PERSPECTIVE

Emerging Markets Q1 2017 Recap: A Strong Start

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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 share the Templeton Emerging Markets Group's overview of what happened in the emerging-markets universe in the first quarter of 2017, including some key events, milestones and data points going back a bit further to offer some perspective.

Overview

- Emerging-market stocks advanced in the first three months of 2017, with the MSCI Emerging Markets Index up 11.4%, recording the strongest first-quarter performance since 2012.[1] Firming economic data in Asia and diminished concerns over potential US trade policy helped lift emerging-market equities.
- Frontier markets lagged emerging markets but outperformed developed markets, with the MSCI Frontier Markets Index up 9.1% in US-dollar terms.[2]
- Among commodities, precious and industrial metals advanced the most, while oil and natural gas prices declined during the quarter. High oil inventory levels and US rig counts have led to increased concerns about oversupply.
- Emerging-market currencies generally gained against the US dollar over the quarter, as waning confidence in the ability of the US government to stimulate growth or impose trade sanctions led investors to adopt a weaker view on the US dollar. The Mexican peso, Russian ruble and South Korean won were among the top-performing currencies. The Turkish lira and Philippine peso, however, depreciated.

Country Updates and Key Developments

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.

In **Asia**, Indian and South Korean equity markets made strong advances in the first quarter, as both markets benefited from local currency strength.

Several economists trimmed their 2017 gross domestic product (GDP) growth forecasts for India, expecting a temporary negative impact on consumption from cash shortages resulting from last-year's surprise move to withdraw large-denominated currency notes from circulation. However, growth is still expected to be strong, forecast at 7.2% in 2017 and 7.7% in 2018, making India one of the fasting-growing major economies in the world.[3]

We continue to favor companies in the consumer sector in India that we feel are well placed to benefit from higher per-capita income and growing demand for goods and services, which, in turn, should support the earnings-growth outlook for consumer-oriented stocks.

In addition, India's ruling party scored gains in state elections, and legislation related to the incoming Goods-and-Services Tax continued to progress.

Meanwhile, South Korea saw court approval of the impeachment of Park Geun-hye, who, later in March, was arrested over an ongoing corruption probe.

Chinese equities benefited from solid economic data, a stable renminbi and easing capital-outflow concerns. Real estate, consumer discretionary and information-technology (IT) companies outperformed over the quarter. The MSCI Taiwan Index reached a five-year high in March, supported by appreciation in the Taiwanese dollar.[4] Industrials, IT and consumer staples were among the top-performing sectors.

Thai shares rose on optimism from local institutional buyers, supported by upward revisions to Thailand's GDP growth forecasts and a neutral monetary policy amid an improved growth outlook.

In Indonesia, the central bank kept rates on hold, expecting growth to continue to progress. Foreign investors in particular turned positive on Indonesian equities.

In **Latin America**, a strong appreciation in the Mexican peso (which had reached an all-time low in January), fading concerns about a deterioration in Mexico's bilateral relationship with the United States, as well as a generally improved outlook in recent months drove the Mexican equity market's solid performance in the first quarter.

We believe the uncertainties of the new US administration have led to lower valuations in Mexico, providing long-term investors an attractive entry point. In our view, the valuations of both Mexico's currency and stocks are compelling as country risk is falling and unemployment remains at decade lows. Inflation expectations, however, continue to be revised upwards and consumer confidence remains depressed.

We believe the financials sector in Mexico looks attractive, with sound asset quality and structural growth opportunities. The Mexican industrial sector is also globally competitive and trading at low valuations. We are also monitoring other sectors, including the consumer sector.

In Chile, a positive trend in copper prices and improved sentiment regarding the outcome of the 2017 presidential elections supported equity prices. Expansionary monetary policy and a positive reform outlook supported investor sentiment in the Brazilian market, while Argentina's equity market responded positively to the Argentine economy's return to growth in the second half of 2016 following a recession in the first half. A possible upgrade to the MSCI Emerging Markets Index further drove investor sentiment.

