MARKET INSIGHTS

Market Bulletin

September 2015

European 2Q15 earnings: Another strong result

In brief

- With 90% of companies in the Euro Stoxx 600 having reported, we estimate that second-quarter 2015 European earnings per share (EPS) grew by 6% year on year (y/y). Earnings were helped by improving credit conditions and a weaker euro.
- While eurozone second-quarter GDP growth slightly undershot expectations, the improving economic environment continues to provide a strong backdrop for regional equity markets.
- The recent sell-off in European equities has helped bring down valuations. Coupled with a third consecutive quarter of healthy earnings growth, this could provide an attractive entry point for investors.

EUROPE ISN'T OUT OF THE WOODS JUST YET

Growth in the eurozone in the second quarter was a little disappointing, coming in below the Bloomberg consensus target at 1.2% y/y (**Exhibit 1**). The consensus forecast among economists had been for growth of 1.3% y/y. Net trade across the eurozone was much stronger than in the first quarter, but this was not enough to offset weaker-than-expected domestic demand.

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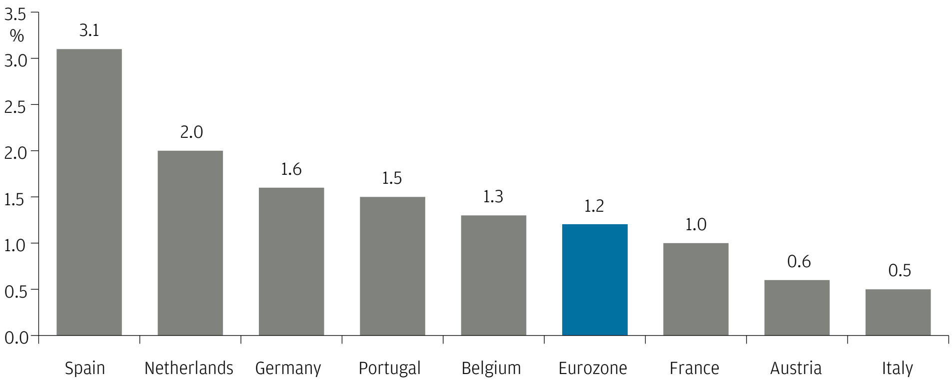
EXHIBIT 1: EUROZONE GDP 2Q 2015

Change year on year



Source: Eurostat, J.P. Morgan Asset Management. Data as of 21 September 2015.

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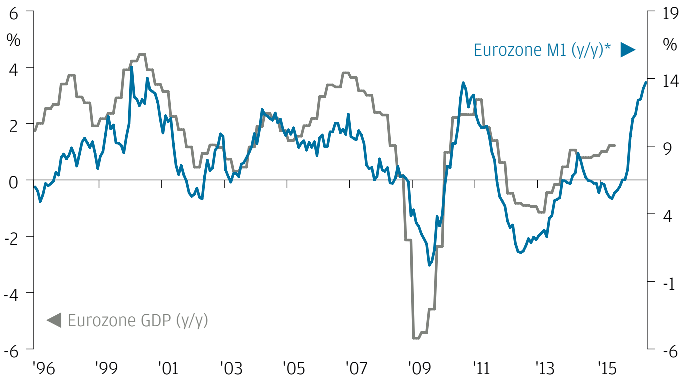
The fact that a cocktail of low interest rates, low oil prices and a weaker euro could only muster 1.2% growth from the eurozone shows that the region is not yet out of the woods. However, this was the ninth consecutive quarter of growth and the relative immunity of the European economy to the Greek crisis and the Chinese slowdown is encouraging. If past relationships are any guide, we should see continued loose monetary policy by the European Central Bank (ECB) translate into faster growth in the coming quarter (**Exhibit 2**).

EXHIBIT 2: EUROZONE GDP VS. MONEY SUPPLY

Change year on year



Source: FactSet, GfK, J.P. Morgan Asset Management. Data as of 21 September 2015.

A steady European economic recovery does not necessarily mean a sluggish environment for European earnings. GDP growth in the 1%–3% range typically leads to 13% y/y growth in EPS for eurozone companies.

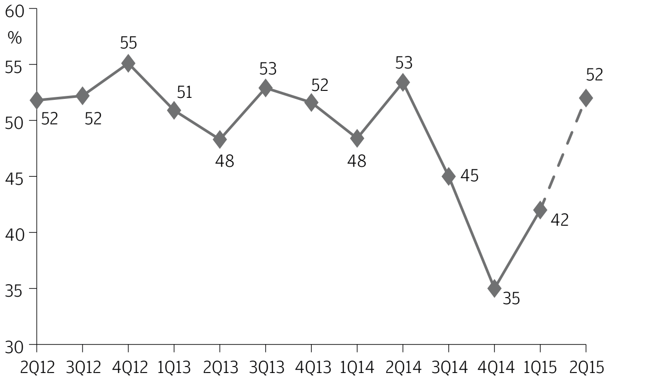
EUROPEAN SECOND-QUARTER EARNINGS SECTOR

Overall, second quarter earnings (**Exhibit 3**) came in at 6.2% y/y EPS growth for the Stoxx 600. Although the headline figure is below the earnings implied by the figures in the chart, when stripping out the negative impact of lower oil prices on overall performance, Stoxx 600 ex-energy EPS growth was at 13.1% y/y.

In addition to the strong earnings results, the number of companies beating their EPS estimates rose significantly. As shown in **Exhibit 4**, 52% of companies exceeded analyst estimates—a marked improvement from recent quarterly earnings seasons. In the final quarter, just 35% of companies beat analyst estimates.

One of the major drivers of strong earnings growth has been the continued beneficial impact of a weaker euro for profit margins and growth. **Exhibit 5** shows year-on-year earnings for export-orientated companies grew by around 8.3% compared to only 5.3% for more domestically orientated peers.

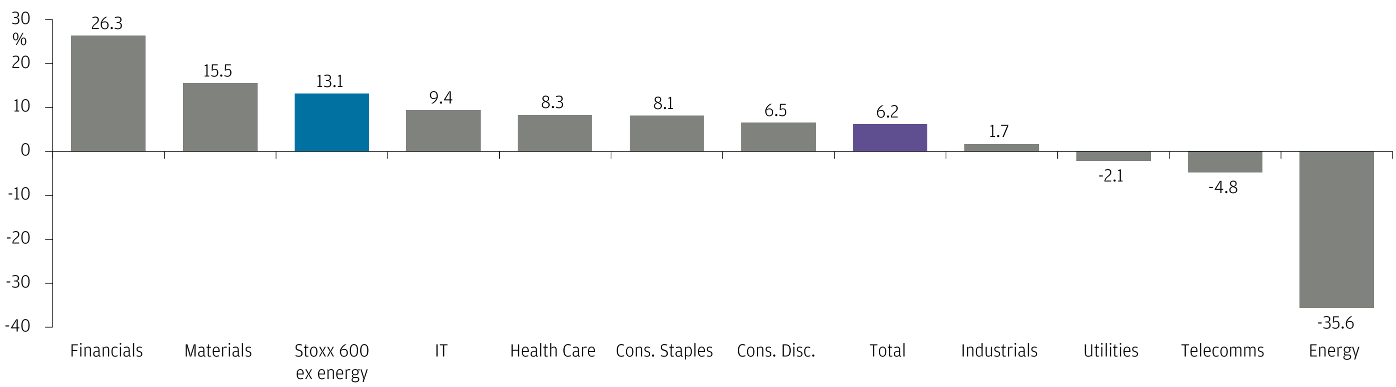
EXHIBIT 4: % OF COMPANIES BEATING EPS ESTIMATES



Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as of 21 September 2015.

EXHIBIT 3: EPS GROWTH BY SECTOR

2Q15, change year on year

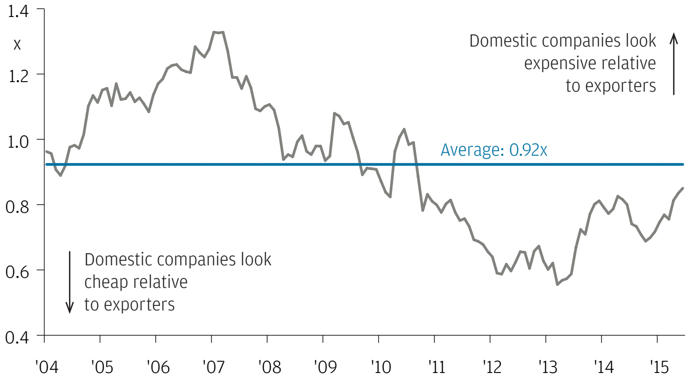


Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as of 21 September 2015.

EXHIBIT 5: EPS GROWTH FOR EXPORTERS AND DOMESTIC-ORIENTATED FIRMS

Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as of 21 September 2015.

EXHIBIT 6: RELATIVE PRICE-TO-BOOK OF EUROZONE DOMESTIC ORIENTATED FIRMS VERSUS EXPORT-ORIENTATED COMPANIES



Source: Bloomberg, Thomson Reuters, J.P. Morgan Asset Management. Data as of 21 September 2015.

Some basic arithmetic highlights how the weaker euro has helped exporters. Last year every USD 100 of revenue that European companies were earning in the US was translating into EUR 74 of revenue. Fast-forward 12 months and every USD 100 of revenue is now worth USD 90 on company income statements. Therefore, the weaker currency is adding around USD 16 for every USD 100 of revenues earned in the US.

However, the feel-good impact of a weaker currency has faded over the summer as the currency has moved up from its recent floors. On a trade-weighted basis, the euro has strengthened 5.2% since its lows in April, although this headline change masks some variation: the currency has risen 7.5% against the Chinese renminbi, for example. This underlines that the impact of a stronger euro will not hit every exporter equally and investors now need to be careful of the currencies to which exporters have exposure, and consider the effect on their bottom line.

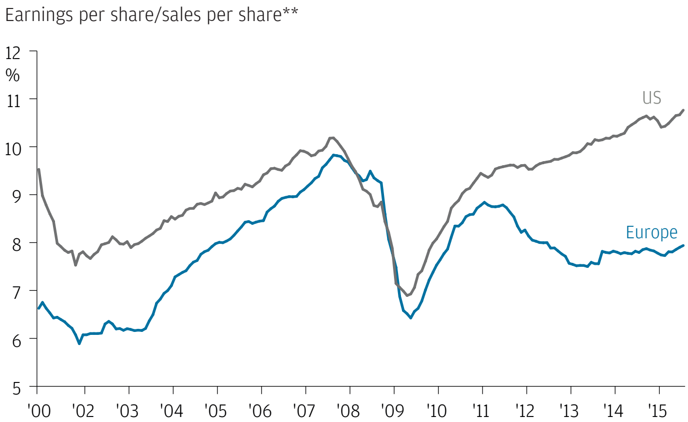
Even if the euro remains relatively weak, most of this weakness is likely already built into the price of export-orientated companies. That is why investors should consider looking for companies that are positioned to benefit from a cyclical upswing in regional growth. We saw this dynamic play out in the recent market moves, which saw domestically focused companies outperforming exporters by a significant margin. The value of export-orientated companies sold off 7.5%, while their domestic-orientated peers lost only 5.3% of their market value. Overall, domestic firms are up 8% so far this year, outperforming export-orientated firms, which have contracted 4%.

Exhibit 6 shows that on a relative price/book (P/B) basis, domestically orientated companies are still trading at a significant discount to more export-orientated companies, suggesting that there may still be some value left in these companies as the eurozone economic recovery continues to take hold.

MARGIN EXPANSION UNDERWAY IN EUROPE

While US margins have been strong since 2011, Europe fell back into recession and implemented severe austerity measures, generating a “double dip” both in margins and in the broader economy. Furthermore, the relative flexibility of US bankruptcy laws and labour market rules allows US-based firms to quickly shed workers and reshuffle debts in order to help the bottom-line. Such changes are more difficult in Europe. These factors have created one of the largest gaps between US and European margins in over two decades.

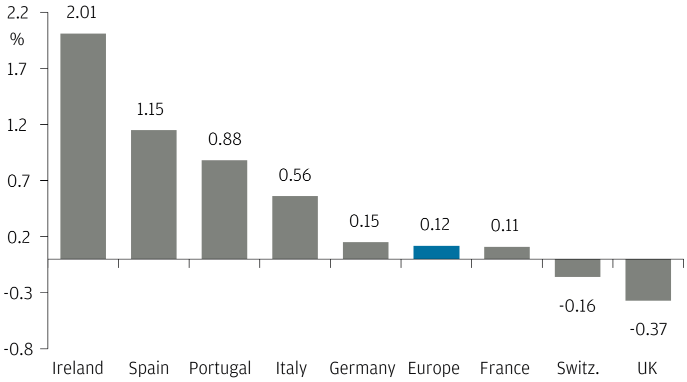
EXHIBIT 7: US AND EUROPEAN OPERATING PROFIT MARGINS



Source: FactSet, MSCI, S&P, J.P. Morgan Asset Management. **Data is last 12 months. Data as of 21 September 2015.

However, profit margins are now improving in several countries, possibly because of reforms to free up labour markets and cut business regulation. Going forward we expect European margins to continue to improve and narrow the gap to the US. As **Exhibit 8** shows, margins appear to be improving the fastest in those economies that have embarked on labour and business reforms, such as Ireland and Spain. These countries are also seeing encouraging growth in employment.

EXHIBIT 8: MARGIN EXPANSION OVER THE LAST 12 MONTHS*



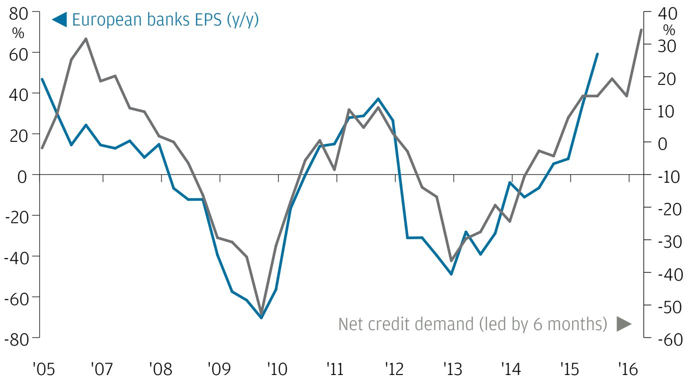
Source: FactSet, MSCI, J.P. Morgan Asset Management. *Data is last 12 months. Data as of 21 September 2015.

FINANCIALS: LEADERS OF THE PACK

In this latest earnings season, it is the financial sector's performance that really stands out. Financials is the biggest sector in Europe, making up nearly 25% of the Euro Stoxx 600 index; therefore, its performance can make or break an earnings season. Thankfully, European financials have been the top performing sector over the last three earnings seasons as they have benefited from a stronger credit environment and a decline in regulatory headwinds.

An improving credit environment is a key factor we have highlighted in previous European earnings reviews. **Exhibit 9** shows how credit demand has taken off in recent months and the earnings of European banks have moved higher with it. But the sector could still have further to run: European financials remain 25% below their previous market peak in October 2007 and represents the only sector in Europe not to have regained this market peak.

EXHIBIT 9: EUROPEAN BANKS EPS VERSUS NET CREDIT DEMAND



Source: ECB, FactSet, J.P. Morgan Asset Management. Data as of 21 September 2015.

ENERGY: NECESSITY IS THE MOTHER OF INVENTION

As shown in **Exhibit 3**, energy stocks have had another torrid earnings season, with EPS down 20% (y/y) as low oil prices have persisted throughout the second quarter of 2015. Brent crude averaged USD 60 per barrel in the three months to June 2015, 40% lower than a year ago. Oil prices have dropped further in the summer months on the back of continued supply and concerns about the fragility of global growth, in particular China.

What does this all mean for energy companies? The situation is certainly tough and does not look like it will get better anytime soon. The latest futures contracts suggest the market does not expect crude oil to return to USD 50+ per barrel until the end of 2016. However, necessity is the mother of invention; we are already seeing some creative cost cutting as oil companies adapt to a world of lower oil. Consider the mega-cap oil companies of Total, BP and Royal Dutch Shell, whose market cap comprises over 60% of the oil & gas sector of the Stoxx 600. Their oil production has fallen on average 11% (y/y) in the second quarter, but costs fell on average 25% (y/y), helped by efficiency gains, favourable commodity hedges, tax benefits and divestments.

Oil companies must walk a fine line with these efforts. They need to make cuts that allow them to maintain their dividends throughout this cheap oil period, but do so in a way that does not inhibit their future growth potential. At the point of writing, dividend yields for the sector as a whole stood at 5.3%, with some of the biggest companies having a dividend yield in excess of 8%.

INVESTMENT IMPLICATIONS

- Eurozone GDP growth was slightly disappointing in the second quarter, but GDP growth in excess of 1% has historically been able to support double-digit earnings growth for eurozone companies.
- An improving economic backdrop, a weaker single currency and improving credit conditions have helped support European earnings in the second quarter of 2015, despite falling earnings from oil companies.
- Much of the benefit of a weaker euro is now baked into the price of eurozone exporters. Investors should consider looking at relatively undervalued domestically orientated companies that could benefit from the cyclical upswing that is finally taking root in Europe.

The Market Insights programme provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the programme explores the implications of current economic data and changing market conditions.

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