FRANKLIN TEMPLETON INVESTMENTS

PERSPECTIVE

October 11, 2018

Trade talks, country-specific concerns and a stronger US dollar created a challenging backdrop for emerging markets in the third quarter, but Manraj Sekhon, CIO of Franklin Templeton Emerging Markets Equity, and Chetan Sehgal, senior managing director and director of portfolio management, are looking beyond the noise of negative headlines. They highlight the effects of a growing disconnect between the negative sentiment permeating the market and positive emerging-market equity fundamentals, and present the team's overview of the emerging-markets universe in the third quarter of 2018.

Three Things We're Thinking About Today

1. The **US Federal Reserve (Fed)** raised its key interest rate by 25 basis points in September, its third increase in 2018, and in line with market expectations. The Fed is widely expected to raise the rate again in December and another three times in 2019. While some investors worry that rising US interest rates could hurt emerging markets, we found that previous tightening cycles did not lead to a long-term downward trend. In fact, since rates were first raised in December 2015, emerging-market (EM) stocks, as represented by the MSCI Emerging Markets Index, have risen over 40% cumulatively in US-dollar terms.[1]
2. An escalation in the trade dispute between the **United States** and **China** resulted in several rounds of tit-for-tat tariffs in recent months. Trade tariffs upon China have come at a challenging time, when its labor-cost advantage is fading and it is embarking upon the process of deleveraging. However, we believe supply-side reforms and deleveraging could help ease structural risks. Meanwhile, a shift towards innovation, technology and consumption as primary drivers of growth supports improved earnings sustainability. Corporate results have also been encouraging, with many companies not just reporting improved operating and financial performance, but also proposing to pay out a higher portion of earnings to shareholders.
3. The passage of two key laws required for the 2019 general elections and a solid macroeconomic environment made **Thailand** one of the best-performing emerging markets over the quarter. The economy grew by a faster-than-expected 4.6% year-on-year in the second quarter,[2] inflation remained well under control despite the rise in oil prices, and interest rates are close to record lows. A current account surplus and large foreign reserves supported the Thai baht. While Thailand's market trades at a premium to its EM peers, we can still find stocks at attractive valuations. We believe major domestic banks are key beneficiaries of Thailand's economic recovery and appear attractively valued to us. Retail companies are another area of interest as they stand to benefit from the rise in consumption ahead of the elections.

Outlook

In the last decade, China has surpassed the United States to become a far more important export market for most large emerging economies, mainly due to its burgeoning consumer market. Thus, trade growth now predominantly comes from intra-EM demand. Rising protectionism in the West may further pivot focus towards regional agreements. Indeed, China appears eager to replace US trade leadership in Asia.

