

C A M B R I D G E   A S S O C I A T E S   L L C

# EUROPEAN MARKET COMMENT: EARNINGS GROWTH IN EUROPE: IS THIS THE YEAR FOR A TURNAROUND?

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## Earnings Growth in Europe

### Is This the Year For a Turnaround?

Corporate profits in Europe should pick up considerably in 2003—at least according to analysts who remain irrepressibly upbeat. The consensus expects FTSE All-Share earnings to expand at a 20.1% clip in 2003 (see Table A). If achieved, this rate would indeed be welcome news for investors, who have seen U.K. corporate earnings beaten down over the last two years, growing just 2.0% in 2001 and shrinking by 1.2% in 2002. Although earnings growth of 20% is certainly possible, given that the earnings level in 2002 had fallen to £92.6, a hefty 39.8% drop from earlier expectations of £153.7 (see Table B), a surge of this magnitude would require the tailwind of a robust recovery in the global economy, of which there is as yet no sign.

From an historical perspective, 20% earnings growth is not only substantially greater than the post-1963 trendline growth of 7.6%, but greater even than growth during earlier periods of rapid expansion (see Table C). For example, trough to peak, from 1986 to 1990, earnings grew at an average rate of 14.3%, while from 1993 to 1996, they rose 13.6%.

It should be noted, in addition, that analysts have posted overly optimistic forecasts in recent years, and the 20% growth forecast seems no exception. In fact, from October 2001 to January 2003 analysts over-estimated the actual earnings level by an average of 11.9% (see Table D). This disparity underscores the considerable uncertainty concerning the true strength of earnings, and one should question whether the fog of visibility has indeed dissipated, leaving analysts with a more lucid vision of impending profits. Persistent uncertainty has been borne out by the steady stream of downward revisions for 2003, falling 14.0% over the last 11 months.

Twenty percent earnings growth expectations also seem difficult to reconcile with current economic forecasts. GDP growth estimates have been lowered sharply in recent months, with current predictions ranging from 2.2% to 2.7% for 2003 and 2.2% to 2.8% for 2004. While it may not be impossible for corporate profits to rise 20% in an economy that expands about 2.5%, these expectations nonetheless seem quite heroic, particularly considering the recent rapid deterioration in economic growth prospects.

A similar dynamic of earnings expectations is playing out on the Continent. The consensus currently expects earnings to expand at a 41.1% rate in 2003 (see Table E). As in the United Kingdom, this is not entirely implausible—continental European earnings fell 21.5% in 2001 and an additional 2.9% in 2002, and are now 55.2% below their 2001 peak. We would note again, however, that for

