



## Monthly Emerging Markets 3Q09 Review

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### Overview

Emerging markets surged in the third quarter of 2009. The MSCI Emerging Markets index rose 21% in US\$ terms during the period. This brought the year-to-date return to 65% in US\$ terms. Part of this return was due to weakness in the U.S. dollar. Strong portfolio inflows and higher confidence in emerging market equities continued to drive prices.

Eastern European markets were the strongest performers during the quarter, after a period of underperformance earlier this year. Markets benefited from lower interest rates, subsiding credit crunch worries and attractive valuations. Turkey was among the top performers with a return of 32% in US\$ terms. A stronger Rand led the South African market to end the three-month period with a 14% gain in US\$ terms.

A rebound in commodity prices from recent lows at the end of 2008 and stronger domestic currencies supported equity prices in Latin America. Asian markets also ended the quarter with double-digit returns due to significant fund inflows and relatively high growth in major markets such as China and India.

Global leaders came together in the US to attend the G20 summit in September, where they vowed to continue stimulus efforts to ensure economic recovery. Leaders also agreed to work towards great coordination of economic policies and tighter monitoring of the financial sector.

### Regional Update

Premier Wen Jiabao signaled that **China** would maintain a loose monetary policy to support the economy's recovery. While bank lending slowed down recently, it totaled US\$1.2 trillion in the first eight months of 2009, exceeding market expectations and accounting for nearly 70% of the total for all of 2008. The country also continued to report robust macroeconomic data during the quarter. GDP growth accelerated to 8% y-o-y in the second quarter of 2009 from 6% y-o-y in the first three months of the year. Fiscal stimulus measures and an expansionary credit policy supported the economy. This brought the growth for the first half of 2009 to 7% y-o-y. Foreign exchange reserves increased 18% y-o-y to US\$2.1 trillion in June, making China the first country to exceed the US\$2 trillion mark. Value-added output grew 12% y-o-y in August, higher than the 11% y-o-y growth in July and its strongest increase so far this year. Retail sales were up 15% y-o-y in August as government-led initiatives drove consumer demand.

The **South Korean** economy grew at its fastest pace in more than five years in the second quarter of 2009. Revised data showed GDP growth of 3% q-o-q, compared to minimal growth in the first quarter of 2009. Government efforts to stimulate growth continued to

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produce results as domestic demand improved as a result of tax incentives and easier access to credit. Growth in private consumption, gross fixed capital formation and manufacturing output drove economic growth during the period. Private consumption increased 4% in the three months ended June 2009, significantly higher than the increase in the first quarter. The Bank also maintained its benchmark interest rate at 2%, a record low, to support the economy. Paving the way for the completion of a free trade agreement between South Korea and the European Union, all outstanding differences were resolved during President Lee Myung-Bak's trip to Europe in July. An agreement is expected to be finalized in February 2010. Once completed, this agreement will be South Korea's second largest trade deal, the biggest one being the accord signed with the U.S. in 2007.

In **Mexico**, GDP contracted 9% y-o-y in the first half of 2009 as a result of the global economic crisis and swine flu outbreak. Declines in the manufacturing, construction and retail sectors negatively impacted GDP. Although industrial output continued to decline, signs of recovery remained evident. Output fell 7% y-o-y July, an improvement from the 10% y-o-y decline in June and 13% y-o-y fall in February. The Finance Ministry forecasted GDP to contract 7% y-o-y in 2009 due to the weak first half. The country is expected to return to growth in 2010 with the Ministry expecting a growth of 3% y-o-y for the year. The Central Bank implemented its final interest rate cut in July, marking the end of the current expansionary monetary cycle, as it balanced efforts to curb inflationary pressures and revive economic growth. The Bank cut the benchmark interest rate by 25 basis points (0.25%) to 4.5%, bringing the total reduction thus far this year to 375 basis points (3.75%). Politically, the ruling Partido Acción Nacional (PAN) experienced the worst defeat in its party's history in the July legislative elections. PAN lost to the opposition Partido Revolucionario Institucional (PRI). PRI's alliance with the Green Party (PVEM) gives them a majority in the Lower House.

More than a year after **Brazil** was awarded investment grade status by international rating agencies Standard & Poor and Fitch Ratings, Moody's upgraded the country's sovereign debt to investment grade in September. Brazil's stable macroeconomic fundamentals and strong fiscal and monetary policies also allowed the economy to return to growth after recording two consecutive quarters of contraction. GDP grew 2% q-o-q in the second quarter of 2009, as tax breaks, monetary easing and lower inflation boosted consumer expenditure. Private consumption rose 3% y-o-y, compared to a 1% y-o-y increase in the first three months of the year. The Finance Minister expects the economy to grow about 1% and 4% y-o-y in 2009 and 2010, respectively. The Bank cut its key interest rate by 50 basis points (0.5%) to a record low of 8.75% in July. Since January, the interest rate has been cut by 500 basis points (5.0%). With the economy showing signs of recovery, the Central Bank also signaled an end to monetary easing. The International Monetary Fund (IMF) commended Brazil's strong macroeconomic foundation which allowed the country to "increase its resilience to the global economic crisis" and maintain financial stability.

