ASIA

Emerging Markets Experience a Healthy Correction in May

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Franklin Templeton Emerging Markets Equity Chief Investment Officer Manraj Sekhon and Director of Portfolio Management Chetan Sehgal present an overview of emerging-market developments in May, including some events, milestones and data points.

Three Things We're Thinking About Today

1. More than 230 China A-share companies were added to the MSCI Emerging Markets (EM) Index on June 1. Initially, the companies will account for only 0.4% of the index, but this will rise to 0.8% in September, when the inclusion rate is raised to 5% of the planned total. If and when all China A-shares are included in the index (100% inclusion rate), it would bring China's total weighting to over 40% of the MSCI Emerging Markets Index.[1] The inclusion of A-shares, in addition to improving liquidity, could prompt increased company disclosure and better market accessibility, thereby enabling access to a wider range of companies in structural growth sectors such as pharmaceuticals, consumer and technology.
2. With rising US interest rates, we have seen the US dollar strengthen, which has traditionally been a headwind for emerging markets. However, the effects today are likely different than previous episodes of dollar strength, as today, most EM currencies have floating foreign exchange regimes, emerging markets in aggregate run a current account surplus, and intra- and inter-regional trade have taken on greater importance within the EM world. The direction of the US dollar itself is far from certain—should the US government aggressively pursue policies to boost exports and manufacturing, it may be inclined to promote a weaker US dollar.
3. Oil prices have been on a generally upward trend this year so far, reaching a multi-year high in May. A host of factors, including higher demand, shrinking global oil inventories and increased geopolitical risks have driven the surge in oil prices. However, recent reports that Organization of the Petroleum Exporting Countries (OPEC) and its allies may increase production led oil prices to decline slightly at the end of May. While we remain constructive on the oil price over the medium to long term, we recognize the elevated earnings risk and focus on companies with low production costs and strong balance sheets.

Outlook

We continue to have faith in emerging markets and believe they will continue to grow at a strong pace, fueled by robust trade and solid commodity prices. The rapid adaptation of information technology in emerging markets such as India and China have further propelled their strong growth. We continue to see improvement in the earnings power and cash flow of many EM companies. The impact of rising US interest rates, China's economic restructuring, stock valuations, market volatility and political events all play a role in our analysis of the development of emerging markets from where we are today. What we have seen so far in 2018 is a reminder that markets can be volatile, and we expect continued volatility this year.

Nevertheless, we remain optimistic about the opportunities that we see in "new economy" sectors related to technology and consumption. EM companies have not only taken part in the technological revolution, but are also at the forefront, becoming global innovators in areas such as e-commerce, mobile banking, robotics and autonomous vehicles. This development has created investment opportunities in a broad array of companies, ranging from internet firms to chip makers, hardware manufacturers and more. Rising wealth in emerging markets is another secular driver and we expect it to continue lifting demand for goods and services. Financials are also interesting to us, as improving macroeconomics in emerging markets create a potential tailwind for banks.

Our investment approach in emerging markets is driven by fundamental research and rigorous stock selection, which emphasizes companies with sustainable earnings power and reasonable valuations. Geopolitical uncertainty may trigger bouts of market volatility, but these can also be opportunities for long-term investors to acquire shares in well-run companies at reasonable valuations.

Emerging Markets Key Trends and Developments

EM equities declined in May, while developed-market stocks finished moderately higher. Renewed global trade tensions, economic and political concerns, and a stronger US dollar contributed to investors' shift away from emerging markets. The MSCI Emerging Markets Index declined 3.5% over the month, compared with a 0.7% gain in the MSCI World Index, both in US dollars.[2]

The Most Important Moves in Emerging Markets This Month

- **Asian stocks** fell against a backdrop of economic and political concerns. Pakistan, Malaysia and South Korea registered the largest declines. Pakistan's shrinking foreign exchange reserves, rising external debt and general election in July stoked market caution. Malaysia retreated as investors grappled with the country's fiscal health and policy direction under a newly elected government. South Korea lost ground as friction between the United States and North Korea threatened to derail peace talks and revive tensions in the Korean peninsula. Bucking the downtrend, China advanced, lifted by better-than-expected manufacturing data and the upcoming inclusion of China A-shares in MSCI's equity indexes.
- **Latin American** stocks came under broad selling pressure, with Brazil, Mexico and Chile leading the way down. Brazil fell as labor strikes against rising fuel costs hit economic activity. Government measures to help reduce pump prices raised concerns about the country's ability to stay market-friendly. Mexico was hindered by political uncertainty ahead of a presidential election in July and a stalemate in negotiations related to the North American Free Trade Agreement (NAFTA). The United States imposed tariffs on steel and aluminum from Mexico and other major trading partners, prompting Mexico to announce retaliatory measures.
- Political instability in **Italy** and growth concerns weighed on European markets, with Greece, Hungary and Poland recording double-digit declines. Political turmoil and a currency crisis weighed on equity prices in Turkey. The Central Bank of Turkey held an emergency meeting in late May, raising a key interest rate by 300 basis points (3%) in an effort to stabilize the lira after a sharp devaluation during the month. Russia bucked the trend, however, ending the month with a gain, supported by higher oil prices, improving macroeconomic data and an appreciation in the ruble. Political optimism was short-lived in South Africa, as investor outflows and weakness in the rand led the equity market to fall.
- **Frontier markets**, as a group, recorded their worst monthly performance in close to a decade in May, and significantly underperformed their EM counterparts. Argentina was by far the weakest performer, declining more than 20% in US-dollar terms.[3] Equity markets in Romania, Vietnam and Nigeria also fell. Concerns over the 2019 general elections and weak sentiment among foreign and domestic investors pressured returns in Nigeria. Meanwhile, Vietnam's market continued to experience profit-taking following strong gains over the first quarter.

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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: MSCI. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

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3. Source: Bloomberg, Buenos Aires Stock Exchange Merval Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance.