FRANKLIN TEMPLETON INVESTMENTS

6 September 2018

# Views on Emerging Markets Equity And Select EM Countries

PERSPECTIVE FROM FRANKLIN TEMPLETON EMERGING MARKETS EQUITY

In light of the Turkish lira and Argentine peso currency drops, fears of Emerging Markets (EM) contagion appear to be on the rise and investors have put pressure on various EM currencies. We think it is important for investors to take note that emerging markets are not homogenous, and the countries that currently dominate the headlines represent a very small part of the EM universe. For example, more than 20 companies in the MSCI EM Index[1] are individually larger than the entirety of the Turkish stock market, and these countries' travails are not representative of the broader EM asset class. Overall, we still have a constructive view on emerging market countries—most of which appear to be operating in an environment where economic growth is improving, commodity prices are stable, currencies in general are undervalued, and inflation is under control. The recent volatility allows us, as stock pickers, to identify fundamentally strong companies and invest at attractive valuations.

Below are our perspectives on some of the high-volatility countries:

**Argentina:**

Since mid-August, there have been renewed attacks on the Argentine peso, and inflation expectations rose. This has prompted the government to formulate more aggressive fiscal policies, which have so far been met with scepticism by the market. In our view, while the financial program committed by the Argentine government is demanding, particularly facing a presidential election in 2019, there is a strong commitment by the incumbent administration to follow through, and Argentina continues to have support from International Monetary Fund (IMF) and the international community. However, significant political uncertainties remain leading up to the presidential elections in 2019, and the current economic contraction is expected to continue for several months at least. We are closely monitoring the sustainability of the administration's policies and the country's economic recovery prospects. Given the current volatility and uncertainty, we currently favour companies with US dollar-linked revenues.

**Turkey:**

We remain cautious in Turkey, where investors' confidence has been dampened by political and institutional uncertainties, a structurally weak current account position, higher oil prices, sharp depreciation of the Turkish lira, and high double-digit inflation amid a challenging geopolitical environment. After years of strong economic growth, an economic slowdown was a risk before the recent volatility, which is now being exacerbated.

The economy is in need of a credible economic plan, and while the Turkish central bank has taken some measures in response to the current situation, including altering certain banking regulations to free up liquidity, investors are looking for a more robust response than seen to date. We continue to closely monitor the dynamics specific to individual companies in this country.

**South Africa:**

While the South African rand has experienced some selloff due to higher EM risk aversion, we believe that it is primarily a function of the rand being among the more liquid bellwether EM currencies. Domestically, South Africa has a generally positive political environment given the new president's business-centric approach, while Gross Domestic Product (GDP) growth is expected to recover from the weaker first half of the year due to stronger agricultural output, consumer spending and construction.

We expect the rand to recover once risk aversion abates and domestic growth improves, and we are monitoring the consumer sectors accordingly.

**Indonesia:**

In Indonesia, the rupiah fell to its weakest level in more than 20 years, partly due to its widening current account deficit. Bank Indonesia has ramped up efforts to stabilize the currency through direct market intervention which included four interest-rate hikes since May 2018, while the government has announced new regulations including higher import taxes for non-essential consumer goods in order to reduce the current account deficit. In the meantime, we believe companies that are highly leveraged on USD debt would be impacted most, alongside with those with high imported cost components, including pharmaceuticals, poultry and select consumer names. On the flip side, a weak rupiah would benefit companies with USD (or linked) revenue such as coal, metals, and other export-oriented sectors.

We believe the country's fundamentals to be largely intact. Indonesia has demonstrated continued resilience to external shocks, benefiting from ongoing reforms over the last decade that have sought to balance its growth drivers and accelerate domestic development.

We are finding potential investment opportunities in many sectors that could benefit from existing demographics and expected reforms. These include banks, which lend to both fast-growing corporations and provide mortgages, credit cards and other retail banking products to consumers, and companies in the consumer, resources and infrastructure-related sectors.

**Our Bottom Line**

In assessing the current state of EM equity, it should be noted that emerging markets consist of diverse countries with different economic growth drivers and varying levels of political risk. We believe the risk of broader EM contagion is limited, and current EM weaknesses in select countries are not likely to result in macroeconomic contagion or broader asset class crises.

While there are certainly specific EM countries with challenged fundamentals that are perhaps skewing overall perceptions, the EM asset class as a whole remains in good health, in our view. The case for emerging markets equities continues to be supported by a constructive global macro backdrop, higher GDP growth, and improving economic fundamentals on the back of ongoing reforms. Cash flow generation has accelerated considerably in recent years, which, when paired with better capital allocation discipline, can help improve long-term return potential to shareholders and typically results in corporate balance sheet deleveraging. Finally, earnings growth across EM companies has been resilient, while valuations have become cheaper during this period of market volatility.

Our key EM investment themes include the structural growth in the technology sector, rising consumption, and economic reforms, and we remain focused on selecting fundamentally strong companies that should be well-positioned to capitalize on these secular trends based on our assessments.

**End Notes**

1 Source: FactSet as of August 31, 2018. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. 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.

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