ASIA

The Impact of US Policy on Emerging Markets: Three Investor Misconceptions

January 30, 2019

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As investors continue to grapple with market jitters brought on by months of US-China trade tensions and other market uncertainties, Franklin Templeton Emerging Markets Equity's Chetan Sehgal explains why the recent volatility could present opportunities in the medium to long term. He also considers some investor misconceptions about emerging markets and the positive factors that many are missing in part three of this series, "The Impact of US Policy on Emerging Markets."

The fallout from the US-China trade war and other uncertainties continue to weigh on investor sentiment for emerging markets. But we don't think the trade spat or some other issues, which we perceive to be short term in nature, should cloud investors' long-term view of the asset class.

We continue to see evidence of some positive emerging market fundamentals that supports our medium- to long-term optimism. We would also note that while 2018 was no doubt a disappointing year for many investors, the prior two years saw very strong returns that outpaced developed markets overall.[1]

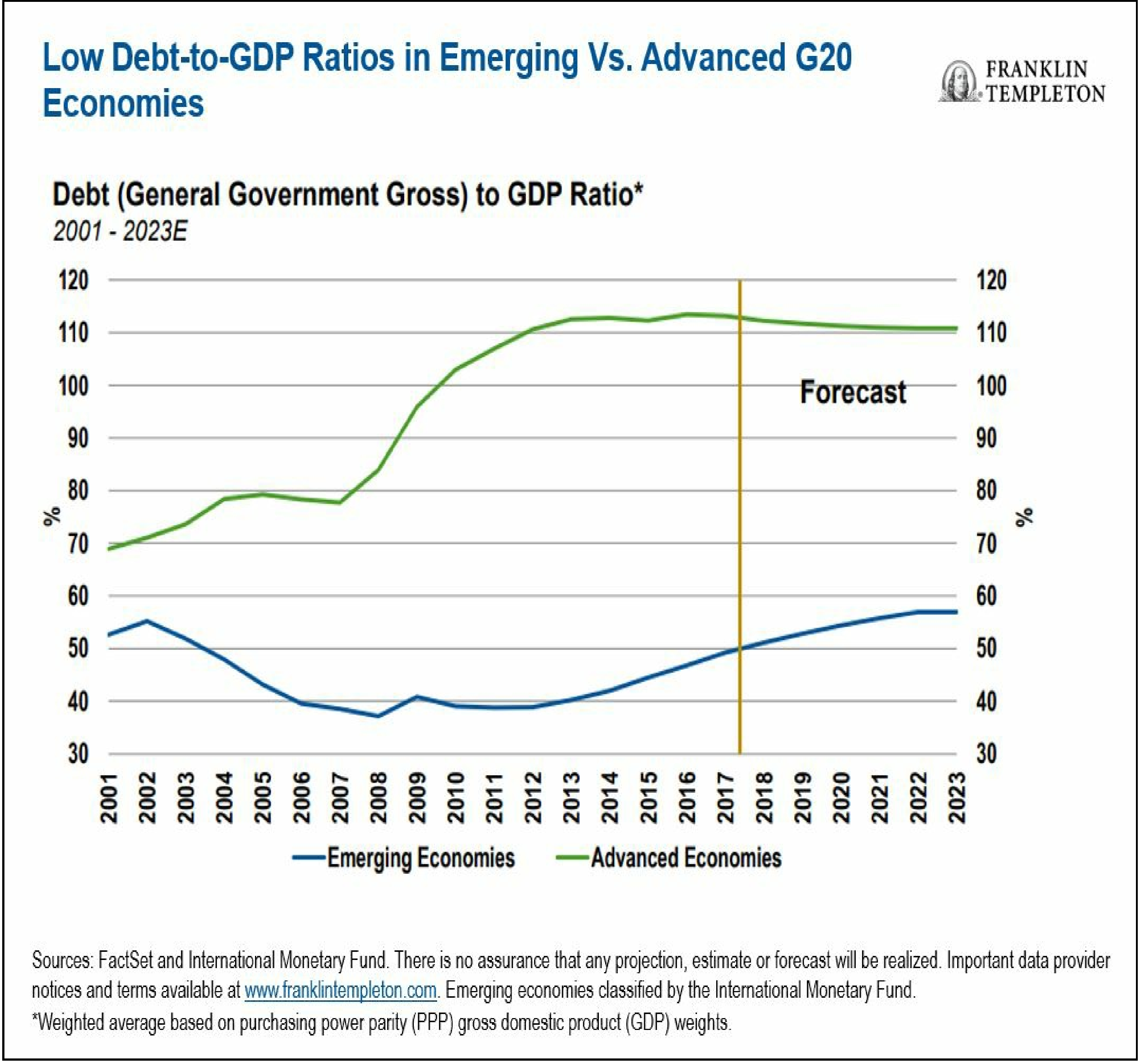
Here are three considerations we think investors are missing when it comes to emerging markets:

