

GUEST BLOGGERS

January 15, 2018



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. Stephen Dover presents the team's overview of what has happened in the emerging-markets universe in the fourth quarter of 2017, including some key events, milestones and data points to offer some perspective.

Three Things We're Thinking about Today

1. The US Federal Reserve (Fed) raised its key interest rate by 25 basis points in December, its third increase in 2017 and in line with market expectations. The Fed is widely expected to raise the rate three times in 2018. Despite increasing concern, the impact of these rate hikes on emerging markets has thus far has been limited, partly because the normalization of monetary policy in the US was anticipated, and also thanks to sound growth and fundamentals in major emerging markets.
2. Politics was at the forefront in December as elections in South Africa, India and Chile grabbed investors' attention. As we step into 2018, politics continue to warrant our attention as three major emerging-market (EM) economies—Brazil, Mexico and Russia—will hold presidential elections. While there is little doubt that President Vladimir Putin will be re-elected for a fourth term, Brazil and Mexico may see a change. With left-wing populist Andres Manuel Lopez Obrador leading in most opinion polls in Mexico, we expect increased market volatility and continue to monitor the situation closely. In Brazil, we expect a favorable outcome with the new president likely continuing to implement key reforms.
3. Emerging markets recorded inflows of about US\$80 billion in 2017, compared to minor inflows in 2016 and outflows in 2013-2015. While 2017 was the third-best year for emerging markets in terms of asset inflows in absolute terms, after 2010 and 2009, in more than 20 years, relative to market capitalization, the recovery of flows has been relatively milder. There may be volatility ahead, particularly as investment flows can often reflect ever-changing attitudes to perceived risk, with inflows as investor sentiment moves "risk-on" and outflows as it moves "risk-off." Even so, major global investors have a lower proportion of exposure to the asset class, below what we would expect given the proportion of global GDP (gross domestic product) and market capitalization that emerging markets represent, and that could support continued inflows.

Outlook

Emerging markets did well in 2017 and we expect the asset class to remain on an upward trend in 2018, against a favorable backdrop of robust economic growth, increased asset inflows, solid foreign reserves, strong current accounts and stable local currencies. Valuations in emerging markets remain attractive, in our view, trading at a discount to their developed-market peers. Earnings of many EM companies have also been gradually improving, in terms of profitability, margins and return on equity (ROE).

We believe Asia remains the most exciting EM region. It offers a range of opportunities, from China, South Korea and Taiwan to countries such as India and Indonesia. Asian companies are also beginning to dominate in industries where European companies used to lead. This is especially so in the automobile and auto-related technology industries.

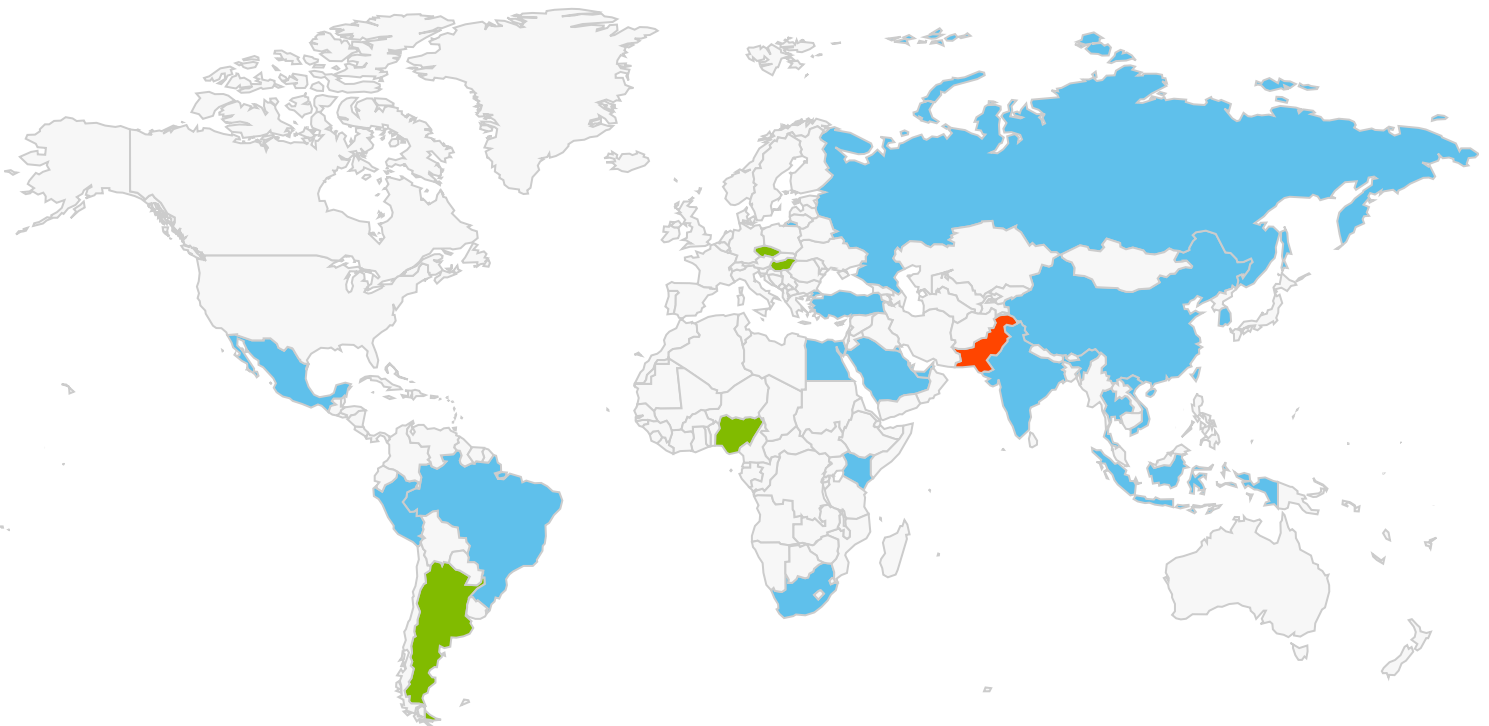
Similarly, we are finding opportunities in Latin America. Brazil has emerged from a prolonged recession and faced several challenges, including high unemployment and corruption scandals, but we are generally positive on the possibilities within that market given the new emphasis on reform efforts.

