PERSPECTIVE

Emerging Markets Experience a Volatile First Quarter

April 11, 2018

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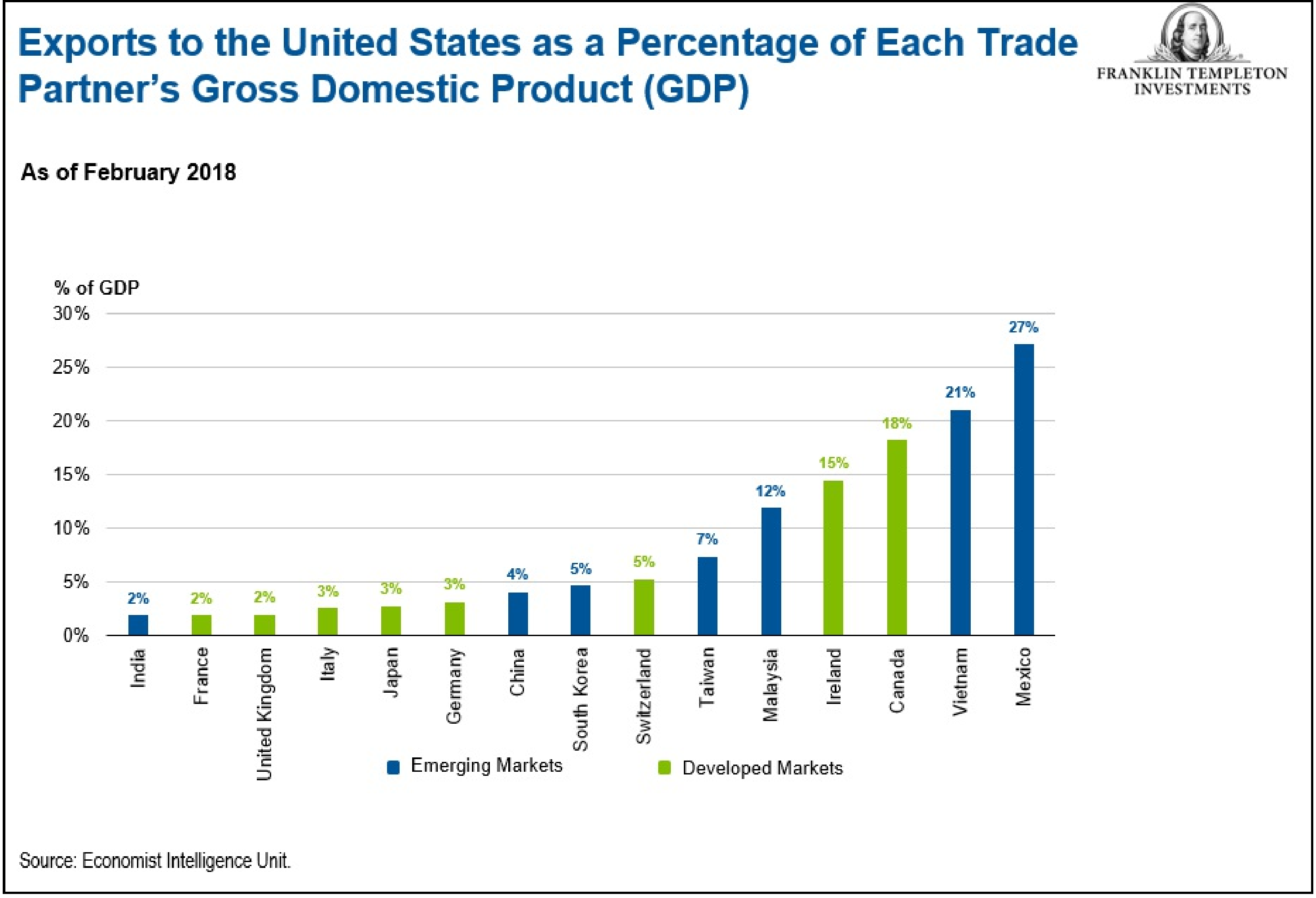
Volatility hit global equity markets hard in the first quarter of 2018, and emerging markets were certainly not immune. Franklin Templeton Emerging Markets Equity CIO Manraj Sekhon and Chetan Sehgal, senior managing director and director of portfolio management, present the team's overview of what has happened in the emerging-markets universe in the first quarter of 2018, and offer their perspective on the potential impact of recent US-China trade tensions.

