PERSPECTIVE

Emerging Markets Suffer Second-Quarter Setback

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Emerging markets suffered a setback in the second quarter, but Manraj Sekhon, CIO of Franklin Templeton Emerging Markets Equity, and Chetan Sehgal, senior managing director and director of portfolio management, don't see a fundamental derailment. They present the team's overview of the emerging-markets universe in the second quarter of 2018 and offer their perspective on global headwinds and tailwinds.

Three Things We're Thinking about Today

1. **Saudi Arabia's** inclusion in the MSCI Emerging Markets (EM) Index, which will likely take effect in at least two tranches over May and August 2019, could transform the Kingdom's capital market and boost the wider MENA region. With only US$9 billion in foreign investment in the Kingdom's stock exchange, Saudi Arabia's new EM status is likely to bring with it significant foreign inflows, which could, in the long term, trickle through to surrounding economies as well. Improving economic fundamentals may also attract investors.
2. The **Indian banking system** is one of the fastest growing banking systems in the world. Taking into account that India's formal economy remains a fraction of the country's gross domestic product (GDP) and that only half of the population's savings are in financial assets, there is significant growth potential for banks. Private-sector banks currently have a market share of ~30%, while state-owned banks make up the rest. State-owned banks, however, are less competitive and lag in areas like automation, technology, customer service and management quality. Thus, we expect private sector banks to grow faster and gain market share. Recent concerns about high levels of bad loans at state-banks could also benefit private lenders.
3. A truckers' strike over diesel prices heightened investor concerns in **Brazil**, weighing on equity prices across the market. However, we believe that opportunities for longer-term investors have emerged as quality stocks are now trading at lower valuations. Overall, we are generally positive on the investment opportunities in Brazil given the continued emphasis on reforms. The country also has great export potential in manufacturing and agriculture, which we believe should reflect in better GDP figures going forward.

Outlook

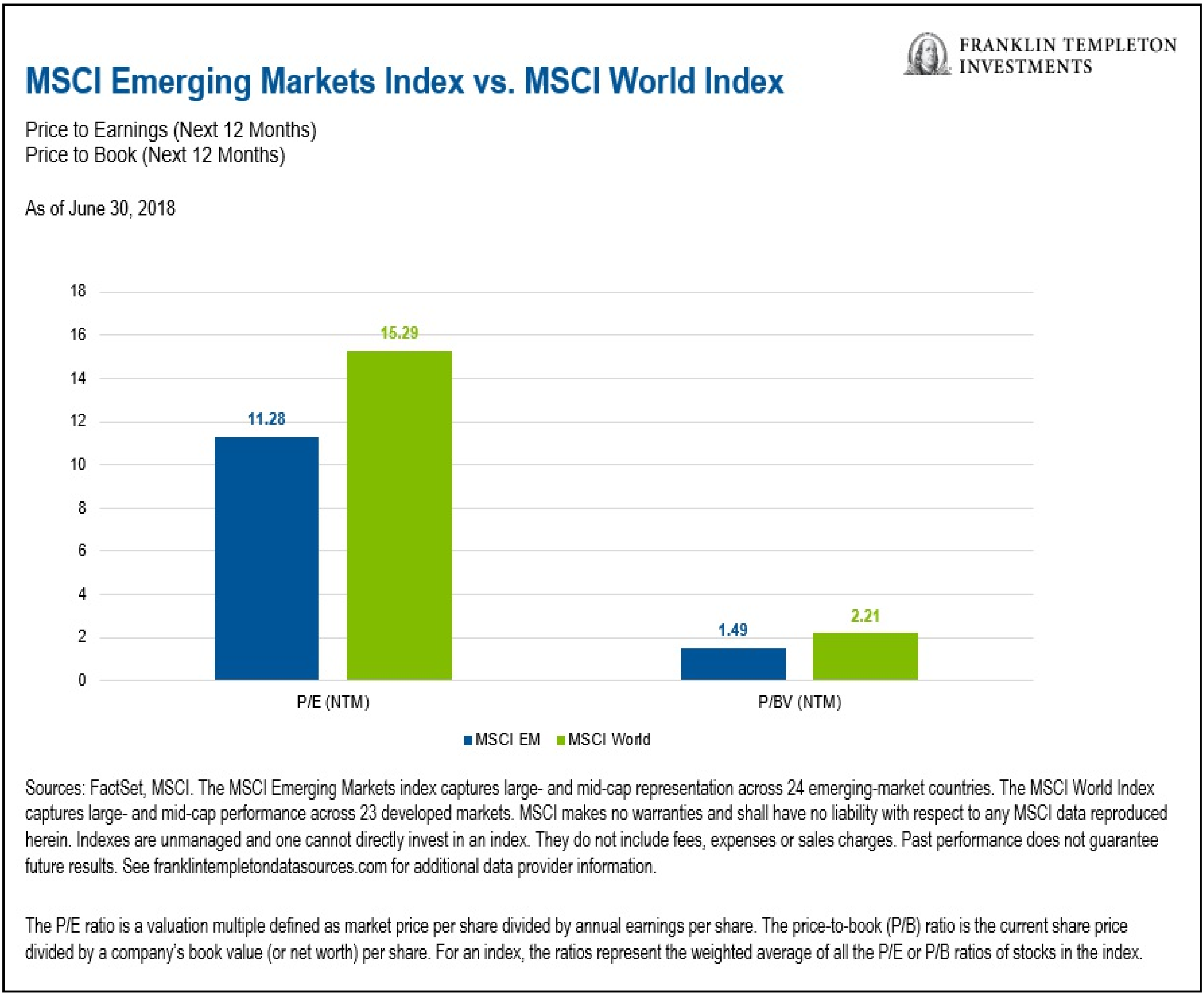
Emerging markets suffered a setback in the first half of 2018, precipitated by investor concerns over rising US interest rates, US dollar strengthening and rising trade tensions, particularly between the United States and China. However, we do not foresee a derailment in emerging–market fundamentals, which should continue to grow at a strong pace.

