Navigating Emerging Markets During Uncertain Times: This Too Shall Pass

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Even though economic activity in many countries has dramatically slowed or stopped due to the coronavirus outbreak, Franklin Templeton Emerging Markets Equity's Andrew Ness still thinks there's underlying long-term potential in emerging markets. He shares the specifics of what he's on the lookout for as an investor in this highly uncertain period—which eventually will pass.

In recent weeks, economic activity across emerging markets has come to a halt, currencies have weakened and equity markets have fallen as coronavirus has swept across the globe. While this situation is rather unique, it isn't the first time in my career a crisis has hit. Our emerging markets team has decades of experience investing through highly volatile periods; this has helped us remain calm in the current crisis. There's no panic within the team—we recognize that this period will pass and that things will recover.

Our team is not only well-resourced, but is locally based, with a presence in 16 countries and multiple time zones. We think that is a key competitive advantage. For example, it has certainly been helpful having a team on the ground in Hong Kong and Shanghai during this trying period to help us better understand what's happening on the ground in China.

Since the coronavirus outbreak first became known, our teams in Hong Kong and China have held more than 500 meetings/calls with companies and industry specialists to gather insight into how it has been affecting business operations. The crisis clearly has hit markets across the globe and volatility remains high. Price swings have been dramatic; for example, we've seen 8 +/- 4% absolute moves in the MSCI Emerging Markets Index in the last two weeks of March.[1] So effectively, we're seeing indiscriminate moves in markets, and fundamental factors are having little impact on where stocks are trading.

We've seen weakness nearly across the board, with the sudden collapse in consumer activity negatively impacting consumer-facing names, such as sportswear brands, auto manufacturers and casino operators. The oil price plunge has also weighed on related sector stocks, and in general, banking stocks have likewise been weak amid slowing credit and loan growth.

However, we don't think there will be systemic banking crises in emerging markets. Banks are generally well-capitalized, and regulators have overall been doing a good job supervising markets. We believe when this crisis passes, banking stocks should remain well positioned to resume growth, given the low levels of credit penetration across the asset class.

A Calm and Rational Investment Approach

At a time when coronavirus-driven country shutdowns have exacerbated investor concerns, the crisis hasn't altered our investment philosophy towards emerging market stocks. We continue to favor competitive, well-managed companies with long-term sustainable earnings power and attractive valuations.

Our approach has been calm and rational, without panic.

Going into this crisis, we pursued a diversified approach within our portfolios, with stocks that reflect our philosophy of owning good-quality businesses with long-term sustainable earnings power at a discount to their intrinsic worth. We look for well-capitalized companies and are cognizant of leverage; we prefer low or appropriately levered companies. Hence, we have not made significant changes to our portfolios on account of the crisis, although we have reduced or exited some investments in companies where we believe there is a longer-term negative impact on the business or where share prices have not corrected in line with the expected negative impact on the business.

We currently favor companies that are both exposed to areas of structural growth and have scope to gain a higher market share through their competitive advantages—whether that's through cash-flow generation, existing market share or technological leadership. For example, online entertainment, gaming and messaging platforms have seen greater use during the coronavirus lockdown period, and we've seen select opportunities in other types of companies, such as insurance for example.

Coronavirus Presents Longer-Term Questions

The degree and duration of demand destruction in developed economies from the coronavirus remains to be seen.

There are a number of questions we're asking ourselves about the longer-term implications of the crisis and what it could mean for the economy and companies we consider investing in, because we believe that the world will likely be different when we emerge from this crisis.

These questions center around:

- The impact on supply chains of key technology, health care and other products and the degree to which end customers and companies are willing to pay more for greater security of supply;
- The degree and duration of demand destruction in the developed economies from COVID-19;
- The likely policy response from authorities globally and the impact from it, including unintended consequences. We know that going into this crisis, the developed world had too much debt, so we should expect government policy will likely further exacerbate post-crisis imbalances;
- And similarly, pre-crisis we saw historic spreads between style factors, and the outcome of the crisis may be a continued bias toward growth equities away from value.

We continue to utilize our locally based teams across the globe to see what's happening on the ground in the emerging market universe. With no hard end date for the pandemic in sight, we'll be considering whether social distancing will become more normalized going forward, and consider whether certain companies could benefit from any permanent behavioral changes in society as technology is embraced.

While we expect to see some significant downgrades for 2020 earnings across most countries and sectors, we also anticipate a significant earnings recovery at some point in the future, assuming the virus outbreak does pass. The immediate outlook for the global economy remains highly uncertain, but we believe our focus on long-term fundamentals should help us navigate the challenges in coming months.

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1. The MSCI Emerging Markets Index reflects mid- and large-cap representation among 26 emerging market 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.