PERSPECTIVE

November Market Recap and Outlook: Bulls Return to Emerging Markets

December 13, 2018

Emerging markets saw a rebound in November, as investors embraced bits of positive news in regard to an easing in US-China trade tensions and as well as slightly dovish thinking about the pace of US interest rate increases. 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 November along with their current outlook.

Three Things We're Thinking about Today

1. During the recent G20 meeting, US President Donald Trump and Chinese President Xi Jinping reached a 90-day **trade truce** to allow both countries to negotiate a comprehensive trade agreement. The US will postpone increasing tariffs to 25% from 10% on US$200 billion worth of Chinese products, while China agreed to substantially increase purchases of American goods and negotiate on structural changes with the United States. If no conclusion is reached, the United States will raise tariffs to 25%. While the markets welcomed the agreement, which signaled both leaders' desire to avoid a full-blown trade war, we believe that uncertainties remain as both countries look to reach an agreeable compromise. We will continue to monitor the situation and look for attractive investment opportunities in sectors related to health care, consumption and manufacturing upgrades, which, over the long term, are less directly impacted by tariff regime changes.
2. The Indonesian rupiah and stock market were among the top emerging-market (EM) performers in November, as government and central bank efforts to stabilize the currency bore fruit, and the country continued to report solid economic growth rates. An increase in interest rates and a decline in oil prices also eased pressure on the currency and widening current account deficit. Overall, 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 continue to find potential investment opportunities in many sectors that benefit from existing demographics and expected reforms. These include banks, which lend to both fast-growing corporates and provide mortgages, credit cards and other retail banking products to consumers as well as companies in the consumer, resources and infrastructure-related sectors.
3. We are very excited about the prospects for the EM pharmaceutical industry, particularly smaller companies. The sector looks promising to us due to three primary drivers: demographics, environmental and lifestyle changes, and innovation. The rapid pace of innovation is perhaps the most surprising driver we see for growth in these types of companies. In recent years, many leading developed-market (DM) pharmaceutical companies have struck partnerships with EM pharmaceutical companies. As increasing prosperity drives demand for health care and healthier lifestyles, EMs are becoming sources of significant growth for the pharmaceutical industry and a center for innovation within the industry itself. We believe this area offers exciting potential for investors, one that will be a significant driver of advancement in society in both EMs and DMs alike in the decades ahead. We are of the opinion that EM health care and pharmaceutical companies are just entering the early stages of development.

Outlook

Investor sentiment towards EMs improved recently, as dovish comments from US Federal Reserve Chairman Jerome Powell raised expectations of an interest rate hike pause in 2019 and led to a more bearish view on the US dollar. An announcement of a trade truce between the US and China post month-end could further support sentiment in the immediate term. However, over the longer term, uncertainties remain as both countries work towards reaching a more permanent solution.

We believe EM valuations have become more attractive as a result of low investor confidence earlier in the year, while cash flows improve and dividend payouts continue. Although EM earnings growth lagged developed markets in 2018, we expect EM earnings growth to resume momentum in 2019, as fundamentals remain strong and many EM currencies have adjusted significantly in 2018.

While short-term volatility may continue, as value-oriented and long-term investors, we continue to seek companies that demonstrate sustainable earnings power and trade at a discount relative to their intrinsic value and other investments available in the market.

Emerging Markets Key Trends and Developments

EM equities rebounded in November and outpaced DM stocks. Hopes for a slower pace of US interest rate hikes in 2019 lifted global markets and buoyed EM currencies against the US dollar. Tentative signs of a respite in US-China trade tensions also supported emerging markets. The MSCI Emerging Markets Index returned 4.1% over the month, compared with a 1.2% increase in the MSCI World Index, both in US dollars.[1]

Emerging Markets Improving Free Cash Flows

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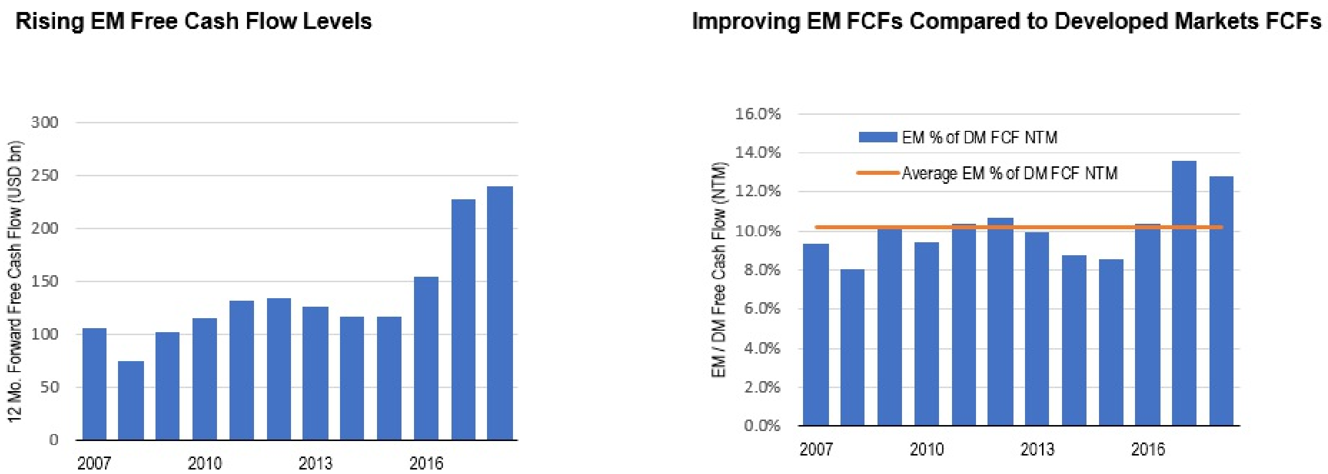

NTM = Next 12 months.

Source: Factset. Factset Emerging Markets Estimates are represented by the MSCI Emerging Markets Index. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. Indexes are unmanaged and one cannot invest directly in an index. Index returns do not reflect any fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized. See www.franklintempletondatasources.com for additional data provider information.

The Most Important Moves in Emerging Markets in November

Asian equities rose, with local currency strength boosting returns in US-dollar terms. Indonesia, India and China drove the advance. Indonesia's stock market rallied, aided by an upswing in the Indonesian rupiah after the central bank unexpectedly raised interest rates to reduce a current account deficit. Stocks in India rose on the back of a stronger Indian rupee, as lower oil prices eased concerns about the oil-importing nation's trade deficit. Investor sentiment toward China improved, as an upcoming meeting between US and Chinese leaders set the stage for potential progress in trade talks. In contrast, Pakistan, Malaysia and Taiwan led declines. Pakistan's market fell amid a sharp drop in the Pakistani rupee, while the country sought a bailout from the International Monetary Fund (IMF). Malaysia's economy grew less than expected in the third quarter, hindered by weaker exports.

Latin American markets, led by Mexico and Peru, corrected in November. Brazil and Colombia also ended the month with declines. Increased political and economic policy uncertainty coupled concerns that persistent inflation could result in higher interest rates weighed on the Mexican market. Equity prices in Brazil corrected on profit-taking, following a double-digit return in October. Gross domestic product (GDP) growth in Brazil accelerated to its highest growth rate this year in the third quarter but failed to meet market expectations. Chile, however, bucked the downward trend, with a positive return driven by appreciation in the Chilean peso, a strengthening economy and progress on its pension reform initiative.

Emerging European markets generally gained, with strong performances recorded in Turkey, Hungary and Poland. The Turkish market rebounded in November with a double-digit return, following significant weakness earlier in the year. Appreciation in the Turkish lira further boosted returns in US-dollar terms. Sentiment in Hungary and Poland benefited from better-than-expected third-quarter GDP growth and an increase in the OECD's (Organization for Economic Co-operation and Development) 2018 and 2019 growth rate projections. Easing liquidity concerns in Poland's banking sector further supported equity prices in that market. Lower oil prices and increased geopolitical risk weighed on share prices in Russia. Elsewhere, appreciation in the South African rand was largely responsible for the solid US-dollar market performance in South Africa.

Frontier markets, as a group, recorded positive returns, outperforming their DM counterparts but underperforming EMs. Estonia, Argentina and Sri Lanka were among the top-performing markets. The Baltic states of Lithuania, Latvia and Estonia appealed to index provider MSCI to assess them as a single region and not as individual markets for the purposes of index classification. Investors in Sri Lanka remained positive despite continuing political instability. In Argentina, the IMF completed its second review, paving the way for a US$ 7.6 billion disbursement. At the other end of the spectrum, Jordan, Tunisia and Nigeria ended the month with declines.

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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: 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.