Midyear outlook: Risk, recovery and new market realities

An evolving outlook

Optimism and caution for the second half of 2020

Health uncertainty vs. economic uncertainty: The need to safely restart growth

The accelerating changes in a COVID-19 world

Emerging markets: Opportunities and the road ahead
The COVID-19 pandemic dealt the global economy a massive blow—a greater and more prolonged one than many initially expected. While our investment professionals remain optimistic about a second-half recovery this year, they are less convinced it will be spelled out as a sharp, “V-shaped” rebound. Our senior leaders offer their view of today’s investment landscape, including the upcoming US elections, and outline the potential risks and opportunities they see.
Key viewpoints

• The low point has probably passed for many economies. Despite a heightened level of uncertainty, we believe expectations have largely caught up with the true depth of economic damage that had been suffered. However, the pace and nature of recovery remains more uncertain than usual.

• We expect multiple stages of relief rallies and corrections in financial markets before a sustainable recovery eventually takes hold many months from now. Until that point, we are focusing on select areas of value in the phase one environment, including a select set of emerging markets as well as developed market safe havens.

• We could see the sharpest and potentially the shortest recession in US history. Our baseline outlook assumes sensible reactions as we are looking at data-driven conclusions as opposed to just knee-jerk reactions. Overall, we believe it is a time to be active as investors. There is not a single asset that is unilaterally a buy right now, in our view.

• The amount of stimulus we have seen in response to this crisis is unprecedented; the fiscal, monetary, and political responses to the crisis globally have led to a world awash with liquidity. Much of that liquidity has gone into the stock markets, explaining a great deal of the markets’ ascent.

• The need to make decisions about the ongoing provision of government support for individual consumers as well as businesses is complicated by the impending election. The highly charged political climate in the United States may make longer-term policy harder to deliver, if it offers political advantage to one party or the other. For investors, there’s also a heightened risk that inequality and populism will lead to rising tax rates and regulatory oversight, particularly in key sectors such as technology.

• The ESG conversation is changing further amid the pandemic, with a greater focus on the social impact of policies. Many governments are supporting jobs, while companies are more cognizant of the reputational risks of layoffs. ESG has become more important, with companies considering it critical to sustainable business performance. In our view, this “delta” of improving ESG in emerging markets is a further tailwind supporting the secular outlook for the asset class as the world emerges from this crisis.
Economic activity slowed more abruptly in the second quarter than was generally expected at the end of the first quarter. The global economy experienced a sudden stop as many countries adopted stringent lockdown measures to slow the spread of the coronavirus. These actions led to a broad global recession that has been deeper and faster than any in living memory. We believe the low point has probably passed for many economies. Despite a heightened level of uncertainty, we believe expectations have largely caught up with the true depth of economic damage that had been suffered. However, the pace and nature of recovery remains more uncertain than usual.

We have seen an ongoing commitment from central bankers to do “whatever it takes” and growing evidence of the coordination of monetary and fiscal policy, that has become a new normal. However, ongoing—stimulus may be required. We see policymakers having no alternative but to continue their support. The next question we ask is “for how long?”

Global challenges of the COVID-19 recovery

We continue to see the challenges of recovering from the current virus-induced recession as global in nature. The level of trade and inter-connected activity will impact many economies, even if they have made more rapid progress in reopening their own countries, as China has experienced. However, we are optimistic activity will resume in all economies as they exit the most stringent phase of any lockdown they have experienced.

Europe may now be taking steps to accelerate its recovery, having been early in closing economies, and suffering a disproportionate hit from the virus. French President Emmanuel Macron and his German counterpart, Chancellor Angela Merkel, have taken the lead in driving forward a coordinated European Union (EU) response to the COVID-19 crisis. The proposed EU recovery fund, offering significant levels of support in the form of grants, rather than loans, is a notable step towards greater fiscal cooperation. Funding some part of this through the issuance of joint liability bonds would be ground-breaking.

The US equity market has benefited from the rapid and unstinting support of the Federal Reserve (Fed). Select companies have been especially well-positioned to take advantage of rapidly changing consumer and business preferences. Accelerated adoption of technological solutions to allow remote working and new ways of conducting business have boosted the fortunes of many companies in the technology sector. We expect these transformational changes to persist even as the immediate driver of the change eases with the virus threat.

As the restructuring of the economy progresses, we expect new businesses to take up the slack left by legacy activities that will not bounce back as quickly, if at all. However, the recovery is unlikely to be smooth and any setbacks to the optimistic assumptions currently gaining dominance may see sharp declines in market confidence.

