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Inside corporate earnings

What to watch: Europe's NGEU—Forget me not! Varning Sverige! Are we reaching the end of the hiking cycle? China—National People's Congress

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What to watch

- **Europe's Next Generation EU (NGEU) – Forget me not!** Europe's Green Deal Industrial Plan will not work without an effective NGEU implementation.
- **Varning Sverige! Are we reaching the end of the hiking cycle?** As the Riksbank struggles to control supply-side-driven inflation, tighter financing conditions are already creating havoc in the housing market. The monetary policy trade-off is becoming increasingly costly. Is Sweden a bellwether for the Eurozone?
- **China – National People's Congress: prudent economic target and harsher rhetoric on geopolitics.** Chinese authorities have confirmed a higher GDP growth target of +5% for 2023 aimed at striking the right balance between policy support and structural reforms. However, a harsher rhetoric means no relief in sight for tense Sino-US relations.

In focus – Earnings season: The end of the corporate party?

- **Despite a general business deterioration in Q4, 2022 was a strong year overall for corporate earnings.** Global revenues jumped by +11.7% y/y and earnings per share (EPS) by +4.3% y/y. 15 out of 23 sectors reported growth for both revenues and EPS, with oil & gas, transportation and hospitality being the biggest winners of the year.
- **However, the excellent performance is set to reverse in 2023, notably for shipping and retail.** The build-up of oversupply, capped pricing power, still-high input prices and waning demand will squeeze margins in some sectors. Conversely, consumer services (hotels & restaurants) and airlines should continue enjoying high booking rates as rising prices do not appear to be a deal-breaker for traveling.
- **With no major revenue growth likely in the first half of 2023, protecting margins will be the top priority.** Cost-cutting strategies such as restructuring and personnel rightsizing should continue in the near term, notably in the US, where profitability is declining more rapidly. However, we still expect further capital expenditures in 2023, mostly in sectors where a switch towards sustainable projects is needed the most (automotive, energy and utilities).

Europe's NGEU – Forget me not!

Europe's Green Deal Industrial Plan (GDIP) will not work without an effective implementation of the post-pandemic recovery fund—Next Generation EU (NGEU). The GDIP, Europe's response to the US Inflation Reduction Act (IRA), is attracting most of the attention; however, NGEU[1] remains key to Europe's green transition. The NGEU fund's main instrument, the Recovery and Resilience Facility (RRF), provides grants and loans to EU member states to also fund essential climate-change policies and related expenditure, for an aggregate total of about EUR724bn. For example, Greece, Italy, Croatia and Spain, the main NGEU beneficiaries, will be able to fund additional average capital expenditure of 2.8%, 1.7%, 1.6% and 1.1% of GDP per year, respectively, during the EU's budget cycle until 2027.

NGEU-RRF funding focuses on *government* spending, especially on climate projects, whereas GDIP aims at scaling up *private* investment. In particular, it creates fiscal space for EU member states to undertake necessary structural reforms and public investment in areas that reflect a common good and are difficult to monetize; this also includes providing public support where market failures hold back private investment (e.g. building renovations to enhance energy efficiency). In contrast, the GDIP facilitates the development, production and installation of products and processes that help reduce emissions by mobilizing private capital.[2]

Climate policy accounts for about one-third of NGEU-RRF spending (Figure 1). In the area of climate policy and energy transition, countries include the expansion of renewable energy systems, such as for the production and use of hydrogen, and the decarbonization of industry (Table 1). Investments into modernization of infrastructure networks, decarbonization of public transport by renewing public vehicle fleets and improvement of energy efficiency of residential and government buildings are also widespread. While most RRF-funded projects focus on growth-friendly investments, the program also spurs a virtuous circle, supporting greater economic and social resilience, and thus fostering greater economic and fiscal convergence between EU member states.[3]

The largest recipients of NGEU-RRF funding – Greece, Italy, Croatia and Spain – have made the most progress since February 2021. To receive funds under the RRF, EU member states submitted Recovery and Resilience Plans (RRPs) outlining their investment plans. Moreover, any disbursements under the RRF are conditional on the fulfilment of the relevant milestones and targets, assessed by the Commission. Italy and Spain, which are set to receive some of the largest total disbursements of RRF funding relative to economic size (10.5% and 6.5% of GDP, respectively), have already applied for their third tranche of funding and are well on track to meet their indicative targets for requesting RRF payments outlined in their RRPs. Croatia and Greece have received their second tranche of funding and are quickly catching up. Interestingly, these countries have traditionally exhibited a low absorption rate of EU structural and cohesion funds in the past (Figure 2), so the progress thus far bodes well for an effective implementation of public projects in these countries.

