PERSPECTIVE

Emerging Markets Q4 2016 Recap: A Wobbly Quarter, but Reasons for Optimism

January 18, 2017

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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 share the Templeton Emerging Markets Group's overview of what happened in the emerging-markets universe in the fourth quarter of 2016, including some key events, milestones and data points going back a bit further to offer some perspective.

Fourth-Quarter Overview

- Developed markets outperformed emerging markets in the final quarter of 2016[1] as expectations of reflationary measures from the incoming administration of US President-elect Donald Trump, solid US economic data and the extension of the European Central Bank's quantitative easing program beyond March 2017, albeit at a slower pace, raised investor confidence.

- Emerging markets gained slightly in December, despite the announcement of a rate hike by the US Federal Reserve (Fed). The MSCI Emerging Markets (EM) Index returned 0.3% in December, but for the quarter as a whole, the MSCI EM Index declined 4.1%, largely due to concerns over the US dollar's surge and an increased possibility of protectionist policies from the incoming Trump administration.[2]

- The US election appears to have had a more limited impact on frontier markets. The MSCI Frontier Markets Index was up 0.5% for the quarter, outperforming emerging markets more broadly.[3] Pakistan did particularly well, ending the quarter with double-digit returns in the run-up to MSCI's announced reclassification of Pakistan to emerging-market status in May 2017.

- In 2016, emerging markets outperformed developed markets for the first time since 2010. The MSCI EM Index returned 11.6%, versus an 8.2% return for the MSCI World Index. The year witnessed a rotation in style from defensive to value, in part reflecting a turnaround in depressed materials and energy companies, which benefited from increased commodity prices.

- In December, the Fed raised rates for the first time in 2016. Signaling increased confidence in the US economy, the Fed increased the key interest rate by 25 basis points (0.25 percentage points). Hawkish views from the Fed point toward the possibility of three hikes in 2017.

- Crude oil prices advanced during the three-month period, as 11 non-OPEC (Organization of the Petroleum Exporting Countries) members including Russia committed to production cuts to curb oversupply in December, following proposed reductions in production from OPEC members in November. Overall, we believe upstream oil companies are best positioned to benefit from higher oil prices, and we remain positive on a number of companies in China, Russia, Thailand, Pakistan and India. However, over the longer term, a higher oil price could result in a potential increase in supply from shale producers as well as a production increase by low-cost producers (for example, OPEC countries and Russia) to support fiscal revenues. Higher oil prices could also lead to a significant increase in drilling activity around the world.

- Most emerging-market currencies depreciated against the US dollar in the final quarter of 2016. The Mexican peso plunged to a record low against the US dollar in November but then recovered slightly. The worst-performing currency, however, was the Egyptian pound, which roughly halved in value following the liberalization of the currency in November. Geopolitical issues continued to weigh on the Turkish lira, which was down 17% against the US dollar.

Country Updates and Key Developments

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.

Latin American markets were among the better performers in the final quarter of 2016, supported by outperformance in October. Brazil, Chile and Peru ended the three-month period with positive returns, while Mexico and Colombia lagged, in US dollar terms.

Investors in Brazil were encouraged by the approval of key reforms, with monetary easing efforts from the central bank, in order to stimulate economic growth, also proving helpful. Returns in Peru were driven by solid economic data and business confidence, while positive political progress and encouraging macroeconomic data supported the Chilean market.

Mexico was the region’s worst-performing market, as concerns of anti-immigration and protectionist policies from the incoming Trump administration weighed on equities as well as the Mexican peso. To counter inflationary pressures from a weaker peso, the central bank raised the key interest rate by 100 basis points (one percentage point).

Asian markets declined over the quarter, underperforming emerging markets as a whole. The Philippines was among the weakest performers on concerns that US protectionist measures could adversely affect trade and the country’s significant outsourcing sector.

Thailand could see some weakness in economic activity due to the one-year period of mourning following the passing of its king in 2016, but we believe this should only be a temporary effect. Thailand’s stock market saw positive performance in December, supported by the energy and financials sectors. The government’s significant economic stimulus measures, reform programs and infrastructure spending appear to be having a beneficial effect on the economy. In addition, lower commodity prices have helped to moderate inflation, boosted consumer purchasing power and enabled the implementation of reforms and accommodative monetary policies, all of which have supported economic growth. General elections are scheduled for late 2017/early 2018, which could see the return of a democratically elected government. We particularly like the consumer services, health care and tourism sectors, as Thailand remains competitive in these areas. Even though Thai banks continue to face near-term challenges from rising non-performing loans and increasing pressure on fee incomes, we continue to selectively favor better-positioned, undervalued Thai banks.

Indonesia and India underperformed amid increased uncertainty following Trump’s victory, and fund outflows. India was further pressured by demonetization measures. In an attempt to fight corruption, counterfeit currency, tax evasion, “black money” and terrorism, the Indian government scrapped usage of the highest denomination INR500 and INR1,000 currency notes from circulation. Accounting for about 85% of the currency in circulation, the liquidity shortage caused by demonetization is expected to negatively impact sectors and supply chains with high levels of cash transactions. These include areas such as real estate, jewelry, retailing, restaurants and consumer durables. As a result, economic activity in the interim will be impacted; however, in the longer term, we expect the situation to normalize and India to continue on a more sustainable growth path. These measures could also help improve transparency, increase tax compliance and accelerate a shift toward a digital economy. In the current climate, financials continue to do well, due to accelerating penetration of banking services and increased credit usage. Additionally, we believe infrastructure-related sectors like cement are well placed to benefit from continued infrastructure and housing development. Pharmaceuticals and information technology remain areas of competitive advantage for India, in our view.

