PERSPECTIVE

Emerging Markets Q3 Recap: Sentiment Remains Strong

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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, we also take into account big-picture context. Here, I outline what's happened in the emerging-markets universe in the third quarter of the year, including some key events, milestones and data points going back a bit further to offer some perspective. Overall, emerging markets saw a strong quarter despite a few global market uncertainties.

Third-Quarter Overview

Global stock markets rose during the third quarter amid generally positive macroeconomic data and accommodative monetary policy across many regions. However, uncertainty about the US Federal Reserve's (Fed's) timing for raising interest rates and concerns surrounding the United Kingdom's historic vote to leave the European Union (EU) weighed on market sentiment at certain points. Broadly, both emerging and developed equity markets advanced, with emerging-market equities generally outperforming their developed-market peers as improving fundamentals and higher yields drove fund flows into emerging markets. The MSCI Emerging Markets Index returned 9.2%, above the 5% gain in the MCSI World Index, both in US dollar terms.[1]

The Fed kept interest rates on hold during its September meeting, but indicated the case for a rate increase was now stronger. Other key developments included the approval of the Shenzhen-Hong Kong Stock Connect program, India's parliament passing the Goods-and-Services Tax reform and the impeachment of Brazilian President Dilma Rousseff. Meanwhile, crude oil prices rebounded in late September as the Organization of the Petroleum Exporting Countries (OPEC) agreed to production cuts.

Markets in Asia continued to gain, making it the strongest-performing emerging-market region for the quarter. The Chinese, Taiwanese, Hong Kong and South Korean markets all produced double-digit returns, while Indonesia, Thailand and India also recorded gains. The Philippines and Malaysia were the weakest markets, ending the quarter with declines. Hong Kong benefited from net flows from its share-trading link with Shanghai and strength in the gaming and property sectors. China's markets gained as macroeconomic figures continued to show improvement. In Taiwan, the central bank left rates on hold in its meeting at the end of the period, while South Korea's second-quarter gross domestic product (GDP) growth data were revised upward.

In Latin America, Brazil stood out with a strong performance as investors cheered the impeachment of Rousseff and welcomed Michel Temer as the country's official president. Weakness in the peso and a tightening monetary policy, however, led the Mexican market to decline during the quarter. Uncertainty surrounding the peace referendum limited gains in Colombia, while low copper prices and a weak economy led the Chilean government to announce a restrictive 2017 budget, impacting investor confidence.

The Hungarian market benefited from an acceleration in GDP growth in the second quarter and low interest rates, while a rebound in oil prices in the last two months of the quarter, an interest-rate cut and better-than-expected second quarter economic-growth data supported Russian equities. A failed coup attempt, imposition of a three-month state of emergency as well as weakness in the lira caused Turkish equities to lag global markets.

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 further.

China

China's economy grew by a slightly better-than-expected 6.7% year-on-year (y-o-y) in the second quarter as government stimulus and a buoyant property market drove industrial activity and retail sales activity showed solid growth. The consumer price index eased to 1.3% y-o-y in August, from 1.8% y-o-y in July, mainly due to lower food price inflation, while producer prices declined 0.8% y-o-y in August, compared with a 1.7% y-o-y decrease in July. Growth in industrial production rose to a five-month high of 6.3% y-o-y in August, from 6.0% y-o-y in July. Fixed asset investment increased 8.1% y-o-y in the first eight months of 2016, unchanged from the growth in the first seven months of the year. Retail sales growth rose to 10.6% y-o-y in August, from 10.2% y-o-y in July, largely driven by strong car sales. Exports declined 2.8% y-o-y to US$190.6 billion in August, while imports rose 1.5% y-o-y to US$138.5 billion, its first increase in nearly two years. This resulted in a trade surplus of US$52.0 billion for the month. Foreign-exchange reserves declined by US$15.9 billion to US$3.2 trillion in August. The government approved the launch of the Shenzhen-Hong Kong Stock Connect program in August, which will allow investors direct access to the two stock markets.

South Korea

GDP growth in South Korea accelerated to a revised 3.3% y-o-y in the second quarter, from a reading of 2.8% y-o-y in the first quarter. Key growth drivers included private consumption and investment. The Bank of Korea (BOK) trimmed its 2016 growth forecast to 2.7% from 2.8%. The BOK maintained its benchmark interest rate at a record low of 1.25% for the third consecutive month in September to support the economy's recovery. Inflation remained below the BOK's 2% target rate for 2016. The consumer price index eased to 0.4% y-o-y in August, from 0.7% y-o-y in July. Exports grew for the first time since end-2014 in August, with a 2.6% y-o-y increase to US$40.1 billion. This followed a 10.2% y-o-y decline in July. Imports also rose, edging up 0.2% y-o-y, the first increase in two years. The trade surplus widened to US$5.3 billion in August, from US$4.3 billion a year earlier, but was smaller than the revised US$7.6 billion surplus recorded in July. The government announced a US$5.2 billion supplementary budget to help stimulate the economy.

India

The Indian economy grew 7.1% y-o-y in the three-month period ended June. This compared with a 7.9% y-o-y expansion in the preceding three months. A slowdown in private consumption growth and decline in fixed investment were key reasons for the moderation in economic growth. The Reserve Bank of India (RBI) left its key interest rate unchanged at a five-year low of 6.5% during the quarter. The consumer price index eased to 5.1% y-o-y in August, from a 6.1% y-o-y increase in July, falling within the RBI's 2%–6% target. The current monetary policy is expected to continue in the medium term, with the appointment of Urjit Patel, deputy governor of the RBI, as governor. The current account deficit narrowed to US$277 million in the second quarter, from US$6.1 billion in the same period a year earlier, as relatively lower oil and gold prices resulted in a significantly smaller trade deficit. Prime Minister Narendra Modi met his Vietnamese counterpart, Nguyen Xuan Phuc in Hanoi in September to discuss expanding bilateral trade and investment relations. The Parliament approved the Goods-and-Services Tax Bill in August. The reform will lead to the creation of a standardized national sales tax.