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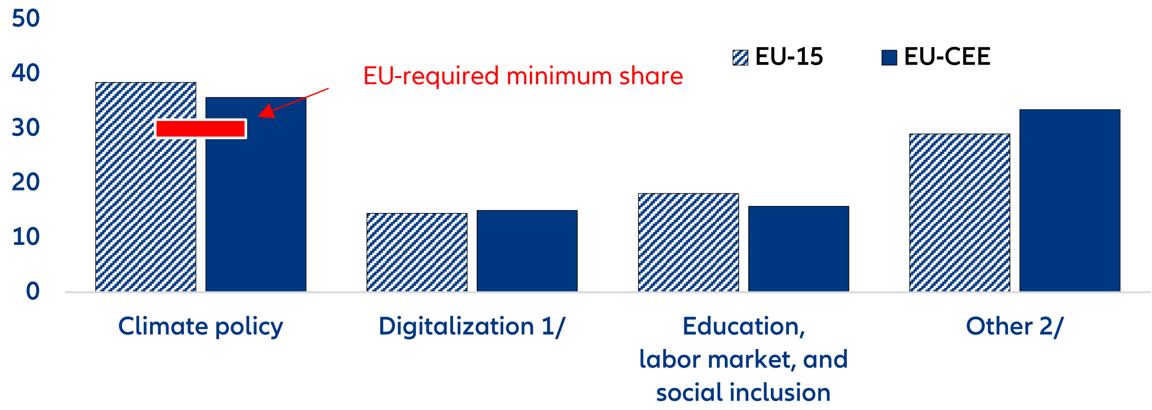
[1] *At the onset of the Covid-19 pandemic, the EU strung together a fiscal stimulus package worth more than EUR2trn, which included the creation of the NGEU with a financial framework of EUR807bn.*

[2] *The GDIP is based on four pillars to achieve this objective: (i) fostering a more predictable and simplified regulatory environment, (ii) allowing faster access to sufficient public sector funding (including the adoption of the Temporary Crisis and Transition Framework (the "TCTF") for State aid), (iii) enhancing skills for green and digital jobs; and (iv) promoting open trade for resilient supply chains.*

[3] *In addition, countries not only benefit from the funds they receive but also from significant spillover effects due to stronger demand within the EU's common market.*

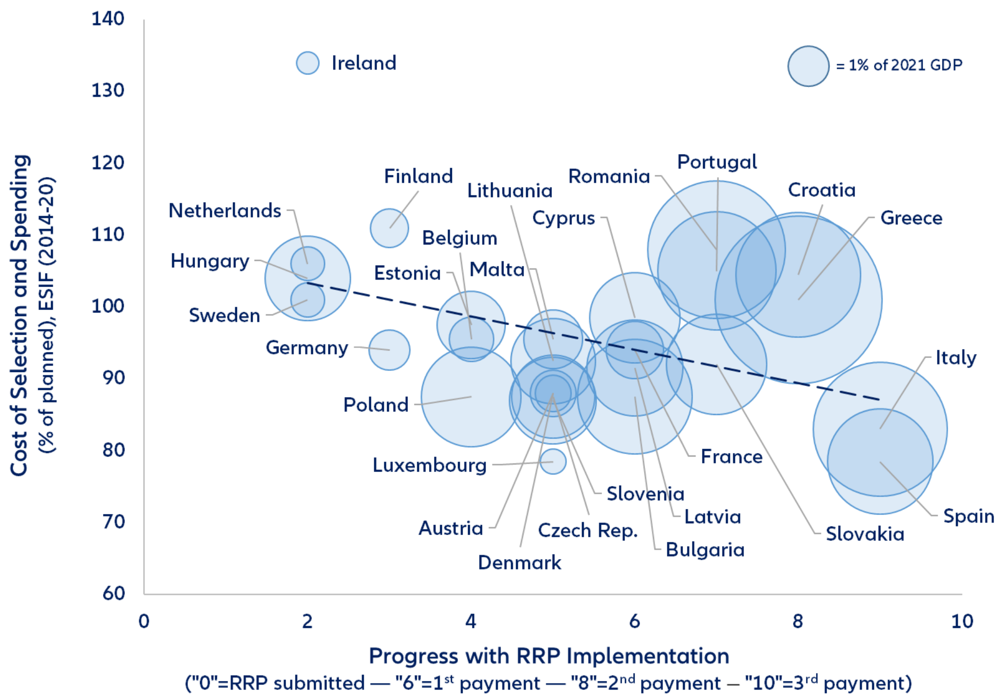
Figure 1. Recovery and resilience fund (RRF) grants: main investment categories (%)



Sources: European Commission, national authorities, Allianz Research. Note: CEE=Central and Eastern Europe. The categorization is based on the assessment of national recovery and resilience plans covering investments. Unweighted country averages. 1/ This category captures only digital infrastructure, but other categories have a high digital content as well (e.g. health, education, public administration); 2/ "Other"=public administration & governance, healthcare system, other public investment, R&D and agriculture.