Chinese shares underperformed amid a depreciation in the renminbi and increased regulatory restrictions in the insurance industry. The Shenzhen-Hong Kong Stock Connect program, which links equity trading between the two exchanges, was launched, but volumes were muted. Hong Kong also lagged its peers as gaming stocks weakened in December amid worries of capital controls from China.

In South Korea, currency depreciation and political turmoil surrounding President Park Geun-hye negatively impacted returns. South Korea’s parliament approved the impeachment motion against Geun-hye over her alleged connection to a corruption scandal, which is also said to include major listed companies. While resulting in increased uncertainty in the near term, we believe the investigation could lead the government and corporates to address some of the concerns around corporate governance and reforms, which is in the interest of all shareholders. In terms of equity sectors, we believe the outlook for semiconductors remains positive in view of increasing demand for dynamic random-access memory (DRAM) and NAND (negative-AND, a logic gate in digital electronics) flash memory, while organic light-emitting diode (OLED) demand continues to see solid growth. Elsewhere, we remain selective in consumer-related areas, avoiding stocks that are purely dependent on domestic consumption, but favoring those with international exposure.

In Europe, Russia was among the top-performing emerging markets, benefiting from the belief that US sanctions against the country could be rescinded. In addition, a rebound in oil prices and better-than-expected third-quarter gross domestic product (GDP) data were also helpful. Elsewhere in Europe, Turkey’s stock market declined, largely due to a devaluation in the lira and a tightening monetary policy.

In **Africa**, political instability and worries of a credit downgrade impacted investor sentiment in South Africa. Elsewhere on the continent, Egypt was one of the worst-performing emerging markets over the quarter. The Central Bank of Egypt floated the Egyptian pound in early November in an effort to stabilize the economy, address the shortage of US dollars and end the foreign-exchange “black market.” We continue to see opportunities in areas such as banking and consumerism. Banks, especially those with strong investment books in local treasuries with long durations at high interest rates, and lower loans-to-deposits ratios, which would allow them to capture the expected corporate and retail credit growth in the near future, are attractive to us. In the consumer space, while there may be a lag before some companies are able to pass on the full impact of the currency depreciation to the end consumer, there are some that look interesting to us as they’ve started increasing their prices ahead of the flotation. Conversely, we remain bearish on real estate, as purchasing power could remain weak for the foreseeable future, while costs increase dramatically.

Our Outlook

We think emerging markets remain at the forefront of the world's most vibrant and fastest-growing economies, with overall GDP growth rates that have been comfortably in excess of the developed world for many years, despite much publicized slowdowns in certain countries. We believe that the long-term investment case for emerging markets remains positive. While emerging markets remain sensitive to macroeconomic indicators and global monetary policy, and volatility is likely to persist for some time, equity markets appear to have begun to readjust, and we believe that confidence is returning to investors. Looking forward, we also expect macroeconomic advances to continue in 2017. This could bode well for top-line growth opportunities and the earnings outlook for emerging-market equities.

We remain positive on the consumer theme in emerging markets and see pockets of potential. For example, the automobile market is one of the most promising sectors, in our view. A lot of consumer markets still have a great deal of pent-up demand; penetration rates remain quite low versus developed markets. In addition, there has been a lot of technological change in the industry, with greater focus on efficiency, lower emissions and a shift toward electric vehicles.

Another area we are focusing on is entertainment. Gaming has great potential, and we see a lot of Chinese tourists attracted toward the casino and related offerings in Macau. Similarly, we see a rapid growth of multiplexes and movie theaters in emerging markets. We are now seeing Hollywood catering to an overseas audience, but the local movie industry in many of these markets has also started flourishing.

In our opinion, probably the greatest concern for emerging markets following Trump's election is the increased possibility of protectionist trade policies. If these policies are as severe as previously stated, the impact could be negative for emerging markets. They could likewise be harmful for global trade, and especially for countries such as Mexico, Vietnam and South Korea. Conversely, we believe such policies may have a lesser impact on those rather closed economies such as India and Indonesia, which are more dependent on domestic dynamics. We believe China could be placed in both categories, as there are parts of the economy that could be hurt and parts of the country that may actually benefit.

Despite the uncertainty surrounding his administration's future policies, there has been some optimism around the election win for Trump. This has been focused primarily around the ideas of less regulation, more fiscal stimulus and the possibility of strong pro-growth policies that might expand the US economy. If that is the case, and there is strong growth, emerging markets could benefit from that progression in the United States. Trump's victory could also be positive insofar as relations between the United States and some emerging-market countries may be put on a more realistic footing. Sanctions against Russia could be lifted and an accommodation may be made with China, so that a higher degree of reciprocity can be instituted. Generally speaking, the thrust is expected to be toward bilateral rather than multilateral agreements, with the emphasis on reciprocal arrangements.

We are of the opinion that the fundamentals of emerging-market equities remain attractive and that valuations likewise generally appear favorable when compared with developed markets. We look forward to the opportunities 2017 will bring.

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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: Based on MSI Emerging Markets and MSCI World Markets Indexes. 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. Ibid.

3. The MSCI Frontier Markets Index captures large- and mid-cap representation across 34 frontier emerging-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.