GENERALI INVESTMENTS

Focal Point

Earnings outlook to favor EA equities

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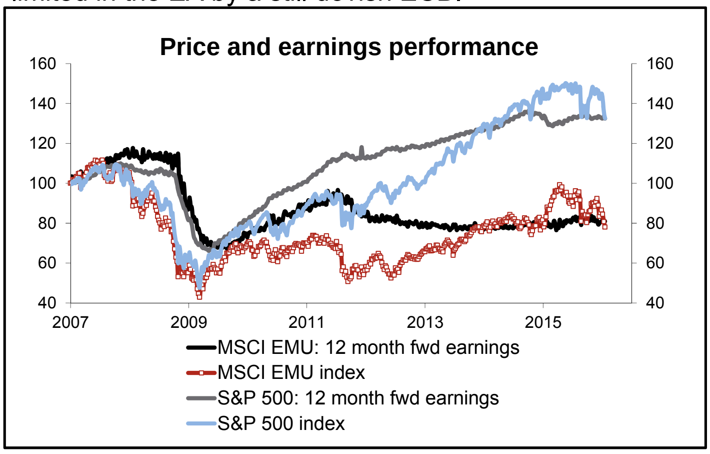
- With the the Fed having just started to gradually reduce its monetary policy support, a key question for 2016 is to what extent global equity markets will be backed by corporate earnings growth.
- At first glance, the outlook is not too reassuring. Global 2016 earnings estimates have been lowered by 16% in the last year and the reported earnings in Q3 have fallen by 4.5% in the US and more than 6% for the euro area (EA).
- Excluding the battered oil and materials sectors, however, the picture appears less worrisome.
- For the US we expect only 3% earnings growth in 2016 with downside risks due to: rising unit labor costs, a strong US dollar and subdued oil prices. By contrast, we anticipate EA earnings to rise by 5-7%, backed by increasing margins.
- Adding the monetary policy support from the ECB, in relative terms EA equities enter 2016 with a better outlook.

As markets are substantially aligned to earnings development so far and current multiples are near their historical average, we need to understand which earnings growth we can expect on both sides of the Atlantic in 2016. This could help to gauge market direction knowing that the Fed's policy shift is a source of concern which impact is limited in the EA by a still dovish ECB.



Since the 2009 trough, earnings have increased both in the US and the euro area (EA). Current market prices have basically matched the earnings trend since the last cyclical peak in 2007. This happened after a period of uncertainty, which lasted until 2014 and maintained prices well below the earnings trend for nearly six years.

That said, while earnings and markets in the US and Japan are now higher by around 25% since 2007, they are still down by 20% for the EA (MSCI EMU).

Looking at the earnings trends, while US and Japanese earnings are 7% and 34% above their trend, the EA ones are 19% below. The peripheral Europe experienced the biggest GDP fall during the crisis. As a result, Greek, Portuguese, Italian and Spanish earnings are below their trends by 80%, 44%, 38% and 29%, respectively, while those for Germany and France are lower by 2% and 16%.

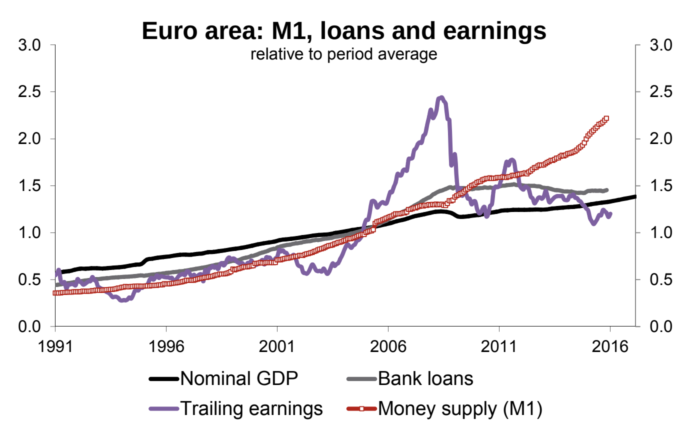
Comparing the EA trailing earnings trend to the ones of money supply, bank credit and nominal GDP we can see the former has trended markedly below the other three. This in turn suggests that profits are not running at all cylinders at the moment and have room to recover, should GDP continue to expand together with bank credit (our base scenario for this year).

Long-term earnings' development is challenging

Over 5-to-10 years, profits are likely to experience some structural pressures, which should induce analysts to be cautious when projecting earnings in a valuation model like DCF or DDM. Indeed, some tailwinds to profits (declining corporate taxes, bond yields and labor costs) are likely to revert in time. We should also consider the negative impact of the climate change on equity sectors and the increasing competition by EM multinationals, which at some point will limit the market share of corporates in the developed world.

Huge profits' estimates decline during 2015

After a good start last year, the rolling 12-month earnings forecasts (provided by IBES) weakened since the last summer. As a result, they are currently only 1% higher than in January 2015 for the US, +4% for the EA and still at +11% for Japan. EMs experienced a deeper fall at -20% together with UK (-14%). Japan shows the lowest weight of energy and material sectors combined (7%), while UK has one of the highest in the developed world (18%).



