PERSPECTIVE

Emerging Markets Third-Quarter Recap: A Stellar Rally

October 20, 2017

Templeton Emerging Markets Group has a wide investment universe to cover—tens of thousands of companies in markets on nearly every continent. While we are bottom-up investors, we also take into account big-picture context. Here, I share the team's overview of what has happened in the emerging-markets universe in the third quarter of 2017, including some key events, milestones and data points to offer some perspective.

Three Things We're Thinking about Today

1. Corporate earnings for emerging-market companies have been showing strong and synchronized growth, driving compelling fundamentals for emerging-market equities. For example, several Chinese internet companies have reported earnings that consistently exceeded market forecasts in recent quarters. In Europe, a rebound in commodity prices has led to positive earnings revisions for metal-and energy-related companies in Russia.
2. We view China's automobile market favorably. The rise of China's upper middle class has continued to drive luxury car demand in the country, as buyers pay more attention to vehicle performance and product quality. Even though China is the largest market globally for cars, vehicle ownership rates in the country remain quite low in comparison with developed markets, indicating potential for further growth.
3. India's economic growth remains strong in a global context, despite a slight deceleration in the second quarter of 2017. Consumer demand has been a key growth driver over the past few quarters and demand arising from the festival season in October could further support growth in the latter part of 2017.

Outlook

We remain optimistic about opportunities among emerging-market equities in the current climate, while remaining mindful of potential risks. Tensions on the Korean peninsula have caused some investors to worry. An outbreak of violence could have global ramifications, with a particular impact on North Asia. However, this threat has been in existence for a long time, and most investors familiar with the region have become accustomed to it.

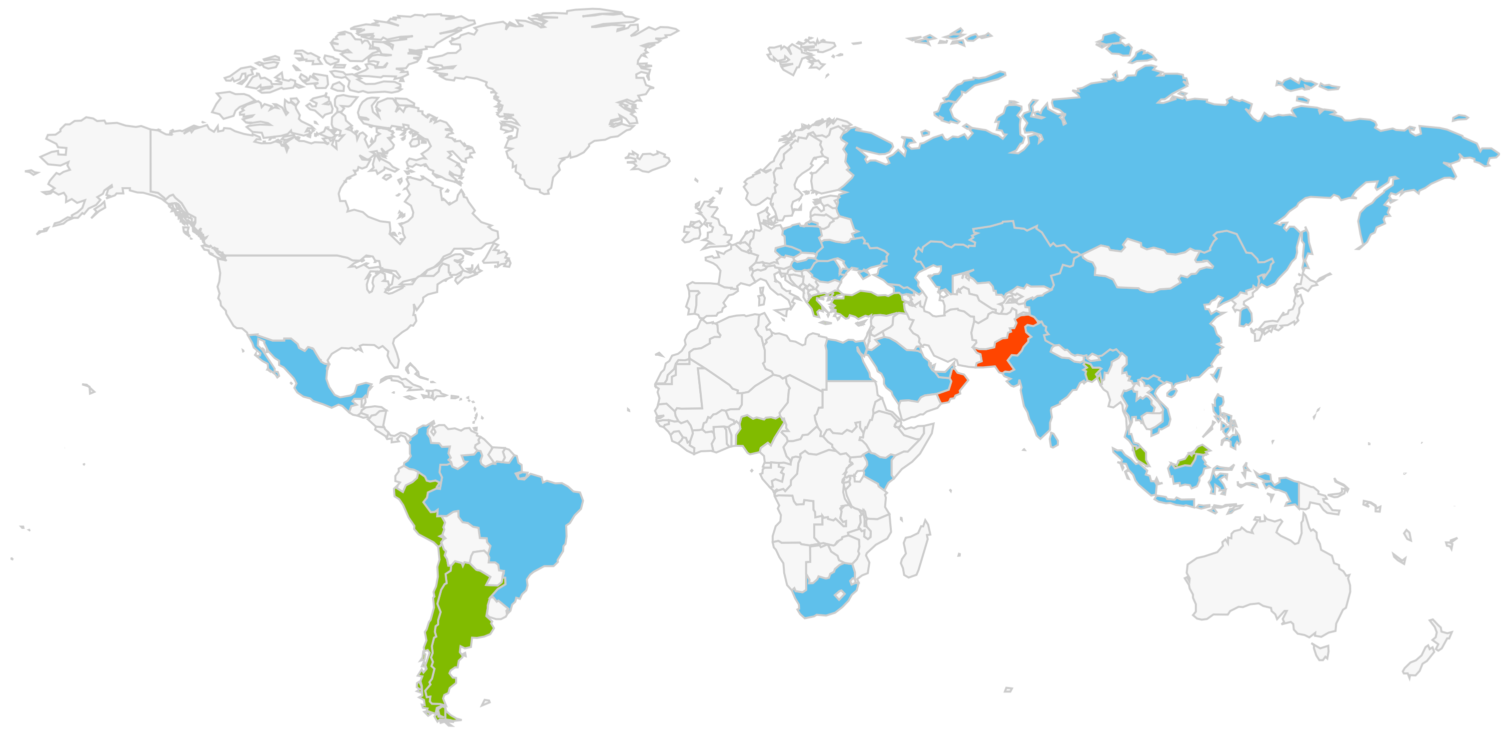
For our part, we continue to proceed with our value-oriented investment process, taking into consideration market sentiment. We believe it is important for investors to be globally diversified through portfolios that include exposure not just to South Korea or Asia but also to other parts of the world.