A multi-asset view of volatility

Our Multi-Asset Solutions investment approach sees volatility as a period of opportunity that produces potential disconnects between market pricing and our expectations. Typically, in such environments market correlations increase and what feels like a refuge underperforms in the ensuing rally. We believe it is important to maintain diversified portfolios, particularly in times of increased investment uncertainty. We also need to recognize that our longer-term outlook may not be reached along a smooth path, and that the current environment is more uncertain than usual.

Namely, the current recession created a gap in private sector income statements and balance sheets that has not yet repaired in many sectors. This gap has been temporarily filled by large-scale fiscal stimulus and monetized by central banks. As an expansion ensues, barring a COVID-19 second wave, it remains to be seen whether policymakers can continue to plug this gap in a fragile, recovering economy, especially in an election year with heightened political risks. Likewise, there is also a risk of diminishing returns to policy actions.

To this point, central-bank support has bolstered the prospects for high-yield bonds. This strategy appears to be part of a wider effort to insulate the market from shocks and avoid a financial crisis coming on top of a pandemic. The market is currently placing a great deal of faith in the ability of policymakers to underpin the full breadth of market sectors. In the case of high yield, the inability of the Fed to protect the
solvency of companies makes a rise in defaults highly probable. In our opinion, the most attractive balance of risk and reward is found in higher-rated, investment-grade corporate bonds.

Looking more broadly across asset classes, we maintain a modestly higher conviction toward global equities than bonds, despite ongoing volatility, reflecting relatively more attractive valuations. In broad terms, bonds have become more highly valued and equity prospects have improved relative to them.

Balancing risks and opportunities
The US economy remains more dynamic than many others around the globe. However, it is also vulnerable to a second wave of infection from the coronavirus. With significant levels of fiscal and monetary stimulus already in place, markets are taking an optimistic view of the balance of risks and opportunities.

The need to make decisions about the ongoing provision of government support for individual consumers as well as businesses is complicated by the impending election. The highly charged political climate in the United States may make longer-term policy harder to deliver, if it offers political advantage to one party or the other. For investors, there’s also a heightened risk that inequality and populism will lead to rising tax rates and regulatory oversight, particularly in key sectors such as technology.

We believe that for the balance of the year, politics will have a growing impact on investment decisions. However, the health and related economic variables are likely to be more important than narrow, traditional political considerations.

In sum, we see the prospects of more modest returns from all assets in the years ahead and continue to see benefits from remaining flexible in our investment approach. Finding assets that offer natural diversification benefits and offsets to any rise in inflation will be particularly appealing. However, in the longer-term we focus on the return potential for stocks. We believe that they should earn their equity risk premium over time, offsetting shorter-term concerns that have tempered our enthusiasm.

Optimism and caution for the second half of 2020

Michael Hasenstab, Ph.D.
Chief Investment Officer, Templeton Global Macro

After four months of economic shutdowns, reopenings and relapses around the world, the global economy unfortunately still appears many months away from a sustainable recovery. It has been encouraging to see the resilient determination to reopen businesses under varying protective measures, but it has been equally concerning to see the resurgences in COVID-19 cases that have necessitated a return to shutdown policies. Stories of restaurants that reopened, only to have to permanently shut down after entire staffs contracted COVID-19 are emblematic of the struggles facing businesses and people around the world. The pandemic is still with us, and its impact on our economies will continue until it has run its course, either naturally or through a cure. While there are reasons for optimism amid the crisis, we are also grounded in the reality that the current predicament may persist for much longer than any of us prefer to believe.

As we pass the midway point of 2020, it still appears too early to pursue additional investment risk, in our view. Recent rallies in risk assets appear to underappreciate the ongoing economic damage and the risks for successive waves of infections that could further suppress economic activity. Some economic data have improved in recent months, but the figures reflect a rebound from the extreme shocks in March and April, not early signs of a trending growth recovery. A V-shaped recovery is highly unlikely, in our view, given the magnitude of job losses, massive aggregate demand destruction, capacity constraints in reopening and ongoing economic damage that is incapable of being reversed in the short run. Instead, we anticipate a more drawn-out gradual recovery.

While we are likely to see a much-needed swell of optimism in the summer months as people venture out to enjoy some sunshine, dine outdoors,
Central bank efforts to bolster liquidity in financial markets through extraordinary policy interventions have been effective, but they do not engineer demand, replace lost revenues or cure insolvencies; they only deepen the debt burdens.”

patronize reopened businesses and head for vacations, the realities of the economic crisis and the health crisis will remain omnipresent. Months ago there were hopes that many jobless claims in the US would prove temporary, but many temporary claims (six-months) are increasingly at risk of becoming permanent job losses as businesses close for the second time or become insolvent. Historically, it takes years for unemployment to return to pre-crisis levels—after the 2008 global financial crisis it took more than six years.