1. Crisis level valuations aren't reflecting continued underlying resilience in emerging markets.

Geopolitical tensions between the United States and China have contributed to a decline in emerging-market stocks, driving valuations to near-crisis levels. However, for us that brings attractive potential opportunities, as we don't see most emerging market economies in crisis situations. We think the pullback we've seen in emerging-market equities in recent months presents some attractive medium- to long-term opportunities.

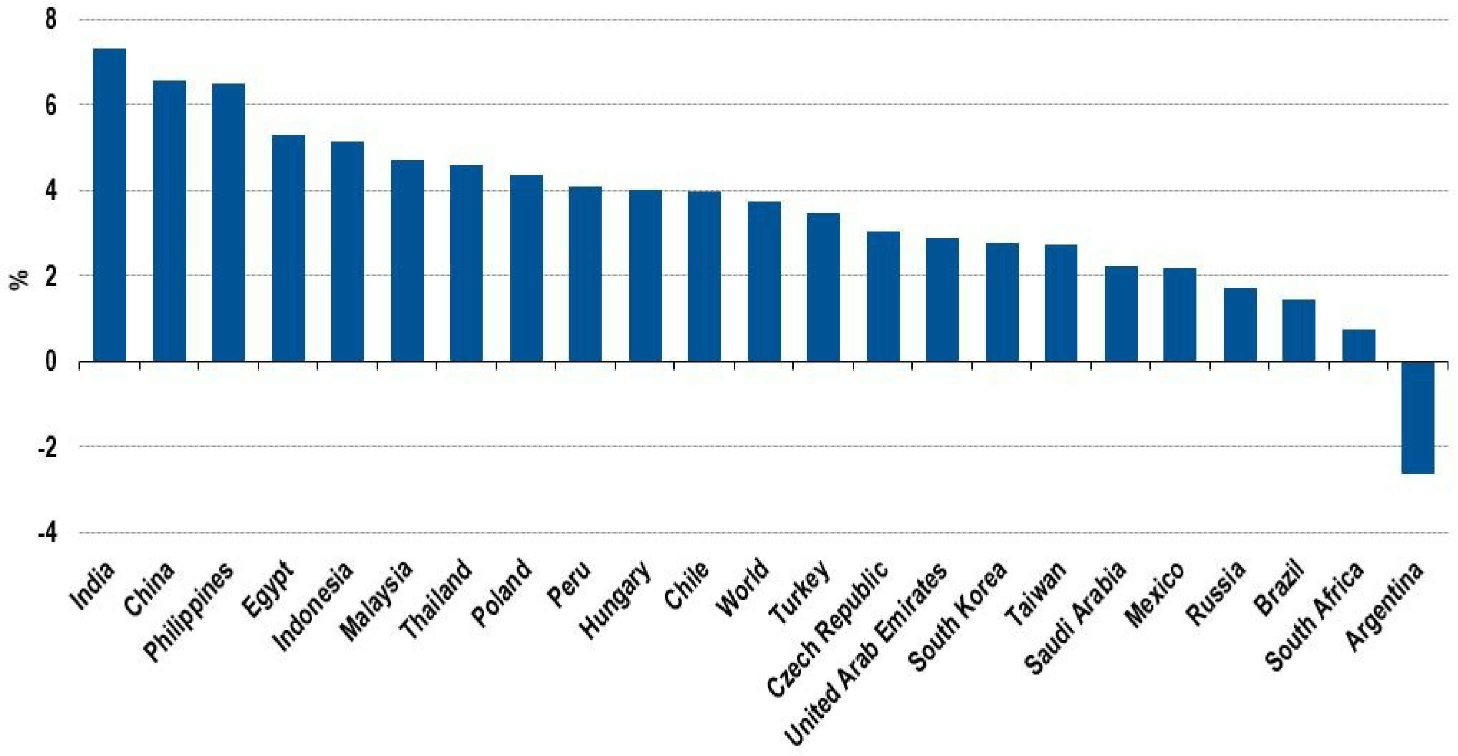
While economic growth overall was perhaps not as strong as had been expected at the start of the year, in 2018 emerging markets still outpaced developed markets. This trend is expected to continue in 2019, with the International Monetary Fund (IMF) forecasting 2019 gross domestic product (GDP) growth in emerging markets at 4.5% versus 2% in developed markets.[2]