However, there could be potential delays in Italy over the near term. Recently, the Italian government announced that it is considering asking the European Commission for a one-year extension to spend the allocated funds since the energy crisis changed some of the initial conditions. So far, Italy has only spent around EUR12bn of the EUR67bn it has received from the first two RRF disbursements, suggesting that the pace of spending needs to pick up substantially over the near term. That said, the country has never managed such an ambitious public investment program in a relative short period of time. Lengthening the "spending period" would require time-consuming legislative changes and could disrupt the governing bloc's political equilibrium.

Figure 2. Implementation progress of NGEU RRPs vs. historical absorption rate of EU funds (%)



Sources: European Commission, Allianz Research

Table 1. Common themes of investment projects under NGEU-RRPs

Climate Policy and Energy Transition		
Renewable energy system	**Climate-friendly mobility**	**Energy-efficient housing**
Improving infrastructure for production and use of hydrogen in industry and transport AUT, BGR, DEU, FRA, PRT	Modernization of infrastructure networks BEL, BGR, CZE, DEU, ESP, EST, FIN, HRV, LTU, PRT, SVK, ROU, SVN	Improving energy efficiency of residential and government buildings BEL, BGR, CZE, DEU, DNK, FIN, FRA, IRL, LTU, HRV, POL,PRT, ROU, SVK, SVN
Decarbonization of industry AUT, BGR, BEL, EST, FIN, FRA, IRL, PRT, SVK, ROU	Decarbonization of public transport BGR, CYP, CZE, ESP, EST, FRA, IRL, HRV, LUX, LTU, POL, PRT	
Construction of new sources of electricity BGR, CYP, ESP, FIN, LTU, POL, SVK,		
Improve management of water resources BGR, ESP, HRV, POL, PRT, ROU		

Sources: European Commission, Allianz Research

Varning Sverige! Reaching the limits for further tightening – bellwether for the Eurozone?

The Riksbank still struggles to vanquish largely supply-side-driven price pressures as the economy drifts into a recession. Sweden is one of the few European countries where inflation seems to have peaked only recently. Last month, inflation declined marginally to 9.3% y/y (down from 10.2% y/y) due to stubbornly high energy prices.[4] Meanwhile, core inflation surprised on the upside with an eye-watering print of 8.5% y/y due to higher goods prices.[5] Much like the ECB, the Riksbank acted too late while significant inflation pressures were already building in early 2022; however, it would have also been difficult to hike rates earlier than the ECB, given its monetary regime of stabilizing the FX rate vis-à-vis the euro. So far, the Riksbank has prioritized fighting inflation (and stemming currency weakness) over risking recession. It recently hiked its policy rate by 50bps to 3.0% and maintained a hawkish rhetoric, disregarding the current economic slowdown. This was the right choice given the risk of high inflation becoming embedded in the economy through higher wages and imported inflation due to Sweden's economic openness. The Riksbank also announced quantitative tightening starting in April by selling government bonds, as well as issuing a larger volume of Riksbank Certificates to mop up excess liquidity, and thus hold short-term market rates close to the policy rate.

The crumbling housing market and weaker economic activity suggest that there are limits to the number of future rate hikes. Rapidly tightening financing conditions during the second half of last year have already lowered aggregate demand across the economy by increasing the cost and risk of investing and encouraging saving, which has led to a significant price correction in the housing market. Sweden has a comparatively high share of households that have a mortgage. On top of this, half of them are on variable rates (Figure 3) and the remainder have fixed rates that reset after between one to five years. After a period of soaring growth when the house-price index rose by +16.8% in 2021, and following a +6.6% rise in 2022 (which effectively doubled house prices in a little more than a decade),[6] prices have fallen -14% since mid-2022 due to higher interest rates. House prices are now down -17% in real terms from their 2022 peak (Figure 4). This is the worst slump for the market since the crash in 1991-92; however, the expected contraction is likely to be more of a correction to a new interest rate environment rather than a housing

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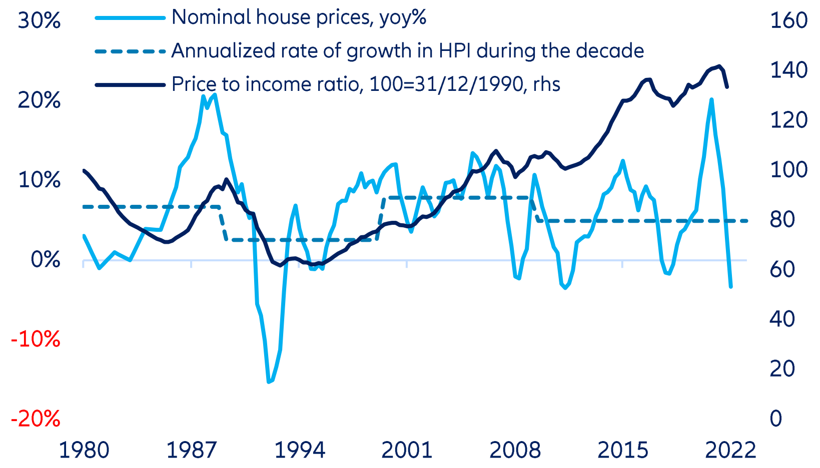
[4] Sweden's government-support measures to cushion the energy-price shock have been small relative to that of other European economies, which limits the extent of fiscal steering.
[5] For comparison, headline and core inflation in the Eurozone stand at 8.5% y/y and 5.6% y/y, respectively.
[6] This numbers are calculated using the SCB Index for the owner-occupied dwellings across the whole Sweden.