Sharply rising bankruptcies will be the next challenge policymakers will need to address. Solvency conditions will likely continue to deteriorate the longer the pandemic lasts and the longer economies take to recover. Central bank efforts to bolster liquidity in financial markets through extraordinary policy interventions have been effective, but they do not engineer demand, replace lost revenues or cure insolvencies; they only deepen the debt burdens. We have concerns that as the pandemic persists through the summer and into the fall and winter months, business insolvencies will worsen with each month of stifled economic activity.

Adding to the complexity of the crisis is the precarious state of the world that existed before the COVID-19 pandemic. Escalating geopolitical risks, rising trade tensions and political polarizations have made it highly difficult for countries to find the collective good will needed to address both domestic and international challenges. In the United States, an increasingly divided population and polarized politics have undercut the cohesion and compromise needed to solve critical issues. These types of political polarizations are occurring around the world, making it difficult to design collaborative solutions to the most profound economic crisis in the post-war era.

Additionally, the deglobalization trends that were already underway before the pandemic erupted are likely to accelerate during the ongoing crisis. As countries increasingly focus on health concerns, national security and other domestic issues, globalization is at risk of being further cast aside. Intensifying trade tensions between the United States and China are a prominent concern but are also just one example among many other decaying trade relations around the world. Structural shifts toward domestic production and regional supply chains would have major implications for the global economy and financial markets.

From an investment standpoint, we are modelling two phases to the global crisis. Financial markets currently remain in the first phase, which is characterized by a prolonged period of elevated risks and uncertainty, with the potential for additional market shocks that could last for multiple quarters. In the second phase, we expect an eventual recovery to gradually take hold, shortly preceded by periods of distorted asset prices and compelling investment opportunities.

Similar to the playbook we used heading into and eventually out of the global financial crisis in 2008/2009, we are taking a two-staged investment approach. In phase one, we are maintaining a largely defensive stance that focuses on higher allocations to safe-haven assets, lower duration exposures in select emerging markets, broad risk-reductions and optimized liquidity.

In phase two, we anticipate pursuing undervalued risk assets, with a particular focus on distressed valuations in higher duration local-currency sovereign bonds, emerging market currencies, and various credit sectors.

Overall, we remain confident that these types of phase two investment opportunities will ultimately arise, but we also recognize that the pandemic may persist for multiple quarters, potentially pushing out the timeline for when certain investment opportunities may become suitable. We expect multiple stages of relief rallies and corrections in financial markets before a sustainable recovery eventually takes hold many months from now. Until that point, we are focusing on select areas of value in the phase one environment, including a select set of emerging markets as well as developed market safe havens.

There is still profound uncertainty over the full economic ramifications of the pandemic and how long it will last. Nonetheless, we continue to glean new information and new insights amid the evolving crisis, as we monitor the global economy on a country-by-country basis to uncover the next opportunities that will arise in the post-pandemic world. We will ultimately get to the other side of this crisis.
Health uncertainty vs. economic uncertainty: The need to safely restart growth

Sonal Desai, Ph.D.
Chief Investment Officer, Franklin Templeton Fixed Income

Economic recovery: A letters’ game

Various prognosticators have attempted to predict the type of recovery we may see—a sharp “V-shaped” rebound from the bottom, or slower “U-shaped” recovery or an “L-shaped” where we linger longer in the depths. To some extent, the type of recovery we see depends on whether one is talking about sequential growth or annualized growth in sequential terms. Right now, we are sticking with our baseline under which, on quarter-over-quarter annualized terms, we should see quite a sharp recovery. Under these terms for the third quarter, we could see a 20%–30% growth rate. That is pretty V-shaped. That said, in year-over-year terms, it will not be V-shaped as we will be at a lower level of gross domestic product (GDP). Whatever letter you use to describe it, I do think that we could see the sharpest and potentially the shortest recession in US history. It is cliché to say, but we are in unprecedented times.

To determine whether people are starting to return to normal, and how, our fixed income team put together a tracker using Google mobility data, OpenTable reservations, and Homeplace—a series of different tools to get real-time information as to how consumer behavior is changing on a biweekly basis. OpenTable reservations, the largest restaurant booking system in the United States, showed a 100% drop in most of March and April because dine-in restaurants were closed. But then very quickly, we started seeing restaurant reservations start to pick up again in May. And it’s not only happening in the United States; reservations are up on a year-over-year basis in Germany, for example. So this trend is something we plan to continue to monitor and track in real time.