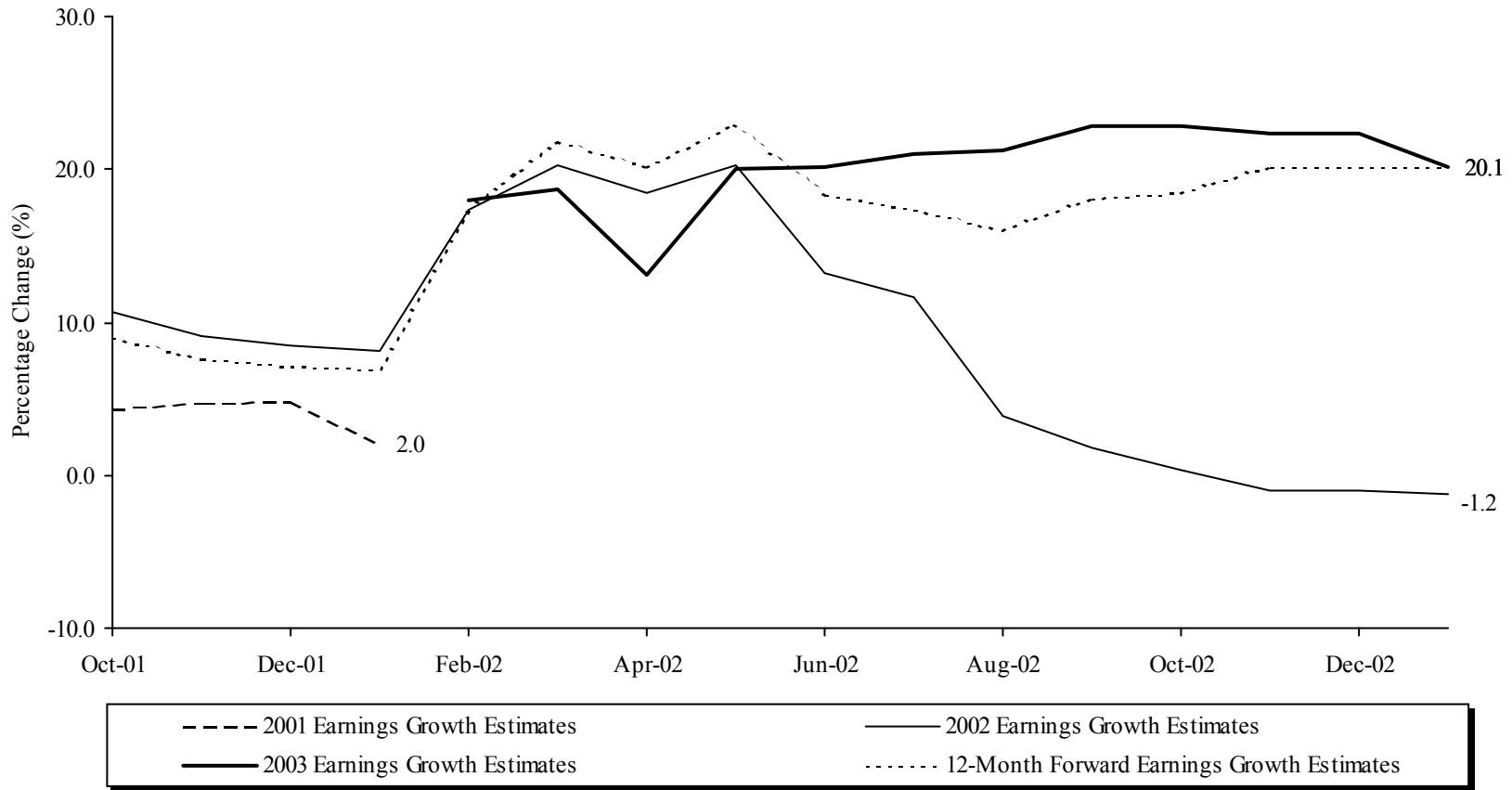
continental European companies, trendline earnings growth since 1963 is 7.5% and that a surge of 41% has never been achieved during this period (see Table F). Trough to peak from 1994 to 2001, earnings rose at the annual average rate of 21.3%.

Moreover, as in the United Kingdom, analysts' forecasts have fallen steadily since 2002, dropping 39.3% since October 2001, while forecasts for 2003 have fallen 23.0% over the last 12 months (see Table G). Finally, 41% earnings growth projections seem completely out of tune with macroeconomic expectations for GDP growth of only 0.9% to 1.2% in 2003 and 2.4% to 2.7% in 2004.

While valuations of the U.K. and European equity markets have crept down in recent months, they still reflect these inflated earnings growth expectations. This suggests that investors have yet to fully recognize the implications for corporate profitability of macroeconomic estimates of sluggish growth and continued headwinds. As such, there remain risks of disappointment if/when the numbers are revised downwards.

