

EMERGING MARKETS COME OF AGE

March 2019

FRANKLIN TEMPLETON
EMERGING MARKETS EQUITY



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WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, 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. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

Emerging Markets Come of Age

Introduction

Emerging markets (EMs) have made great strides in the past few decades, yet outdated perceptions about them persist. The implications are serious. Investors who hold on to old assumptions about EMs are likely to overlook the transformation of these economies—and systematically under-allocate to the fastest-growing parts of the world.

We believe that an undeniable change in the long-term narrative for the entire asset class is taking place, driven by the pursuit of a better life. This change is so apparent that the term, “emerging” doesn’t seem to be the right nomenclature for these markets today. These economies have deliberately adjusted their policies, implementing reforms in ways that are now demonstrating results. This paper explores three areas we believe investors should pay attention to that together constitute a new reality in EMs—one that challenges enduring misperceptions:

New Reality #1: EM institutions have made policy improvements that should contribute to increased resilience during times of stress.

New Reality #2: EM economies have diversified, with consumption and technology offering new drivers of growth.

New Reality #3: EM companies are leapfrogging established models through innovation and technology.

“ An undeniable change in the long-term narrative for the entire asset class is taking place, driven by the pursuit of a better life.”



The New Emerging Market Landscape

From Brazil to Malaysia, the first group of EMs that debuted 30 years ago stood out as a mixed collection of commodity exporters, low-cost manufacturers and not much else. Today's EMs, however, tell a different story.

Meaningful progress on various fronts has fundamentally changed the secular EM narrative. It now revolves around growing incomes and an improving quality of life, driven by people's powerful desire for a better future. As a reflection of how far EMs have come, consider they drove almost half (44%) of the world's GDP growth in 2017—up from 20% in 1987 (Exhibit 1).

Even so, outdated perceptions about EMs persist, and they have become a major cause of their under-representation in many investors' portfolios. Sticking with these old assumptions can have serious implications for investors; they are likely to overlook the transformation of these economies and continue to systematically under-allocate to the fastest-growing parts of the world.

In this paper, we challenge three common myths about EMs, and explain why investors should reconsider the potential risks and rewards of EM investing.

EMs Increasingly Driving Global Growth

Exhibit 1: Emerging Markets as % of World GDP



Source: International Monetary Fund (IMF), World Economic Outlook as of October 2018.

Never Waste a Crisis

New Reality #1: EM institutions have made policy improvements that should contribute to increased resilience during times of stress.

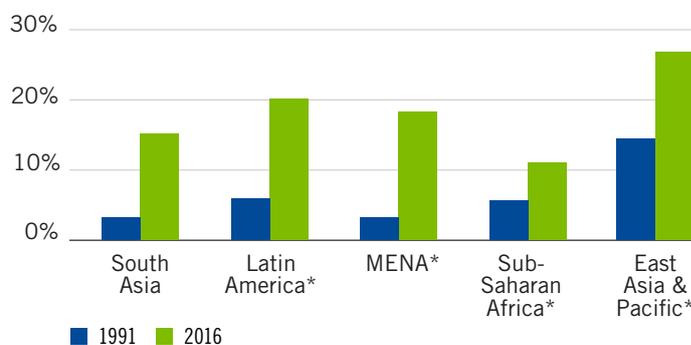
EMs continue to be perceived as vulnerable to economic crises. Without question, EMs have had their fair share of turmoil. The Asian Financial Crisis (AFC) in the late 1990s, marked by currency crashes and equity sell-offs, was a defining moment in EMs' collective history. The crisis brought home the dangers of running large current account deficits and over-relying on short-term US-dollar borrowings, all the while defending currencies pegged to the dollar with slim foreign reserves. Banks were not spared, as those with high levels of non-performing loans and thin capital cushions came under pressure.

Today, headline-grabbing problems in outlier EMs such as Turkey, Argentina, Venezuela and Pakistan reinforce dated perceptions. However, these are very small countries in the context of the MSCI EM Index. Turkey, which is the largest of this group, comprises less than a 1% weight in the benchmark. To put this size into perspective, there are at least 10 companies individually larger than the country weight of Turkey in MSCI EM Index¹.

We view these countries as substantial outliers given their debt and other challenges. Although the broad economic characteristics of these four lagging EM countries have worsened relative to their own ten-year history, many other EM markets have improved. We believe positive change is underway. EM institutions, in many cases, have drawn lessons from past crises and continue to strengthen policies and governance. In our view, the reforms have made some EMs more resilient to various sources of stress.

Specifically, there are a number of compelling signs of institutional and policy improvements. First, EMs have collectively increased their foreign reserve holdings since the early 1990s (Exhibit 2). Reserves matter because they are a key pillar of support for currencies.

EMs Have Significantly Increased Their Currency Reserves Exhibit 2: International Reserves as a % of GDP



*Indicated developing.

Source: Franklin Templeton Capital Market Insights Group, World Bank and IMF, as of December 2016.

1. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges.

Secondly, many EMs have abandoned currency pegs to the US dollar, making them less vulnerable to speculation or a strengthening of the greenback. EMs that made the move include those that were most severely affected by the AFC, such as Thailand and South Korea.