The decline of the profit estimates for the year 2016 is even more impressive: 8.4% for the EA, 11% for the US and 28.5% for EMs. Other than the negative influence of weaker EM growth and deteriorating global trade (which weighted on export-oriented industrials), a key factor was the impact of the oil and commodities price fall on the energy and material sectors (which 2016 earnings declined by 44% and 35%, respectively).

The repercussions of weaker EM economies along with low credit growth, higher capital requests and subdued net interest margin have been felt in other cyclical sectors like European capital goods and banks (with 2016 earnings estimates declining by 10% and 14%, respectively).

Ex-energy and material, earnings are less weak

Thanks to improved economic domestic conditions in the US as well as in the EA and Japan, earnings figures appear less negative once energy and material sectors are excluded. Thus, for the adjusted median sector in the EA the 2016 estimate declined by a limited 3% (vs. the broader 8.4%) in the last year.

This better result was also visible during the Q3 reporting season which admittedly was overall a bad one (especially for the Nordics within the European context). The yearly earnings growth was indeed negative around 6% in the developed world. But, once energy and materials are excluded, the median sector growth is higher. The EA growth was +7% for earnings and +4% for sales (earnings for energy were -44% yoy and -9% for materials).

Inside Europe, the dichotomy was significant. Firms more exposed to developed countries (DM) beat expectations (by 3%), while the ones with a higher presence in the EM reported lower earnings than analysts forecasted (by 9%). Overall European firms were able to upgrade their guidance (change to previous announced earnings figure by the companies' officials) maintaining it in the positive territory both for earnings and sales (as is the case since Q4 2014). For the US, the impact of the weaker oil prices and stronger dollar was substantial by nearly -8%. Then, industrials more exposed to EM did the rest.

EA earnings: decent growth ahead

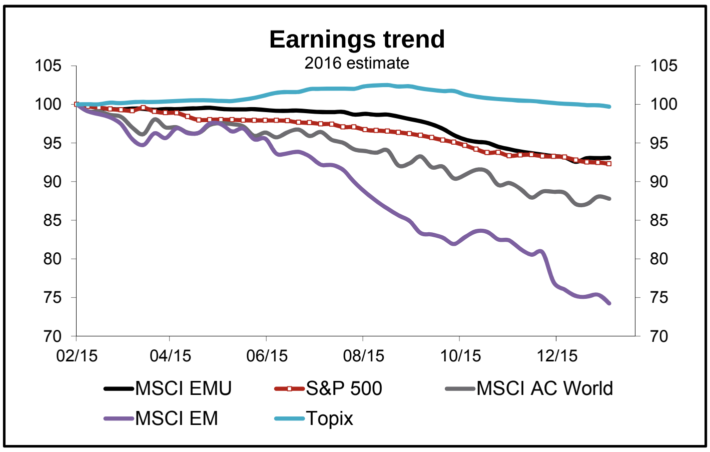
Given the enduring weakness of commodity prices, global trade, Chinese indicators and in general EM economies we expect a weak reporting season in Q4.

Overall, we should conclude the 2015 with a realized earnings growth vs. 2014 of 8.6% for the euro area, -1.5% for Europe, 0% for the US and +13.5% for Japan.

We expect the dollar to continue to put some pressure on US earnings (we see the EUROUSD at 1.02 by the year end). Every 10% gain for the trade-weighet dollar (TW) hits S&P EPS by ~$2.50 (about 2%). Thereafter, the TW growth (in yoy terms) should stabilize, mitigating its negative impact on earnings.

The same is true for the oil price (net of the benefits for the discretionary sectors). Should the oil price decrease further by 5$/bbl from our estimate around 40$ by the end of 2016, the US earnings would decrease by 1$ p.s. (-0.8% on top of 120.5$ p.s., which is our estimate for 2016) mainly due to lower energy sector profits.

The low oil price does not bode well for the MSCI EMU, too (having more or less the same sensitivity to earnings as for the S&P 500 index).



As far as the trade weighed euro (TW euro) is concerned, we estimate its depreciation by 14% since April 2014 to the end of this year to have a cumulative positive impact of +6.5% on earnings. This is the translation effect to which we add a minor but positive market share benefit. Overall, we judge that only a 1.5% is the benefit left for 2016 for euro area earnings.

Furthermore, the composite PMIs remain supportive for earnings in EA and Japan and also for US when the service subcomponent is taken into account. That said, the US manufacturing ISM is below the 50 treshold which represents a point of weakness for industrial firms. The negative trends observed in Q3 (due to global trade and commodities) should continue to affect also the imminent Q4 reporting season. Here, the first observation is that analysts' expectations have been reduced significantly since October, both in the US and in Europe. The downgrade is widespread through all sectors, except for telecoms and utilities in the US. That said, the downgrade in the US is similar to the average one experienced since 2011 (-4%) before the reporting seasons started: The average beat thereafter (after all firms actually reported) has been 3.3% on average.