Overall, we believe the investment case for emerging markets continues to center around demographics, a rising middle class and domestic consumption. The most striking development recently, though, is the dramatic transformation of many emerging-market companies that used to depend on "old-economy" models (such as commodities or infrastructure) moving into more innovative, value-added products and services.

The technology space is especially interesting to us in this regard, with several emerging-market companies becoming leading players in the development of world-class technology.

Regional Outlook

As at 30 September 2017



Regional Outlook

As at 30 September 2017

Bangladesh
: All macro indicators seem positive, downside to investments appears low.

China
: Our overall outlook for China remains stable. Supply-side reforms have not only helped sectors that were facing overcapacity but also banking sectors, by reducing the nonperforming loans from state-owned enterprises in the affected sectors. We believe the strengthening renminbi has also relieved the fear of capital flight and rebuilt confidence in China for many overseas investors.

Hong Kong
: Hong Kong may see a slowdown in the second half of 2017 following robust performance in the first half, as the factors driving that performance liquidity, Chinese economic growth and asset market booms may not be sustainable.

India
: Strong macro fundamentals, under-penetration and strong management talent make Indian corporations attractive to us, but fairly rich valuations with near-term earnings challenges make us neutral on the market.

Indonesia
: Economic growth should hold steady this year, recovering slowly. Politics will likely heat up in 2018 with the presidential election in April 2019.

South Korea
: Macro indicators are sound but concerns on regulation and geopolitical risks are growing.

Malaysia
: Market valuations appear fair but may continue to increase on the back of positive earnings revisions and a strengthening ringgit. Short-term risks include crude oil price volatility and upcoming elections.

Pakistan

Uncertainty remains with concerns on a political reshuffle and a high current account deficit.

Philipenes

Stable outlook, with a potential upside if the tax reform package is passed in the Senate in September/October and if the government speeds up infrastructure spending.

Singapore

We anticipate political stability and improving gross domestic product (GDP) growth this year and next.

Sri Lanka

Macro picture appears negative but could likely improve.

Taiwan

Macroeconomic data is stable and positive. Geopolitical situation is relatively safer when compared with other countries in the region. However, we are carefully monitoring the strong currency and demanding equity market valuations.

Thailand

Our overall outlook remains stable to slightly positive. In our opinion, economic stability remains strong with a possible gradual improvement in economic growth.

Vietnam

Annual GDP growth is likely to be above 6%, underpinned by resilient domestic demand, rebounding agricultural production, and strong export oriented manufacturing. This is likely to be only partially offset by declining oil production.

Czech Republic

Strong economy not currently reflected in stock market performance. We are carefully monitoring October elections—if ANO gets majority, low risks to investors' perception change and possible upside given reasonable market valuation, high yield and strong economic outlook.

Georgia

The central bank seems to have inflation and the currency more under control. GDP growth is strong and the government continues to push a healthy reforms agenda. Economy is still vulnerable, though, as a large part of GDP formation is correlated with Russia.

Greece

2017 and 2018 expected GDP growth point to a recovery in Greece, so the past crisis might be well behind us. Balance sheet constraints for companies may be limiting the recovery, however.

Hungary

Relatively good macro outlook, stable political situation and discounted market valuation vs. broader EMs lead us to take a rather positive near-term outlook for the market.

Kazakstan

We have an overall stable outlook. Potential risks include oil price volatility.

Poland

Strong economy, and we see no major visible risks to continued robust economic growth despite more conflict with the European Union. However, the recent rally means attractively priced opportunities may be limited.

Romania

The government's populist reforms are pushing some macro indicators in the wrong direction: increased budget deficit, increased current account deficits (driven by consumer spending from unsustainable salary increases) and increased inflation. All these will likely put pressure on the currency and interest rates going forward, which may impact GDP growth starting 2018.

undefined

In a stable oil price/ruble environment, domestic names should benefit due to earnings revisions and increased demand. Political situation should remain stable as no serious competition is expected in presidential elections next year. However, macro risks are high due to high volatility of commodities prices.

Turkey

With the current expansionary fiscal policy, GDP growth expectations for 2017 have increased to 5%–6%. There will be two elections in 2019, but we think Turkey should perform strongly until that point.

Ukraine

Reform process may be slow but the country seems to be moving to a more stable political and economic environment. Valuations of listed companies are low and imply high cost of equity.

Argentina

The economic recovery is gaining strength, which, combined with a favorable election outcome in October, should sustain asset performance into the next 12 months.

Brazil

The near-term outlook is challenging in view of 2018 presidential elections, which should bring higher volatility, although a favorable outcome is expected. Our long-term outlook is positive with a new president likely to continue promoting reforms.

Chile

The likely victory of pro-market candidate Piñera should pave the way for a recovery in business and consumer confidence, supporting investment and consumption.