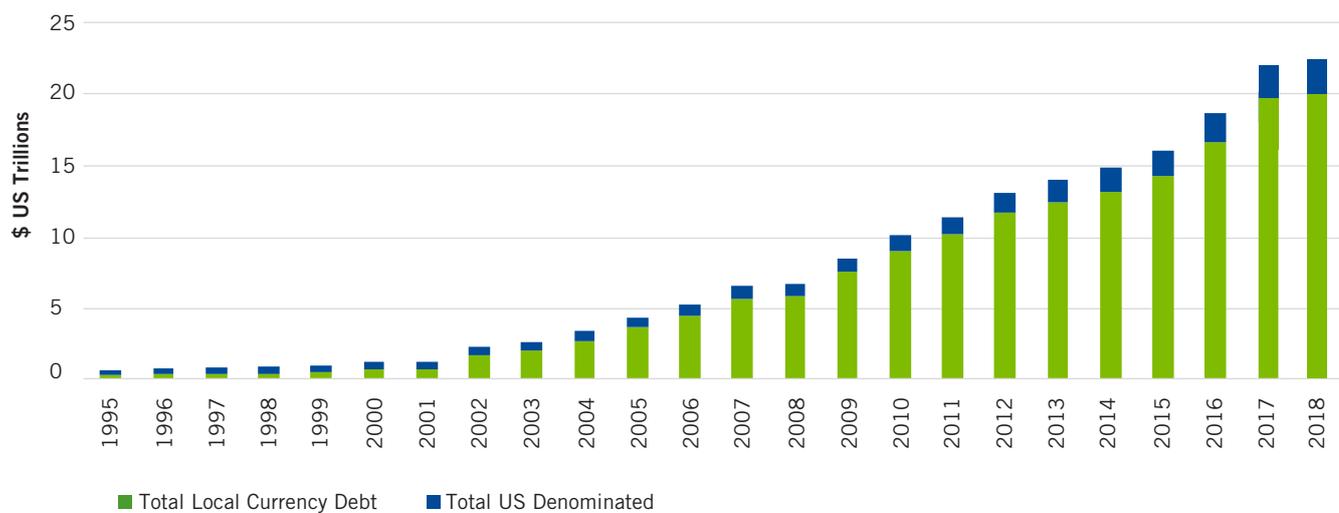
As a whole, EMs have also reduced their reliance on US-dollar debt. At the same time, they have been

diversifying their sources of borrowing, and local currency debt issuance has increased (Exhibit 3).

Finally, EM banking systems reflect improving health. Regulators in many markets have raised the bar for areas such as risk management and capital adequacy, in line with global trends (Exhibit 4).

EMs Diversifying Sources of Borrowing

Exhibit 3: US Denominated vs Local Currency Debt

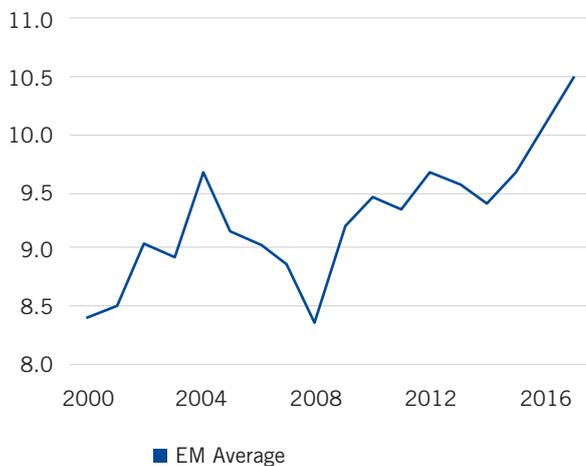


Source: Franklin Templeton Capital Markets Insight Group, Bank for International Settlements, and Institute of International Finance, as of June 2018.

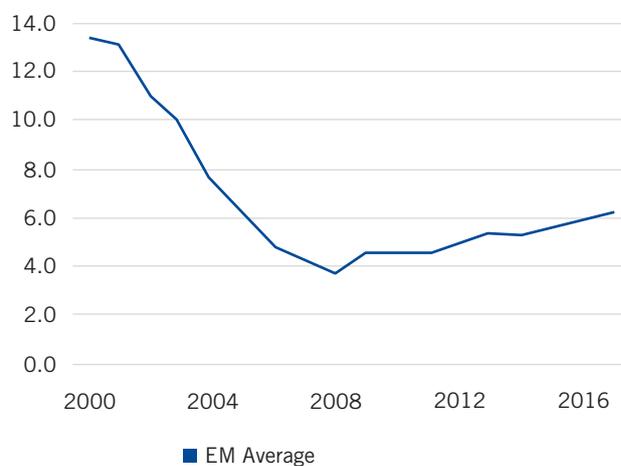
Banking Systems Don't Signal Crisis

Exhibit 4: Improving Health of Emerging Markets Banking Systems

Average Capital to Assets Ratio (%)
2000 – 2017



Non-Performing Loans (%)
2000 – 2017



Source: World Bank, based on a simple average of the Countries in the MSCI EM Banks Index. As of December 2018. Indices are unmanaged, and one cannot invest directly in an index.

An overall improvement in EM policies and fundamentals provides a vital buffer against some of EMs' traditional threats—higher US interest rates and a stronger US dollar. EMs may even be better-positioned to manage these challenges compared with developed markets (DMs) today, where debt ratios are considerably higher by comparison. Government debt to GDP is around 46% in EMs against 98% in DMs; household debt is also a smaller percentage of GDP in EMs than in DMs (Exhibit 5).

