THIS MONTH'S TOPIC

US and European corporate earnings: after four quarters of stagnation, what is the outlook for 2020?

Fourth quarter 2019 earnings season confirmed the flat trend of the past 12 months. Hardly had 2019 ended than all eyes turned to 2020. For several months now, the earnings growth consensus for 2020 looked too optimistic. The spreading of coronavirus has only made us more cautious. The epidemic will certainly have a big impact on the first quarter of 2020 but some catching-up can be expected in the following quarters. In the short term the market should remain nervous. In the longer term a cautious optimism should eventually prevail.

IBRA WANE,
Senior Equity Strategist

Flat earnings for the fourth consecutive quarter...

Q4 2019 earnings season is gradually coming to its end. The time is ripe for an assessment and to adjust our forecasts for 2020 while factoring in the coronavirus impact.

Earnings were flat for the fourth consecutive quarter in Q4 2019 on both sides of the Atlantic, at +3.1% for S&P 500 companies and -0.2% in Europe (see carts 1& 2). They continued to be driven by the sharp slowdown in global growth since its 2017-2018 peak, and, in the case of the US, the fading of the impact of the 2017 tax reform.

Nonetheless, downward momentum in earnings forecasts has been less pronounced in the US than in Europe. Q4 2019 blended earnings of S&P 500 companies were ultimately a little better than expected, (+3.1% as of 18 February vs. -0.3% on 1 January) while it was the contrary for the Stoxx 600 in Europe, (-0.2% vs. +3.7%). We mustn't read too much into this slight uptick in US Q4 forecasts as it has not spilled over into the following quarters; just the contrary.

...wide sector disparities

However, the stagnation Q4 2019 of earnings conceals wide sector disparities in both the US and Europe.

2019 results marked by a mediocre global context and the fading impacts of the US tax reform

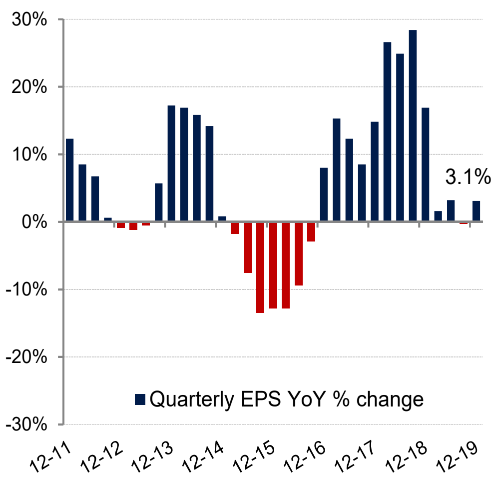
Energy and commodities stocks have dragged down overall earnings growth on both sides of the Atlantic. They alone have subtracted three to four points of EPS growth from the S&P 500 and the Stoxx 600 (see charts). These two sectors have declined over the past few quarters mainly because of slowing growth worldwide, particularly in China. Many commodity prices fell in Q4 2019, including an average year-on-year decline of 9% by both Brent and the CRB index of industrial commodities. Meanwhile, oil sector earnings fell far more in the US than in Europe, as US groups are more integrated upstream and, hence, more exposed to shifts in crude oil prices.

On the other hand, financial companies' earnings fared well, in both the US (+12%) and Europe (+4%), albeit more so in the US, given the economy's stronger growth, a more favourable yield curve, and the leading role played by their investment banks.

Across the other sectors, in the US, manufacturing (-10%) and consumer discretionary (0%) took a hit, due, respectively, to troubles at Boeing, Ford and GM.

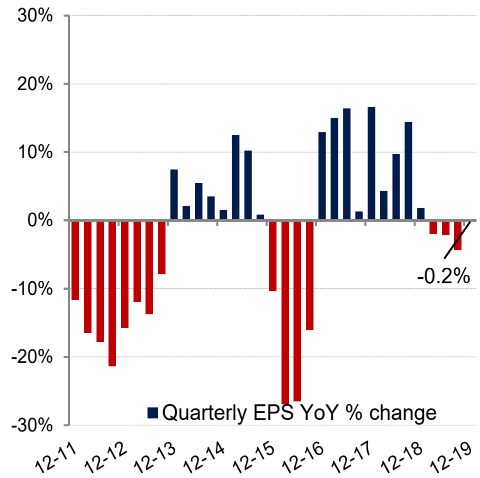
However, technology – a sector that is crucial to Wall Street, accounting for almost 25% of total capitalisation – recovered

1/ S&P 500 Quarterly results



Source: IBES, Amundi Research

2/ Stoxx 600 Quarterly results



Source: IBES, Amundi Research

THIS MONTH'S TOPIC

For months, the 2020 consensus seemed far too optimistic...

