Market Bulletin

March 2016

European Q4 2015 earnings: Economies are from Venus, markets are from Mars

In brief

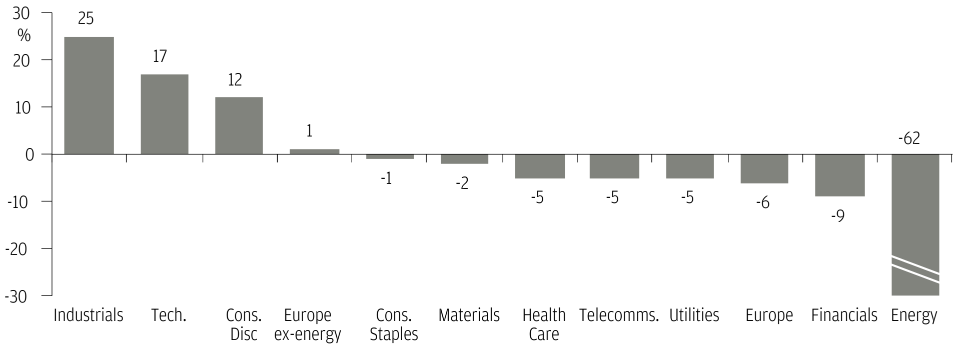
- With 85% of companies in the Euro Stoxx 600 having reported (as of 16 March 2016), we estimate that European fourth-quarter 2015 earnings per share (EPS) declined by 5.9% year on year (y/y).
- As has been the case in recent quarters, the headline number is badly distorted by the sharp falls in the energy market. Excluding energy, Stoxx 600 EPS actually grew by 1.2% (y/y).
- Another unwelcome feature is the disconnect between equity returns and the performance of the domestic economy. Regional equities are 1% lower than where they were at the end of December 2014 even though the eurozone economy grew by 1.5% in 2015

EUROPEAN FOURTH-QUARTER EARNINGS

Overall, we estimate fourth-quarter earnings growth to be -5.9% (y/y) for the Stoxx 600 (**Exhibit 1**). As has been the case in the last few earnings seasons, the headline number is distorted by the large falls in the energy sector. Excluding energy, Stoxx 600 EPS growth is currently 1.2% (y/y). The core of the eurozone continues to show improvement, with eurozone ex-energy EPS registering an 11.0% y/y increase.

The economic recovery in Europe is beginning to help out more cyclically orientated sectors, such as industrials and consumer discretionary.

EXHIBIT 1: STOXX 600 EPS GROWTH BY SECTOR



Source: Bloomberg, Thomson Reuters, J.P. Morgan Asset Management; data as of 16 March 2016.

AUTHOR

Alex Dryden
Market Analyst

Even when adjusting for the impact of energy, this earnings season was underwhelming, although the weakness was not broad based. More cyclical sectors, such as industrials, technology and consumer discretionary, experienced a relatively strong fourth-quarter.

One of the major detractors from the headline earnings number was the financials sector, which saw EPS fall by 9% (y/y) in the fourth quarter. As financials make up 25% of the Stoxx 600, the performance of this sector can have a disproportionately large impact on headline earnings. Investors should be cognisant of the large one-off costs, fines and write-downs that are distorting earnings within the European financial sector.

Earnings results for the fourth quarter may come as a surprise, at a time when credit conditions across the eurozone have been improving and the demand for loans—particularly business loans—is reaching its highest level since 2006. The issue, however, appears to be credit supply rather than demand. As we highlight in **Exhibit 2**, the latest credit impulse data—which measures the change in the rate of net new lending—shows that the supply of loans in the later half of 2015 slowed considerably. New loan issuance fell sharply after the market turmoil and economic uncertainty of the summer, despite the pickup in demand. This fall in loan issuance hampered fourth-quarter profits across the financials sector.

The supply of credit fell sharply after the volatility in the summer which has hurt financial earnings

EXHIBIT 2: EUROZONE CREDIT IMPULSE

Six month change in aggregate credit

Source: Bloomberg, ECB, J.P. Morgan Asset Management; data as of 16 March 2016.

In the latest surveys, the credit impulse looks better and banks are beginning to issue new loans again. This increase in loan issuance is being driven by the European Central Bank's (ECB's) renewed attempts to get credit pumping via another round of Targeted Longer Term Refinancing Operations (TLTROs). The new round of TLTROs, combined with interest rate cuts, essentially allow eurozone banks to borrow at 0%—and at negative yields if banks can show they have increased their non-residential lending to the private sector. The new borrowing facilities should encourage more lending and soften the impact of negative policy rates on bank profitability, at least relative to previous expectations. Whether the banking sector as a whole sees an improvement in earnings will depend on many factors, but for many the net effect will be positive.

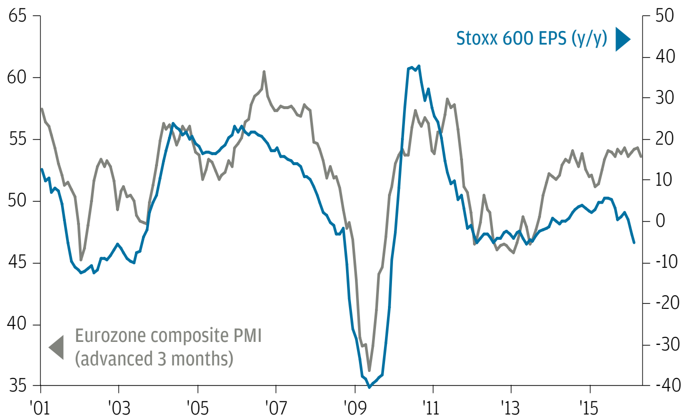
DIVERGING ECONOMICS AND EQUITIES

Mixed fourth-quarter earnings results provide a good reminder of the need for investors to be highly selective in their approach to European equities. But the larger puzzle, for some, will be why the Stoxx 600 index is 2% lower than it was in December 2014 despite the 25% increase in the size of the ECB balance sheet, a weaker euro, low oil prices and 1.8% growth in European GDP in 2015—the fastest rate of growth since 2011.

As we highlight in **Exhibit 3**, the relationship between regional manufacturing purchasing managers' indices and earnings performance has broken down in the last couple of years.

Despite an improving economic picture, earnings are declining

EXHIBIT 3: EARNINGS PER SHARE GROWTH VERSUS EUROZONE COMPOSITE PMI



Source: Markit, Stoxx, J.P. Morgan Asset Management; data as of 16 March 2016.

Why has this economic progress not translated into stronger equity market performance? A big part of the answer is the change in index composition away from cyclical firms towards more defensive ones. As we highlight in **Exhibit 4**, defensive sectors in the European index now make up 34% of the Stoxx 600, up from 23% 10 years ago. The shift towards more defensive industries and away from cyclical sectors will have reduced the overall sensitivity of the European market to changes in the economic backdrop.

This goes part way to explaining the divergence we highlighted in **Exhibit 3**. However, the separation between European equities and the European economy runs deeper than just sector composition. **Exhibit 5** shows the relative breakdown of international exposure, consumption, manufacturing, and energy and commodities for both the regional economy and equity markets.

A clear message of this chart is that the Stoxx 600 is much more dependent on the commodities and manufacturing sectors than the wider European economy is. With energy and mining firms contributing 20% of the profits earned by companies in the index and the Bloomberg Commodity index now 67% below its peak, it's no surprise to see equity markets suffer. But with the commodities sector accounting for just 3% of European employment, the negatives for the broader economy are more than outweighed by the positive impact of lower energy costs for businesses and consumers.

The shift towards defensive sectors is making the index less responsive to changes in the economy.

EXHIBIT 4: STOXX 600 WEIGHTING TO DEFENSIVE SECTORS*

Source: Stoxx, Thomson Reuters DataStream, J.P. Morgan Asset Management. *Defensive sectors are consumer staples, healthcare and utilities. Data as of 16 March 2016.

One area that is showing considerable strength is the domestic consumer in Europe. In a recent paper, *The case for Europe*[1], we highlighted the following as evidence of a rebound in the fortunes of the European consumer:

- New registrations of passenger cars grew by 13% (y/y) in December 2015, the fastest rate of growth since March 2010.
- Retail spending rose by 3.0% in the third quarter of 2015 (y/y), the fastest rate of growth in over two years.
- Consumer confidence, particularly in the periphery, reached multi-year highs in the last six months of 2015.

With personal consumption accounting for 56% of the European economy, these recent improvements will drive regional growth. But this may not be fully reflected in the stock market going forward, given that consumer-related services make up only 29% of the total profits of the Stoxx 600. Once again, the big lesson for investors is to be active and highly selective and not to take the headline performance of the index at face value.

INVESTMENT IMPLICATIONS

- Despite the broadly encouraging economic picture, fourth-quarter earnings for European companies were disappointing. This highlights a growing divergence between the performance of the domestic economy and the impact on earnings.
- It is possible to construct a portfolio that is reflective of improving economic conditions within the eurozone and is protected from the disproportionally large impact that commodities and manufacturing has on the main Stoxx 600 benchmark. But this can only be achieved via careful sector and company selection, reinforcing the case for active management.
- Companies have managed their cost base carefully through the downturn, which suggests that as growth recovers the earnings performance can outstrip top line earnings growth.

[1] *Market Insights: The case for Europe,* Vincent Juvyns & Alex Dryden, J.P. Morgan Asset Management, February 2016.

A significant divergence is opening up between the economy and equity market

EXHIBIT 5: CHARACTERISTICS OF THE EUROPEAN EQUITY MARKET AND ECONOMY

	STOXX 600		EUROPEAN ECONOMY	
	Item	% share	Item	% share
International exposure	Foreign-sourced profits, share of total profits	43%	European exports, share of total GDP	45%
The European consumer	Consumer related services, share of profits	29%	Personal consumption, share of total GDP	56%
Manufacturing	Profits from manufacturing & goods-producing industries, share of total profits	57%	Employment from manufacturing & goods-producing industries, share of total employment	23%
Energy & commodities	Share of profits, 2014	19%	Share of total employment	3%

Source: Eurostat, FactSet, Stoxx, J.P. Morgan Asset Management; data as of 16 March 2016.

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