GENERALI INVESTMENTS

Focal Point

Earnings growth to turn back into positive territory

October 24, 2016

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- US and euro area (EA) 2016 corporate earnings expectations were particularly hit in H1. For the EA this was mostly due to the high weight of financials (17%), the stronger trade-weighted euro and in part lower nominal GDP growth.
- Since July, global earnings estimates for the current year have stabilized thanks to the rebound in commodity prices, better exporters' profit momentum and the positive effects of low yields in reducing the cost of debt.
- Looking ahead, we expect earnings to gradually recover over the coming quarters, with profits growing 5% in the EA and only 2-3% in the US next year. The outlook for emerging markets (EM) is more encouraging (ca. 7%).
- Near term, downward revisions of earnings expectations may yet burden equity markets, with 2017 consensus forecasts (+13% yoy for the US, the EA and EMs) appearing too optimistic.
- Further out, however, attractive dividend yields and moderately rising earnings still leave leeway for moderate equity gains in the EA on a 12-month view.

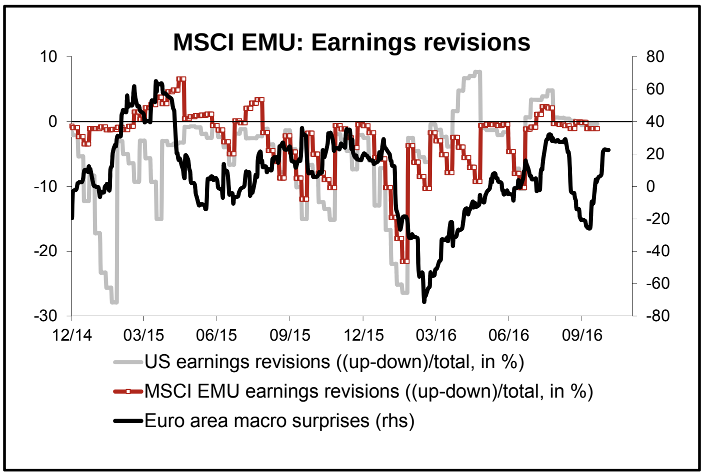
Since the last peak (2006-2008) EA trailing earnings (TE, profits estimates referred to the last 12 months) are down by 30% while the US ones are higher by 25%. Whereas the S&P earnings have suffered in the Lehman crisis as well, reaching a trough in 2009, they have almost doubled since then. The MSCI EMU earnings, however, have grown much less (by 27%), mainly due to Southern Europe which experienced a much more severe GDP and profit collapse, especially during the sovereign crisis (2011-2012).

More recently, earnings estimates for 2016 have dropped by 9% year-to-date (YTD) for both the US and the EA. For this year, the current consensus earnings growth is +0.6% for both the EA and the US, which is lower than our January estimate of +6% and +3%, respectively (which was also under consensus at that time). The profit set-back came about as a result of the price collapse in oil and commodities, the crisis of confidence ignited by China, the banking capital and low return issues and finally the Brexit. The decline was slightly more pronounced if compared to the historical average fall in analysts' forecasts. In the EA it was due to lower financial profits (-25%), lower GDP growth (reducing profits by nearly 1.5%) and a higher real trade-weighted (TW) euro (passing from -6% to +4% yoy).

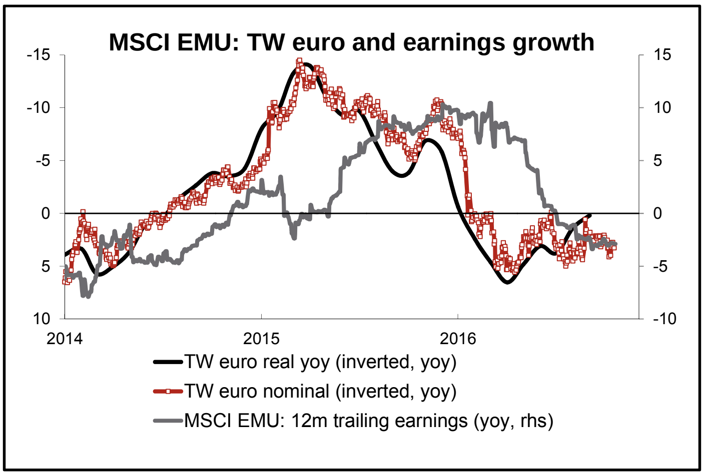
Earnings ex commodities proved more resilient

Adjusting for particular sectors' contributions, corporate profits appear more resilient compared to the broader indices. For example, the EA 2016 consensus estimate for the median sector ex-commodity lost only 4% YTD vs. 9% of the index. In the last available reporting season (Q2), while the earnings growth for the broader EA index was -5% yoy, for the median sector it was less negative at -2.7%. The median stock and the median sector ex-commodity did even better: +2.4% and +0.9% yoy, respectively.

