

## PERSPECTIVE

# Fundamentals Drive Emerging Market Performances in April

May 10, 2019

Franklin Templeton's Emerging Markets Equity team walks through events moving emerging markets in April and discusses the three things the team is thinking about today. The team believes the current market environment provides an attractive entry point for investors, particularly in the small-cap stock space.

## Three Things We're Thinking About Today

1. A higher-than-expected first-quarter economic growth rate of 6.4% and indications of a shift in focus to structural reform by senior leaders at the Politburo meeting raised market concerns that the **Chinese** government could refrain from implementing further stimulus measures. However, we do not expect to see any policy tightening in the near term. We believe first-quarter growth benefited from earlier tax cuts, which boosted retail consumption and property sales. The US Federal Reserve's (Fed) dovish stance also helped reduce pressure on capital outflows, resulting in a more benign monetary environment with stronger loan growth in the banking system. Going forward, however, liquidity remains a concern with a significant amount of bonds due for repayment in the second half of the year. An increase in inflation, a change in the Fed's policy or an unexpected turn in US-China trade talks could also have an impact. Further, the industrial and manufacturing segments of the economy remain challenging. Thus, we believe the government could continue to implement selective fiscal measures to support the economy.
2. **South Africa** was one of the best-performing markets in April, ahead of general elections in May. We expect the incumbent, market-friendly African National Congress (ANC) party to win a parliamentary majority. While we have seen some progress in reforms, a strong mandate for President Cyril Ramaphosa could allow the government to accelerate the implementation of much-needed reforms as well as stimulate the domestic economy. The state electricity utility, however, has worrying debt levels, raising the possibility that there could be further state help which has spurred concerns of a credit downgrade. Moody's, the last of the rating agencies to issue an investment-grade rating, delayed its rating announcement to the second half of the year. While easing short-term worries, the announcement needs to be monitored as any downgrade could significantly impact the country's ability to service its debt. Against this background, our focus has been on retail companies that offer attractive valuations and businesses with more international exposure.
3. One of the world's largest one-day elections was held in **Indonesia** during April, where the country's presidential, parliamentary and regional elections all took place on the same day. While official results are expected in May, early results indicate a comfortable victory for President Joko Widodo and his Indonesian Democratic Party of Struggle. We have seen Indonesian equities run up in the last six months and expect the market to continue to do well on high expectations from the new government, improving macroeconomic indicators including consumption, current account balance and inflation as well as a more accommodative global monetary policy. We expect the government to continue to focus on infrastructure development and expanding social welfare including efforts to promote education, boost investment and implement key reforms. We continue to favor companies geared to benefit from the country's superior demographics and rising consumerism.

## Outlook

We believe emerging market (EM) fundamentals remain positive. We continue to see a reversal in the negative rhetoric from 2018 and stabilization in many markets. The Fed has taken a more dovish tone this year, compared to last year. In terms of US-China trade relations, although signs pointed towards a near-term agreement, the possibility that a trade agreement is not reached remains a major tail risk.

Oil prices rose in April after US President Donald Trump decided to terminate sanction exemptions on Iranian crude oil. Taking a longer-term view, however, we believe that oil prices could remain relatively range-bound, given growth in supply and easing demand with a global economic slowdown. In our view, stable oil prices should support consumption and ease inflation for certain Asian economies, such as India and Indonesia, that are net importers of oil.

We believe the current market environment provides a particularly attractive entry point for investors. In particular, the EM small-cap space remains attractive to us. While the asset class saw a rebound in the first quarter of this year, EM small caps did not keep pace with their EM large-cap counterparts. As an active manager, we continue to seek out companies which we believe will succeed over the long term, while striving to reduce downside risk and thus enhance risk-adjusted returns.

## Emerging Markets Key Trends and Developments

EM equities rose in April, though occasional wobbles caused them to finish behind developed market stocks. Optimism around continued progress in US-China trade talks was dampened by fears of a pullback in Chinese stimulus measures, as well as economic and political concerns in specific countries such as Turkey. EM currencies collectively weakened against the US dollar. The MSCI Emerging Markets Index increased 2.1% over the month, compared with a 3.6% return in the MSCI World Index, both in US dollars.<sup>1</sup>

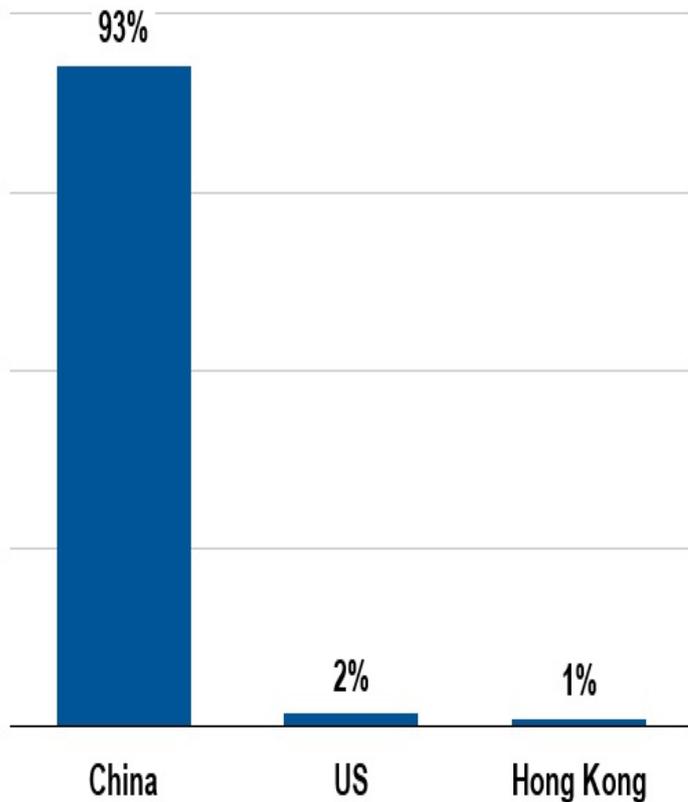
# MSCI China vs. MSCI USA: Revenue Source by Country



Last 12 Months, as of April 2019

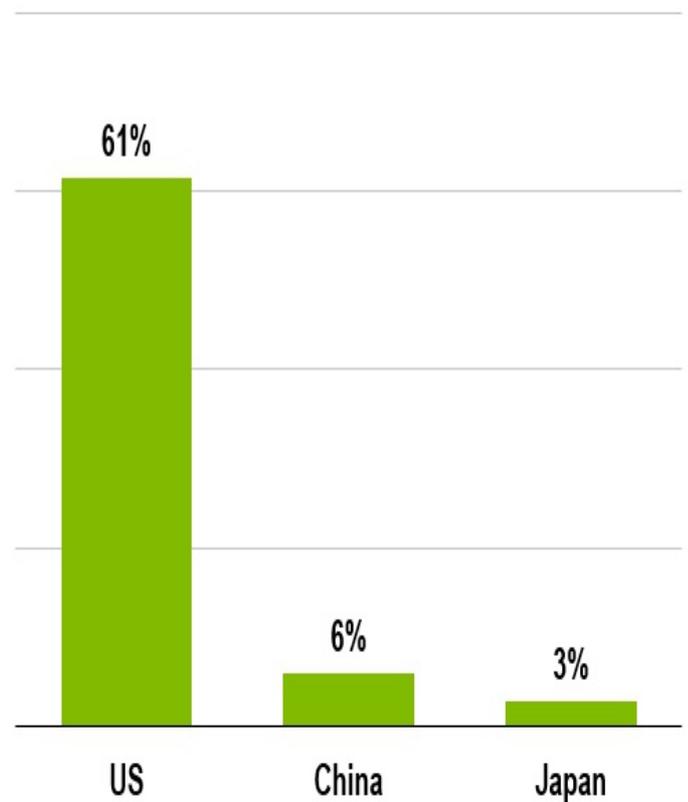
## China

(% Total Revenue)



## US

(% Total Revenue)



For illustrative purposes only.

Source: Factset, April 2019. The MSCI USA Index has 624 constituents and is designed to measure the performance of the large- and mid-cap segments of the US market. The MSCI China Index has 469 constituents and captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

## The Most Important Moves in Emerging Markets

- Asian stocks advanced but lagged broader EMs. Taiwan, China and Thailand were the top regional performers. Taiwan's stock market was supported by gains in technology heavyweights. Chinese equities rose on reports of a potential US-China trade deal in May, even as signs of economic stabilization in China sparked worries that officials could pare stimulus efforts. In Thailand, the government introduced measures to boost a slowing economy. Conversely, stocks in Pakistan and Malaysia declined. Pakistan remained in talks with the International Monetary Fund (IMF) to secure a bailout for its struggling economy.
- Except for Mexico, Latin American markets declined in April. Mexican lawmakers approved the labor reform, fulfilling a key condition for the new US-Mexico-Canada trade deal. Appreciation in the Mexican peso also drove returns in US dollar terms. While first-quarter gross domestic product (GDP) growth in

Mexico disappointed, solid consumer confidence, higher real wages and encouraging industrial activity data provided reasons to remain optimistic. In Brazil, downward economic growth revisions by financial institutions and government interference in wholesale diesel prices weighed on market performance. Progress on the reform front, with the social security reform passing the first hurdle, and advancing to the second phase of the voting, late in the month, however, supported sentiment.

- Emerging European markets, as a group, fared better than their EM counterparts in other regions, with Greece and Russia among the leaders. Equity prices in Turkey and the Czech Republic, however, declined. Higher oil prices and appreciation in the Russian ruble drove returns in the Russian market. The South African market rallied during the month, ahead of general elections in May. Expectations of political continuity with a strong mandate for President Ramaphosa and the president's focus on reforms and the economy led investors to adopt a positive view on the market. Appreciation in the South African rand also led to higher US-dollar returns.
- Frontier markets recorded mixed results in April, with positive performances in Kazakhstan, Romania and Kuwait offsetting declines in Argentina, Sri Lanka and Nigeria. The National Bank of Kazakhstan surprised investors with an interest rate cut in April amid easing inflation expectations. Expectations of an upgrade to EM status by MSCI continued to drive stock prices in Kuwait. Concerns that a series of coordinated suicide bombings in Sri Lanka could impact tourism revenues and domestic economic activity pressured stock prices. Confidence in Argentina continues to fade despite IMF support as depreciation in the peso and high interest rates and inflation continued to worry investors.

## Important Legal Information

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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.](#) Sources: MSCI, FactSet as of March 31, 2019. 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. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

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