In addition, many investors often overlook the fact that emerging-markets debt-to-GDP levels are relatively low when compared with developed countries (see chart below).



We believe this solid growth outlook and the other positive fundamental factors we see in emerging markets indicate equities have the potential to rebound should some of the recent market uncertainly subside.

Estimated 2018 Gross Domestic Product (GDP) Growth: Emerging Markets Compared to Developed Markets

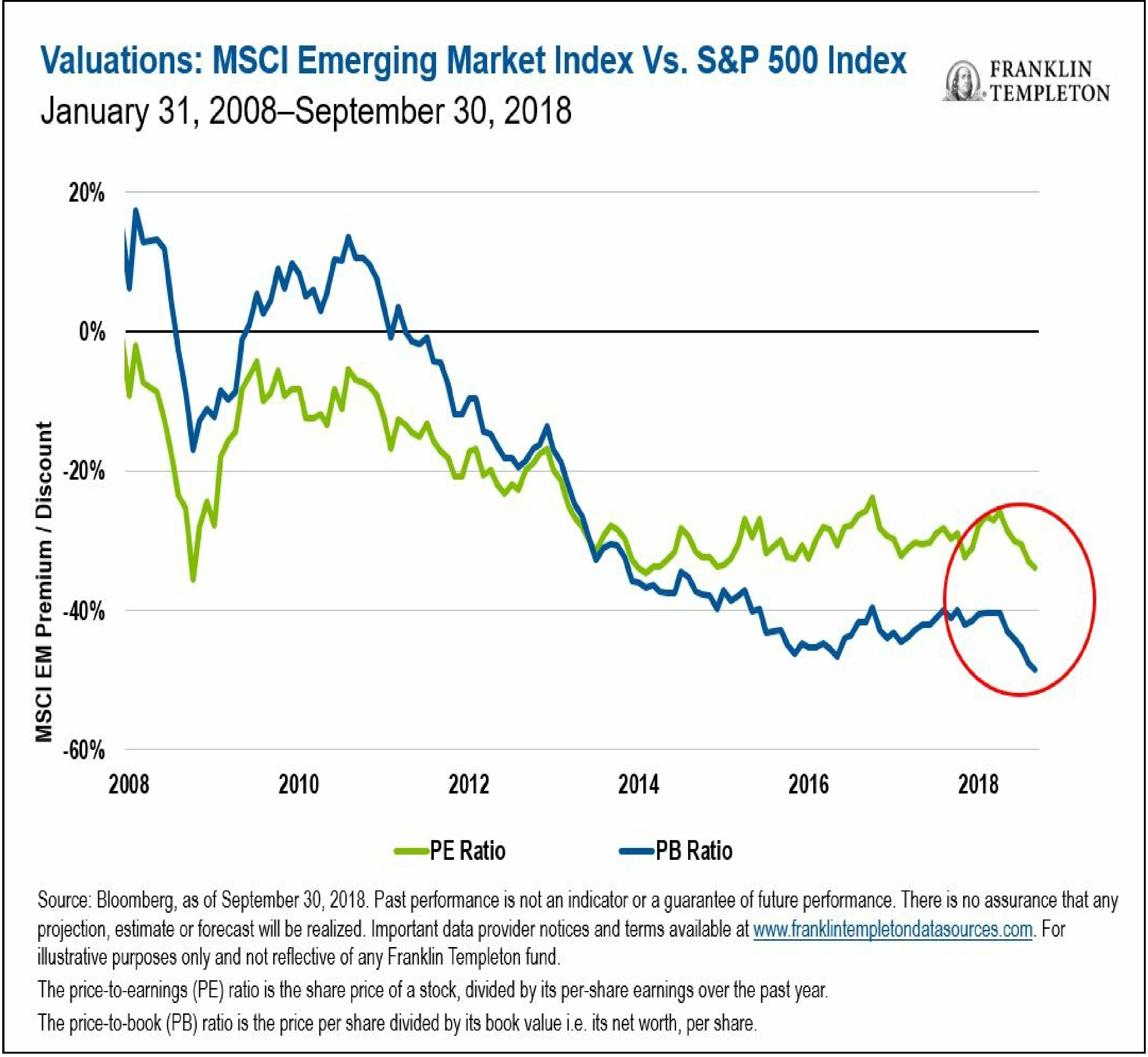


Sources: FactSet, International Monetary Fund, October 2018. There is no assurance that any projection, estimate or forecast will be realized. Important data provider notices and terms available at www.franklintempletondatasources.com.

2. The corporate environment looks supportive.

Despite weaker currencies in emerging markets, corporate earnings growth in US dollar terms was positive in 2018 and looks sustainable to us, so we think cheaper valuations could attract long-term, value-oriented investors toward companies that are currently trading at a discount.

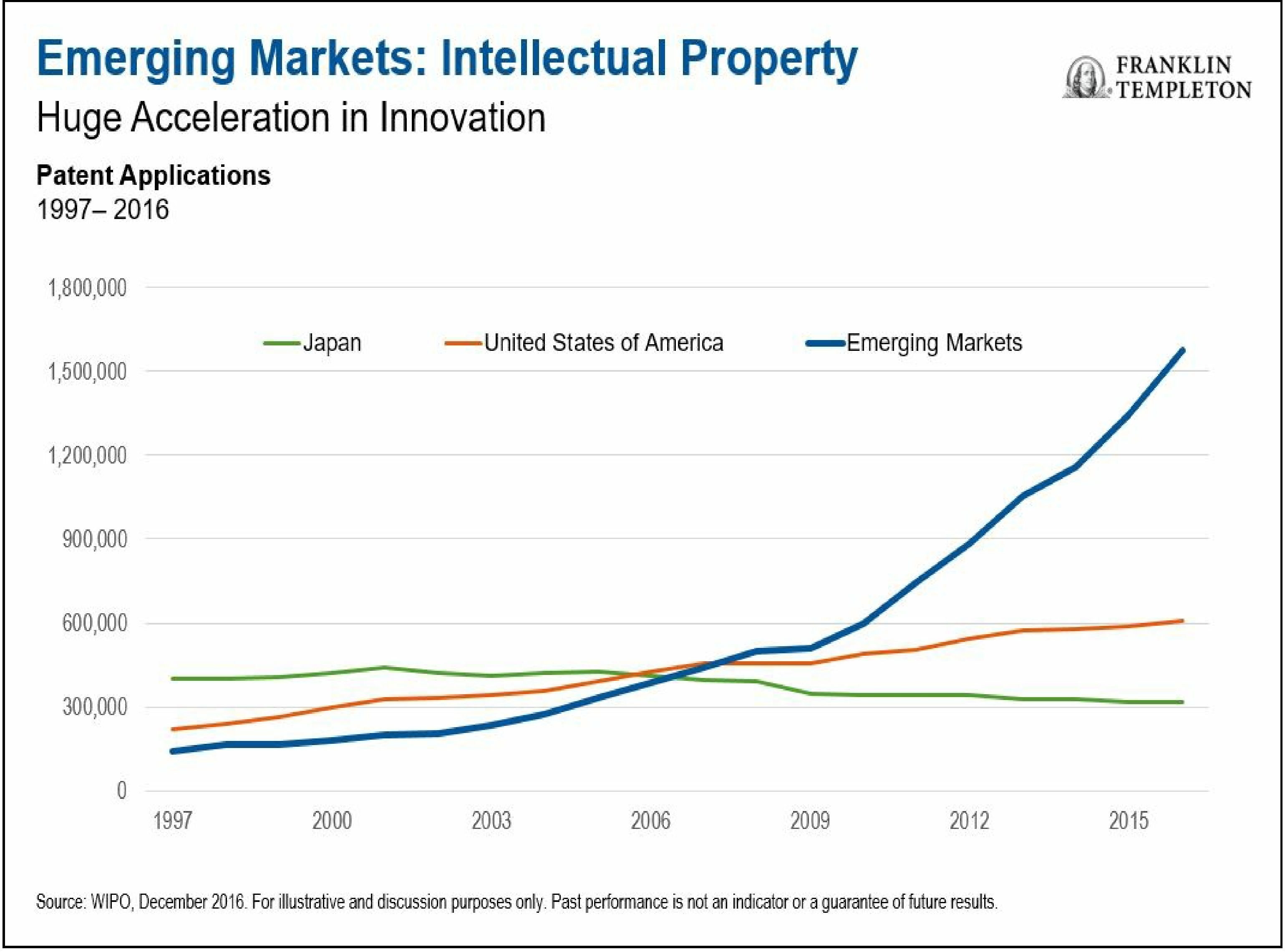
Against this brighter backdrop, we’ve seen an improvement in corporate governance, with better transparency between company’s stakeholders and decision makers. We think this creates a supportive environment for shareholders, whether that’s in technology companies or niche small-capitalization consumer businesses in emerging markets.



3. Consumerism and technology are the engine of emerging-market growth.

While we saw some headwinds for emerging markets last year, in our view, they obscured the bigger picture—some emerging-market companies are now world leaders in the areas of financials, technology and in the production of many consumer goods.

In fact, patent applications in emerging markets have overtaken that of Japan and the United States and show no sign of abating. We think this reflects the growing innovations we've seen coming out of emerging-market companies—from mobile payment and lending systems to driverless cars and health care services. Emerging markets in many cases have been able to adopt new technologies at a fast rate because there are no legacy systems that need to be replaced or integrated first.



We are confident technology will remain a primary driver in emerging markets, whether manifested through world-leading semiconductor manufacturing, e-commerce or other areas. Despite some recent corrections we've seen in some technology-orientated emerging-market companies, we still believe many of them have sustainable earnings potential.

Consumerism in emerging markets should help drive growth in many regions. Growing middle-class populations and increasing affluence—the premiumization of the market—continues to spur demand for high-end products available in emerging markets. In our view, companies with superior products should see sustainable growth in the years to come.

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1. Based on the MSCI Emerging-Markets Index, which was up 37.28% in 2017 and 11.19% in 2016, and the MSCI World Index, which was up 23.97% in 2017 and 7.86% in 2016. The MSCI Emerging-Markets Index captures large- and mid-cap representation across 24 emerging-markets countries; the MSCI World Index captures large- and mid-cap representation across 23 developed-markets countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

2. International Monetary Fund, January 2019. There is no assurance that any estimate, forecast or projection will be realized.