Historically, we have seen sharp market gyrations (typically downwards) in both EM equities and currencies ahead of tightening by the US Federal Reserve. However, during the actual implementation of previous US rate hikes, EM currencies have often appreciated, as have equities—illustrating that markets tend to price in a worst-case scenario prior to the event.

Although many EM companies hold US dollar-denominated debt, and a stronger US dollar could affect earnings, we do not believe that a stronger US dollar derails the EM story. It should also be noted that EMs generally have a higher proportion of local currency issuance, and that much of the US dollar-denominated debt is backed by US dollar-denominated revenues at the corporate or sovereign level. It is important to note that the effects today are likely different than previous episodes of dollar strength. Today, most EM currencies have floating foreign exchange regimes. Emerging markets, as a group, run a current account surplus, and the effect of a strong dollar will differ for countries depending on each nation's economic structure and policies.

While trade tensions have prompted a cautious EM outlook over the short term, we believe intra-EM trade has become more important in recent years, and rising protectionism may further pivot focus towards greater regional agreements.

Despite the expected market volatility, we maintain a constructive view of emerging markets, supported by what we believe are attractive valuations, strong earnings growth potential and solid fundamentals. Emerging markets, as measured by the MSCI EM Index, had a forward price-to earnings ratio of 11.3x and price-to-book ratio of 1.7x, as of June 30, 2018.[1] Emerging markets trade at a ~25% discount to developed markets (as represented by the MSCI World Index[2]) and remain attractive, in our opinion.



Emerging Markets Key Trends and Developments

EM equities bore the brunt of mounting global trade tensions to finish the second quarter lower, while developed-market stocks eked out a modest gain. The EM pullback was compounded by local economic and political concerns as well as a stronger US dollar. The MSCI EM Index declined 7.9% over the quarter, compared with a 1.9% gain in the MSCI World Index, both in US dollars.

The Most Important Moves in Emerging Markets in the Quarter

- Asian stocks collectively retreated and were hampered by an escalating US-China trade spat and receding local currencies. Pakistan, Thailand and Indonesia led the way down. Pakistan’s widening current account deficit and shrinking foreign exchange reserves dented investor sentiment. Thailand succumbed to market caution even as officials raised their 2018 economic growth forecast on the back of stronger exports, tourism and domestic demand. Indonesia lost ground as the rupiah slid against the US dollar, prompting Indonesia’s central bank to raise its key interest rate sooner than expected.