“ An overall improvement in EM policies and fundamentals provides a vital buffer against higher US interest rates and a stronger US dollar.”

Rising Rates Impact Global Debt

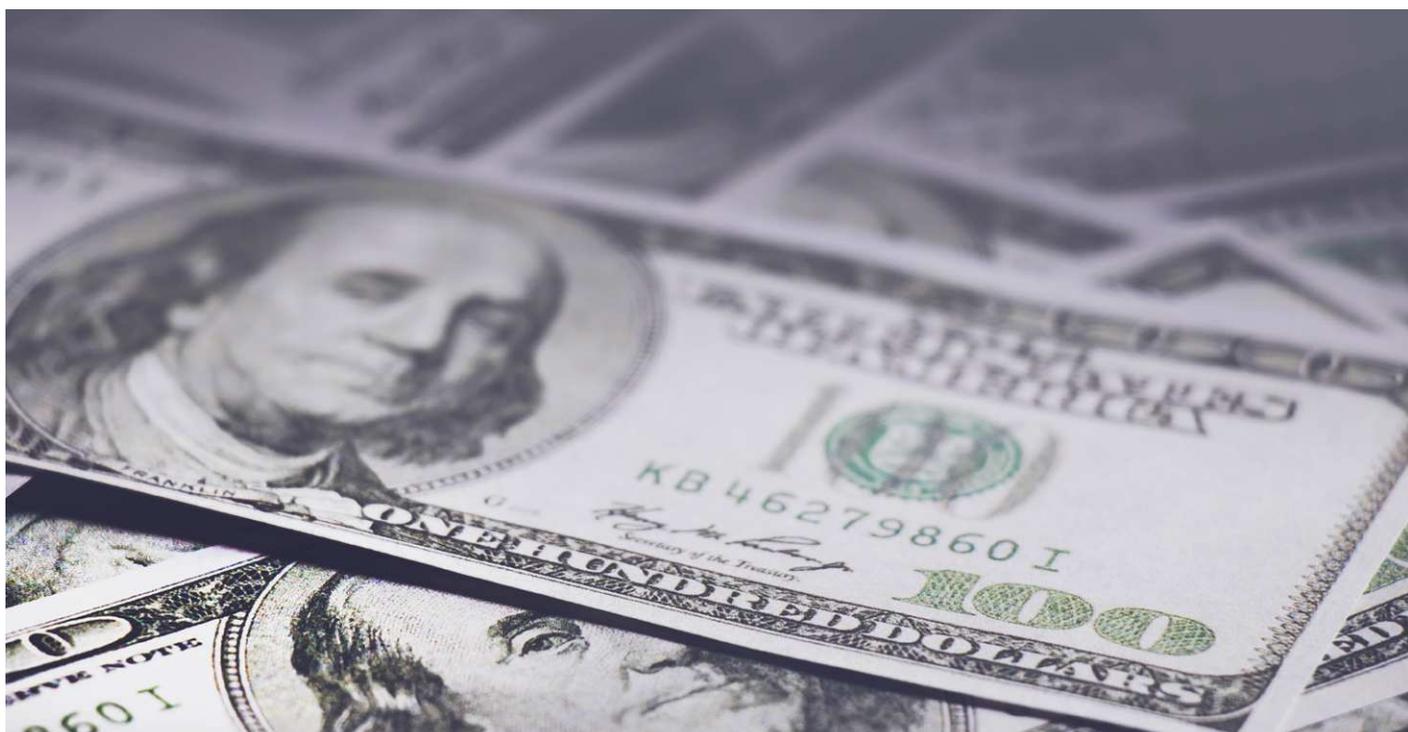
Exhibit 5: Higher Rates to Disproportionately Impact Developed Markets

Emerging vs. Developed Markets: Debt

Government Debt % of GDP	2008	2018
Emerging Markets	31%	46%
Developed Markets	73%	98%

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

Source: The Bank for International Settlements (BIS), as of September 2018. Credit to non-financial sector* from all sectors at market value - percentage of GDP, *non-financial sector (both private-owned and public-owned).