... The Coronavirus has reinforced these doubts!

The size of the Chinese economy has quadrupled since the time of SARS in 2003...

(+9%) after declining for three consecutive quarters.

In Europe, autos (-27%) were squeezed by lower volumes and the costs of future development (CO^2, autonomous cars, etc.) while luxury goods (+14%) continued to gain despite the Hong Kong demonstrations. Earnings improved as well in consumer staples (+7%), healthcare (+4%) and in industry (+5%); the latter being driven by the momentum of Airbus and the electrical equipment

After four flat quarters, what is the earnings outlook for 2020?[1]

To date (February 24), the IBES consensus continues to forecast 2020 EPS growth of about +9% for the MSCI ACWI, including +8% in the US, +7% in Europe and as high as +15% in emerging markets.

For many months we had felt that these forecasts were unrealistic and were rather considering a 5% EPS growth, both the US and Europe, given top-line pressures and poor pricing power of corporates, late-cycle wage rises spillover from higher customs duties and less share buybacks in the US ,

A new factor has now emerged – the coronavirus epidemic, with all its resulting uncertainties on global growth and business operations.

The coronavirus epidemic has thrown a wrench into forecasts

While the epidemic is developing and many restrictions remain in place, it would be guesswork to quantify the coronavirus's global impact. Still, it does appear greater than the SARS epidemic of 2003 which hit Chinese GDP hard in the 2nd quarter of that year. However, as usual in this type of crisis, the initial shock is likely to be mostly absorbed in the following months, due to firebreaks being set up (with a more favourable policy mix, etc.), automatic stabilisers (falling bond yields, etc.) and deferred consumption of some durable goods. For example, Chinese growth was hit by SARS for just three months before beginning to rebound sharply in the third quarter of 2003.

But this time, the initial shock should be greater, due to unprecedented quarantine measures taken in Wuhan and its Hubei region and nationwide travel restrictions. A lack of workers, of masks in sufficient numbers and of spare parts is nipping in the bud any attempt at relaunching work on a large scale. For example, according to the US Chamber of Commerce in Shanghai, which is 700 km from the epicentre of the epidemic, two thirds of US companies in the Shanghai region have resumed production since 10 February, but 78% of them don't have enough workers to operate at a normal pace. Meanwhile, Volkswagen, to take one example, had planned to reopen its Shanghai plant on 10 February, but has already pushed back this date twice, to 17 and then 24 February.

Beyond China, the global fallout of the coronavirus epidemic will be of another magnitude compared to SARS, as China's share of the global economy has quadrupled since SARS.

...especially as China is now at the heart of many value chains

China, the "world's workshop", is now at the heart of many value chains. As a result, the repercussions of the coronavirus-related standstill will be felt not just in China but well beyond.

Wuhan, for one, is a major auto production centre. That's where Dong Feng, China's second-largest automaker, is headquartered, along with many foreign automakers and equipment makers, such as GM, Nissan, PSA, Renault, Honda, Valeo or Faurecia. With supplies of electronic cables from Hubei cut off, Kia, Hyundai and Renault Samsung Motor plants 1500 km way, in Korea, have been forced to lay off 25,000 workers temporarily.

China is also a key player in electronics and many foreign manufacturers rely on its subcontractors. According to the *Nikkei Asian Review*, as of March 2019, 41 of Apple's 200 main suppliers were Chinese, i.e. three times greater than in 2012 and more than its US suppliers (37). On top of that, many foreign suppliers do some of their manufacturing in mainland China, such as Taiwan's Foxconn, which, early February, lowered its 2020 Sales guidance, as its workers were quarantined when they returned from vacation leave.

Something that is less widely known: China is also closely intertwined into pharmaceutical value chains. 80% of active principles used in Europe are from Asia, China in particular. This could lead to empty stocks or even supplies being cut off entirely.

Lastly, despite the support measures announced, the post-epidemic rebound should be less stark than in 2003, as the Chinese economy's structure has changed profoundly since then. In 2003, China was far more focused on manufacturing; nowadays, services are playing a much greater role. One way to think of it is this: in 2003, additional workers were all that was needed to ramp up the pace of production line and make up ground lost to SARS; this time, it will be harder to make up the lack of services.

