PERSPECTIVE

August Recap and Outlook: Finding Opportunities in Volatility

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Market volatility marked the month of August, with sharp declines in the Turkish lira and Argentine peso souring investor sentiment for emerging markets overall. 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 in August and why they don't see the asset class heading for a severe crisis.

Three Things We're Thinking about Today

1. Sharp falls in the Turkish lira and Argentine peso stoked contagion concerns, knocking emerging-market (EM) currencies and equities in August. We believe the asset class is far from experiencing a severe crisis. Turkey makes up just a small part of the EM universe; within the MSCI Emerging Markets Index there are more than 20 companies whose individual weightings are larger than Turkey's as a whole.[1] Argentina is not in the index, but when it's included in 2019, its weighting is expected to be even smaller than Turkey's. Ultimately, emerging markets are a group of diverse countries with markedly different economic and political climates. While sensational headlines often cause indiscriminate selling across emerging markets, we can use this opportunity to invest in fundamentally sound companies at what we consider to be attractive valuations.
2. Shares in several online gaming companies came under pressure as regulators in China announced the possibility of limiting the number of new games, as well as the number of hours children spend on these games. An ongoing suspension in new game approvals—the result of a restructuring in government agencies—weighed on the industry. We maintain a positive view on the industry as we believe underlying fundamentals remain solid. We expect select companies to benefit from increased monetization of existing popular games and continued growth in other businesses, including digital content and online advertising.
3. Comprising more than 20,000 companies with an aggregate market capitalization of more than US$5 trillion and daily turnover of about US$40 billion,[2] we believe the EM small-cap asset class offers investors the potential for a significant opportunity. EM small caps are more likely to be driven by domestic demand, favorable demographics, local reform initiatives and innovative niche products. In our view, EM small caps offer attractive risk/return attributes in the current global economic environment, as exposure to the EM small-cap space typically complements exposure to the EM large-cap space, particularly in areas such as health care and consumerism. Moreover, given the size of the investment universe, EM small caps have generally limited research coverage, often resulting in mispriced stocks and providing active investors with attractive investment prospects.

Outlook

Macroeconomic factors—including mounting global trade tensions, a stronger US dollar and rising interest rates—have been primary contributors to market volatility this year. During such periods, EM equities generally face heightened risk aversion and indiscriminate selling, often at the expense of solid fundamentals. As long-term investors, we attempt to look past short-term market turbulence to identify long-term value in EM equities.

It is also important to note that the EM asset class is not homogeneous. As stock pickers, we can choose among the varied opportunities that emerging markets offer to build well-diversified portfolios that seek to avoid excessive risks. Overall, we still have a constructive view on emerging markets, which are operating in an environment of improving economic growth and stable commodity prices. EM currencies in general are undervalued, in our opinion.

Accordingly, we believe the contagion impact upon the broader EM asset class should be limited, given most countries have more robust institutions, orthodox economic policy, stronger finances, lower inflation and lower near-term financing requirements.

Emerging Markets Key Trends and Developments

EM equities retreated in August as uneven progress in trade talks and country-specific challenges weighed on the asset class. Turkey, Argentina and Brazil confronted steep drops in their currencies and stocks amid economic and political uncertainty. Conversely, developed-market equities advanced. The MSCI Emerging Markets Index fell 2.7% over the month, compared with a 1.3% gain in the MSCI World Index, both in US dollars.[3]

The Most Important Moves in Emerging Markets in August

- **Asian** equities fell, hampered by declines in Pakistan and China. In Pakistan, a newly elected government grappled with the country's massive current account deficit and potential need for an international bailout. China's trade row with the United States deepened as both countries imposed fresh tariffs on each other's goods and flagged more duties ahead. The trade tensions added to concerns around China's deleveraging campaign and weaker-than-expected economic data. Conversely, stocks in the Philippines, Thailand and South Korea stood out. The Philippine central bank unveiled its largest interest-rate hike since 2008 to tackle rising domestic inflation.
- **Latin American** markets beat a collective retreat, with stocks in Brazil, Chile and Peru leading the way down. Brazil's second-quarter economic growth was subdued as a nationwide truckers' strike hit businesses and consumers. Meanwhile, political uncertainty heightened ahead of a general election in October as jailed ex-president Luiz Inacio Lula da Silva remained popular in polls. Peru's economy grew less than expected in June, though its expansion in the second quarter as a whole was robust. Mexican equities fell the least within the region. Investor sentiment was cushioned by Mexico's new trade deal with the United States as both countries worked on revising the North American Free Trade Agreement (NAFTA).
- Emerging **European equities** lost ground as Turkey's economic and political challenges gripped markets. The United States raised tariffs on metals from Turkey amid deteriorating bilateral relations, fueling anxieties about structural weakness in the Turkish economy. The lira slumped, leading to a double-digit slide in Turkish equities. Greek and Russian stocks also declined. The United States announced new sanctions on Russia, triggering weakness in the ruble. In contrast, stocks in Hungary and Poland gained. Hungary's economy grew faster than expected in the second quarter. South Africa's stock market fell as the rand lost value, largely due to broad caution toward emerging markets and concerns around South Africa's proposed land reform.
- **Frontier markets** declined, faring worse than their EM counterparts. Argentina was the region's weakest performer as the peso tumbled. The government approached the International Monetary Fund for an early release of bailout funds, while the central bank hiked its key interest rate to 60% to shore up the currency. Stocks in Lebanon and Nigeria also pulled back. Nigeria's economic growth slowed in the second quarter as oil production declined. However, Oman, Bangladesh and Romania bucked the downtrend. Oman's budget deficit fell sharply in the first half of the year as oil and gas revenues surged.

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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: FactSet, as of August 31, 2018. See www.franklintempletondatasources.com for additional data provider information.

2. Source: Bloomberg, as of August 31, 2018.

3. Source: MSCI. 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. 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. Past performance is not an indicator or guarantee of future performance.