Emerging Markets Insights

Expectations of Economic Normalization in 2021 Drove Confidence in Emerging Markets in the Final Quarter of 2020

Three Things We're Thinking About Today

1. Although the **Chinese** market lagged its emerging market (EM) counterparts in the final quarter of 2020, Chinese equities were among the leading outperformers for 2020. Geopolitical tension between China and the United States remains a key headwind that is likely to persist under President-elect Joe Biden's administration, though we could see a shift to a more constructive tone. The US Department of Defense (DoD), however, recently added a number of Chinese companies to a list of those deemed to have some military connection. The executive order prevents US investors from holding any companies on the list, starting in late 2021. Although business operations should not be directly impacted by the ban, stock prices will likely be subject to some near-term volatility as a result of some forced selling. China appears to be the only major economy with gross domestic product (GDP) growth in 2020, underpinned by a diversified domestic economy driven by innovation and digitalization. Although regulatory tightening in the internet sector has raised some concerns over the short term, it could lower industry risk in the longer term. We continue to see the emergence of high-quality companies that are well-placed to benefit from ongoing market consolidation and booming domestic consumption.

2. **India** has seen surging COVID-19 infections, but with mortality having been contained, economic reopening has continued. Although the disruption of traditional business models has weighed on some companies, we expect to see a positive impact on Indian technology service providers. The information technology (IT) services sector has been largely ignored over the last few years due to slowing growth and margin pressures, but both higher client traction as well as structural cost saving initiatives have offered support. As India embarks upon indigenization and import substitution, the resurgence of manufacturing activity, as well as global efforts to diversify supply chains, could drive demand across a range of product categories including electronics, defense, automobile parts and pharmaceuticals. Normalization of credit stress on the back of falling interest rates and improving liquidity should have a positive impact on banks, an area where we maintain a positive outlook. Meanwhile, negative real rates in India will provide very significant support for the economy and markets going forward.

3. **Brazil**, despite the political noise, has continued to focus on important economic reforms that are leading to a structural downward shift away from its historically high real interest rate. The central bank has also cut its policy interest rate to a record low, which reduces the cost of renegotiating or restructuring loans, and could be a catalyst for longer-term credit growth. Credit penetration in Brazil is far below many other markets, signaling room to head higher in the coming years; we think this supports prospects for the financial sector. More broadly, negative real rates should provide structural support to Brazil's growth outlook. We are also witnessing a long-term trend of "equitization" of investments that benefits participants in the financial services industry. Challenges remain in Brazil, however, including rising debt levels as a result of stimulus measures, paired with uncertainty surrounding continued economic reforms

Market Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
Mexico (42.9%)	Greece (-6.6%)
Colombia (35.1%)	Saudi Arabia (2.8%)
Malaysia-EM (32.6%)	Philippines (3.9%)

Sector Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
Financials (37.1%)	Energy (3.8%)
Utilities (33.8%)	Industrials (3.6%)
Consumer Discretionary (18.5%)	Information Technology (-4.3%)

Currency Performance (MSCI EM Index, USD)
% Change

Best	Worst
South Africa (13.6%)	Argentina (-9.4%)
Colombia (12.7%)	Peru (-0.6%)
Chile (10.9%)	Saudi Arabia (0.0%)

Source: FactSet, three-month period ending 12/31/20.

amid a politically fragmented environment. This may, in turn, place upward pressure on longer-term interest rates. The planned end of emergency aid in place to support those impacted by COVID-19 lockdown measures could also impact economic recovery.

Outlook

Key EMs, particularly in East Asia, substantially outperformed other countries in terms of health outcomes, economic impact and equity markets in 2020. Many companies have successfully executed during the pandemic and should emerge out of the crisis in a stronger competitive position. We continue to closely monitor the pace of recovery in what we consider good-quality companies that have corrected significantly beyond the limited near-term impact to their intrinsic value.

The challenges of 2020 have highlighted structural advantages and other beneficial secular trends in EMs that we believe bode well for 2021. The resilience of key markets in East Asia during the crisis, paired with their ability to capitalize on secular shifts to the new economy, should drive continued strength in 2021. Laggards, including India and Brazil, stand to benefit from a uniquely accommodative environment of negative real rates (and an undervalued currency in Brazil), combined with ongoing reform efforts and excess capacity in the economy, boosting growth.

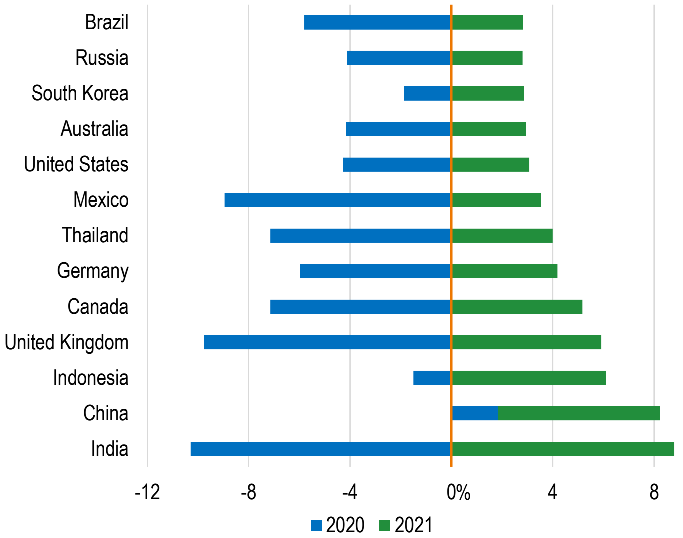
This broadening of economic recovery in EMs should continue to drive improved earnings visibility into 2021 and amounts to a compelling opportunity across EMs as a whole—both from a near-term tactical perspective as well as structurally. For so many different markets across this landscape to concurrently offer compelling investment potential, individually and in aggregate, presents an exceptional investment window, in our view.

However, we expect COVID-19 to remain prevalent in 2021. While some countries have already started inoculation, production and distribution of the vaccine in sufficient scale are challenges equal to its development. As such, we expect many countries to continue to experience sporadic viral outbreaks, which will add volatility to the underlying trend of economic and market recovery.

Emerging Markets Key Trends and Developments

Renewed risk appetite in the fourth quarter of 2020 buoyed EM equities, which outpaced developed market stocks. COVID-19 vaccine breakthroughs fanned hopes for full economic reopenings and eclipsed concerns around resurgent outbreaks, the spread of a new coronavirus strain, and US-China tensions. Additional US economic stimulus and increased clarity on US election results also lifted market sentiment. With the fourth-quarter rally, EM equities erased pandemic-driven losses earlier in the year and ended 2020 sharply higher, ahead of developed market stocks. The MSCI Emerging Markets Index increased 19.8% during the quarter, while the MSCI World Index returned 14.1%, both in US dollars.[1]

Economic Recovery Expected in 2021
Real GDP growth forecasts post pandemic
2020–2021



Source: International Monetary Fund (IMF) forecasts for 2020/2021, World Economic Outlook (WEO), Macrobond. There is no assurance that any estimate, forecast or projection will be realized.

The Most Important Moves in Emerging Markets in the Fourth Quarter of 2020

- Asian markets collectively advanced in the fourth quarter. Technology-heavy indices in South Korea and Taiwan soared as both economies saw robust demand for their technology exports. Stocks in Indonesia and Thailand climbed as expectations of economic normalization sent investors into markets that had fallen behind the region's rally. China's market was a regional laggard even as its economy continued to recover. China's increased scrutiny of its internet industry, plus a US order restricting US investments in certain Chinese companies, triggered market unease.
- Latin American equities and currencies staged a rally on growing investor confidence and stronger commodity prices. Stocks in Colombia surged amid higher prices for oil, the country's major export. Brazil's market was another bright spot as optimism around its economic rebound outweighed worries over its fiscal deficit following massive stimulus to tackle the pandemic. Mexican stocks gained on improving economic activity and the prospect of steadier US-Mexico relations under Biden's administration.
- Emerging European stocks swung higher. Upbeat global cues and coronavirus vaccine rollouts in various parts of Europe helped investors look past mounting COVID-19 infections and fresh mobility curbs in the region. Markets also welcomed a trade deal between the European Union and the United Kingdom following the latter's exit from the single market. Russian equities rose on higher oil prices, thanks to an improved outlook for global oil demand. In the Middle East and Africa region, a risk-on mood boosted South Africa's equities and currency. The economy posted a stronger-than-expected rebound in the third quarter.

Regional Outlook

Three-Month Period Ended December 31, 2020

Market	− Neutral +	Investment Thesis
Emerging Asia		Economies in East Asia appear to be leading the recovery globally. The potential for more stable US-China engagement under US President-elect Joe Biden's administration further supported the region's outlook. The ASEAN region and India have lagged in terms of COVID-19 normalization, but economies are gradually re-opening.
China		Economic conditions are expected to remain weak and patchy even if COVID-19 stabilizes, as it remains a global issue. However, the government's policy response will likely soften the impact. It seems that China is on its way to being the first to recover, barring any new waves. In general, we believe China will most likely emerge stronger from this crisis.
India		Long-term fundamentals including under-penetration, formalization and digitalization of the economy and a stable government remain intact. However, the strong earnings revival outlook is offset by the near-peak market valuations.
Indonesia		The 12-month outlook remains uncertain. The government has been rushing to reopen the economy despite increasing COVID-19 cases and fatalities. COVID-19 containment efforts in Indonesia are among the weakest in the ASEAN region, while the government's stimulus program rollout has also been slow and ineffective.
South Korea		Macro indicators have been deteriorating due to the COVID-19 pandemic; but we expect the situation to normalize once it dissipates. However, concerns about government regulations are growing, and geopolitical tension with North Korea is escalating, which we think warrants close attention.
Taiwan		The negative impact of COVID-19 has been diminishing and we have seen signs of recovery in some technology-related products, which should be positive for Taiwan's export- and technology-oriented economy. Although the trade dispute between the United States and China continues, relations are not expected to worsen under a Biden administration, although any normalization back to the pre-Trump era also remains distant. The situation, however, can provide businesses with more confidence and fewer uncertainties in which to operate. The restrictions on Huawei have likely reached their worst point, in our view, providing more upside than downside risk to supply chains. Overall, stretched market valuations may lead to a short-term correction, but the medium to longer-term outlook remains positive, given fifth generation wireless technology (5G) deployment and the acceleration of production relocation from China.
Thailand		Although the near-term domestic outlook appears more positive than its ASEAN peers as the economy reopens, the overall outlook is negative due to: i) a weak global trade outlook; ii) decline in tourist arrivals; iii) lack of private investments to spur domestic consumption; iv) political uncertainties.
Latin America		Expectations of a recovery in 2021 and a Biden-led US administration bode well for the region. A gradual lifting of COVID-19-related mobility restrictions should further help the situation.
Brazil		The COVID-19 pandemic is expected to have a lasting impact on Brazil's economy. The speed and strength of recovery will depend on the government's resumption of its ambitious economic reforms, which should provide the basis for higher long-term economic growth and a better business environment for companies. Record-low interest rates should continue driving domestic flows to equities.
Mexico		Mexico has an open economy (over a third of GDP) heavily exposed to the United States (over 70% of exports go there). The forecasted solid US recovery is driving the recovery in economic activity in Mexico. The length of disruptions from flow restrictions to contain the COVID-19 spread will determine the level of recovery. Given that the business community realizes that a victory by the opposition is unlikely, they have decided to compromise with the current administration.
Peru		Political volatility has been hindering Peru´s economic recovery, shifting focus away from government spending and infrastructure investment. We expect to see continued political noise ahead of the upcoming 2021 elections. The tailwind of favorable fund inflows into EMs and commodities could help offset the political uncertainty.
Emerging Europe		New waves of COVID-19 cases across Europe have prompted an increase in social distancing measures and a slowdown in the region's economic recovery.
Czech Republic		The European Commission's Economic Sentiment Index showed a month-on-month improvement in December. The industrial sector, like most of its peers, continued to expand. Consumer confidence remained low, however, despite rising in December. Confidence could start to improve in late-March with the advent of Spring, especially if it leads to easing COVID-19 worries.
Hungary		Economic confidence returned to its summer levels in December, supported by growth across most areas. Overall hiring appetite returned to expansionary levels with all sectors, especially service, recording an increase in confidence. In contrast, households' unemployment fears deteriorated marginally and, unlike in the Euro area, the industrial sector remains far below its pre-COVID-19 levels. Consumer confidence could start to improve in late-March with the advent of Spring, especially if it leads to easing COVID-19 worries.
Poland		Like its Eastern European peers, sentiment improved in December after a contraction in November but remained below levels recorded in the summer. All sectors, especially services and retail, recorded growth. In the labor market, hiring appetite returned close to its September peak, with unemployment fears softening albeit remaining above third-quarter levels. Consumer confidence could start to improve in late-March with the advent of Spring, especially if it leads to easing COVID-19 worries.
Russia		In a stable commodities/ruble environment, companies should benefit from earnings revisions and improved dividend yields. US/EU sanctions remain a key risk.

The graphic reflects the views of Franklin Templeton Emerging Markets Equity regarding each region and are updated on a quarterly basis. All viewpoints reflect solely the views and opinions of Franklin Templeton Emerging Markets Equity. Not representative of an actual account or portfolio.

Regional Outlook

Three-Month Period Ended December 31, 2020

Market	– Neutral +	Investment Thesis
The Middle East		The region's outlook remains tied to a recovery in oil prices and government expenditure. Solid reserves provide some economies with some protection.
Kuwait		Kuwait has a strong fiscal position but a delay in reform and issuance of debt law could erode government finances. Non-oil GDP is somewhat shielded, as most Kuwaitis are employed by the government. MSCI EM Index inclusion saw minimal market volatility.
Qatar		Activity related to FIFA 2022 preparations and liquefied natural gas production expansion present a case for growth and earnings uptick for the next 3-4 years. High sovereign reserves and a low oil budget breakeven point offer Qatar solid stability in times of downturn.
Saudi Arabia		The outlook is challenging and remains anchored to a recovery in oil prices and government/public investment fund (PIF) spending. Substantial foreign exchange reserves and PIF assets provide some comfort.
UAE		The equity market is cheaper than its MENA peers, but the macro outlook is poor. Moreover, the equity market is already well-owned by foreigners, making it hard to see a re-rating in the near-term. The end of the upgrade cycle for Kuwait may mean that some fresh regional money could return to the UAE.
Africa		The economic environment appears to be improving; however, domestic currency risk remains in several markets.
Egypt		We expect growth to remain positive and recover gradually, while discretionary spending could remain under pressure. We see receding inflation with a potential for further interest-rate cuts and expect the currency to remain largely stable. A longer disruption in tourism is one of the key risks being a major source of foreign currency.
Kenya		The outlook is starting to improve, with what appears to be a faster recovery in economic activity.
Nigeria		The risk of further currency weakness remains high, while a weak political and macroeconomic environment creates a challenging environment for stocks.
South Africa		The broad outlook appears to be improving given the post-COVID-19 recovery and some positive news on reform. However, a long-term recovery is still dependent on the ability of government to execute and commit to other reforms.

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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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