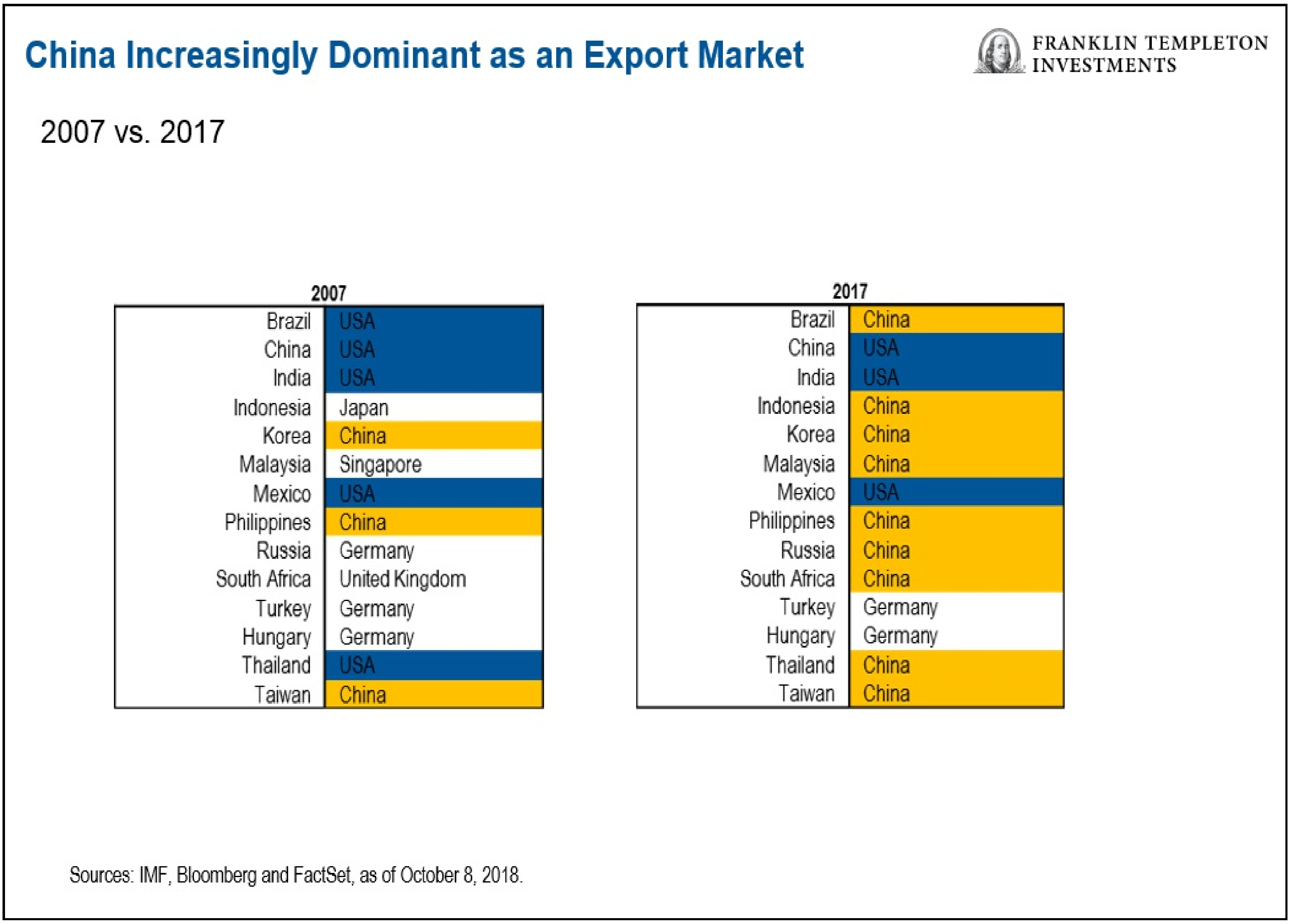
In emerging markets in general, we continue to like themes such as the structural growth in the technology sector, rising consumption and economic reforms. Technology is reshaping the global economy. While emerging markets were once disadvantaged by poor infrastructure, digitalization and new technologies have enabled emerging markets to address development challenges and leapfrog technological change.

We aim to look beyond the “noise” of negative news headlines and instead focus on the underlying fundamentals of the EM asset class. We find a disconnect between the negative sentiment permeating the market and positive EM equity fundamentals, including rising cash flows, improving capital-allocation discipline, corporate deleveraging, healthy earnings and discounted valuations.

Not all emerging markets will be hurt by the same factors, and performances of individual emerging markets vary considerably. 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.

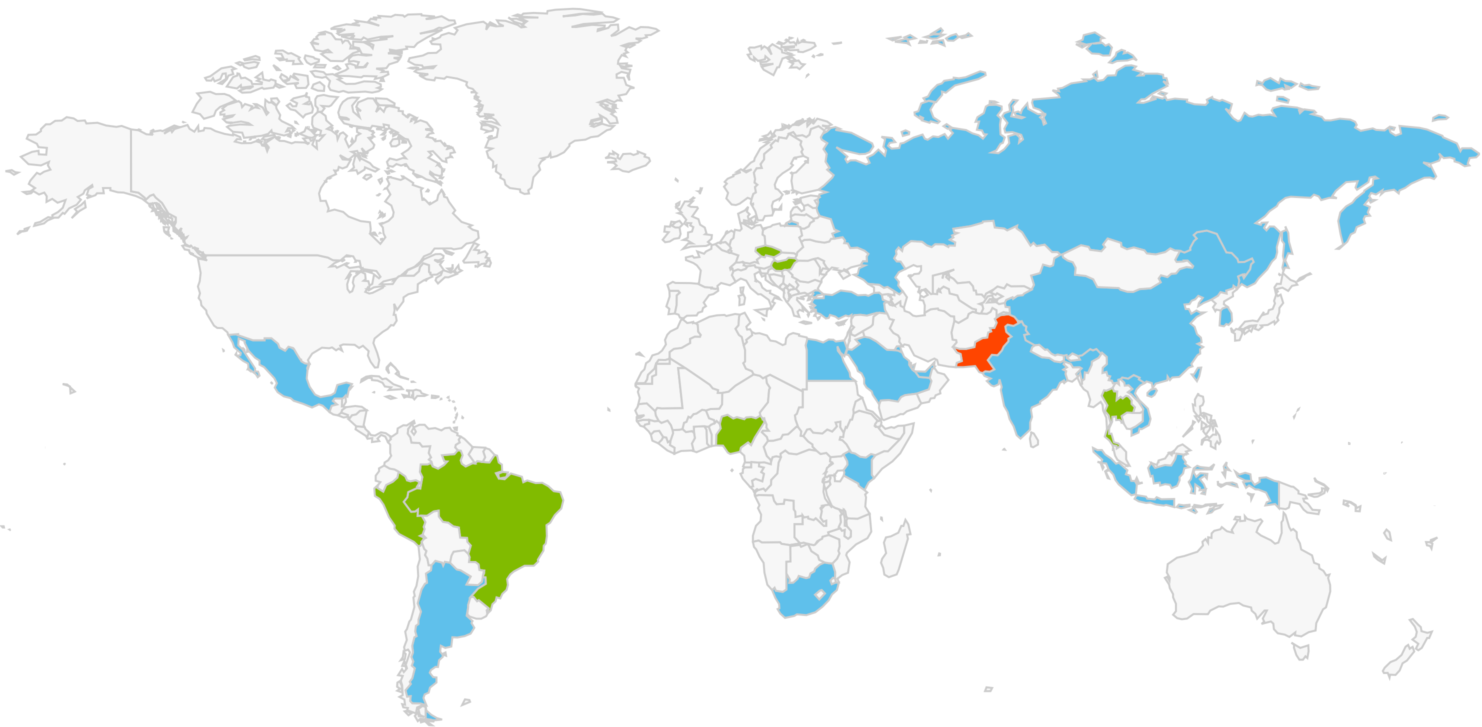
Emerging Markets Key Trends and Developments

EM equities began the third quarter on a strong footing but ended the period lower. Mixed news on trade talks, country-specific concerns and a stronger US dollar created a challenging backdrop for emerging markets. Conversely, developed-market stocks advanced. The MSCI Emerging Markets Index fell 0.9% over the quarter, compared with a 5.1% gain in the MSCI World Index,[3] both in US dollars.



The Most Important Moves in Emerging Markets This Quarter

- **Asian** equities fell amid a raft of economic concerns, led lower by China, Pakistan and India. China's deleveraging campaign and deepening trade row with the United States weighed on the outlook for its economy. Pakistan struggled with its growing current account deficit and shrinking foreign exchange reserves. India was hobbled by a decline in the rupee, a wider current account deficit and troubles in the non-bank lending industry. In contrast, stocks in Thailand, Taiwan and Malaysia were the top gainers. Thailand's economy grew faster than expected in the second quarter and the military government took steps towards holding a general election by May next year. Taiwan benefitted from an advance in technology stocks, especially index heavyweight Taiwan Semiconductor Manufacturing Company.
- **Latin America** was the best-performing region over the quarter, driven by strength in Brazil and Mexico. Brazil's market benefitted from the growing popularity of a more market-friendly candidate in electoral polls ahead of the October elections, coupled with resilient corporate earnings, higher commodity prices and reasonable valuations. Market sentiment in Mexico was supported by easing political uncertainty following Andrés Manuel López Obrador's victory in July's presidential elections and a conclusion on the revised North American Free Trade Agreement (NAFTA). Canada reached an agreement late in the period to join the revised trade deal between the United States and Mexico. The accord, renamed United States-Mexico-Canada Agreement (USMCA), is expected to be signed in November. Colombia, Peru and Chile, however, recorded declines.
- **Emerging European markets**, as a group, gained during the quarter, supported by a surge in September. Poland's equities rose ahead of FTSE's reclassification of the market from EM to developed-market status in September. Higher oil prices and attractive valuations drove stock prices in Russia. Despite a strong rebound in September, following appreciation in the lira and a sharp increase in interest rates, Turkey's market ended the three-month period with a double-digit decline. A strong dollar and worries about a proposed land reform weighed on investor sentiment in South Africa. On the positive side, some of the more controversial requisites of the proposed reform were eased in the country's Mining Charter.
- **Frontier markets** declined, lagging their EM peers, partly due to asset class outflows. Lebanon, Nigeria and Sri Lanka were among the weakest markets, ending the quarter with double-digit declines. Nigeria was dragged down by slowing economic growth, high inflation and a decline in foreign direct investment, coupled with uncertainty ahead of the general elections in February 2019. Equity prices in Sri Lanka were impacted by a devaluation in the rupee and external debt funding concerns. Bahrain, Oman and Kuwait, however, fared better, ending the quarter with positive returns. The FTSE upgrade later this year and hopes of inclusion in the MSCI Emerging Markets Index in the future continued to drive positive sentiment in Kuwait.



Outlook

As of September 30, 2018

China

Uncertainties surrounding the US-China tariff dispute weigh on China's economic outlook. The immediate impact could be limited, but if tariffs ultimately affect the global supply chain of technology products, the longer-term impact on China’s growth could be material. The government’s easing policy may, however, mitigate the impact but results may be limited given the need for continuation of supply-side reform and deleveraging.

India

Long-term fundamentals including under-penetration, formalization of the informal economy and a stable government remain intact, but near-term earnings challenges lead us to maintain a neutral view on the market.

Indonesia

Economic growth remains steady. However, politics will likely heat up ahead of the legislative and presidential elections in April 2019.

South Korea

Macro indicators remain sound. The geopolitical situation warrants close attention, while concerns about government regulations are growing.

Pakistan

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

Taiwan

Macroeconomic data remain healthy but inflation may start to rise, pressuring interest rates. While a strong Taiwanese dollar weighed on corporate earnings, recent weakness should ease concerns. The major overhang, however, is the trade dispute between the United States and China. Many Taiwanese companies have production plants in China and could be impacted if the situation worsens.

Thailand

Overall outlook is positive. Economic stability remains strong with continued improvement in economic growth. The upcoming general election could further boost sentiment.

Vietnam

Steady outlook. GDP above 6%, underpinned by resilient domestic demand, rebounding agricultural production and strong export-oriented manufacturing.

Czech Republic

Relatively safe market, with an open economy and current account surplus. Do not expect any significant issues unless there is a significant global slowdown.

Hungary

The economy is doing well but structural problems may be accumulating.

undefined

In a stable oil price/ruble environment, domestic names should benefit due to earnings revisions and increased demand. The political situation should remain stable with the next presidential election scheduled for 2024. However, macro risks remain high due to volatile commodity prices and the possibility of additional US/EU sanctions.

Turkey

Weak demand and high cost of funding has resulted in a challenging macroeconomic environment for companies. Non-performing loans are expected to rise in the short-term. A recovery may start after March 2019 elections.

Argentina

The US$50 billion package from the IMF has saved the Macri administration from an early departure, but it has not restored investor confidence that could help meet the country's financial requirements for 2018 and 2019. The government was forced to accelerate fiscal consolidation in exchange for an acceleration of disbursements. While the financial plan looks feasible in theory, it seems challenging to implement, politically, despite opposition approval for the 2019 budget.

Brazil

The near-term outlook is challenging in view of 2018 presidential elections, which could bring higher volatility. Our long-term outlook, however, is positive with the new president likely to continue promoting reforms.

Mexico

The conciliatory and prudent speech of President-elect Andrés Manuel López Obrador coupled with the handshake agreement between the United States and Mexico to continue under the guidelines of the former NAFTA have helped contain pressure on the currency and triggered a relief rally in the equities market.

Peru

We expect political noise but believe that it should not deviate Peru from its sustained long-term growth trend.

Kuwait

FTSE upgrade later this year and potential MSCI upgrade to EM status could be positive catalysts for the market. Kuwait'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 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 VAT implementation have been successful. 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.

Kenya

GDP growth could pick up after stalling last year, but credit remains constrained and the IMF facility review is at risk.

Nigeria

The market is improving from a macro perspective with higher oil production, higher oil price, steadying inflation, and foreign exchange liquidity. However, some investors do have concerns regarding investment into Nigeria given the substantial claims against telecom company, MTN.

South Africa

The outlook is less positive than 3-6 months ago, weighed by a slow recovery and weaker global backdrop and sentiment. Domestically, though, the country should be past the lowest point.

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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 September 30, 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. Past performance is not an indicator or guarantee of future performance.

2. Thailand's National Economic and Social Development Board, August 2018.

3. Source: Factset. 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. 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.