PERSPECTIVE

Central Bank Easing in Focus in July

August 13, 2019

The US Federal Reserve's recent interest rate cut will likely be positive for emerging markets overall, given the importance of the US economy as a growth driver, according to our emerging markets equity team. The team shares its view of this and other events shaping emerging markets today.

Three Things We're Thinking About Today

1. For the first time in more than a decade, the **US Federal Reserve** (Fed) cut the policy interest rate by 25 basis points. While the cut was widely expected, the market was disappointed by the reference to the rate as a "mid-cycle adjustment" and not likely the beginning of a prolonged easing cycle. However, the Fed did concede that uncertainties remain, leaving the door open to rate cuts in the future. We believe that the rate cut will likely help extend US growth longer and will likely be positive for emerging markets (EMs) overall, given the importance of the US economy as a growth driver. The rate cut also alleviates upward pressure on the US dollar, helping EM currencies, while also facilitating greater flexibility in EM monetary policy (e.g., rate cuts in South Korea, Indonesia and Thailand). History over the last four Fed rate cycles has shown that EMs tend to outperform the US market in the 2-3 year period following the first rate cut.[1] The only exception to this was in the run-up to the Asian financial crisis in the late 1990s.
2. **Brazil's** lower house of Congress overwhelmingly approved a landmark pension reform bill in July, a positive step in a process that should substantially shore up the country's fiscal situation. While it still needs a full congressional vote, we think this is a positive development. Savings from the reform are expected to reach US$235 billion over the next 10 years. After the approval of the pension system reform, we expect tax reform to come next, along with privatizations and more microeconomic reforms aimed at improving Brazil's regulatory environment. Therefore, from an investment standpoint, we expect a recovery could be felt first in state-owned enterprises, along with infrastructure plays, capital markets platforms (e.g., stock exchanges), and other capital-intensive industries. Despite the strong market performance this year, we remain constructive on the outlook for Brazil's market and believe industries with higher exposure to the domestic economy could benefit from further progress.
3. **India's budget** for fiscal year 2019/20, which aims to give the economy a boost via tax cuts and other measures to stimulate foreign investment, was released in July. We believe the government is moving in the right direction by focusing on improving the investment climate and diversifying the source of government funding, which should lower the cost of capital in the long run. However, clarity is still required in some areas. With the elections behind us, we expect market focus to shift to the fundamentals, such as earnings growth, inflation and fiscal prudence. The risks we currently see are related to global factors, such as trade tensions, US monetary policy and rising oil prices. However, rising domestic consumption has tilted India's economy to be less reliant on the export sector, which makes India less vulnerable to adverse global factors, in our view. As a result, we retain our positive outlook for India's equities in the medium to long term.

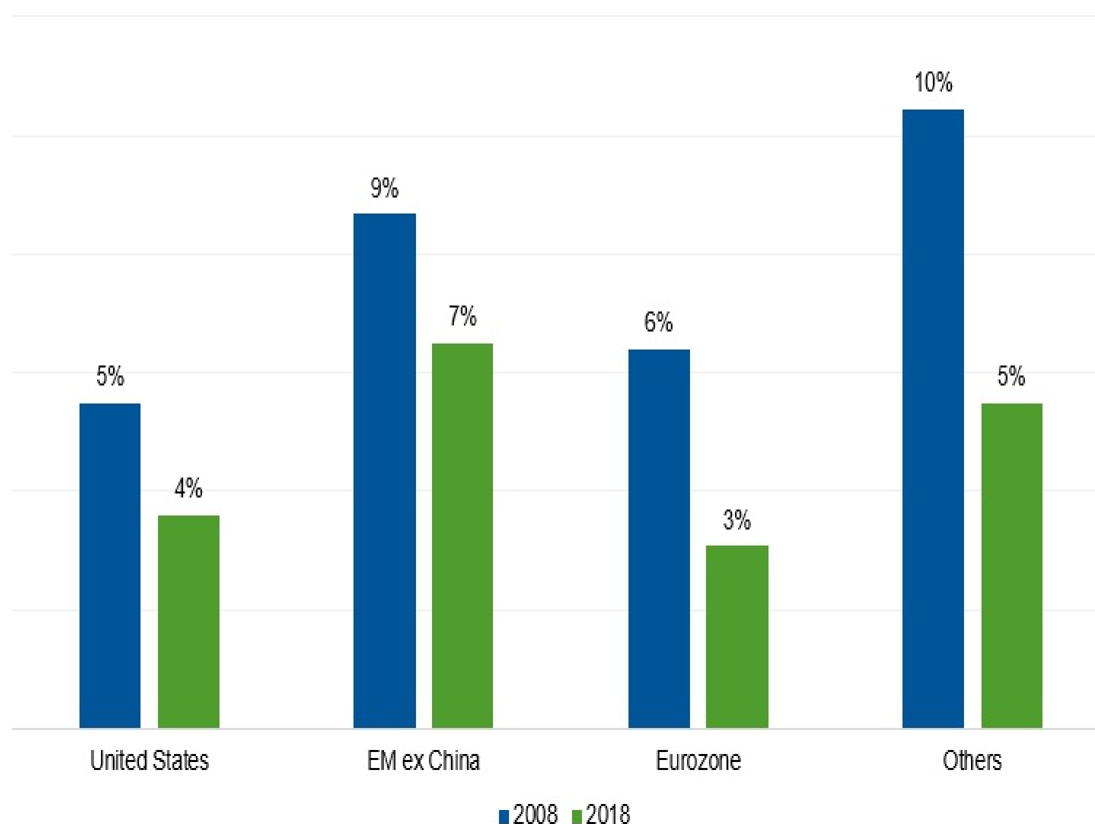
Outlook

The United States and China described their July trade talks as “constructive” and are expected to meet again in September. However, on August 1, US President Donald Trump surprised markets with plans to impose a 10% tariff on the last US$300 billion tranche of imports from China, effective September 1. In retaliation, China halted purchases of US agricultural products and allowed the renminbi to depreciate above the symbolic level of seven to the US dollar, leading the United States to label China a currency manipulator.

The US-China dispute has escalated from trade to technology, and now to financial areas with accusations of currency manipulation. We think the risk of a deepening long-term confrontation is rising. Given prolonged trade tensions, many global companies have been highlighting supply-chain diversification even before the latest developments. While negative for China, this could lead to increased capital expenditure in other Asian markets and beyond.

The recent truce in the US-China trade conflict was notable for its brevity: the increasingly antagonistic stance between the United States and China suggests the trade war will likely persist beyond the 2020 US presidential election cycle. We think investors should be prepared for ongoing market volatility.

However, we believe many fundamentally sound companies can still be found in emerging markets, where the macroeconomic backdrop remains largely healthy. Among companies we favor are those that are nimble in adapting to changes, demonstrate financial resilience (reflected by characteristics such as a strong balance sheet, high cash flows and sustainable earnings) and trade at attractive valuations.



Emerging Markets Key Trends and Developments

EM equities declined overall in July, while developed market stocks advanced. Market sentiment was largely unsteady amid persistent global trade tensions, a weaker outlook for world economic growth and shifting expectations for the size of a potential US interest rate cut. EM currencies generally weakened against the US dollar. The MSCI Emerging Markets Index lost 1.1% over the month, compared with a 0.5% return in the MSCI World Index, both in US dollars.[2]

The Most Important Moves in Emerging Markets in July

- Asian markets confronted diverse headwinds in July. Stocks in South Korea fell the most in the region as the country's trade disputes with Japan and North Korea's missile launches fueled investor caution. In India, equities declined. The government's budget announcement disappointed investors who had expected more stimulus measures, while corporate earnings were largely subdued. Chinese stocks closed lower amid lingering uncertainty around US-China trade relations and a slowdown in China's economy. In contrast, markets in Taiwan and Indonesia rose. Taiwan's index was buoyed by strength in technology heavyweights. In Indonesia, the central bank trimmed its benchmark interest rate to support domestic economic growth.

- Brazil was the only market in Latin America to end the month with a positive return, while Peru, Chile and Mexico were among the weakest. Brazil's central bank cut its key benchmark interest rate by 50 basis points to a record low of 6.0%, raising expectations for another rate cut in September. Investors also cheered the passing of the pension reform by the lower house in July. The resignation of the finance minister and concerns about state-owned petroleum company Pemex's business plan coupled with weak, albeit better-than-expected, gross domestic product (GDP) data weighed on equity prices in Mexico. Some progress was made on tax and pension reforms in Chile, while the Colombian government announced several new reforms including one targeting capital markets.
- The Europe, Middle East and Africa region as a whole lost ground in July. Poland, South Africa and Egypt led the declines. Turkey and the UAE, however, bucked the downward trend, ending the month with solid gains. The South African finance minister announced a US$4 billion bailout for the state-owned power utility Eskom, raising concerns about the country's widening budget deficit. International ratings agency Fitch also cut its outlook on its BB+ South Africa's sovereign rating to negative from stable, citing economic growth and budget concerns. Attractive valuations and continued progress on the reform front supported the UAE market.

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1. Source: Bloomberg. Emerging markets represented by the MSCI EM Total Return Index. Past performance is not an indicator or guarantee of future performance. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. See www.franklintempletondatasources.com for additional data provider information.

2. 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. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results. 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.

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