FRANKLIN TEMPLETON

Investment Team Update
July 31, 2021

Emerging Markets Insights

Regulatory Uncertainty in China Weighed on Emerging Markets in July

Three Things We're Thinking About Today

1. China is in the middle of a tightening regulatory cycle, implementing anti-monopoly, data security and industry-specific regulations. Increased regulatory scrutiny, especially the new policy governing the after-school tutoring (AST) industry, has elevated market volatility and investor fears of policy risks in China. The underlying thread that ties the intense regulatory activities across many industries lies in Beijing's determination to develop China into a "modernized socialist economy," including objectives of common prosperity, green development and independence in key technologies and industries. Geopolitics also plays a key role. It is critical to evaluate the alignment of companies with China's long-term strategic goals. **Regulatory cycles are not uncommon in China**—policy and regulatory scrutiny should be seen as ongoing risks when it comes to investing in China, to be carefully monitored and integrated in company research and portfolio management. Given the role of innovation as a driver of productivity and gross domestic product growth, we don't believe government regulatory efforts aim to curtail digital sector growth as a whole.

2. In **China's education sector**, we believe that current regulatory scrutiny on the AST industry is driven by the government's desire to reduce the educational burden on children and parents, in the context of government concerns regarding the country's slowing birth rate. Key stipulations in the new policy included that AST must be "not-for-profit" entities, in which case all profits and cashflows must be reinvested into the business and sponsors (shareholders) cannot lay claim to profits, foreign investors can no longer invest in AST via the Variable Interest Entity structure, which could likely result in company de-listings, and AST institutions are not allowed to use capital markets for financing. The implications of the new policy make it evident to us that the current AST business model is no longer viable, nor are the current listing structures. It is unclear how the businesses will restructure to satisfy key regulatory requirements (not-for-profit and no foreign investment), and necessary operational changes to the business model will likely take an extended period of time to resolve.

3. Although concerns of widening regulatory changes in **China's internet sector** weighed heavily on stock prices in July, more recent efforts by the securities regulator to ease market concerns offered investors some comfort. Similar to many regulators globally and as seen in the past in China, we believe that recent actions serve to ensure that private enterprises remain aligned with the government on issues such as market competition, product safety, social policies, public good and national security. Over the medium term, we see the larger challenge to China's internet sector being rising competition, which will require from investors greater emphasis on fundamentals and stock selection. Despite these challenges, we continue to believe that some of the leading Chinese internet names warrant a core allocation in emerging market (EM) portfolios due to ongoing earnings sustainability, fueled by a proven ability to expand and diversify their total addressable market.

Market Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
Egypt (7.0%)	China (-13.8%)
Turkey (6.6%)	Philippines (-11.7%)
Argentina (6.4%)	Peru (-9.1%)

Sector Performance (MSCI EM Index, USD)
Cumulative Return

Best	Worst
Materials (-1.8%)	Real Estate (-17.4%)
Utilities (-1.9%)	Consumer Discretionary (-14.1%)
Information Technology (-3.0%)	Telecommunication Services (-11.8%)

Currency Performance (MSCI EM Index, USD)
% Change

Best	Worst
Turkey (3.2%)	Peru (-5.4%)
Kuwait (0.3%)	Chile (-4.1%)
Indonesia (0.3%)	Colombia (-3.4%)

Source: FactSet, one-month period ending 07/31/21.

Outlook

Globally, COVID-19 continues to dominate headlines and we expect it to remain prevalent for the rest of 2021 and going into 2022. While some emerging markets have made solid progress with inoculation, the challenges of new COVID-19 variants and the distribution of vaccines have hindered others. As a result, we can expect many countries to continue experiencing sporadic COVID-19 outbreaks that will add volatility to the underlying trend of economic and market recovery.

There has, however, been a growing divergence between the perceived challenges and EM's demonstrated structural strengths. We highlight three key areas that warrant attention—demand, sentiment and inflation. We see demand remaining robust, and technology's role as a key economic engine has only strengthened during the pandemic. Inflation concerns in the US have reemerged, but we believe—among EMs at least—that inflationary pressures should be relatively short-lived.

Although sentiment is soft amid fresh COVID-19 outbreaks, slow vaccination progress, and other country-specific concerns, vaccination programs are ramping up in EMs, which should enable further economic reopenings. A progressive return to normalization is supportive of the technology and consumption themes that have become the new drivers of economic growth for many EMs, with all of that also leading to an earnings rebound that can be expected from a lower base last year.

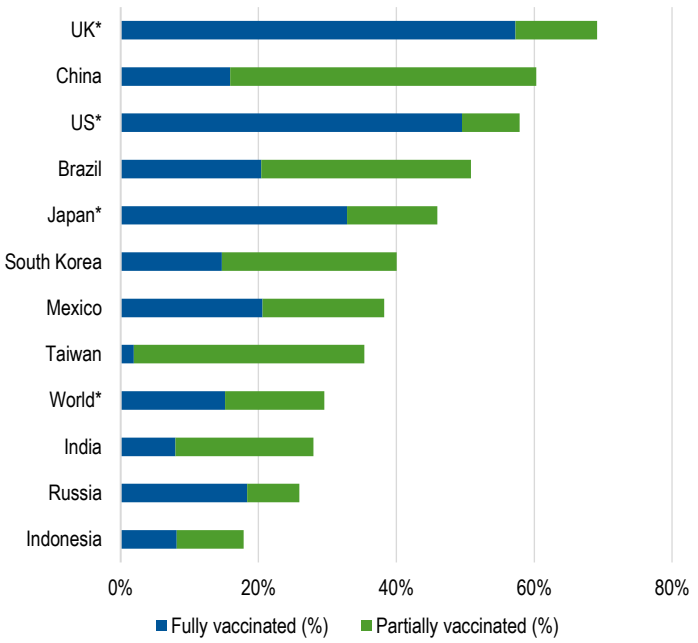
As a whole, EM economic fundamentals have improved in the past decade, and we believe they are in a stronger position today to cope with any market volatility. Our overall outlook for EMs remains positive, with long-term investment opportunities underpinned by EMs' structural strengths and the competitiveness of their companies.

Emerging Markets Key Trends and Developments

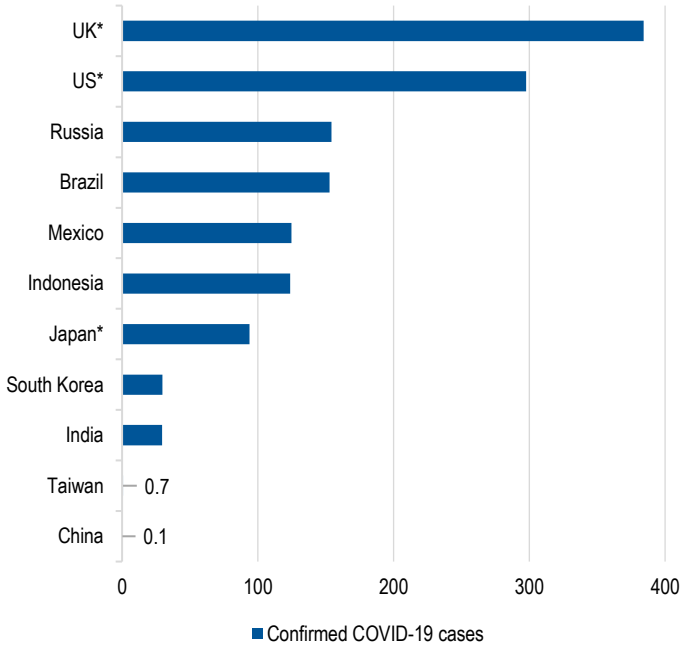
EM equities fell in July, whereas developed market stocks advanced. China weighed on EMs' overall performance as a series of regulatory curbs in the country sent its market sharply lower. The global spread of a COVID-19 variant also dampened economic growth expectations and undercut investors' risk appetite. The MSCI Emerging Markets Index fell 6.7% over the month, while the MSCI World Index rose 1.8%, both in US dollars.[1]

Snapshot of COVID-19 Trends Across Key Markets

EM vaccination rates vs DM
As of August 8, 2021



Daily new confirmed COVID-19 cases (per one million)
Seven-day moving average



Source: Our World in Data. *Developed Markets.

The Most Important Moves in Emerging Markets in July 2021

- Emerging Asian equities retreated in July, notching the weakest regional performance within EMs. Stocks in China fell as it tightened regulations across the AST, internet and property industries, raising concerns about policy risks. In the Philippines, Thailand and South Korea, markets lost ground amid rising COVID-19 cases and new mobility restrictions. Outbreaks led Thailand to cut its 2021 economic growth forecast. Bucking the downtrend, Indian equities rose modestly, thanks to strong earnings reports from some companies.

- Latin American markets declined on concerns about the COVID-19 Delta variant and its impact on the global recovery. Weakness in regional currencies further impacted returns. Depreciation in the Brazilian real and weak market sentiment overshadowed a bullish economic outlook in Brazil. The government raised its 2021 economic growth forecast to 5.3% from 3.5% driven by expectations of continued growth in key economic indicators including manufacturing and retail sales, and continued vaccination efforts. Mexico, however, bucked the trend, ending July with gains as companies generally reported above-consensus second-quarter earnings.
- The Europe, the Middle East and Africa region was the top performing EM region in July, driven by strength in Egypt, Turkey and Kuwait. Stocks in South Africa recorded local-currency gains but fell in US dollar terms owing to the South African rand's weakness. Potential implications of recent riots in the country also concerned investors. Russian equities, however, fell slightly against a backdrop of volatile oil prices that ended the month little changed. Russia's central bank raised its key interest rate sharply to curb rising inflation.

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.

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