PERSPECTIVE

Emerging Markets Show a Quiet Resilience

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As the world watches the US-China trade spat roll on, it is important to look beyond the headlines and examine the economic reality and progress within emerging markets, according to Franklin Templeton Emerging Markets Equity's Andrew Ness. He explains why investors should pay attention to the economic evolution taking place in emerging-market economies.

Maintaining perspective matters, particularly when we consider emerging markets. Despite ongoing US-China trade discussions, intra-emerging markets trade has blossomed in recent years—with China replacing the United States as the largest export destination for other emerging markets as a whole.[1] However, there have also been some positive developments in other emerging markets that have flown under the radar.

Three decades ago, emerging market economies typically relied on commodity exports. Those exports drove economic development and manufacturing, and also contributed to the creation of global supply chains.

Since then, emerging markets have evolved through structural reforms and improved regulation, so we've seen improved resilience. In addition, heightened domestic demand has helped many of these countries grow irrespective of external forces.

However, we believe there are still some emerging-market developments that remain under-appreciated.

Misconceptions Remain

Some common assumptions about emerging markets are not accurate, in our view. One misconception is that production processes of goods from these economies can often be unethical and poorly regulated. This can lead to concerns about quality of goods as well as reliability of services.

There may be an element of truth in this concern for some markets, but it's certainly not true of all emerging markets. We'd argue it's important to recognize the regulatory changes that have been happening in certain emerging markets to improve the market environment.

As investors, we do recognize these and other macro developments, but also consider individual stocks from a bottom-up perspective.

When we're examining investment opportunities in emerging markets, corporate governance is an important consideration. We take aspects such as quality management, ownership structure and history of business conduct into account. We also proactively engage with company management and other stakeholders to monitor corporate governance practices and promote positive change when needed.

Progressive Companies in Russia Focus on Shareholder Returns

For example, some significant regulatory changes in Russia have led us to reconsider equity investment opportunities there. The Russian government has implemented some politically challenging measures such as tax increases and pension reforms, with plans to raise productivity growth through higher spending on infrastructure, health and education.

Several progressive dividend policies and strong buyback programs have emerged from Russia recently, but headlines have largely focused on geopolitical tension between the US and Russian governments. Over the years, we have worked with businesses in regard to governance factors. As such, some of these companies have increased their focus on shareholder returns.

Innovation in India

Emerging markets used to have a simple roadmap to growth: produce and sell abroad. Some countries offered large pools of affordable labor to become low-cost manufacturing hubs. This often left the fortunes of these countries vulnerable to changes in the developed markets they exported to.

What today's headlines fail to reflect is that emerging market economies have evolved. As they become increasingly more developed, they are growing their "high-tech" exports to meet growing global demand.

In India, for example, innovation has become a priority. Its national strategy "Decade of Innovations 2010-20" is committed to strengthening science, technology and innovation capacities. Its objective is to increase gross expenditure on research and development to 2% of India's gross domestic product by 2020. The country's commitment to innovation is also reflected in India's "Make in India" initiative to strengthen its manufacturing sector.

Brazil's Environmental Considerations

Emerging market countries are also playing an integral role in the generation of renewable energy.

In Brazil's manufacturing sector, for example, we've seen certain companies make considerable progress in regard to environmental considerations, which are starting to influence business decisions.

One Brazilian auto parts manufacturer has worked to significantly reduce its carbon dioxide emission through the introduction of alternative biofuels (ethanol) in its internal combustion engines. The company has taken this a step further to develop a solution to improve ethanol productivity at its sugar cane mills.

We believe this should further improve the use of renewable fuels in Brazilian cars, which are already mostly dual-fuel cars—vehicles that run on more than one type of fuel, i.e. gasoline blended with either ethanol or methanol fuel.

