Europe

Strategy Matters

Portfolio Strategy Research

Why valuations are not as stretched as they seem

Europe's P/E has doubled since the lows in 2012; we believe any value case now rests increasingly on low bond yields and/or earnings catch-up. We expect bond yields to rise but only modestly given the ECB's commitment to sovereign purchases. But low yields are unlikely to be a driver of further equity re-rating, in our view. Indeed we expect earnings to be the main driver of performance especially for the Euro area and periphery. These markets have operational gearing and lead indicators point to earnings improvement; moreover their Shiller P/Es are below average.

Value has disappeared...

With the P/E ratio now at 16.2x many investors argue that there is no value in European equities and it's only with reference to low bond yields that equities continue to be attractive. We have some sympathy with this view – the ERP remains high (c.7.3%). And while the risk premium should come down in future years as growth improves and deflation risks recede, this may not help to reduce the cost of equity if bond yields also rise to reflect better nominal growth.

...but plenty of earnings potential

We continue to see value in Europe in terms of earnings catch-up and lots of recent lead indicators point to a turn in earnings (PMIs, Consumer Confidence, M1 growth). In addition margins and ROE – which are still far below peak in Europe – are linked to improvements in economic growth.

Accounting for earnings catch-up, valuation is not stretched

The Shiller P/E (price divided by 10-year average EPS) for Europe is still around its long-term average; whereas in the US it is far above trend. Moreover, in Europe the 10-year average EPS is itself very low. Far from being an overly generous measure of valuation for Europe which assumes some return to pre-crisis trend earnings (one many investors including ourselves doubt), we believe the EPS it's based on is fairly depressed with potential to improve as economies recover.

Euro area, and especially the periphery, offer most upside

Our economists have upgraded their estimates for 2016 Euro-area GDP growth to 1.9% driven by improvements in the periphery. The unresolved debt problems in Greece are clearly weighing on performance in recent weeks, but it is here we see the most value with the cyclically-adjusted or Shiller P/Es for Italy and Spain remaining especially low.

Sharon Bell, CFA
+44(20)7552-1341 sharon.bell@gs.com
Goldman Sachs International

Peter Oppenheimer
+44(20)7552-5782 peter.oppenheimer@gs.com
Goldman Sachs International

Christian Mueller-Glissmann, CFA
+44(20)7774-1714 christian.mueller-glissmann@gs.com
Goldman Sachs International

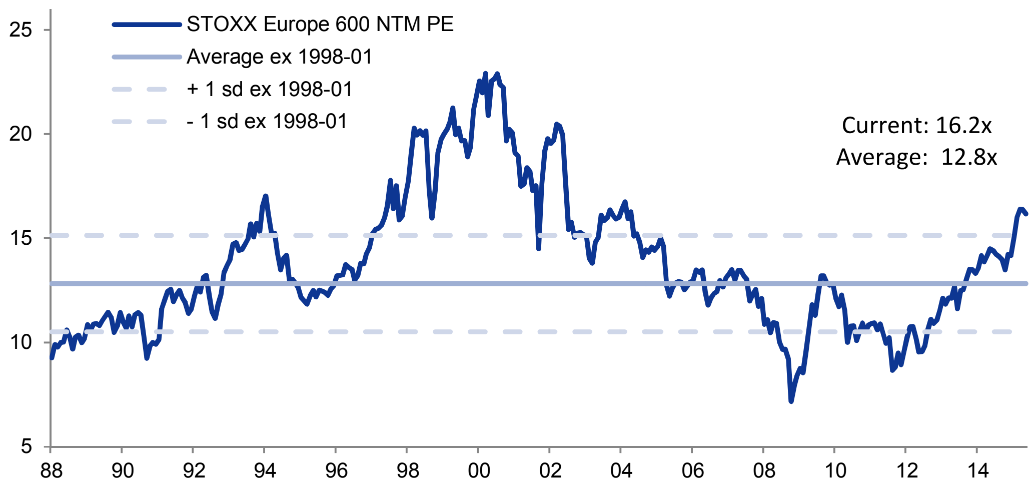
Anna Huang
+44(20)7774-1107 anna.huang@gs.com
Goldman Sachs International

Why valuations are not as stretched as they seem

Value disappearing

On a standard 12-month forward consensus P/E basis the Stoxx Europe trades at 16.2x – more than one standard deviation above the average for the last 14 years. It's difficult to argue relative to history that the market isn't stretched; only in the tech bubble period were valuations higher for any sustained length of time (Exhibit 1). This rise in valuations and the dangers it poses, especially for the US was discussed in detail in *Top of Mind: Valuations – Dangerous Territory?,* May 29, 2015.

Exhibit 1: Valuations are beginning to look stretched in Europe
Stoxx Europe 600 NTM P/E



Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

Versus bonds equities still offer substantial value; our measure of the European equity risk premium (ERP) is about 7.3% and this is both high versus the average and our macro model of where the ERP should trade. But if this is merely because bonds are over-valued then if and when bond yields rise equities may still be vulnerable. We discussed this in *GOAL: Cross-asset risk premia & yields; downgrade commodities & credit,* May 20, 2015. Therefore the rise in equity valuations must surely leave equities more vulnerable if bond yields eventually adjust upward, something our fixed income strategists expect to happen, albeit more slowly this cycle given the still high output gaps and low inflation in Europe. But this is very different from 1999/2000 when the equity market was at a similar level to today while bond yields were much higher and the ERP was close to zero (on our estimates).

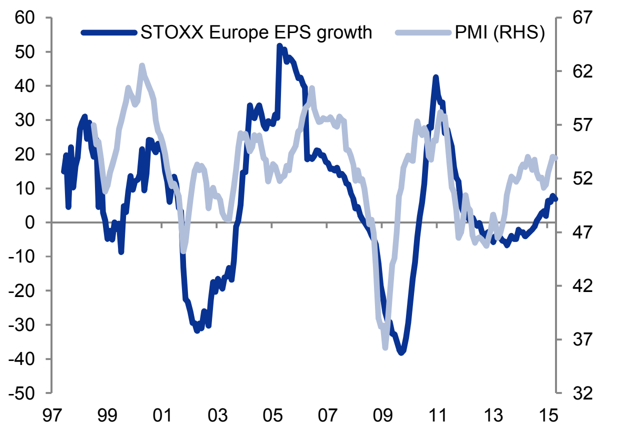
For European companies though we think the potential for earnings recovery is substantial, and more than enough to justify current prices. This is with the caveat that a negotiated solution is eventually reached for Greece; something which at present is adding to European risks. This concern notwithstanding, many near-term indicators are pointing to strong earnings growth and also valuation is still fair or even below fair-value for some markets, in our view, allowing for earnings to normalize (we discuss the topic of normalized earnings later).

But earnings indicators improving...

Earnings remain depressed in Europe as a result of several years of low and sometimes negative economic growth. We expect Europe STOXX 600 aggregate EPS to grow by 5% and 15% in 2015 and 2016, respectively; ex commodities sectors these figures are 13% and 14% growth.

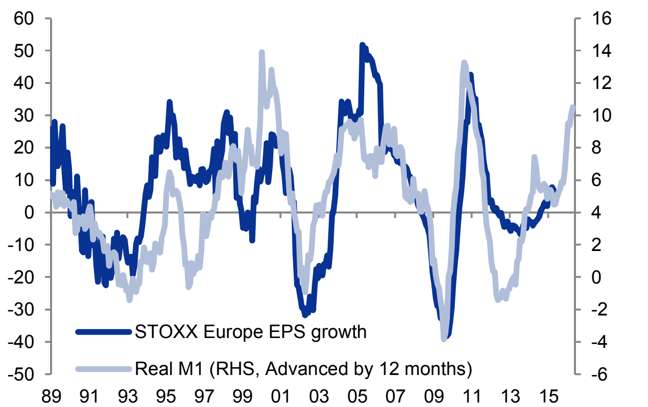
We see several indicators which point to the potential for earnings to improve over the next few years. For example, PMI data, IP growth, real M1 growth and consumer confidence for Europe all indicate a pace of earnings improvement which if anything is a little above the rise in earnings we've seen so far this cycle (see Exhibits 2-5). In addition I/B/E/S consensus EPS revisions have turned positive, up 0.3% in the last month for 2015. Not a large revision, but a substantial change from last year and the beginning of 2015 where every month saw downgrades.

Exhibit 2: Composite PMI points to double-digit EPS...
Stoxx Europe 600 EPS growth vs. Euro area composite PMI



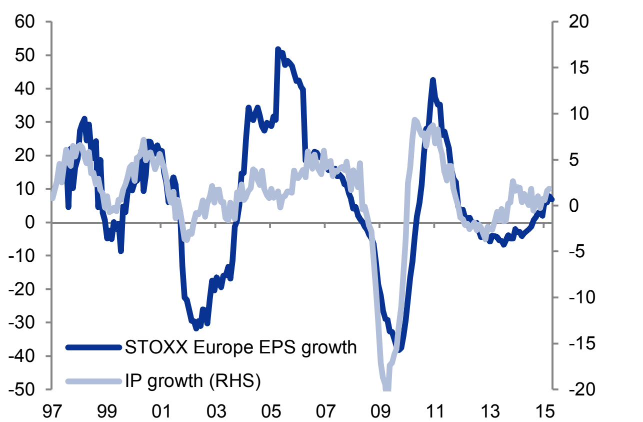
Source: I/B/E/S, Haver, Goldman Sachs Global Investment Research.