In the United States, consumer confidence and retail sales have also rebounded strongly. The signs of a V-shaped initial recovery are all there. The question is whether this initial recovery can maintain its momentum—and here it will be crucial to see how different states react to the fact that as some business activity reopens and people go out after isolation, we inevitably see some pick up in the number of new infections.

I think it’s important to recognize that a lot of the people who are more willing to go back to work and go out socially are likely in younger age brackets where COVID-19 generally carries much lower risk of serious health consequences. They have weighed the risks of going out again versus staying at home and have chosen the former.

We also need to recognize that some people have far fewer options than others. Only around 35% of people can work from home, so that leaves 65% of the population that really cannot—for them staying home means not getting a paycheck. I think that is something we definitely need to consider when we look at the speed at which people are allowed to go back to work. We also need to look at what might be prudent for someone in a rural area to do might not be for someone in large metropolitan area.

The central bank response

The amount of stimulus we have seen in response to this crisis is unprecedented. Several countries were already experimenting with negative interest rates, leading many observers to wonder whether the US central bank would follow. However, our research has found that negative interest rates are not particularly stimulative. Importantly, the most negative interest rates have gone globally is 75 basis points, and if we use a standard Taylor Rule, we would need rates to be –16% in the United States. I think the Federal Reserve will likely pursue other policy measures before it actually considers moving to negative rates—yield curve control seems the most likely candidate, but I also think the Fed will first want to gauge the impact of the massive measures already in the pipeline as well as the strength of the recovery.

Outside the United States, I think the European Central Bank (ECB) has clearly stepped up its response, making up in spades for some initial missteps when COVID-19 first began to spread to Europe; and eurozone policymakers have made important progress towards a greater degree of mutual fiscal support, with a first limited form of debt mutualization. While the outlook for countries like Italy and Spain is poor because the lockdowns had a severe economic impact there, the strong
stimulus will help the eurozone as a whole, and should alleviate the problem that the countries which were most negatively impacted by the coronavirus also have the least fiscal bandwidth to combat it.

The question is whether all this stimulus will cause inflation to pick up down the road. Over the next couple of quarters, I am not overly concerned about inflation. After that, I think all bets are off. This is not a prolonged depression where we would typically see deflation. We are seeing a trend of reshoring of production—bringing manufacturing back to one’s home country—particularly production of goods related to the health care and technology sectors. The reason companies outsource in the first place is to reduce costs. When they bring it back home, costs will rise and we may have an inflationary impact down the line. On top of that, we are going to come out of this crisis period with a massive monetary overhang, massively easy fiscal policy, some reduction to potential supply because of weak investment, and more stringent protectionist barriers. As such, it is very hard for me to see a scenario where we do not see some pickup in inflation. For that reason, I think Treasury Inflation-Protected Securities could offer good value over the medium term.

US political uncertainty
The United States is currently going through a period of what I would call intense soul-searching, long overdue and much needed. Unfortunately, times like this also lead to what I would call political opportunism. We are certainly seeing that on every side. Looking through the recent, quite tragic events in the United States, and going forward into the latter half of the year, we need to recognize that the US elections are still four months away. While the polls seem to be showing the Democrats are out in front, a lot can change. Let us remember that the economy was roaring five months ago.

Even without a full Democratic or Republican sweep in November, it is hard to overstate the level of uncertainty in regard to what the likely path of policy will be. Over the next several months, we will get greater detail on what the policy platform of the Democratic presidential and vice-presidential candidate will be, which should help shape our outlook on different sectors. On the Republican side, in the case of a sweep, the outlook is more known. And if it’s not a sweep—if we have a president who is of a different party than the Congressional majority—any incoming administration will find it hard to dramatically change policies. So, putting it into perspective, over the next few months we will have much greater detail on what the policy platforms will be and as the polls become clearer, we will have views as to how the market impact will play out.

Looking into next year, without a doubt, geopolitics will be in focus. Relations with China are going to become a much larger focus, not just for the United States, but also for the euro area—there is a lot of unhappiness with how China has managed its global role in this pandemic crisis.

Looking into next year, without a doubt, geopolitics will be in focus. Relations with China are going to become a much larger focus, not just for the United States, but also for the euro area—there is a lot of unhappiness with how China has managed its global role in this pandemic crisis.

Time to be active
Overall, we believe it is a time to be active as investors. There is not a single asset that is unilaterally a buy right now, in our view. More than ever, selectivity by country, by sector, by asset class, and within asset classes by industry and individual companies is required. The importance of thoughtful, skilled bottom-up research cannot be emphasized enough in the current environment.

