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Eurozone: Profits turn the corner

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EUROZONE: PROFITS TURN THE CORNER

For years the economic picture in the eurozone has been characterized by weak growth, low increases in productivity and a gradual upcreep in unit wage costs. This doubtless had a negative impact on companies' profits. In its Economic Bulletin (Issue 1/2015) the ECB demonstrated that profit margins for non-financial corporations fell dramatically during the 2008/9 recession, and have also decreased over the past two years. During these periods, gross operating surplus dropped more sharply than real value added. Increases in labor and capital costs per unit produced could not be passed on to selling prices. However – as the ECB rightly points out – profit margins had risen sharply before the 2008 crisis, making it difficult to estimate appropriate reference values.

Despite shrinking profit margins over the past two years, European stock markets have been going from strength to strength. Sceptics view this as the real economy and financial markets drifting apart under the influence of a flood of liquidity from central banks, investors' hunts for yield faced with a zero interest rate policy and disrupted monetary policy transmission channels to the real economy. But does this really explain why European stock markets are booming? In this context, it is important to remember that many European markets are still well below previous levels. Despite the recent climb, the EuroStoxx50 is still around 25% off the highs reached in 2007/8. Stock indices were even harder hit than overall earnings during the crisis. As a result, the price/earnings ratio of European indices is anything but above-average. In addition, companies represented on these indices often operate on a very international plane, and carry out a substantial part of their business outside the eurozone with its weak growth.

For these reasons alone, the upward trajectory of European stock markets should not be viewed as divorced from the real economy. But another important reason has to be taken into account. Following concerns about deflationary trends, the markets are increasingly recognizing that an economic upswing is emerging in Europe. These expectations are justified given improved price competitiveness thanks to the slide in the euro, and the substantial purchasing power gains resulting from the oil price collapse. Real retail sales within the eurozone have recently returned strong growth. In 2015, the eurozone will see a consumer-driven upswing.

Thanks to the pickup in the economy, profit expectations are likely to brighten as well. But are profit trends in the eurozone really going to change that dramatically? Seen from a macroeconomic perspective, a host of factors play a role. Of course, higher capacity utilization on the back of the associated cost degression helps. However, this is unlikely to give a substantial boost to profits as overall economic growth rates are simply too low. However, there is another factor at play. As a result of the collapse in oil prices, terms of trade, i.e. the relationship between export and import prices, have improved. Companies enjoy lower input costs. Their profit margins will only remain unchanged if, faced with fierce competition, they are forced to pass the cost savings in their entirety onto the end purchaser. However, in a good, or improving, economic climate and with sinking import prices, most companies are able to expand their profit margins. We believe that, in 2015, companies will use the sharp reduction in costs thanks to the oil price to gently expand profit margins which had been squeezed in recent years. In macroeconomic terms, this means that the GDP deflator, the measure of inflation of domestic production, will increase at a faster rate than unit labor costs (as long as there are no unexpected developments in production levies and subsidies).

Based on these considerations, we have attempted to estimate the profit development of non-financial corporations using the expected macroeconomic data for 2015. Nominal gross domestic product across the eurozone is likely to increase in 2015 by 2.7%, after 1.7% last year. With an increase of 2.3%, labor compensation will rise somewhat faster than in 2014 (+2.1%), but slightly less than nominal GDP. As a result, the GDP deflator will increase by 1.2%, somewhat stronger than unit labor costs (+0.8%).

Eurozone: Gross domestic product, employment, productivity, costs

% change on year earlier

	2013	2014e	2015f
Gross domestic product, in current prices	0.9	1.7	2.7
Gross domestic product, chained volumes	-0.4	0.9	1.5
Gross domestic product, deflator	1.3	0.8	1.2
Employment			
- Economically active	-0.8	0.4	0.6
- Employees	-0.7	0.6	0.7
Labor productivity per econ.active person	0.3	0.4	0.9
Labor compensation per employee	1.7	1.5	1.6
Labor compensation	0.9	2.1	2.3
Unit labor costs	1.4	1.0	0.8

e=estimate;f=forecast.

In the following, we assume a broad correlation between developments in the economy as a whole and in non-financial corporations in the eurozone. This was already the case in 2014. We estimate that companies' gross value added will, at 2.8%, grow slightly more than labor compensation (+2.6%) in 2015. As a result, gross operating surplus (with growth of 3.2%) will be substantially better than in previous years, in which it had predominantly declined. Net operating surplus will experience even stronger growth in 2015, because depreciation will only increase slightly as a result of reduced inflation rates for capital goods and a low investment volume. When the balance of receivable and payable income from investment is subtracted from net operating surplus, the result is net entrepreneurial income. Particularly given the sharp drop in the net interest burden, this figure for non-financial corporations performs extremely well. We expect NFCs' net profits to climb by 4.9% in 2015, after 1.8% last year.