Exhibit 3: Real M1 tends to lead EPS
Stoxx Europe 600 EPS growth vs. Euro area real M1 growth



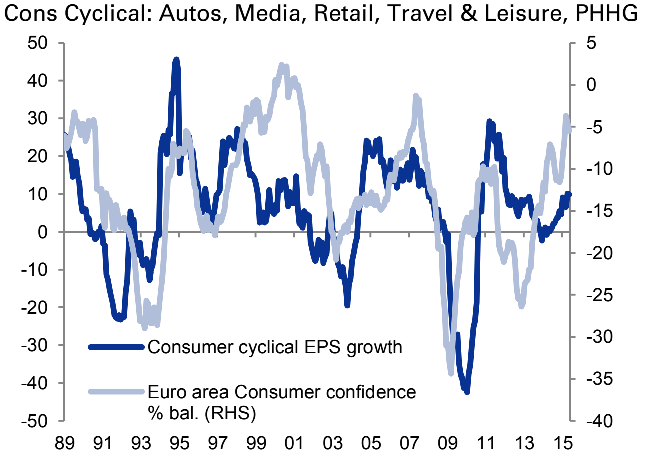
Source: I/B/E/S, Haver, Goldman Sachs Global Investment Research.

Exhibit 4: IP starting to pick-up in line with earnings
Stoxx Europe 600 EPS growth vs. Euro area IP growth



Source: I/B/E/S, Haver, Goldman Sachs Global Investment Research.

Exhibit 5: Consumer confidence accelerates
Cons Cyclical: Autos, Media, Retail, Travel & Leisure, PHHG

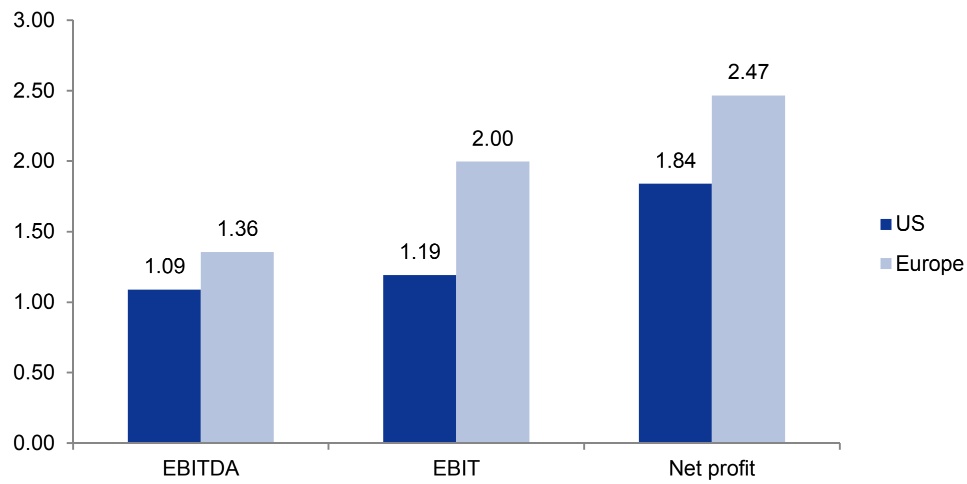


Source: I/B/E/S, Haver, Goldman Sachs Global Investment Research.

And operational gearing in Europe is high

Exhibit 6 is only rough and takes an average of gearing across all years since 1980 (excluding any years when sales grew and earnings fell). It shows that for Europe every move in sales saw a 2x jump in EBIT and an even greater improvement in earnings growth. European companies tend to be very sensitive to growth moves which explains in part the weakness in earnings in recent years. US companies which benefit from both more labor flexibility and less exposure to operationally-geared sectors (banks, autos, cap goods etc.) tend to have lower gearing to the economic cycle. If both domestic growth in Europe and global growth pick up in 2H15, as our economists forecast, this should be especially advantageous for European companies.