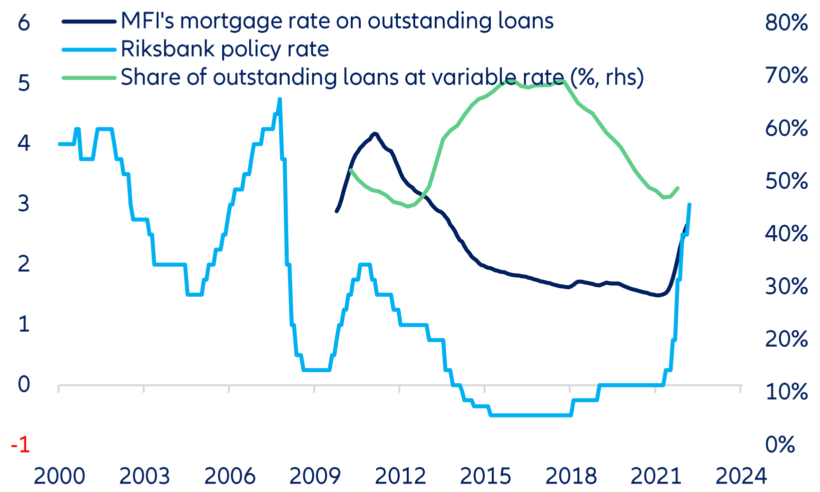
market crash. The recent correction in house prices has only marginally improved housing affordability, which has deteriorated for more than three decades.

Figure 3. Sweden: house prices and price-to-income ratio



Sources: SCB, OECD, Refinitiv Datastream, Allianz Research

Figure 4. Sweden: mortgage lending rate and share of variable rate mortgages



Sources: ECB, Riksbank, Refinitiv Datastream, Allianz Research

Going forward, the Riksbank's monetary stance will be influenced in the near term by the exchange rate and current wage negotiations, which are likely to result in a higher settlement than in the past. However the future rate path undoubtedly hinges on the scale of the economic contraction, largely fueled by the deteriorating housing market. The Riksbank will likely mirror the policy rate increase at the ECB Governing Council meeting next week. We expect a 50bps hike in March, followed by at least two more hikes until summer, which will put the terminal rate at 4%. We expect a GDP contraction of -1.2% y/y this year (followed by a shallow recovery of +0.9% next year) as the housing market continues to plummet and the Riksbank remains restrictive for longer.

China – National People's Congress: prudent economic target and harsher rhetoric on geopolitics.

We share the Chinese authorities' conservative growth outlook for 2023. At the annual "Two Sessions" of the National People's Congress, which started at the end of last week, the government published its economic roadmap for 2023. The GDP growth target was set at "around 5%", down from "around 5.5%" last year and below market expectations. The target matches our (below-consensus) GDP growth forecast of +5%. Despite some upside risk, policymakers seem cautious for 2023 due to a weak external environment (weighing on Chinese exports) and uncertainty about the length and intensity of the post-Covid consumer rebound.[7] Labor market expectations underscore the cautious stance, with the unemployment rate target set at "around 5.5%", down from last year's "no more than 5.5%". More easily achievable economic targets put less pressure on policy support while leaving more room to tackle structural issues.

Chinese authorities seek to strike the right balance between policy support and tackling structural issues. Despite the pivot towards more growth-oriented policies since the end of last year, the revised economic targets and priorities at the Two Sessions somewhat dampen expectations of much further policy easing this year. On fiscal policy, the target for new issuance of local government special bonds was set at RMB3.8trn – slightly lower than our expectation of RMB4trn (which would be unchanged from last year). This suggests a likely slower pace of infrastructure investment as the government probably aims to reduce the fiscal deficit. On monetary policy, the People's Bank of China is likely to retain its easing bias. Last year's guidance suggesting policy rate cuts was also dropped, and we no longer expect any changes in policy rates this year. Overall, it seems that Chinese authorities will try to take advantage of the post-Covid recovery to advance structural reforms. More specifically, mentions of the real estate market confirm our expectation of no strong trend reversal this year (especially in housing starts), and that consolidation among property developers is likely. Separately, the precise plan for infrastructure projects should be announced in the coming months, focusing on technology and the green transition.