Columbia

The Colombian economy is showing encouraging signs with receding inflation and better consumer trends. Consumers seem to have assimilated the value-added tax (VAT) increase from its fiscal reform. The economy and, in particular, government finances should improve on the back of stable/increasing oil prices and better execution of its infrastructure program.

Mexico

Macroeconomic outlook is stable and equity valuations are slightly below historical averages. We believe Mexico's risk profile has increased with the ongoing NAFTA renegotiation (we expect a positive outcome) and the 2018 presidential election. The latter could lead to increased volatility given the tight expected race based on recent polls.

Peru

GDP growth is expected to have bottomed this year after the economy was hit with the ramifications of the Oderbrecht scandal and abnormally high rains in the first half of the year. GDP growth should accelerate driven by a healthy consumer environment coupled with higher metal prices. Valuations for financial institutions and consumer names look attractive to us.

Kuwait

Potential FTSE upgrade would be a positive catalyst for the market. This market's fiscal position appears stronger than its regional peers and hence more defensive. A persistent risk is political deadlock, which often leads to slower fiscal reforms and investments.

Oman

Oman's economic situation remains fragile. Reforms are picking up but more needs to be done to decrease the fiscal deficit. Debt levels remain relatively low but are creeping up quickly, while foreign reserves are relatively low compared to regional peers.

Qatar

Risks include slowing economic growth, political conflict and deadlock, and continued weak investor appetite.

Saudi Arabia

Economic growth appears stable, and the National Transformation Plan is being redrafted to reflect more realistic targets.

United Arab Emirates

Within the region, the UAE is least dependent on oil revenues. Fiscal reforms have been successful, and we expect further reforms such as VAT implementation. However, the strong property sector needs to be monitored closely.

Egypt

Egypt has made a committed step toward economic reforms. It is witnessing receding inflation and a strengthening currency.

Kenya

If we look past the elections and assume stability after the result, Kenya will likely tick along at 4%–5% growth. However, we think the market has already priced in this potential outcome.

Nigeria

The market is improving from a macro perspective with higher oil production, better oil price, steadying inflation, and a floating currency.

South Africa

Much depends on the ANC elective conference in December—if the Zuma faction loses, that could be positive for South Africa.

Emerging Markets Key Trends and Developments

Emerging-market equities significantly outperformed their developed-market counterparts in the third quarter of 2017, with the MSCI Emerging Markets Index surging 8.0% compared with a 5.0% gain in the MSCI World Index, both in US dollars.[1] This outperformance came despite a slight pullback in September, the first month of decline for emerging-market equities in 2017.

For the quarter as a whole, some of the main drivers of emerging-market performance included generally encouraging economic data from China, signs of economic recovery and hopes for reform in Brazil, a strong rebound in global commodity prices based on firming demand, and emerging-market currency strength against the weaker US dollar.

The Most Important Moves in Emerging Markets This Quarter

Amid a general rally in global equities and a return of investor confidence, the largest emerging markets—Brazil, Russia and China—were among the top performers in the third quarter.

Brazil posted a substantial double-digit gain, fueled by easing monetary policy, appreciation in the real against the US dollar, hopes for continued reform and higher commodity prices. In Latin America, Chile and Peru were also notable performers, on encouraging political developments, progress in second-quarter economic growth, and, for Chile, stronger copper prices.

A solid earnings season buoyed Russia, along with a rally in oil prices and appreciation in the ruble. In Europe, Hungary and Poland also gained ground. However, Greece was an outlier, recording a double-digit decline, especially toward the end of the quarter on worries about asset quality in its banking sector.

A robust earnings season also drove China’s market. Additional factors included inflows from foreign investors and solid second-quarter economic growth, the latter supported by strength in industrial production, retail sales and fixed-asset investment.

In Asia, Thailand’s market saw a double-digit gain on the back of stronger-than-expected economic growth driven by exports and tourism. In contrast, Pakistan was among the worst performers in emerging markets overall, impacted by a sharp mid-quarter decline due to political turmoil.

Markets in Africa gained moderately in the third quarter. Although South Africa rose, it underperformed its global peers as it continued to be impacted by weakness in the rand, political uncertainty and investor outflows.

Frontier-market stocks also moved higher over the quarter, performing largely in line with their emerging-market counterparts.[2] However, performance across individual markets was much more widely dispersed. Markets such as Kuwait, Kenya and Argentina recorded significant gains. Meanwhile, Nigeria lost ground, affected by the naira’s sharp devaluation in August. Sri Lanka and Ukraine were also among markets that declined.

Emerging-Market Earnings Growth

FRANKLIN TEMPLETON INVESTMENTS

September 2002–September 2017

Sources: FactSet, MCI Emerging Markets Index, as of September 30, 2017. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance. See www.franklintempletondatasources.com for additional data provider information.

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Important Legal Information

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Based on the MSCI Emerging Markets Index versus the MSCI World Index, US dollar terms. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. The MSCI World Index captures large- and mid-cap performance across 23 developed markets. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance.

2. Based on the MSCI Frontier Markets Index, which captures large- and mid-cap representation across 30 frontier markets countries. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance.