PERSPECTIVE

Emerging Markets Q2 2016 Recap: Brexit Could Offer Silver Lining for Some

July 12, 2016

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Templeton Emerging Markets Group has a wide investment universe to cover—tens of thousands of companies in markets on nearly every continent! While we are bottom-up investors, we also take into account big-picture context. Here, I outline what's happened in the emerging markets universe in the second quarter of the year, including some key events, milestones and data points going back a bit further to offer some perspective. Overall, the second quarter was positive for emerging markets, with those in Europe most impacted by the United Kingdom's decision to leave the European Union (EU), while emerging markets in Latin America and Asia fared better.

On June 23 the United Kingdom voted to leave the EU, surprising many investors. The uncertainty of the situation and what came next affected all markets in the wake of the vote, and emerging markets were not exempt, with the MSCI Emerging Markets (EM) Index experiencing a post-vote decline.[1] Most markets, however, quickly rebounded.

We believe that the longer-term impact could be positive since the center of gravity for capital markets activity could move east away from London toward markets in the Far East, such as Shanghai. In addition, emerging markets' trade and investment is widely diversified; the amount of trade with the United Kingdom is relatively small for most emerging-market countries. There are some specific markets where ties to the United Kingdom are greater, and the impact could be felt more acutely. For example, some Southeast Asian nations with historic ties to the United Kingdom could be negatively impacted. There could be a silver lining for certain emerging-market countries, however, with some manufacturing and services possibly moving from the United Kingdom to Eastern European countries in the EU where costs are low.

Generally speaking, the Brexit event actually brightens our view of emerging markets and the investment potential we see for the long term. The Brexit vote shows the world that political instability is not concentrated in emerging markets—it can be found even in developed markets. While volatility may be with us a while, in our view, the markets have already begun to readjust. Part of the volatility was related to the surprise element of the vote. The markets simply did not price the leave scenario in properly.

The big question for market observers now is the knock-on effect in the EU generally. If it is perceived that other members may decide to leave the EU, then the uncertainty will continue and that could be bad for markets in Europe and the United States. However, it is our view that emerging markets should be able to differentiate themselves and individual countries should be able to bounce back based on their unique fundamentals.

Second-Quarter Overview

Emerging markets maintained an upward trend in the second quarter of 2016 as strength in Latin American equities compensated for weakness in Emerging European markets. The MSCI EM Index ended the quarter up 0.8% in US dollar terms.[2] This brought the return for the first half of the year to 6.6%, significantly higher than the 1.0% gain for the MSCI World Index.[3] The outperformance can generally be attributed to the dovish stance taken by several major central banks globally following the United Kingdom's decision to leave the EU, a search for income-producing assets as well as a rebound in commodity prices.

Latin America was the best-performing region for the quarter, with Brazil and Peru ending the quarter with double-digit gains. Strong appreciation in the Brazilian real, an improvement in business sentiment and generally positive economic data drove equity prices in Brazil. The victory of business-friendly candidate Pedro Pablo Kuczynski as the country's next president supported the Peruvian market, along with higher copper prices. At the other end of the spectrum, a tightening monetary policy and increased risks to economic activity weighed on the Mexican market.

Asian markets ended the quarter slightly higher, with the Philippines, Indonesia and India among the top-performing markets. The Philippines benefited from a positive market outlook on the recently inaugurated administration of President Rodrigo Duterte, while the passage of a tax amnesty law and easing monetary policy boosted equity prices in Indonesia. Foreign direct investment liberalization, the passage of bankruptcy and finance bills in parliament and a positive domestic policy environment were constructive for Indian stocks. Chinese equities lagged on renewed concerns about the Chinese economy, while the Malaysian market declined on selling ahead of rebalancing, resulting in a reduction in the market's weighting in the MSCI EM Index.

Emerging European markets were among the weakest emerging-market performers over the three-month period as the Brexit vote rattled investor confidence in the region. Russia bucked the trend, however, ending the quarter with gains, benefiting from better-than-expected first-quarter gross domestic product (GDP) data, a rebound in oil prices and undemanding valuations. South Africa gained as mining stocks rebounded with the rise in commodity prices.

Country Updates by the Numbers

For those who are interested in really diving into the numbers, I am including some country updates that show changes in key economic indicators and measures more recently and going back further.

China

The Chinese economy expanded 6.7% year-over-year (y-o-y) in the first quarter of 2016, slightly slower than the 6.8% y-o-y increase recorded in the fourth quarter of 2015. The consumer price index eased to 2.0% y-o-y in May, from 2.3% y-o-y in April, largely due to lower food price inflation, while producer prices declined 2.8% y-o-y in May, compared to a 3.4% y-o-y decrease in March. Industrial output grew 6.0% y-o-y in May, unchanged from April, while retail sales growth edged down to 10.0% y-o-y in May, from 10.1% y-o-y in April. Growth in fixed-asset investment, however, declined to 9.6% y-o-y in the first five months of 2016, from 10.5% y-o-y in the four-month period ended April. Foreign exchange reserves declined by US$27.9 billion to US$3.2 trillion in May, after increasing in March and April, largely due to strength in the US dollar. German Chancellor Angela Merkel met President Xi Jinping in China, where both leaders agreed to strengthen bilateral cooperation. Moreover, Chinese companies signed agreements valued at US$15.0 billion with German companies and deals worth US$4.1 billion with US companies during the quarter.

South Korea

GDP growth in South Korea eased to a revised 2.8% y-o-y in the first quarter of the year, from 3.1% y-o-y in the final quarter of 2015. Weaker growth in private consumption and exports and a decline in corporate investment were among the key reasons for the slowdown. Growth in government expenditure, however, accelerated in the first three months of the year. Concerns about weakening domestic consumption coupled with continued weakness in exports led the Bank of Korea (BOK) to reduce the benchmark interest rate by 25 basis points (0.25%) to a record low of 1.25%. This was the BOK's first rate cut since June 2015. The consumer price index eased to 0.8% y-o-y in May, from 1.0% y-o-y in April, largely due to higher food price inflation. The government announced a US$17.0 billion fiscal stimulus package to support the domestic economy and reduced its 2016 GDP growth forecast to 2.8% from 3.1%, citing potential impact from Brexit and corporate restructuring. Finance Minister Yoo Il-ho announced plans to inject more than US$9.0 billion into state-run banks to support the restructuring of the shipping industry. After unexpectedly losing its majority in the National Assembly in parliamentary elections held in April, the conservative Saenuri Party regained a majority in June with the rejoining of seven members, giving the party 126 seats compared to the 122 seats held by the main opposition Minjoo Party.

India

India's GDP grew 7.9% y-o-y in the first three months of 2016, compared to a revised 7.2% y-o-y growth in the last three months of 2015. The growth was supported by private consumption. Economic growth accelerated to 7.6% y-o-y in the fiscal year 2015/2016, from 7.2% in the preceding year. The Reserve Bank of India maintained its benchmark interest rate at a five-year low of 6.5% in June, after a 25 basis- point (0.25%) cut in April as domestic conditions for growth showed signs of gradual improvement. The consumer price index increased to 5.8% y-o-y in May, from a revised 5.5% y-o-y rise in April, largely driven by a 7.6% y-o-y growth in food inflation. Wholesale prices rose for the second consecutive month in May, up 0.8% y-o-y, compared to 0.3% y-o-y in April, mainly due to an increase in food and manufactured goods prices. The Nikkei/Markit India manufacturing Purchasing Managers' Index (PMI) rose to 51.7 in June, from 50.7 in May, while the services PMI decreased to 50.3, from 51.0 in the same months.[4]

The government eased foreign direct investment restrictions, allowing 100% foreign participation in nine sectors, including civil aviation, pharmaceuticals and single-brand retailing. The lower and upper houses of parliament passed a finance bill, which is expected to strengthen the central bank's independence in setting monetary policy, and also passed the Insolvency and Bankruptcy Code 2016, which should increase the ease of doing business in the country.

Brazil

The Brazilian economy contracted 5.4% y-o-y in the first quarter (which was not as bad as forecasters had feared), following a 5.9% y-o-y decline in the fourth quarter of 2015. This was the eighth consecutive quarterly decline in GDP, as investment and consumption continued to decrease. The central bank maintained its key interest rate at a nine-year high of 14.25% during the quarter, amid an economic recession, political instability and concerns about the government's fiscal situation. Consumer prices rose 9.3% y-o-y in May, the same pace as in April, and remained higher than the central bank's 2.5% to 6.5% target range. The current account deficit narrowed to US$29.5 billion or 1.7% of GDP in the 12-month period ended May, from US$34.1 billion (2.1% of GDP) in the 12-month period ended April. The Senate voted to formally initiate impeachment proceedings against President Dilma Rousseff in May, which required her to step down for up to 180 days, pending the result. Vice President Michel Temer took over as the country's acting president.

South Africa

South Africa's economy contracted 0.2% y-o-y in the first quarter of 2016, the first contraction in more than six years. In comparison, GDP grew a revised 0.5% y-o-y in the last quarter of 2015. Declines in mining and manufacturing were among the key reasons for the contraction. Weak global demand and lower commodity prices resulted in an 8.5% y-o-y decrease in mining production, while manufacturing declined 0.9% y-o-y in the first quarter. The manufacturing PMI increased to 53.7 in June, from 51.9 in May.[5] The South African Reserve Bank maintained its key interest rate at 7.0% in May, after raising the rate by 75 basis points (0.75%) in the first quarter. The consumer price index eased to 6.1% y-o-y in May, from 6.2% y-o-y in April, but remained just above the Reserve Bank's 3% to 6% target range. International ratings agencies Standard & Poor's and Moody's affirmed South Africa's sovereign rating at BBB- and Baa2, respectively, while Fitch Ratings maintained a BBB- rating with a stable outlook.[6]

Russia

The Russian economy contracted by 1.2% y-o-y in the first quarter of 2016 (a better result than forecasters had expected), following a 3.8% y-o-y decline in the fourth quarter of 2015. The Economy Ministry expects GDP contraction in 2016 to slow down to 0.2% y-o-y, from 3.7% y-o-y in 2015. The Central Bank of Russia reduced its benchmark interest rate by 50 basis points (0.5%) to 10.5% in June, on lower inflation expectations. This was the central bank's first rate cut since July 2015. The central bank lowered its year-end inflation forecast to 5.0%–6.0% from 6.0%–7.0% and estimated GDP growth at 1.3% for 2017. Consumer prices rose 7.3% y-o-y in May, the same pace as in April and March, and at the lowest level in more than two years. Fitch Ratings affirmed Russia's local and foreign currency sovereign debt rating at BBB- with a negative outlook.[7] Prime Minister Dmitry Medvedev signed a decree mandating state-owned companies to pay at least 50% of profits as dividends, as part of efforts to reduce the budget deficit, amid relatively lower oil prices.

Turkey

GDP growth in Turkey eased to 4.8% y-o-y in the first quarter of 2016, from 5.7% y-o-y in the final quarter of 2015. Household consumption and government expenditure were key growth drivers. Growth in household consumption accelerated to 6.9% y-o-y in the first three months of the year, from 4.7% y-o-y in the last three months of 2015, while government spending increased 10.9% y-o-y, compared to 8.1% y-o-y in the same periods. Turkey's central bank maintained its benchmark interest rate at 7.5% during the quarter on concerns about inflation. However, the central bank lowered the overnight lending rate by 50 basis points (0.5%) to 9.0%, for the fourth consecutive month, while keeping the overnight borrowing rate unchanged at 7.25%. Consumer prices rose 6.6% y-o-y in May, unchanged from April. Aimed at expanding bilateral relations with East Africa, Prime Minister Recep Tayyip Erdogan visited Uganda, Kenya and Ethiopia during the quarter. The ruling Justice and Development Party elected former transport minister Binali Yildirim to succeed Ahmet Davutoglu as the party chairman and country's prime minister.

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: The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries. Indexes are unmanaged, and one cannot directly invest in them. They do not reflect fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

2. Ibid.

3. The MSCI World Index captures large- and mid-cap representation across 23 developed-market countries. Indexes are unmanaged, and one cannot directly invest in them. They do not reflect fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

4. Source: Nikkei News press releases: Nikkei India Manufacturing PMI™, July 1, 2016; Nikkei India Services PMI™, July 5, 2016.

5. Source: Barclays Purchasing Managers' Index (PMI), South Africa Bureau for Economic Research, July 1, 2016.

6. Source: Moody's Investors Service, May 6, 2016; Fitch Ratings, June 8, 2016.

7. Source: Fitch Ratings, April 15, 2016.