

## Europe: Portfolio Strategy

# Strategy Matters

## Why earnings are likely to surprise to the upside in 2010

We remain positive on the market and revise up our DJ Stoxx net income (pre-exceptionals) forecasts to a 19% fall in 2009, and a 34% rise in 2010 (-24% and 28% ex Financials, respectively). Better Financial earnings, enhanced operational leverage and stronger EM growth are key factors.

### Raising our earnings estimates

We have been bullish on the markets since April, when our preconditions for a sustained recovery were met. Fears about a 'profitless' recovery are overdone, in our view, despite a sluggish economy; we upgrade our forecasts for DJ Stoxx 600 net income (pre-exceptionals) to -19% for 2009 (from -38% previously) and +34% for 2010 (from +19%). In terms of net income ex Financials, we expect -24% for 2009 and +28% for 2010. Current bottom-up I/B/E/S consensus is -21% for 2009 and +24% for 2010 for the total market, making us well above consensus for next year. Our end-year target of 235 for DJ Stoxx remains unchanged, as we expected investors to 'pre-pay' for a large part of the early recovery that we are now seeing more evidence of in earnings; we expect a 20% return over the next 12 months.

### Improved Financials, operational leverage and stronger EM are key

Three key factors account for our earnings revisions: (1) Better Financials results than we previously expected: our banks analysts expect banks' pre-provision earnings to rise 13.7% in '09 and 65.3% in '10 (they previously expected -8% in '09 and +53% in '10); (2) increased operational leverage as corporate costs have been cut dramatically; and (3) stronger forecasts for emerging markets, to which Europe is increasingly exposed; Euroland exports to EM now account for 48% of total non-euro area exports.

### Europe top-down profit growth forecasts for 2009 and 2010 (%)

	2008	Growth rates (%)	
		2009E	2010E
<b>Actual/ Model results (all pre excep.):</b>			
Sales	6.3	-5.6	7.5
EBIT	1.5	-17.8	22.5
<b>Net income ex financials</b>	<b>-6</b>	<b>-24</b>	<b>28</b>
Net income financials pre-exception.	-77.2	13.7	65.3
Weight of financials pre-except.	37%	13%	18%
<b>Net income pre-exceptionals DJ STOXX</b>	<b>-33</b>	<b>-19</b>	<b>34</b>

Source: Datastream, Goldman Sachs Global ECS Research.

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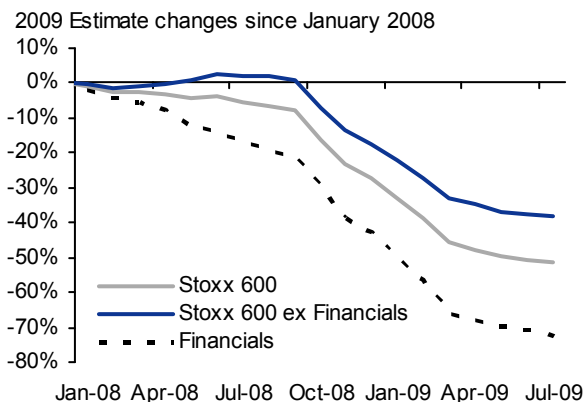
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## Not a 'profitless' recovery

The correction in markets from June 11 followed a sharp rise from the lows in March, and was attributed to many factors. Poor US labour market data for June raised concerns about the lack of future growth in an environment of ongoing deleveraging and higher unemployment. Fears over central bank exit strategies were also a focus. But, above all, in our view it reflected a natural transition from what we described as a 'trust me' phase to a 'show me' phase (see *Strategy Matters, 2H outlook – an upward trend but with increased alpha*, July 9, 2009). Investors who were prepared to accept, on faith, the survey data indicating that the global economy was no longer deteriorating, were less convinced about the justification of further rises in risky assets without more tangible evidence of a sustainable recovery. In addition, we believe this skepticism reflected a concern that there would be a profitless recovery.

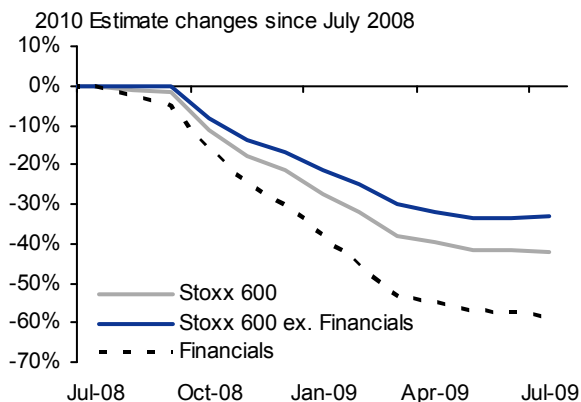
Interestingly, the consensus, in aggregate, was surprisingly slow to accept that conditions were really very bad in the first place. As Exhibit 1 shows, outside the Financials group, earnings estimates for this year and next did not start to fall until October last year – at pretty much the same time that reported earnings themselves started to weaken.

**Exhibit 1: 2009 estimates have been revised down...**



Source: Worldscope, I/B/E/S, Goldman Sachs Global ECS Research.

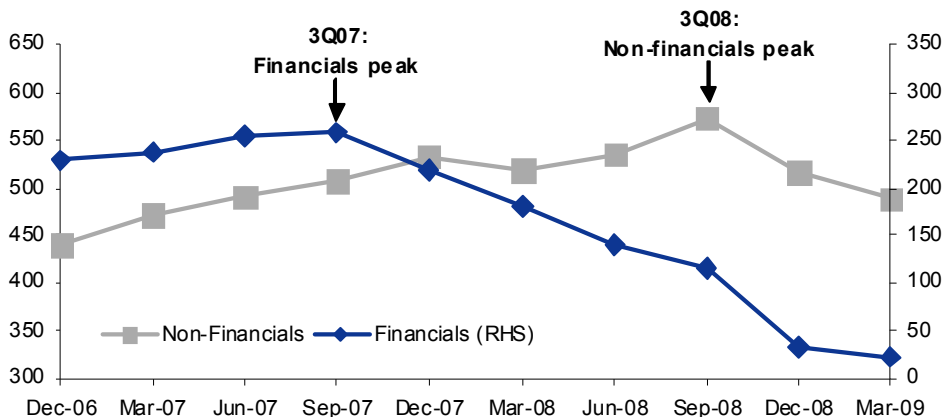
**Exhibit 2: ...as have 2010E, although to a lesser degree**



Source: Worldscope, I/B/E/S, Goldman Sachs Global ECS Research.

As Exhibit 3 shows, the peak in earnings for Financials was in 3Q2007, a full year before the peak in non-Financials' earnings. For many months the problems in the corporate sector were assumed to be a function of the financial sector's woes alone. Companies outside this sector were generally reporting robust growth and strong order books until the autumn of 2008. The collapse of Lehman marked a watershed; only subsequently did estimates start to fall more broadly.

**Exhibit 3: Financials' earnings peaked a year before those of the rest of the market**  
 LTM\* earnings for Stoxx 600 companies using current constituents (€ bn)

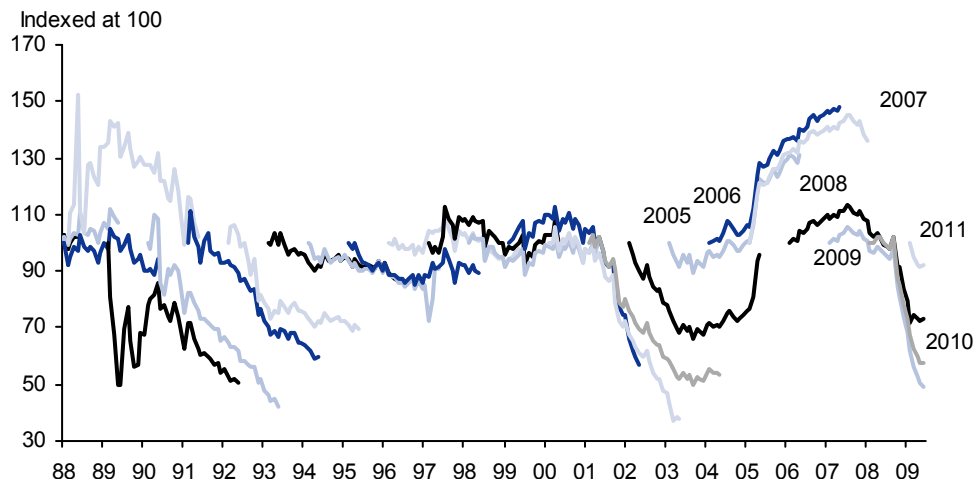


\* for LTM, we aggregate four quarters of data if possible, and if not, the last two reported semi-annual periods

Source: *Worldscope, I/B/E/S, Goldman Sachs Global ECS Research.*

It is not unusual for analysts to cut numbers slowly in a downturn and to be too optimistic. Indeed, the typical pattern is that estimates start the year too high and gradually come down through the year. Exhibit 4 shows the pattern of how estimates in Europe have changed for each year back to 1988. Each line shows the initial EPS forecast (rebased to 100) and each estimate revision up to the release of actual results. The rise in expectations from 2005 through to 2007 was remarkable by historical standards, but estimate downgrades in 2009 now match those in 2002 and the early 90s.

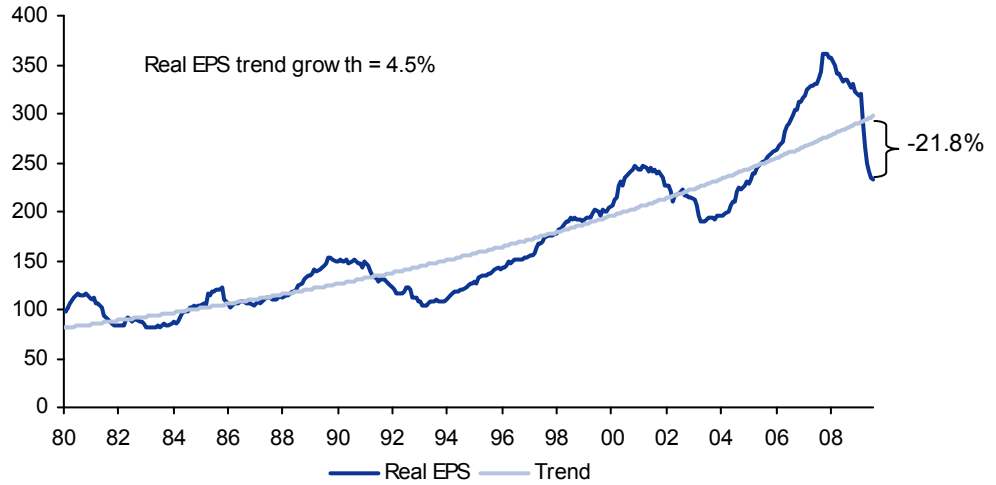
**Exhibit 4: 2009 EPS estimate downgrades now match those in 2003 and the early 90s**



Source: *Datastream, I/B/E/S, Goldman Sachs Global ECS Research.*

The actual falls in profits have also been remarkable. Exhibit 5 shows the level of profits in Europe relative to their trend, in real terms, since 1980. Having peaked at 32% above this trend, overall reported EPS has now fallen 22% below the long-run trend.

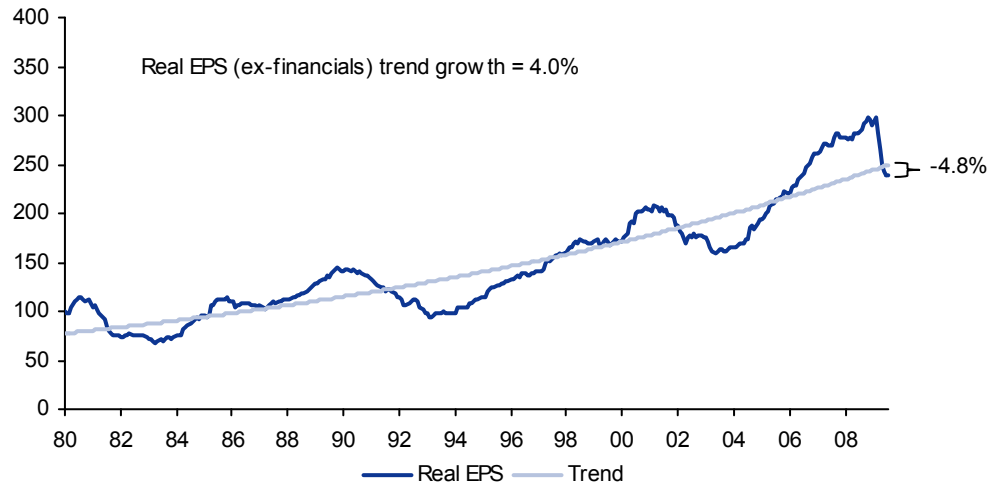
**Exhibit 5: Real EPS trend has now fallen 22% below the long-run trend ...**



Source: Datastream, Goldman Sachs Global ECS Research.

Of course, much of this can be explained by the Financials – which experienced a particularly severe profit decline (in common with post-bubble sectors in previous cycles such as technology post-2000 and Japanese banks post-1989). When we look at the market ex Financials, earnings have now receded to below the long-run trend, but only moderately so. We would, of course, expect further falls this year (on a net income (pre-exceptionals) basis we expect a total fall of 19%).

**Exhibit 6: ... but this is mostly explained by the Financials...**



Source: Datastream, Goldman Sachs Global ECS Research.

## Raising our estimates

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We have been bullish on the markets and have recommended an increase in cyclical exposure since April. Initially, this reflected the satisfaction of a number of the key conditions that we thought would be required for a sustained recovery in the markets: cheap valuations, signs of improvements in the second derivative of growth, a sharp narrowing of credit spreads, and the ability of investors to shrug off negative earnings revisions. More recently, however, we have been arguing that profits may actually rise more quickly than many people expect.

There are three key reasons for this:

- (1) Financials pre-provision earnings have been stronger than expected.
- (2) Increased operational leverage as a result of sharp cost cutting.
- (3) Improved EM growth prospects.

### US upgrades

Indeed, such considerations have prompted our US colleagues to revise their forecasts for S&P earnings earlier this week (see *Macro to Micro shift part II: 2H 2009 update*, July 20, 2009). They raised their 2009 and 2010 operating earnings estimates for the S&P 500 to \$52 (from \$40) and to \$75 (from \$63), reflecting their expectation of yoy growth of 5% and 45%, respectively. The \$12 per share increase in their profit forecast for each of the next two years stems primarily from a lower estimate of provisions and writedowns in the Financials sector. They now assume provisions and writedowns total \$17 per share in 2009 and \$6 in 2010 (compared to previous assumptions of \$23 and \$8, respectively). Measured on a pre-provision and pre-writedown basis, our US colleagues' estimates are \$69 in 2009 and \$81 in 2010, equivalent to a yoy fall of 15% followed by a yoy rise of 17%, respectively. The S&P 500 currently trades at 965, or 12.9x our 2010 operating EPS estimate, or 11.9x our pre-provision and pre-writedown EPS estimate.

### Our new forecasts for Europe

**We have made meaningful changes to our Europe forecasts – particularly for 2010, where we are above consensus.** Our new forecasts point to a 19% fall in net income (pre-exceptionals) this year and 34% rise in 2010. This compares to our previous forecasts of a 38% decline for 2009 and a 19% rise for 2010. Current bottom-up I/B/E/S consensus is -21% for this year and +24% for 2010 – making our forecasts for next year significantly higher than consensus. For net income ex Financials we forecast a fall of 24% for 2009 and a rise of 28% for 2010.

**Exhibit 7: We expect profits to recover strongly in 2010**

2008 figures are a combination of published results and Goldman Sachs Research analysts' estimates

	Growth rates (%)		
	2008	2009E	2010E
<b>Actual/ Model results (all pre excep.):</b>			
Sales	6.3	-5.6	7.5
EBIT	1.5	-17.8	22.5
<b>Net income ex financials</b>	<b>-6</b>	<b>-24</b>	<b>28</b>
Net income financials pre-exception.	-77.2	13.7	65.3
Weight of financials pre-except.	37%	13%	18%
<b>Net income pre-exceptionals DJ STOXX</b>	<b>-33</b>	<b>-19</b>	<b>34</b>
<b>Level of EPS for the DJSTOXX</b>	<b>19.4</b>	<b>15.7</b>	<b>21.1</b>

**Key assumptions:**

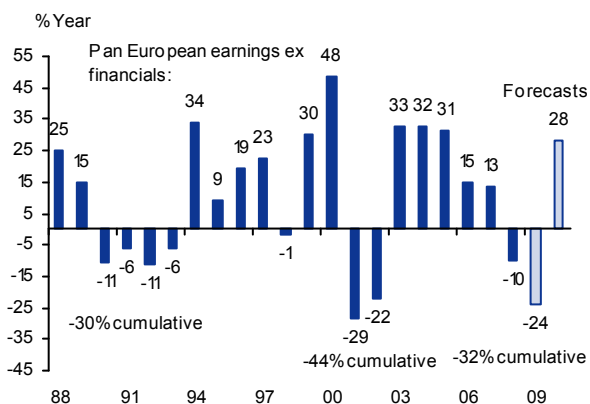
Volumes	-	-2.4	2.2
Selling prices	-	-3.1	4.5
Raw materials	-	-4.9	4.2
Labour costs	-	-0.2	0.2
Cost of debt (%)	-	9.0	8.5

Source: Datastream, Goldman Sachs Global ECS Research.

These profit increases for 2010 appear to be very strong but it is worth noting that this is not unusual in the first year of a recovery (see Exhibits 8 and 9). Profit rises of 20%-30% are not uncommon in the early stages of a recovery; and looking at the market ex Financials, the first year of profit recovery in the early 1990s and early 2000s showed 33% and 34% increases in profits, respectively.

**Exhibit 8: Ex-financials, we expect 2009 profits to be among the worst in the last twenty years**

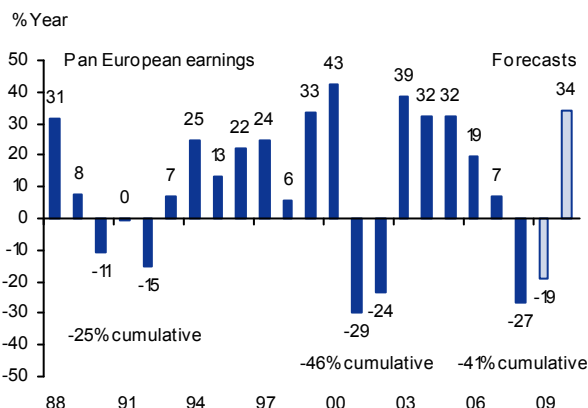
Historical data based on DJ STOXX 600 ex Financials (all data is pre-exceptionals and pre-GW writedowns)



Source: Worldscope, Goldman Sachs ECS Research.

**Exhibit 9: Including financials, 2009 and 2010 earnings figures are higher**

Historical data based on DJ STOXX 600 (all data is pre-exceptionals and pre-GW writedowns)



Source: Worldscope, Goldman Sachs ECS Research.

**Despite these estimate revisions, we are not making any changes to our end-year target for DJ Stoxx. Our expectation at the start of the year was that once a share price recovery began it would be 'front loaded' and very strong, in the range of 30%-50% over the first 6-12 months. This expectation was consistent with the shape of initial share price recoveries following other severe bear markets. Our belief was that investors would 'pre-pay' for the first part of the recovery that we are now beginning to see with these earnings revisions. We expect the DJ Stoxx to return around 20% over the next 12 months; this does imply a much lower return in the first half of next year, but we think that much of the improvement in earnings in 2010 will begin to be priced into the market in the latter part of this year.**

## **Financials improvements**

When we last published our top-down profit forecast in March of this year, we used our analysts' bottom-up estimates for Financials. At the time, they forecast an 8% fall in earnings in 2009 followed by a 53% rise in 2010. The profile of recovery in this sector has been brought forward, with our banks analysts now expecting net income pre-exceptionals in aggregate to rise 13.7% in 2009 and 65.3% in 2010. This obviously makes a meaningful difference to our overall forecasts. Bear in mind that Financials, even now, make up 23% of the DJ Stoxx market capitalization and an estimated 13% of earnings this year and 18% in 2010.

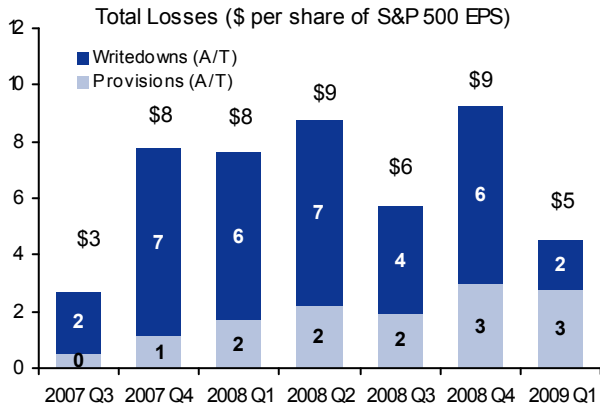
Similar changes have had an impact on our colleagues' US earnings forecasts. Indeed, \$11 of our US strategists' \$12 earnings adjustment to 2009 has come from their Financials estimate, and \$7 of the \$12 adjustment to 2010 comes from Financials.

There are two main reasons for the changes in the Financials estimates:

- (1) Lower writedowns and provisions on both sides of the Atlantic.
- (2) Stronger pre-provision earnings forecasts. Many of the large banks have exceeded analysts' expectations on capital markets and mortgage refinancing activity. As far as the US is concerned, recent data also suggests that an inflection point may have been reached in the rate of credit card delinquencies that would help to boost financial earnings in 2H2009.

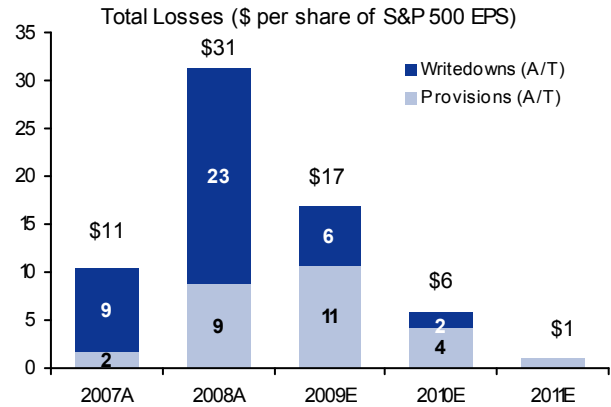
In the US, our strategists forecast the Financials' share of S&P 500 EPS will be \$2 in 2009 and \$14 in 2010, compared with their previous estimates of a loss of \$9 per share in 2009 and a positive contribution of \$7 per share in 2010. Financials generated \$15 per share in 2007 and lost \$14 per share in 2008.

**Exhibit 10: US quarterly losses from Financials' provisions and writedowns** as at July 17, 2009



Source: Compustat, Goldman Sachs Global ECS Research.

**Exhibit 11: US annual losses from Financials' provisions and writedowns** as at July 17, 2009



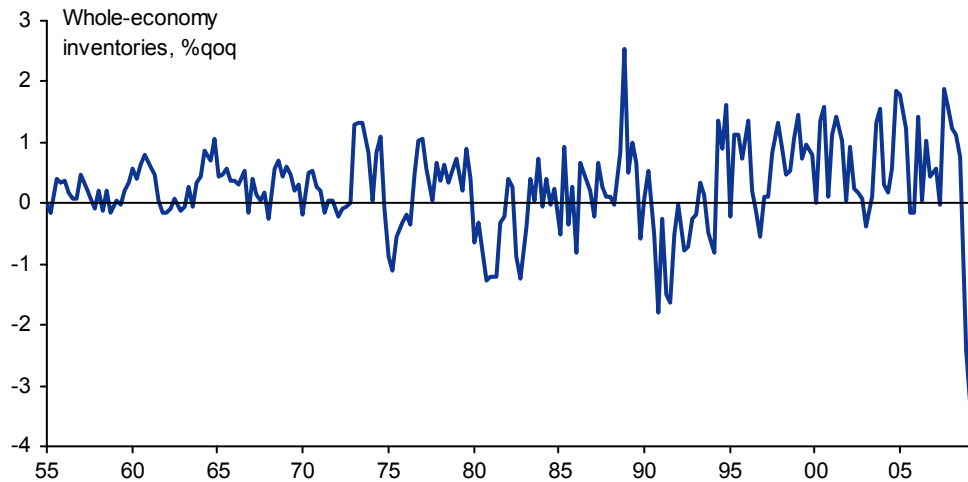
Source: Compustat, Goldman Sachs Global ECS Research.

### Operational leverage

A key theme that we have discussed recently is the rise in operational leverage – this implies that for any given unit of sales, the rise in profits would tend to be bigger (see *Strategy Matters, 2H outlook – an upward trend but with increased alpha*, July 9, 2009).

