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When will the earnings momentum rise on the European equity markets?

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The stock exchanges have been moving sideways and down for weeks. There are of course enough uncertainty factors such as the Greek crisis, the correction on the Chinese stock exchange, and the expected interest rate increase in the USA that can serve as explanation. However, one factor that has (so far) been left out of the equation is the fact that company earnings are hardly growing. The increase on stock exchanges is fundamentally justified if the valuation levels are rising across the board without earnings growth (e.g. price rises due to the low interest rates) or if company earnings themselves are rising (thus justifying the valuations). The interest rates can actually not fall any further, which means that the stock exchanges cannot get any impulse from that end.

How does the other factor, earnings growth, look? There is no clear answer to that question. Some market participants are rather sceptical. In the following I will try to shed some light on these factors, company earnings and earnings momentum.

Worldwide quick recovery of company earnings after the financial crisis

Published earnings (EPS), long-term earnings trend (EPS long term), and company earnings generated on average over the past 10 years (Shiller method) 1975 – 2015

Source: MSCI World; as of July 2015; Shiller method green line

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The chart highlights the fact that over the past 40 years (June 1975 – June 2015) company earnings have been rising at a relatively stable rate of 5.3% per year (long-term earnings trend – red line), taking into account cycles. After the financial crisis (2008) company earnings saw a relatively quick recovery, embarking on a trend that has been held for the past three years. However, over the past four months, earnings have been sliding slightly but steadily. This is a warnings signal that we have to keep an eye on: without earnings growth, no further price increases can be justified, given the current valuation. Only once earnings start rising again can a price increase be fundamentally justified.

Earnings growth only in some sectors

Earnings growth has become a rare commodity in the current environment, but it still exists – albeit only in specific sectors. Among them are the IT sector, the financial industry, and consumer goods. Especially consumer goods have continuously reported falling earnings in the past months, and we may have seen the beginning of a trend reversal. The high-flyer of the past months, i.e. the biotech sector, has recorded earnings growth of 100% in less than three years. But most recently it has recorded falling earnings, joining the traditional pharmaceutical companies. The situation in the energy sector is dramatic, with earnings falling by more than 30% in the past half year. Among the sectors that have incurred falling earnings are the industrial sector, raw materials, and telecoms.

The European earnings lack momentum

Earnings (EPS) generated in Europe (ex UK), long-term earnings trend (EPS long term), and company earnings generated on average over the past 10 years (Shiller method) 1975 – 2015

Source: MSCI

Source: MSCI

While Europe has rising earnings to show for in contrast to the global trend, said trend lags expectations. There is currently a significant gap between Europe and the long-term EPS trend (red line). In fact, earnings are back at the level of 2000, i.e. of 15 years ago!

Will earnings boost again?

The expansive monetary policy of the European Central Bank and the recently weak euro should facilitate a significant boost of earnings for companies. However, falling demand from the emerging markets, in particular from China, somewhat contradicts this scenario.

The general question is whether a return to the long-term earnings growth trend will be possible in the short run. The growth sectors of technology and biotech are underrepresented in Europe. In order for earnings to return to their long-term trend growth, they would currently have to rise by 47%. For the time being, this is unlikely to happen.

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