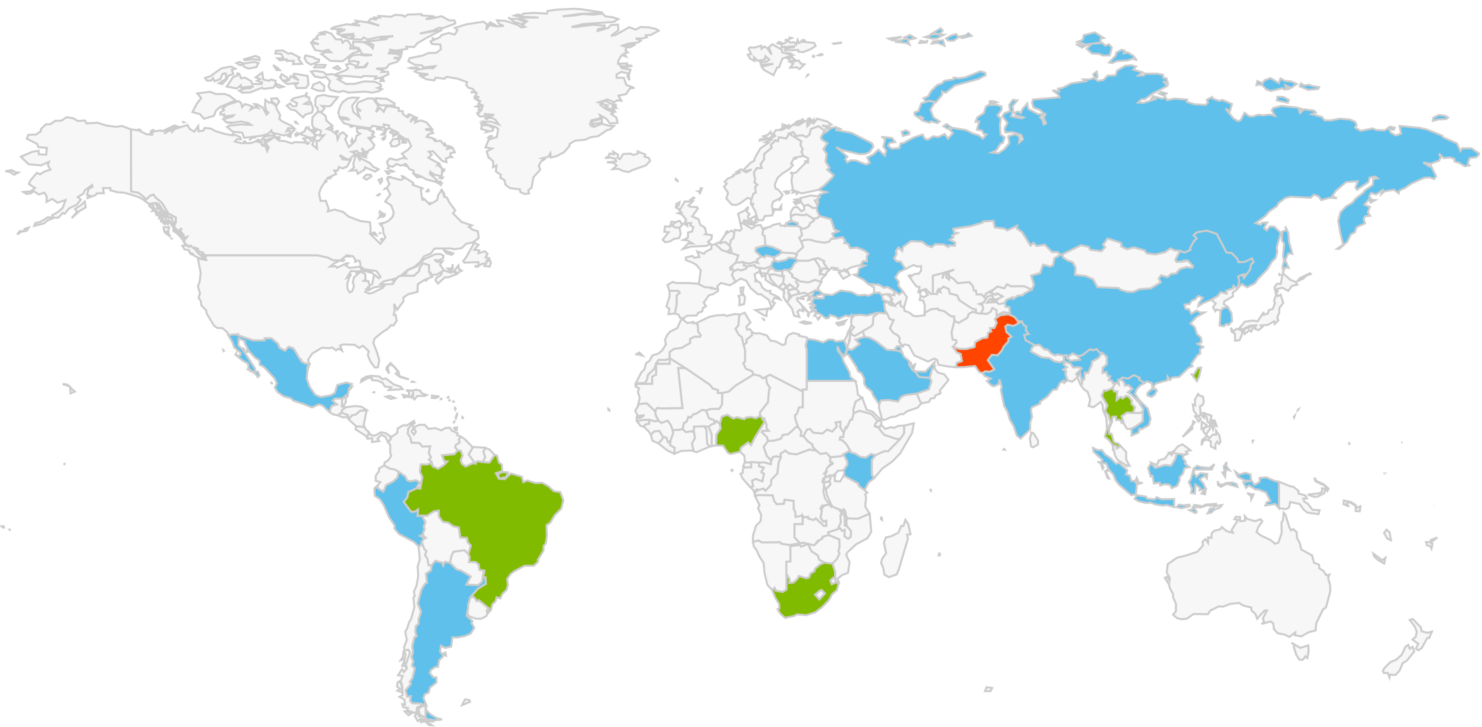
- Brazil was one of the worst-performing markets in Latin America and among emerging markets as a whole. Stocks in Chile also underperformed their EM peers, while Mexico and Peru ended the quarter with relatively smaller declines. Brazil’s market was weighed down by concerns that labor strikes could impact economic activity, volatility ahead of the upcoming presidential elections, as well as weakness in the real. Colombia was a bright spot, however, recording a solid gain, supported by the victory of a market-friendly candidate in the presidential elections.

- Concerns about a trade war between the United States and the European Union, coupled with political anxiety in Italy, led European emerging markets to underperform their global peers. Turkey, Hungary and Poland were among the weakest regional markets, ending the quarter with double-digit declines. Rising inflation, a depreciating currency, high interest rates and political turmoil drove down equity prices in Turkey. President Recep Tayyip Erdogan won re-election with a majority in the June elections. In Russia, although the market fell, it performed better than its peers as oil prices remained on an upward trend. Weakness in the rand, portfolio outflows and disappointing first-quarter GDP growth weighed on equity prices in South Africa.

- Frontier markets had a tough second quarter, significantly underperforming their global counterparts. Argentina was by far the weakest market, losing over 40% in US-dollar terms, driven entirely by the devaluation in the peso, amidst a volatile political and economic environment. Vietnam, Morocco and Lebanon also lost ground. The Vietnamese market experienced profit-taking following strong gains over the first quarter. Tunisia and Mauritius, on the other hand, ended the quarter with gains.