As we pointed out in the above report, the extent to which costs have been cut is extraordinary by historical standards. Inventory levels have fallen to a far greater extent than in previous downturns (see Exhibit 12 for UK data), and capex costs have also been cut sharply.

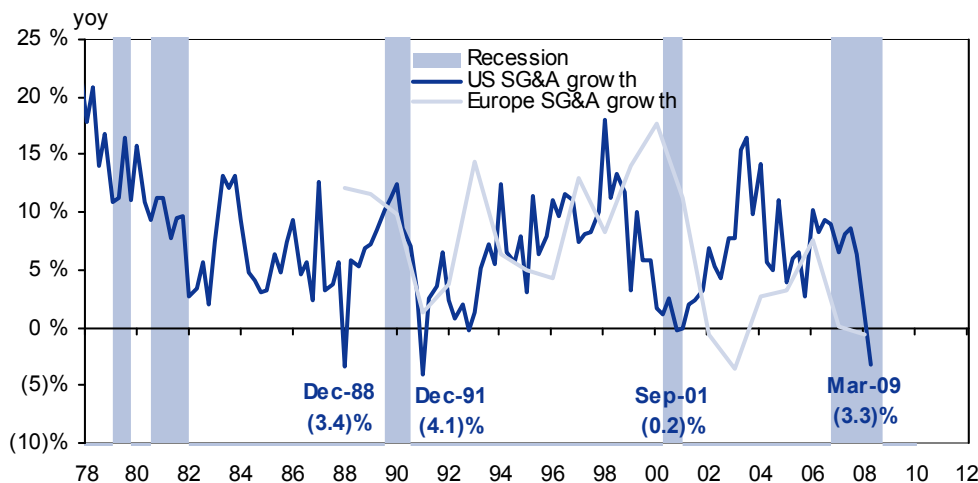
**Exhibit 12: UK inventories – a sharper decline than normal at this stage of the cycle**



Source: ONS, Goldman Sachs Global ECS Research.

Overall SG&A costs are falling sharply. Exhibit 13 shows quarterly data for the US and annual data (to the extent it is available) for Europe. The falls in costs in the current cycle are much sharper than in previous recessions (marked by the shaded bars).

**Exhibit 13: US and European SG&A costs are falling sharply**

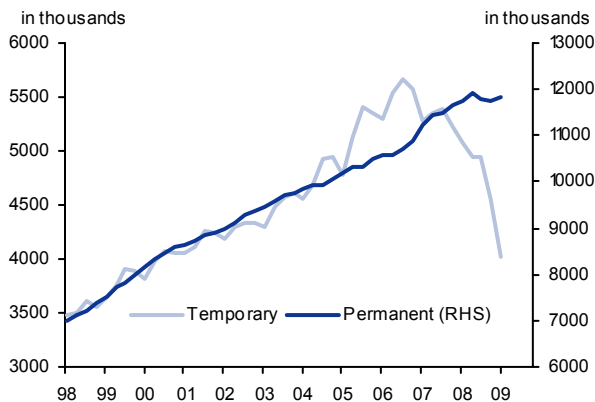


Source: Datastream, Firstcall via Factset, Goldman Sachs Global ECS Research.

Furthermore, companies have reduced variable labour costs by cutting temporary staff, or by increasing the number of permanent staff on part-time or short working weeks (subsidized by the government in Germany).

**Exhibit 14: In Spain, temporary workers bear the brunt of cost cutting...**

Workers in permanent employment has stayed steady



Source: Haver Analytics, Goldman Sachs Global ECS Research.

**Exhibit 15: ...whereas permanent employees are working reduced hours in Germany**

Employees temporarily laid-off or working reduced hours



Source: Haver Analytics, Goldman Sachs Global ECS Research.

In addition to the increase in operational leverage, we have also reflected the increase in our oil team's price forecast to \$85 and \$95 for the end of 2009 and 2010, respectively. This, of course, increases part of the input cost assumptions that we make but, at the same time, boosts the likely revenue for the oil sector. We remain bullish on commodity prices in general, and the resources sectors make up 15% of DJ Stoxx market capitalization.

### Stronger Emerging Market growth

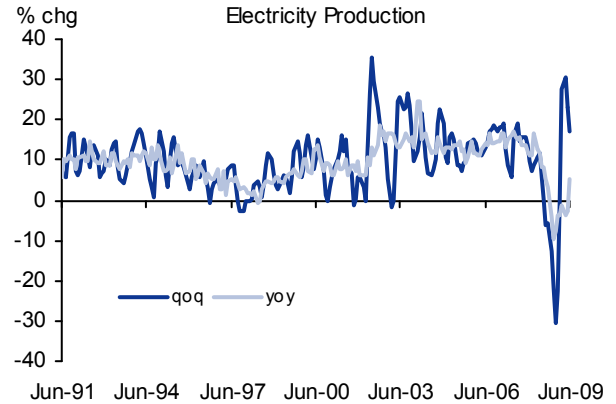
Since we last published our profit forecasts in March (see *Strategy Matters: European Earnings look set to more than halve from the peak*, March 30, 2009), our economists have made upward revisions to GDP forecasts, in particular in China. As Exhibits 17 and 18 show, the pace of recovery in China is looking notably 'V' shaped. Our economists estimate that GDP growth accelerated to 16.5% on a quarter on quarter annualized basis in 2Q2009, from 6.3% in 1Q2009. This level of sequential growth is close to the all-time high of 18.5% qoq annualized growth achieved in 3Q2003 after the SARS episode.