Starting from the second quarter, the negative momentum of 2016 estimates reached its trough and started to stabilize. The more cautious Fed's stance was crucial together with the stabilization of the US dollar and the commodity



prices. They contributed to a rebound of the global trade in nominal terms (volumes remained weak) and the manufacturing sector. As a result, profits of commodity-related and export-oriented companies troughed as well. In the EM and in the UK, currency depreciation added to the cited positive effects. After the Brexit, the better profit momentum extended to the broader indices as economies (EA included) proved more resilient than expected and global monetary policies became even more dovish. Finally, the strong rally of EA corporate bonds and EMBI spreads (in USD) had bought about further lowering of the cost of debt for corporates, thus helping profit stabilization. The better earnings momentum was mirrored by the US NIPA profits (derived from national accountings and referring to all US corporations), which are currently running at -2% yoy, after having plunged by more than -15% at the end of 2015. The current profit stabilization has scope to extend in the short term, so that the 2016 earnings estimates for the EA and the US could slightly increase from current levels, matching our current yoy estimate in the range of +1% to +3% (+0% to +2% for the US).



Under consensus estimates for 2017

Looking further ahead into the next year, the current consensus for US earnings in 2017 is at 131.2 US dollar per share (p.s.), which represents an annual earnings growth of almost 13%. The expectations are more than 50% higher than the historical annual earnings growth of 7.3%. The consensus is even more optimistic for other developed markets, expecting an annual earnings growth which is almost three times higher than the historical one.

Area	past earnings growth, p.a.	expected yoy growth 2017, GIE	expected yoy growth 2017, Consensus	difference * 2017
US	7.3%	1% - 4%	13.0%	-10.5 pp
Euro Area	4.4%	4% - 6%	13.1%	-8.1 pp
Japan	3.1%	5% - 7%	9.0%	-3.0 pp
EMs	9.6%	6% - 9%	13.2%	-5.7 pp

* Midpoint of GIE forecasts minus consensus

Our earnings estimates came from the analysis of different financial and macro variables, empirically found to be driving corporate profits. Among the most significant variables employed are GDP, exchange rates, wages, commodity prices, world trade and NIPA earnings.

While short term macro surprises could continue to soften a bit, the global GDP growth should slightly increase in the next year (from 2.9% in 2016 to 3.2% yoy) also thanks to an exit from recession of Russia and Brazil.

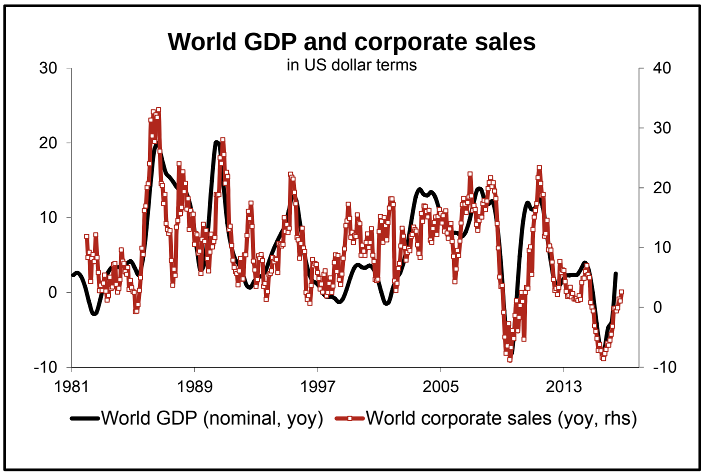
That said, our profit forecasts remain below consensus for 2017 both in the US and in the EA due to a persisting low sales growth environment and possible negative spillovers from political uncertainty (Brexit process, as well Italian referendum and core Europe elections). As a matter of fact, we are still facing a weaker economic growth versus history which is reflected by the percentage of companies characterized by negative sales growth: 41% globally, 56% in Japan, 37% both in the EA and the US.

In this respect, the consensus estimates for 2017 remain uncomfortably high at around 13% (which makes 2018 earnings estimates unrealistic as well) and analysts are likely to revise downward their forecasts in the next months.

Higher earnings growth expected in EMs vs. DMs

United States. For 2017 we are forecasting earnings growth in the range between 1% and 4%. The effective nominal US dollar exchange rate is forecast to appreciate, which would put pressure on NIPA earnings together with higher wage growth and higher unit labor costs. Furthermore, while exports are expected to increase in both 2016 and 2017, their increase is estimated at a very modest 2% and 3%, respectively. At some point, weak NIPA profits should also weigh on capex and wages growth.

Euro area. Our expectations for 2017 earnings growth is in the range between 4% and 6%, which would represent a turnaround from the -5% trough experienced during the summer.



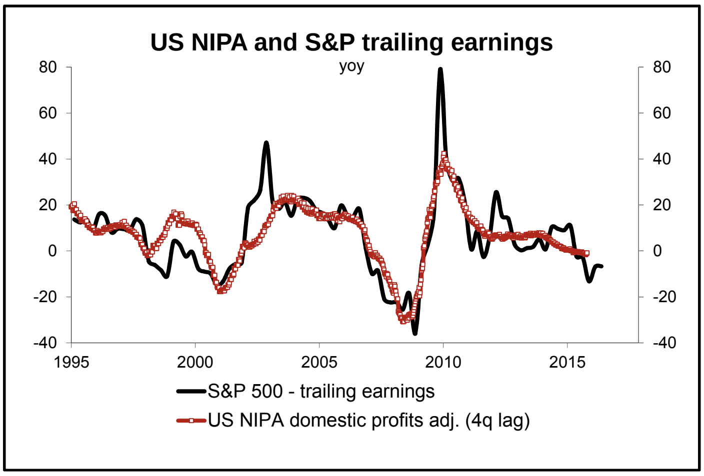
Specifically, earnings are to be dampened by weak world trade growth (around 1–2% in real terms), which is substantially lower than the average of 4% seen since 2011. Furthermore, a slight strengthening of the trade-weighted euro will exert some headwinds to the economy, while oil prices are likely to advance only very moderately. Overall for the next months, EA profits should remain volatile, but easing headwinds to financials (stabilizing yields, continuing loan growth and lower cost of debt) should contribute to higher earnings.

Overall, in a mild negative scenario after the Brexit, the single digit earnings growth should allow firms to broadly maintain current dividends. A 3.2-3.5% dividend yield on EA equities should then be achievable within 12 months with the chance to see final prices not too distant from current ones. Capacity utilization is continuing to increase and this, together with low input costs (including debt), a stable cross vs. the USD, a dovish ECB and decent GDP growth, should help margins and ROE (return on equity) to recover from the current depressed level, although not spectacularly.

United Kingdom. We expect nearly 3% earnings growth in 2017, even though base effects can bring spikes in annual figures. The weaker pound is a factor behind a better profit outlook.

Japan. For 2017 we expect a rather decent earnings growth of around 6% (versus a consensus of 8.5%) mostly due to the implementation of the fiscal policy package which is to offset in part factors weighing on growth like low inflation, increasing wage costs, the strong yen and decreasing exports.

Across India, China, and Russia, the 2017 expected earnings growth lies in the range between 6% and 8%. In case of **Brazil**, it is a bit higher (between 7% and 10%). Some factors represent a cap for even higher earnings growth. In particular, relatively high real yields together with subdued global trade dampen the outlook for **India**. As for **China**, while yields are at a rather low level and supportive, many other factors point to weak earnings. For example, the macroeconomic climate index has started to improve timidly but remains at the lowest level since the last seven years. Both imports and export growth is negative and retail sales are currently growing at around 10% yoy vs. a historical average of 15%. While a hard landing is not expected, the Chinese real GDP growth is forecast to decrease in a controlled way closer to 6.2% in 2017. Overall, the earnings growth in the EM universe is consistent with GDP growth and looks encouraging when compared to that of the developed world (DM). EM earnings are expressed in local currency and eventually subject to currency devaluation.



Conclusions

Overall, the future yoy earnings' growth should remain contained in the developed world, but is to recover back into positive territory in 2017. For EMs, the earnings growth outlook is more encouraging (6–8% vs. 2–6% in the developed world, in local currency terms).

Focusing on the EA and the US, we think the relative price performance during this year did not reflect properly the different earnings trends. Indeed, the S&P 500 has outpaced the MSCI EMU by nearly 10% (total return YTD). However, this is mostly due to a relative "inflation" of US PEs. Indeed, the PE differential between the S&P 500 and the MSCI EMU became greater in the period by 1.1 points (from 1.9 to 3), which corresponds to a 7% price increase for the US not justified by a better profit dynamic. For the last two years, trailing earnings have been higher for the EA than for the US (+1 pp since 2014 and +5 pp since 2015). Mainly as a result of a better profit outlook and lower valuations (13.6X 12-month forward PE vs. a 16.6X US one), we forecast the total return for the EA equities to be slightly positive over a one-year time versus a negative low-digit one for the US.

Imprint

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