PERSPECTIVE

Emerging Markets Record Mixed Performances in February

March 13, 2019

Emerging market equities saw mixed performances in February, with stocks in Asia faring better than stocks in Latin America and emerging Europe, which underperformed. Franklin Templeton's Emerging Markets Equity team outlines what drove market moves during the month and where they see opportunities today. They see reasons to be optimistic about Brazil in particular.

Three Things We're Thinking About Today

1. US President Donald Trump's decision to delay the March 1 tariff hikes following progress in trade talks reduced global tensions. Reports that US and Chinese negotiators are working on the final details of a **US-China trade** deal boosted sentiment towards emerging markets (EMs). We remain cautiously optimistic as the United States and China continue to resolve their differences, while their trade relationship evolves. Even with a trade deal, however, long-term strategic rivalry is likely to continue. We also expect the Chinese government to continue supporting the domestic economy, as evidenced by the recent implementation of targeted fiscal and monetary policies. We will continue to monitor the situation and look for attractive investment opportunities—likely in sectors related to health care, consumption and manufacturing upgrades, which over the long term, are less directly impacted by tariff regime changes.
2. Nuclear-armed rivals **India and Pakistan** faced their worst crisis in years during February over disputed territory in Kashmir. However, both countries have expressed that they do not wish to see further escalation of the situation. While one cannot rule out more border incursions from both sides, we believe chances of escalation are limited due to mounting international pressure calling for restraint. Recent developments are also viewed positively, with Pakistan releasing the captured Indian fighter pilot and taking steps to restrain terrorists. In our view, the current conflict has limited impact on investment strategy, and we retain conviction in our holdings in India and Pakistan. We are monitoring the situation closely, which remains fluid at this point.
3. Brazilian President Jair Bolsonaro presented the long-awaited **social security reform** proposal to the Congress in February. We are of the view that the proposal, which includes a higher-than-expected estimated fiscal savings of about US $300 billion over 10 years, signals the president's commitment to improving the government's fiscal deficit. Although some dilution in the reform is expected, this is a step in the right direction, and we expect to see a strong emphasis on reforms and privatization from the new government. This should, in turn, provide a basis for higher economic growth and a better business environment for the companies. We continue to have a favorable view on domestic-oriented themes, including financials and consumer-related sectors. These should benefit from better economic activity in a low-inflation and higher credit-availability environment.

Outlook

US interest-rate-hike expectations have declined sharply, spurring gains in EM currencies and equities, as well as large flows into the EM asset class. Easing global trade tension further benefited sentiment. However, we believe that for the market rally to be sustainable, earnings need to improve. Improved corporate governance in EMs could also argue for a longer-term rerating.

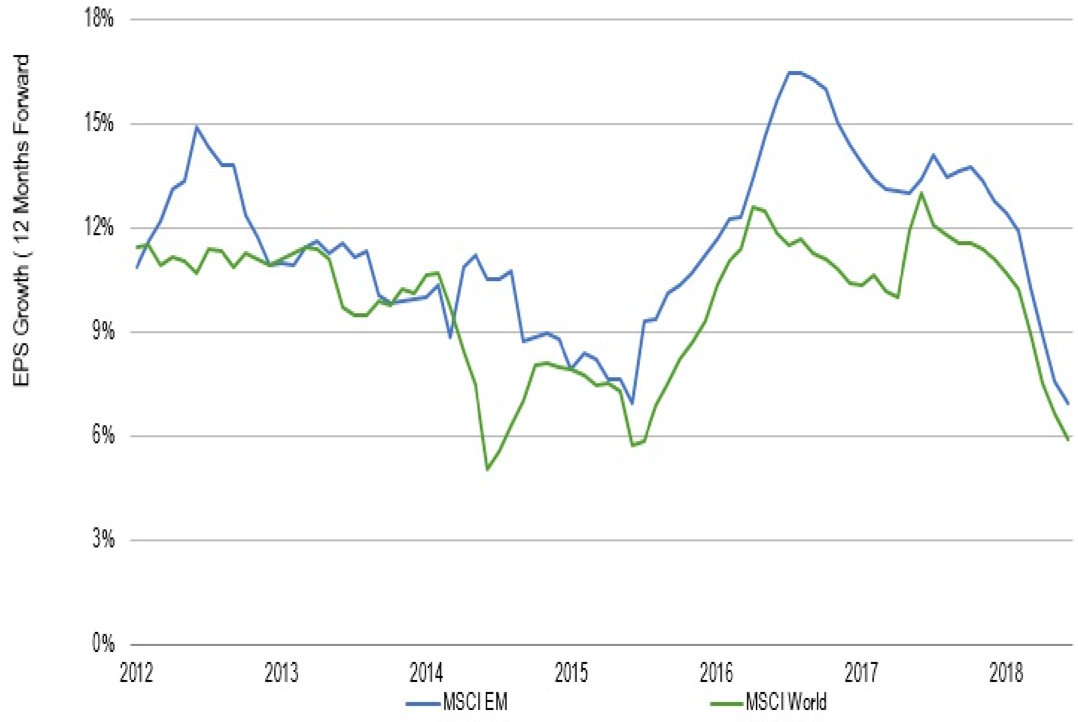
We believe technology will continue to reshape the global economy, as technology disruptors become the norm by transforming industry landscapes, e-commerce continues to accelerate, and companies continue to embrace technology and innovation.