As fundamental stockpickers, we are equally excited about individual opportunities in other parts of the world, such as in places like Russia, which has fallen out of favor. In such situations, we are finding companies we regard as extremely well run, growing at a fast pace, and providing exposure to key themes such as economic growth, demographic changes and local consumer trends.

Emerging Markets Key Trends and Developments

Global equity markets advanced during the fourth quarter of 2017. Investors mainly focused on continued indications of positive economic growth from several regions and the progress of tax reform in the United States. However, we did witness a brief correction in the information technology (IT) sector on profit-taking and a rotation into other areas including financials.

Emerging markets continued to outperform developed markets, supported by better earnings and economic growth prospects, strong asset inflows and higher commodity prices. The MSCI EM Index rose 7.5%, compared with a 5.6% gain in the MSCI World Index, both in US dollars.¹ A similar trend was witnessed over most of the year as EM equities outpaced developed markets. 2017 marked emerging markets' best annual performance since 2009 with a 37.8% gain, much higher than developed markets' 23.1% return.²



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China

Our overall outlook for China remains stable. Supply-side reforms have been supportive, while the strengthening renminbi has also relieved the fear of capital flight for many overseas investors. However, inflationary pressures could rise in 2018 and uncertainties on Sino-US trade could impact the current account surplus.

India

Strong macro fundamentals, under-penetration and strong management talent make Indian corporations attractive to us, but fairly rich valuations with near-term earnings challenges make us neutral on the market.

Indonesia

Economic growth should hold steady this year, recovering slowly. Politics will likely heat up in the latter part of the year with the presidential election in April 2019.

South Korea

Macro indicators are sound but concerns on regulation and unstable geopolitical environment.

Pakistan

Uncertainty remains with concerns on a political reshuffle and a high current account deficit.

Taiwan

Macroeconomic data is stable and positive. Geopolitical situation is relatively safer when compared with other countries in the region. However, we are carefully monitoring the strong currency and demanding equity market valuations.

Thailand

Our overall outlook remains stable to slightly positive. In our opinion, economic stability remains strong with a possible gradual improvement in economic growth.

Vietnam

Annual GDP growth is likely to be above 6%, likely to be only partially offset by declining oil production. Persistent fiscal imbalance is a concern, however.

Czech Republic

Strong economy not currently reflected in stock market performance. We are carefully monitoring the ANO party's political agenda, especially since it failed to form a coalition with other parties.

Hungary

Relatively good macro outlook, stable political situation and attractive market valuations vs. broader emerging markets lead us to take a positive near-term outlook for the market.

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In a stable oil price/ruble environment, domestic names should benefit due to earnings revisions and increased demand. Political situation should remain stable as no serious competition is expected in upcoming presidential elections. However, macro risks are high due to elevated volatility of commodity prices and the possibility of additional US/EU sanctions.

