

Europe's Earnings Cycle Just Getting Started

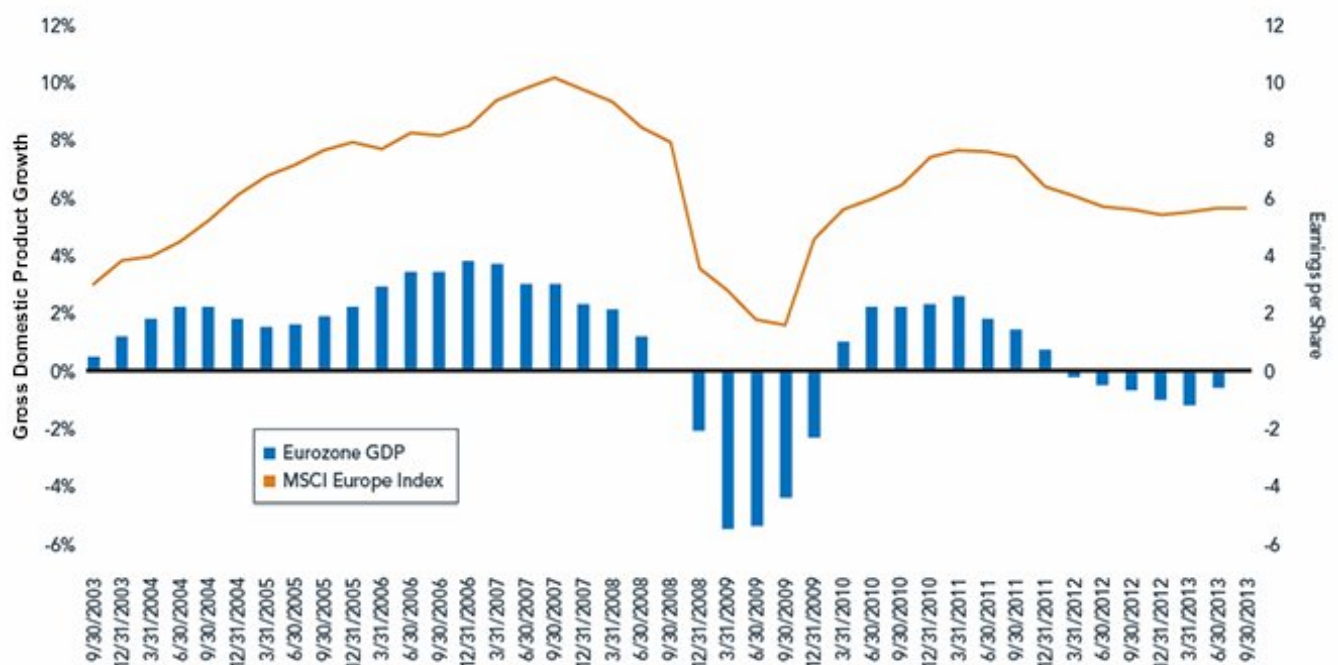
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Europe's economy experienced six straight quarters of negative economic growth—or contraction—before returning to a positive growth rate—or expansion—in the second quarter of 2013. The recovery in Europe has been supported by accommodative monetary policy, low inflation and a moderation in fiscal austerity. Consumer spending has improved and manufacturing surveys are pointing toward expansion. This stabilization of the European economy is encouraging, and many have begun to look for investment opportunities emanating from this nascent recovery. **Early Stages of Economic and Earnings Recovery**

One reason to have a positive view on European equities is that the current stage of the economic cycle—being very early in the economic recovery—may imply the earnings cycle is about to also shift into a higher gear. We graphed year-over-year growth in the economy against the MSCI Europe Index earnings per share to highlight how Europe's earnings have responded to growth or contraction in the economy over the last 10 years. The picture shows a tight correspondence of earnings levels with growth and contraction in the economy. **Figure 1: Eurozone Economic Growth and Earnings Growth for MSCI Europe Index**



Sources: WisdomTree, Bloomberg. (9/30/03–9/30/13). You cannot invest directly in an index. Past performance is not indicative of future results.

• **Earnings Cycle Just Getting Started** – It is important to remember that Europe's economy is just starting to show signs of growth, and this recovery has not shown up in the earnings of corporations yet—at least

on a trailing 12-month basis. Generally speaking, if an index has a lower estimated [price-to-earnings \(P/E\) ratio](#) compared to its trailing P/E ratio, the forecast is calling for earnings growth. This pickup in earnings expectations for the MSCI Europe Index can be witnessed in the difference between the estimated and [trailing 12-month P/E ratios](#) of 19.6x and 14.6x, respectively. But trailing 12-month earnings for MSCI Europe would have to grow approximately 80% to reach the highs of 2007, and grow around 35% to reach the most recent highs of 2011. Putting this in perspective, both the [S&P 500](#) and MSCI Emerging Market indexes have already surpassed their pre-recession earnings highs.

- **Economic Growth Expected to Turn Positive** – The most recent quarter-over-quarter gross domestic product (GDP) print was positive 0.3%, and it marked the first positive growth in six quarters, but the year-over-year change was still negative 0.6%¹. Since the second-quarter GDP reading, there have been improvements in the Purchasing Managers' Index (PMI), with multiple readings above 50, typically a sign of economic expansion. As a result, many economists are forecasting the eurozone to return to positive economic growth early next year. A positive economic growth environment could be expected to flow through to better growth in earnings.

Small Caps for Recovery If one believes Europe is recovering, I'd encourage a look at small-cap companies, which are more sensitive to trends in the economy because of their cyclical exposure and are typically more highly leveraged to economic growth. In other words, small caps often have higher beta—or market reactions—to both the ups and downs in the markets. As I previously wrote [here](#), European small caps have outpaced large caps year-to-date, and some of the outperformance can be attributed to a stronger euro hurting the large-cap exporters. Small caps are more domestically sensitive, deriving more of their revenues from a particular region than their large-cap compatriots, which allows them to sidestep the drawbacks of the currency strength. WisdomTree has designed the [WisdomTree Europe SmallCap Dividend Index](#) to focus solely on small-cap dividend-paying equities in Europe. To learn more, click [here](#). *Read the full research [here](#).* 1As of 06/30/2013.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments focusing on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility.