Newsletter for May 2015

Earnings Growth: Poor but Carrying a Load of Expectations

It does not matter which part of the world you are in. We are in the thick of the earnings reporting season for the March quarter of the year. And it has been a source of much debate lately. We have been having a few thoughts ourselves on how we should look at these earnings in different markets, what the markets have been doing and if at all there are any investment opportunities being created in the process owing to the short-sightedness of markets. There is also the matter of viewing these in the context of slowing GDP growth in some parts of the world and feeble recovery in others.

Nominal GDP Growth is Poor

Given the slowing economic wherever you look in the world, it is not surprising that revenue and earnings growth estimates for benchmark indices have been coming off - quite alarmingly in some cases. One would have expected the weak commodity environment to have offered some respite. However the weakening revenue growth has indeed continued to have a dampening effect on earnings growth as well, as we can see across markets.

Country	Real GDP growth QoQ (SAAR)	Inflation	Nominal GDP	as of
US	0.20%	-0.10%	**0.10%**	1Q 2015
Japan	1.50%	2.40%	**3.90%**	4Q 2014
China	7.00%	1.40%	**8.50%**	1Q 2015
Eurozone	1.30%	-0.20%	**1.10%**	4Q 2014
India	7.40%* (new version of GDP)	6.30%	**14.20%**	1Q 2015
UK	1.20%	0.00%	**1.20%**	1Q 2015
Indonesia	4.70%	6.40%	**11.40%**	1Q 2015

Source:Bloomberg

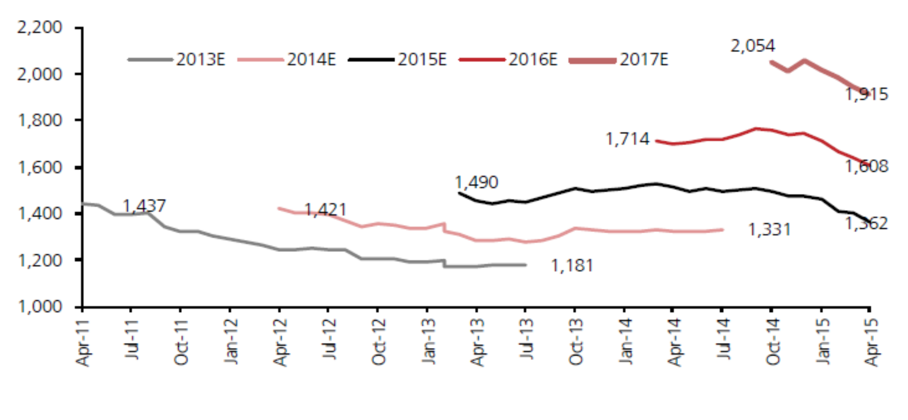
Earnings Growth is Struggling

Globally earnings growth is weak or artificially boosted by currency moves. The US dollar rally over the past two quarters or more has increased the complexity. It has turned things on the head for a few markets where the impact has been swift and magnified such as Europe, Japan, Korea and the US itself. US corporates have been smarting from a strong dollar hit on their reported earnings while their European brethren have been benefitting from the weak Euro. Japan has gained while Korea is bruised. These cross-currents of currencies have led to large differences in reported and underlying earnings. Companies have been taking pains to explain these and analysts' tearing their hair in despair. But through this the underlying trend remains weak.

In China, the A-share companies' revenue and earnings growth continue to be weak. For 2014, market earnings grew 6.4% while non-financial revenues grew only 0.4%. In Q1CY15, the non-financial revenue fell 4.5%, the first decline since the global financial crises.

Take a look at India and Indonesia. Both countries are huge beneficiaries of weak crude oil prices. It allows them elbow room to restructure their fiscal balances. While this is being done in both places with varying degrees of successes, the headline GDP growth numbers continue to disappoint. Earnings growth estimates and reported figures remain tepid and continue to be revised downwards even as stock prices have remained elevated. India has seen earnings being revised downwards almost continually for the past three years now. However the stock market has been rallying in the hope of an imminent reversal of this trend.

BSE-30 Index EPS estimates trend, March fiscal year-ends, 2013E-17E (₹)



Source: Kotak Institutional Equities estimates

Markets Need Earnings Growth to Further Rally

Look at the table below to see the performance of the indices versus the decline in earnings estimates. Investors who have been bidding up the Indian and Indonesian markets for the past few quarters are now realising that the path to earnings recovery is tortuously slow and ridden with pitfalls and that this could take longer than previously imagined. Result, both markets sold off through April.

