June 2022), Energy (9.5, up 0.1ppt from a 33-month low in November and down from its 12.8 record high in November 2022), Industrials (11.1, down from its 11.2 record high in early October), Consumer Discretionary (9.4, up 0.1ppt w/w to a new record high this week), Health Care (8.7, up 0.2ppt from its 8.5 record low at the end of April and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, up 0.1ppt w/w and down from its 7.7 record high in June 2020).

US Economic Indicators

Consumer Price Index (*link*): Both the headline and core CPIs matched expectations in November, both on a monthly and yearly basis. *Headline* CPI rose 0.3% last month, after increasing 0.2% in each of the prior four months, while the *core* CPI increased 0.3% for the fourth straight month. On a *year-over-year basis,* the *headline* rate climbed to 2.7% from 2.6% in October and 2.4% in September—which was the lowest rate since February 2021; it peaked at 9.1% in June 2022. Meanwhile, the core rate was at 3.3% in November for the third month, after slowing from September 2022's 6.6% to 3.2% in both July and August of this year—which were three-year lows. The *goods inflation* rate fell to -0.2% y/y in November, narrowing from -1.3% in September, with the durable goods rate at -2.0% y/y, narrowing from August's -4.2%; the rate peaked at 18.7% in February 2022. The rate for nondurable goods (0.4% y/y) moved above zero for the first time in four months, up from a recent low of -0.7% in September; it peaked at 16.2% in June 2022. *Services excluding energy services* is drifting lower, though remains relatively high at 4.6%, well above rates a couple of years ago. Looking at *durable goods prices*, there's lots of red in the yearly percent changes, though they are up from recent lows: used cars & trucks (-3.4% y/y), furniture & bedding (-1.8), major appliances (-1.0), and new vehicles (-0.7); motor vehicle parts & equipment moved back above zero this August (1.9%) for the first time since last August, though eased to 1.5% in November. Here's a snapshot of yearly rates for some key *nondurable goods* prices from highest to lowest: recreational commodities (7.1%), food (2.4), apparel (1.1), medical care commodities (0.4), and housekeeping supplies (0.4). The rate for recreational commodities is down from its recent high of 11.2% in April, while energy prices fell back below zero in August (-4.0) and fell deeper into negative territory in September (-6.8), though the decline narrowed to -3.2 by November. It posted a recent peak of 3.7% in May. The rate for medical care commodities drifted down toward zero from its recent peak of 3.1% in June. Turning to services inflation, *rent of shelter* remains high, though the yearly rates are easing from their recent highs in April 2023: rent of primary residence (to 4.4% from 8.8%) and owners' equivalent rent (4.9 from 8.1). Turning to *non-housing-related services*, the yearly rate for transportation service (7.1) remains high, though is down from recent highs, while the rate for recreation services (3.5) is up from September's 2.2%—which was the lowest since mid-2021. Meanwhile, the yearly rate for education & communication services is hovering around 2.0%, while the medical services (3.7) rate has been on an accelerating trend, up from its recent bottom of -2.6% in September 2023, though stalled just below 4.0% last month. The rate for other personal services (4.2) remained at September's rate after moving up to 5.1% in July from 4.0% in May—which was the lowest rate since October 2021.

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