PERSPECTIVE

August Ruled by Global Economic Slowdown and Trade Fears

September 11, 2019

Trade fears, social unrest in Hong Kong and Brexit uncertainties weighed on markets in August. Franklin Templeton Emerging Markets Equity expects continued volatility, but an interest-rate cut from the US central bank in September could help stabilize emerging market currencies. The team shares its latest outlook.

Three Things We're Thinking About Today

1. August saw **US-China trade tensions** escalate with several rounds of retaliatory actions following US President Donald Trump's announcement early in the month of new tariffs on Chinese goods. The United States also formally labeled China as a currency manipulator after the Chinese renminbi depreciated to above seven per US dollar for the first time since 2009. These events sparked a broad and deep selloff in Chinese equities as well as global stock markets. However, we believe that China's economy may be better able to absorb the trade issues than the market fears. It is important to note that China's growth is now less dependent on trade than it was a decade ago. China's trade balance with the United States has narrowed, and, at a current-account level, China's imports of US services (as opposed to goods) has grown; China's economy has been re-balancing with domestic consumption the key driver of economic growth. Policy changes in recent years, including a more flexible exchange rate, state-owned enterprise reform paired with support for private companies and looser monetary and fiscal policy, should also soften the US-China trade impact. Additional infrastructure investment may also be a key near-term support for China's economy. It should also be emphasized any impact of the trade dispute is not limited to China. Recent data indicated a contraction in US manufacturing in August for the first time since 2016.
2. **Social unrest in Hong Kong**, which entered its third month in August, has been adversely affecting key business areas in the city. A deterioration in the retail, hospitality and real estate sectors as well as a reduction in tourist arrivals has resulted in sharp share price corrections in related companies. While we expect the business environment to remain challenging in the near term as the government continues efforts to resolve issues, we anticipate some stabilization in the medium term. Moreover, we have also seen a number of companies implementing cost-reduction initiatives and streamlining operations, to support profitability and strengthen their overall business models. Although retailers have been especially impacted, it is important to note that some companies have substantial operations in neighboring markets, such as mainland China, which continue to contribute to earnings. Valuations have also become more attractive with decent dividend yields, which are particularly appealing in an environment of low interest rates.
3. The **Mexican** economy has been buffeted by weaker-than-expected data and bouts of uncertainty. In the second quarter, gross domestic product (GDP) (on a year-on-year basis) contracted for the first time since the 2009 economic crisis. While we expect the volatility in financial markets to continue in the interim amid uncertainty about policies the newly elected administration will pursue, we believe the financials and consumer discretionary sectors remain attractive. Valuations have fallen to attractive levels, while profitability remains high. The domestic banking sector is underpenetrated compared to regional and global peers, especially in the consumer segment, providing strong structural growth potential. Separately, the country's favorable demographics, which includes a young working population, also helps support

consumerism. Moreover, Mexico has done quite well in positioning itself as a manufacturing hub for the United States. The cost of labor in Mexico is lower than China, so not only is Mexico well-positioned geographically in the supply chain, it is an inexpensive place for manufacturing and a potential beneficiary from US-China trade tensions. Remittances from the United States also aid the consumer sector.

Mexico De-Rating Provides Upside Potential

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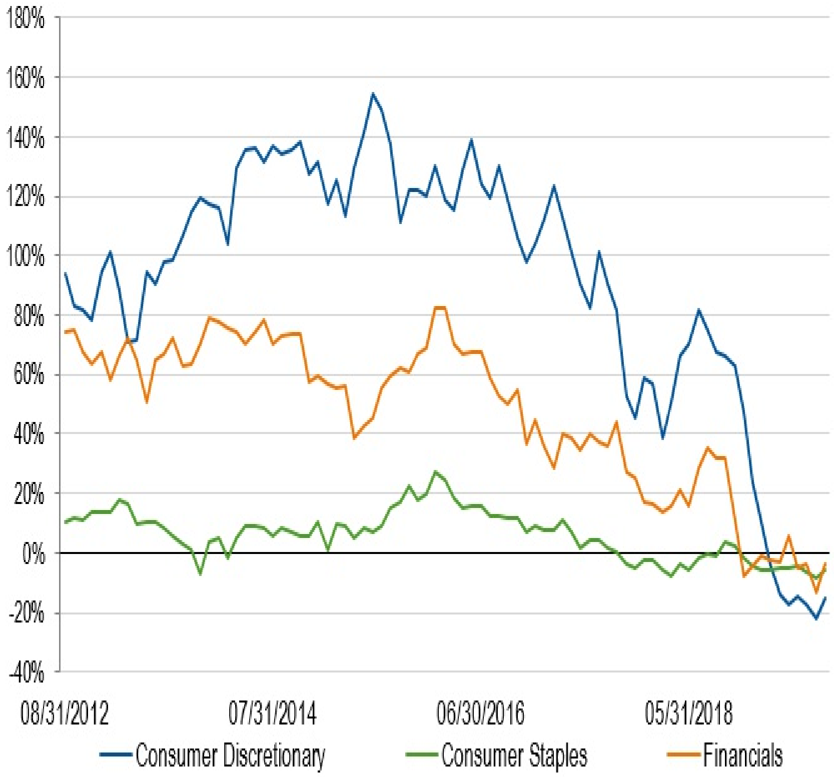
Mexican sectors' (financials, consumer staples, consumer discretionary) premium to emerging markets has disappeared.

