PERSPECTIVE

The Emerging Market Appeal in a Low-Yielding World

October 08, 2019

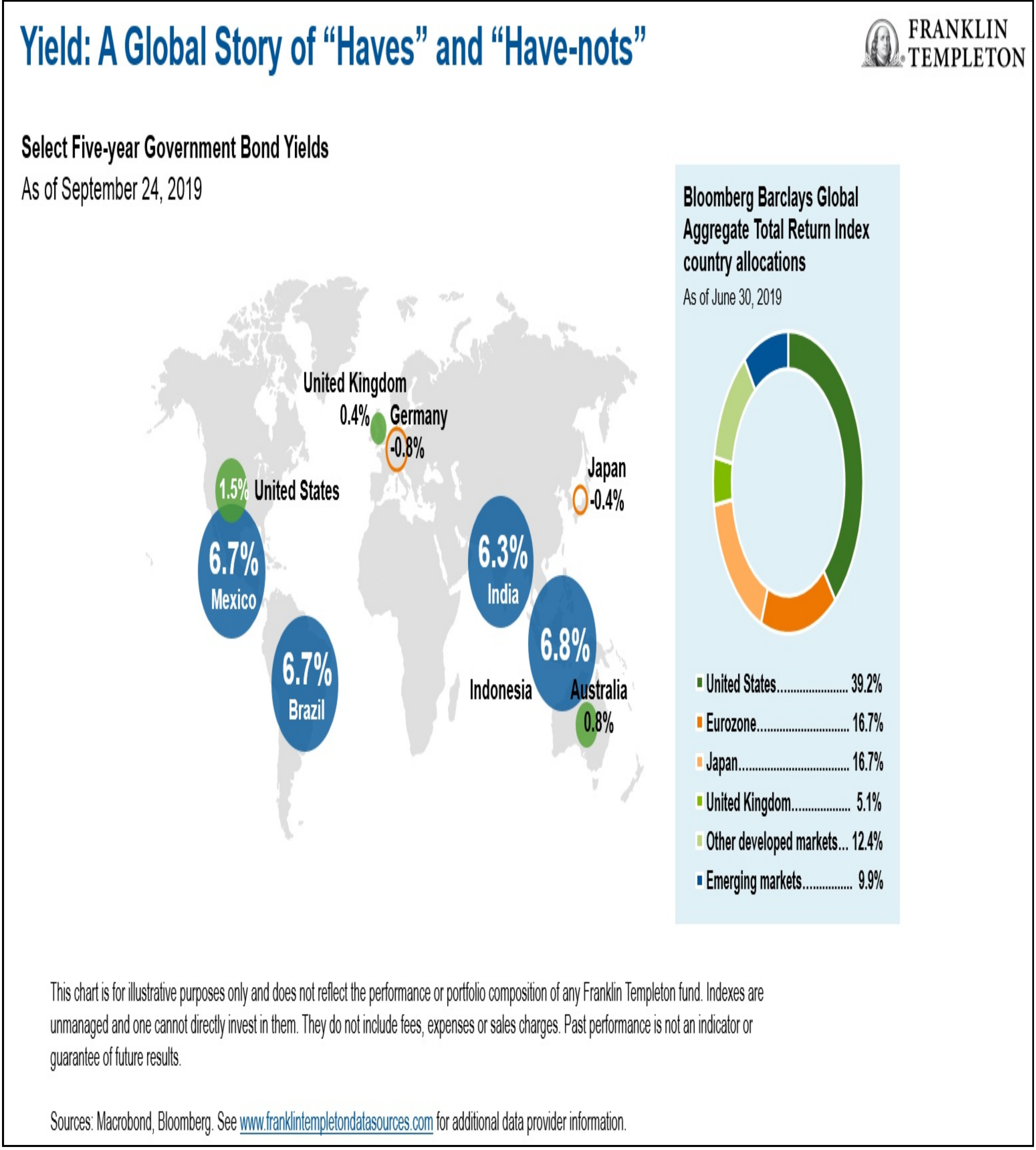
Subash Pillai
Head of Client Investment Solutions - APAC
Franklin Templeton Multi-Asset Solutions

Global investors searching for income opportunities may find the current climate particularly challenging, given a growing pool of negative-yielding debt. Franklin Templeton Multi-Asset Solutions' Subash Pillai outlines why he thinks yield-seeking investors might take notice of emerging markets.

With developed market fixed income yields at or near record lows, we think many yield-seeking investors may need to look outside the box to satisfy their income requirements. For example, these investors may be asking themselves whether now is a good time to buy more German or Japanese long-term sovereign debt—both of which are at negative yields.

We believe there's a strong case for income investing in emerging markets, which we see as the main driver of global growth over the next century.

Investors might consider allocating more capital to bonds in places like India, Indonesia, Mexico or Brazil, where sovereign debt yields are hovering around the 6% to 7% range.[1]

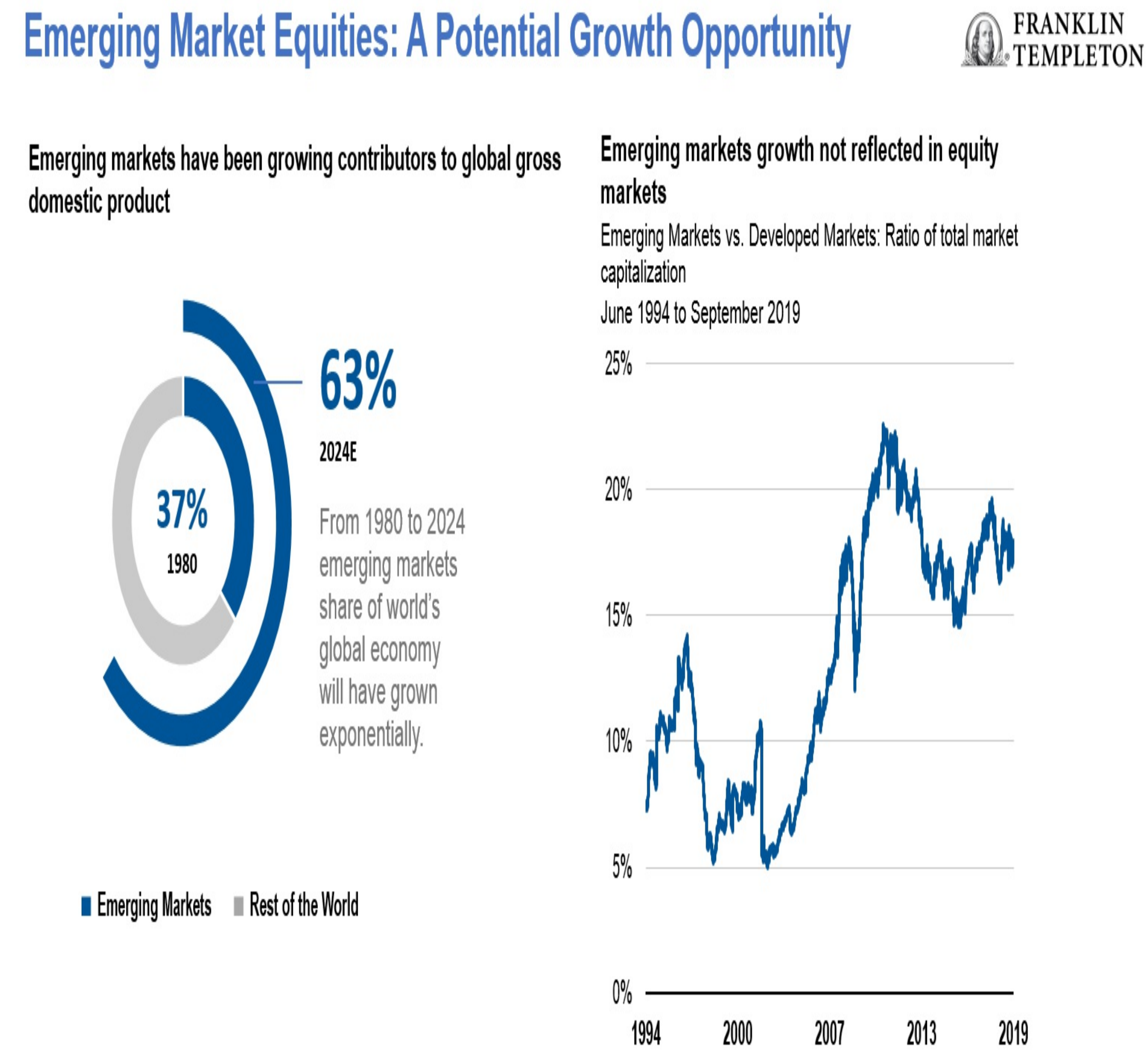


A Story of Transformation

As the name implies, emerging markets are a story of transformation. In the past few decades, we have witnessed dramatic economic shifts, driven in part by changing demographics, the rise of consumerism and the embrace of new technological innovations. For these and other reasons, emerging market equities also represent a compelling investment opportunity in our view. The shift from old economy to new economy in emerging markets is well-entrenched, as is the shift from foreign to domestic revenues.

