PERSPECTIVE

Emerging Markets Equity Investing: Never Waste a Crisis

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Emerging-market equity investors are likely happy to bid goodbye to 2018—a year filled with challenges and uncertainties. Chetan Sehgal, Franklin Templeton Emerging Markets Equity's director of portfolio management, examines some of these challenges and uncertainties, and makes the case that investors may have been overreacting. He says many emerging markets were unjustifiably priced for crisis-type situations.

In 2018 the world economy—and global relations—entered unfamiliar territory, with rising geopolitical and policy risks. We are witnessing the global supply chains and trading relationships that have been integral to growing global prosperity come under increasing pressure. Thus far, emerging markets (EMs) appear to have borne the brunt of the fallout: an asymmetric—and, in our view, excessive—market reaction that has contributed to valuations at near crisis levels by November 2018. However, these are valuations that to us represent increasingly attractive buying opportunities, given where fundamentals stand.

What Are Markets Anticipating?

There has been a substantial divergence in performance between EM and US equities during 2018, on a scale that we find challenging to justify. While the United States has benefited from the one-off, near-term impact of tax cuts and repatriation of overseas profits, this impact is expected to sharply fade in the coming two years, which is forecast to result in widening EM outperformance in terms of economic and earnings growth. The International Monetary Fund sees EM economic growth in 2019 holding steady at 4.7%, while it has forecasted growth in advanced economies to slow from 2.4% in 2018 to 2.1% in 2019. Additionally, estimated EM earnings growth of 10.5% in 2019, while below projections of 15.4% for 2018, would nonetheless compare favorably with estimated US earnings growth of 9.5% for 2019, down from 21.2% for 2018.[1] On a forward-looking basis, we believe current fundamentals do not warrant the declines seen in EM assets over 2018. And while investor expectations may deteriorate, we think the gap between EM fundamentals and valuations is such as to provide a reasonably large margin for performance potential.

Trade tensions have been a primary contributor to weakness in EM equities, and while exports remain a key engine of growth for EMs, they are increasingly shipped to other emerging economies; the relative importance of developed markets has declined. Similarly, the roles of consumption and technology in generating economic growth have become more prominent; EMs have become more domestically orientated. While tariffs undoubtedly come at a challenging time for China as it seeks to deleverage its economy, the impact will also be felt globally—recent US corporate earnings announcements and concurrent equity market volatility are testaments to this. Politicians may yet conclude that trade wars are not easy to win.

Resilient to Contagion and Financial Shocks

EM equity sentiment and performance have also been impacted by the increased perception of crisis, driven by the much-publicized travails of smaller nations. We believe that weaknesses in markets such as Turkey and Argentina are unlikely to result in broader macroeconomic contagion, given the extent to which these countries have been outliers in terms of financing requirements and unorthodox policymaking, though the impact on sentiment has evidently resulted in a degree of equity market transmission. Moreover, these markets make up a small part of the EM and frontier market universe: within the MSCI Emerging Markets Index, there were about 20 companies as of October 2018 that had individual weightings larger than Turkey's as a whole; Argentina is even less consequential from an index standpoint.

US-dollar (USD) strength has been a further factor behind EM weakness over 2018. The near-term boost to US gross domestic product growth from tax cuts has placed upward pressure on interest rates, while repatriation as a result of regulatory change has increased demand for USD assets. Accordingly, while EM earnings growth has been in double digits in local currency terms, it has been substantially weaker when USD-denominated.

> *"Emerging markets are confronted with a number of near-term challenges, resulting in valuations that were approaching crisis levels by November 2018—but longer-term buying opportunities for us are developing given continued underlying fundamental strengths."*
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> Chetan Sehgal, Director of Portfolio Management, Franklin Templeton Emerging Markets Equity

While rising rates—by design—apply pressure to growth and inflation expectations, this is not solely restricted to EMs, and most debt ratios are considerably higher in the developed world. EMs in aggregate have shifted to current account surpluses, floating exchange rates and a reduced reliance on USD debt funding. However, those emerging economies (and companies) pursuing less prudent policies have been punished heavily by financial markets. Investors appear to be increasingly discerning between winners and losers, which presents opportunities for active management.

Technology and Rising Affluence

The near-term challenges and poor sentiment toward EM assets have, in our view, obscured the longer-term picture, which is one of transformation as economies increasingly evolve away from dependence on exports, commodities and state-owned enterprises and toward more resilient sources of growth. Technology has become a primary driver of returns in emerging markets, whether manifested through world-leading semiconductor manufacturing, online gaming or internet banking, while e-commerce platforms facilitate rising consumerism. We retain confidence in the sustainable earnings power of many technology-orientated EM companies despite some sharp share-price corrections over 2018.

Consumption in EMs is not only a story of superior demographics and increased product penetration. Growing middle-class populations and increasing affluence should continue to drive "premiumization," spurring demand for high-end products in EMs. We believe companies with strong premium-brand positioning and superior products should see sustainable and higher-than-average industry growth levels in the years to come.

Never Waste a Crisis

EM valuations have been approaching crisis levels due to substantially weakened confidence (and performance), yet cash flows and earnings generally remain resilient. These conditions, when paired with improving corporate governance that includes dividend payouts and buybacks, present an increasingly attractive long-term buying opportunity for us. Many currencies have been cheap, and as value-oriented, long-term investors, we continue to invest in companies that demonstrate sustainable earnings power and trade at a discount relative to their intrinsic value and other investments available in the market.

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1. Sources: FactSet, MSCI and Standard & Poor's. Data as of 10/31/18. Based on estimated earnings-per-share growth of the MSCI Emerging Markets Index and the S&P 500 Index. There is no assurance that any estimate or projection will be realized. 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. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Important data provider notices and terms available at www.franklintempletondatasources.com.