PERSPECTIVE

Emerging Markets Q1 2016 Recap: A Turn in Fortunes

April 15, 2016

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The Templeton Emerging Markets Group has a wide investment universe to cover—tens of thousands of companies in markets on nearly every continent! While we are bottom-up investors, it helps to have some big-picture context. Here, I outline what's happened in the emerging markets universe in the first three months of the year, including some key events, milestones and data points going back a bit further to offer some perspective. Overall, the first-quarter of the year (Q1) was marked by a turn in fortunes for emerging markets, which saw many investors return to the asset class after a challenging 2015.

In our opinion, the long-term investment case for emerging markets remains positive for a number of reasons. Economic growth rates in general continue to be faster than those of developed markets, emerging markets have much greater foreign reserves than developed markets and the debt-to-gross domestic product (GDP) ratios of emerging-market countries generally remain lower than those of developed markets. Even with major economies like Russia and Brazil in recession, emerging markets overall are expected to grow 4.3% in 2016, more than twice the rate of the 2.1% growth projected for developed markets.[1] Though investors have been concerned with China's growth rate slowing down, China remains one of the fastest-growing economies in the world.

Emerging-market countries account for nearly three-fourths of the world's land mass and four-fifths of the world's population,[2] present considerable potential in terms of resources and demographics, and look to be in a strong position to potentially benefit from technological advances. It is also important to remember that emerging-market countries represent a large share of world economic activity and equity market capitalization. Many investors have been underweighted in emerging markets and in our view, this underweight position could represent a potential risk, especially as emerging markets appear undervalued versus developed markets based on price-to-earnings and price-to-book ratios.[3]

First-Quarter Overview

Despite weakness at the start of 2016, emerging-market equities managed to close the first quarter of the year substantially higher, thanks to a rally in the latter half of the quarter. Market participants were reassured by the dovish tone struck by several major central banks around the world, especially the US Federal Reserve, which led to weakness in the US dollar and corresponding strength in most emerging-market currencies. Meanwhile, the European Central Bank announced greater-than-expected easing measures, cutting rates as well as extending its monthly asset-purchase program from €60 billion to €80 billion per month. Concerns regarding China's GDP growth and renminbi devaluation also eased somewhat, while political developments in Brazil suggesting a potential change in policy raised investor confidence further. Commodity prices rallied in the latter part of the period, buoyed by hopes that measures to restrain production by major energy and metals producers would ease oversupply issues.

Emerging-market equities significantly outperformed their developed-market counterparts in the first quarter, with the MSCI Emerging Markets Index up 5.8% compared with a 0.2% loss for the MSCI World Index, both in US dollar terms.[4] Among the various emerging-market regions, indexes tracking Latin America, Europe, the Middle East and Africa recorded double-digit gains, but emerging markets in Asia generally lagged, advancing only slightly.[5]

Brazil was one of the best-performing individual markets globally, driving gains in Latin America. The likelihood of President Dilma Rousseff's impeachment raised investors' hopes for a change in leadership well before Brazil's general elections in 2018. Peru and Colombia were also among top-performing global markets, the former driven by currency strength and anticipation ahead of presidential elections in April, while the latter was supported by select economic indicators that showed positive momentum.

Most markets in Europe recorded double-digit returns, led by Turkey, where fourth-quarter economic data, including growth figures, surpassed market expectations. Russian equities also performed strongly, as the ruble saw its strongest quarter in four years and several economic indicators suggested an improving environment.

African markets were propelled higher by South Africa, boosted by the rise in metals prices and record-high appreciation in the rand. However, select African markets such as Nigeria and Egypt retreated over the quarter.

In Asia, Southeast Asian markets such as Thailand, Malaysia and Indonesia were consistently strong during the quarter, supported by continued foreign inflows. In addition, Thailand benefited from currency strength, positive stock-specific news and signs of improving consumer confidence and strengthening domestic activity, largely supported by government spending and tax incentives, while Malaysia and Indonesia were aided by easing monetary policy and stimulus measures. In contrast, China and India were the region's weakest performers. Although Chinese equities gained substantially in March thanks to easing concerns regarding growth, capital flows and currency devaluation, they ended the quarter lower due to significant weakness earlier in the period. Similarly, notable strength for the Indian market in March was insufficient to offset declines in January and February.

Country Updates by the Numbers

For those who are interested in really diving into the numbers, I am including some country updates that show changes in key economic indicators and measures more recently and going back farther.

