

Flash Economics

23 January 2019 - 100

What is the appropriate level of European share prices?

Share prices in Europe have fallen markedly since the second quarter of 2018.

We seek to determine the appropriate level of stock market indices in the euro zone, and therefore the current degree of equity market undervaluation. We will therefore analyse:

- The outlook for earnings per share, given the trend in corporate profitability and the economic cycle;
- The outlook for the PER (or the risk premium on equities), given the outlook for interest rates and long-term growth.

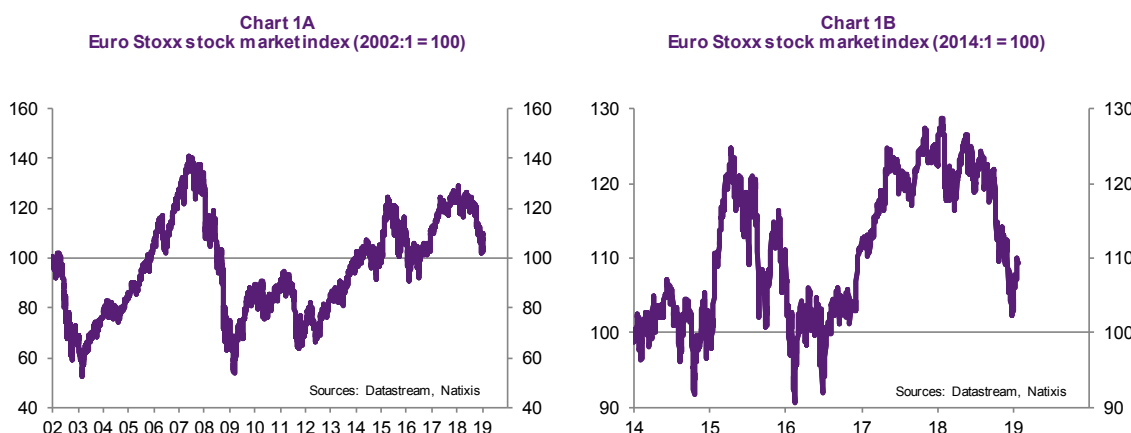
We then believe that the level of the euro zone's stock market index is currently 25% too low compared with its normal level.

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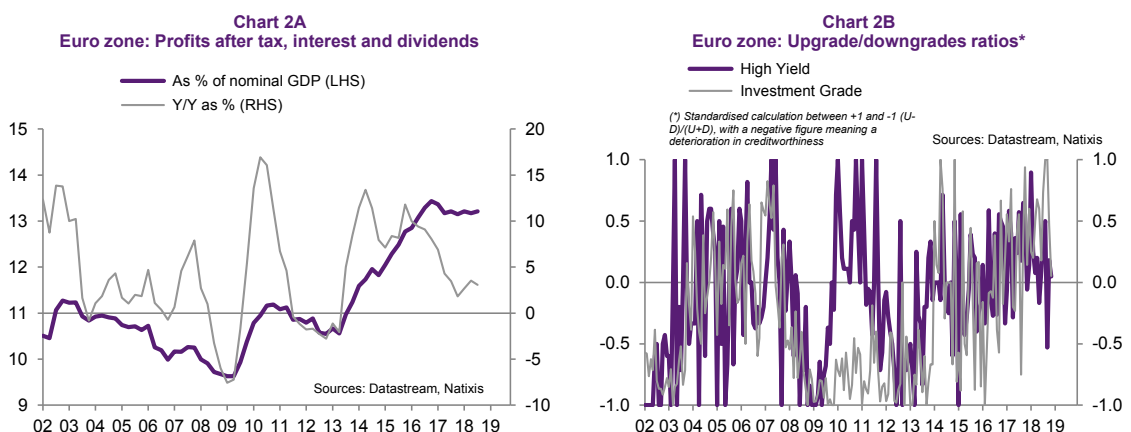
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Marked decline in the euro-zone equity market in 2018

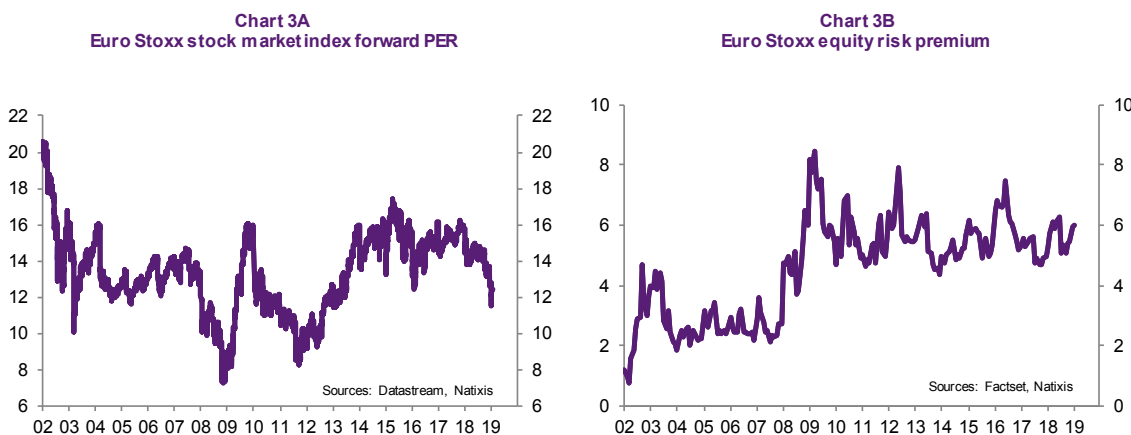
Charts 1A and B show the marked decline in the euro-zone equity market from the second quarter of 2018.



This decline seems very excessive: companies' profitability continues to improve (Chart 2A) and so do their ratings (Chart 2B).



At the end of 2018, the PER was very low and the equity risk premium was very high (Charts 3A and B).

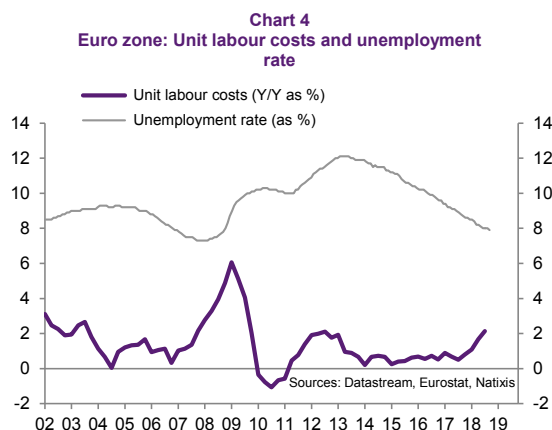


We therefore seek to determine the appropriate level of the euro-zone equity market in early 2019.

Outlook for earnings per share

Corporate profitability in the euro zone (Chart 2A above) is bolstered by:

- The limited acceleration in unit labour costs despite the fall in unemployment (Chart 4);



- The low level of interest payments on debt (Chart 5) thanks to low interest rates.

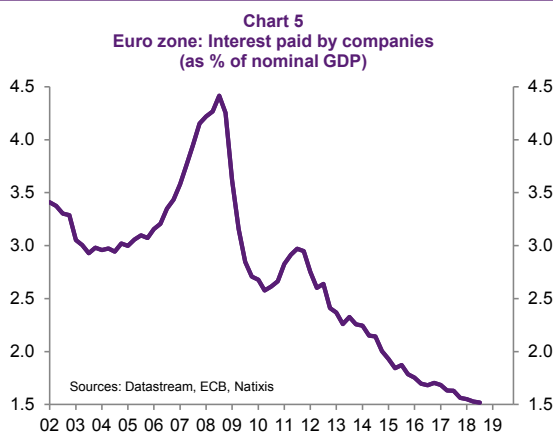


Table 1 shows the consensus forecasts for earnings per share.

Table 1: Earnings per share (consensus, as % per year)

Year	Euro Stoxx
2017	15.6
2018	6.5
2019	8.3
2020	8.5

Sources: Datastream, Natixis

Given the outlook for growth and profitability, our econometric estimations lead to a forecast of earnings per share growth of around +6% per year in 2019 and 2020, a little lower than the consensus.

Outlook for the PER

The ECB will probably hardly raise its interest rates from the end of 2019.

Chart 6A shows that financial markets do not expect any hike in short-term interest rates, Chart 6B that they expect a limited rise in long-term interest rates.

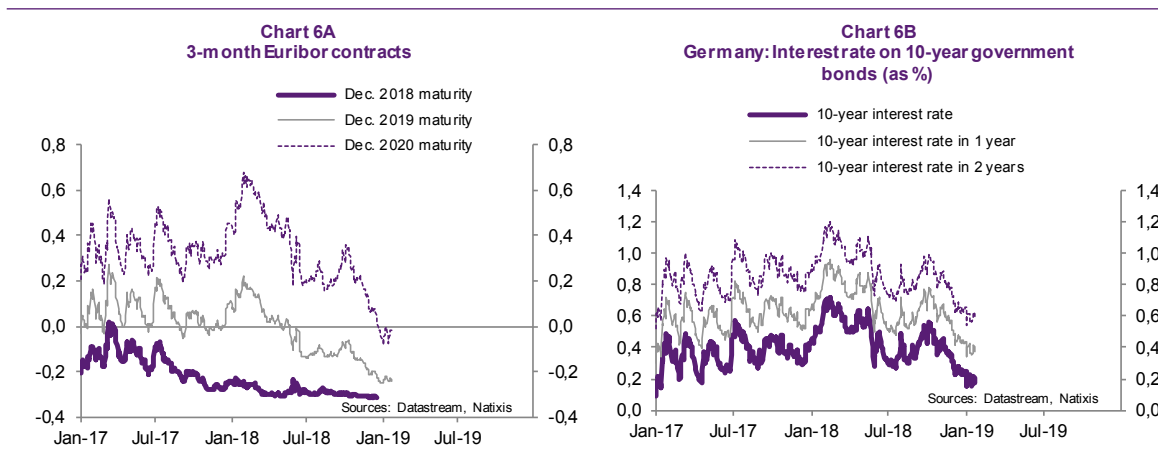
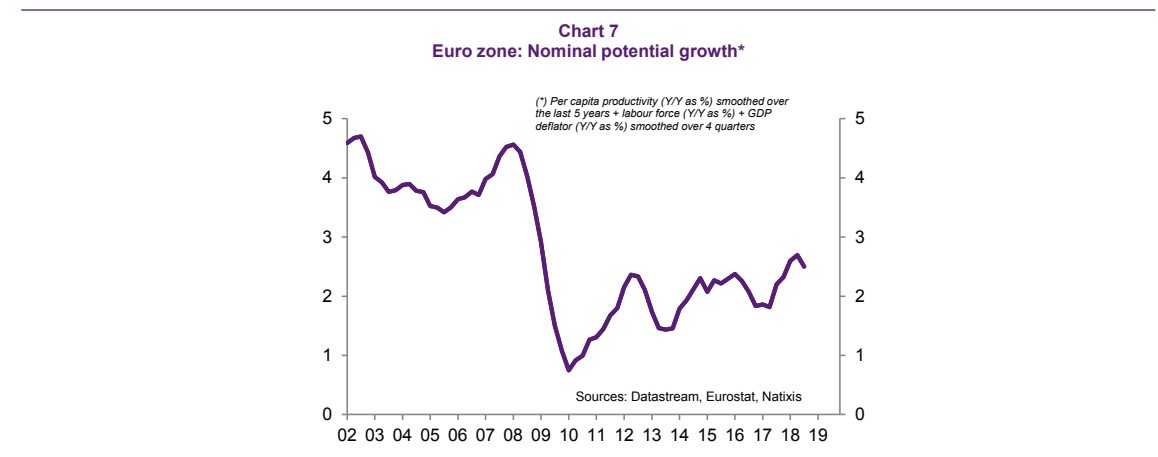
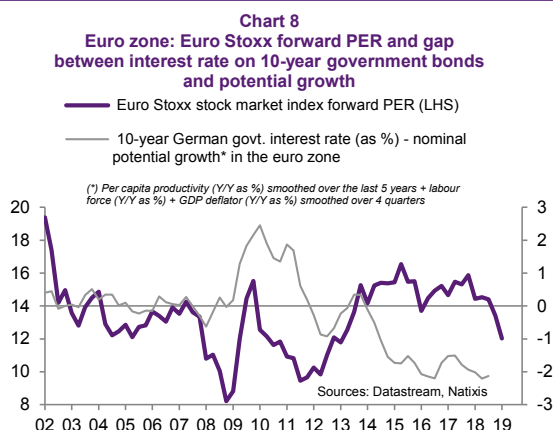


Chart 7 shows nominal potential growth in the euro zone, calculated as the sum of the trend in productivity gains, labour force growth and growth in the GDP deflator.



We compare the PER on the Euro Stoxx to the gap between 10-year interest rates in Germany and nominal potential growth (Chart 8).



We see that at the current level of the gap between the 10-year interest rate in Germany and nominal potential growth in the euro zone (-210 basis points), the PER should be far higher, around 15.5 and not 12, which corresponds to a 30% undervaluation.

Conclusion: What would be a "reasonable" level of the Euro Stoxx in early 2019?

We have seen that:

- We should expect earnings per share growth for the Euro Stoxx of around 6% per year in 2019-2020. The consensus forecasts of earnings per share growth are therefore 2.5 percentage points per year too high;
- The PER on the Euro Stoxx that corresponds to the long-term interest rate and nominal potential growth is around 15.5 and not 12.

All things considered, this indicates that the euro zone's stock market index is currently 25% too low.

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