

Emerging Markets Insights

Another Positive Quarter for Emerging Markets

Three Things We're Thinking About Today

- Inflation** concerns in the United States have reemerged as a stimulus-fueled global economy springs back from the depths of the pandemic. Even as we stay true to our bottom-up and stock-driven investment approach, we remain vigilant about possible macroeconomic headwinds. The recent shift in the US Federal Reserve's (Fed's) tone on inflation reflects the solid demand backdrop that we have observed. The price hikes reflect rising commodity prices, supply bottlenecks, and pent-up demand—an interplay of factors unique to the pandemic. Many emerging market (EM) companies have been measured about passing on higher input costs to customers, recognizing that much of the increase stems from near-term supply disruptions. Efficiency gains and competition among companies have also kept prices in check. Our view is that inflationary pressures will be relatively short-lived. Conversely, experience suggests that the Fed's messaging around tapering and preparations for such a move are likely to create more market volatility than the actual reduction of bond purchases. The real risk will be abrupt liquidity withdrawal on expectations of rate rises and the end of unprecedented stimulus, which could bring about more market caution.
- Across major EMs, technology's role as a key economic engine has only strengthened during the pandemic. Many companies have adapted swiftly to an increasingly contactless world, bringing forward digital transformation to draw consumers and lift productivity. As technology has advanced, semiconductor chips have become a growing part of almost all consumer goods with the **semiconductor industry** experiencing a cyclical and secular boom as growing digitalization powers a surge in demand, while COVID-19 continues to drive a global supply shortage. Historically, many chip designers outsourced the manufacturing to key Asian companies with specialized manufacturing prowess and lower costs. Some of these manufacturers are now counted among the largest foundries globally and can partner with and produce chips for clients globally. This collaboration—rather than direct competition—is a key advantage of their business model. Over time their advantage has shifted from primarily cost to intellectual property, with fewer competitors able to progress to the next level of technology. This is illustrative of EM companies underpinning innovation—by providing the hardware infrastructure, these EM companies have become a key enabler of global digitalization. Although the sector in general has corrected off its recent peak, we maintain a positive long-term view on the semiconductor industry.
- Despite recent investor attention on heightened regulatory challenges on China's technology companies, operations on the ground continue to expand with China known for having the highest e-commerce penetration rate in the world. Beyond traditional models, the emergence of "community group buying," where a group leader—who typically has about 100-500 people in a chat group—promotes a selection of products that are sourced directly from farmers, distributors and brands to the group via a mini-app. The bulk order is delivered to the community group leader,

Market Performance (MSCI EM Index, USD)

Cumulative Return

Best	Worst
Brazil (22.9%)	Chile (-13.7%)
Poland (18.7%)	Egypt (-9.2%)
Hungary (14.8%)	Peru (-8.8%)

Sector Performance (MSCI EM Index, USD)

Cumulative Return

Best	Worst
Health Care (14.1%)	Real Estate (-6.0%)
Industrials (13.2%)	Telecommunication Services (2.0%)
Energy (12.2%)	Utilities (2.1%)

Currency Performance (MSCI EM Index, USD)

% Change

Best	Worst
Brazil (12.5%)	Turkey (-4.7%)
Hungary (4.1%)	Argentina (-3.9%)
Poland (3.7%)	Pakistan (-3.1%)

Source: FactSet, three-month period ending 6/30/21.

who unpacks it for customers to collect. For each community member, buying in larger quantities ensures a lower cost. It also helps make products available in smaller cities, which would have a prohibitive price in smaller quantities. For e-commerce companies, it solves problems such as high logistics costs and spoilage in grocery; something that other delivery models could not address efficiently. The total addressable market in grocery is huge in China, implying strong growth potential. Although the community group buying model is still at an early stage and continues to evolve, we believe it will gain relevance in **China's e-commerce market**. Its ability to address lower-income consumers and logistics challenges faced in developing markets makes it highly applicable to other EMs such as Indonesia, India and Brazil.

Outlook

Although the worldwide impact of COVID-19 continues to abate as accelerating vaccine inoculation drives normalization, some countries continue to be impacted by additional waves and COVID-19 variant concerns, especially for populations that remain unvaccinated. In general, however, we expect to see a gradual global recovery with EMs, especially China, taking the lead.

In terms of market drivers, the overarching theme remains that of the post-pandemic recovery. We are focused on identifying which companies and economies are best placed for the rebound, as we expect to see wide variation in the pace and nature of recoveries. However, we remain confident that most EM economies could normalize in the next 12-18 months.

At a sector level, we believe that local, consumption-driven growth will remain a core theme for EM economies. We believe companies with strong premium-brand positioning and superior products should see sustainable and higher-than-average industry growth levels in the years to come. Furthermore, demographic shifts and societal changes such as an aging population as well as the COVID-19 pandemic have intensified pressures on health care systems, driving demand for hospitals, medical suppliers and pharmaceuticals. We also expect that the wider adoption of digital, fintech and technology solutions to accelerate economic growth, while creating opportunities for well-positioned, innovative companies.

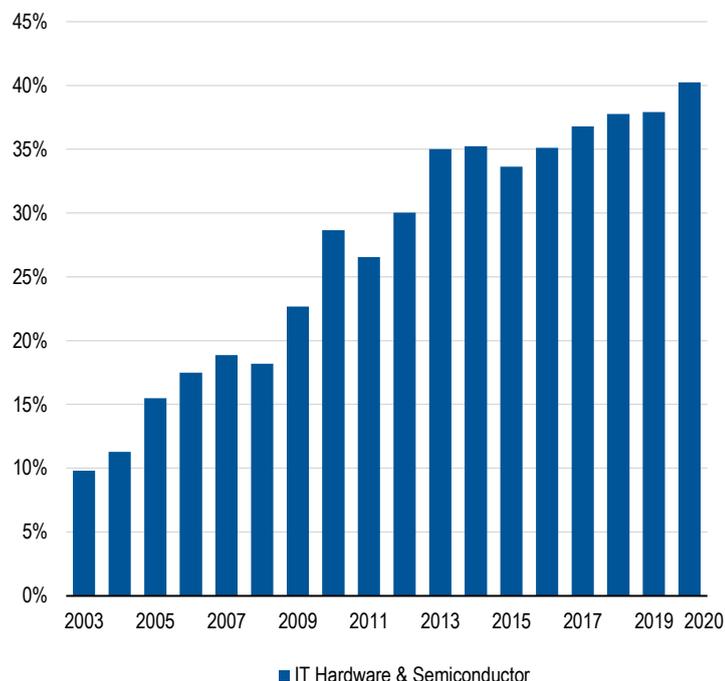
Additionally, we continue to see manufacturing companies in key Asian economies gain share globally, including China, Taiwan and South Korea, where technological advancement is on par or superior to developed country peers. Supportive factors include supply constraints by overseas competitors that were disrupted by the COVID-19 pandemic, and secular industry transformation globally, especially in areas such as automation and decarbonization.

Emerging Markets Key Trends and Developments

EM equities rose over a volatile quarter, finishing behind developed market stocks. Investors swung between optimism and caution as they weighed COVID-19 vaccine rollouts, economic reopenings and higher commodity prices against fresh COVID-19 outbreaks and rising inflation. Concerns that the US Federal Reserve could tighten monetary policy sooner than expected capped risk appetite. The MSCI Emerging Markets Index rose 5.1% over the quarter, while the MSCI World Index returned 7.9%, both in US dollars.¹

Asia's Growing Contribution to the Tech Value Chain and Global IT Services

IT Hardware & Semiconductor Companies*: Asia's % of Global Revenue 2003–2020



Sources: MSCI, FactSet. *Based on LTM revenues of companies in the MSCI AC Asia ex JP / Technology Hardware & Equipment & Semiconductors & Semiconductor Equipment % MSCI AC World/ Technology Hardware & Equipment & Semiconductors & Semiconductor Equipment. Data as of January 2021. **Past performance is not an indicator or a guarantee of future performance.**

The Most Important Moves in Emerging Markets in the Second Quarter of 2021

- Asian equities booked a quarterly gain but underperformed their EM peers. Stocks in Taiwan and India rallied, notwithstanding COVID-19's resurgence in both markets. Taiwan's strong export performance underpinned its economic resilience. In India, signs of slowing contagion and a pickup in vaccinations lifted hopes for the economy's recovery. Chinese equities logged a modest gain amid mixed economic data, policy normalization concerns, tighter regulations for the internet industry, and US-China tensions. Meanwhile, stocks in Indonesia and Thailand declined as both countries grappled with new COVID-19 waves. Thailand announced new pandemic restrictions and cut its full-year economic growth forecast.

- Latin America was the top-performing EM region during the quarter, largely due to strong performances in Brazil and Mexico. Appreciation in the Brazilian real, improving vaccination trends and better-than-expected first-quarter gross domestic product (GDP) growth boosted Brazilian equities. Higher commodity prices along with an improving global outlook further supported market sentiment. Improving domestic demand as well as a US-led recovery in manufacturing and exports lifted Mexican equities. The country's central bank raised its key interest rate by 0.25% in June, amid rising inflationary pressures. The Chilean market, however, declined on lower copper prices in June and concerns about a tax hike on the mining sector, while worries of a market-unfriendly government weighed on Peru.
- The Europe, Middle East and Africa (MENA) region outperformed its EM peers, driven by gains in Eastern Europe and the Middle East. Hungary, Poland and the Czech Republic were among the top EM performers during the month, recording double-digit returns on increased normalization prospects amid an acceleration in vaccine rollouts. Higher oil prices and easing geopolitical risks buoyed equity returns in Russia, as investors viewed the meeting between Russian President Vladimir Putin and his US counterpart Joe Biden in a positive light. At the other end of the spectrum, Egypt and South Africa ended the three-month period with declines. A stricter lockdown amid a third COVID-19 wave in South Africa eclipsed optimism surrounding the announcement of much-needed energy reforms.

Regional Outlook

Three-Month Period Ended June 30, 2021

Market — Neutral + Investment Thesis

Emerging Asia

China		Economic growth will likely exceed the government's 6% target because of strong exports and appears unlikely to derail as sporadic COVID-19 outbreaks continue to be addressed swiftly. A stronger CNY should offset inflationary pressures, while policy normalization and internet regulation risks have also been priced in.
India		Long-term fundamentals remain robust in view of increasing consumer penetration, growing formalization of the economy, a reform push and a stable government. However, near-peak market valuations have offset a strong earnings revival outlook.
Indonesia		The 12-month outlook appears more constructive than a quarter ago. Progress in the country's vaccination program should aid the economy's reopening. Government reforms could support private investments, while stimulus measures such as cash handouts could bolster consumption.
South Korea		Macro indicators have begun normalizing post the peak of the pandemic, although concerns about government regulations remain. Geopolitical tensions with North Korea also warrant close attention.
Taiwan		Signs of demand recovery for some technology-related products should be positive for Taiwan's export- and technology-oriented economy. US-China relations might be past their nadir, which should help business confidence. Although stretched market valuations and inflation concerns could lead to short-term market declines, the longer-term outlook remains positive to us, given fifth generation wireless technology (5G) deployment and gradual recovery from the COVID-19 outbreak.
Thailand		The overall outlook appears constructive, thanks to good pandemic management and progress in vaccine rollouts. A reopening domestic economy should drive consumption, though a weak tourist arrival outlook and political concerns could be partial drags. A global economic recovery should support exports.

Latin America

Brazil		The economy has been recovering at a faster-than-expected pace. The sustainability of its recovery is likely to be supported by the continuation of economic reforms, privatizations and concessions, which should underpin higher long-term economic growth and a better business environment. Low interest rates should continue driving domestic investor flows into equities. However, political uncertainty could sustain market volatility ahead of the presidential elections in late-2022.
Mexico		Mexico has an open economy that is heavily exposed to the United States (most of Mexico's exports head there). A solid US recovery has driven a rebound in Mexico's economic activity. However, the duration of COVID-19 restrictions in Mexico could still determine the strength of the recovery.
Peru		Political volatility has been hindering Peru's economic recovery, shifting focus away from government spending and infrastructure investment. Continued political noise following the presidential and Congress elections remains a concern. Nonetheless, investor flows into EMs and higher commodity prices could be a tailwind.

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 June 30, 2021

Market — Neutral + Investment Thesis

Emerging Europe

Czech Republic		The economic recovery is broadening according to the sentiment survey results as of May, with a noticeable improvement in consumer sentiment and a stabilization of household inflation expectations. This is unlikely to stop the central bank from normalizing interest rates. There is upside risk for gross development product (GDP) growth in 2022 and 2023.
Hungary		Broad economic sentiment improved in May, but the economy seems to be somewhat less energetic than you would expect given the size of the stimulus, which is likely due to the impact of COVID-19 on tourism and the election campaign that is putting some investment on hold.
Poland		Real GDP growth, based on the European Commission's survey, indicates an expected expansion of 4.6% in 2021 and 5.1% in 2022, implying an upside for 2021, relative to the Polish central bank's 4.1% forecast.
Russia		In a stable commodities/ruble environment, companies should benefit from positive earnings revisions and improved distributions to shareholders. Potential sanctions from the United States or European Union remain a key risk.

The Middle East

Kuwait		Kuwait has a strong fiscal position. However, a delay in reforms, including the issuance of a debt law, could erode government finances and potentially impact the economy through a slowdown in capital expenditure. The non-oil economy has remained somewhat shielded as most Kuwaitis are employed by the government. We are mindful of relatively rich market valuations and a weak growth outlook.
Qatar		Activities related to the Federation Internationale de Football Association (FIFA) 2022 preparations and liquefied natural gas production expansion present a case for growth and earnings upticks for the next three to four years. High sovereign reserves and a low oil budget breakeven point are also positives. We think Qatar offers stability, though full market valuations could limit investment opportunities.
Saudi Arabia		The outlook appears to be improving but remains anchored to a normalization of economic activity, a recovery in oil prices and government/public investment fund (PIF) spending. Substantial foreign exchange reserves and PIF assets provide some comfort.
UAE		The market is cheaper than its MENA peers amid its higher dividend yield. Cyclical stocks (especially in Dubai) have been re-rating as real estate sales continue to grow and vaccination programs globally boost tourism.

Africa

Egypt		Economic growth and discretionary spending have been recovering gradually. Inflation is expected to remain tamed despite higher commodity prices. We also expect the currency to remain largely stable. An extended disruption in tourism—a source of foreign currencies—could be a key risk, though the government has so far provided support.
Kenya		The outlook continues to improve, with what appears to be a faster recovery in economic activity.
Nigeria		The risk of further currency weakness remains high, and weak political and macroeconomic conditions are likely to create a weak environment for stocks. However, persistent higher oil prices and potential assistance from the International Monetary Fund for Africa could be supportive.
South Africa		The broad outlook appears to be improving given the economic recovery and some positive news on reforms. However, we think a long-term recovery is still dependent on the government's ability to implement and commit to other reforms.

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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.

- ▶ **80+ portfolio managers and research analysts**
- ▶ **16 years on average of industry experience**
- ▶ **8 years on average with Franklin Templeton**

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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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