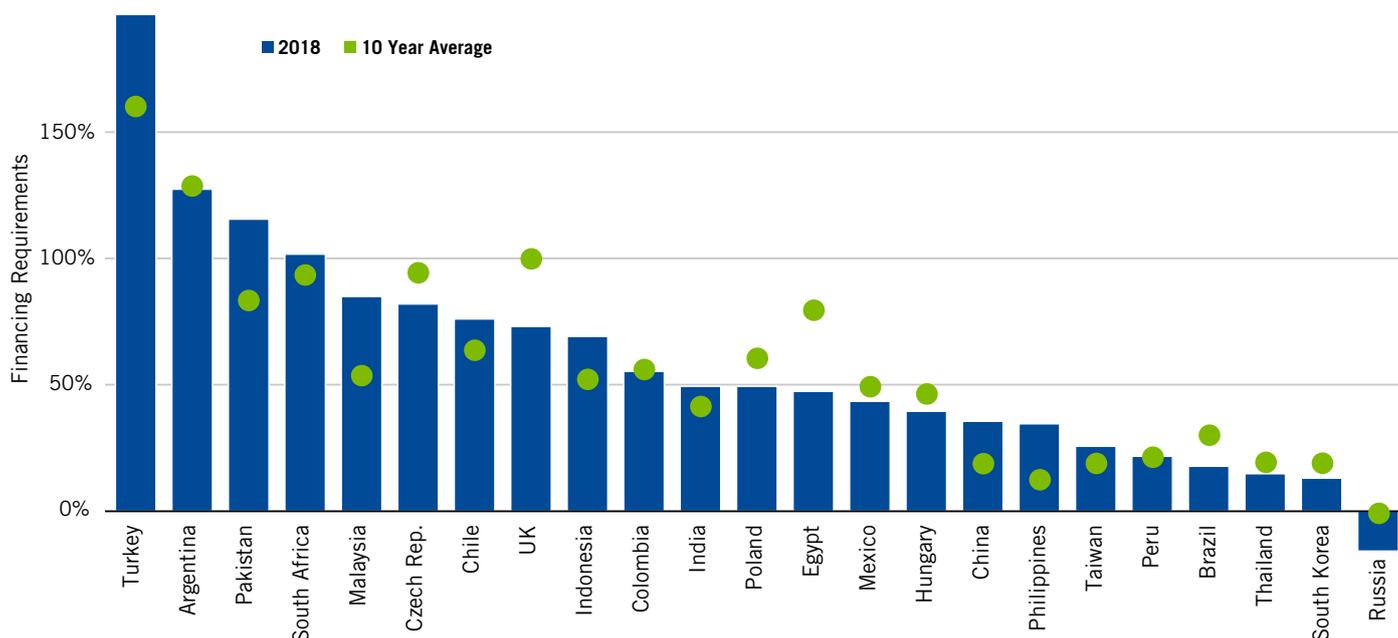
Certainly, the EM universe has its outliers, and not every country has embraced responsible and credible macroeconomic policies (Exhibit 6). Much-publicised setbacks in certain economies have occasionally colored investors' perception of EMs as an asset class and led to broad equity market routs. But given the overall improvement we have seen in EM institutions and policies, we do not expect the travails of such countries to result in broader macroeconomic contagion in the manner we have seen in the past.

“ The disparity among EM challenges points to the importance of taking an active approach in EM investing.”

Importantly, the disparity among EM challenges points to the importance of taking an active approach in EM investing. Against the broader trend of EM institutional improvement, investors should remain mindful about distinguishing more resilient economies from weaker ones.

EM Countries Show a Range of Fiscal Approaches

Exhibit 6: Gross External Financing Requirements (% of FX Reserves)



Source: FactSet, IMF, Capital Research, as of June 2018.

Constant Evolution

New Reality #2: EM economies have diversified, with consumption and technology offering new drivers of growth.

A simple roadmap guided most EMs looking for growth some 20 to 30 years ago—produce and sell abroad. Countries with abundant reserves of oil, precious metals or other commodities shipped them to resource-hungry industrialised nations. Other economies tapped large pools of affordable labor to become cheap manufacturing hubs for the West. Unsurprisingly, the fortunes of these EMs often shifted with the rest of the world's.

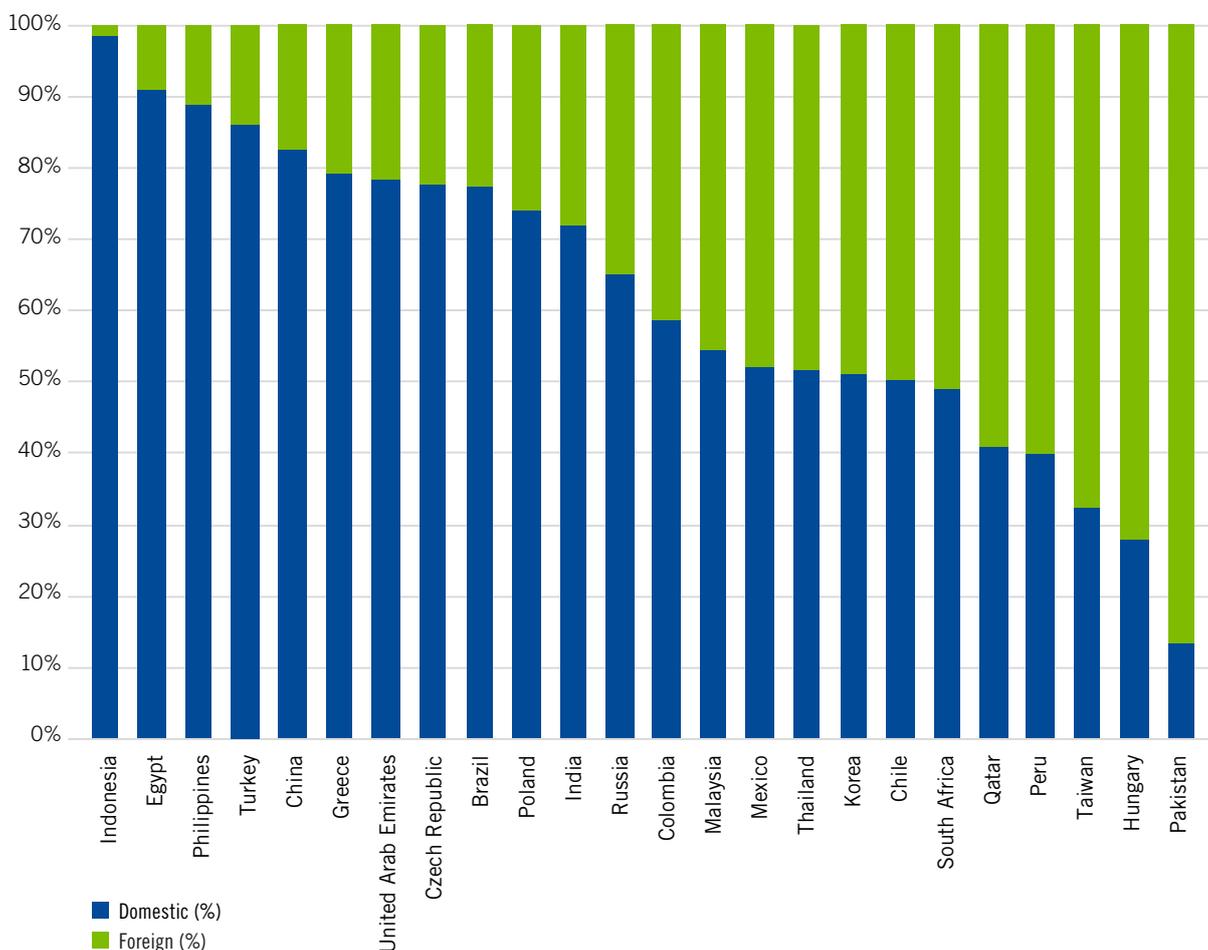
The echoes of this past remain strong. Many investors continue to view EMs as cheap exporters reliant on DMs for growth and are uneasy about the perceived cyclicality of EM investing.