China

China's economy grew 6.8% on a year-over-year basis (y-o-y) in the final quarter of 2015, slightly slower than the 6.9% y-o-y growth in the third quarter. For 2015 as a whole, GDP grew 6.9%, in line with market expectations. In comparison, the economy grew 7.3% in 2014. The government set an annual GDP growth target of 6.5% to 7.0% for 2016–2020. The consumer price index rose to 2.3% y-o-y in February, its highest level in nearly two years, from 1.8% y-o-y in January, largely due to higher food prices over the Lunar New Year holiday. Exports declined 25.4% y-o-y in February, an acceleration from the 11.2% y-o-y contraction in January, while imports decreased 13.8% y-o-y in February, an improvement from the 18.8% y-o-y contraction in January. As a result, the trade surplus nearly halved to US$32.6 billion in February, from US$63.3 billion in January. Growth in retail sales moderated to 10.2% y-o-y in the first two months of 2016, from 11.1% y-o-y in December. In comparison, retail sales grew 10.7% for 2015 as a whole. Industrial production rose 5.4% in the January to February period, compared to an increase of 5.9% y-o-y in December, while growth in fixed asset investment stabilized at 10.2% y-o-y for the same period, in line with growth recorded in 2015, on a rebound in property investment. Foreign exchange reserves declined by a relatively smaller US$28.6 billion to US$3.2 trillion in February, compared to a US$99.5 billion decline in January, a likely indication of some success at curbing capital outflows, and stability in the renminbi. International rating agency Moody's changed its outlook on China's government credit ratings to negative from stable, while affirming its Aa3 rating.[6]

South Korea

GDP growth in South Korea accelerated to 3.0% y-o-y in the fourth quarter of 2015, from 2.7% y-o-y in the third quarter as growth in private consumption and government expenditure strengthened. For the year, the economy grew 2.6%, compared to 3.3% in 2014. The Bank of Korea maintained its benchmark interest rate at a record low level of 1.5% during the quarter. The consumer price index rose to 1.3% y-o-y in February, from 0.8% y-o-y in January, largely due to higher food and petroleum prices. Exports declined 12.2% y-o-y to US$36.4 billion in February on weakening external demand, especially from China, South Korea's largest trade partner. Weak domestic demand led imports to decrease 14.2% y-o-y to US$29.0 billion, resulting in a US$7.4 billion trade surplus for February. Finance Minister Yoo Il-ho announced an economic package worth more than US$20 billion to support the domestic economy. Nearly 15 years after it was drafted, the parliament finally passed South Korea's first anti-terrorism legislation. As part of efforts to increase bilateral commercial relations, South Korea disclosed plans to invest US$50 million to build an information technology park in Islamabad, the capital of Pakistan. Aimed at increasing trade and investment relations, South Korea and Egypt signed a number of memorandums of understanding in February.

India

GDP growth in India eased to 7.3% y-o-y in the final quarter of 2015, from a revised 7.7% y-o-y in the preceding quarter. Growth drivers included the manufacturing and services sectors. The agriculture industry, however, lagged with output declining 1.0% y-o-y in the fourth quarter. The Reserve Bank of India maintained its benchmark interest rate at 6.75% during the first quarter of 2016. The consumer price index eased to 5.2% y-o-y in February, from 5.7% y-o-y in January, after rising for six months, mainly due to lower food price inflation. Wholesale prices declined 0.9% y-o-y in February, unchanged from January, mainly due to lower fuel and power prices. Exports declined 5.7% y-o-y to US$20.7 billion in February, while imports dropped 5.0% y-o-y to US$27.3 billion, leading the trade deficit to narrow to US$6.5 billion in February, from US$7.6 billion in January. French President Francois Hollande visited India in January where he met with Prime Minister Narendra Modi. Both leaders agreed to expand bilateral business and investment relations and signed 16 agreements in areas including urban sector development, alternative energy and the "Make in India" initiative. India's Union Budget 2016/17 projects a deficit of 3.5%, compared to a 3.9% estimate for 2015/16, with a focus on boosting investment in the agriculture, infrastructure and social sectors as well as employment generation.

Brazil

The Brazilian economy contracted 5.9% y-o-y in the last quarter of 2015 largely due to a decline in consumption and investment. An acceleration from the 4.5% y-o-y decline recorded in the third quarter, this was the seventh consecutive quarter of reduction. For 2015 as a whole, GDP contracted 3.8%. Balancing concerns about rising inflation, and domestic and global economic risks, the Central Bank of Brazil left its key interest rate unchanged at a nine-year high of 14.25% during the quarter. The consumer price index eased to 10.4% y-o-y in February, from 10.7% y-o-y in January, largely due to lower food price inflation, but remained above the central bank's 2.5% to 6.5% target range. Brazil and Ethiopia signed a memorandum of understanding in trade and investment. International rating agency Standard & Poor's downgraded Brazil's sovereign rating by one level, to BB from BB+, maintaining a negative outlook, due to considerable political and economic challenges.[7] Moody's downgraded Brazil's sovereign credit rating to Ba2, "junk" status, and changed the outlook to negative, on rising political and debt concerns.[8] Finance Minister Nelson Barbosa announced plans to provide US$20.4 billion in credit from state-owned banks to help businesses weather the economic recession. Brazil's largest political party, the Brazilian Democratic Movement Party, withdrew its support from the ruling party coalition, increasing the likelihood of impeachment for President Dilma Rousseff. Former President Luiz Inácio Lula da Silva was appointed chief of staff to the president in March.