Looking across credit sectors, we believe high yield has probably gone too far, too fast. Most risk assets have accelerated on the back of both the expectation and execution of the massive monetary easing, but also increasingly an expectation that the
economic recovery will validate the asset-price moves. While I am perhaps more optimistic than some in terms of the recovery, I think it would be a wrong to assume that the recovery will be swift. Therefore, I view the recent recovery in risk assets—including high yield—with some caution. We continue to prefer the investment-grade space, but some sectors will be impacted for a longer period of time; for example, those related to business travel, hospitality and leisure.

In sum, the risks to the economic outlook are very real. Our baseline outlook assumes sensible reactions as we are looking at data-driven conclusions as opposed to just knee-jerk reactions.

The accelerating changes in a COVID-19 world

Stephen Dover, CFA
Head of Equities

The COVID-19 pandemic seems to have accelerated changes that might have otherwise taken a decade or more. Examples of rapid industry shifts include: work from anywhere, remote sports and entertainment, greater reliance on restaurant take-out and delivery services, increasing industry consolidations, supply chains returning domestically, bankruptcies of many small—especially retail—businesses, and the move of urban digital-era hubs to lower-cost areas. In contrast, some businesses we thought would change have not. For example, ride sharing hasn’t increased—it has actually slowed dramatically.

There is a disconnect between the stock markets and Main Street. Stock prices remain elevated despite economic data indicating deep economic harm. The fiscal, monetary, and political responses to the crisis globally have led to a world awash with liquidity and short-term fiscal stimulation. Much of that liquidity has gone into the stock markets, explaining a great deal of the markets’ ascent.

The key question looking ahead is whether the stock markets will continue to climb based on monetary and fiscal responses or whether something could make equity markets unwind.

Typically, bear markets happen when there is monetary tightening—I think that is unlikely to happen. This time around, the negative catalyst could be economic disappointments relative to expectations for a sharp, “V-shaped” recovery. I continue to believe that stock market and economic fundamentals will not remain disconnected forever.

There are several factors that are currently affecting the markets outlined below:

**Historic unrest around racial injustice and the upcoming US elections**

I am very heartened to see how many companies have spoken out about racial injustice and societies’ needs. When social unrest is unaddressed, it can affect the overall economy. Increased diversity and greater fairness are good from an economic and societal perspective. Companies will be impacted more than ever by their engagement in societal issues. Many, if not most public companies, are moving toward a wider stakeholders’ model of stewardship of their firms. In my view, environmental, social and governance (ESG)-focused investing will become increasingly mainstream, and many investors will screen for companies that take these matters seriously.

The US presidential candidates present two of the most different political approaches in recent memory, with policy differences on how to address the recovery from COVID-19; the tax system; the role of government in health care; immigration and the workforce; whether and how to address climate change; and whether to take a unilateral or multilateral approach to foreign policy.

The US Congress outcome is as important as who wins the US presidency, and the market may experience additional volatility as we approach the election. The markets have not yet priced in the potential for large increases in personal capital gains taxes, corporate tax increases, and additional business and environmental regulations if the Democratic party wins the US presidency as well as the majority in the US Congress. There would also likely be increased attention to companies and sectors that will benefit from a Democratic party sweep.

**COVID-19 infections continue**

Much of the recent stock market volatility can be attributed to changes in the outlook for COVID-19 infections. In my view, equity markets’ resilience in the face of rising disease uncertainty demonstrates that investors may be
primarily concerned with reserve bank actions and governments’ fiscal stimuli globally, largely ignoring economic fundamentals and the high degree of uncertainty surrounding the pandemic’s path. News around the infection rate, potential vaccines, and better medications to heal the sick will likely continue to roil the markets.

Growing tension between the United States and China
Relations between the United States and China have deteriorated significantly in recent months into several disputes including the origins of the COVID-19 pandemic, Hong Kong’s independence, trade, Huawei, the South China Sea, and other issues. The bipartisan, “anti-China” rhetoric is likely to increase into the US elections—and global trade is likely to suffer.

One of the biggest economic trends may be the relocation of supply chains to be closer to developed countries because of trade tensions, sovereignty issues, and lower cost differentials. I believe there will be a big move back to the United States, particularly the Midwest region of the United States. The employment cost-differential of manufacturing in China vs. the United States has dropped dramatically as the cost of employment in China has risen. More importantly, automation, robotics, lower energy costs, and higher productivity in the United States make a case for industries to return to the United States.

The US economy is about 70% dependent on the consumer, and we may go back a little bit more to 1960s–1970s levels where industrial spending (CapEx) was a greater part of the economy. This would make the US economy much more balanced.

China will likely still grow its gross domestic product at a sustained, slower rate more focused on consumers’ increasing incomes. I’m still bullish on China—I think it’s going to develop differently, with a much more consumer-driven, high-technology economy.

The concentration of a few winners in the equity markets
Performance disparities have been extreme as investors try and pick a few winners. Just six “FAAANM” stocks—Facebook, Apple, Alphabet, Amazon, Netflix, and Microsoft—have appreciated 263.82% over the past five years versus the rest of the US equity market (S&P 500 Index without the FAAANMs) appreciating only 35.68%. The FAAANM stocks account for about one-third of the S&P 500 Index’s return over the past five years. (See chart above)

The US markets have generally outperformed overseas markets. However, if you exclude the FAAANM stocks from US indexes, the US equity markets have performed about in line with overseas’ markets, and any difference is from currency moves.

Index returns offer more evidence of divergence—the relative performance of the NASDAQ Index is 12.81% year-to-date, compared with the S&P 500 Index which returned –3.08% through June 30, 2020. The NASDAQ is about 80% weighted in technology, consumer services, and health care sectors, which are the best-performing sectors, while the S&P 500 is only weighted about 53% in the same sectors.

Look for opportunity globally
Just ten years ago, the US constituted about 40% of the market capitalization of the world. Now it’s approaching 60% which I believe on a relative basis, makes the argument to invest outside of the United States. In addition to China, I am positive on some emerging market countries and Europe, which seems to be ahead of the curve on coming out of the pandemic.

Globally, while low interest rates, fiscal stimuli, and easily available financing have helped keep alive some weak companies, debt is not a substitute for lost revenues and profits. I think companies that have the following characteristics will do well over time: clear business strategies, economic moats, workforce diversity, attention to ESG, returns above the cost of capital, strong balance sheets, positive cash flow, and skills leveraging technology.
Emerging markets: Opportunities and the road ahead

Manraj Sekhon, CFA
Chief Investment Officer, Franklin Templeton Emerging Markets Equity

With the spread of COVID-19 having slowed in recent months, the focus of policymakers and markets has started to shift from the immediate needs of the health crisis towards the economy. Across both developed and emerging markets we are seeing containment, albeit with uneven progress, and economies globally are starting to reopen.

Consensus suggests that a potential vaccine is at least 12 to 18 months away—and in the interim countries will need to start operating effectively again, whether from a health, social or governance perspective. The long-term—and far-reaching—economic consequences of lockdowns will also become clearer and need to be managed.

There is no clear template that any country can follow in dealing with this crisis, but several factors have been shown to successfully drive containment. Decisive policymaking paired with effective execution have been crucial, alongside social cohesion and economic resilience.

As we look to 2021 and beyond, we think these attributes will help countries get through the immediate crisis, while those economies and companies with sustainable comparative advantages will weather what is likely to be an extended period of weaker economic performance.

A stronger case for emerging markets

The crisis has highlighted the strengths of emerging markets, whether in terms of their social, governance and health care systems, or the fiscal and corporate reforms they have undertaken over the last two decades. Robust balance sheets across emerging markets have proven to be a source of resilience, and we believe that will continue.

Before the full scale of the crisis became clear, the expectation was for China to deliver some of the largest fiscal and monetary stimulus among major economies. However, the developed world has turned out to be the biggest deployer of stimulus—far exceeding what we saw in the global financial crisis—and how this will eventually be repaid has yet to be determined.

Stimulus in emerging markets has been more measured, in part due to lesser means in certain countries, while others have left room for further action. Policy support has been fairly limited in East Asian markets that have deftly handled the pandemic, such as South Korea and Taiwan, while China has ample ammunition for further spending, to be targeted across both old and new economy infrastructure.

The future brought forward

Secular trends driving opportunities in emerging markets have accelerated because of the crisis. In effect, the future has been brought forward. That boosts our optimism in economies and companies that benefit from this evolution of the asset class.

We have been focused on three new realities in emerging markets. One is their increased institutional resilience. Corporates across many emerging markets entered the crisis with stronger balance sheets compared to developed countries—net cash levels once considered inefficient have proven to be prudent. Countries such as Brazil, India, China and South Korea have benefited from institutional reforms in years past, entering this crisis with stronger foundations and greater fiscal flexibility relative to history and Western peers—which also bodes well for recovery.

Second, the nature of emerging markets economies has changed. We have seen a transformation in the last decade away from cyclical sectors and dependence on foreign demand, towards domestic consumption and technology. The contribution of trade to the Chinese economy has halved from its peak, ensuring that China is no longer beholden to a recovery in Western economies.

The third reality centers on innovation, and the notion of emerging markets “leapfrogging” the developed world in terms of infrastructure and business models. We have seen this unfold in areas such as mobile telecoms, broadband, e-commerce, and e-payments—and more recently in new areas such as education and health care amid lockdowns. Such business models are highly suited to the structures of emerging markets, and benefit from the availability of superior data coverage at substantially lower cost in countries including China and India.

New business models have also impacted Western popular culture. For example, TikTok, a video-streaming
platform owned by China-based private company ByteDance, has helped galvanize discussion of social issues in the United States and other parts of the world. Run by an American chief executive officer, growth in TikTok’s already strong viewership has drastically accelerated this year. A range of emerging market companies that originally targeted domestic needs are finding acceptance and renewed traction in the developed world.

Multi-year opportunities
South Korea embodies much of these new emerging market realities. Its economy has undergone significant restructuring, and its fiscal position and corporate balance sheets are healthier than before. The country is also highly plugged into the “new economy,” with world class companies across hardware (particularly semiconductors and batteries) and the internet space. In a post-pandemic world, big data, remote working, cloud computing and various other areas will drive increased demand for semiconductors.

India’s pharmaceutical industry is another world leader. While India’s primary health care ranks poorly, the pharmaceutical sector nonetheless possesses strong intellectual capital and enormous scale, with the result that Indian companies form the backbone of global vaccine production. Large US and European companies developing COVID-19 vaccines are receiving—and need—manufacturing support from Indian companies in order to produce at the required volumes in the future. While current headlines may focus on India’s management of the pandemic, this risks obscuring the progress in other areas, as is often the case in the emerging world. Emerging markets have underlying strengths that are not always well-known, and therein lies the opportunity for investors.

US-China relations: Pragmatism will prevail
The nature of US-China relations has changed, at both the political and economic levels. Washington’s view of China as a rival superpower has brought about a different policy stance: the current administration is taking a sharper approach than before, which is likely to persist.

The US presidential election also has a huge effect on the country’s rhetoric: the US government has expressed its displeasure with China on various occasions in recent weeks, but limited policy action has followed. Clearly, the United States wants to project a tough stance on China but it also needs to continue a highly mutually beneficial economic relationship; the interconnectedness of companies and consumers globally means that neither country can afford to cut the other off.

Rhetoric will likely remain heated as the election approaches but once passed, and as a US economic recovery becomes clearer, the tone should improve. US companies that target China’s domestic market or manufacture in the country will find it difficult to secure other credible and sustainable sources of demand or supply, which will point to a more pragmatic outcome in US-China relations, albeit with a more hostile overtone.

Geopolitical risks are par for the course for emerging market investors. While we continually factor these considerations into our investment decisions, of far greater importance are company fundamentals and earnings sustainability, as well as the irrefutable combination of demographics and long-term growth potential.

Environmental, social and governance (ESG): More critical than ever
Company engagement is a crucial part of emerging market investing. Bringing about better corporate behavior and a better understanding of companies’ responsibilities toward all stakeholders are efforts we continue to push in our stewardship of client capital.

The tone of engagement in emerging markets has shifted: companies that formerly took a narrow, hard-nosed approach to returns are adopting more accommodative measures. In countries such as South Korea, South Africa and Brazil, companies are placing more emphasis on ESG issues. We have seen leading companies in South Korea publicly apologize for governance
missteps and manage their balance sheets more effectively through returning capital to shareholders. ESG reporting has become mandatory in some countries, a trend we expect to continue elsewhere.

The ESG conversation is changing further amid the pandemic, with a greater focus on the social impact of policies. Many governments are supporting jobs, while companies are more cognizant of the reputational risks of layoffs. ESG has become more important, with companies considering it critical to sustainable business performance. In our view, this “delta” of improving ESG in emerging markets is a further tailwind supporting the secular outlook for the asset class as the world emerges from this crisis.

Endnotes
1. Proposed by Economist John Taylor, Taylor’s rule outlines how central banks might alter interest rates in response to changes in economic conditions to stabilize an economy in the short term while still maintaining long-term growth.
2. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.
3. Morningstar.com
4. As of July 2, 2020, technology is 49.42%, consumer services is 20.13%, and health care is 10.47%, Nasdaq.
5. As of July 2, 2020, information technology is 27.5%, consumer discretionary is 10.8%, and health care is 14.6%, S&P 500 Indices.

WHAT ARE THE RISKS?
All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest rate movements may affect the share price and yield. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Diversification does not guarantee profits or protect against risk of loss.

