Three reasons why European earnings look set for strong recovery

James Sym, Fund Manager, European Equities
28 Apr 2015

With the first quarter earnings season now underway in Europe, fund manager James Sym explains why he expects strong corporate earnings growth in the region this year.

Since the financial crisis of 2009, earnings from eurozone corporates have lagged far behind those of their US counterparts, which have already surpassed their previous peak levels. We see this as an opportunity for European investors as eurozone earnings have the potential to stage a strong recovery from their current depressed levels. In our view, eurozone corporates have the potential to achieve double digit earnings growth in 2015. There are three key factors that explain why we think this European earnings recovery will take place: the drop in oil prices, weaker euro and lower funding costs.

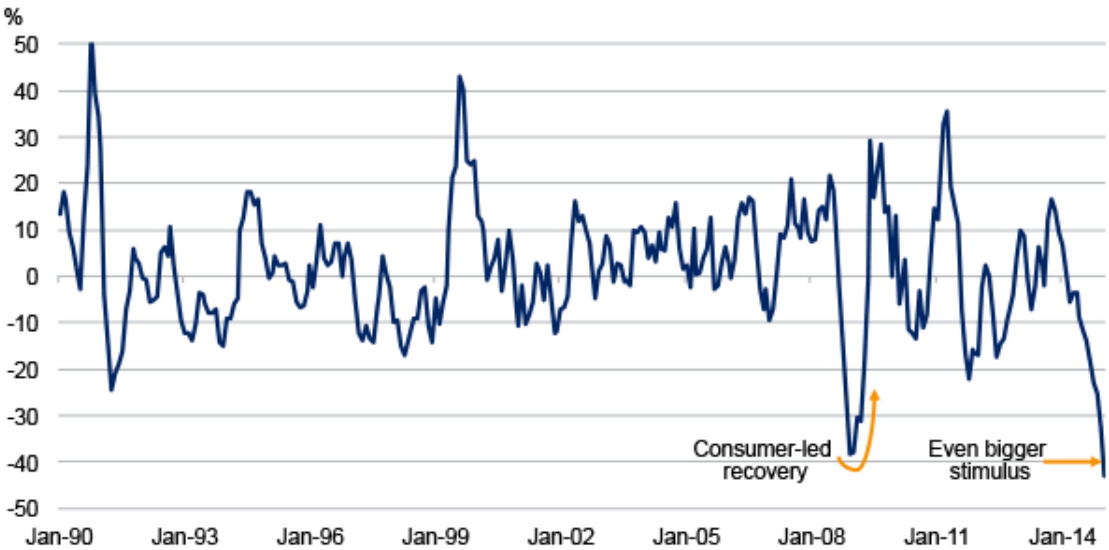
Our calculations suggest that the oil price drop represents a €1000+ boost to each European household. A boost of this magnitude has the potential to drive a real uplift in consumer spending. Subdued consumer demand has historically been a problem for the eurozone but there are signs that this may be changing, with Germany publishing stronger retail sales data in recent months. Meanwhile, although the oil price drop is certainly a negative for the region's oil & gas producers, the sector makes up a relatively small part of the European stockmarket compared to the US.

The euro has weakened substantially versus the US dollar, largely because the US Federal Reserve has ended its quantitative easing programme while the European Central Bank (ECB) is only just beginning. We think the weaker euro alone has the potential to boost eurozone corporate earnings by 5-8% this year, though clearly some companies will benefit more than others.

Meanwhile, another effect of the ECB's quantitative easing programme has been to drive sovereign bonds yields even lower, thereby reducing funding costs for both corporates and consumers.

On a sector-specific note, it is worth mentioning the expected pick-up in bank earnings. In aggregate, the banks reported earnings of around €40 billion in 2014 as they took significant provisions ahead of the ECB's Asset Quality Review. Lower provisioning this year suggests they should earn around €80 billion.

Current conditions add up to a substantial stimulus



Source: Morgan Stanley as at January 2015. Average six-month percentage change in the oil price, the euro-dollar exchange rate and 10-year bond yields.

The chart above shows the average six-month percentage change in the oil price, the euro-dollar exchange rate and 10-year bond yields. As we can see, there has been a significant drop recently, exceeding even the drop witnessed at the start of the financial crisis. At that time, the three factors combined to form a stimulus that resulted in a substantial consumer-led recovery. We think the same can happen this time around, only now the stimulus is bigger so the recovery potential is greater.

Related articles quantitative easing consumers earnings growth oil prices James Sym Europe ex UK Equities