Regional Outlook

As of 30 June 2018



Outlook

As of June 30, 2018

China
: The overall outlook for China remains stable but we are cautious as uncertainties are rising. Supply side reforms and deleveraging could help ease structural risks but rising trade tensions could offset the benefits of stronger global growth. The RMB is at risk from a stronger US dollar driven by increases in US interest rates.

India
: Strong macro fundamentals, under-penetration, formalization of economy and a stable government, but near-term earnings challenges lead us to maintain a neutral view on the market.

Indonesia
: Economic growth has been recovering slowly. However, politics will likely heat up in 2018 with the presidential election in April 2019

South Korea
: Macro indicators remain sound. The geopolitical situation warrants close attention, while concerns about government regulations are growing.

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

Taiwan
: Cross-strait geopolitical risk has always existed and is well-known. Macroeconomic data remain healthy but inflation may start to rise, pressuring interest rates. While a strong Taiwanese dollar weighed on corporate earnings, recent weakness should ease concerns.

Thailand
: Overall outlook is positive. Economic stability remains strong with continued improvement in economic growth. The upcoming general election could further boost sentiment.

Vietnam

Steady outlook. GDP above 6%, underpinned by resilient domestic demand, rebounding agricultural production, and strong export-oriented manufacturing.

Czech Republic

The recent business survey data were positive and inflation has moderated recently. The central bank's latest assessment signals a modest deceleration of real GDP growth to 3.4%, from its earlier forecast of 3.9%.

Hungary

Economic data generally remain strong in recent months, with high industrial and construction confidence, but consumer sentiment normalizing back to previous high levels from the exceptionally large jump in April. The central bank remains committed to a loose monetary stance.

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In a stable oil price/ruble environment, domestic names should benefit due to earnings revisions and increased demand. The political situation should remain stable with the next presidential election scheduled for 2024. However, macro risks remain high due to volatile commodity prices and the possibility of additional US/EU sanctions.

Turkey

Turkey currently employs a tight monetary policy and slightly expansionary fiscal policy with an expected GDP growth of 3%. If the economy cools down and inflation normalizes, Turkey could offer significant upside in view of its undemanding valuations.

Argentina

Portfolio outflows have resulted in a run on the currency, higher inflation, lower GDP growth and a change in the political outlook. The presidential campaign has already started and public confidence in the government has been negatively impacted by events in late April / early May. The IMF agreement could support asset valuations but it is far from clear that a sustainable recovery in sight.

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

Macroeconomic outlook is stable and equity valuations are below historical averages. We believe Mexico's risk profile has increased with the ongoing NAFTA renegotiation and the 2018 presidential election.

Peru

Peru witnessed a peaceful political transition amidst a supportive international economic environment. Peru ´s economic and debt indicators stand favorably versus its regional peers. The resignation of the Finance Minister (signaling the challenges that the new president has in terms of building political consensus with the opposition) could indicate that the implementation of infrastructure projects, vital for economic growth recovery, could decelerate. We expect political noise but believe that it should not deviate Peru from its sustained long-term growth trend.

Kuwait

Potential FTSE upgrade could be a positive catalyst for the market. This market'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

Risks include slowing economic growth, political conflict and deadlock, and continued weak investor appetite.

Saudi Arabia

FTSE and MSCI EM upgrades could be strong catalysts for the market. The country continues to have stable economic growth, while the National Transformation plan and Vision 2030 is being redrafted to reflect more realistic targets.

United Arab Emirates

Within the region, the UAE is least dependent on oil revenues. Fiscal reforms such as the recent VAT implementation have been successful. The economy boasts a robust service sector, and positive current account and fiscal balances. The strong property sector, however, needs to be monitored closely.

Egypt

Egypt has made a committed step toward economic reforms. It is witnessing receding inflation and a strengthening currency.

Kenya

GDP growth could pick up after stalling last year. The government's interest rate cap on bank lending could be relaxed or lifted, further supporting growth.

Nigeria

The market is improving from a macro perspective with higher oil production, higher oil prices, steadying inflation, and foreign exchange liquidity.

South Africa

The political change has significantly improved the country's prospects. The implementation of reforms and job creation could drive growth.

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1. Source: FactSet, as of June 30, 2018. 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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