Market Bulletin

July 2016

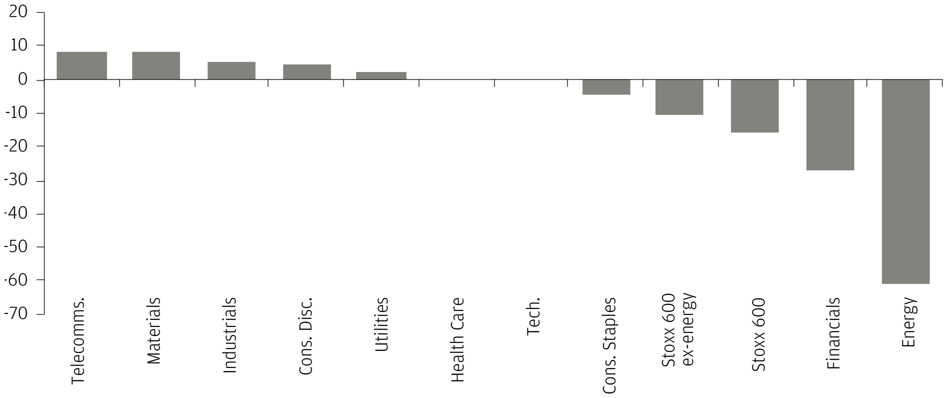
European Q1 2016 earnings season: Assessing the post-Brexit landscape

In brief

- With 410 companies in the Euro Stoxx 600 now having reported, we estimate that European earnings per share (EPS) for the first quarter of 2016 declined by 16.0% year on year (y/y). But this headline number is badly distorted by the sharp falls in just two sectors—energy and financials (**Exhibit 1**).
- Excluding energy, Stoxx 600 EPS actually fell by 10.5% (y/y), and EPS growth for eurozone companies remains in positive territory, with EPS growth of 1.4% (y/y) in the first quarter of 2016.

EXHIBIT 1: STOXX 600 EPS GROWTH

% change year on year



Source: Bloomberg, Thomson Reuters Datastream, J.P. Morgan Asset Management; data as of 19 July 2016.

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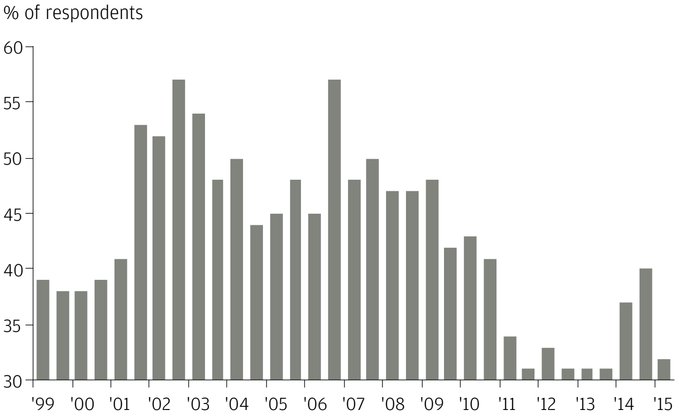
WHAT DOES BREXIT MEAN FOR EUROPEAN EQUITIES?

As the dust begins to settle following the UK referendum on membership of the European Union (EU), so far it is eurozone, rather than UK, equities that have been hit the hardest. The MSCI Europe ex-UK index is down 2% since 23 June, compared with a 5% gain in the FTSE All-Share Index over the same time period.

Some of these moves are driven by fears that Brexit will disturb the European recovery, though goods exports from the EU to the UK make up just 2% of the region's GDP. It is financial and political contagion that investors fear most. As demonstrated by **Exhibit 2**, trust in the EU has fallen to just over 30% in recent years, as voters across the trade block have become increasingly disaffected. The fear is that this heightened Euroscepticism will make for unpredictable—and potentially economically costly—results in 2017, when we will see general elections in countries representing 40% of EU GDP.[1]

EXHIBIT 2: TRUST IN THE EU



Source: European Commission, J.P. Morgan Asset Management; data as of 19 July 2016.

It is possible that watching the UK suffer the consequences of its decision might cause support for these Eurosceptic forces to wane. The main establishment parties actually did better than expected in the Spanish general election, held a few days after the UK referendum. Either way, political uncertainty looks set to be a key factor for investors in the months ahead.

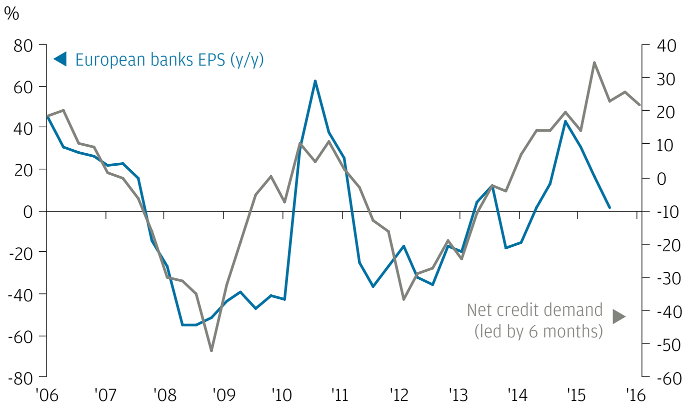
One potential economic upside from the Brexit decision—for some companies—is the prospect of a weaker pound. The pound has fallen 15% on a trade-weighted basis since its high in the summer of 2015, and it could well fall further, given the UK's very large current account deficit and the uncertainty over its continued relationship with the EU.

A falling currency gives a helping hand to FTSE 100 earnings, which source approximately 75% of their revenues from overseas. Indeed, the four-week moving average of net earnings revisions (defined as upgrades minus downgrades) has just turned positive for the first time since early 2013 on the back of the weaker pound. Many of the UK firms included within the pan-European indices such as the STOXX 600 are large and international in nature. So the benefit of a weaker pound could also help the broader European index move higher.

FINANCIALS: STUCK IN A "TRIANGLE OF TROUBLE"

One of the main detractors from the first-quarter earnings number was the financials sector, which saw EPS decline by 27% (y/y). The latest set of EPS numbers was disappointing, especially considering that the wider economic and credit picture has improved materially in the last few quarters. As we highlight in **Exhibit 3**, improving demand for credit is typically reflected in rising EPS for regional banks. However, in the last couple of quarters, we have seen the opposite, with credit demand picking up while bank EPS growth continues to slow.

EXHIBIT 3: EPS FOR EUROPEAN BANKS VS. NET CREDIT DEMAND



Source: European Central Bank, MSCI, J.P. Morgan Asset Management; data as at 25 July 2016.

Declining EPS growth is concerning and highlights the challenging operating environment for European banks. You could say that European banks were stuck in a "triangle of trouble", with regulatory pressures, negative rates and overbanking in many EU economies all working to stifle earnings growth within this crucial sector.

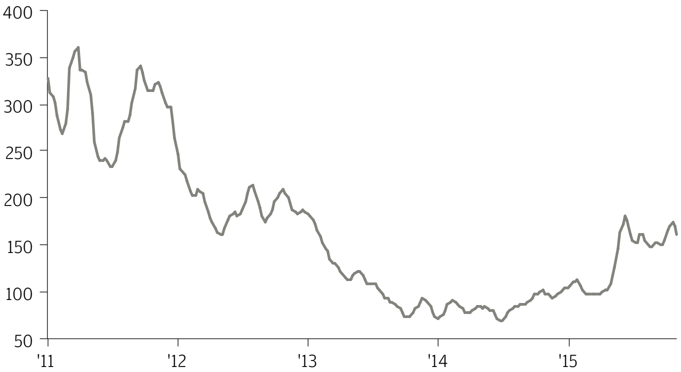
I. Regulatory pressures

New regulations in response to the global financial crisis have helped strengthen bank balance sheets and this is reflected in the credit default swaps (CDSs) of major European banks. As highlighted in **Exhibit 4**, the cost of insuring against a default in European banks has risen a little since the start of the year, but is well below its peak in 2011 and 2012 during the height of the eurozone debt crisis.

[1] Those countries that have scheduled elections are Germany, France, Netherlands and Bulgaria.

EXHIBIT 4: EUROPEAN BANK CREDIT DEFAULT SWAPS

Four-week moving average



Source: Bloomberg, Standard & Poors, J.P. Morgan Asset Management. Index is the S&P/ISDA CDS European Banks Select 15. Data as of 25 July 2016.

However, the implementation and complexity of regulation is beginning to hurt profitability. A study in 2010 found that to comply with Basel III, a mid-sized European bank would require up to 200 full-time workers.[2] The regulatory burden on European financials is likely to increase in the coming years as the Basel III accords won't be fully implemented until 2018.

II. Overbanking challenges

It has long been known that Europe has too many banks. The latest data from the European Central Bank (ECB) show that the region has 6,146 banking institutions. That compares with 5,289 in the US.[3] On a GDP-adjusted basis, the average is USD 3.4 billion per bank in the US, compared to just USD 1.9 billion per bank in the eurozone.

A surfeit of banks in one particular region erodes profit margins and leads to misallocation of financial and human capital, which harms growth as capital is not allocated in an optimal manner. However, overbanking in Europe could also provide merger-and-acquisition opportunities, as the challenges facing banks have pushed price-to-book ratios down to 0.6x. Before the financial crisis, the average ratio for the sector was close to 2.0x.

III. Negative interest rates

Regulatory pressures and overbanking have long been challenges facing regional banks. But it is only in recent months that negative interest rates have been added to the list of troubles for banks. In the first quarter of 2016, 18 listed banks in the eurozone reported earnings, and in every report the management team highlighted the damaging effect of negative interest rates on their earnings. UBS has warned that the current negative interest rate environment could erode 20% of the banks' earnings over the coming years. However, the recent launch of the newly revamped Targeted Longer Term Refinancing Operations (TLTROs) should provide some support to profit margins by allowing banks to borrow at the negative deposit rate.

Within earnings for eurozone financials, the bottom line—rather than the top line—is where the "triangle of trouble" makes itself felt the most. Over the last year, revenue growth within eurozone financials has recovered by over 20% as the region has seen economic growth pick up. However, this has not trickled down into underlying earnings, with net income for the sector up only 0.5% over the same time period. In the two years following the financial crisis, net income in the financial sector recovered 33% per annum. Since the eurozone debt crisis in 2012, net income for financials has grown at just 1.4% per annum. There is some disparity across Europe, with France and Scandinavia seeing slightly stronger net income numbers than peripheral banks. However, no country has been able to emulate the profit rebound seen in the previous recovery.

A greater regulatory burden, pressure on margins from excessive competition and the negative interest rates that act as a charge on their deposits with the ECB are all putting pressure on expenses and eroding overall profitability.

The issue for investors is that the Stoxx 600 has a 20% weighting to financials, making it the single-biggest sector within the index. Investors allocating to Europe need to adopt an active approach and may consider avoiding banks, particularly those in the periphery that have significant retail banking exposure, for the foreseeable future.

[2] Härle, P., Lüders, E., Pepanides, T., Pfetsch, S., Poppensieker, T. and Stegemann, U. (2010), *Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation*, McKinsey Working Papers on Risk, Number 26.

[3] Source: US data = Federal Deposit Insurance Corporation (FDIC). European data = ECB; data as of 22 July 2016.

INVESTMENT IMPLICATIONS: LOOK FOR SAFETY IN MORE THAN ONE HARBOUR

- Although headline EPS growth within Europe was disappointing, much of the negative news was concentrated in two major sectors—financials and energy. Investors in European equities need to remain nimble and active and consider increasing exposure to those sectors with positive earnings growth.
- European equities have had a tough run. But there are hidden bull markets within the region. One example is Ireland, where the stock market has achieved a real compounded annual growth rate (CAGR) of 11.5% for the last seven years. Another is the consumer staples sector, which has returned 14.5% on a real CAGR over the same time period.
- Political risk remains within European equities post-Brexit. However, Brexit has presented some potential upside for pan-European equity indices as large-cap UK equities are driven higher by commodities and the weakening of the pound.
- European banks continue to face a "triangle of trouble" where overbanking, regulatory pressures and negative interest rates continue to put pressure on EPS growth. But though new regulations can hamper bank profitability in certain respects, it is important for investors to recognise that the new regime is also helping to strengthen the stability of European banking system and reduce the potential severity of the next crisis.

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