Turkey

With the current expansionary fiscal policy, GDP growth expectations for 2017 have increased to 5%-6%. High inflation and political risk, however, lead us to adopt a more cautious view.

Argentina

The economic recovery is gaining strength, which, combined with a favorable election outcome in October, should pave the way for the much-desired upgrade from frontier to EM status. Until that happens, the market should sustain positive asset performance.

Brazil

The near-term outlook is challenging in view of 2018 presidential elections, which could bring higher volatility, although a favorable outcome is expected. Our long-term outlook is positive, with a new president likely to continue promoting reforms.

Mexico

The country's macroeconomic outlook is stable and equity valuations are below historical averages. We believe Mexico's risk profile has increased with the ongoing NAFTA renegotiation (though we expect a positive outcome) and the 2018 presidential election. The latter could lead to increased volatility given the tight expected race based on recent polls. Economic activity tends to remain strong leading up to presidential elections.

Peru

GDP growth is expected to have bottomed in 2017 and should accelerate going forward, driven by a healthy consumer environment coupled with higher metal prices. However, a more sustained recovery might be delayed until the political scenario gets resolved. Valuations for financial institutions and consumer names look attractive to us.

Kuwait

Potential FTSE upgrade would be a positive catalyst for the market. Kuwait's fiscal position appears stronger than its regional peers and hence more defensive. A persistent risk is political deadlock, which often leads to slower fiscal reforms and investments.

Qatar

Undemanding valuations and improving current account but slowing economic growth, political conflict and deadlock, weigh on investor appetite.

Saudi Arabia

Economic growth appears stable, and the National Transformation Plan is being redrafted to reflect more realistic targets.

United Arab Emirates

Within the region, the UAE is least dependent on oil revenues. Fiscal reforms have been successful, and we expect further reforms such as VAT implementation. However, the strong property sector needs to be monitored closely.

Egypt

Egypt has made a committed step toward economic reforms. It is witnessing receding inflation and a strengthening currency but some security risk still exists.

Kenya

With election results now validated and protests muted, economic growth is likely to be about 5%. However, we think the market has already priced in this outcome.

Nigeria

The market is improving from a macro perspective with higher oil production, better oil prices, steadying inflation and a floating currency.

South Africa

The December ANC elective conference ended with a compromise arrangement led by Cyril Ramaphosa, but with half of the top six senior executives from the Zuma faction. While leadership by Cyril Ramaphosa is positive, we will be monitoring the situation to see if key reforms can be passed under this arrangement.

The Most Important Moves in Emerging Markets the Quarter

Asian markets were among the top EM performers with India, South Korea and Singapore recording double-digit returns during the fourth quarter. The ruling party's victory in two key state elections and expectations of a pro-growth budget in the fiscal year ending March 2019 buoyed market sentiment in India. Equity prices in South Korea were driven by easing geopolitical tensions, solid economic growth and strong appreciation of the won. In contrast, Taiwan was one of the weakest performers as profit-taking in the IT sector and a rotation into materials and financials held back returns. Political instability continued to weigh on Pakistan, where stock prices declined.

Latin America, despite a faster-than-expected economic recovery and continued monetary easing, delays in social security reform continued to weigh on investor sentiment in Brazil. The Mexican market, however, was one of the worst performers, both in the region and globally, on resumed interest-rate hikes in December and uncertainty in the NAFTA (North American Free Trade Agreement) renegotiation process. A double-digit gain in December following the election of Sebastian Pinera as president, coupled with appreciation in the peso and higher commodity prices, drove gains in the Chilean market.

Central European markets including the Czech Republic and Hungary performed well, supported by generally solid macroeconomic fundamentals. The Russian market was largely driven by higher oil prices and a larger-than-expected interest-rate cut in December, while depreciation in the lira limited Turkey's returns in US dollar terms.

South Africa was one of the best-performing markets in Africa, driven by hopes of a change in policy following the victory of pro-business candidate Cyril Ramaphosa in the ruling African National Congress presidential elections, as well as strong appreciation in the rand. The Egyptian market, however, declined despite improving macroeconomic fundamentals.

Frontier markets as a group lagged their EM counterparts over the three-month period. Vietnam and Kazakhstan were notably strong performers, while Argentina and Kenya also recorded positive returns. The Vietnamese market was among the top-performing markets globally, driven by continued foreign investor interest and strong macroeconomic fundamentals including robust economic growth. In contrast, equities in Kuwait and Sri Lanka fell.

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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.

[1.](#) Source: Based on the MSCI Emerging Markets Index versus the MSCI World Index, US dollar terms. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. The MSCI World Index captures large- and mid-cap performance across 23 developed markets. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance.

[2.](#) Ibid.