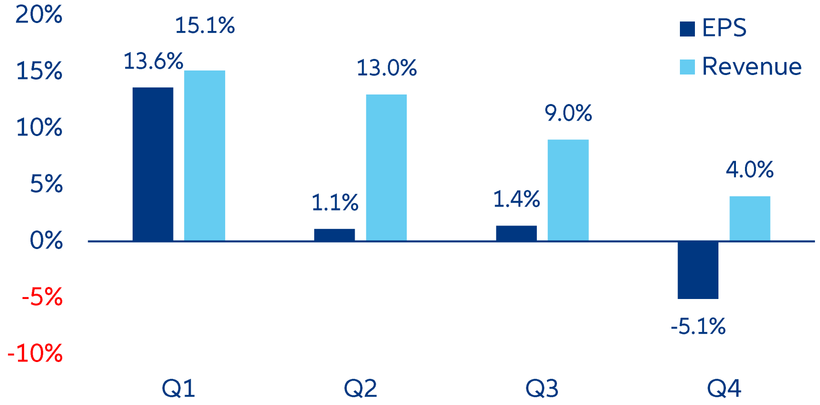
The Two Sessions also validate changes in government positions. The newly appointed Foreign Minister, Qin Gang, is taking the position after being China's ambassador to the US between 2021 and 2023. He is known to speak publicly in a sharp and direct way, potentially generating media headlines on China's diplomatic stance. China's voice and position will continue to strengthen globally – as has been the case in the past few years (roughly since President Trump's administration or President Xi's second mandate). This means that China will aim to position itself as a spokesperson for emerging markets. While we continue to think that the likelihood of a direct or indirect military conflict between the US and China is low over the near term, tensions and economic measures revolving the technology race and rivalry between the two countries are likely to remain.

[7] *For more details, see our story "China – The reopening is going well, but don't get too excited" in [The silver lining for global trade]*

In focus – Earnings season: The end of the corporate party?

Strong performance in the first half of 2022 more than compensated for the business deterioration in the second half of the year. Although 2022 was a bumpy year, with persistent high inflation, the continued conflict in Ukraine, tense geopolitics and China finally reopening, global corporate revenues jumped by +11.7% y/y and earnings per share (EPS) by +4.3% y/y (Figure 5).

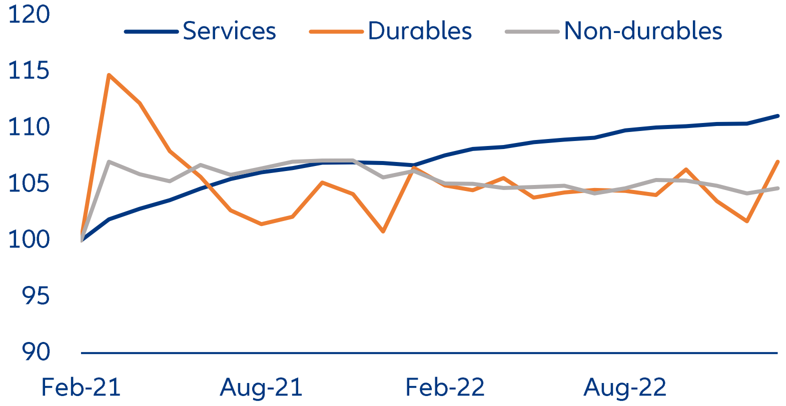
Figure 5. Revenue and earnings per share (EPS) y/y growth rates in 2022, global average

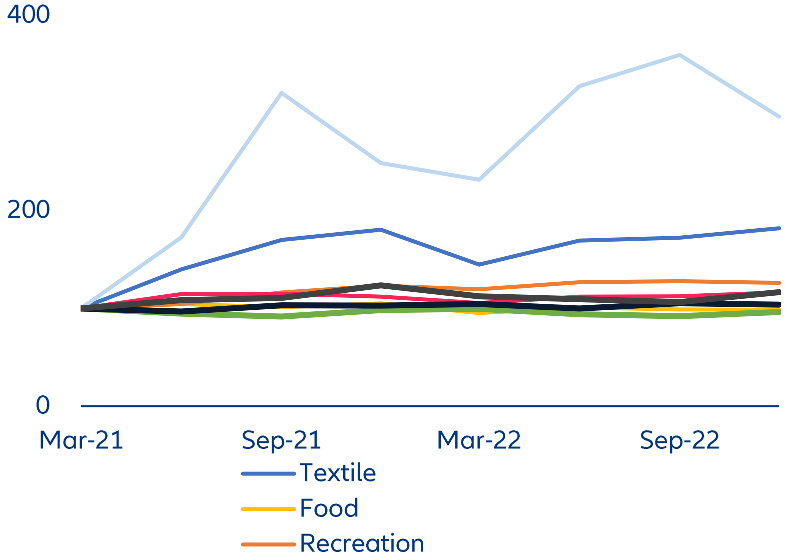


Sources: Eikon Reuters (Q4 considers financial results released until 06 March 2023), Allianz Research

Most sectors reported higher revenues and earnings, with oil & gas, transportation and hospitality sectors outperforming. The oil & gas sector benefited from the surge in oil prices and record-high refining margins after the invasion of Ukraine, while the post-pandemic air-traffic recovery and longer-than-expected momentum for ocean freight rates boosted the transportation sector. The hospitality sector benefited from rising occupancy rates and prices at hotels and restaurants after the lifting of pandemic restrictions on both sides of the Atlantic (Figures 6 and 7).