While a public narrative focused on EMs' economic exposure to DMs continues to make headlines, it neglects to recognise that EM economies have evolved dramatically as they have moved up the development ladder.

In some of the largest EMs, such as China, we are seeing the rapid rise of homegrown economic drivers—consumption and technology—overshadow old industries linked to commodities or low-cost exports. Rapidly rising domestic consumption within large economies such as China has, in turn, resulted in a greater share of intra-EM economic exposure relative to DMs (Exhibit 7).

EM Countries Draw on Both Domestic and Foreign Revenues

Exhibit 7: MSCI EM Domestic vs Foreign Revenue by Country



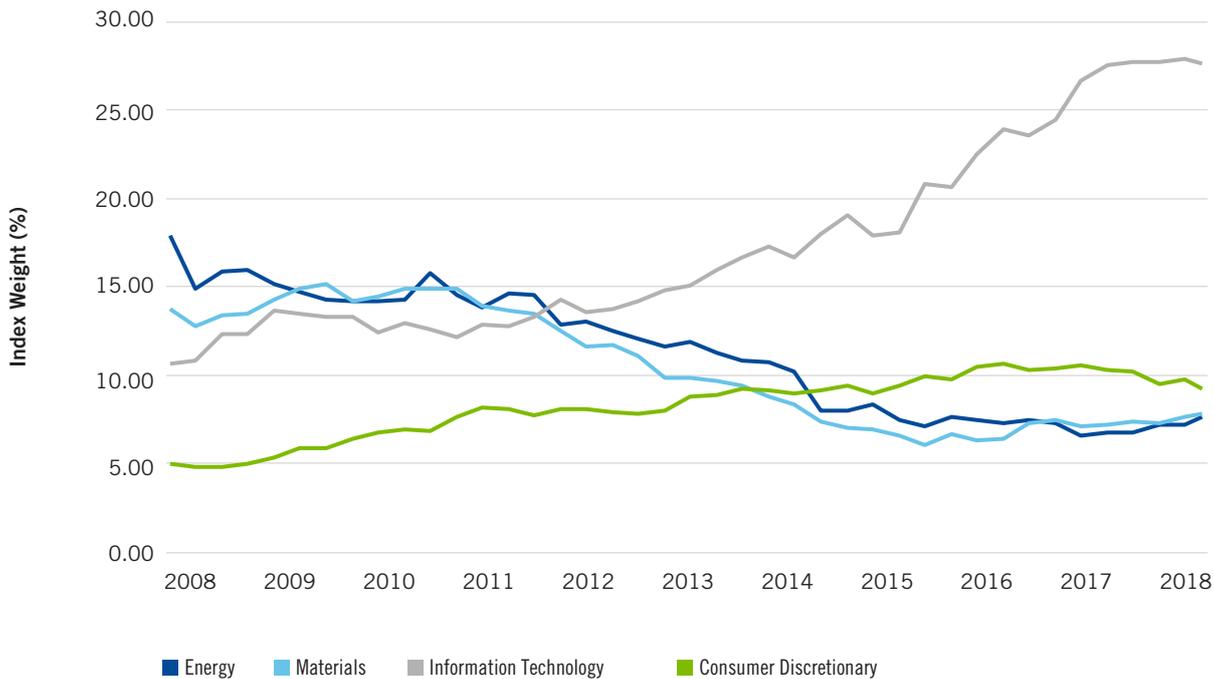
Source: Franklin Templeton Capital Market Insight Group, MSCI, FactSet, as of August 2018.

Changes in the MSCI EM Index illustrate the shifting economic landscape. In the past ten years, energy has nearly halved its weighting in the MSCI EM index from 15% to 8%; the materials sector has also shrunk (Exhibit 8). However, information technology's weighting has more than doubled from 11% to 27%, and the consumer discretionary sector has also grown.

“ In the past decade, China has displaced the US to become the top export destination for many EMs.”