**Table A**  
**FTSE ALL-SHARE EARNINGS GROWTH ESTIMATES**

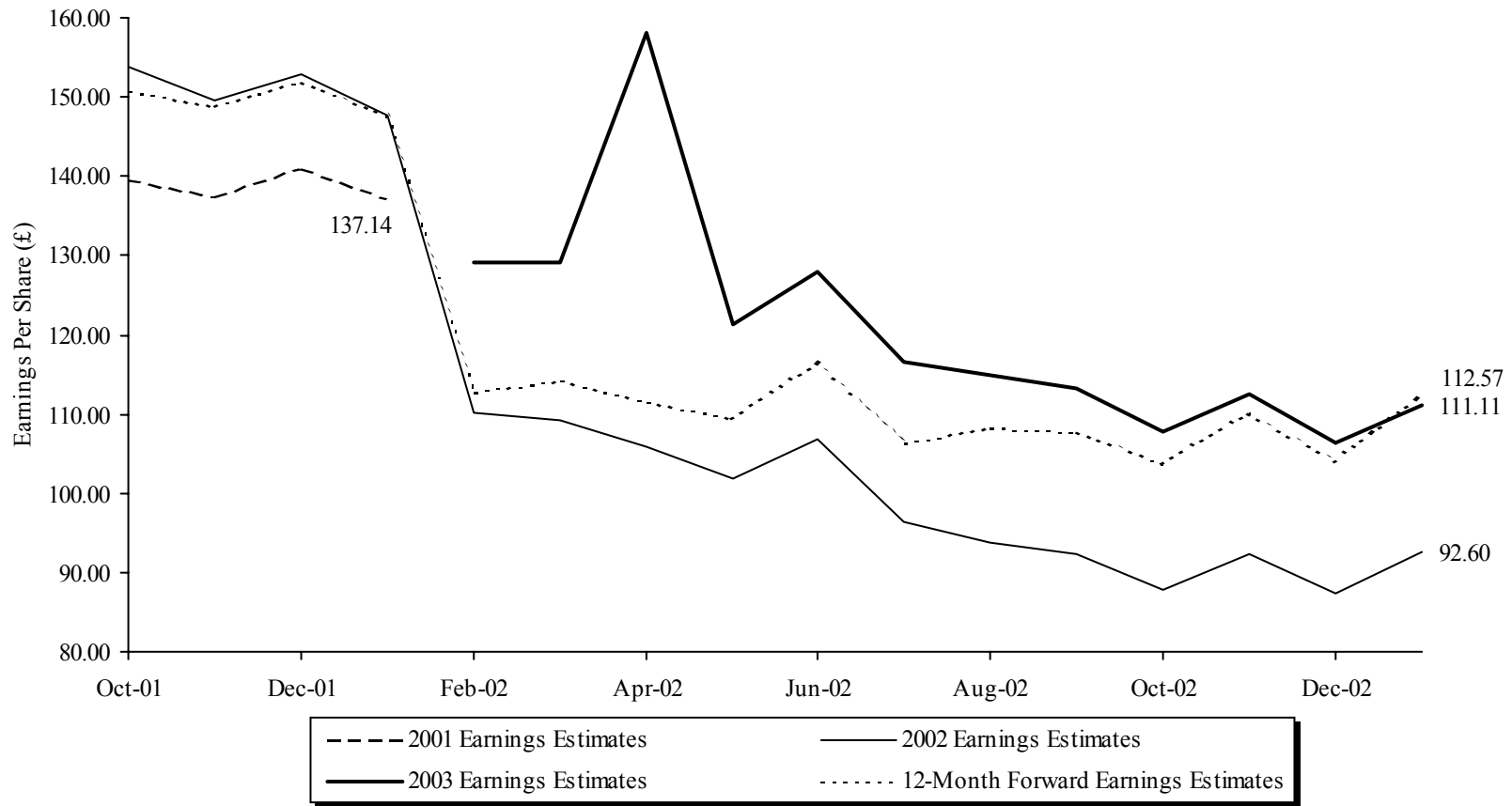
**1 October 2001 - 31 January 2003**



Source: Thomson Financial.

Note: Earnings growth estimates are consensus I/B/E/S estimates.

