FRANKLIN TEMPLETON

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Perspective from Franklin Templeton Emerging Markets Equity

An Emerging Markets Update on Recent Coronavirus-Related Volatility

Aggressive actions in China have now largely contained the coronavirus there, although a rise in international infections has triggered a roller coaster for global financial markets. Our Franklin Templeton Emerging Markets Equity CIO weighs in on the investment implications of recent coronavirus-related volatility for China and emerging markets.

With the shift in the coronavirus from being a China-centered outbreak to a global pandemic, we've witnessed a substantial upheaval in health systems, consumer behavior, economic activity and markets globally.

Developed markets are leading declines, with several indicators pointing to a potential US recession—including US Treasuries, equities and commodities—driven by fear of sustained demand destruction. Some of the smaller flow-driven economies in Asia have likely already fallen into a short-term recession.

China: First In, First Out

Aggressive actions by the Chinese government have now largely contained the virus there, with the number of daily new cases dropping to single digits outside of Hubei, and less than 50 across the country as a whole. China's contribution to new cases globally has fallen from over 90%, to less than 5% in the last month, which is also reflective of rising international infections. Still, reversals to higher numbers of new cases cannot be entirely ruled out.

In February, Chinese efforts were focused on containment, while also ensuring migrant workers returned to their provinces of work to restart production post the extended Lunar New Year break. In March, we've started to see utilization rates recover considerably as the objective shifts to normalization of production. Alternative high-frequency data from multiple sources suggest production levels have recovered to above 60%, which is corroborated by our own ongoing dialogue with companies—albeit with variation by industry and region. Challenges are not limited to the supply side, however, with some companies maintaining lower capacity utilization rates due to near-term softness in demand and accumulating inventories.

Policy support in China has been targeted to reduce the impact on the financial system. The People's Bank of China (PBOC) has set up a low interest rate special refinancing fund to support impacted industries, while commercial banks have also lowered interest rates for those companies. The Ministry of Finance has also provided interest subsidies for small and medium enterprises, as well as support for local governments in their control efforts.

On a relative basis, China's stock market has been remarkably resilient throughout this crisis, with the MSCI China down some 8% from the broad market peak on February 19 to March 9.[1] Interestingly, we've seen new equity fund launches in February continue to see very strong demand, with most sold out in 1–2 days, raising some US$15bn over the month.[2] Government efforts to stabilize the market through encouraging buying support has had a very notable impact in addition to the direct stimulus.

At a company level, we think there are some clear beneficiaries, ranging from the health care sector, as well as those that have been helped by the shift online—including education, e-commerce and cloud computing. Other sectors, such as cement and spirit producers, have remained resilient in share-price terms but are clearly impacted in the near term at a business level. Nonetheless, the bulk of companies are more badly impacted, predominantly those in the consumer, leisure and transport space.

The Knock-On Effect

The extent to which developed markets are able to contain the spread of the virus, and thus the severity and duration of the global economic impact, will now be critical. Those developed economies with higher leverage present in the financial system, aged populations (where mortality appears to be higher), as well as inefficient and fragmented health care provision are at greater risk. The market response thus far suggests a lack of confidence in the preparedness of many countries.

Government support more generally has varied widely, with fiscal stimulus thus far in developed economies unlikely to be sufficient. For example, US$8bn in the United States (0.04% of gross domestic product) and a recently doubled figure of US$8bn in Italy (0.4%). These actions are substantially weaker than the aggressive approach seen in parts of Asia that were affected early in this crisis, including stimulus of US$15bn in Hong Kong (4.2%) and US$5bn in Singapore (1.3%). We'd expect government efforts globally to increase considerably.

Longer-Term Questions

Our thinking is now more focused around the longer-term implications of the crisis, and what it could mean for the economy and companies we look at. These center on:

- The impact on supply chains of vital technology, health care and industrial products, and the degree to which end customers and companies are willing to pay more for greater security of supply. This is likely to play out over the next year and beyond.
- The degree and duration of demand destruction in the West. In the short term, we are likely to see a deflationary shock. From an economic perspective, it is critical that the financial system does not come under excess strain.
- Given that globally both monetary and fiscal policy were highly accommodative going into this crisis, there are risks of unintended consequences from the further stimulus efforts needed now, as existing imbalances post the global financial crisis are exacerbated.
- For equity markets, it is also likely that a slowing global economy coupled with lower interest rates will further boost growth stocks over value, as investors reward longer term visibility with a premium.
- Companies that could benefit from any permanent behavioral changes in society, as technology is likely to be more strongly embraced e.g. increase in e-commerce, e-learning, cloud computing, etc.

Investment implications

Our teams in Hong Kong and China have held more than 500 meetings and calls with companies and industry specialists since the outbreak began. Across our coverage we've also completed reviews of existing holdings, the companies most affected, as well as updating views on our most favored stocks in light of the market correction. We have shortlisted the top recommended names (most of which are already owned) and many of these have not corrected sharply, suggesting some look through of the current episode and some reasonable market efficiency.

Many companies have pointed to sharp earnings declines in the first quarter, possibly spilling into the second quarter. In most instances however, even a severe decrease in near-term company profitability does not meaningfully alter the long-term intrinsic value of our holdings. We have modeled 2020 earnings declines of 25–75% and find the impact upon intrinsic value at a portfolio level to be very limited. These assessments have given us confidence in our overall portfolio positioning, despite recent market volatility.

Endnotes

1. The MSCI China Index captures large- and mid-cap representation across 701 constituents, and covers 85% of the China equity universe. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.
2. Source: Wind, as of March 3, 2020.

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