Figures 6 and 7. Consumer spending in the US (left) and Germany (right) in the past two years

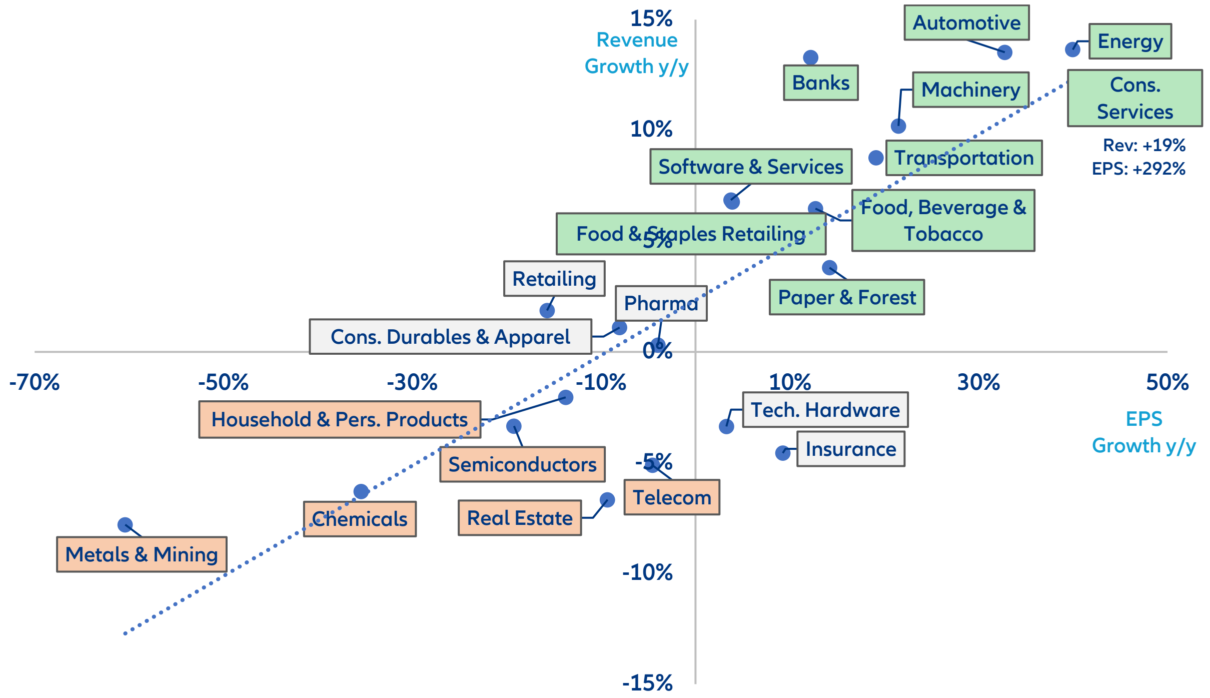




Source: Refinitiv Datastream, Allianz Research

While the automotive sector did better, metals & mining have had a challenging start of the year. Last quarter, the automotive sector surprised on the upside, with revenues growing on average by +14.0% y/y and EPS by +34.2%, particularly boosted by the performance of original equipment manufacturers (OEMs). Their revenues grew by +17.3% y/y and EPS by +48.7% y/y, thanks to the product mix, price increases, and production reorientation towards high-margin models. Higher volumes also helped: the industry sold 18.4mn vehicles worldwide in Q4 (+4.4% q/q and +2.9% y/y), a sign that it is progressively bouncing back from the chip shortage. The metals & mining sector struggled the most as demand waned amid recession fears and rising production costs squeezed margins (Figure 8). In fact, the latest data point to sluggish demand growth: global industrial production decelerated at +0.34% y/y in January 2023 compared to +0.5% on average over the last quarter of 2022.

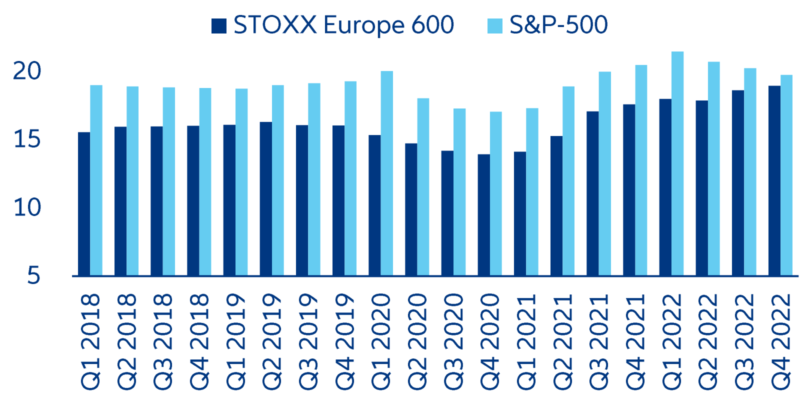
Figure 8. Q4 2022 revenue and earnings per share growth by sector, global average



Sources: Eikon Reuters (as of 07 March 2023), Allianz Research

The profitability gap is narrowing between the US and Europe. Although businesses in the US have always had better margins than those in Europe, the gap between the two regions has tightened over the last few quarters. The EBITDA margin of US companies in major stock indices has significantly deteriorated (Figure 9), where it reached the pre-pandemic level of around 19.2%. In contrast, in Europe, the EBITDA margin continued to grow to 19.0% in Q4 2022 (from 17.6% in Q4 2021 and 16.0% in the 2018-2019 period) despite the proximity to the conflict in Ukraine. This resilience has been underpinned by government support to ease the burden of high energy bills, along with efforts made by industries to minimize energy consumption as much as possible (even without significant production cuts).

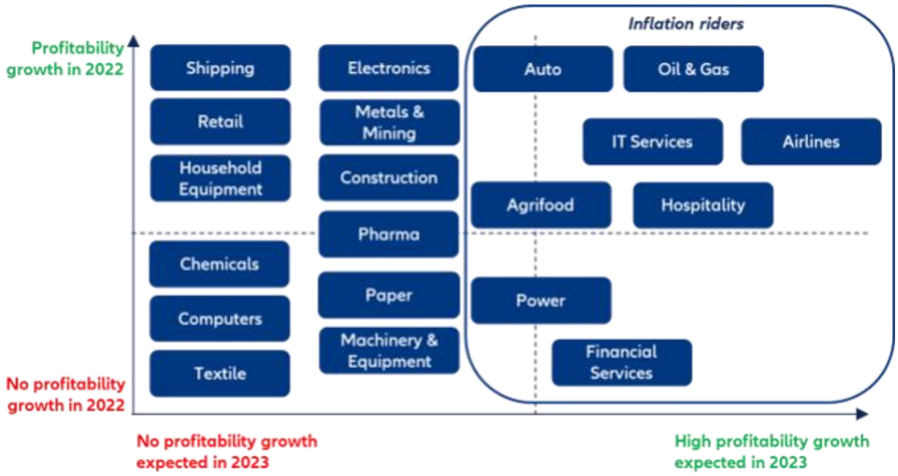
Figure 9. EBITDA margin (%) of the S&P-500 and the STOXX Europe 600



Sources: Bloomberg, Allianz Research

Looking ahead, we expect airlines to continue outperforming while shipping and retail will struggle. Booking numbers point towards another good summer season in 2023, boosted by increased tourists (with the return of Asian travelers) and prices at a peak for both flying and lodging. Airfares in particular show no sign of slowing down due to industry-wide capacity constraints, with delayed aircraft deliveries and a persistent shortage of pilots. Nevertheless, if persistent inflation intensifies the cost-of-living crisis, households might cut back on spending for leisure and tourism, which had become a "staple" in post-pandemic budgets. However, shipping and retail are suffering from a reversal in the supply-demand imbalance; oversupply is wiping out the gains made in 2021-2022 thanks to high post-pandemic demand. In Q4, shipping rates fell to near-2019 levels, while retailers have turned to steeper discounts to clear excess stocks. For 2023, our forecast for global trade growth in volume is +0.9%, which together with the expansion of ocean carriers' fleets will push shipping rates down further this year. For retailers, we believe that still-high inflation will further intensify price competition, continuing to diminish the sector's margins (Figure 10).

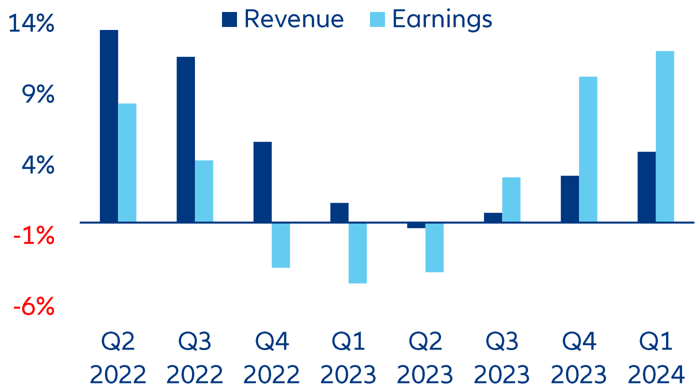
Figure 10. Profitability of each sector in 2022 (actual) and 2023 (expected)