**Table B**  
**FTSE ALL-SHARE EARNINGS ESTIMATES (£)**  
**1 October 2001 - 31 January 2003**



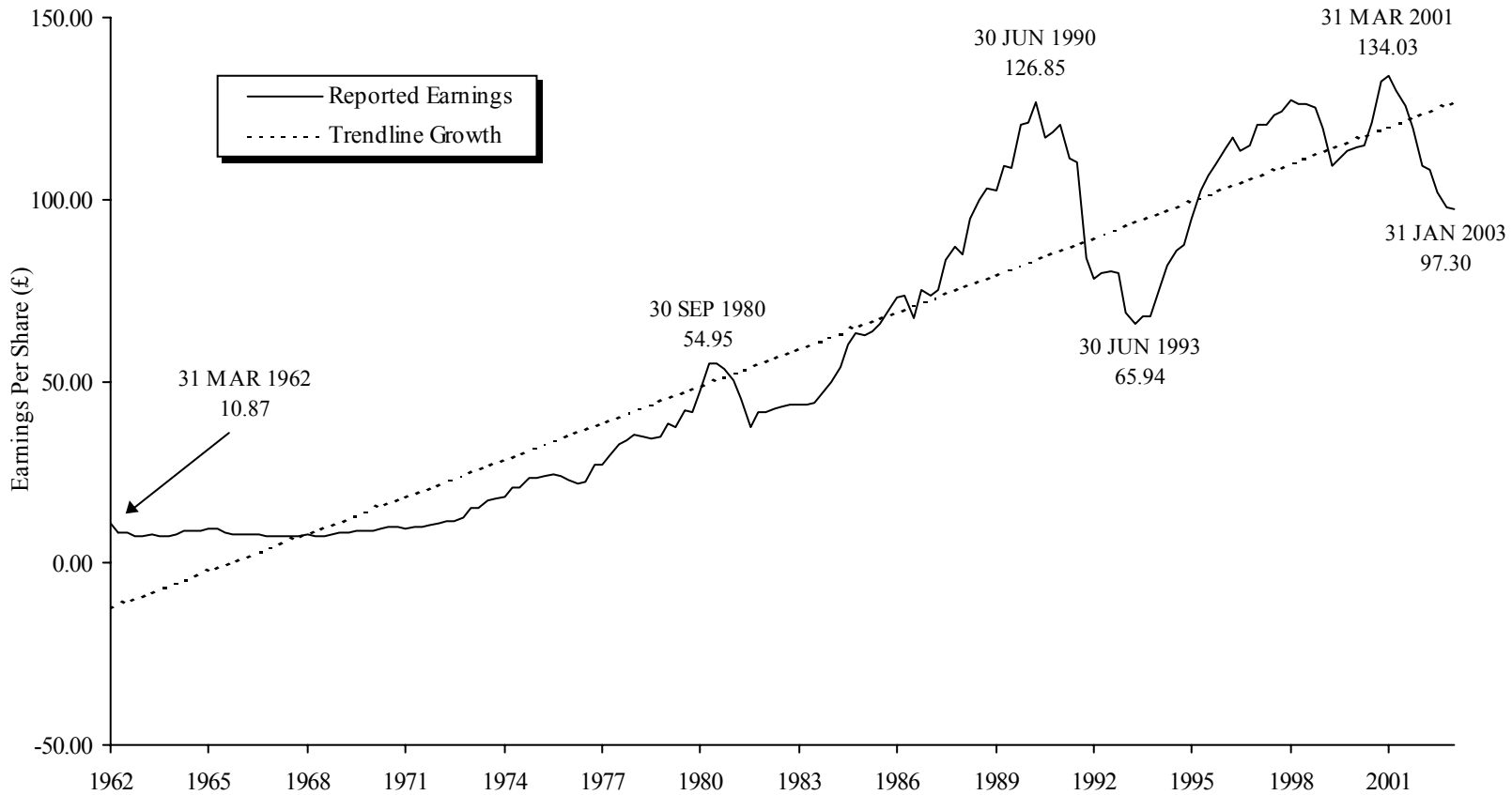
Sources: Thomson Datastream and Thomson Financial.

Note: Earnings estimates are calculated from consensus I/B/E/S price/earnings growth estimates.

Table C

FTSE ALL-SHARE REPORTED EARNINGS (£)