South Africa

South Africa’s economy grew 0.6% y-o-y in the final quarter of 2015, easing from the 1.0% y-o-y growth recorded in the third quarter. A contraction in manufacturing, mining and agriculture, and a slowdown in finance and construction growth were the key reasons for the moderation in economic growth. The agriculture sector contracted 14.1% y-o-y, while mining and manufacturing both declined by less than 1% y-o-y during the fourth quarter. For the entire year, GDP grew 1.3% y-o-y, slightly slower than the 1.4% growth in 2014. The South African Reserve Bank raised its benchmark interest rate by 75 basis points (0.75%) to 7.0% during the quarter in view of the depreciation in the rand and high inflationary pressures, despite growth concerns. The consumer price index rose to 7.0% y-o-y in February, the highest level in close to seven years, from 6.2% y-o-y in January, and remained above the Reserve Bank’s 3% to 6% target range. An increase in food prices resulting from a drought was the main reason for the jump in inflation. The 2015 current account deficit narrowed to 4.4% of GDP, from 5.4% of GDP in 2014, due to a 40.9% y-o-y decline in the trade deficit. President Jacob Zuma met his Nigerian counterpart Muhammadu Buhari during a visit to the country in March, where Zuma stressed the importance of increasing business relations in sectors such as agriculture, tourism, mining and automotive.

Russia

GDP growth in Russia declined 3.8% y-o-y in the fourth quarter of 2015, slightly better than the 4.1% y-o-y contraction recorded in the third quarter, according to preliminary data. The economy contracted 3.7% y-o-y in 2015, following a 0.7% y-o-y expansion in 2014. This was the first annual decline since 2009 as low oil prices, economic sanctions and a weak ruble impacted the domestic economy. The central bank forecasts GDP to contract 1.3% to 1.5% in 2016. However, Economic Development Minister Alexey Ulyukayev expects the economy to grow 0.7% in 2016 and between 1.5% and 2.5% in 2017. The central bank maintained its benchmark interest rate at 11.0% during the quarter due to high inflation risks. Inflation moderated for the fourth consecutive month in February as food, housing and transportation prices rose at a slower pace. The consumer price index eased to 8.1% y-o-y in February, from 9.8% y-o-y in January. The manufacturing purchasing managers’ index (PMI) declined to 49.3 in February, the third consecutive month with a score below 50, from 49.8 in January. A reading above 50 indicates an expansion in manufacturing output, while a number below 50 points to a contraction. Russia and Morocco signed bilateral cooperation agreements in a number of areas including investment, environmental protection, energy and tourism.

Turkey

Turkey’s Central Bank maintained its benchmark interest rate at 7.5% during the quarter on concerns about inflation. The consumer price index eased to 8.8% y-o-y in February, from 9.6% y-o-y in January, as food and transportation prices rose at a slower pace, but still remained above the Central Bank’s medium-term target of 5%. The current account deficit decreased to US$2.2 billion in January from US$2.4 billion a year earlier. For 2015, the current account deficit narrowed to US$32.1 billion from US$43.6 billion in 2014, mainly due to a smaller trade deficit. In an effort to expand trade and investment relations, President Recep Tayyip Erdogan visited the West African nations of Ivory Coast, Ghana, Nigeria and Guinea. Turkey signed a number of agreements in areas including tourism, energy, health and environment with Guinea, and memorandums of understanding in information technology and energy with Ghana. International rating agency Fitch affirmed Turkey’s long-term foreign currency sovereign debt rating at BBB-, with a stable outlook.[9] The European Union and Turkey voiced their commitment to accelerating the accession process.

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Important Legal Information

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. Source: IMF World Economic Update, January 2016. There is no assurance that any estimate or forecast will be realized.

2. Sources: Economist Intelligence Unit; Consensus Economics. Data as of 9/30/15.

3. The price-to-earnings (P/E) ratio is an equity valuation multiple defined as market price per share divided by annual earnings per share. The price-to-book (P/B) ratio is the current share price divided by a company's book value (or net worth) per share.

4. The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries. The MSCI World Index captures large- and mid-cap representation across 23 developed-market countries. Indexes are unmanaged, and one cannot directly invest in them. They do not reflect fees, expenses or sales charges. Past performance is no guarantee of future results.

5. Source: MSCI. The MCSI Latin America Index captures large- and mid-cap representation across five emerging-market countries in Latin America. The MSCI Emerging Markets EMEA Index captures large- and mid-cap representation across 10 emerging-market countries in Europe, the Middle East and Africa (EMEA).The MSCI EM Asia Index captures large- and mid-cap representation across eight emerging-market countries. Indexes are unmanaged, and one cannot directly invest in them. They do not reflect fees, expenses or sales charges. Past performance is no guarantee of future results.

6. Source: Moody's Investors Service, March 2, 2016.

7. Source: Standard & Poor's, February 17, 2016.

8. Source: Moody's Investors Service, February 24, 2016.

9. Source: Fitch Ratings, February 26, 2016.