Exhibit 6: Operating leverage high in Europe
Average ratio of EBITDA/EBIT/EPS growth to sales growth (last 10 years)

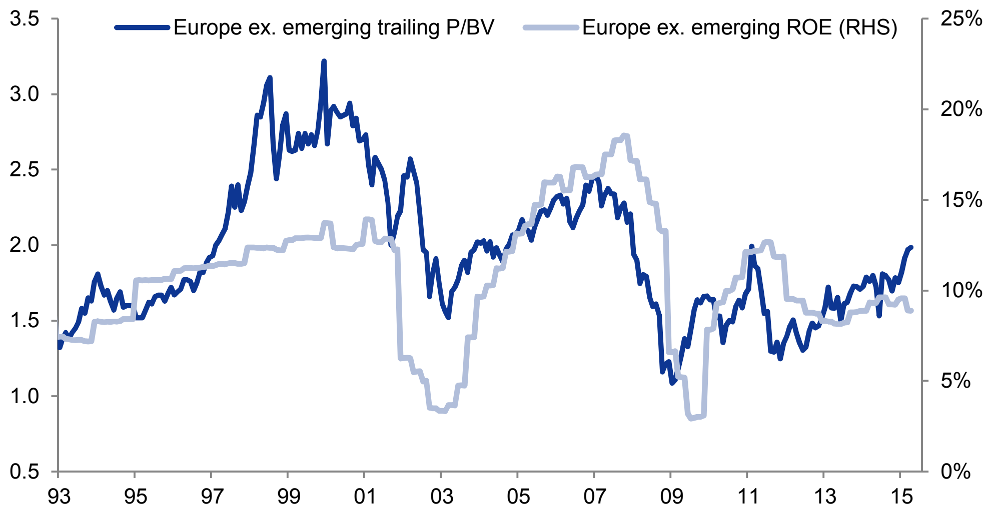


Source: Datastream, Goldman Sachs Global Investment Research.

Improvement in margins and ROE hold the key to long-term value

Price to book has risen in Europe along with the P/E, but still remains around the long term average at 2.0x.

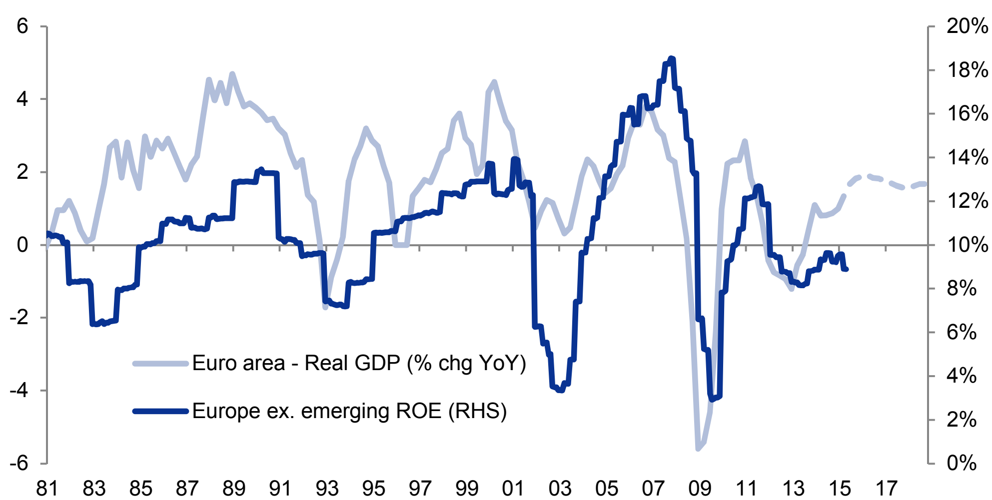
Exhibit 7: P/BV has moved back up to long-term average...
Europe ex. emerging trailing P/BV vs. ROE



Source: Datastream, Goldman Sachs Global Investment Research.

Any further expansion in price to book needs to come via an improvement in ROE, in our view. Improved ROE should also feed into higher book values via retained earnings and hence higher prices without necessarily seeing a rise in price-to-book itself. **ROE also has a pretty strong relationship with growth**; in Exhibit 8 we show ROE with Euro-area GDP. This is largely because margins and asset turnover are driven by companies' ability to make full use of their capacity, lowering fixed cost as a percentage of output so when growth is stronger they tend to produce better returns.

Exhibit 8: ...but higher valuations should be supported by higher ROE
Euro area Real GDP growth and forecasts (% yoy) vs. Europe ex. emerging ROE



Source: Datastream, Goldman Sachs Global Investment Research.

Margins in the next few years should be boosted by low energy costs and still muted wage inflation. Low interest costs should also continue to benefit companies. Overall the growth forecast by our economists in the next few years is consistent with a rise in ROE back up to 12%-14%, similar to 2011.