**Exhibit 16: Sequential GDP growth in China approaching historical high**



Source: National Bureau of Statistics (NBS), CEIC, Goldman Sachs Global ECS Research.

**Exhibit 17: Electricity data in China also showing very strong growth**



Source: NBS, CEIC, Goldman Sachs Global ECS Research.

Although this is only one country, our economists expect BRICs growth in aggregate to average 8% in 2010. This increasingly matters for the European market as the proportion of exports from the Eurozone to emerging markets has become very meaningful. Indeed, as Exhibit 19 shows, emerging markets collectively make up 48% of non-Eurozone exports.

**Exhibit 18: Emerging Markets now make up 48% of total Eurozone exports**

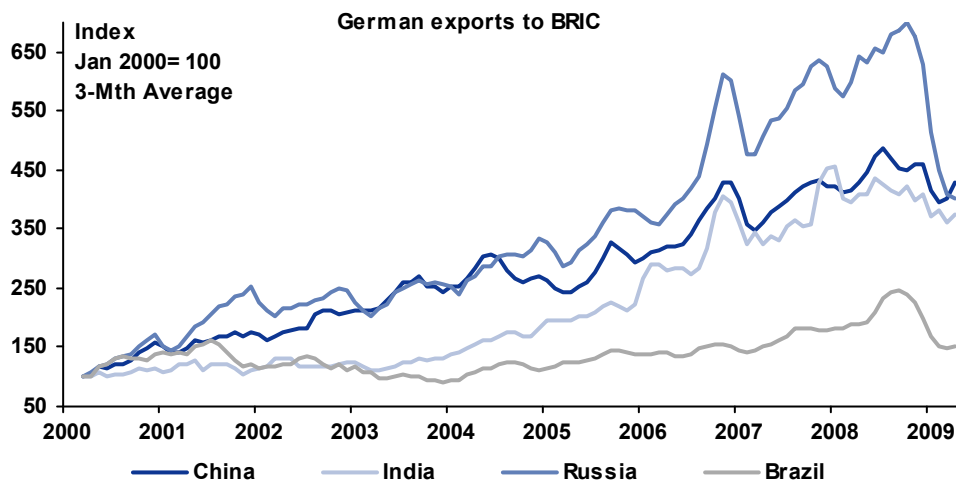
Trading partners	Share of Euro-zone exports 2008
UK	14.2
Sweden	3.5
Denmark	2.2
Switzerland	5.5
Norway	1.3
<b>Europe</b>	<b>26.7</b>
New EU	13.8
Turkey	2.7
<b>Emerging Europe</b>	<b>16.5</b>
Russia	5.0
OPEC	5.9
<b>Russia+OPEC</b>	<b>10.9</b>
China	4.2
Asean	2.8
Japan	2.2
India	1.5
Korea	1.3
<b>Asia</b>	<b>12.0</b>
<b>US</b>	<b>13.0</b>
<b>Latam</b>	<b>4.4</b>
<b>Africa</b>	<b>6.5</b>
<b>Other</b>	<b>9.9</b>
<b>Total</b>	<b>100.0</b>
of which to <b>Emerging markets</b> <sup>1</sup>	<b>48.1</b>

<sup>1</sup>Consists of New EU, Turkey, Russia, OPEC, China, Asean, India, Korea, Latam and Africa

Source: Goldman Sachs Global ECS Research.

As Exhibit 20 shows, even with the collapse in exports to this region over the past year, the overall value of exports has only fallen back to 2007 levels on average and is significantly higher than was the case in the early part of the decade.

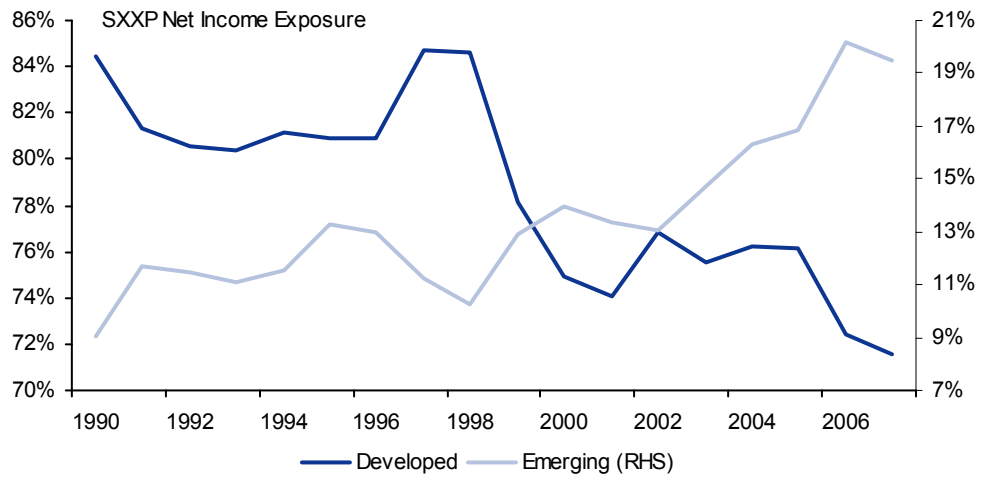
**Exhibit 19: Rise in EM exports over time has been striking, even with the recent collapse**



Source: Haver Analytics, Goldman Sachs Global ECS Research.