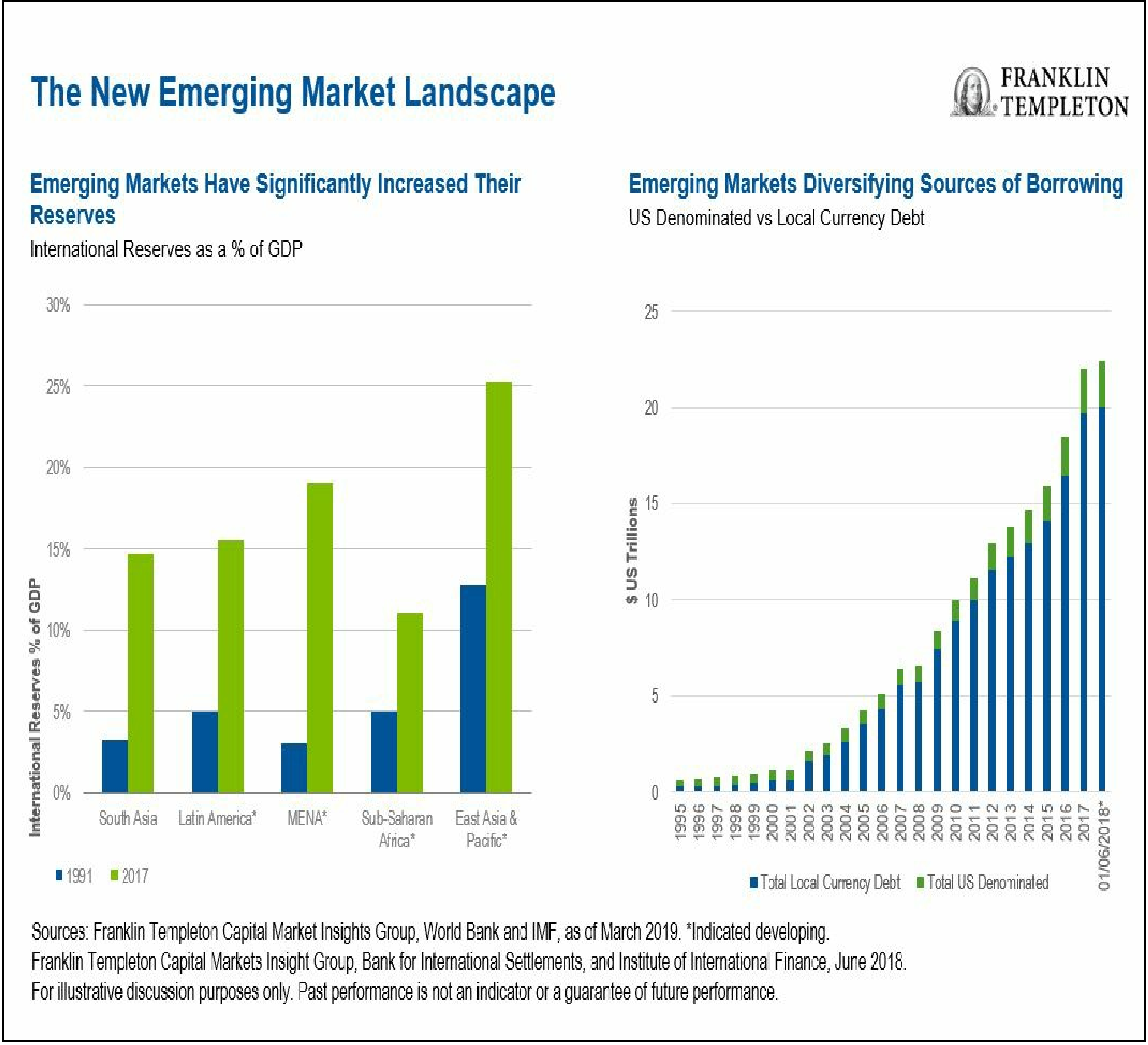
Learning Lessons from the Past

We remain primarily focused on individual company fundamentals to assess long-term prospects on a case-by-case basis.

We tend to favor high quality and sustainable companies where we see long-term potential. Our teams on the ground identify potential opportunities; our local reach is particularly useful when we consider the potential opportunities in relatively untapped segments of the market.

We believe today's emerging markets are now more resilient than in previous decades, emerging stronger after periods of economic hardship—such as the 1997 Asian Financial Crisis that affected much of Southeast Asia.

Many emerging economies learned lessons from the past, building up cash reserves and diversifying away from US dollar-denominated debt.



Conclusion

The emerging markets of today bear little resemblance to the emerging markets of 1989. Since that time, emerging markets have become far more outward-looking, while also developing stronger trading relationships between each other.

We think investing in emerging markets boils down to the mismatch between perception and reality. We encourage investors to look beyond the headlines to see how emerging markets have become resilient, standalone economies.

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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.

1. Source: Intracen, December 2018.