Emerging markets in **Europe** saw diverse performances in the first quarter. Major stock indexes in Poland and Turkey ended the quarter with double-digit gains in US-dollar terms, while equities in Russia and Greece generally saw declines. The Polish economy grew at its fastest pace in nine years in the final quarter of 2016, while a decline in natural gas prices pressured investor sentiment in Russia. Turkey's equity market rose on higher-than-expected fourth-quarter GDP growth data, despite a weaker lira.

In **Africa**, South African shares underperformed their emerging-market peers largely based on a 9% decline (in US-dollar terms) in the final week of March,[5] most of which was driven by depreciation of the rand due to a cabinet reshuffle resulting in the removal of the finance minister.

Our Outlook

After a return to form in 2016 and following an encouraging start to 2017, many of the factors that originally attracted investors to emerging markets may be coming back into play, including generally stronger earnings growth, higher economic growth and robust consumer trends. Even in regions that are still going through adjustment and rebalancing, we are seeing improved visibility and increasing signs of robust underlying economic conditions such as low debt, stabilizing commodity markets, reduced currency volatility and improving consumer confidence.

The general landscape of emerging-market corporations has undergone a significant transformation from the often plain-vanilla business models of the past (tending to focus on infrastructure, telecommunications, classic banking or commodities) to a new generation of innovative companies that are moving into technology and higher value-added goods and services. Furthermore, we are starting to see the establishment of globally represented brands originating from emerging-market countries.

The information-technology (IT) sector has been growing in importance in emerging markets, and is becoming more integral and competitive. In addition to Internet companies, which stand to benefit from a movement toward more online transactions, we see potential for attractive long-term investment opportunities in the following areas: shopping, gaming and other services, hardware companies providing application processors and memory chips for smartphones, graphic processing units for data centers and artificial-intelligence applications, as well as connectivity and processor integrated circuits for autonomous cars and devices related to the "Internet-of-Things."

That being said, we think pockets of potential still exist across the energy sector. Overall, we believe oil companies with upstream operations are best positioned to potentially benefit from higher oil prices, and we remain positive on a number of companies in China, Russia, Thailand, Pakistan and India. Over the longer term, higher oil prices could result in a potential increase in supply from a number of areas—more shale producers, increased drilling activity around the world, and/or a production increase by low-cost producers to support fiscal revenues.

Valuations Remain Attractive

We believe the recent improvement in emerging-market fundamentals should be helpful for continued strength in emerging-market equities, and we also believe valuations in these markets appear attractive relative to developed markets.

In terms of valuations, at the end of March, the MSCI Emerging Markets Index had a price-to-earnings (P/E) ratio of 14.9 times and a price-to-book (P/B) value of 1.6 times, compared with a P/E of 22.1 times and P/B of 2.3 times for the MSCI World Index.[6]

Nonetheless, we are mindful of potential volatility and remain watchful for risks ahead, some of which include the potential of further increases in US interest rates, uncertainty about the new US administration's policies, and potential currency moves.

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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. Based on the MSCI Emerging Markets Index versus the MSCI World Index. The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 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. Past performance is not an indicator or guarantee of future performance.

2. The MSCI Frontier Markets Index captures large- and mid-cap representation across 30 frontier markets countries. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance.

3. Source: IMF World Economic Outlook January 2017 Update. There is no assurance that any estimate, forecast or projection will be realized.

4. The MSCI Taiwan Index is designed to measure the performance of the large- and mid-cap segments of the Taiwan market. 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 performance.

5. Source: FTSE JSE Africa All-Share Index. The All Share Index represents 99% of the full market cap of all eligible equities listed on the Main Board of the JSE. 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 performance.

6. The P/E ratio for an individual stock compares the stock price to the company's earnings per share. The P/E ratio for an index is the weighted average of the price/earnings ratios of the stocks in the index. For an individual company, the price-to-book (P/B) ratio is the current share price divided by a company's book value (or net worth) per share. For an index, the P/B ratio is the weighted average of all the price/book ratios of stocks in the index.