Box 4

RECENT DEVELOPMENTS IN THE EARNINGS OF EURO AREA FIRMS

The financial market turmoil that got underway in the summer months of 2007 has tested the strength of euro area firms' balance sheets. The turmoil has brought about tighter external financing conditions for both financial and non-financial corporations and, more generally, an outlook for slower growth in the euro area economy. Both factors are likely to weigh on corporate profitability. Against this background, this box describes developments in the growth of the actual and expected earnings per share (EPS) of listed companies in the euro area since the outbreak of the financial turmoil.

Chart A Earnings growth of corporations in the euro area: financials and non-financials

(annual percentage changes)

Source: Thomson Financial Datastream I/B/E/S.
Note: Earnigs growth refers to aggregate earnings per share of firms included in the Dow Jones EURO STOXX index. The diamond refers to the average twelve month ahead earnings per share growth forecasts as of May 2008.

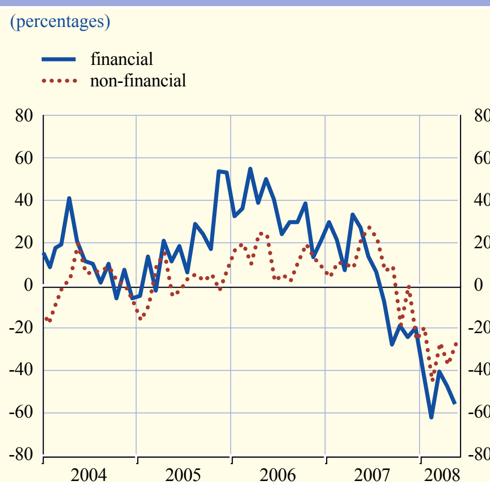
Chart A plots actual and expected EPS growth for both financial and non-financial corporations that are listed on euro area stock markets. It shows that actual EPS growth of financial corporations has fallen sharply from previous elevated levels since the beginning of 2008, whereas an only gradual and comparatively minor slowdown in actual EPS growth can be detected for non-financial corporations. Indeed, the turbulent period in financial markets has had a more marked impact on profitability in the euro area financial sector. For financial corporations, sharp price falls in financial assets, together

with writedowns on loans, led to lower earnings growth in late 2007 and in the first months of 2008. Looking ahead, professional stock market analysts nevertheless expect earnings growth for both sectors to remain, on average, relatively robust over the next 12 months.

To gauge the dynamics of expected EPS, Chart B depicts the so-called earnings revision ratio for both financial and non-financial corporations. This indicator measures the balance between the number of upward revisions by companies to EPS expectations for the next 12 months and the corresponding number of downward revisions in terms of the total number of earnings estimates. As can be seen in the chart, the financial sector's earnings revision ratio deteriorated immediately and markedly as from the summer of 2007, reversing the previously sustained pattern of upward revisions. Moreover, the same also applies to the non-financial sector, albeit with a delay of a few months. Thus, the recent sentiment around earnings seems, at the current juncture, to be rather negative despite the resilience in the earnings outlook.

Chart B Euro area earnings revision ratio: financial and non-financial corporations

(percentages)

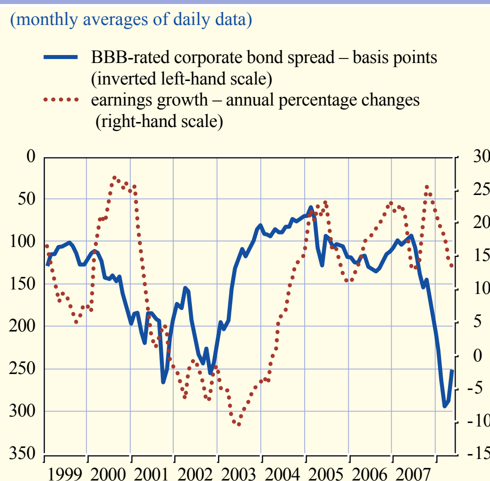


Sources: Thomson Financial Datastream I/B/E/S and ECB calculations.
Note: Number of upward minus number of downward revisions in twelve-month ahead earnings per share by companies listed in the Dow Jones EURO STOXX as a percentage of the total number of estimates.

Further information about an economy's earnings sentiment can be found by analysing corporate bond spreads. The relationship between corporate bond spreads and firms' earnings prospects can be viewed from two different angles. First, the prices of corporate bonds embed, among other things, the probability of the company to default, as seen by investors. More precisely, everything else being equal, higher corporate bond spreads for the economy as a whole signal a higher likelihood for firms to default. The likelihood of defaults, in turn, usually increases in an environment where firms' earnings prospects deteriorate. Second, corporate bond spreads also play an "active" role on firms' earnings prospects through the influence they exert on the financing costs. For instance, higher corporate spreads make fewer investment opportunities profitable, which – everything else being equal – lowers the earnings prospects for firms.

Chart C Earnings growth and corporate bond spread

(monthly averages of daily data)



Sources: Thomson Financial Datastream I/B/E/S and ECB calculations.
Note: Earnings calculated as the ratio between the Datastream EMU total market stock price index and the corresponding price/earnings ratio. Corporate bond spread refers to the Merrill Lynch index of BBB-rated corporate bonds with a maturity of 7 to 10 years.

Chart C plots the earnings growth of listed euro area companies together with euro area BBB-rated corporate bond spreads. As can be seen, corporate earnings growth and markets' perceived credit risk have moved broadly in parallel over the past ten years. For instance, during the pick-up in credit spreads in 2000, euro area earnings growth dropped more or less in tandem. From 2002 until 2004, BBB-rated bond spreads gradually declined to historically low levels, spurred by improved stock market sentiment, lower default rates and, arguably, some under-pricing of risk on the part of investors. At the same time, corporate earnings growth began to improve. As from 2005, BBB spreads remained at low levels until the recent turmoil got underway in the summer months of 2007. As indicated in the chart, euro area BBB-rated corporate bond spreads nearly tripled between June 2007 and May 2008, from 90 to around 250 basis points. In the same period, the earnings growth of both non-financial and financial corporations listed on the stock market moderated only slightly. This seems to suggest that the rise in bonds spreads was initially driven mainly by the ongoing re-pricing of risk, rather than reflecting – as in past episodes – a deteriorating economic outlook and higher default probabilities. On the basis of what has happened in the past, a further weakening of earnings growth might be expected to restore the historical relationship.

To sum up, the earnings growth dynamics of listed companies in the euro area decelerated strongly in the case of financial corporations in the first months of 2008, but has thus far declined only somewhat in that of non-financial corporations. On average, analysts expect relatively robust earnings growth for the two sectors over the next 12 months. On balance, however, the recent revisions to corporate earnings expectations are negative, suggesting downward risks to earnings growth in the quarters ahead. Thus, it cannot be ruled out that the higher financing costs witnessed since the outbreak of the financial turmoil, in conjunction with other factors such as rising input and wage costs, will dampen euro area firms' earnings prospects in the latter part of 2008 and in early 2009.