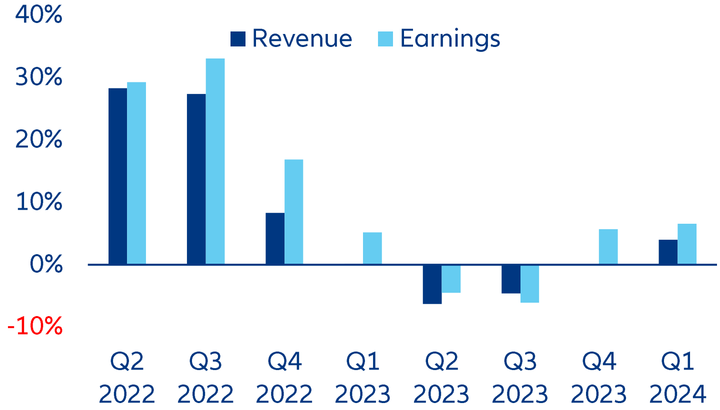


Source: Allianz Research

Amid a tough economic environment, 2023 is set to be a year of bold cost-cutting plans globally, with margin protection the top priority for companies. While pricing power varies between sectors, the general sentiment is that the price hikes of 2022 have already gone too far; many companies have said it is now impossible to continue raising prices without losing market share. This capped pricing power coupled with still-high production costs (labor, energy and commodities) will continue squeezing corporate profits, at least in the first half of this year and mostly in the US. No revenue growth is likely in the first quarters of the year in both the US and Europe, while the fall in EPS for American and European companies may be hitting the bottom in Q2 and Q3, respectively (Figures 11 and 12). This outlook is confirmed by the increased amount of negative guidance released so far by companies' executives.

Figures 11 and 12. Quarterly revenue and EPS y/y growth for the S&P-500 (top chart) and the STOXX Europe 600 (bottom chart), actual figures and market forecasts



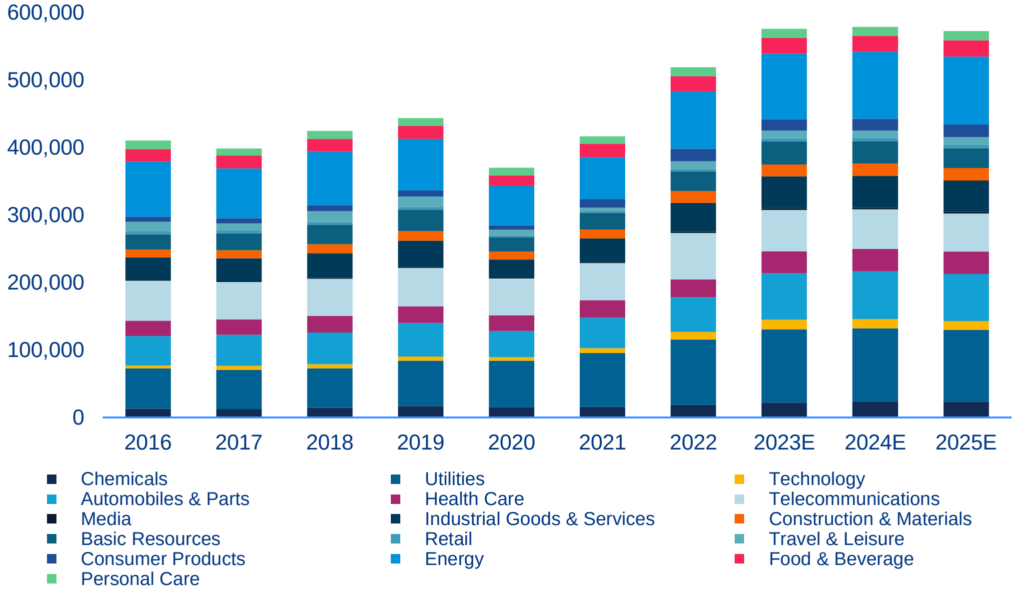


Sources: Eikon Reuters (as of 28 February 2023), Allianz Research

Although balance sheets remain solid, with cash levels still above those of 2019, we can expect a reduction in share buyback programs, additional restructuring projects and personnel rightsizing. Nevertheless, we do not see companies skimping in capital expenditures this year as long-term growth expectations (2024-2025) require short-term investments in anticipation. Especially in Europe, capex has recently been boosted by the European Green Deal[8] agreed in 2020, with growth of +12.5% in 2021 and +24.5% in 2022. A further +11% increase is estimated in 2023, driven by increases in the automotive (+35% y/y), energy (+15%) and utilities (+13%) sectors, for which the market expects large investments to reach the EU's green objectives (Figure 13).

[8] In July 2020, the EU adopted the "Taxonomy on Sustainable Activities", which sets out the conditions that economic activity has to meet in order to qualify as environmentally sustainable, reinforcing the need to redirect money towards sustainable projects.

Figure 13. Capital expenditures (EUR mn) by sector in Europe, actual and forecast numbers



Sources: Bloomberg, Allianz Research

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