European markets and sectors in general have margins below their previous peaks. As shown in Exhibit 9, US margins are at peak levels whereas the Euro area and periphery Europe have net income margins which are some 300 bps or more below previous highs.

Exhibit 9: Margins for European indices below peaks
IBES % Net income margin peak is taken from 2004-15

	Current	Max	Difference
S&P 500*	8.9%	9.1%	-0.2%
SWISS MARKET	13.8%	14.2%	-0.4%
FTSE 250	7.0%	7.5%	-0.5%
DAX	5.1%	6.7%	-1.6%
CAC 40	6.5%	8.5%	-2.0%
STOXX	7.1%	9.7%	-2.6%
FTSE100	7.7%	10.9%	-3.2%
EURO STOXX 50	6.5%	10.0%	-3.5%
FTSE ITALIA MIB	3.1%	7.0%	-3.9%
IBEX 35	6.2%	13.2%	-6.9%

*ex. financials and utilities

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

There are also marked differences across sectors with financials, resources and telecoms having the lowest margins versus previous peaks.

In some cases, such as oil and basic resources, we are concerned that margins will never climb to previous peaks as these industries have changed substantially in recent years with additional oil supply and a slowing in demand growth for commodities from China. But for financials and domestic consumer sectors in Europe we see some room for margins to normalize. For telecoms and banks their margins are again not likely to rise to previous high, but may nonetheless see some recovery.

Exhibit 10: Margins versus peak for European sectors
I/B/E/S % net income margin peak is taken from 2004-15 for Stoxx Europe 600

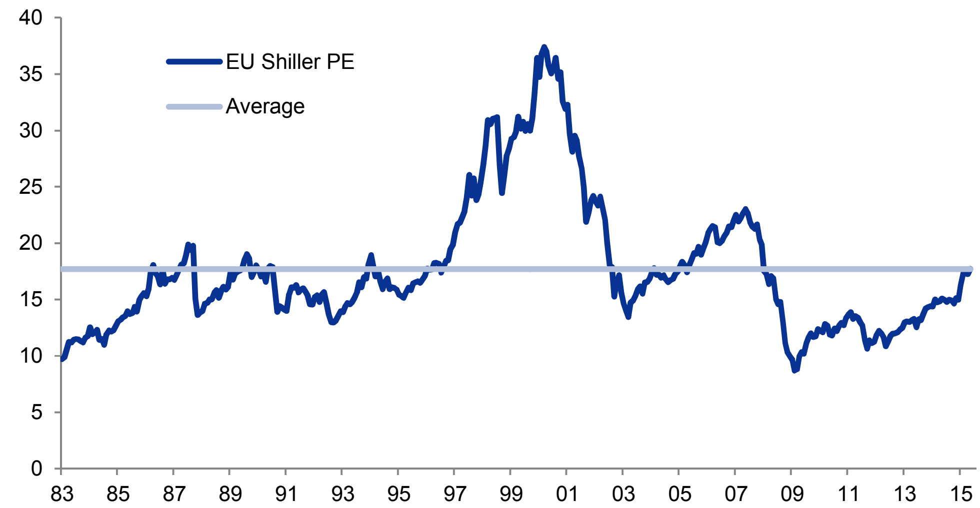
	Current	Max	Difference
Chemicals	8.3%	8.3%	0.0%
Technology	10.5%	10.6%	-0.1%
Media	10.5%	10.6%	-0.1%
Food and Beverages	12.9%	13.3%	-0.4%
Industrial Goods and Services	5.6%	6.1%	-0.5%
Autos and Parts	3.9%	4.6%	-0.7%
Retail	2.8%	3.5%	-0.7%
Travel and Leisure	4.2%	5.3%	-1.1%
Construction and Materials	4.0%	5.8%	-1.8%
Real Estate	41.6%	43.4%	-1.8%
Health Care	18.9%	21.1%	-2.2%
Insurance	6.6%	9.1%	-2.5%
Personal Care and Household Goods	10.0%	12.8%	-2.8%
Oil and Gas	4.2%	7.7%	-3.5%
Utilities	4.5%	9.1%	-4.6%
Telecom	6.7%	12.2%	-5.6%
Basic Resources	4.5%	13.9%	-9.4%
Banks	16.4%	27.5%	-11.1%
Financial Services	14.0%	36.7%	-22.8%

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research.

Value is hiding in the potential for earnings recovery

If we assume that earnings are starting to recover it makes sense to look at a cyclically-adjusted market valuation metric such as the Shiller P/E. This is the ratio of today’s price over the 10-year rolling average of earnings, all in real terms. On this basis, the market doesn’t look as stretched; Europe is around its average valuation after a substantial re-rating post 2012.