Shrinking Materials Sector, Growing Technology Sector

Exhibit 8: MSCI EM select sector change



Source: Franklin Templeton Capital Market Insights Group, MSCI, and FactSet, 10-year period as of August 2018.

Penetration and premiumisation

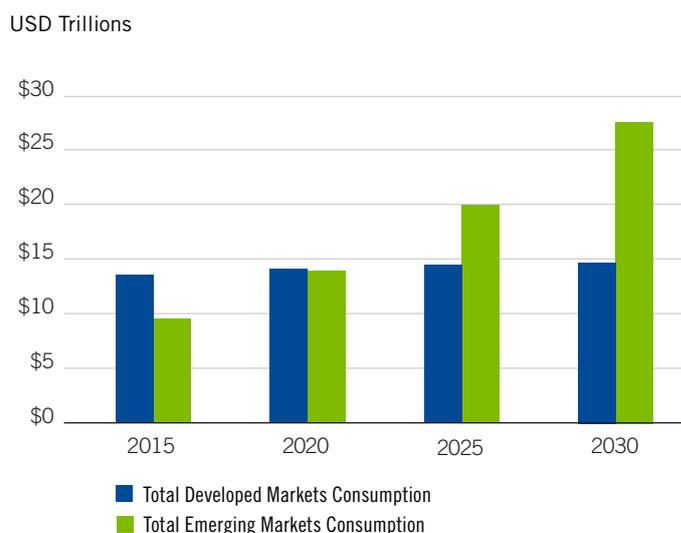
Consumption has played a significant role in propelling emerging economies. A growing middle class, confident in its newfound wealth and outlook, has been spending more on goods and services at home. Companies ranging from retailers to banks have seen market penetration increase.

Beyond this trend lies another, known as “premiumisation.” As incomes continue to rise, demand for higher-quality goods and lifestyle experiences has picked up. Altogether, EM consumption looks set to climb further and exceed that in DMs by a wide margin (Exhibit 9).

Just how strong an economic engine can consumption be? Look to China. Consumption has overtaken trade and investment combined to account for more than half of the country’s GDP. The might of Chinese consumers has even been felt abroad. In the past decade, China has displaced the US to become the top export destination for many EMs, thanks in part to its booming consumer market. The rise of intra-EM trade signals EMs’ decreased dependence on DMs for growth (Exhibit 10).

Fast-Growing Middle Class Consumption in EMs is Projected to Surpass DMs

Exhibit 9: Middle Class Consumption



Source: Franklin Templeton Capital Market Insights Group, Brookings Development, as of June 2018. There is no assurance that any projection, estimate or forecast will be realized.

China Increasingly Dominant as an Export Market

Exhibit 10: Top Destination of Exports for Selected Emerging Markets Countries

	2007	2017
Brazil	USA	China
China	USA	USA
India	USA	USA
Indonesia	Japan	China
Korea	China	China
Mexico	USA	USA
Russia	Netherlands	China
South Africa	USA	China
Thailand	USA	China
Taiwan	China	China

Source: United Nations Conference on Trade and Development, Macquarie Research, in terms of merchandise exports, as of July 2018.

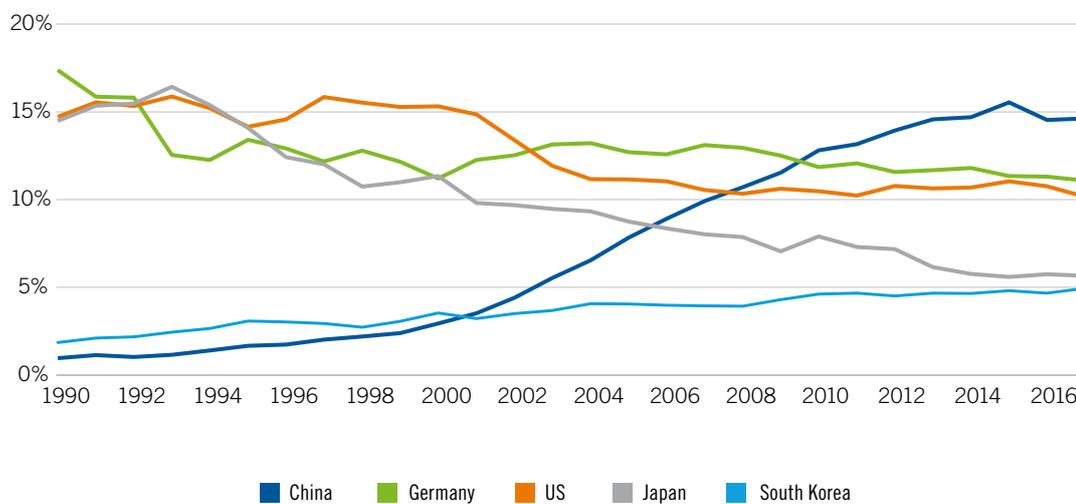
Climbing the technology curve

Then there is technology. EMs that achieved initial success as producers of cheap home appliances or electronic parts have set their sights further up the value chain. Indeed, with China and South Korea as leading examples, the EM share of global high value-add exports has risen dramatically since the start of the twenty-first century, rendering this impression out of step with reality. (Exhibit 11).

To be sure, consumption and technology have not taken off at the same pace across every EM. Nonetheless, we believe EMs together are on a sure path of transformation, lifted by the age-old desire for progress. We believe their new domestic drivers of growth are poised to be steadier and more sustainable than the traditional drivers of the past.