Brazil

The Brazilian economy contracted for the ninth consecutive quarter in the three-month period ended June. GDP declined 3.8% y-o-y in the second quarter, but was an improvement from the 5.4% y-o-y decrease in the first quarter. Gross fixed capital formation fell 8.8% y-o-y, while household spending decreased 5.0% y-o-y and government expenditure declined 2.2% y-o-y in the second quarter. The Central Bank maintained its key interest rate at a 10-year high of 14.25% during the quarter. The consumer price index rose to 9.0% y-o-y in July, from 8.7% y-o-y in June, and remained higher than the Central Bank's 2.5%–6.5% target range. In an effort to revive the economy, the government announced privatization plans to boost infrastructure development and participation from the private sector as well as from foreign investors. The Senate voted to impeach President Rousseff for violating fiscal laws, with 61 of the 81 Senators voting in favor, ousting her from office. Temer became the country's official president and is expected to remain in office until the end of 2018.

South Africa

The South African economy returned to growth in the second quarter, after contracting by a revised 0.1% y-o-y in the first quarter. GDP grew by a better-than-expected 0.6% y-o-y in the three-month period ended June, supported by a rebound in manufacturing. The manufacturing sector grew 3.6% y-o-y in the second quarter, compared with a 0.9% y-o-y contraction in the first quarter. The South African Reserve Bank maintained its key interest rate at 7.0% during the quarter as inflation moderated to its lowest level so far this year and within the Reserve Bank's 3%–6% target range. The consumer price index eased to 5.9% y-o-y in August, from 6.3% y-o-y in June, as electricity and other fuels costs rose at a slower pace. Food inflation, however, reached a seven-year high. Exports rose 9.0% y-o-y in July, while imports declined 2.4% y-o-y in the same period, resulting in a trade surplus of US$359 million. Growth in retail sales declined to a weaker-than-expected 0.8% y-o-y in July, from a revised 1.4% y-o-y increase in June. President Jacob Zuma held talks with visiting Indian Prime Minister Modi in July on a range of topics, including the economy and defense.

Russia

Russia's GDP contracted in the second quarter by a better-than-expected 0.6% y-o-y. This was the economy's best performance over the last 18 months and compared with a decline of 1.2% y-o-y in the first quarter. Higher oil prices supported the country's economic performance. The Ministry of Economic Development expects GDP to contract 0.2% in 2016. In comparison, the economy shrank 3.7% in 2015. The central bank reduced its benchmark interest rate by 50 basis points (0.5%) to 10.0% in September, on an improved inflation outlook. The consumer price index eased to 6.9% y-o-y in August, from 7.2% y-o-y in July and 15.7% y-o-y in September 2015. The manufacturing purchasing managers' index rose to 50.8 in August, from 49.5 in July. A reading above 50 indicates an expansion in manufacturing output, while a number below 50 points to a contraction. In an effort to restore political and economic relations, Russian President Vladimir Putin met his Turkish counterpart Recep Tayyip Erdogan in St. Petersburg in August. The ruling United Russia party won a constitutional majority in parliamentary elections in September, securing 343 of the 450 seats in the State Duma.

Turkey

GDP growth in Turkey eased to 3.1% y-o-y in the second quarter of 2016, from a revised 4.7% y-o-y in the first quarter, as investment declined and growth in household consumption and exports moderated. The Central Bank maintained its benchmark interest rate at 7.5% during the quarter, but lowered the overnight lending rate by 75 basis points (0.75%) to 8.25%. The overnight borrowing rate remained unchanged at 7.25%. The consumer price index eased to 8.0% y-o-y in August, from a six-month high of 8.8% y-o-y in July, on lower food price inflation. The central government budget surplus widened to US$1.6 billion in the first eight months of 2016, from US$215 million in the same period last year. International Ratings agency Fitch maintained the country's long-term local currency-issuer default rating at BBB-, but downgraded its outlook to negative.[2] Subsequently in September, Moody's Investors Service downgraded the country's sovereign credit rating to Ba1 from Baa3 and assigned a stable outlook.[3] The government declared a three-month state of emergency after the failed coup attempt in mid-July.

Our Outlook

Sentiment toward emerging markets continues to become more positive as many investors look for higher yields and the risk perception toward the asset class improves. A rebound in emerging-market currencies, easing concerns about a hard landing in China, attractive valuations and robust economic fundamentals in many economies are some of the factors that have continued to support the performance of emerging markets.

Companies in the consumer-related sectors and information technology are particularly attractive to us in the current environment, especially as technology is becoming more integral and competitive in emerging markets. Moreover, we think selected commodity shares remain attractively valued, especially as commodity prices show signs of bottoming out. Oil prices, for example, are currently significantly higher than their recent lows.

GDP growth in many countries has also been slowly improving, and over the next few years, countries like Russia and Brazil could see the biggest relative improvements. As a group, the International Monetary Fund expects emerging markets to grow 4.4% in 2016 and accelerate to 4.9% in 2017; in comparison, developed markets are expected to expand 1.8% in 2016 and 1.9% in 2017.[4]

While there has been some concern about potential future interest-rate increases by the Fed, we believe this has been largely discounted by the markets. However, larger- or faster-than-expected increases could result in some added short-term volatility.

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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. 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 an index. They do not reflect any fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

2. Source: Fitch Ratings Agency, August 19, 2016.

3. Source: Moody's Investors Service, September 23, 2016.

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