In Europe (Stoxx 600) the estimated growth for the median sector in Q4 went down by near 8.5pp while it appreciated by 1.5pp before the Q3 season started. Nevertheless, the current earnings growth for the median sector in Q4 is left at +5.6% yoy vs. +4.7% at the beginning of the Q3 reporting season.

For the S&P, the expected yearly growth is currently -4.4% (sector median at -2%). Our second relevant observation is that the sector median earnings growth continues to be

Sector	Forecasted Q4 EPS growth, %y/y S&P 500		Stoxx 600	
	Current	01-Oct	Current	01-Oct
Consumer Discretionary	8.4%	13.6%	-4.2%	15.6%
Consumer Staples	-1.9%	1.0%	-12.7%	-2.9%
Energy	-69.4%	-61.6%	-30.8%	-21.9%
Financials	8.2%	19.1%	442.1%	621.1%
Health Care	4.3%	5.3%	5.0%	12.7%
Industrials	-2.1%	2.8%	30.8%	43.6%
Materials	-23.8%	-4.6%	-2.5%	0.6%
Technology	-4.1%	-0.1%	6.2%	8.8%
Telecom	18.4%	18.8%	94.1%	221.3%
Utilities	-6.7%	-6.1%	31.9%	56.3%
Market	**-4.4%**	**1.0%**	**38.0%**	**51.9%**
Median	-2.0%	1.9%	5.6%	14.2%
Market ex-financials	-5.0%	-0.8%	8.6%	28.0%
Market ex-energy	1.5%	7.8%	110.6%	167.3%
Market ex-energy & fin.	0.1%	4.0%	11.4%	31.5%

Source: Thomson Reuters

higher in the EA than in the US. We see a continuation of this trend, thus forecasting an earnings growth for the EA of 7% (or 5% taking into account a more prudent view on energy earnings) and only +3% for the US. Of course, both estimates are at risk given the uncertainty surrounding global growth and trade and commodity prices.

We check the consensus forecasts for Q4 obtained for sectors and indices by aggregating stocks via a bottom-up approach. We can confirm EA earnings growth is expected to remain higher than US and Japanese ones, even more when we exclude the energy sector.

In order to come up with a final forecast of earnings growth in 2016 we use different models for which we estimate the evolution for relevant economic variables during the year (real GDP, inflation, wages etc.).

Based on our extensive analysis, we estimate earnings growth of 5-7% for the euro area both in 2016 and 2017, while only 3% in the US (8% and 2% for Japan for the corresponding years). The result is slightly lower than consensus in 2016 (by nearly 3.5pp for the US, EA and Japan), while the differences in 2017 are more significant: -7.6pp for the euro area, 12pp for the US and 9pp for Japan. For the US we forecast 120.5$ in 2016, nearly +3% yoy.

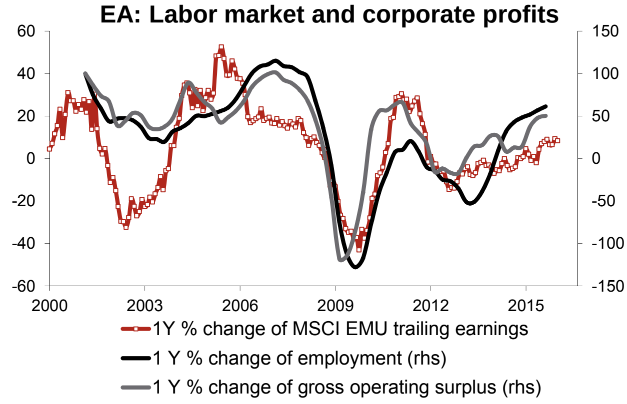
As far as the EA is concerned, its domestic economy should continue to expand in 2016 due to declining unemployment and fiscal drag, high consumer and business confidence, low input costs (wages, commodity and debt service) and supportive monetary policy. As a result, EA earnings growth is overperforming the US one. Even to a lesser extent, the TW euro remains supportive to euro area earnings together with an increasing underlying inflation figures.

In particular, the GDP progression in the EA in 2016 in presence of muted input costs and investments growth should enhance the capacity utilization. Subdued unit labor costs (ULC) should then permit margins and profits to expand.

CONCLUSIONS

In our base scenario we expect a high single digit earnings growth for the euro area and Japan and a minor growth in the US. Risks to our scenario remain high, mainly due to EM, commodity prices and Chinese woes. Chances of a US recession should also remain contained otherwise, even with a decent earnings growth in the EA the market will apply a lower multiple to those profits (PE), fearing that

EA: Labor market and corporate profits



they will be soon at the peak of their cycle. This, of course, will have negative repercussions for the market return overall. Given our economic scenario (an US GDP growth around 2.5%, 0.9% in Japan and 1.6% in the EA), the forecasted earnings growth in the euro area can theoretically back a similar price return during the year. Valuations are indeed around historical norms. Furthermore, the cyclically adjusted PE is 12.8X, way below historical average (17.6X), and bond yields continue to be sufficiently low with a supporting central bank.

Imprint

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