31 March 1962 - 31 January 2003



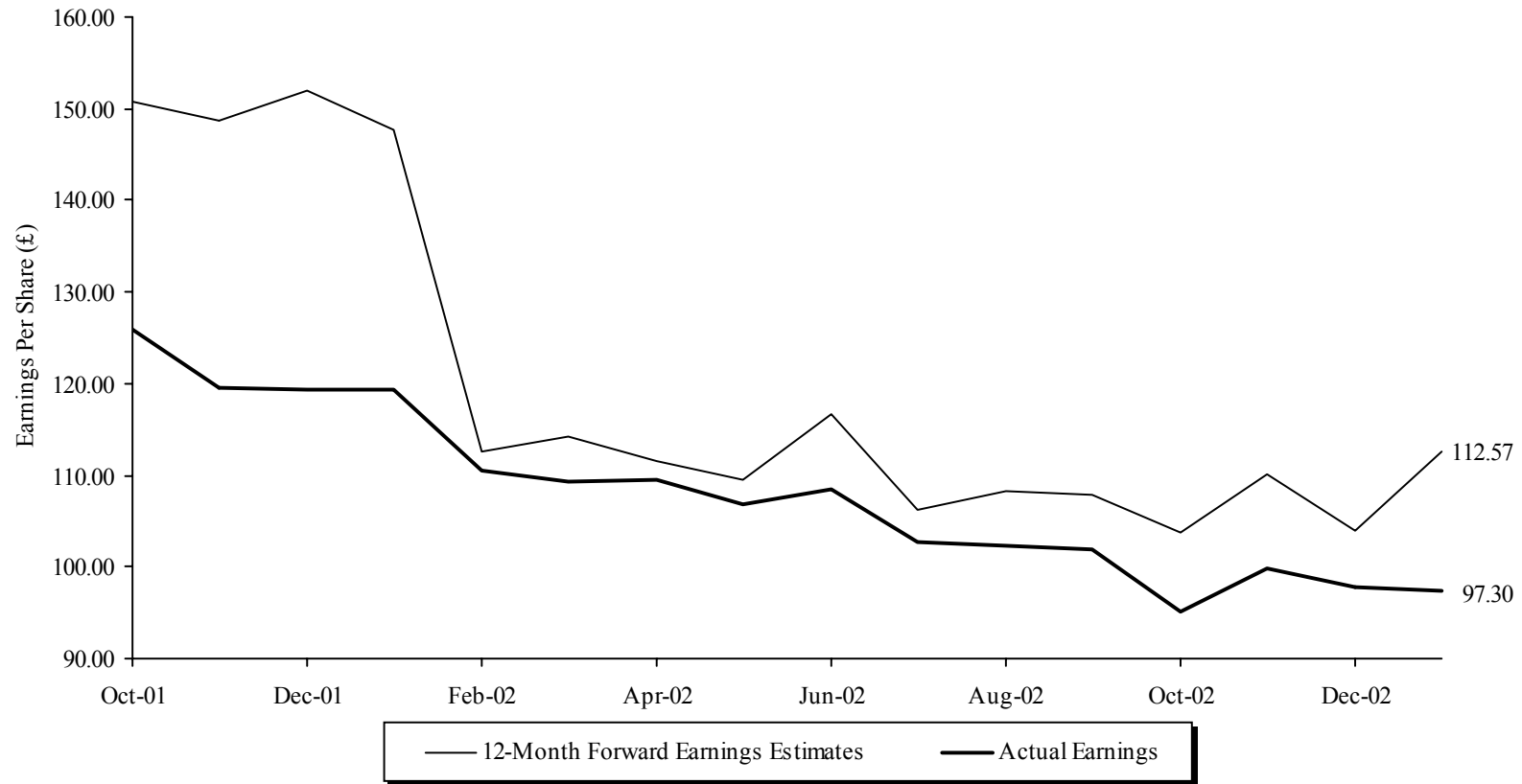
Source: Thomson Datastream.

Note: The FTSE All-Share had an average annual earnings growth rate of 7.62%.

