PERSPECTIVE

Emerging Markets Record Diverse Performances in November

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It was a mixed month for emerging markets in November, as shifting expectations about a trade deal between China and the United States continued to drive market sentiment. Our emerging markets equity team explains why US-China trade issues may not be that big of a concern for some emerging markets, and provides an overview of the news and events shaping markets during the month.

Three Things We're Thinking About Today

1. MSCI completed the third phase of the 20% partial inclusion of **China A-shares** in its benchmark indexes during November. Following the increase, the MSCI Emerging Markets Index included 472 China A-share companies with a total weighting of 4.1%. If and when all China A-shares are included in the index, they could account for over 16%, bringing China's total weighting to over 40%. The increased exposure is likely to result in additional inflows in China's domestic A-share market, which, along with improving liquidity, could provide better market accessibility to a wider range of companies in structural growth sectors such as health care, technology and financials. An aging population and rising health care costs should drive demand for health care, including services provided in facilities such as hospitals and clinics. Technological advancements and infrastructure development—including 5G and Internet of Things—are important investment themes. We believe the financials sector also stands to benefit from structural reforms as financial institutions are playing an increasingly important role in the efficient allocation of savings and resources.

2. **Environmental, social and governance (ESG)** analysis is an essential and integral element of our due diligence and is incorporated into our research process. We believe that ESG factors can have a material impact on a company's current and future corporate value and are an embedded component of the rigorous fundamental bottom-up research our team conducts. As part of assessing a company's sustainability, we seek to develop a deep understanding of a company's ESG practices, with the goal of identifying business models that are most likely to sustain high returns and resist competitive pressure over time. Our analysts consistently evaluate material environmental and social issues such as raw material sourcing, waste disposal and safety practices. In assessing corporate governance, we evaluate factors including capital allocation, management track record and conflicts of interest. When potential concerns arise, we believe engaging is in the best interest of our shareholders and will lead to better returns.

3. We believe that, at its core, corporate governance determines how well companies are able to operate in the longer-term interests of all shareholders. Take, Russia, for example. Most investors are unlikely to associate Russia with governance excellence. Yet, many Russian companies have taken the initiative to set higher governance standards and promote shareholder value. As a result, we have seen companies adopt international standards, implement share buyback programs and raise dividends to enhance shareholder value. Indicating the shift in corporate mindsets, the dividend payout ratio in **Russia** increased from 21.8% at end-2013 to 33.0% at end-2018.[1] Despite this, Russia remains one of the most undervalued markets globally, trading at a forward price-to-earnings multiple of 6x and a dividend yield of 7%, as of end-

November.[2] Overall, we believe Russia continues to offer interesting opportunities for emerging market (EM) investors through exposure to select, well-established companies across the information technology, financials, energy and consumer-related sectors.

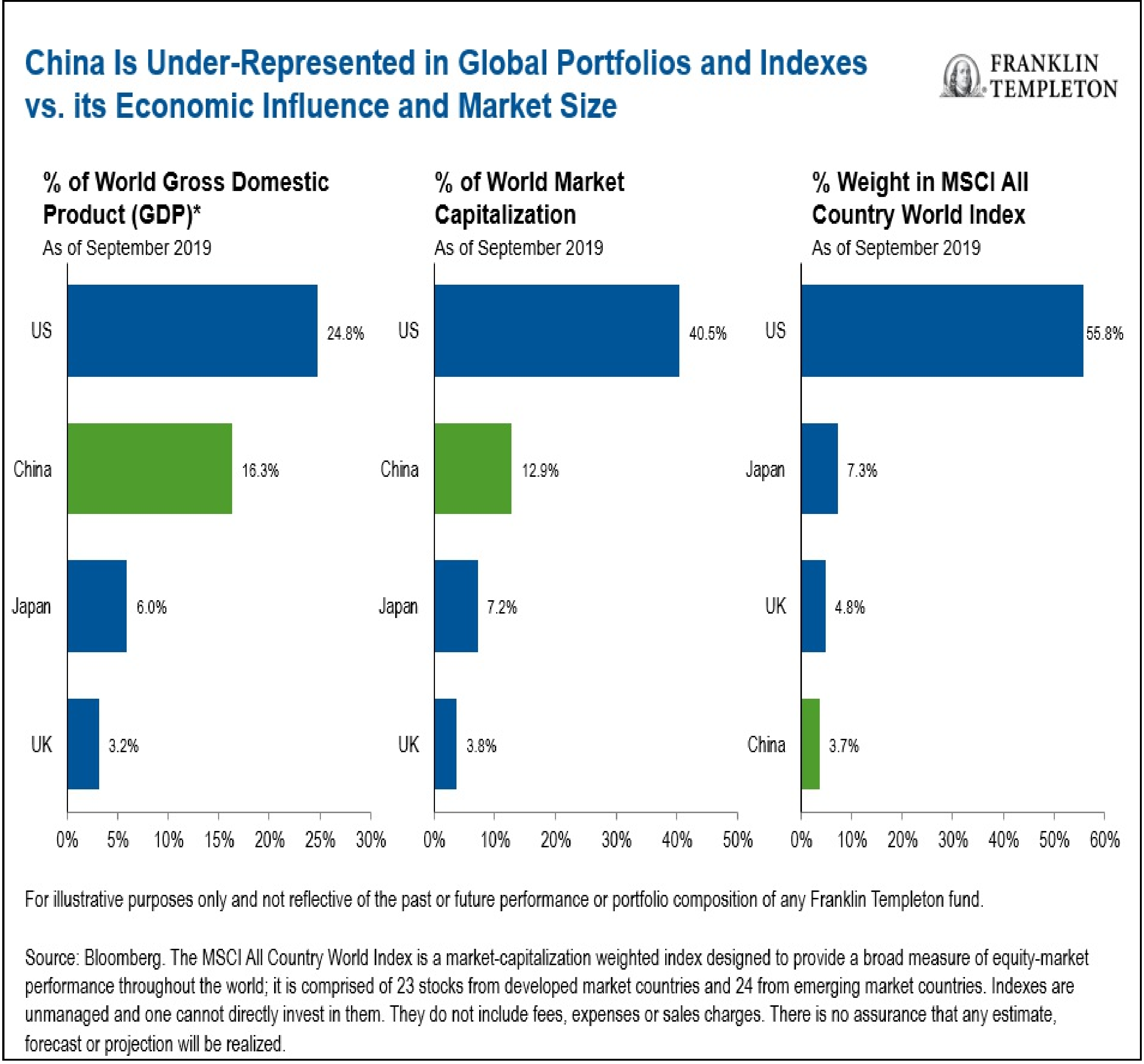
Outlook

Shifting expectations for the prospects of a phase-one trade deal between China and the United States continued to drive market sentiment in EMs. The passing of the Hong Kong democracy legislation by the United States, which the Chinese government viewed as US interference in domestic matters, raised concerns that negotiations could be hindered. While we believe a trade deal would be in the interest of both economies, we expect continued volatility as both governments pursue an amicable agreement.

We are of the opinion, however, that the dependence of EMs on developed economies continues to decline. EMs have become far more outward-looking, while also developing stronger trading relationships between each other. We believe today's EMs are now more resilient than in previous decades, emerging stronger after periods of economic hardship—such as the 1997 Asian Financial Crisis that affected much of Southeast Asia. Many emerging economies learned lessons from the past, building up cash reserves and diversifying away from US dollar-denominated debt.

We have also seen how EM companies are using innovation and technology to leapfrog and disrupt traditional business models. We believe areas such as e-commerce, digital banking and mobile computing will likely be fundamental drivers of the global economy for years to come. EMs' accelerating internet usage and penetration are likewise hastening opportunities for efficiencies, driving cost savings and improving ease of doing business. Promising fields such as artificial intelligence, autonomous driving, robotics and the Internet of Things continue to attract investment, signaling what we view as strong prospects.

Consumerism and rising wealth in EMs should also help drive growth in many regions. Growing middle-class populations and increasing affluence continue to spur demand for high-end products in EMs. This "premiumization" trend could boost demand for higher-end items such as luxury cars or services such as entertainment and wealth management. In our view, companies with superior products and services should experience sustainable growth in the years to come.



Emerging Markets Key Trends and Developments

Equities edged lower in November, while developed market stocks advanced. Political unrest in parts of Latin America weighed on investor sentiment and dragged currencies in the region lower. Mixed reports on US-China trade talks aimed at finalizing a partial trade deal also fed market caution. The MSCI Emerging Markets Index edged down 0.1% over the month, compared with a 2.8% return for the MSCI World Index, both in US dollars.[3]

The Most Important Moves in Emerging Markets in November

Asian equities rose modestly over the month, thanks to gains in Pakistan, China and Taiwan. Chinese equities rose on signs of progress in US-China trade talks (though fresh US legislation supporting protesters in Hong Kong reined in market optimism). Taiwan’s stock market benefited from strength in technology heavyweights. Conversely, market declines in the Philippines, Indonesia and South Korea held back the region’s overall performance. Philippine equities succumbed to profit-taking as the central bank paused its interest rate cuts. South Korea’s central bank trimmed its economic growth forecasts amidst slower consumption and sluggish exports, and the Korean won weakened.

Social unrest and political turmoil weighed on sentiment in Latin America. Chile was the weakest market in the region, ending the month with a double-digit decline, as protests triggered by a rise in train fares in Santiago escalated into widespread violence. Political noise overshadowed progress on the reform front in Brazil, impacting investor confidence. Depreciation in the Chilean peso and Brazilian real further impacted equity prices. Central banks in Mexico and Peru reduced interest rates during the month amid efforts to stimulate economic growth.

Markets in the Europe, Middle East and Africa region recorded mixed results, ending November with a minor decline. Turkey and Hungary were among the top performers, while stock markets in Poland and Egypt declined. Although equity prices fell in South Africa as lower gold prices weighed on performance in materials companies, appreciation in the South African rand helped offset the decline in US dollar terms. The Russian equity market took a breather in November following a strong performance in October.

Important Legal Information

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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1. Sources: MSCI, Bloomberg.

2. The price-earnings (P/E) ratio is a valuation multiple defined as market price per share divided by earnings per share.

3. Source: MSCI. 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. 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.