PERSPECTIVE

Emerging Markets Second-Quarter 2017 Recap: The Streak Continues

July 13, 2017

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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 team's overview of what happened in the emerging-markets universe in the second quarter of 2017, including some key events, milestones and data points to offer some perspective.

Overview

- Emerging-market (EM) stocks outperformed their developed-market counterparts for the sixth consecutive month in June, with the MSCI EM Index returning 1.1%, compared with a 0.4% gain in the MCSI World Index.[1] For the quarter as a whole, the MSCI EM Index was up 6.4%, while the MSCI World Index was up 4.2%. Key drivers of emerging-market performance included encouraging economic data in China, investor inflows and corporate earnings growth.

- Frontier markets outperformed developed markets and performed in line with their emerging-market counterparts. The MSCI Frontier Index gained 6.3% in US-dollar terms over the quarter.[2] Nigeria, Sri Lanka and Kenya were among the top-performing frontier markets. An improvement in foreign-exchange liquidity coupled with undemanding valuations drove stock prices in Nigeria. However, equity prices in Bahrain and Oman declined.

- Commodity prices declined during the second quarter despite a late-June rally. West Texas Intermediate (WTI) crude oil spot prices declined 9% during the quarter.[3] At the end of June, however, oil prices recorded their strongest rally of 2017 after US producers appeared to curtail their drilling activity and government data showed a sharp drop in US gasoline supplies as summer demand picked up. Iron-ore prices rallied in June after buckling under tighter Chinese credit earlier in the quarter.

- Emerging-market currencies appreciated slightly against the US dollar. Central European currencies such as the Czech koruna, Hungarian forint and Polish zloty were among the top-performing currencies as the stronger euro offered support. Meanwhile, the Argentine peso, Chilean peso and Russian ruble depreciated.

Country Updates and Key Developments

Asia was the top-performing region for the quarter with equity markets in China, South Korea and Taiwan among the best market performers. The MSCI Taiwan Index reached a 17-year high in June,[4] with the information technology (IT) and financials sectors driving gains. South Korea's major equity index reached a record-high level in June amid foreign buying and strength in IT and health care companies.

The IT sector was also a key driver of performance in China. Index-provider MSCI's announcement to add mainland A-shares (large Chinese mainland shares) to its indexes next year aided overall market sentiment.

As active managers, we do not follow the index. We continue to find value in Internet-related and consumer-oriented stocks in China. The Chinese government remains focused on its "Internet Plus" initiative where IT will play a key role in fueling China's next stage of economic growth. In the consumer area, we view the automobile market favorably, as penetration rates remain quite low versus developed markets. Entertainment is another area that is interesting to us. For example, in China and in emerging markets generally, we see a rapid growth of multiplexes and movie theaters, along with other types of entertainment venues.

Elsewhere, international ratings agency Standard & Poor's raised Indonesia's credit rating to investment grade, bringing it in line with Moody's and Fitch. The news provided a lift to Indonesian equities.

Generally disappointing first-quarter corporate earnings weighed on equities in Thailand, while the materials, telecommunications and energy sectors underperformed in Malaysia. Despite posting gains, equity markets in Thailand, Malaysia and India lagged their regional peers.

Challenges in the implementation of the Goods and Services Tax (GST) and profit-taking cooled the Indian market in June, but India's market remains quite strong year-to-date. Moderating inflation data in June opens the door to potential central-bank easing, and we believe the implementation of the GST should benefit many companies. While India still faces some bureaucratic barriers, we are optimistic about India's potential and the case for investing there.

In **Latin America**, market-friendly political news and hints of an end to monetary tightening raised investor confidence in Mexico. Positive growth expectations helped drive outperformance in Peru. MSCI's decision to delay the reclassification of Argentina to emerging-market status in June led to a market correction during the month, but the MSCI Argentina Index ended the quarter in positive territory. Meanwhile, profit-taking led the Chilean market to end the quarter with a decline.

In **Eastern Europe**, Russia was among the weakest performers amid investor concerns that lower oil prices could impact 2017 corporate-earnings growth. Additional US sanctions also worried many investors. Macroeconomic data during the quarter pointed towards a recovery, however, with gross domestic product (GDP) expanding in the first half of 2017 after two consecutive years of contraction. Energy, financials and IT companies continue to look attractive to us from a value standpoint. We also think the energy sector provides good dividend yield potential in a low-oil-price environment, while financials and IT companies provide exposure to Russia's domestic economy with attractive growth prospects and relatively cheap valuations.

Turkey was one of the region's top performers. Stronger-than-expected first-quarter GDP growth, a stronger lira and the passing of the referendum on the package of constitutional amendments helped buoy the market. Hungary, Poland and the Czech Republic also outperformed as appreciation in their domestic currencies offered support.

In the **MENA** region, MSCI said it would consider upgrading Saudi Arabia to emerging-market status (the decision would be announced in June 2018), which could attract more investor flows. The news spurred a rally in Saudi stocks in late June, along with the naming of Prince Muhammad bin Salman as crown prince. Qatar's stock market declined after six Arab countries cut diplomatic ties in June for allegedly supporting terrorism.

Our Outlook

We believe emerging markets continue to offer superior growth potential compared with developed markets. The long-term trend of increased consumer penetration and improving affluence, leading to a shift to more premium products and services, should continue to bode well for these markets in the future.

Consumer demand growth is a prominent investment thesis within our portfolios. We look for opportunities in areas relating to consumer products. These include consumer staples, retailing, and discretionary purchases such as automobiles. We also look for opportunities in services such as consumer finance where we see companies we think can achieve high growth rates and sustainable profits.

Technology is another major investment theme. Many emerging-market companies have become leading players in the adoption and development of technology, and IT has outperformed other emerging-market sectors in the second quarter and first half of 2017. Although we are cautious of the share-price advances in some Internet stocks, we continue to see value in the sector across emerging markets as a whole. Our focus is on earnings sustainability as a result of innovation, dominant platforms or technology.

In addition to Internet companies, which stand to benefit from the move toward more online transactions, we see potential for attractive long-term investment opportunities in many other areas. These include: shopping, targeted advertising, gaming and other services, graphic processing units for data centers and artificial intelligence applications, and connectivity and processor integrated circuits for autonomous cars and devices related to the "Internet-of-Things."

In the memory segment, smartphones have been upgrading memory content for better performance, which has helped drive demand for and pricing of dynamic random access memory (DRAM) chips. Demand for DRAM chips from data centers is also picking up, which we think should further support prices.

Valuations Remain Attractive

In terms of valuations, as of the end of June, the MSCI EM Index had a trailing price-to-earnings ratio (P/E) of 14.9x, a price-to-book value (P/B) of 1.7x and dividend yield of 2.4%. That compares with a P/E of 21.5x, P/B of 2.3x and dividend yield of 2.4% for the MSCI World Index.[1]

We are of the opinion that the fundamentals of emerging-equities remain attractive. However, we are cautious on certain developments that may generally emanate from any possible "black swan" event—that is, a major shock that can't be predicted. China is a dominant country within emerging markets, both as a market and a demand-driver for many industrial commodities. Any slowdown in China and derailment of its structural adjustment process could have short-term implications for sentiment toward emerging markets as a whole.

On a broader level, the world is still imbalanced. Many countries have high debt levels, and concerns surrounding that and other macroeconomic factors could lead to short-term volatility.

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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, US dollar terms. 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: US Energy Information Administration.

4. The MSCI Taiwan Index contains 89 constituents 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. Pat performance is not an indicator or guarantee of future performance.

5. Source: MSCI, as of June 30, 2017. 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. Dividend yield is calculated by dividing the annual dividend per share by the current price.