Key Stock Indices - Estimate changes vs Performance

Index Name	Index	Bloomberg Earnings Growth Estimates				Index	P/E	BEst P/E
	Current	Current	4Wk % Chg	3 Mth % Chg	6 Mth % Chg	6M Pct Chg	(Trailing)	(1-yr Fwd)
ASIA PACIFIC								
S&P/ASX 200 INDEX	5,625.24	337.74	(1.84)	(3.57)	(5.54)	1.96	20.30	16.66
KOSPI INDEX	2,097.38	148.73	(19.43)	(17.52)	(1.68)	6.85	33.54	14.10
HANG SENG CHINA ENT INDX	14,182.98	1,423.58	(0.17)	(2.28)	(2.99)	33.15	10.23	9.96
SHANGHAI SE COMPOSITE	4,333.58	244.58	(1.75)	(4.74)	(1.50)	75.47	21.50	17.72
HANG SENG INDEX	27,718.20	2,078.63	(0.19)	(2.74)	(3.64)	16.42	11.75	13.33
NSE CNX NIFTY INDEX	8,315.65	531.30	(0.82)	13.75	12.57	(0.49)	22.27	15.66
JAKARTA COMPOSITE INDEX	5,172.48	324.93	(1.74)	(4.12)	6.81	2.79	22.44	15.92
NIKKEI 225	19,620.91	1,046.90	(0.08)	12.93	16.02	14.58	36.04	18.74
TOPIX INDEX (TOKYO)	1,598.33	102.53	(0.36)	12.09	14.39	16.22	27.16	15.59
FTSE Bursa Malaysia KLCI	1,805.49	109.18	(0.33)	(3.20)	0.64	(1.08)	16.50	16.54
NZX 50 Gross Index	5,747.95	298.73	(0.17)	0.29	0.05	4.68	19.13	19.24
PSEi - PHILIPPINE SE IDX	7,777.90	395.47	0.11	(0.91)	11.73	7.96	21.21	19.67
Straits Times Index STI	3,470.80	242.46	(0.72)	(1.19)	5.68	5.43	15.48	14.31
TAIWAN TAIEX INDEX	9,663.72	717.19	(0.55)	(0.66)	13.68	6.97	17.10	13.47
STOCK EXCH OF THAI INDEX	1,505.12	100.25	(0.74)	(3.08)	4.34	(4.22)	19.61	15.01
UNITED STATES								
S&P 500 INDEX	2,116.10	118.04	0.17	(0.81)	(1.86)	3.75	18.69	17.93
DOW JONES INDUS. AVG	18,191.11	1,114.90	1.48	3.26	(2.00)	3.27	15.78	16.32
NASDAQ COMPOSITE INDEX	5,003.55	226.99	(0.41)	(3.41)	8.27	7.36	29.02	22.04
EUROPE								
Euro Stoxx 50 Pr	3,612.89	230.20	(0.48)	(1.08)	4.08	16.37	20.46	15.69
FTSE 100 INDEX	7,067.90	418.12	(2.32)	(4.22)	(11.92)	6.66	24.06	16.91
DAX INDEX	11,653.71	788.37	1.67	1.51	8.41	24.38	18.44	14.78
CAC 40 INDEX	5,017.50	304.14	(0.55)	(1.38)	4.93	18.23	25.73	16.50
MSCI INDICES								
MSCI AC ASIA x JAPAN	619.68	46.99	0.02	(0.17)	4.97	8.61	13.29	13.19
MSCI EM	1,035.00	79.55	(0.32)	(1.81)	(3.00)	4.15	14.60	13.01
MSCI EUROPE	135.99	8.01	(1.56)	(1.37)	4.15	17.55	23.42	16.97
MSCI WORLD	1,794.70	102.07	1.27	(0.37)	(3.38)	4.54	18.76	17.58

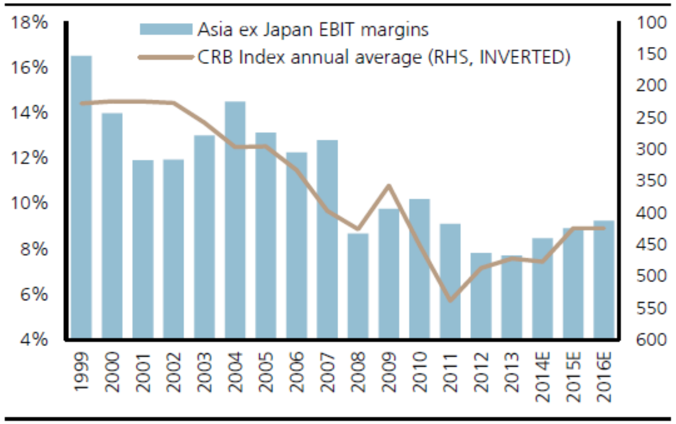
Source: Bloomberg

Remember, that globally stock markets have been rallying largely on the backs of the easy monetary policies of the Central Banks. However PE re-rating can take them only so far and before long earnings must manifest themselves for markets to hold up, consolidate and/or rally onward. This has now become the central debate and in a way the biggest challenge for many global markets to sustain their rallies.

The Silver Lining is in Potentially Bottoming Margins

The hope in Asia ex-Japan (and also the world) is that weak commodity prices will give way to higher margins in the quarters ahead, lifting earnings and estimates of investors. With sales growth constrained by poor nominal GDP growth and PE above long term averages, the load of earnings growth has to be carried by margins. The bulls' case is that this is a typical early cycle phenomenon. Low utilisation and falling costs (commodities primarily) would be the support for margin improvement. Asian margins have had a strong correlation with dropping commodity prices.

Figure 1: Asia ex Japan EBIT margins vs commodity prices



Source: Worldscope, IBES, Thomson Datastream, UBS estimates

This could lead to markets growing into the upcoming earnings uptick. We are looking closely for evidence of this and keeping our fingers crossed. All our endeavours are to look for such beneficiaries.

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