However, many investors remain stuck in the past when it comes to how they think about emerging markets—failing to recognize the new opportunities now in front of them. We think it's important to think about not only today's opportunities, but position for the future as well.

China is a shining example of an emerging market that rose from an agrarian society to a global superpower in just a few decades. But it's not the only emerging economy on the rise. Emerging markets today represent more than 50% of the global economy, based on gross domestic product (GDP).[2] Emerging markets overall have been growing faster than developed markets overall for the past decade, with projected 2019 and 2020 GDP growth more than double that of advanced economies, according to the International Monetary Fund.[3]



For illustrative purposes only. Past performance is not an indicator or a guarantee of future performance. There is no assurance that any estimate, forecast or projection will be realized.

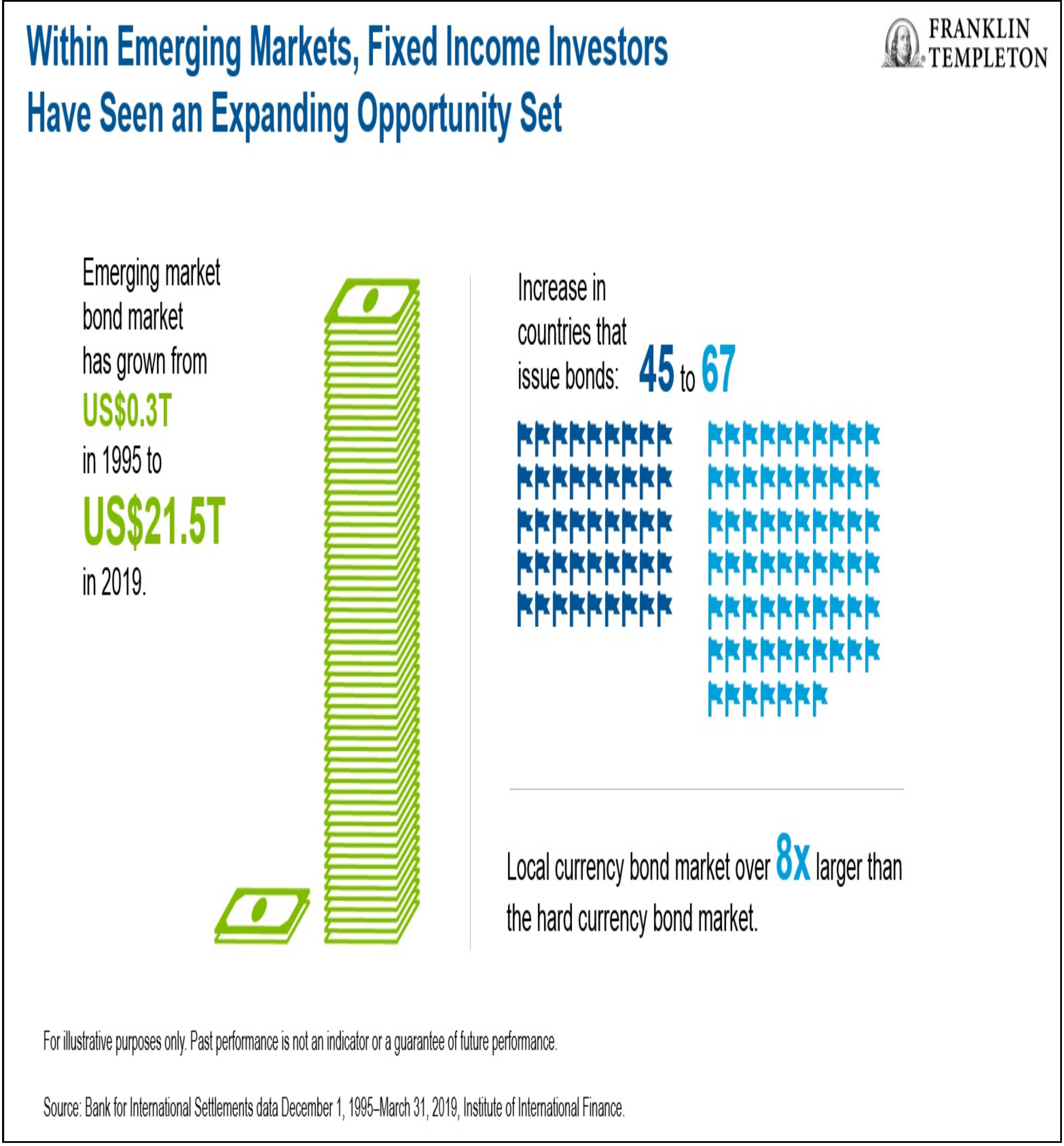
Sources: Bloomberg, BIS (Bureau of International Settlements), MSCI. Emerging Markets are represented by the MSCI Emerging Markets Index. Developed Markets are represented by the MSCI World Index. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges. 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. See www.franklintempletondatasources.com for additional data provider information.

Opportunity Set Has Been Expanding

Within fixed income, investors have seen an expanding opportunity set, including government (sovereign) bonds as well as corporate credit. These can be issued in local or “hard” currencies—such as the US dollar, yen or euro. The emerging market fixed income universe has grown from US$0.3 trillion in 1995 to US$21.5 trillion in 2019.[4]

From a global fixed income perspective, a number of factors are currently shaping financial markets today, including geopolitical risks and trade tensions, populism and political polarization. In addition, markets are grappling with unrestrained deficit spending in the developed world, low interest rates and underappreciated inflation risks, as well as overvaluations in many risk assets. As investors search for yield, emerging-market fixed income can look compelling—although certainly not without some risks.

Within equities, emerging markets represent slightly more than 17% of the world’s market cap of $80.9 trillion.[5] More opportunities continue to open up to foreign investors in these dynamic markets, with increasing weights in major benchmark indexes. Domestic Chinese equities now have a greater presence in both the MSCI and FTSE Emerging Markets Indexes—with more shares still to be added. Meanwhile, Argentina and Saudi Arabia also saw status upgrades from index providers.



Given higher growth prospects with generally lower valuations compared to developed markets—to us, this makes a compelling investment case.

Emerging market equities have fluctuated in recent months, driven primarily by uncertainties around US-China trade negotiations and US monetary policy. Despite the uncertainties, we believe improving fundamentals generally support the asset class. These fundamentals include a combination of flexible exchange rate systems, greater fiscal discipline and stronger sovereign balance sheets. Overall, we consider equities' structural drivers to be largely intact, including the rise of consumerism and technology. We seek to invest in companies that demonstrate sustainable earnings power and potential resilience against market uncertainty.

Lessons of the Past

Past crises have taught emerging market economies to minimize external borrowing and focus on their own domestic markets, improving their resilience to external shocks. As a result, we've generally seen higher-than-average credit quality for local currency issuances. The average debt-to-GDP ratio for emerging market countries has dropped despite rapid growth in local currency debt issuance.

Local currency bonds also tend to be more liquid than hard currency bonds as domestic investors step in to buy just as foreign investors are fleeing.

We favor select currency positions in countries we view as having healthy or improving fundamentals, along with attractive risk-adjusted returns. For example, in Indonesia, we expect continued emphasis on prudent, stable economic management as part of President Joko Widodo's administration. The country has benefitted from greater policy coherence and increasing transparency in recent years. Ongoing reforms have sought to balance the country's growth drivers and potentially accelerate domestic development.

Brazil has certainly faced some recent headwinds, but we note its central bank is independent, which is an orthodox policy approach. And, the country's finance minister seems committed to appropriate policies. Reforms underway in Brazil represent a major structural shift that we think should unlock the economy's domestic growth drivers.

These are just a couple of examples. Our long experience of emerging market investing tells us that an active allocation approach—applying top-down as well as bottom-up perspective—to decide the weightings of asset classes across a portfolio may help illuminate risks in aggregate. This approach may also help investors make decisions around their expectations.

Taking a dynamic approach ourselves allows us to maintain a long-term view while remaining on the ball about macroeconomic changes—dialing up or down our exposure across asset classes as we deem appropriate based on factors such as economic and inflation forecasts, valuation measures and historical risk premia.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Investment Adventures in Emerging Markets blog.

For timely investing tidbits, follow us on Twitter @FTI_Emerging and on LinkedIn.

Important Legal Information

Data from third-party sources may have been used in the preparation of this material and Franklin Templeton ("FT") has not independently verified, validated or audited such data. FT accepts no liability whatsoever for any loss arising from use of this information, and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FT affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

What Are the Risks?

All investments involve risks, including the possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. 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.

---

1. Source: Bloomberg, as of September 24, 2019.

2. Source: International Monetary Fund DataMapper, April 2019 World Economic Outlook, data from 2008-2018. GDP based on purchasing power parity, share of world.

3. Source: International Monetary Fund, April 2019 Economic Outlook database. There is no assurance that any estimate, forecast or projection will be realized.

4. Sources: Bank for International Settlements, Institute of International Finance. Data from December 1, 1995, through March 31, 2019. Past performance is not an indicator or guarantee of future results.

5. Source: MSCI via Bloomberg. Emerging markets are represented by the MSCI Emerging Markets Index. Developed markets are represented by the MSCI World Index. 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. See www.franklintempletondatasources.com for additional data provider information.