Three Things We're Thinking about Today

1. The United States is a large net importer of goods, and China alone is responsible for roughly 60% of the US trade deficit. Thus, **protectionist measures** initiated by the US could likely have an impact on Chinese exports to the United States. Despite retaliatory actions from China, we do not anticipate a full-blown trade war. Structurally, China is rebalancing its economy and is also actively diversifying away from the United States as a key export destination. At present, exports to the United States constitute less than 5% of China's gross domestic product (GDP) and this has been on a downward trend. This is significantly lower than the US' other trade partners. We believe that trade disruptions should only impact China in the short term and may help speed up China's efforts to upgrade its economy with additional investment in the service and higher value-added manufacturing sectors.
2. The **information technology** (IT) sector experienced increased volatility over the quarter. An increase in regulatory scrutiny, concerns about data and user-privacy practices in social media companies and trade worries provided investors with reasons to realize gains. Taking a longer-term view, however, we believe that fundamentals generally remain sound. The IT sector in emerging markets continues to provide many interesting opportunities, from hardware and software to various forms of e-commerce and entertainment. The key is to evaluate the sustainability of companies' earnings and valuations relative to their history as well as peers. We are also monitoring plans to introduce China depositary receipts of offshore-listed companies, as this could be a positive catalyst for US- and Hong Kong-listed Chinese IT companies.
3. North Korean leader Kim Jong Un visited China in late March to meet President Xi Jinping. Kim's commitment to denuclearization indicates movement in the right direction. While it is too early to draw any conclusions, geopolitical risk in the region has eased recently. Any concrete steps could bode well for the **Korean peninsula** and may result in increased economic activity between the South and North, which could benefit South Korean companies. Agreement on a revised US–South Korea trade agreement also eased trade concerns. South Korea has a powerful export sector encompassing a range of products—shipbuilding, construction, car making, consumer electronics and advanced technology, among others—with globally competitive levels of expertise in many fields. A sophisticated domestic consumer economy along with increasing penetration of South Korean brands into other Asian markets also bode well for South Korean companies.



Outlook

We believe prospects for emerging markets remain sound despite the recent increase in volatility. Emerging markets have historically bounced back from external shocks, and they displayed a healthy resilience amid choppy trading in early 2018. We still see strong tailwinds underpinning emerging-market equities even as we are mindful of the challenges that may arise.

Importantly, emerging-market economies look poised for further growth. The International Monetary Fund estimates 4.9% GDP growth for emerging markets in 2018, up from 4.7% in 2017.[1] While protectionist trade actions taken by the United States have cast a shadow over the synchronized global growth that has lifted stock markets, the long-term outcome remains to be seen. The scope and strength of international trade flows should not be underestimated, as evident by the historical growth in intra-Asia trade.

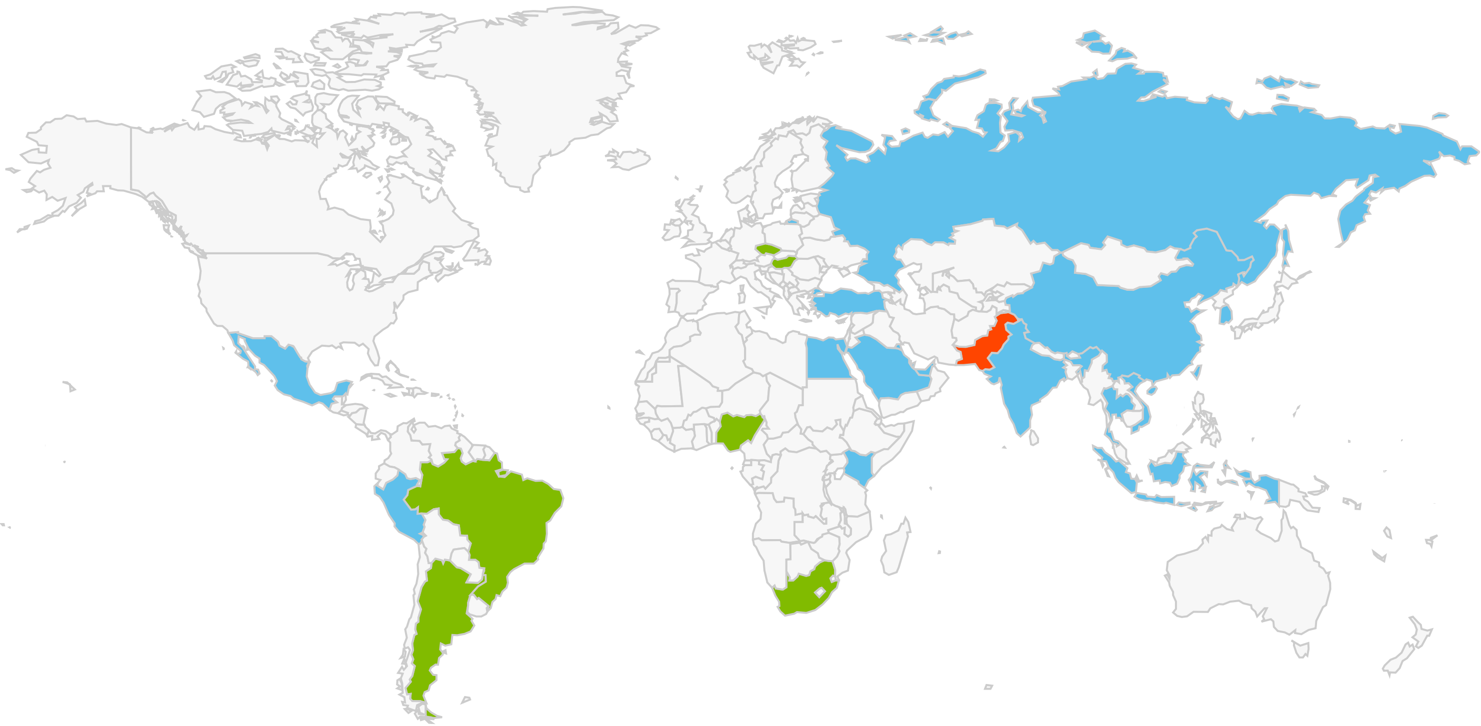
We believe that the key drivers for emerging markets—IT and consumerism—remain intact. EM companies have not only embraced the use of technology but have also become global innovators in many areas, ranging from e-commerce to mobile banking, robotics, autonomous vehicles and more. Rising wealth in emerging markets is another secular driver. We expect demand for goods and services to continue growing as incomes head higher. And as consumers meet their basic needs, aspirational wants usually follow. This "premiumization" trend could boost demand for high-end items such as luxury cars or for services such as entertainment and wealth management.

Emerging Markets Key Trends and Developments

Global markets started 2018 on a high note, but a slowdown in global growth momentum and concerns about a potential trade war between the United States and China weighed on market sentiment later in the quarter, curbing January's gains. Emerging markets as a group, however, ended the quarter in positive territory, outperforming their developed-market counterparts. The MSCI Emerging Markets Index returned 1.5% over the three-month period, compared with a 1.2% correction in the MSCI World Index, both in US dollars.[2] Strong asset-class inflows, higher oil prices and a strong corporate earnings season drove returns in EM equities.

Regional Outlook

As at 30 June 2018



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As of 31 March 2018

China
: The overall outlook for China remains stable but we need to be cautious as uncertainties are rising. Supply side reforms and deleveraging could help ease structural risks but rising trade tensions could offset the benefits of stronger global growth.

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 lead us to maintain a neutral view on the market.

Indonesia
: Economic growth has been recovering slowly. However, politics will likely heat up in 2018 with the presidential election in April 2019.

South Korea
: Macro indicators remain sound with recent signs of improvement in the geopolitical situation but concerns about government regulations remain.

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

Taiwan
: Cross-strait geopolitical risk has always existed and is well-known. Macroeconomic data remain healthy but inflation may start to rise, pressuring interest rates. A strong Taiwanese dollar continues to weigh on corporate earnings.

Thailand
: Overall outlook remains stable, with gradual improvement in economic growth.

Vietnam

Steady outlook. GDP above 6%, underpinned by resilient domestic demand, rebounding agricultural production, and strong export-oriented manufacturing, which will be only partially offset by declining oil production.

Czech Republic

Strong economy not currently reflected in stock market performance. We are carefully monitoring the ANO party's political agenda, especially since it failed to form a coalition with other parties.

Hungary

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

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In a stable oil price/ruble environment, domestic names should benefit due to earnings revisions and increased demand. The political situation should remain stable following the re-election of President Putin. However, macro risks are high due to volatile commodity prices and the possibility of additional US/EU sanctions.

Turkey

With the current expansionary fiscal policy, 2018 GDP growth expectations have increased to 4%. There will be two elections in 2019, but we think Turkey should perform strongly until that point.

Argentina

The economic recovery is gaining strength, which, combined with a favorable election outcome in October, should pave the way for the much-desired upgrade from frontier to EM status. Higher international rates, however, have punished the high-beta Argentine market. On balance, our outlook is positive.

Brazil

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

Mexico

Macroeconomic outlook is stable and equity valuations are below historical averages. We believe Mexico's risk profile has increased with the ongoing NAFTA renegotiation and the 2018 presidential election. The latter could lead to increased volatility given the tight expected race based on recent polls. Economic activity tends to remain strong leading up to presidential elections.

Peru

Political uncertainty and additional problems in the construction sector led to a reduction in 2018 GDP growth forecast from 4.2% to 3.5%, despite high copper prices. Peru has been resilient to several episodes of low popularity of its presidents, which has not prevented the economy from growing at a steady pace.

Kuwait

Potential FTSE upgrade could 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.

Qatar

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

Saudi Arabia

FTSE and the potential MSCI EM upgrades could be strong catalysts for the market. The country continues to have stable economic growth, while the National Transformation Plan and Vision 2030 is being redrafted to reflect more realistic targets.

United Arab Emirates

Within the region, the UAE is least dependent on oil revenues. Fiscal reforms such as the recent value-added tax (VAT) implementation have been successful. The economy boosts a robust service sector, and positive current account and fiscal balances. The strong property sector, however, needs to be monitored closely.

Egypt

Egypt has made a committed step toward economic reforms. It is witnessing receding inflation and a strengthening currency but some security risk still exists.

Kenya

With election results now validated and protests muted, 2018 economic growth is likely to be about 5%. However, we think the market has already priced in this outcome.

Nigeria

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

South Africa

The political change has significantly improved the country’s prospects. The implementation of reforms and job creation could drive growth.

The Most Important Moves in Emerging Markets the Quarter

Asian stocks nudged higher in a volatile quarter, with Pakistan, Thailand and Malaysia posting the strongest returns. Pakistan introduced measures to shore up its economy, including a devaluation of the rupee to cope with a growing current account deficit. Thailand rose on the back of soaring exports that underpinned the government’s robust economic outlook for the year. Malaysia benefited from the ringgit’s advance to its highest level in nearly two years. Conversely, the Philippines, Indonesia and India were the weakest performers. The Philippines and Indonesia were hobbled by sharp declines in their currencies. India fell following the reintroduction of a long-term capital gains tax on equities.

Latin America was the top-performing region over the quarter, mainly due to strong performance in January. Brazil and Peru recorded double-digit gains over the quarter, while Mexico and Chile lagged. Brazil was supported by lessening political uncertainty and expectations of continued easing monetary policy following a 50-basis-point cut in the benchmark interest rate over the quarter to a new record low. This came despite disappointing fourth-quarter GDP growth. In Peru, investors hoped that the resignation of President Pedro Pablo Kuczynski amid a corruption scandal could allow the government to focus on the economy. In Mexico, however, lower manufacturing and consumer confidence data coupled with monetary policy tightening weighed on stock prices.

In Europe, Russia and the Czech Republic stood out, while equity prices in Poland, Greece and Turkey declined. Higher oil prices, stronger earnings growth prospects and undemanding valuations supported the Russian market. But in Poland, concerns that a strong zloty could hurt exports overshadowed strong economic growth data for the fourth quarter of 2017. Weakness in the Turkish lira was largely responsible for the decline in that market. Greece retreated despite moving closer toward exiting its bailout program and the approval of a package of fiscal, labor and energy reforms.

The South African market declined over the quarter, underperforming its EM peers, despite stronger-than-expected fourth-quarter GDP growth and an interest-rate cut in March. International ratings agency Moody’s also raised the country’s sovereign outlook from negative to stable. African National Congress (ANC) leader Cyril Ramaphosa was sworn in as South Africa’s new president following the resignation of Jacob Zuma. Egypt was among the top emerging-market performers, driven by an aggressive monetary easing policy and an upgraded GDP growth forecast for the current fiscal year.

Frontier markets outperformed their emerging-market counterparts during the quarter, with Kenya, Romania and Vietnam recording double-digit gains. Foreign and domestic investor interest continued to support the Vietnamese market, which reached a record high during the three-month period. In contrast, Argentina was among the weakest, impacted by profit-taking after strong performance in 2017, concerns surrounding wage negotiations and inflation, and effects of a longer-than-expected drought.

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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. Source: International Monetary Fund World Economic Outlook January 2018 Update. There is no assurance that any estimate, forecast or projection will be realized.

2. 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.