PERSPECTIVE

Views on Emerging-Markets Equity and Select EM Countries

September 10, 2018

In light of the Turkish lira and Argentine peso currency drops, fears of emerging-market (EM) contagion appear to be on the rise, and various EM currencies have been under pressure. Here, Franklin Templeton Emerging Markets Equity provides perspective on some of the impacted countries in the headlines recently: Argentina, Turkey, South Africa and Indonesia. In the team's view, current EM weakness in select countries is not likely to result in macroeconomic contagion or broader asset-class crises.

Franklin Templeton Emerging Markets Equity

We think it is important for investors to take note that emerging markets are not homogeneous, and the countries that currently dominate the headlines represent a very small part of the EM universe. For example, more than 20 companies in the MSCI EM Index[1] are individually larger than the entirety of the Turkish stock market. So these countries' travails are not representative of the broader EM asset class.

Overall, we still have a constructive view on EM countries—most of which appear to be operating in an environment where economic growth is improving, commodity prices are stable, currencies in general are undervalued, and inflation is under control. The recent volatility allows us, as stock pickers, to identify fundamentally strong companies and invest at attractive valuations.

Argentina

Since mid-August, there have been renewed attacks on the Argentine peso, and inflation expectations rose. This has prompted the government to formulate more aggressive fiscal policies, which have so far been met with skepticism by the market. In our view, the financial program committed by the Argentine government is demanding, particularly when facing a presidential election in 2019. But the incumbent administration has a strong commitment to follow through, and Argentina continues to have support from the International Monetary Fund (IMF) and the international community. However, significant political uncertainties remain leading up to the presidential elections in 2019, and the current economic contraction is expected to continue for several months at least.

We are closely monitoring the sustainability of the administration's policies and the country's economic recovery prospects. Given the current volatility and uncertainty, we currently favor companies with US dollar-linked revenues.

Turkey

We remain cautious in Turkey. Political and institutional uncertainties, a structurally weak current-account position, higher oil prices, a sharp depreciation of the Turkish lira and high double-digit inflation amid a challenging geopolitical environment, have all dampened investors' confidence. After years of strong economic growth, an economic slowdown was a risk before the recent volatility, which is now being exacerbated.

South Africa

While the South African rand has experienced some selloff due to higher EM risk-aversion, we believe that it is primarily a function of the rand being among the more liquid bellwether EM currencies. Domestically, South Africa has a generally positive political environment given the new president’s business-centric approach, while Gross Domestic Product (GDP) growth is expected to recover from the weaker first half of the year, due to stronger agricultural output, consumer spending and construction.[2]

We expect the rand to recover once risk-aversion abates and domestic growth improves, and we are monitoring the consumer sectors accordingly.

Indonesia

In Indonesia, the rupiah fell to its weakest level in more than 20 years, partly due to its widening current account deficit. Bank Indonesia has ramped up efforts to stabilize the currency through direct market intervention, which has included four interest-rate hikes since May 2018. While the government has announced new regulations including higher import taxes for non-essential consumer goods in order to reduce the current account deficit. In the meantime, we believe companies that are highly leveraged on US dollar (USD) debt would be impacted most, alongside with those with high imported cost components, including pharmaceuticals, poultry and select consumer names. On the flip side, a weak rupiah would benefit companies with USD (or linked) revenue such as coal, metals and other export-oriented sectors.

We believe the country’s fundamentals to be largely intact. Indonesia has demonstrated continued resilience to external shocks, benefiting from ongoing reforms over the last decade that have sought to balance its growth drivers and accelerate domestic development.

We are finding potential investment opportunities in many sectors that could benefit from existing demographics and expected reforms. These include banks, which lend to both fast-growing corporations and provide mortgages, credit cards and other retail banking products to consumers, and companies in the consumer, resources and infrastructure-related sectors.

Our Bottom Line

In assessing the current state of EM equity, it should be noted that emerging markets consist of diverse countries with different economic growth drivers and varying levels of political risk. We believe the risk of broader EM contagion is limited, and current EM weaknesses in select countries are not likely to result in macroeconomic contagion or broader asset-class crises.

While there are certainly specific EM countries with challenged fundamentals that are perhaps skewing overall perceptions, the EM asset class as a whole remains in good health, in our view.

The case for emerging markets equities continues to be supported by a constructive global macro backdrop, higher GDP growth and improving economic fundamentals on the back of ongoing reforms. Cash-flow generation has accelerated considerably in recent years, which, when paired with better capital allocation discipline, can help improve long-term return potential to shareholders and typically results in corporate balance sheet deleveraging. Finally, earnings growth across EM companies has been resilient, while valuations have become cheaper during this period of market volatility.

Our key EM investment themes include the structural growth in the technology sector, rising consumption and economic reforms. We remain focused on selecting fundamentally strong companies that we believe should be well-positioned to capitalize on these secular trends, based on our assessments.

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What Are the Risks?

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: FactSet as of August 31, 2018. 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. They do not include fees, expenses or sales charges. 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.

2. Source: IMF World Economic Outlook Update, July 2018. There is no assurance that any estimate, forecast or projection will be realized.