Quick thoughts: Emerging markets disrupt, innovate, and power transformation

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The news on emerging markets (EMs) is they have some of the best-performing companies, year-to-date. EMs have innovative companies capable of disrupting established industries, changing the course of a country's economic outlook, while generating strong growth and returns. The Franklin Templeton Emerging Markets Equity Group and Martin Currie each have individual strategies aimed at capturing the opportunity in EMs. To get their different perspectives, I held a roundtable with Andrew Ness, Portfolio Manager, Franklin Templeton Emerging Markets Equity; and Alastair Reynolds, Portfolio Manager, Martin Currie.

- COVID-19's strong variants and slow vaccine distribution affect many EM economies. However, these economies continue to rebound strongly. EMs are less indebted than developed regions across sovereign, corporate, and household levels, and thus the opportunity for a meaningful recovery from a low base remains high.
- EM economies are increasingly powered by disruptive and innovative companies that are globally competitive. COVID-19 accelerated their development and growth. The growing sophistication of the EM consumer, in addition to private sector banks, provide opportunities that reflect the resilience of EM economies, and more avenues to participate in EM consumer growth as wider adoption of consumer credit increases.
- If global inflation continues and interest rates rise, leading EM economies appear likely to remain strong due to lower debt levels and less reliance on US dollar funding—and with higher technology exposures, present good growth opportunities. Commodities are still an important part of many EM economies and the recent rise in commodity prices supports many EM countries.
- While the managers have some differing views on countries such as India, both agree that South Korea and Taiwan offer opportunities in technology sectors given their persistent growth, world-class intellectual property (IP), and globally competitive companies. Both agree on exposure to the EM consumer and industrial materials sectors, and companies that are not debt-constrained.
- While the pandemic remains the primary determinant and influencer for economic markets throughout 2021, the underlying trends in innovation, disruption, and transformation will continue to make EM relevant, resilient, and competitive.

See how our independent investment managers think about EM, on the following pages.

Andrew Ness
Portfolio Manager
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Emerging Markets Equity

Alastair Reynolds
Portfolio Manager
Martin Currie
Emerging Markets

Stephen **How is the virus affecting how you think about strategies?**

Andrew Obviously, COVID sadly continues to dominate the headlines and it does feel a little bit like Groundhog Day. I think I mentioned this time last year that we expect COVID to remain prevalent for the year. It seems to be very much the case again. And, while some countries in emerging markets have made solid progress with the inoculation, what we're seeing is that the production and distribution of vaccines in sufficient scale are proving to be challenges of a similar scale to the development of these vaccines. So as a result, I think we can expect many countries to continue experiencing sporadic COVID outbreaks. That's going to add volatility to the underlying trend of economic and market recovery. It's a lot of doom and gloom, but let's put that in context.

We think that emerging markets are still likely to remain resilient in the face of this challenge, and you have to look at many factors that we've discussed in the past about the resilience of the emerging market opportunity set. Emerging market economies overall still remain much less indebted than developed economies. And that's at the sovereign level, it's at a corporate level, and the household level. If you look at banking systems across emerging markets, they've largely withstood stress and that's despite the moratoriums that have been imposed upon banks across the board…We've got the reopening trade that's supporting the technology and consumption themes that have become the new drivers of economic growth for many emerging markets, and all of that is leading to a sharp earnings rebound that we'd expect from very much a low base last year.

Stephen **Alastair, with the virus continuing, many countries have had different monetary or fiscal stimulus. How does that fit into your current approach? I know you're primarily a bottom-up stock picker, but how are you thinking about fiscal stimulus and monetary policy of various countries?**

Alastair We think about that in a couple of ways, Stephen. On the fiscal side, we see the biggest fiscal packages came from developed market governments. So really, it's about making sure that the stocks that we're in and our strategy overall are going to be beneficiaries of that uptick in spending in the developed economies. US President Joe Biden's infrastructure plan could be the next example of that; a developed-market-led fiscal expansion. That would underpin demand for building materials and other capital goods sectors within EMs.

On the monetary side, it's really come down to the extent to which each local domestic financial sector will be used as an intermediary in providing alleviation against the impacts of COVID. There, we were looking to avoid markets where there was a strong foreign influence that could fall victim to nationalism. If the local government favored putting a bigger-than-normal burden onto a foreign-owned-banking sector, we could be in for a rough ride. Mexico would be an example of a banking sector that could run the risk of that happening.

Otherwise, we've been looking at banks' abilities to participate by assisting the governments in debt moratoriums. We have been favoring banks with strong balance sheets to allow them to play their part in helping the economy whilst still funding themselves through the first stages of the crisis. What we're then looking for is a bit of relaxation of regulation as we go further through the recovery—for governments to allow the banks to march out of providing this support structure in a way that's conducive to their earnings.

Stephen **Alastair, are there particular countries where you're more or less positive on the financials?**

Alastair We see banks as one of the real areas of outstanding value in emerging markets overall. We particularly like banking systems where the banks are well-capitalized. You're getting that valuation attraction but backed up by robust bank balance sheets. That view translates into certain markets being much more positive than others. I would single out India as one example where we think there is such a gulf between the private sector banks with their relative balance sheet strength compared to their state-bank brethren. India's been a market where, we think, private sector banks can really take market share in this environment, as well as managing to navigate the crisis.

Stephen **Andrew, how are you looking at banks, and what countries are you finding more or fewer opportunities?**

Andrew Similar to Alastair in some ways, we've seen banks as an attractive way to play the emerging market consumer opportunity. We still see a number of these major emerging market economies are significantly underbanked, i.e., very few people still have credit cards, very few people have mortgages. Even very few people in many countries have deposit accounts. So, there's still a process of "banker-ization" as we could call it to take place in many of these countries. And that reflects one of the many under-penetration stories that we look to exploit.

If you look at banks and how they've fared, there obviously were considerable casualties of COVID, given the impact of government policy. We had the moratoria that I mentioned earlier, we've had interest rates being cut to support borrowers, we've had some debt forgiveness programs, etc., and the underlying economic contraction itself, which clearly creates a negative credit environment. But looking forward, as we all hopefully do, we look at the banking sector with more optimism and we should expect to see banking-sector returns expanding, in some cases fairly rapidly, over the next two years. And that's because we expect provisions will start to normalize. Some banks will start to see large recoveries because of, probably, being too prudent and provisioning during the downturn. We'd expect to see significant loan demand recovery. And in addition to that, we've got the digitization theme and that's going to keep a lid on costs for many of these banks.

And, then we start to look at the inflationary environment. And if you do start to see rising rates, then clearly, we've got the additional potential for net interest margins to start to expand. So, I think it's a reasonably constructive environment for many of these banks.

Stephen **Alastair, one of the biggest areas we always have questions about within emerging markets is China. China came out of the COVID crisis before almost any other country and is actually, to some extent, tapping the brakes. What's your outlook on China?**

Alastair Our outlook on China is one of continued growth. We don't think their progress has in any way peaked, although we expect growth will come at a slightly lower rate than what we've been seeing in recent quarters. We've already seen a slight tightening of credit provisions this year in China. We think that's timely. We think that the economy is recovering under its own steam. And that's keeping us very interested in China as a place to pick individual stocks.

Now, as to how that translates into positioning, I think there are a couple of areas there that offer distinct opportunities. On the one hand in offshore markets, so that's Hong Kong-listed or US-listed Chinese names, our focus has been very much towards large platform-based businesses—internet gaming, e-commerce, those kind of areas of the market. This is very much playing domestic Chinese demand, whether that be in business or in consumer.

But also, I think there's a real opportunity in the domestic Chinese markets, where that would be through A-share exposure. This is where we focus on fast-moving, innovative companies. So, areas like healthcare and drug development we find very exciting given China's aging economy.

Self-developed technology is another theme that we're seeing in China. Technology is one industry that the government is incentivizing and prioritizing to achieve national self-sufficiency. The need for self-sufficiency in key industries may be forced upon them, but we're certainly seeing that as a theme worth following up on in China.

Stephen **Andrew, I know you also have followed China for a long time. Where are you seeing opportunities?**

Andrew We see considerable growth opportunities, still, across a range of areas that these businesses are exposed to whether that's e-commerce, it's gaming, it's payments, it's the cloud-computing companies, it's cybersecurity. There are a whole host of growth opportunities that we still see very clearly.

The feedback that we've had from our analysts on the ground and from the companies that we've been engaging with is still that they see strong growth opportunities persisting. There's still confidence in the current and the future demand outlook, and I think that's slightly contrary to the market's more bearish view, perhaps.

Many companies still believe that they can manage their input cost pressures effectively. And again, that's something of concern, given the rising input costs that we've experienced across many markets.

And then, finally, we're seeing a great deal of corporate activity by many Chinese businesses, well-managed companies that have got strong balance sheets. They look to have emerged stronger from the pandemic, and we're seeing plenty of opportunities to deploy capital towards growth. I think we're still pretty optimistic about many of the private-sector businesses that we continue to back in that market.

Stephen **Andrew, I realize that you think about how you invest in everything from a bottom-up perspective. Are you seeing evidence from companies that support the view that inflation is rising?**

Andrew I think we're certainly seeing signs of inflation throughout the asset class. And that's a reflection of supply bottlenecks, ongoing shipping disruptions, but also the recovering demand that we're seeing in many economies. So, it shouldn't surprise anyone that we're seeing an uptick in prices. In addition to that, you've had obviously the very strong commodity background that's lifting headline inflation. Our expectation is that should ultimately prove transitory, and we look for inflation to moderate going forward, but it's certainly not something that we spend a huge amount of time forecasting. What we are seeing is a policy response from certain parts of this asset class, they have started to tighten, other parts of the asset class are more willing to wait. And I think if you look at the recent US Treasury market action, it seems that growth, and not inflation, is the concern for investors. That could obviously change if we talk about this in a month's time.

If inflation does persist, however, is it a big risk for emerging markets? I think that's the key question. And our view would be it all depends on what type of inflation we're experiencing. And there are two very different views. There's the benign version, which argues you should experience some inflation as there's a natural global recovery post the economic lockdown that we went through, but that won't generate sufficient long-term inflation concerns. And then, you get a much more sinister scenario that sees continued overheating because of low interest rates and fiscal push, this snap-back in demand, much stickier inflationary pressures, and you start to see an elevation of core rates. I think I'm personally sympathetic much more to the more benign scenario; important to note that we don't bake that into our strategy. We see these things as a source of risk, not source of alpha. But I think there remains significant slack and spare capacity in most economies, and I think especially on the labor side. We'd argue that it's difficult to see this recovery leading to significant and persistent upward pressure on wages. So, if that's the case, then I don't think we should be too scared of an upward move and inflation across much of emerging markets. We'd see it as an expected part of the economic normalization process post the crisis.

Stephen **It's very interesting. All of our macro economists are really continuing to discuss that question of how sustainable it will be, and then whether companies will be able to pass it along. Andrew, can you just name the couple of countries that you're most positive about and the couple of countries that you're least positive about?**

Andrew I think if you look at South Korea, alongside Taiwan, they seem to have managed the pandemic better than many other parts of the world. And that's despite the recent flare ups that we've seen in infection rates in both. And if you look at the composition of both their markets, they're very tech-dominated. And again, that's been the right place to be during the crisis. But we also expect many of those tech trends to have accelerated during the crisis and emerge in a much stronger position, post the pandemic.

And just as a reminder, we form our investment opinion, by through a bottom-up lens. If we look at South Korea, however, from a top-down perspective, there's multiple support for that market as well. We see very low levels of debt at the sovereign level, and again, that provides options and flexibility. If growth does disappoint, that there's scope for additional fiscal stimuli, and we're talking here from the UK to the US where two countries that are incredibly debt constrained, it seems, or maybe not given the new experiment that we're pursuing, but certainly South Korea's debt to gross-domestic-product (GDP) less than 50%

of the sovereign level, puts it in a very enviable position. We've got corporate balance sheets are highly cashed up. And I think investors have spent years trying to persuade South Korean corporates to leverage up, to no avail in many cases. But actually, those cashed-up balance sheets are proving to be exceptionally timely and something of a tremendous strategic boost to the country, given the opportunities to deploy capital that will emerge post the pandemic.

South Korea is not a major tourist destination. I'm not sure many of us are applying to jet off to Seoul, although I would highly recommend it. So, it's obviously much less impacted by the collapse in global tourism. And then, finally, we're also starting to see emerging signs of improvements in South Korean corporate governance, and that's been very much encouraged by the government, and that's got the potential to further help rerate the market higher over time. So, that remains a very attractive place for us to invest in.

I mentioned China, but that's predominantly because of our less-optimistic view on the opportunity for state-owned banks in China. We think there'll be a significant amount of national service that there'll be called upon to perform, so we prefer to invest elsewhere.

The Indian market has had its challenges with COVID, but at the same time, we've seen tremendous progress on the reform agenda of the Narendra Modi administration. So, highly rated, high-quality Indian companies that I don't necessarily see underperforming significantly because they're able to demonstrate growth, but we find better growth and valuation opportunities elsewhere in the asset class.

Stephen **Alastair, what countries and sectors are you most optimistic about and which are you less so?**

Alastair I share some similarities to what Andrew was saying. And also, I guess, quite stand-out differences as well. So that makes a market.

We have, in similar fashion to Andrew's strategy, South Korea as a positive—really the big attraction for us there is its world-class intellectual property [IP]. What we're seeing there are the leading technology firms and industrial manufacturing firms in South Korea, at the vanguard of the world in terms of IP. As evidence we see that, last year in 2020, Asia had more patent applications than Europe and the US combined, for example. So, South Korea's really one of those areas where the world hasn't really sat up and taken notice of just how far its IP has come, but the years ahead will really bring that home to bear. So, that's why we're in South Korea.

Maybe where we're slightly different from Andrew's strategy is in our stance on India. There is nothing that Andrew's been laying out there that we wouldn't agree with as such; high valuations, it's a highly rated market. I guess where we see a difference there is just in the exceptional, bottom-up opportunities that we see at an individual-company level. India is a market that is still deeply under-penetrated in any line of business activity that you choose, and the strength of the leading business franchises is unparalleled. The relative competitive advantage of individual franchises in India gives us the confidence to pay up and view those businesses as high-growth, long-term opportunities.

We've also had a long-term preference toward technology. We think we are well into a new era of strong disruption—businesses everywhere are being fundamentally changed by the adoption of technology. And that's something that really plays to emerging market strength, that plays particularly to Asia's strengths. Technological change also extends to industrial materials, where areas like electric vehicle (EV) batteries, for example, or even some more basic feedstock materials are where we're seeing what we believe will be a strong, secular demand just getting underway. Technology enabled growth has been a very powerful driver of EM companies so far, but it's still in its very early stages. So, those are some of the areas where we are very positive.

On the negative side, I think I share a similar viewpoint to Andrew that much of Southeast Asia is still lacking the visibility of growth beyond the impacts of COVID for us to get really excited about. The lack of vaccine availability in these nations means they are likely to face significant health and economic pressures. The other area I'd maybe point to is the Middle East where we've been seeing a lot of stock market development, particularly in Saudi Arabia where there's a lot of reform agenda going on. The reforms sound positive, but we don't really see the valuations being attractive for what we see in store.

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