FRANKLIN TEMPLETON

Investment Team Update
October 31, 2021

Emerging Markets Insights

Solid Corporate Earnings and Economic Reopenings Drove Returns in October

Three Things We're Thinking About Today

1. As we examine the emerging market (EM) landscape today, the **rise of leverage** within economies is a key trend. Leverage can be a double-edged sword, as it can be positive, but also represents a source of risk. Over the past decade, the level of debt has gone up not just in EMs, but across the world. COVID-19 has certainly led to a dramatic increase in government debt in some countries but, in general, debt to gross domestic product is currently much lower in emerging economies than in developed countries—which is one reason for our bullish view. Aside from an increase in China, corporate debt as well as household (consumer) debt levels in EMs also remain much lower than in the developed world. As such, we feel that EMs have much more headroom available to support growth with increased debt levels without a significantly detrimental impact.
2. **Cash flows** are one of the reasons we remain positive on EMs. In the last decade, EMs have underperformed the developed world in terms of return on equity. But over the last decade there has been a trend of improving free cash flows (in both absolute terms and relative to developed markets) that has indeed accelerated in the last year. EM companies are generating much more free cash this year because both commodity-oriented and technology-oriented companies (in particular, the semiconductor industry) have been doing well. As cashflows increase, we believe this will ultimately result in improved returns on equity for EM stocks and should likely propel a rerating.
3. EM companies have been preparing for **climate change** in multiple ways. Some are seeking to meaningfully decarbonize in high-emitting sectors, while others are providing environmental solutions through their products and services. Against this backdrop, our objective to understand the climate commitments of our investee companies incorporates both local and global perspectives. Our investment process incorporates top-down policy and industry studies, bottom-up company research, and comprehensive environmental, social, and governance analysis including climate considerations.

Market Performance (MSCI EM Index, USD)

Cumulative Return

Best	Worst
Egypt (15.2%)	Brazil (-9.0%)
Peru (13.4%)	Chile (-6.3%)
Argentina (10.8%)	Korea (-2.3%)

Sector Performance (MSCI EM Index, USD)

Cumulative Return

Best	Worst
Consumer Discretionary (7.0%)	Healthcare (-7.1%)
Telecommunication Services (3.3%)	Real Estate (-3.7%)
Financials (2.0%)	Utilities (-3.0%)

Currency Performance (MSCI EM Index, USD)

% Change

Best	Worst
Peru (3.7%)	Turkey (-7.6%)
Russia (2.6%)	Brazil (-3.3%)
Thailand (2.0%)	Czech Republic (-1.4%)

Source: FactSet, one-month period ending 10/31/21.

Outlook

Signs that the COVID-19 Delta variant may be peaking in some countries, coupled with the continued reopening of economies and acceleration in the vaccine rollouts, continued to support the global economic recovery. Despite easing regulatory worries and cheaper valuations following the recent market correction, concerns of contagion risk from China Evergrande continued to weigh on market sentiment. Although some EM central banks tightened monetary policy amid rising inflationary pressures, we believe that accommodative monetary conditions in most markets continue to provide a conducive environment for global equities. EMs, in particular, offer an attractive investment opportunity, in part due to undemanding valuations and improving cash flows.

EM equities trade at a discount to the developed world despite strong growth potential and headroom for credit consumption. As of end-October 2021, the forward price-to-earnings (P/E) ratio for EMs, as measured by the MSCI Emerging Markets Index, stands at 12.7x whereas developed stocks, as represented by the MSCI World Index, have a forward P/E ratio of 19.5x.[1] Valuations in Eastern Europe and Latin America are even lower—and not just on an absolute basis, but even relative to their own history. Latin America is rich in natural resources and looks to benefit from the commodity boom taking place amid the recovery from the pandemic. Prices for most of these commodities have risen, which represents a natural tailwind for the economies in those regions, with improving terms of trade being one benefit. Similarly, countries in Eastern Europe—primarily Russia—are key commodity producers, including nickel, aluminum and, of course, Russia is a leading oil-producing nation.

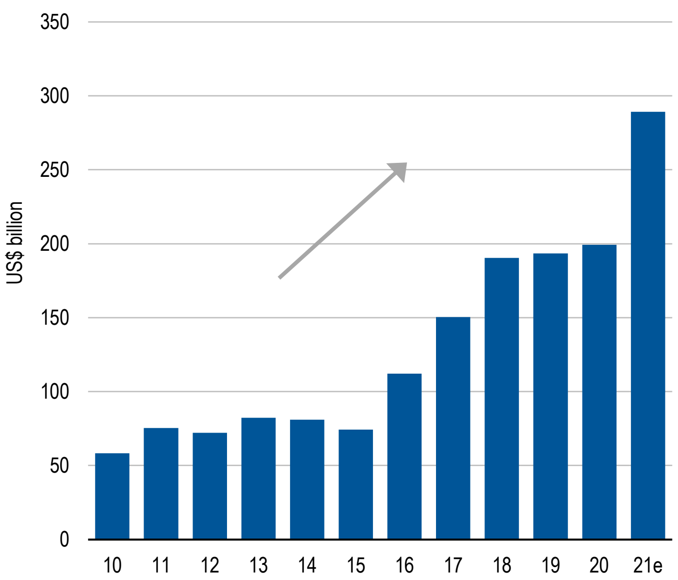
Three main pillars remain the focus of our long-term, fundamental, bottom-up investment approach to EMs. The first one is *structural opportunities*, which we call the beta within the asset class. We seek to capitalize on long-term structural trends such as demographics, technology, and consumption, and this is the lens through which we look when assessing the outlook for EM countries. What we look for within these structural opportunities represents the second pillar, *sustainable earnings power*. We seek to buy shares of companies with long-term earnings potential at a discount to their intrinsic worth. Lastly, *stewardship* is the delta, which represents the difference we try to make as investors through our relationships and engagement with companies to promote positive change.

Emerging Markets Key Trends and Developments

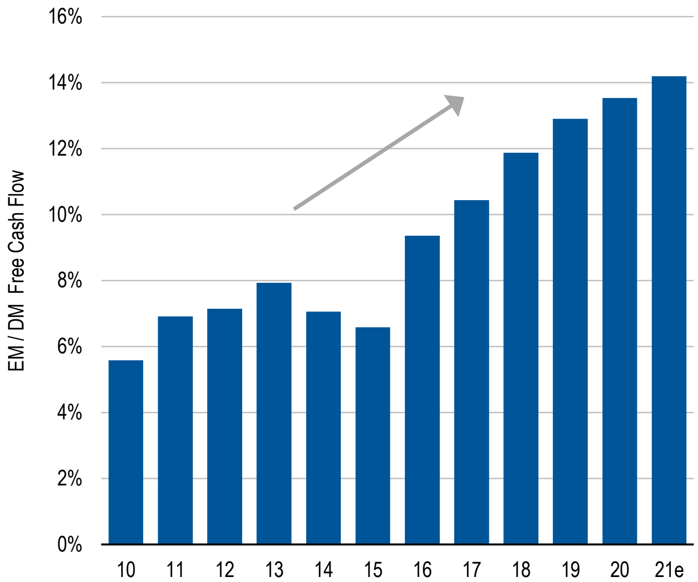
Continued economic growth and robust corporate earnings globally supported investor sentiment in October. EM equities rose, although monetary policy tightening in several countries kept the asset class behind developed market stocks. The MSCI Emerging Markets Index rose 1.0% over the month, while the MSCI World Index returned 5.7%, both in US dollars.[2]

Rising Free Cash Flow in Emerging Markets

Emerging Market Free Cash Flow
2010–2021 (estimate)



Emerging Market % of Developed Market Free Cash Flow
2010–2021 (estimate)



For illustrative purposes only. Past performance is not an indicator or a guarantee of future performance. There is no assurance that any projection, estimate or forecast will be realized.
Source: MSCI, FactSet, as of October 2021. Free Cash Flow=Net Cash from Operating Activities - Capital Expenditures (Additions to Fixed Assets). Important data provider notices and terms available at www.franklintempletondatasources.com.

The Most Important Moves in Emerging Markets in October 2021

- Emerging Asian equities advanced in October. Economic reopenings in Southeast Asia lifted the region's stocks. The Philippines and Thailand announced plans to ease COVID-19 restrictions for vaccinated visitors from certain countries. Indonesia's market also benefited from tax changes that could boost the country's finances, as well as strong commodity prices. In China, stocks rose on easing fears around the country's regulatory curbs and property sector leverage. Conversely, in South Korea, a pullback in a key technology heavyweight held back the overall market. Indian equities finished lower as the Indian rupee's weakness offset local currency gains.
- A decline in equity prices in regional heavyweight Brazil dragged Latin American equities into negative territory. Brazil's market fell as the government's proposal to extend welfare payments raised concerns that it could breach its spending cap. The central bank lifted its key interest rate sharply amid rising inflation. Stocks in Mexico edged down as the economy's momentum slowed. In Chile, political uncertainty ahead of an upcoming presidential election, a contentious proposal to allow further pension withdrawals and the central bank's interest-rate hike pressured the market. At the other end of the spectrum, Peruvian equities surged. President Pedro Castillo reshuffled his cabinet, which investors viewed as a sign of moderation in his policy approach.
- Higher oil prices drove equity returns in the Europe, Middle East and Africa region, leading to continued outperformance against its EM peers. Supported by higher energy prices, the Egyptian market ended the month with double-digit gains, making it the region's top performer. Investors also remained positive on the country's continued economic recovery and solid fundamentals. Russian stocks advanced on the back of rising oil prices and appreciation in the ruble. South African equities, however, declined marginally as a depreciation in the South African rand eroded local-currency returns.

1. Source: MSCI, FactSet. Indices 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 a guarantee of future results.**
2. 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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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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