**Table D**

**FTSE ALL-SHARE 12-MONTH FORWARD EARNINGS ESTIMATES AND ACTUAL EARNINGS (£)**

**1 October 2001 - 31 January 2003**



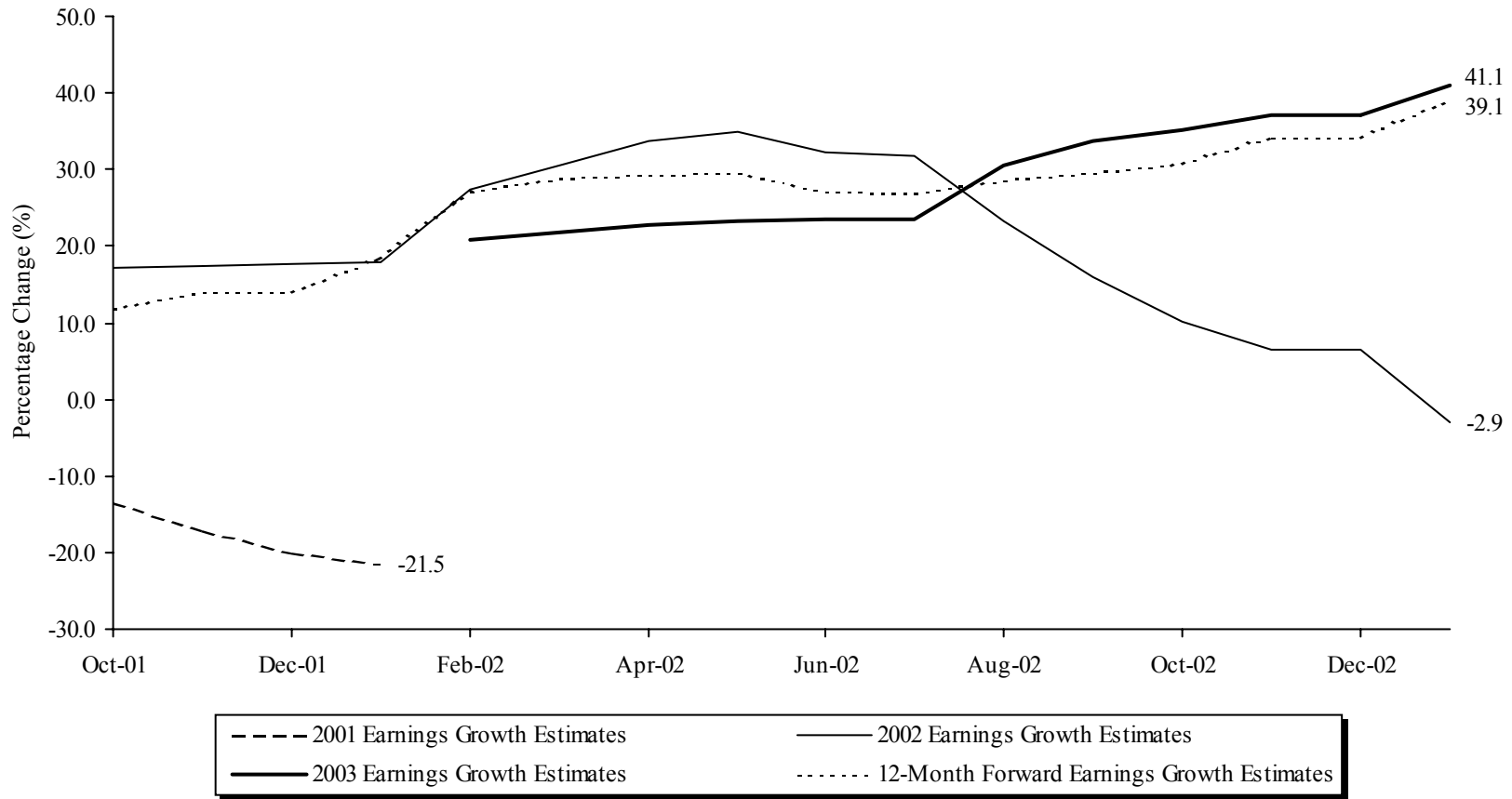
Sources: Thomson Datastream and Thomson Financial.

Note: Twelve-month forward earnings estimates are calculated from consensus I/B/E/S 12-month forward price/earnings growth estimates.

**Table E**

**FTSE EUROPE EX UNITED KINGDOM EARNINGS GROWTH ESTIMATES**

**1 October 2001 - 31 January 2003**



Source: Thomson Financial.