The companies and/or case studies shown herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton. Past performance does not guarantee future results.
IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. All investments involve risks, including possible loss of principal.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton (“FT”) has not independently verified, validated or audited such data. FT accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FT affiliates and/or their distributors as local laws and regulation permits. Please consult your own financial professional or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com—Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton U.S. registered products, which are not FDIC insured; may lose value; and are not bank guaranteed and are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

Australia: Issued by Franklin Templeton Investments Australia Limited (ABN 87 006 972 247) (Australian Financial Services License Holder No. 225328), Level 19, 101 Collins Street, Melbourne, Victoria, 3000 / Austria/Germany: Issued by Franklin Templeton Investment Services GmbH, Frankfurt, Mainzer Landstr. 16, 60325 Frankfurt/Main, Tel 08 00/0 73 80 01 (Germany), 08 00/0 59 11 (Australia), Fax +49(0)69/72 23 120, info@franklintempleton.de, info@franklintempleton.at / Canada: Issued by Franklin Templeton Investments Corp., 200 King Street West, Suite 1500 Toronto, ON, M5H3J4, Fax (416) 364-1163, (800) 387-0830, www.franklintempleton.ca / Netherlands: Franklin Templeton International Services S.à r.l., Dutch Branch, World Trade Center Amsterdam, H-Toren, Se verdip 36, 1077 XV Amsterdam, Netherlands. Tel +31 (0) 20 575 2890 / United Arab Emirates: Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority, Dubai Office: Franklin Templeton, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel +971-4-4284100, Fax +971-4-4284140 / France: Issued by Franklin Templeton France S.A., 20 rue de la Paix, 75002 Paris France / Hong Kong: Issued by Franklin Templeton Investments (Asia) Limited, 17/F, Chater House, 8 Connaught Road Central, Hong Kong / Italy: Issued by Franklin Templeton International Services S.à r.l.—Italian Branch, Corso Italia, 1—Milan, 20122, Italy / Japan: Issued by Franklin Templeton Investments Japan Limited / Korea: Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Yuido-Dong, Youngdungpo-Gu, Seoul, Korea 150-968 / Luxembourg/Benelux: Issued by Franklin Templeton International Services S.à r.l.—Supervised by the Commission de Surveillance du Secteur Financier–8A, rue Albert Borschette, L-1246 Luxembourg, Tel +352-46 66 67-1, Fax +352-46 66 76 / Malaysia: Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd / Poland: Issued by Franklin Templeton Asset Management (Poland) TFI S.A., Rondo ONZ 1, 00-124 Warsaw / Romania: Issued by Bucharest branch of Franklin Templeton Investment Management Limited (“FTIML”) registered with the Romanian Financial Supervisory Authority under no. PMP01SFIIM/000005/14.09.2009, and authorized and regulated in the UK by the Financial Conduct Authority / Singapore: Issued by Templeton Asset Management Ltd. Registration no. UEN 201704401E. 7 Temasek Boulevard, #38-03 Suntec Tower One, 038997, Singapore / Spain: Issued by Franklin Templeton International Services S.à r.l.—Spanish Branch, Professional of the Financial Sector under the Supervision of CNMV, José Ortega y Gasset 29, Madrid, Spain. Tel +34 91 426 3600, Fax +34 91 577 1857 / South Africa: Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorised Financial Services Provider. Tel +27 (21) 831 7400, Fax +27 (21) 831 7422 / Switzerland: Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich / UK: Issued by Franklin Templeton Investment Management Limited (FTIML), registered office: Cannon Place, 78 Cannon Street, London EC4M 7HA, Tel +44 (0)20 7073 8500, Authorized and regulated in the United Kingdom by the Financial Conduct Authority / Nordic regions: Issued by Franklin Templeton International Services S.à r.l. Contact details: Franklin Templeton International Services S.à r.l., Swedish Branch, filial, Nybrokan 5, SE-111 48, Stockholm, Sweden. Tel +46 (0) 545 012 30, nordicinfo@franklintempleton.com, authorised in the Luxembourg by the Commission de Surveillance du Secteur Financier to conduct certain financial activities in Denmark, in Sweden, in Norway and in Finland. Franklin Templeton International Services S.à r.l., Swedish Branch, filial conducts activities under supervision of Finansinspektionen in Sweden / Offshore Americas: In the U.S., this publication is made available only to financial intermediaries by Templeton/Franklin Investment Services, 100 Fountain Parkway, St. Petersburg, Florida 33716. Tel (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax (727) 269-8716. Investments are not FDIC insured; may lose value; and are not bank guaranteed. Distribution outside the U.S. may be made by Templeton Global Advisors Limited or other sub-distributors, intermediaries, dealers or professional investors that have been engaged by Templeton Global Advisors Limited to distribute shares of Franklin Templeton funds in certain jurisdictions. This is not an offer to sell or a solicitation of an offer to purchase securities in any jurisdiction where it would be illegal to do so. Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.