The transformation of the EM consumer is another key theme for us. Favorable demographics and urbanization dynamics, coupled with an underleveraged EM consumer, bring opportunities to tap into a growing domestic consumer market, and rising affluence continues to drive premiumization.

As such, we continue to favor companies that provide exposures to these key themes of consumption and technology, where we have confidence in management's ability to deliver sustainable growth that we believe the market may be mispricing.

MSCI EM Index Vs. MSCI World Index: Earnings Expectations

As of February 2019



For illustrative purposes only. EPS=earnings per share.

Sources: FactSet, MSCI, IBES estimates, as of February 2019. 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. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

Emerging Markets Key Trends and Developments

EM equities edged higher in February, trailing developed-market (DM) stocks. Progress in US-China trade talks drove investor optimism that was later tempered by pockets of geopolitical and economic concerns. The MSCI Emerging Markets Index edged up 0.2% over the month, compared with a 3.1% return in the MSCI World Index, both in US dollars.[1]

The Most Important Moves in Emerging Markets This Month

- Asian stocks rose, with Taiwan, China and Malaysia posting the strongest returns. Hopes for an end to the US-China trade row lifted broad market sentiment. The United States delayed a planned increase in tariffs on Chinese goods as trade negotiations advanced. China's market also gained on signs of easing credit conditions in the country. Investor confidence was capped by geopolitical uncertainty amid rising military tensions between India and Pakistan. A US-North Korea summit aimed at denuclearizing the Korean peninsula also failed to achieve a deal. Markets in Pakistan, Indonesia and the Philippines recorded the largest declines.

- February saw Latin America give back some of January's strong gains. Equity prices in Brazil, Mexico and Chile declined. Profit-taking and disappointing 2018 gross domestic product (GDP) growth data weighed on the Brazilian market, despite the unveiling of a better-than-expected social security reform. In Mexico, mixed macroeconomic data and concerns surrounding the state-owned oil company weighed on investor sentiment. At the other end of the spectrum, Colombia and Peru recorded positive returns, supported by improving economic data.
- Equity markets in Emerging Europe declined in February, with Poland, Turkey and Russia leading the way down. Despite a rebound in oil prices, equity prices in Russia fell partly due to depreciation in the Russian ruble. Weakness in the Polish zloty was largely responsible for the decline in that market. The Czech Republic market, however, bucked the regional trend, ending the month with a small gain. The South African rand depreciated in February, following a strong gain in January, making South Africa one of EM's weakest markets in February.
- Frontier markets fared better than their EM counterparts but trailed DMs. Romania, Vietnam and Nigeria led returns. Investors in Romania reacted positively to the government's largest draft budget, which did not include revenue estimates from a recently discussed bank levy. Elections dominated headlines in Nigeria, where following a one-week delay, President Muhammadu Buhari was re-elected. Following a strong performance in January, Argentina ended the month with a double-digit decline, partly due to a weak Argentine peso. Rising inflationary pressure and concerns about austerity measures also impacted investor confidence.

What are the Risks?

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. Sources: MSCI, FactSet as of February 28, 2019. 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. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.