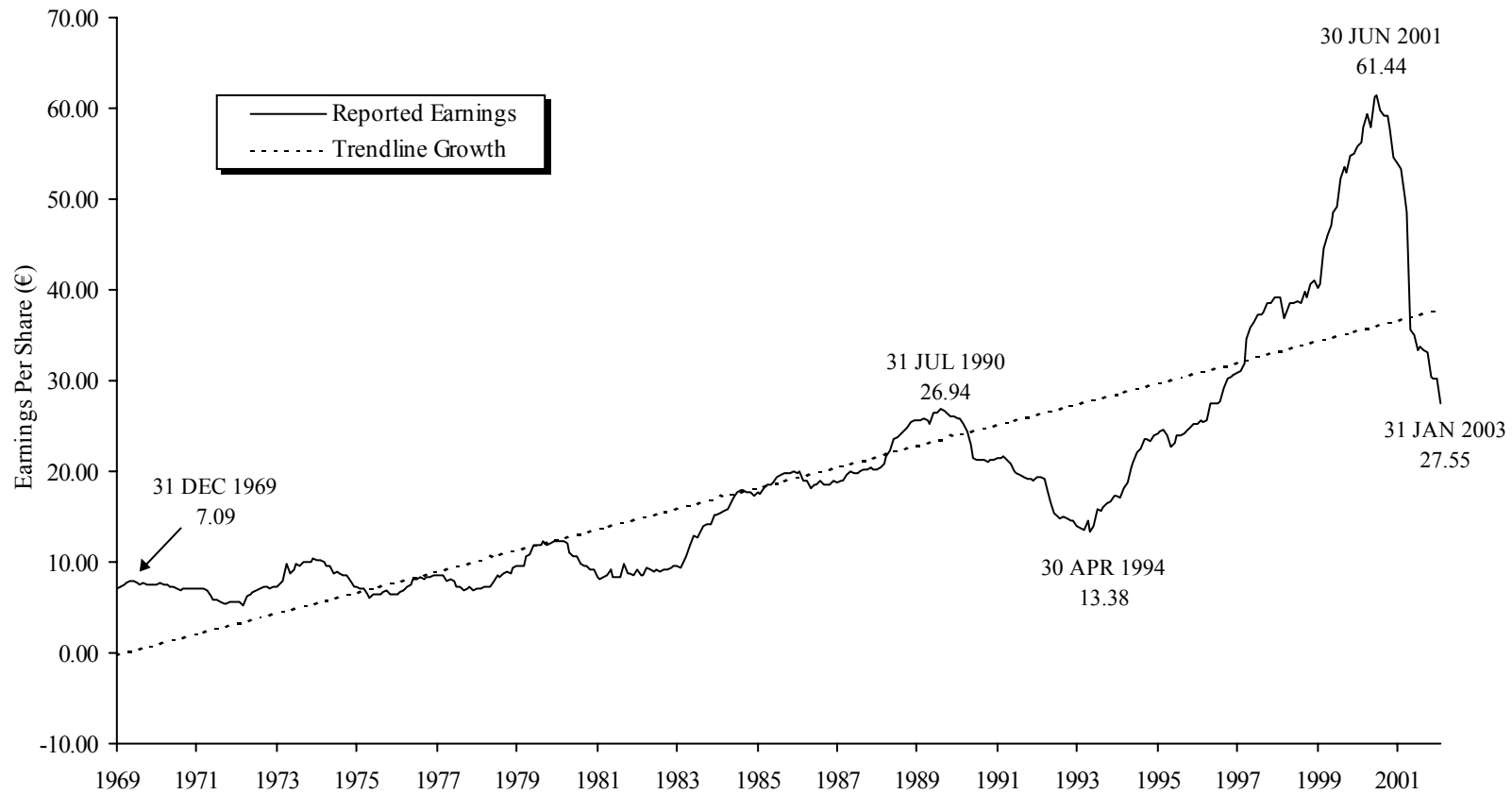
Note: Earnings growth estimates are consensus I/B/E/S estimates.