[1] *See our longer version in a thematic paper soon available: US and European corporate earnings: after four quarters of stagnation, what is the outlook for 2020?*

THIS MONTH'S TOPIC

...and the exposure to China of the Stoxx 600 companies increased eightfold over the same period!

Earnings cut are inevitable...

... the capacity of the market to look beyond the valley will depend of the length of the epidemic

In recent days, the epidemic seems to be slowing down in China but has started to spread beyond, especially in South Korea, Iran and Italy.

Within China, the preventive measures taken one month ago, just before the Chinese New Year (24-30 January) remain nonetheless very strict which is casting doubt on the announcements of business returning to normal. If these restrictions were to last a few more weeks, many companies would face liquidity squeezes. No doubt they would receive public assistance but, as usual, smaller private-sector companies would be much more vulnerable.

Earnings will be under particular pressure at one fourth of listed companies

Given the Chinese economy's increased weight and involvement in value chains, the global repercussions should be greater this time, and will spill over clearly into companies' financial results.

For example, Stoxx 600 companies' direct exposure[2] to China averages almost 8%, up from less than 1% in 2003. Meanwhile, of the 24 sectors of the GICS nomenclature, six are more than 10% exposed. These six sectors – autos, energy, luxury goods, semi-conductors, tech hardware and basic materials – together account for 23% of the market capitalisation of the Stoxx 600, but, more importantly, 37% of the rebound in earnings forecast for 2020.

In the US, S&P 500 companies' 5% exposure to China is slightly lower than Europe, but exposure is 10% or higher in six sectors as well, out of which five are in common with Europe (autos, energy, luxury goods, semi-conductors and tech hardware), along with a sixth, consumer services, which includes hotel and restaurant chains, cruise ships and casinos. These six sectors that are most heavily exposed to Chinese demand together account for 18% of the market capitalisation of the S&P 500 and 26% of the rebound in earnings forecast for 2020.

In light of the above, 2020 earnings forecasts will depend closely on how fast business returns to normal in China. This is particularly the case in Europe, which is more heavily exposed to China and where domestic margins are generally lower than those achieved in emerging markets. Sales warning and Profit warning should therefore bourgeon in Q1 2020.

If the epidemic wears off a bottoming out should take suit from April. However, the extent of this will vary from sector to sector. To take one example, only a very few restaurant meals, hotel stays, and cancelled travel plans will be made up. In contrast, a significant portion of lost sales in the first quarter in luxury goods, will be made up later.

All in all, assuming a peak in April,instead of the 7 to 8% 2020 EPS growth thus far forecast by the IBES consensus (for the United States and Europe), we feel it is more reasonable to adjust our post-coronavirus forecasts from +5% to +2% in the US and from +5% to 0% in Europe, as Europe is more heavily exposed.

It's still worth being cautiously optimistic

After showing very little reaction at the start of the epidemic, the equity markets finally buckled on 24 February, one month to the day after the start of quarantine measures in Wuhan. From peak to trough (from 19 to 25 February), the Stoxx 600 and S&P 500 lost 7%-8%, but given their previous rally, they were only down 3% since the start of the year, following increases of 23% and 29% last year.

In the past, sharp equity sell-offs have always been followed by a rebound in subsequent months. The same could happen this time, but the timing and extent of any rebound are uncertain.

In particular, the timeframe will depend on how the epidemic progresses. With SARS, the market bounced back after the epidemic hits its peak. This time, investors will also be looking at when businesses and supply chains return to normal, which could delay the rebound by a few more weeks.

As for the extent of the upturn, while valuations may still have some upside potential due to particularly low interest rates, it is also important to take into account forthcoming cuts to earnings forecasts.

Between the string of poor economic indicators, profit warnings and defaults to follow, a possible rebound of the epidemic and the unpredictability of the Democratic primary in the United States, the market could remain volatile for some weeks. That's why hedging strategies are crucial.

That being said, between the authorities' determination to provide support, the watchful eyes of the central banks and the lack of alternatives to equities in an environment of extremely low interest rates, cautious optimism is still the proper stance.

(Finalised on February 25, 2020)

[2] *Regarding luxury goods, a distinction must be made between direct exposure (purchases by Chinese persons in China) and indirect exposure (purchases by Chinese tourists outside China); indirect exposure is typically twice as high as direct exposure.*

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