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# Earnings strong amid volatility – and banks march on

A Q2 earnings review from BlackRock Fundamental Equities, August 2024



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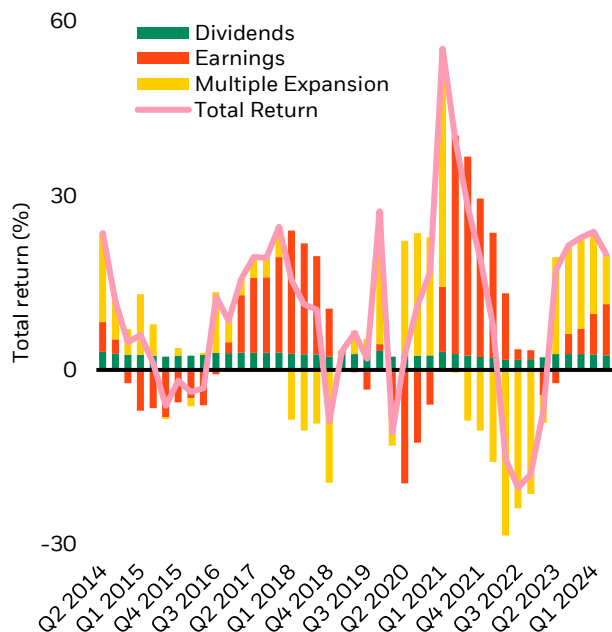


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## How earnings matter to markets

MSCI World sources of total return, 2014-2024



Source: BlackRock Investment Institute, August 16, 2024

<sup>1</sup> Bloomberg, August 16, 2024

<sup>2</sup> Earnings numbers in this report from LSEG I/B/E/S, August 13, 2024

<sup>3</sup> Goldman Sachs, July 24, 2024

<sup>4</sup> Bloomberg, August 16, 2024

## Earnings not responsible for the pullback

The second-quarter earnings season was in full flow when the markets plunged at the end of July. Yet earnings weren't the reason for the pullback. Concerns over U.S. employment data led to fears of a recession, and this was exacerbated by traders selling their positions as the yen strengthened after a Bank of Japan rate rise. Some investors also began to worry about the future earnings of those technology companies that are investing heavily in artificial intelligence (AI). This all led to changes in the risk premium for equities, while earnings remained solid.

The price-to-earnings (PE) ratio of global stocks fell around 10% in the summer pullback to a level similar to the start of the year.<sup>1</sup> Yet earnings held up well in Q2, growing 12.5% in the U.S. and 4.3% in Europe – both better than expected.<sup>2</sup> The chart shows how valuations have played a smaller role in equity returns this year versus 2023, while the contribution from earnings has grown. And in the long run, it's earnings that drive markets.

AI-related stocks have been in focus all year, and earnings were again impressive for those beneficiaries of AI spending such as semiconductor companies and semi-equipment makers. Yet an area of the market that has more quietly outperformed in 2024 has been the banks – and European banks in particular.

Towards the end of July, European banks were up 29% on a total-return basis, versus 15% for the MSCI World Index.<sup>3</sup> And earnings for financials overall remain strong, outperforming Europe with 15% growth, second only to utilities in Q2. Banks sold off and recovered alongside the broader market during the August volatility. But European bank valuations sit at a PE ratio of just 6x today, versus a long-term average of around 13x since 2004.<sup>4</sup> This represents a buying opportunity, in our view, although it's important to be selective. We believe the banks can maintain strong earnings even if interest rates fall further in Europe. We don't see a return to the zero-rate era that followed the Global Financial Crisis.

## Still backing the banks – selectively

Yet selectivity does become increasingly key as rates come down and the overall move up in bank share prices potentially fades.

Three positive trends emerged from the Q2 earnings season:

**Mentions of loan growth**, especially from banks in Spain and Ireland. This is good for business – and a healthy sign for the economy – and we don't believe it's reflected in bank valuations.

**Deposit growth across Europe**, which we believe is being driven by rising wages – notably in Spain, Ireland and Germany.

**Attractive capital return plans.** Higher interest rates have boosted the net interest income for banks, allowing many of them to return a significant amount of cash to shareholders. Some European banks plan to return between 40-50% of their total market cap over the next three years, and our estimate of the sector average is 33%.<sup>5</sup>

We like those banks with a strong retail franchise that are in a good position to capture deposits as wages grow. We also like some of the banks that plan to return lots of cash – meaning investors are “paid to wait” for valuations in select names to rebound to a level we believe is more appropriate given earnings potential.

We have been saying since the start of this new investment regime – of higher rates and sticky elements of inflation – that we expect higher volatility and greater dispersion in earnings. We believe this can be a rewarding environment for skilled stock pickers to take advantage of market jitters to add to positions where the fundamental earnings case remains strong – and some of the European banks fit this description.

<sup>5</sup> Source: BlackRock Fundamental Equities analysis, August 24.

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