The **South African** economy contracted 3% q-o-q in the second quarter, its third consecutive quarterly decline. It was, however, a significant improvement from the 6% q-o-q decline in the first quarter of 2009. The manufacturing, wholesale and retail trade and hospitality sectors were the major culprits. Conversely, growth in construction and mining activity, ahead of the upcoming 2010 World Cup, and a recovery in Chinese demand for commodities, had a positive impact on GDP. The South African Reserve bank left its benchmark interest rate unchanged at 7% in September, as inflationary pressures continued to ease. This followed a 50 basis points (0.5%) cut in August. Consumer prices reached a two-year low of 6% y-o-y in

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August. The Bank has cut its key interest rate by a total of 500 basis points (5.0%) since December 2008 to support the domestic economy. International ratings agency, Moody's, upgraded South Africa's foreign currency credit rating by one level to A3 from Baa1, in view of the country's resilience to the global financial crisis. This will lower the cost of servicing the country's foreign debt. Its local currency rating was, however, reduced by one level to A3 from A2. Signaling the likelihood of improved relations between the U.S. and South Africa, U.S. Secretary of State Hillary Clinton visited South Africa in August where she also met President Jacob Zuma.

**Russia's** GDP declined 11% y-o-y in the second quarter of 2009. This compared to a contraction of 10% y-o-y in the first three months of the year. Major reasons for the economy's performance included weak external demand, investment and consumption. The Economy Ministry forecasts GDP to grow 1.6% y-o-y in 2010, as signs of recovery emerged in recent months. The Central Bank maintained an expansionary monetary policy by cutting its benchmark interest rate by 100 basis points (1%) to 10.5% during the quarter, due to easing inflationary pressures and efforts to support the economy. A 21-month low, consumer prices rose 11.6% y-o-y in August. U.S. President Barack Obama met his counterpart in Russia, where both sides signed an agreement on nuclear arms reduction. Meanwhile, Foreign Minister Sergei Lavrov visited Vietnam where both countries vowed to boost trade and increase cooperation in the energy, telecommunications and technology sectors. Moreover, Russia and Turkey signed energy agreements as well as a customs accord to improve trade relations while Russia has also approved a nuclear energy deal with Turkey.

In **Turkey**, fiscal stimulus measures coupled with monetary easing supported economic recovery with GDP decline shows signs of bottoming. GDP contracted 7% y-o-y in the second quarter of 2009, compared to a 14% decline in the preceding three-month period. Consumption recovered significantly, with private consumption contracting just 1% y-o-y, compared to a 10% y-o-y decline in the previous quarter. Moreover, the Central Bank maintained an expansionary monetary policy during the third quarter to support the domestic economy. The Bank cut its benchmark borrowing interest rate by 150 basis points (1.5%) to 7.25%. Inflation continued to ease with consumer prices increasing 5% y-o-y in August, well below the Bank's target for the end of the year. Turkey and Chile signed a free trade agreement in July to boost bilateral trade and economic relations. Trade between the two countries is expected to double as a result of the accord. Turkey and Russia signed energy agreements as well as a customs accord to improve trade relations while Russia has also approved a nuclear energy deal with Turkey.

## **Outlook**

While the global economic crisis did interrupt some of the emerging markets growth momentum, we expect the long-term growth of these markets to continue. Although we are optimistic about the markets' upside potential, it is important to realize that volatility is still with us and will be with us for a while. This means that there will be down markets as well as up markets. We therefore must pay attention to valuations and long-term earnings growth prospects in order to avoid buying or holding expensive stocks as a result of dramatic price rises that we have seen. Most important for value investors, the current valuations of emerging markets remain attractive. Selective markets such as Russia and Hungary are down to single-digit P/Es, making them especially appealing. In addition to emerging markets, we think frontier markets are looking interesting and could become tomorrow's emerging markets.

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Emerging markets offer a number of important advantages to investors and there are very good reasons why a positive long-term view of these markets should be adopted. Most important, emerging markets are still expected to grow at a much faster rate than developed markets. Although the slowdown in the global economy has had an impact on these markets, emerging economies are becoming more domestically driven. Government expenditure in areas such as infrastructure as well as private domestic consumption will, at least partially, offset the decline in growth resulting from slowing exports. Looking at the stability and safety of emerging markets, it is important to note the accumulation of foreign exchange reserves which puts these economies in a strong position to weather external shocks.

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