Fears Over Virus Outbreak Curb Investor Optimism in January

February 14, 2020

by Team

of Franklin Templeton Investments

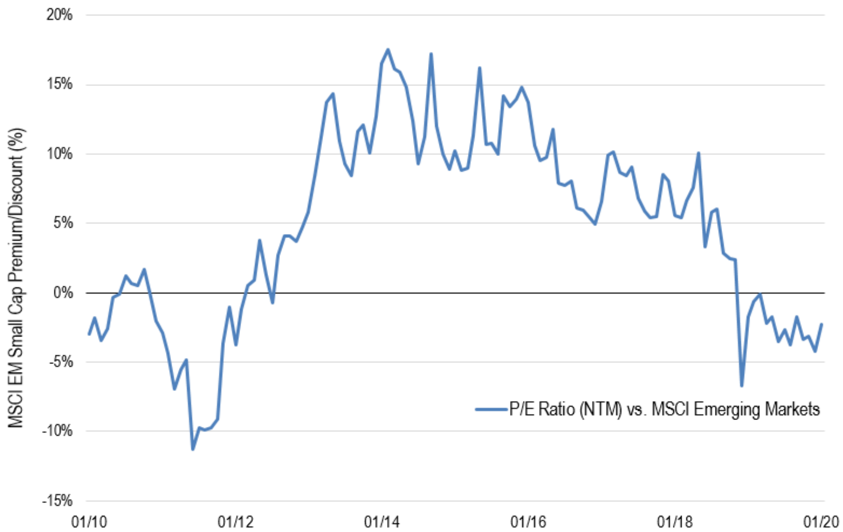
Three Things We're Thinking About Today

1. The outbreak of the **2019 Novel Coronavirus in China**, which has spread across Asia and other parts of the world, has had a negative impact on sentiment in the short term. Business activity and consumption in China has been significantly impacted as people curtail their movements as a preventive measure. This is expected to result in a materially negative growth print in the short term. Sectors such as travel, leisure, retail and select sub-segments of discretionary consumption are being directly impacted in the near term. We could, however, see the government respond through additional stimulus measures such as further rate cuts, measures to encourage infrastructure spending or boost consumption. While we continue to monitor the situation, we currently believe the long-term growth outlook for China and Chinese equities remain unchanged.
2. **India's fiscal deficit** target for the budget was raised to 3.8% of gross domestic product (GDP) for fiscal year 2020 (FY20) in view of lower revenues, while the target for FY21 was set at 3.5%. While there were high market expectations for fiscal expansion given weakness in India's economy, the FY20 budget largely reflected the government's decision to stay on the fiscal consolidation path, with no significant stimulus to the economy (beyond some modest measures to boost income and infrastructure). Additionally, we believe the Indian economy and corporate earnings growth are set for a gradual recovery over the next one to two years, supported by growth-oriented policy measures already undertaken.
3. Although **emerging market (EM) small caps (SCs)** recorded positive returns in 2019, the asset class lagged their EM large-cap (LC) counterparts. Key reasons for this dispersion included wide performance differentials between LCs and SCs in markets such as India and South Korea and that LCs structurally have higher exposures to the financials and energy sectors as well as big technology companies. We, however, believe that the structural story for EM SCs remains intact, i.e., SCs are levered to idiosyncratic local economic dynamics, particularly consumption. Attractive valuations in the asset class and solid earnings potential further support the investment case for SCs, in our view.

Emerging Market Small-Capitalization Stocks Trading at a Discount to Large-Capitalization Stocks

FRANKLIN TEMPLETON

MSCI Emerging Markets Small-Cap Index and MSCI Emerging Markets Index
As of January 31, 2020



Source: FactSet, as of January 31, 2020. MSCI Emerging Markets Small Cap Index includes small cap representation across 26 EM countries. The MSCI Emerging Markets Index captures large- and mid-cap representation across 26 EM countries. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** The price-to-earnings ratio, or P/E ratio, is an equity valuation multiple defined as market price per share divided by annual earnings per share. For an index, the P/E ratio is the weighted average of the P/E ratios of all the stocks in the index.

Outlook

Investor optimism following the US-China “phase one” agreement was overshadowed by fears over the coronavirus outbreak in China, which has also spread to other parts of the world. By the end of January, EM equities had declined more than 7% from their mid-month peak. The current outbreak is occurring after a year of strong performance in equity markets (the MSCI Emerging Markets Index was up 19% in 2019). This suggests that further losses could occur as uncertainty persists in the coming weeks and markets continue to consolidate after a period of strong performance.

The situation remains fluid, and the spread of the coronavirus has brought uncertainty to the near-term growth outlook. We are closely monitoring the impact of the outbreak on emerging market economies and equity markets. However, in our current assessment, downside risks are biased towards the short term, while the long-term outlook remains intact.

The macroeconomic situation in emerging markets remains robust, with 2020 economic growth expected to be more than double that in developed markets.[1] Moreover, the policy environment has improved, with supportive fiscal, economic and monetary policies and a renewed focus on structural reforms in many emerging markets.

We believe emerging markets remain attractively valued and trade at a substantial discount to developed markets, while relative earnings are at a three-year high and are expected to see a recovery in growth during 2020. Emerging markets are also increasingly focusing on capital efficiency: the capital expenditure-to-sales ratio has fallen relative to developed markets, helping the free cash flow yield of emerging markets rise above that of developed markets.

Emerging Markets Key Trends and Developments

Stock markets worldwide fell in January, with EM equities slipping more than their developed market counterparts. EMs surrendered initial gains driven by the signing of a partial US-China trade deal, as the spread of a new virus in China and other markets clouded the global economic outlook. Prices of oil and industrial metals declined amid concerns of weaker demand. EM currencies were broadly lower against the US dollar. The MSCI Emerging Markets Index declined 4.7%, while the MSCI World Index edged down 0.6%, both in US dollars.[2]

The Most Important Moves in Emerging Markets in January 2020

Most Asian markets retreated as a virus outbreak in China dominated investor sentiment. Chinese equities ended January lower despite starting the month on a positive note, as worries about the health crisis outweighed relief from a pause in the US-China trade conflict. Potential drags on manufacturing and consumption in China topped economic concerns. Stocks in South Korea, which counts China as a major trading partner, pulled back. Thai equities fell as China halted group tours, dampening prospects for Thailand’s key tourism industry. However, stocks in Pakistan rose. Signs of economic stabilization, including a narrowing current account deficit, supported market confidence.

Apart from Mexico, Latin American equities and currencies declined over the course of the month on fears that the coronavirus could impact commodity demand and prices. As of the end of January, no cases had been recorded in South America. Weakness in regional currencies were largely responsible for the equity market declines in Brazil, Colombia and Chile. A decline in copper prices on demand concerns from China further weighed on sentiment in Chile. The Mexican market ended the month with gains supported by appreciation in the peso and US approval of a trade treaty between Mexico, the United States and Canada.

Markets in the Europe, Middle East and Africa region also generally lost ground. External shocks pressured investor confidence in the region, including the US killing of an Iranian general which raised fears of a Middle East conflict (that quickly subsided), and the virus outbreak in China. Currency weakness in South Africa and Russia was to blame for most of the underperformance in the South African and Russian equity markets. Politics were at the forefront in Russia, with President Vladimir Putin proposing amendments to the constitution, which included shifting some presidential powers to the parliament. Egypt, Turkey and the United Arab Emirates, however, bucked the trend and ended January with gains.

https://emergingmarkets.blog.franklintempleton.com