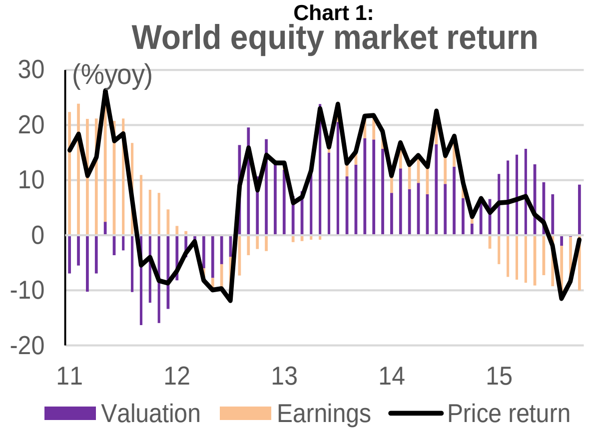
Earnings in the spotlight

November 2015

Global equity markets have delivered strong returns since the depths of the financial crisis. More of those gains have come from rising valuations than earnings growth. Now that valuations are in line with historical averages, future gains will be dependent on the strength of earnings.

Unfortunately it has not been a strong year for earnings overall. Analysts entered 2015 expecting world earnings growth around 10% but falling commodity prices and weak Chinese growth have seen those expectations downgraded, and earnings are now expected to be around flat for the year. This is shown in Chart 1.

Chart 1:



Source: Datastream

Will 2016 be a better year for earnings?

We tackle this question by firstly looking at the most recent US reporting season.

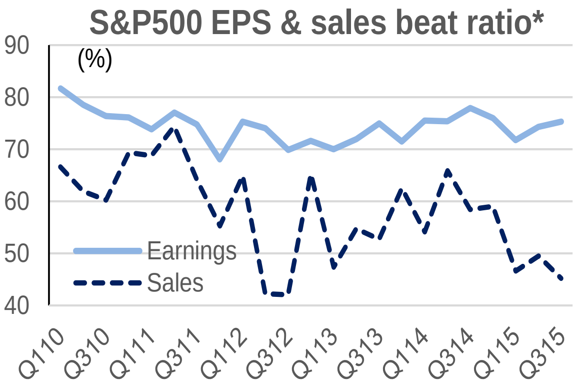
Recent US corporate results suggest that the operating environment remains soft. More than half of US companies failed to meet expectations for sales in the September quarter. The issues have been:

+ a weaker than expected global economy
+ low oil prices
+ a high US dollar.

The better news, however, is that companies were active in managing costs so that around 75% of S&P500 companies exceeded expectations for earnings. This is in line with the greater cost focus among Australian companies in recent years.

Over the past year, US earnings have actually fallen 2% as shown in Chart 2. Not great news overall. But this has to a large extent been driven by the energy sector, which has been hit by falling energy prices. Excluding energy, earnings increased by 6% as shown in Charts 3 and 4. So the underlying story remains better. Similar results were recorded in Europe as the energy sector dragged down overall earnings growth but underlying results were better.

Chart 2:



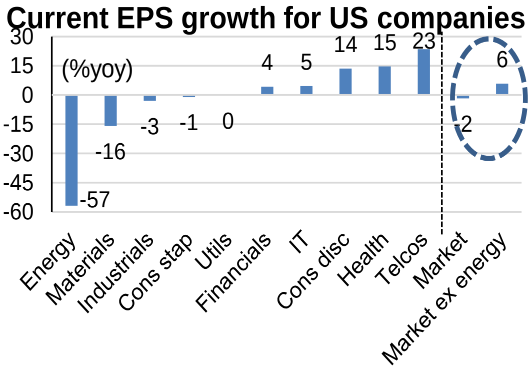
* % of companies reporting ahead of analyst expectations

Source: Datastream

So, where to from here?

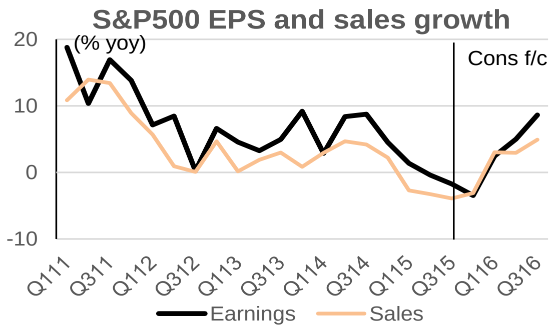
Analysts expect US earnings growth to rebound after a disappointing 2015, with big turnarounds for energy and materials companies as commodity prices stabilise. Meanwhile, companies exposed to the US consumer market are anticipated to see solid conditions on the back of improved spending.

Chart 3:



Source: Datastream

Chart 4:



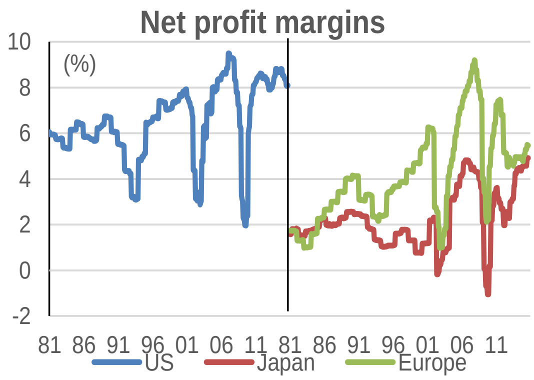
Source: Datastream

The prospects are brighter for Europe and Japan in 2016 and beyond. We expect these markets to have the best earnings growth, and for this to translate through to strong equity returns. Some of the contributing factors include:

+ Europe has taken longer to rebound from the financial crisis than the US but this recovery is now accelerating. This should translate to stronger earnings growth, particularly from the financial sector, over the next couple of years.
+ European companies have the potential to improve margins as they take advantage of structural reforms, particularly to the labour market, introduced since the crisis.
+ The profitability of Japanese companies is also set to rise. The Japanese Government has introduced a range of corporate governance initiatives designed to push companies to operate more efficiently and distribute excess cash back to shareholders. This should lead to rise in margins over coming years compared to previous margins shown in Chart 5.

In summary, equities have had a solid run as valuations have risen off cyclical lows. To keep rising, earnings will need to take over as the major driver of returns. While recent headline earnings have been uninspiring, the underlying trends are more constructive. Earnings have been negatively impacted by currency movements, energy and other one-off factors. As these fade, earnings growth should start to pick up. Indeed, companies continue to have the ability to cut costs and engage in share buyback initiatives in order to support earnings. Japanese and European companies particularly stand out.

Chart 5:



Source: Datastream

For more information about how company earnings and share market returns impact your investments, please contact BT Investment Solutions.

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