Sector forward price/earnings ratio discount/premium to emerging market sectors



Sources: FactSet, MSCI, August 2019. Past performance does not guarantee future results. See www.franklintempletondatasources.com for additional data provider information.
The P/E ratio for an individual stock compares the stock price to the company's earnings per share.

Outlook

Global and emerging market (EM) equities have seen swings in sentiment in recent months, driven primarily by changing US Federal Reserve (Fed) policy and ongoing US-China trade-related negotiations/Trump tweets. We remain cautious and expect continued volatility as both economies work toward resolving outstanding issues. The increased likelihood of a no-deal Brexit has further clouded the global outlook.

Amid this macro-driven volatility, we continue to search for companies with sustainable drivers of earnings growth that we believe can withstand market uncertainty. Domestically-oriented businesses may be well positioned to benefit from structural demand drivers like the confluence of technology and consumption in e-commerce, or the ongoing consumer need for financial services.

On the positive side, a dovish Fed interest rate outlook bodes well for EMs. We believe an interest-rate cut in September could continue to alleviate upward pressure on the US dollar, helping stabilize EM currencies, while also facilitating greater flexibility in EM monetary policy. Despite the escalation in trade rhetoric, we are of the view that the long-term structural drivers of EMs remain intact. We believe that investors should be cognizant of EMs' improving fundamentals, which have brought more resilience and stability to the asset class.

Key Trends and Developments

EM equities fell in August and lost more ground than developed market stocks amid mounting fears of a global economic slowdown. The US-China trade row intensified as both countries announced new rounds of trade tariffs, while an inversion of the US Treasury yield curve stoked worries that the United States could be headed for a recession. EMs registered portfolio outflows, and EM currencies declined against the US dollar.

The Most Important Moves in Emerging Markets in August

- Asian markets retreated against a backdrop of trade and geopolitical friction. Stocks in Pakistan, South Korea and China notched the largest declines. South Korea's trade feud with Japan heightened as both countries decided to end preferential trade treatment for each other. China aimed retaliatory tariffs at imports from the United States after the latter unveiled more duties on Chinese products, including consumer goods such as smartphones. The yuan declined against the US dollar, adding to bilateral tensions. Although equity prices in Thailand declined, the market fared better than its regional peers, as investors cheered the approval of a US$10 billion stimulus package.
- Latin American markets underperformed their global peers in August. Argentina was by far the weakest market globally, following President Mauricio Macri's poor performance in primary elections, which raised doubts about his re-election prospects in October's presidential elections. The debt re-profiling and imposition of capital controls added to market concerns. Albeit, this volatility has remained contained within Argentina alone. Although better-than-expected second-quarter GDP growth data, low inflation and expectations of additional interest-rate cuts provided some comfort to investors, Brazilian equity prices declined in US dollar terms largely due to weakness in the real. Mexico was an outperformer, ending the month virtually unchanged, supported by a 25-basis point[1] interest-rate cut by its central bank.
- Depreciation in regional currencies weighed on market performances in the Europe, Middle East and Africa region during August. Turkey, South Africa and Saudi Arabia lagged the most. In South Africa, Finance Minister Tito Mboweni released an economic policy paper, which outlined a series of reforms and proposals targeted at stimulating the domestic economy. A decline in oil prices stemming from demand concerns impacted the Russian market. At the other end of the spectrum, Egypt was the top EM performer in August, returning close to 10% in US dollar terms. Egypt's central bank surprised markets with a larger-than-expected 150-basis point interest rate cut amid a downward inflation trend.

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1. A basis point is a unit of measurement. One basis point is equal to 0.01%.