Moving Up The Value Chain

Exhibit 11: Percentage of World High Value-add Exports (1990 – 2017)



Source: Franklin Templeton Capital Market Insights Group, MSCI, and FactSet, as of December 2017.

Global Innovators

New Reality #3: EM companies are leapfrogging established models through innovation and technology.

As a common fallacy goes, the past predicts the future. And so many investors expect EMs to track DMs' development path. By extension, as DMs move up the technology curve, EMs should naturally follow behind.

We disagree. Several EMs have seized the lead in innovation and are leapfrogging the West in areas such as e-commerce, digital payment, mobile banking and electric vehicles. As a broad indication of EMs' collective advance, they have overtaken the US and Japan in terms of patent applications (Exhibit 12).

Coupled with the inflection in patent applications, we also see a long runway of growth for the semiconductor industry amid rapid developments in areas such as the Internet of Things, artificial intelligence, and autonomous driving with direct implications for EM company prospects.

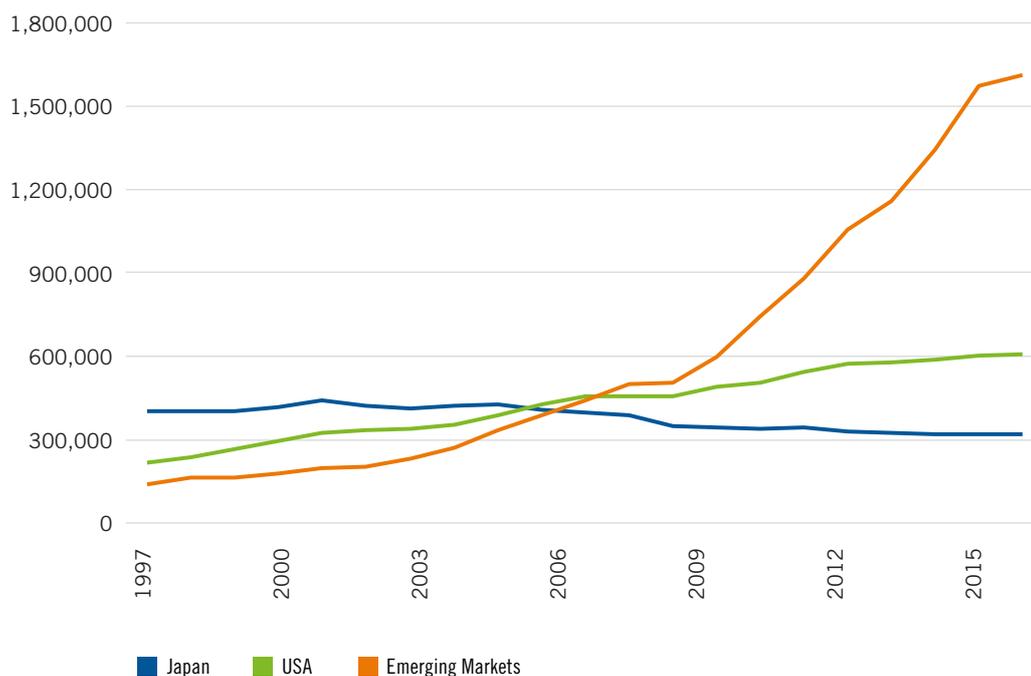
For instance, South Korea and Taiwan already stand tall as two of the world's largest semiconductor manufacturers today. South Korea-based Samsung Electronics, which made its mark producing televisions in the 1970s, has gained global dominance in memory chips. Meanwhile, some of the most sophisticated chips powering a host of devices such as smartphones and servers come from Taiwan Semiconductor Manufacturing Company (TSMC). This is a company with an exceptional track record in first developing and then extending an intellectual property lead over established US competitors such as United Foundries and Intel.

In some ways, EMs' weaknesses have become their strengths. Unhindered by sunk investments in legacy systems or infrastructure, they have had ample room to come up with creative solutions for some of their biggest challenges.

EM Acceleration in Innovation

Exhibit 12: Patent Applications From 1997–2017

Patent Applications



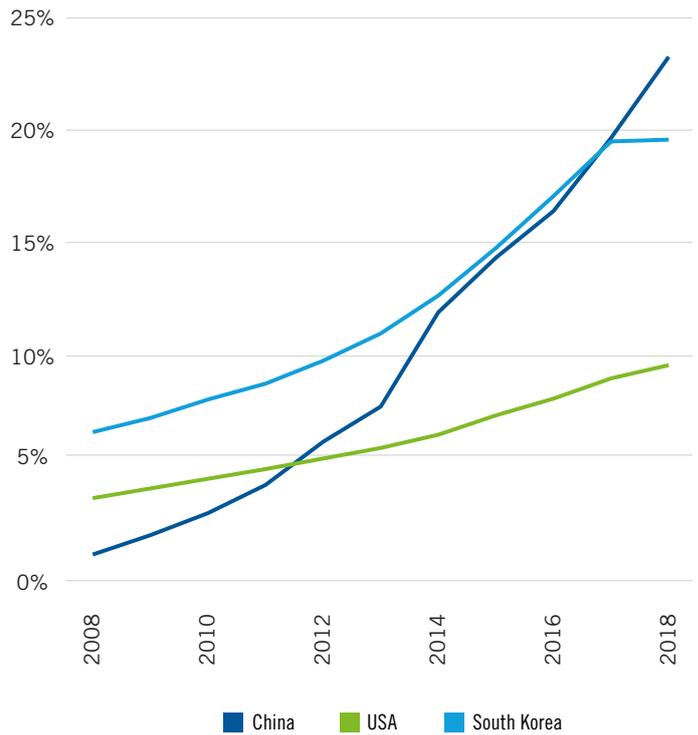
Source: World Intellectual Property Organization (WIPO), as of December 2018.

Take e-commerce as an example. In China, a confluence of economic, social and technological changes gave online shopping a solid start. A new generation of affluent and savvy consumers, faced with a lack of retail stores and malls, began turning to the internet with their smartphones to purchase goods online. Today, e-commerce makes up a far higher percentage of retail sales in China than in the US (Exhibit 13).

Alibaba Group has emerged as a clear winner in China's competitive e-commerce industry. The company, which did not exist until 1999, has become one of the world's largest retailers and reaped an annual revenue in 2018 of \$51.9 billion USD. Not content with its success at home, it has ventured into regions such as Asia and is shaking up retail models abroad.

EMs' Faster Adoption of Technology

Exhibit 13: E-commerce % of retail sales (2008 – 2018)



Source: CLSA, Nielson, and Goldman Sachs Investment Research, as of December 2018.



China is also breaking new ground when it comes to digital payments. E-commerce has played a part; so has the slow development of credit card systems. Consumers paying for online purchases have found it easier to tap Alibaba's payment function Alipay. Meanwhile, WeChat Pay, launched by gaming and social media company Tencent, has gained traction among the company's massive user base. Digital payments, whether for food or transport, have become commonplace across China. The value of China's digital payment market is multiple times that of the US (Exhibit 14).

China is not the only example. Halfway around the world, Latin America is rewriting rules in the retail industry. As physical stores venture into e-commerce, gaps in existing delivery systems have compelled retailers there to invest in their own logistics and distribution networks to get their products into consumers' hands. Brazil-based Lojas Americanas is among companies that are reinventing business models in this regard.

Mirroring the rise of EMs: Alibaba, a leading global tech player

Alibaba is a prime example of a company that has taken the global lead in innovation. It straddles the fields of consumption and technology—China's new economic engines—and has been relentless in exploring new ways to extend its reach.

The e-commerce giant's Singles Day shopping event demonstrates the scale of the opportunity it has. This is a 24-hour online shopping event, similar to Black Friday or Cyber Monday in the US, which takes place on the 11th of November each year. The most recent, in 2018, generated sales of \$30.8 billion. By comparison, the total online sales in the US across Thanksgiving, Black Friday and Cyber Monday was \$17.9 billion.

More recently, Alibaba has rolled out its Ling Shou Tong program—a service aimed at bringing traditional mom-and-pop shops into its vast ecosystem by helping them improve inventory management with big data. Success in this area could upend the conventional view of e-commerce as a rival to physical stores.

Of course, technological progress is uneven across EMs. But some of the most disruptive innovations have hailed from these markets and we expect them to pull ahead of DMs in an increasing number of areas. Certain EM companies have shown exceptional agility in solving consumers' problems, and those that can continue to do so are likely to enjoy sustainable earning power ahead.

The Dominance of Third-Party Payments

Exhibit 14: Total Value of Third-Party Payments (2010 vs 2017)

Value (US\$ tn)	2010	2017
China	0.2	21.5
U.S.	0.5	0.7

Source: Nielson, Goldman Sachs Global Investment Research, as of December 2017.
*Third-party payments: Payments processed by non-bank firms. It is usually done via desktop, mobile devices or non-bank terminals.

Capitalising on Potential Opportunities

All told, we are witnessing a transformation in the EM landscape. EM institutions continue to strengthen, and better policies have led to steadier economic fundamentals. EMs are also diversifying their economies. Together, they have become more domestically driven, aided by consumption and technology as new economic engines. When it comes to technology, a number of EM companies have made exceptional progress and are leapfrogging established DM counterparts in multiple industries.

None of this is to downplay the challenges that certain EMs still face in their development. This is where on-the-ground research and an active investment approach becomes critical. We believe, however, that an undeniable change in the long-term narrative for the entire asset class is taking place, driven by the pursuit of a better life. While the macro backdrop will likely continue to influence EM equity performance over the short-to-intermediate term, people's desires and ambitions are a powerful driver of progress that will not easily be denied.

In this context, we urge investors to revisit their approach to EM investing. Carefully considering a core allocation that more closely reflects EMs' structural prospects will provide meaningful exposure to a different set of growth drivers than a predominantly DM-focused strategy.

At the same time, taking a longer-term view will allow the powerful trends at work enough time to play out without fear of being whipsawed by episodic market volatility. In addition, we believe that the best investment results require an active approach; the ability to identify companies with sustainable earnings power that trade at a discount to their intrinsic value. While this framework is a departure from some of the more traditional asset allocation approaches, we think it should help prepare investors to best take advantage of the opportunities available in the EM asset class today.

Key Takeaways

- EM institutions have made policy improvements that should contribute to increased resilience during times of stress.
- EM economies have diversified, with consumption and technology offering new drivers of growth.
- EM companies are leapfrogging established models through innovation and technology.

“ People's desire and ambitions are a powerful driver of progress that will not easily be denied.”

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Franklin Templeton Emerging Markets Equity

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