Emerging Markets Insights

# Optimism in Asia Drives Emerging Market Outperformance in October

## Three Things We're Thinking About Today

1. **Emerging market (EM) small-capitalization (small-cap)** stocks outperformed their large-cap counterparts over the last six months. A catchup from the sharp underperformance in the first quarter was a key driver of the stronger EM small-cap recovery. EM small caps have attracted less investor attention due to the growing market concentration of performance in a handful of mega-cap companies, as disruption from the COVID-19 pandemic drove interest in technology giants. But as we see normalcy return more rapidly in key EMs, this should enable broader economic and market recovery, as evidenced by the recent outperformance of EM small caps. We believe that the long-term structural story for EM small caps is not undone and remains compelling, underpinned by domestic economic drivers and the consumption growth story. As such, we believe that dedicated small-cap exposure should be viewed as complementary to large caps.

2. Despite the COVID-19 pandemic, EMs have shown a continued appetite for **structural reforms** that could lay the foundation for lasting economic recoveries. China, for example, has stayed true to its longer-term goal of making domestic consumption a major economic engine—and a source of potential ballast during external demand shocks. The government's recent moves to boost local luxury consumption tie in with this ambition as officials relaxed duty-free shopping rules, igniting a surge in duty-free sales in China. We see China's domestic travel and duty-free industries heading for a boom in the next few years. India's sizable fiscal deficit has limited the government's ability to spend on shoring up its economy. We expect privatizations and other economic reforms to offer more support by attracting investments. The country's "Make in India" initiative, aimed at growing the manufacturing sector, appears well placed to benefit from several trends. Brazil has also continued to pursue structural reforms despite economic disruptions and political noise. Officials recently passed new rules for the natural gas and sanitation industries in a bid to unlock hefty investments in the coming years.

3. The recent **weakening of the US dollar** relative to EM currencies can be attributed to the continued challenge of containing COVID-19 in the United States, the unprecedented level of US fiscal stimulus and dovish monetary policy, and market expectations of subsequent fiscal stimulus. The weakening of the US dollar comes off the back of a prolonged period of US dollar strength relative to most currencies. We expect some reversal of this previous trend of US dollar strength, but view it unlikely for the US dollar to give up all its gains relative to EM currencies in the near to medium term given global economic uncertainty, low US inflation expectations and the continued importance of the US dollar as the global reserve currency. The weaker US dollar is generally beneficial for EM equities—and especially Asian equities—with many companies domestically oriented. As such, earnings should improve in US dollar terms. A weaker dollar also gives emerging economies more leeway for fiscal measures.

**Market Performance (MSCI EM Index, USD)**

Cumulative Return

| Best | Worst |
|---|---|
| Indonesia (8.7%) | Poland (-16.0%) |
| Philippines (7.9%) | Greece (-13.9%) |
| China (5.3%) | Turkey (-12.5%) |

**Sector Performance (MSCI EM Index, USD)**

Cumulative Return

| Best | Worst |
|---|---|
| Telecommunication Services (6.3%) | Energy (-7.2%) |
| Consumer Discretionary (5.2%) | Real Estate (-2.3%) |
| Information Technology (2.0%) | Consumer Staples (-1.7%) |

**Currency Performance (MSCI EM Index, USD)**

% Change

| Best | Worst |
|---|---|
| Mexico (3.8%) | Turkey (-8.1%) |
| Pakistan (3.5%) | Argentina (-2.8%) |
| Korea (3.1%) | Poland (-2.5%) |

Source: FactSet, one-month period ending 10/31/20.

## Outlook

We have seen increased differentiation within EMs amid rapid changes brought about by various economic, social, and exogenous shocks such as the pandemic. As a whole, EM equities have been resilient, though this masks wide divergences across countries and sectors. As a region, emerging Asia has outperformed. By industry, the narrow leadership of internet, technology, consumer and other "new economy" companies thriving amid COVID-19 has been apparent.

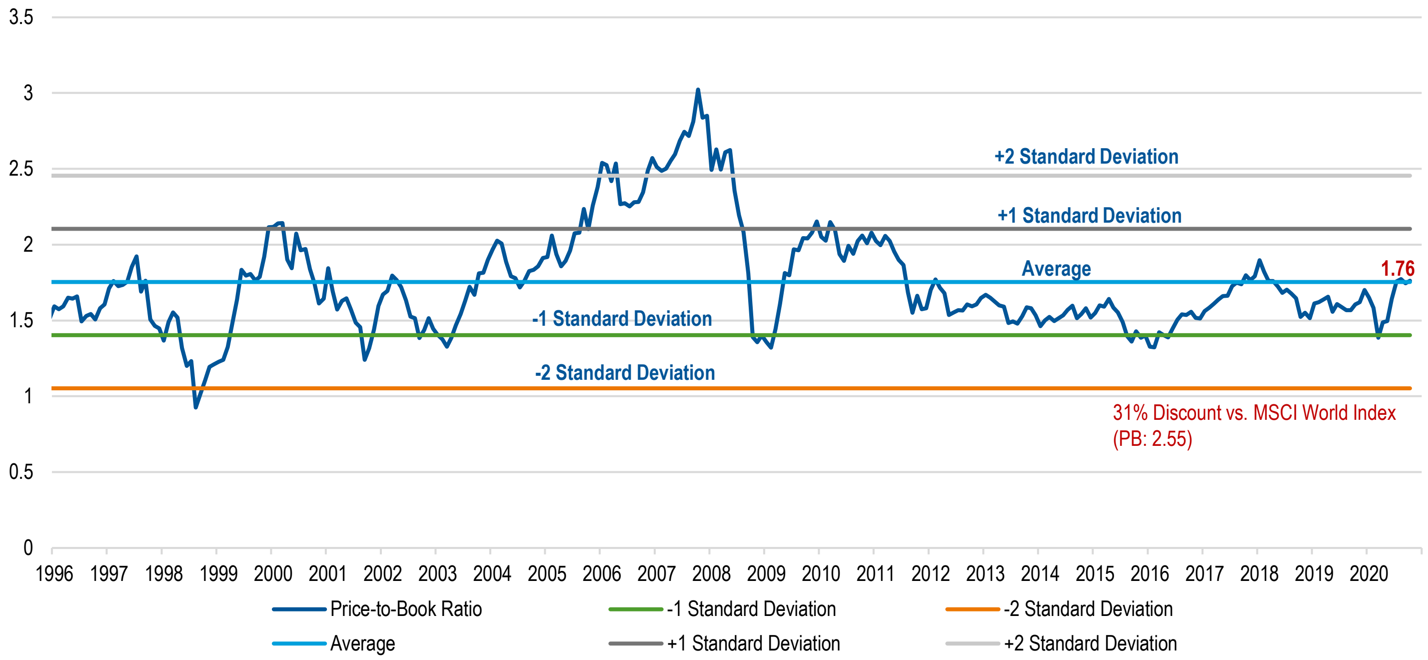
Technology- and consumer-centric companies that have dominated their fields with the help of durable competitive advantages look attractive to us. In our view, innovation and technology have been the driving forces behind EMs' recovery amid the COVID-19 fallout. Social distancing especially has supported the growth of e-commerce, remote working, online learning and entertainment streaming. We also remain optimistic about the longer-term potential for consumption growth, whether through a rising penetration of goods and services or a "premiumization" in demand.

While developments from the US presidential election—and their potential impact on US-China relations—could spur market volatility, our focus remains on individual companies that could fare well over the longer run. We see resilience in technology leaders that have become integral to supply chains globally and are likely to weather changing geopolitical dynamics, as well as companies capitalizing on strong domestic and secular drivers of growth.

## Emerging Markets Key Trends and Developments

EM equities finished a volatile month higher, while developed market stocks declined. Recovering economic momentum in emerging Asia cushioned EMs' performance against renewed recession fears in Europe as mounting COVID-19 infections pushed several countries back into lockdowns. Rising coronavirus cases in the United States, plus uncertainty around additional fiscal stimulus and the presidential election, also drove market caution. The MSCI Emerging Markets Index increased 2.1% during the month, while the MSCI World Index declined 3.0%, both in US dollars.[1]

**EM Valuations. Discounted vs. History and Developed Markets**
MSCI EM Index: Price to Book Ratio
September 1995*–October 2020




For illustrative purposes only. **Past performance is not an indicator or a guarantee of future performance**.
Source: Franklin Templeton, MSCI, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.
Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.
* First available date.

### The Most Important Moves in Emerging Markets in October 2020

- Asian equities defied market routs globally to deliver gains. Stocks in China rose as its economic resurgence gained pace, with industrial production and retail sales beating growth expectations in September. Taiwan's market advanced; investors welcomed strong corporate earnings and the economy's third-quarter rebound on the back of robust technology exports. Indonesian equities surged as the government relaxed coronavirus curbs in Jakarta and passed a job creation law aimed at reducing regulations and boosting investments. Conversely, Thailand's market fell amid continued pro-democracy protests. In Malaysia, political tussles weighed on the country's stocks.

- In Latin America, Brazil's stock market and its currency, the real, weakened. Concerns around the country's fiscal health overshadowed its current account surplus and a strong rebound in its economic activity. Stocks in Peru retreated amid political uncertainty as lawmakers re-attempted to impeach the country's president. Conversely, Mexican equities rose, with the Mexican peso's appreciation adding a boost. The government announced an infrastructure program underpinned mostly by private investments.
- Emerging European markets pulled back as a fresh wave of COVID-19 infections in Europe brought on tighter mobility restrictions. A faltering outlook for economic momentum and energy demand drove oil prices lower. Against this backdrop, Russian equities fell. Turkey's equities and currency lost ground. The central bank's decision to not raise its key policy rate amid heightened inflation undercut investor sentiment, as did geopolitical tensions surrounding the country. In the Middle East and Africa region, South African stocks gained, thanks to strength in the South African rand.

## Franklin Templeton Emerging Markets Equity

### Local Knowledge, Global Reach

In a sea of overlooked and under-researched companies, there's no substitute for local market knowledge. Our on-the-ground investment team of over 80 portfolio managers and analysts across nearly 20 countries distinguishes Franklin Templeton Emerging Markets Equity from the crowd. Investors benefit from our networks of local business contacts, access to in-person company visits and real time response to local market events.

Our global reach through Franklin Templeton Investments provides access to sophisticated risk management and trading resources. Portfolio management collaborates closely with the Investment Risk Management Group, which provides detailed risk analytics to complement the team's assessment of risk exposures.

- **80+ portfolio managers and research analysts**
- **16 years on average of industry experience**
- **8 years on average with Franklin Templeton**

1. 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.

**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. Smaller and newer companies can be particularly sensitive to changing economic conditions. Their growth prospects are less certain than those of larger, more established companies, and they can be volatile.



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