Table F

## MSCI EUROPE EX UNITED KINGDOM REPORTED EARNINGS (€)

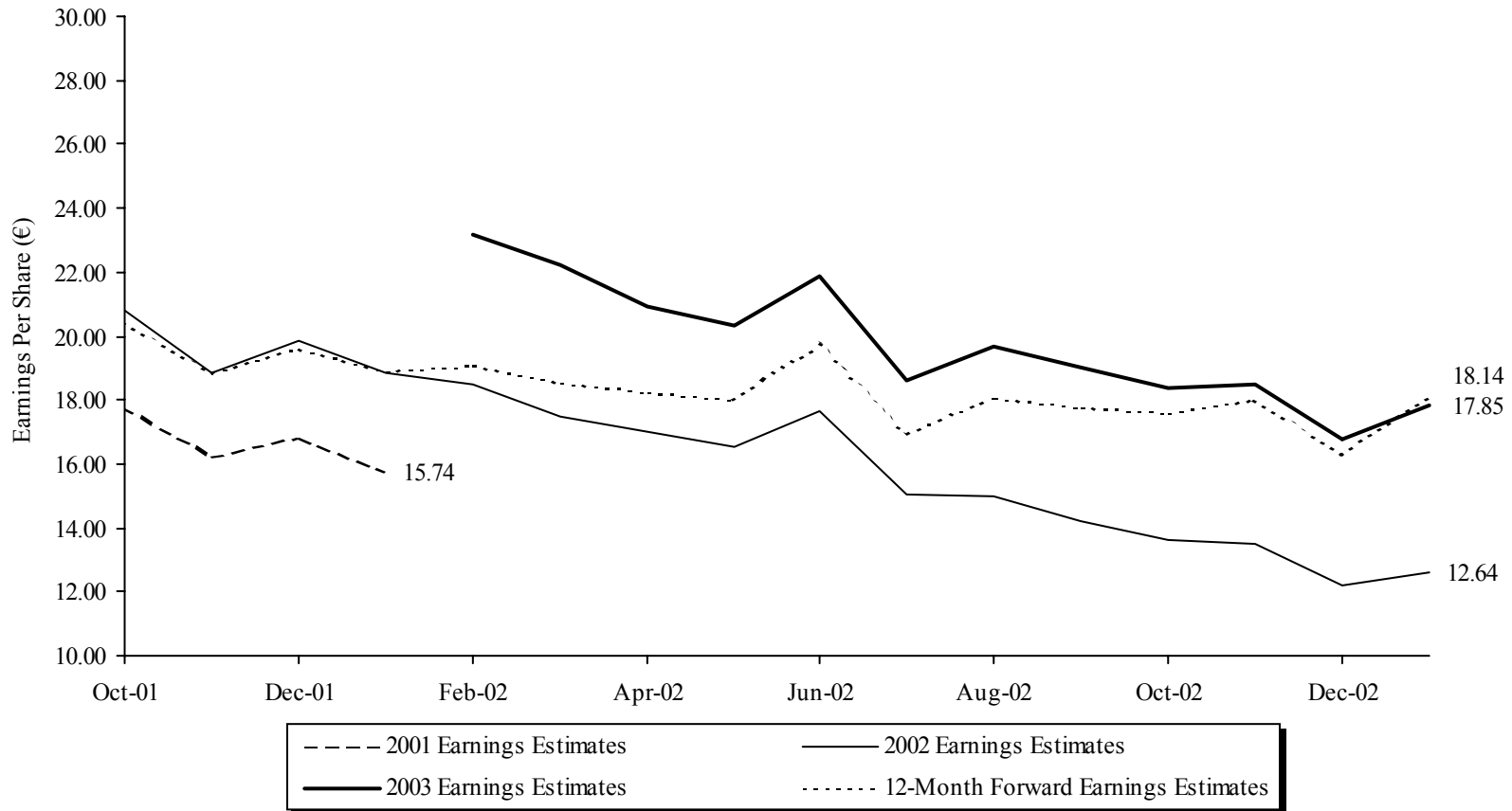
31 December 1969 - 31 January 2003



Source: Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: MSCI Europe ex U.K. had an average annual earnings growth rate of 7.49%.

**Table G**  
**FTSE EUROPE EX UNITED KINGDOM EARNINGS ESTIMATES (€)**  
**1 October 2001 - 31 January 2003**



Sources: Thomson Datastream and Thomson Financial.

Note: Earnings estimates are calculated from consensus I/B/E/S price/earnings growth estimates.