PERSPECTIVE

July Recap and Outlook: Frontier Markets Lead Rebound

August 20, 2018

Manraj Sekhon, CFA
Chief Investment Officer
Franklin Templeton Emerging Markets Equity

Chetan Sehgal, CFA
Senior Managing Director, Director of Portfolio Management,
Franklin Templeton Emerging Markets Equity

July marked the first month of the calendar year where emerging markets posted positive performance overall, with frontier markets leading the way. Manraj Sekhon, CIO of Franklin Templeton Emerging Markets Equity, and Chetan Sehgal, senior managing director and director of portfolio management, present the team's overview of the emerging-markets universe and three things on their mind in particular today.

Three Things We're Thinking about Today

1. The left-wing coalition headed by Andrés Manuel López Obrador (AMLO) won by a landslide in **Mexico's** general election. We do not expect a radical change in terms of Mexico's fiscal or central bank policy as a result of AMLO's win. Overall, we continue to have a positive outlook for the country. High consumer confidence, combined with a gradual disinflation process, a healthy labor market and credit availability, should help support private consumption this year. If the new administration can deliver on its promises and still preserve solid economic fundamentals, we could see healthy growth in Mexico this year and in 2019.
2. The recent market correction across emerging markets has made valuations even more attractive, helping us find interesting opportunities related to secular technological trends. Growth in the **e-commerce** sector, for example, continues to accelerate, gaining an increasing share of the retail market in countries such as China and India. We believe the long-term growth of e-commerce companies hinges on their ability to scale and increase their market penetration. More importantly, these companies are using innovation to their advantage to disrupt traditional business models in other industries such as transportation and health care to pursue new revenue streams.
3. We believe **China's** deleveraging process has been more orderly than may appear at first glance. The fact that regulators allow banks to report non-performing loans reflects their confidence in the system's ability to bear those losses. We remain positive on China's overall growth trajectory. Some observers estimate that the trade war and other issues could shave up to 100 basis points off China's gross domestic product (GDP) growth, but this is not much considering that growth is still expected to exceed 6% this year.[1] We continue to favor companies that stand to benefit from structural trends like e-commerce, growing affluence and premiumization.

Outlook

Rising trade tensions, particularly between the United States and China, have prompted a cautious investor outlook, affecting emerging markets over the short term. However, we believe the market correction was overdone, and a widespread recovery could occur in the second half of the year. In our opinion, what has been hurting sentiment is not trade policy itself, but the uncertainty caused by escalating trade tensions. We believe businesses can adapt and develop long-term strategies around trade policies once there is greater clarity.

We consider fears regarding US dollar strength to be overblown. While a few countries such as Argentina and Turkey may have skewed overall investor perceptions, we believe that many emerging-market (EM) currencies are attractively valued and well-supported after recent downward moves. On the US dollar, short-term global risk aversion and a slight upward move in the US interest rate trajectory have contributed to strength, but we do not expect these drivers to be sustained over the long term.

EM equity fundamentals remain strong, a factor largely ignored by the market. Cash flow generation has accelerated considerably, which, when paired with better capital allocation discipline, improves returns to shareholders and results in corporate balance sheet deleveraging. Similarly, earnings growth has been resilient, supported by technological advances and domestic drivers such as consumerism. Moreover, valuations in general have become even cheaper despite this good news.

Our investment philosophy remains centered on three tenets: value, patience and a bottom-up approach. We take a holistic view of value to also assess sustainability, quality and growth.

Emerging Markets: Key Trends and Developments

EM equities rebounded in July but trailed their developed-market counterparts. Constructive trade talks between the United States and European Union eased fears of a global trade war and lifted investor sentiment. EM stocks recorded their first monthly gain since January this year, aided by local currency strength against the US dollar. The MSCI Emerging Markets Index returned 2.3% over the month, compared with a 3.1% gain in the MSCI World Index, both in US dollars. [2]

The Most Important Moves in Emerging Markets in the Quarter

- Asia recovered amidst hopes for a respite in global trade tensions. Thailand, the Philippines and India advanced the most. Thailand’s economic activity continued to accelerate, and the government raised its outlook for export growth this year. India rallied on a string of positive news, including strong corporate earnings and lower goods and services taxes on a range of consumer products. Conversely, China and South Korea declined. China was held back by ongoing trade tensions with the United States and the yuan’s fall against the US dollar. South Korea trimmed its economic growth forecast for 2018, citing weakness in investments and the labor market.
- Positive political developments and stronger domestic currencies propelled Latin American markets in July. Brazil and Mexico were among the top markets. Equity prices in Brazil were driven by favorable election news, strong earnings results and appreciation in the real. In Mexico, despite some initial fears of a less business-friendly administration, the peso and financial markets largely rallied in July. The new government vowed to uphold fiscal discipline, maintain an independent central bank and indicated that implemented reforms, including the privatization of the energy sector, would not be reversed. Colombia, in contrast, declined, largely due to a fall in oil prices.
- Easing concerns about a trade war between the United States and the European Union in July bolstered emerging European markets. Poland and the Czech Republic were among the top-performing markets in the region. Undemanding valuations continued to attract investors to the Russian market, despite declining oil prices in July. Turkey, however, significantly lagged its peers. Higher-than-expected inflation, inaction from the central bank and a devaluation in the lira weighed on equity prices. South Africa’s market was supported by growing reform expectations under President Ramaphosa, improved business and consumer confidence, and an appreciation in the rand.
- Frontier markets overall rebounded in July, faring better than their EM and developed-market peers. Argentina, Bahrain and Kuwait led performances. The Argentine market bounced back with a double-digit return after a weak first half, supported by an appreciation in the peso. Positive sentiment in Kuwait continued to be driven by the expected FTSE upgrade to emerging-market status later this year and hopes of inclusion in the MSCI Emerging Markets Index in the future. At the other end of the spectrum, Bangladesh, Jordan and Oman ended the month with declines.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

The comments, opinions and analyses expressed herein are solely the views of the author(s), are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

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.

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

2. Source: MSCI. 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. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

© 2018. Franklin Templeton Investments. All rights reserved.