Exhibit 11: Shiller P/E has moved back up to average in Europe
European cyclically-adjusted P/E– price divided by 10-year average real EPS

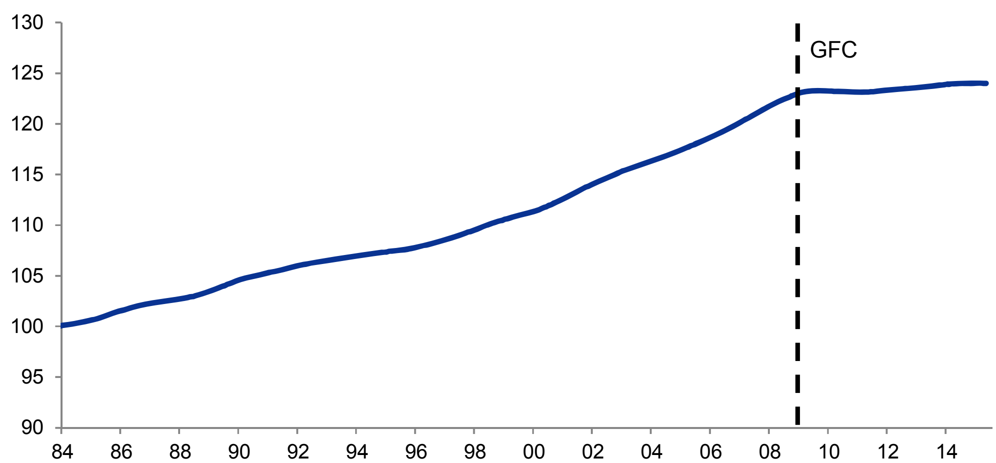


Source: Datastream, Goldman Sachs Global Investment Research.

But is the Shiller P/E a fair metric for Europe? We think this is really a question as to whether the 10-year average EPS on a rolling basis is right or fair, or is the path of future profits now so substantially different as to render the last 10 years meaningless. The Shiller P/E implicitly assumes that earnings move around a long-term trend which is captured by a 10-year period and that they can catch-up to that trend.

However, far from the 10-year average EPS being too high and not something which Europe can catch-up to, there is an argument that it is too low. Exhibit 12 shows the 10-year rolling real EPS series underlying the Shiller or cyclically-adjusted P/E for Europe, far from being at an exceptionally high level, the 10-year average has been flat for the past six years. To benchmark valuations off this low level of EPS – reflecting in large part the earnings performance post the GFC and then again post the sovereign crisis – is a relatively low hurdle.

Exhibit 12: European earnings have not recovered to trend levels
10-year rolling average of European earnings (log values and indexed, 1983 = 100)



Source: Datastream, Goldman Sachs Global Investment Research.

Put another way, the Shiller P/E has risen as the risk premium has fallen but it's risen versus a relatively weak EPS picture in recent years.

To be clear we are not advocating a view that earnings can return to the pre-crisis trend – we think there are good reasons why growth is likely to be slower in the future than it was on average in the two decades prior to 2007, including:

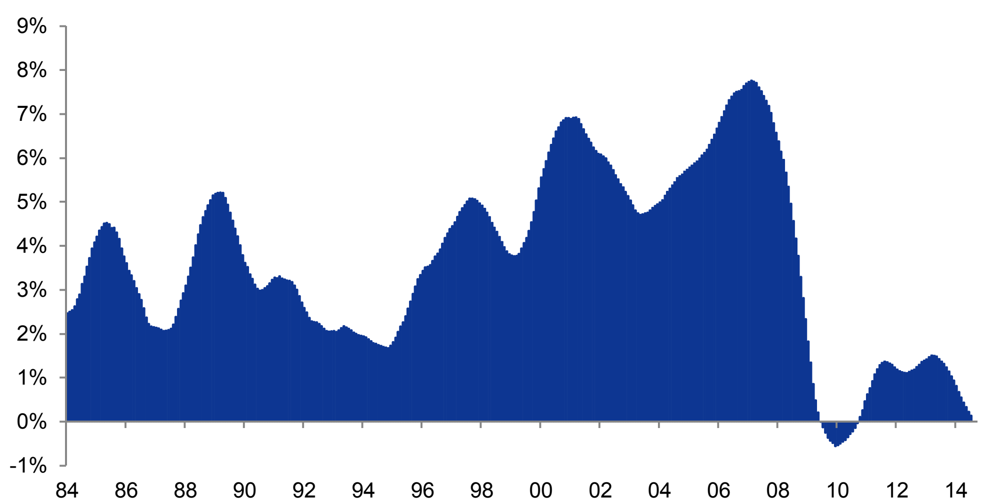
- **Lower trend GDP growth;** Euro area GDP growth even in 2015 is expected to be 1.5% on our economists' estimates and there is evidence that even in the US and UK where economies have recovered, earlier trend productivity growth may have weakened;

- **Lower demand from EM; end of commodity capex cycle.** The super cycle in commodity-related demand, and infrastructure spend in China have both been big drivers of European company earnings in Oil & Gas, Basic resources and Industrials, but these trends are likely to have slowed see *The New Oil Order: Reality of oil market will trump perception and positioning,* May 18, 2015 and *420 projects to change the world: Shale and OPEC fight for market share; rest of industry fights for relevance,* May 18, 2015.

- **Less investment means less growth.** Finally, European companies have not invested in recent years, and capex rates have been especially low; while there are many reasons for why this might be (*Fortnightly Thoughts: Why isn't corporate capex higher?,* May 6, 2015) one possible result is that future growth will be lower. We have discussed previously how companies have large cash balances and these generate no return, which is likely to continue to be a drag on growth potential for European corporates.

However, we equally think the last 10 years of growth are also a little harsh to compare future potential with. As shown in Exhibit 13, 10-year average real growth rates have plummeted. To this end we think the Shiller P/E based on the last 10-year average of earnings is likely to understate the potential for European earnings and price recovery. This is especially true for the Euro area and peripheral Europe.

Exhibit 13: European real earnings was 4%-5% in the 1990s and 2000s but in the last 10-years it has been zero
Rolling 10-year real EPS growth (yoy %)

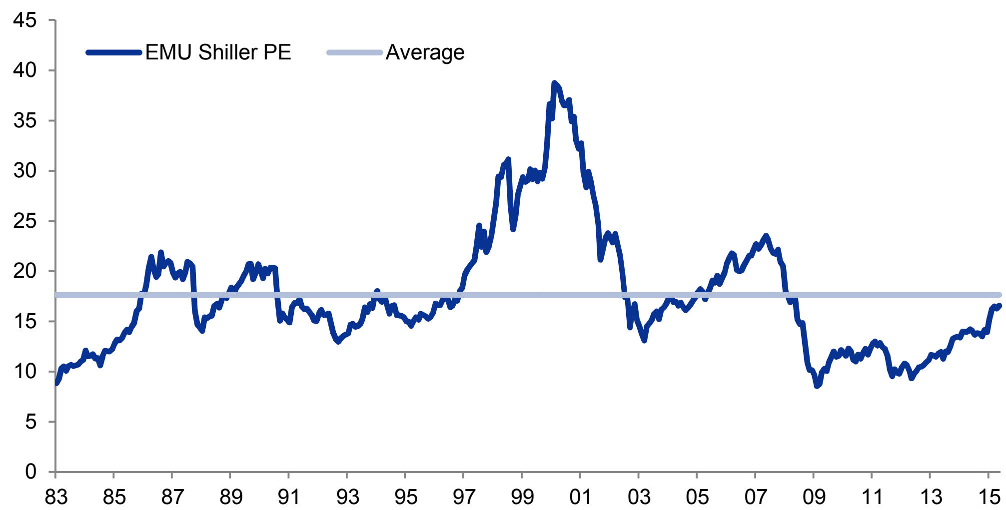


Source: Datastream, Goldman Sachs Global Investment Research.

Where is the value?

A fair place to start may be where earnings are most muted and most below normalized levels. We find more value in the Euro area than in Europe in total; **the Euro-area Shiller P/E is slightly below its historical average, again based on already very depressed 10-year average real EPS.** So if over time 10-year average EPS improves as the Euro area recovers then the cyclically adjusted P/E would naturally become cheaper.

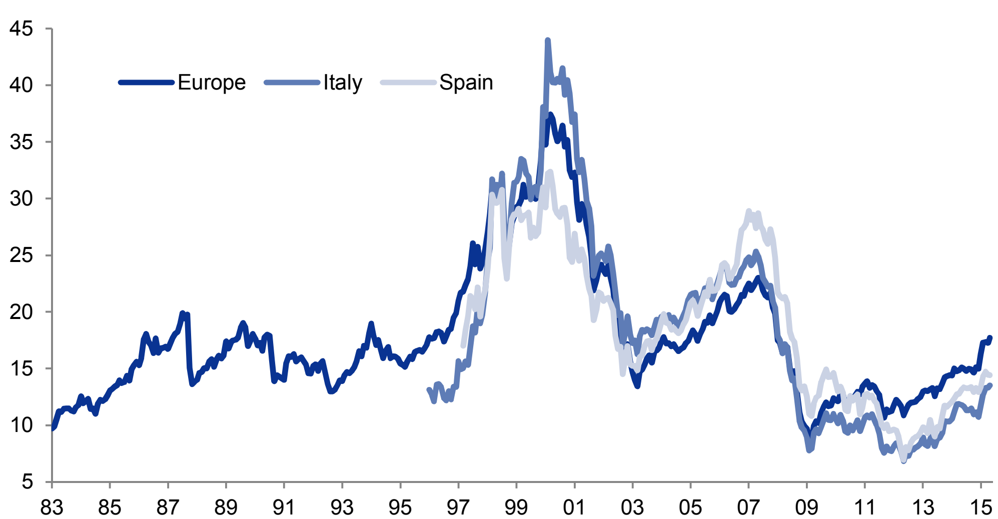
Exhibit 14: EMU trades at a c.6% discount to its long-term average Shiller P/E
European Monetary Union cyclically-adjusted P/E– price divided by 10-year average real EPS



Source: Datastream, Goldman Sachs Global Investment Research.

Our economists recently upgraded 2016E Euro-area GDP to 1.9% from 1.7%, see *European Economics Analyst: Europe's outlook: The recovery broadens but political risks linger,* May 21, 2015. And this comes after two previous upgrades to Euro-area GDP earlier in the year. Moreover they continue to argue that the near-term risks are skewed somewhat to the upside.

Exhibit 15: Italy and Spain are at a discount to the rest of Europe and their own history
European, Italian and Spanish cyclically-adjusted P/E– price divided by 10-year average real EPS



Source: Datastream, Goldman Sachs Global Investment Research.

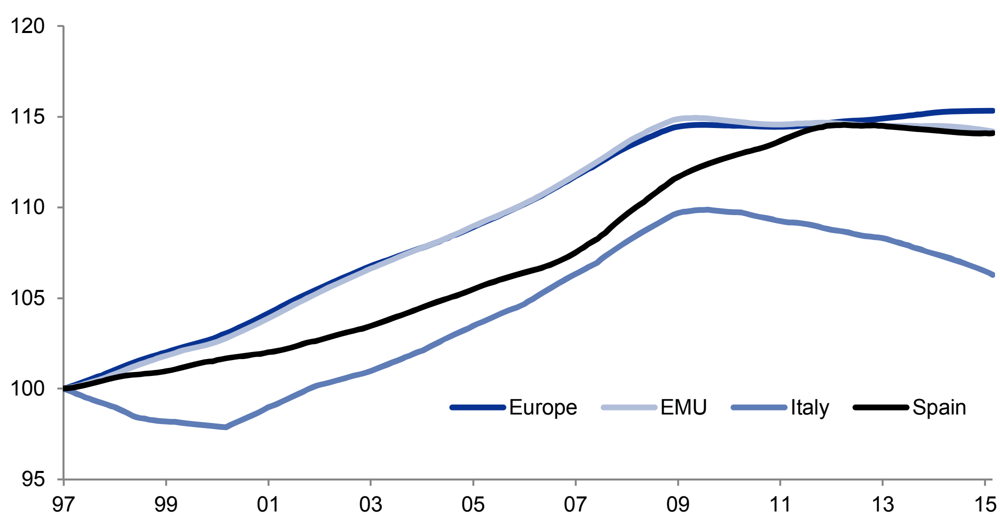
The recent GDP upgrades have been to Italy and Spain where the recovery has strengthened in recent months, lead indicators have generally been strong and loan growth has picked-up. We now forecast 2.8% GDP growth in Spain in 2015 and 2.4% in 2016. Spanish growth this year is likely to be stronger than in the UK or the US. Italy is growing more slowly but the forecast changes if anything are more marked, having been in recession in the previous three years. The cyclically-adjusted Shiller P/Es for Italy and Spain are still comparatively low and for Italy in particular this is already from a relatively depressed 10-year earnings average. The Shiller P/Es ex. financials are also still low in Italy and Spain (Exhibit 16).

Exhibit 16: ...Even ex. financials the Shiller P/Es for Italy and Spain are low
Cyclically-adjusted P/E ex. financials – price divided by 10-year average real EPS

Source: Datastream, Goldman Sachs Global Investment Research.

And the 10-year rolling EPS is especially depressed for Italy – reflecting the large financial sector which has been a huge underperformer.

Exhibit 17: 10-year rolling earnings have been very weak for Italy
10-year rolling average of earnings (log values and indexed, 1997 = 100)



Source: Datastream, Goldman Sachs Global Investment Research.

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Reg AC

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