While these exhibits show the share of exports using national income data, the trend is reflected in the net income exposure of European companies too. According to Worldscope, based on those companies in the DJ Stoxx 600 for which data is available, the share of profits from emerging markets has roughly doubled over the past decade. This weighting is supported by our own analysts' estimates of revenue exposure to emerging economies.

**Exhibit 20: Contribution of emerging economies to European companies' profits doubled over the last 10 years**



Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.

## The model and details

### Exhibit 21: Earnings declines already mark the third-worst profit contraction

As of July 17, 2009

		S&P 500 EARNINGS		
EPS Peak	EPS Trough	Peak to Trough EPS Decline	EPS Recovery	
			One Year After Trough	Two Years After Trough
Dec-09	<b>Dec-14</b>	(32)%	<b>69 %</b>	194 %
Dec-16	<b>Dec-21</b>	(81)	<b>138</b>	238
Dec-29	<b>Sep-38</b>	(79)	<b>31</b>	74
Sep-41	<b>Jun-46</b>	(29)	<b>71</b>	122
Jun-51	<b>Dec-52</b>	(12)	<b>5</b>	16
Jun-56	<b>Dec-58</b>	(20)	<b>18</b>	13
Dec-59	<b>Sep-61</b>	(10)	<b>15</b>	30
Dec-66	<b>Sep-67</b>	(5)	<b>11</b>	20
Sep-69	<b>Dec-70</b>	(8)	<b>17</b>	37
Sep-74	<b>Sep-75</b>	(10)	<b>30</b>	55
Dec-81	<b>Dec-82</b>	(11)	<b>21</b>	43
Jun-86	<b>Jun-87</b>	(10)	<b>41</b>	66
Jun-89	<b>Mar-92</b>	(24)	<b>14</b>	43
Sep-00	<b>Mar-02</b>	(31)	<b>22</b>	49
Jun-07	<b>Mar-09</b>	(53)		
<b>Historical Average</b>		<b>(26)%</b>	<b>36 %</b>	<b>71 %</b>

Source: Compustat, Goldman Sachs Global ECS Research.

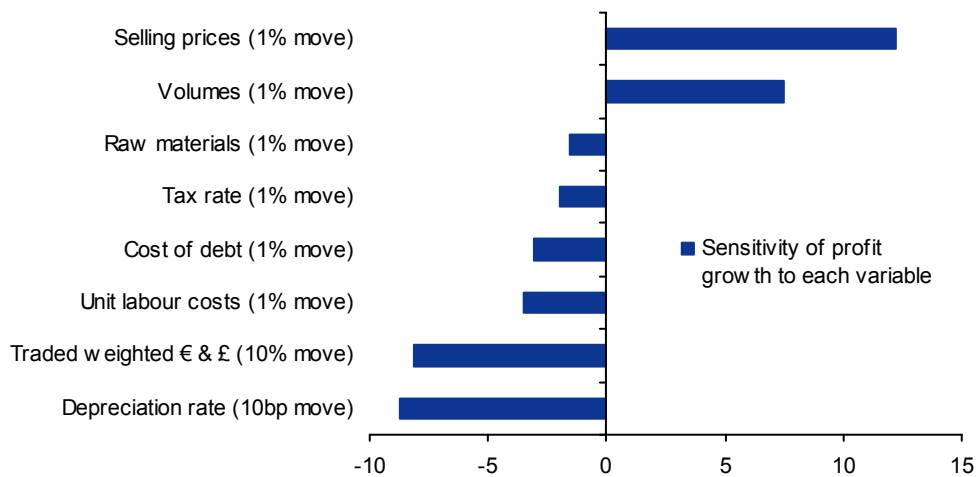
Our model is very sensitive to the inputs used. The 2009 and 2010 estimates are based on our economists' forecasts for GDP, inflation and exchange rates and our commodity team's forecasts for oil prices. For example, for selling prices, we use a 45/45/10 mix of CPI forecast, PPI forecast and oil price forecast. We use a very similar breakdown for raw materials cost, though we only mix PPI and commodity prices 90/10.

The model has different sensitivity levels to different inputs. In Exhibit 23, we show the sensitivity of our model to changes in some of the key variables. Our profit model is most sensitive to selling prices, volumes and the exchange rate. But this assumes all other things are equal, which, of course, never happens. If selling prices were to fall, wage costs and raw materials would almost certainly fall as well.

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**Exhibit 22: Profit sensitivities in our top-down European profit model**

All sensitivities based on 2010 estimates (%)



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Source: Goldman Sachs Global ECS Research.

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Global	30%	51%	19%	54%	52%	44%

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