FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

31 December 2018

Emerging Markets Outpace Developed Markets in the Final Quarter of 2018

EMERGING MARKETS INSIGHTS

Three Things We're Thinking About Today

1. The US Federal Reserve (Fed) raised its key interest rate by 25 basis points in December, its fourth increase in 2018, and in line with market expectations. While the Fed lowered its US gross domestic product (GDP) growth and inflation forecasts slightly, it continued to see relatively strong growth in the US economy. **US interest rate hike** projections for 2019 and the longer run were also lowered, with two interest rate hikes expected in 2019, instead of three. While rising rates—by design—apply pressure to growth and inflation expectations, this is not solely restricted to emerging markets (EMs), and most debt ratios are considerably higher in the developed world. EMs in aggregate have shifted to current account surpluses, floating exchange rates and a reduced reliance on US-dollar debt funding. However, those emerging economies (and companies) pursuing less prudent policies have been punished heavily by financial markets. Investors appear to be increasingly discerning between winners and losers, which presents opportunities for active management.

2. US dollar strength has focused attention on weaker commodity prices and dented investor enthusiasm for emerging markets in recent months—stoking fears that the current climate could lead to a repeat of the 1997-1998 Asian Financial Crisis (AFC). However, we believe these concerns are largely overdone as the last two decades of mass financial reforms have transformed emerging **Asia's financial markets**. Twenty years on from the AFC, we regard the economic landscape in many EMs as fundamentally stronger than it was back then. Our experience suggests investors should focus less on what's going on in the United States, and more on the developments on the ground in the countries themselves. In many cases, EMs have drawn lessons from past crises to strengthen policies and governance. In addition, many EM economies are less commodity-driven then they were decades ago. Therefore, the whims of commodity prices have less influence. Changes in US policy could, of course, still cause pain in EM countries with high external debt. But we have noticed a general shift. Asian monetary policy is no longer as highly correlated with US interest rates and is more dependent on local growth and inflation conditions.

3. The recent decline in oil prices has helped ease pressure on the Indian rupee, current account deficit and inflation. The **Indian** economy also continues to perform well; government capital expenditure (capex) through infrastructure spending has progressed well, corporate capex involving capacity expansion is gradually unfolding, and we believe that household capex is also improving. Consumption remains robust as well. India went through a challenging environment recently where shadow banks, typically referred to as non-banking financial companies (NBFCs) in India, suffered liquidity issues, raising concerns of systemic risk and liquidity across the entire financial system. Liquidity has since been normalizing and credit flows returning. While upcoming elections could impact sentiment in the interim, we do not foresee a significant impact on the domestic economy. As such, our assessment of the macro picture and corporate fundamentals (with continued economic recovery and corporate earnings growth acceleration) supports our favorable long-term conviction for India's market.

Market Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
+Brazil (13.6%)	-Pakistan (-22.1%)
+Indonesia (9.8%)	-Colombia (-18.9%)
+Qatar (8.4%)	-Mexico (-18.7%)

Sector Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
+Utilities (3.7%)	-Health Care (-16.1%)
+Real Estate (1.5%)	-Consumer Discretionary (-13.5%)
+Financials (-0.8%)	-Information Technology (-12.6%)

Currency Performance (vs. USD)
% Change

Best	Worst
+Turkey (12.9%)	-Pakistan (-10.5%)
+India (3.8%)	-Colombia (-8.6%)
+Indonesia (3.6%)	-Russia (-5.6%)

Source: FactSet, three-month period ended 12/31/18.

Outlook

Trade tensions have been a primary contributor to weakness in EM equities, and while exports remain a key engine of growth for EMs, they are increasingly shipped to other emerging economies; the relative importance of developed markets has declined. Similarly, the roles of consumption and technology in generating economic

A note to our readers: Given the rapid changes that can take place in global markets, it is often difficult to provide up-to-date materials that address the most current situations. The following update is valid only as of 31 December 2018.

growth have become more prominent; EMs have become more domestically orientated. While tariffs undoubtedly come at a challenging time for China as it seeks to deleverage its economy, the impact will also be felt globally.

Despite slowing global growth, EMs are still widely expected to achieve faster economic growth than developed markets (DMs) in 2019 and for the foreseeable future. The International Monetary Fund (IMF) forecasts EMs to grow 4.7% in 2019, more than double the 2.1% estimate for DMs[1]. EM currencies are relatively cheap after declining in 2018; returning to 2001-2002 levels. We expect to see a recovery in 2019.

EM valuations have become increasingly attractive due to weakened confidence (and performance), yet cash flows and earnings generally remain resilient. EM earnings growth is expected to exceed that of the US and DMs, resuming the trend witnessed in 2017. These conditions, when paired with improving corporate governance that includes dividend payouts and buybacks, present an increasingly attractive long-term buying opportunity for us and should contribute to renewed optimism in the EM asset class.

Emerging Markets Key Trends and Developments

EM equities fell over the fourth quarter, though they fared better than their DM counterparts. Concerns about global economic growth, US interest rate hikes and US-China trade relations stoked market volatility during the period, as they did in much of 2018. The year proved challenging for global markets as a whole, with EM equities losing more ground than DM stocks. The MSCI Emerging Markets Index fell 7.4% over the quarter, compared with a 13.3% decline in the MSCI World Index, both in US dollars.

Rising Rates Impact Global Debt: Higher Rates to Disproportionately Impact Developed Markets

Emerging vs. Developed Markets: Debt

Government Debt as % of GDP	2008	2018
Emerging Markets	31%	48%
Developed Markets	73%	100%

Household Debt as % of GDP	2008	2018
Emerging Markets	20%	39%
Developed Markets	76%	72%

Source: BIS data last updated as of 12 December 2018. Total credit to households (core debt) percentage of GDP; total credit to the government sector (core debt) percentage of GDP – at nominal value. Indexes are unmanaged, and one cannot invest directly in an index. They do not include fees, expenses or sales charges. Aggregates based on conversion to US dollars at market exchange rates..

The Most Important Moves in Emerging Markets This Quarter

- Asian equities pulled back in the fourth quarter, with Pakistan, Taiwan and South Korea leading regional losses. Pakistan's financial health weakened, while the government sought a bailout from the IMF. Technology-heavy indexes in Taiwan and South Korea were hobbled by weakness in technology stocks. Conversely, markets in Indonesia, the Philippines and India gained, aided by local currency strength. The Indonesian rupiah and Philippine peso rose on central bank action to shore up the currencies against the US dollar. The Indian rupee also advanced as lower oil prices eased worries about the oil-importing nation's trade deficit.

- Latin America was the only EM region to end the quarter with a minor gain, solely because of the strong performance of the Brazilian market in October. Equity prices in Brazil rallied on the victory of a more market-friendly candidate in presidential elections as well as appreciation in the Brazilian real. At the other end of the spectrum, Colombia and Mexico recorded double-digit declines. Increased political and economic policy uncertainty and higher interest rates, partly driven by higher inflationary pressures, impacted investor sentiment in Mexico. A decline in oil prices and depreciation in the Colombian peso weighed on the Colombian market.

- Emerging European markets lost ground, with Greece, Russia and the Czech Republic especially weak. Hungary and Turkey, however, held on to earlier gains to end the quarter with positive returns. Lower oil prices and increased geopolitical risk weighed on share prices in Russia. The Turkish market benefited from a double-digit gain in November, following significant weakness earlier in the year, as political tensions eased, and the Turkish lira appreciated. The South African market declined but fared relatively better than its EM peers. The South African economy returned to growth in the third quarter of 2018, following two consecutive quarters of contraction.

- Frontier markets corrected over the final quarter of the year but performed better than their global counterparts. Lithuania, Romania and Tunisia were among the weakest markets. Vietnam and Kenya also underperformed. Global trade concerns and weak market sentiment weighed on equity prices in Vietnam despite positive earnings results and robust GDP growth. Sri Lanka, Lebanon and Estonia, however, bucked the trend, ending the three-month period with gains. Investors in Sri Lanka remained positive despite continuing political instability and weakness in the Sri Lankan rupee.

Regional Outlook

Three-Month Period Ended 31 December 2018

Market	(–) N (+)	Investment Thesis
Asia		Solid macroeconomic fundamentals, but the US-China trade dispute and slowing global growth could impact some markets.
China		The negative outlook is mainly driven by the uncertainties surrounding the US-China trade dispute. As the US cycle matures and global growth momentum slows, China's GDP growth is expected to ease to 6.0-6.1% in 2019. While the trade dispute and Huawei incident could lead to weaker exports, government stimulus and tax cuts are expected to support domestic consumption and fixed asset investment.
India		Long-term fundamentals include under-penetration, formalization of economy and a stable government remain intact. However, the improving current account deficit and easing inflationary pressure along with a strong possibility of an improvement in corporate earnings are offset by higher-than-average valuations and incremental political uncertainty.
Indonesia		Economic growth remains steady. However, politics will likely heat up ahead of the legislative and presidential elections in April 2019.
South Korea		Macro indicators remain sound. However, concerns about government regulations are growing, while the geopolitical situation warrants close attention.
Pakistan		Uncertainty remains with concerns on a political reshuffle and high current account deficit.
Taiwan		The major overhang is the US-China trade dispute. Many Taiwanese companies have production plants in China and could be impacted if the situation worsens. Weaker-than-expected demand for information technology-related products is also worrying. Inflation has been manageable, limiting pressure on interest rates.
Thailand		Economic stability remains strong, but growth outlook is moderate. The upcoming general election should support near-term sentiment, but outlook could be challenging post-election.
Vietnam		GDP remains above 6%, underpinned by resilient domestic demand and strong export-oriented manufacturing. US-China trade tariff issue is an uncertain risk.
Europe		Solid economies with attractive valuations; Turkey remains an outlier.
Czech Republic		Relatively safe EM, with an open economy and current account surplus. Do not expect any significant issues unless there is a significant global slowdown.
Hungary		The economy is doing well but structural problems seem to be accumulating. However, the near-term outlook should not be impacted.
Russia		In a stable oil price/ruble environment, domestic names should benefit from earnings revisions and increased demand. The political situation should remain stable with the next presidential election scheduled for 2024. However, macro risks remain high due to volatile commodity prices and the possibility of additional US/EU sanctions.
Turkey		Weak demand and high cost of funding has resulted in a challenging macroeconomic environment for companies. Non-performing loans are expected to rise in the short-term. A recovery may start after the March 2019 elections.

cont'd.

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

Regional Outlook, continued
Three-Month Period Ended 31 December 2018

Market	(–) N (+)	Investment Thesis
Latin America		Solid economic situation in most economies. Improving political situations in markets such as Brazil and Peru, but some concerns remain in Mexico and Argentina.
Argentina		The US$57 billion IMF Stand-By Arrangement should meet the government's financing needs until end-2019 but failed to lower sovereign spreads to a level that would allow Argentina to return to the international financial markets. Meeting the government's 2020-2024 financial needs, however, look challenging in view of the US$35 billion average annual requirement. The market believes that the victory of the opposition in 2019's presidential election could trigger a debt renegotiation.
Brazil		The new government's emphasis on implementing ambitious economic reforms could provide a basis for higher economic growth and a better business environment for companies.
Mexico		We expect volatility in financial markets to continue as uncertainty about how the new Mexican administration will run the country persists.
Peru		President Vizcarra's approval ratings have continued to consolidate at higher levels, while Fujimorism seems to have lost appeal to the masses. We expect political noise but believe that it should not cause Peru to deviate from its sustained long-term growth trend.
Middle East		Varied outcomes in different markets—some affected by macro and political factors, others benefiting from reforms and FTSE/MSCI upgrades.
Kuwait		FTSE upgrade and potential MSCI upgrade to EM status could be positive catalysts for the market. Kuwait's fiscal position appears stronger than its regional peers and hence more defensive. A persistent risk is political deadlock, which often leads to slower fiscal reforms and investments.
Qatar		Risks include slowing economic growth, political conflict and deadlock, and continued weak investor appetite.
Saudi Arabia		FTSE and MSCI EM upgrades could be strong catalysts for the market. The country continues to see stable economic growth, while the National Transformation plan and Vision 2030 is to be redrafted to reflect more realistic targets.
United Arab Emirates		Within the region, the UAE is least dependent on oil revenues. Fiscal reforms such as the value-added tax implementation have been successful. The strong property sector, however, needs to be monitored closely.
Africa		Weaker global outlook impacting some economies; potential remains for improvement going forward, encouraging macroeconomic signs.
Egypt		Egypt has made a committed step toward economic reforms. It is witnessing receding inflation and a strengthening currency.
Kenya		GDP growth could pick up after stalling last year, but credit remains constrained and the IMF facility review is at risk.
Nigeria		The market is improving from a macro perspective with steadying inflation and foreign exchange liquidity. However, there are concerns with regard to investment in Nigeria given the substantial claims against telecom company MTN.
South Africa		The outlook remains muted, although signs of improvement were evident in the third-quarter GDP data. While still weighed down by a slow recovery and weaker global backdrop and sentiment, domestically the country should be past the lowest point.

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FRANKLIN TEMPLETON EMERGING MARKETS EQUITY

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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.

- **85+** portfolio managers and research analysts
- **15** years on average of industry experience
- **9** years on average with Franklin Templeton


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1. Source: International Monetary Fund, World Economic Outlook Database, October 2018.

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