Eurozone: Non-financial corporations

	in EUR bn			% change on year earlier		
	2013	2014e	2015f	2013	2014e	2015f
Gross value added (+)	5122	5199	5345	0.3	1.5	2.8
Employee compensation (-)	3076	3153	3235	1.1	2.5	2.6
Production levies (-) minus subsidies	56	57	58	2.2	2.0	2.0
= Gross operating profits	1984	1989	2052	-1.4	0.3	3.2
Writedowns (-)	1011	1027	1037	1.5	1.6	1.0
= Net operating profits	973	972	1015	-4.3	-0.1	4.4
Incoming property income (+)	509	489	475	-9.9	-3.9	-2.9
Outgoing interest and rent (-)	253	209	175	-17.6	-17.4	-16.3
= Entrepreneurial income, net	1266	1289	1352	-1.2	1.8	4.9

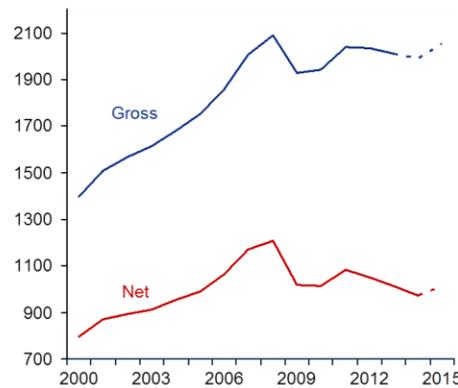
e=estimate; f=forecast.

We therefore expect the increase in all NFC profit definitions (within the national accounts) to outstrip growth in value added in 2015, prompting an at least modest rise in profit shares. In general, profit shares will stabilize. However, substantially higher shares of gross operating surplus in value added, as were the norm pre-2008, are unlikely to be achieved for the foreseeable future. But in our view this is not decisive. It is anyway near-impossible to define an economically-appropriate level for profit share. More important

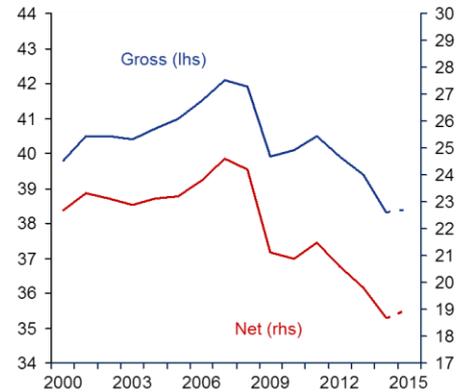
is that profit levels of non-financial corporations in the eurozone, which had stagnated, or even fallen, in recent years, are once again on the up, and for the long term. The conditions for this upturn in profit shares look set to remain in place well beyond 2015, given the strengthening economic recovery and the cost relief due to the slump in commodity prices.

Eurozone: Gross and net operating surplus of non-financial corporations

in EUR bn



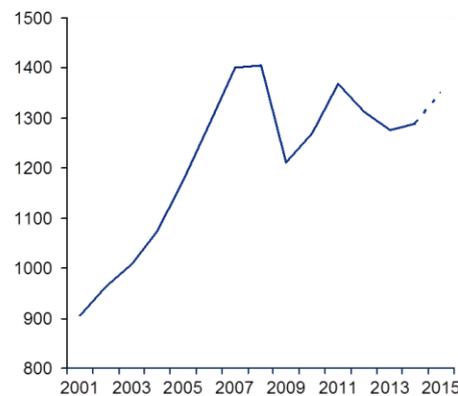
as % of value added



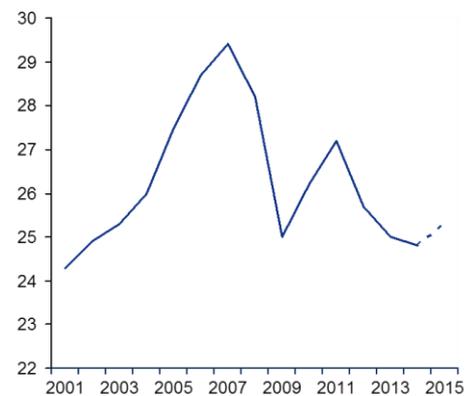
Sources: ECB; own estimates.

Eurozone: Net entrepreneurial income of non-financial corporations

EUR bn



as % of value added



Sources: ECB; own estimates.

Of course, the estimates of profit trends in the eurozone made here in the framework of the national accounts cannot be mapped one-to-one onto the companies listed in the European stock indices. However, they do suggest that, broadly speaking, the corporate earnings outlook is improving again. In addition, taking into account that profits earned by EMU companies outside the eurozone have increased in value as a result of the appreciation of many currencies against the euro, the profits of internationally active companies listed on EMU stock exchanges will record above-average growth. Thus, the upward trend in share prices is founded in the real economy.

As always, the evaluations are subject to the following cautionary notes.

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