



FRANKLIN TEMPLETON
INVESTMENTS

Emerging Markets Overview

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MARKET VIEWS

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Overview

Emerging markets ended February virtually unchanged as investors remained concerned about Greece's high debt levels, China's tightening policies and the U.S. Federal Reserve's 0.25% increase in the short-term loan rate for banks. The MSCI Emerging Markets index returned 0.4% in US\$ terms. Latin American markets were the top performers, benefiting from higher commodity prices and strong domestic currencies. Weak economic data from the Euro zone, concerns about Greece's high deficit levels and a weak Euro led Eastern European markets to correct affect a period of outperformance in January. The Turkish market ended the month with a double-digit decline despite a credit rating upgrade by Standard & Poor's, due to recent arrests over allegations of a coup plot dating back to 2003, contagion from Greece and a weaker Lira. Asian markets recorded mixed results in February with Thailand, the Philippines and Hong Kong outperforming their regional peers. China also ended the month with positive returns despite the continuation of gradual tightening measures to curb excessive bank lending.

Regional Update

Asia

The People's Bank of China (PBOC) raised its cash reserve ratio for banks for a second time in 2010. The PBOC raised the reserve ratio for banks by 50 basis points (0.5%) to 16.5% for the country's largest banks and 14.5% for the smaller banks. The measure is aimed at curbing excessive bank lending. Consumer prices eased to 1.5% y-o-y in January after reaching a 13-month high of 1.9% y-o-y in December 2009. Imports surged in January, leading the trade surplus for the month to decline to US\$14.2 billion from US\$18.5 billion in December 2009. Imports jumped 85.5% y-o-y due to a recovery in domestic demand, greater demand for raw materials for export products and a low comparison base. Exports also continued to improve with a 21.0% y-o-y increase, compared to a growth of 17.7% y-o-y in December.

Trade and manufacturing continued to recover in South Korea. Exports jumped 33.7% y-o-y in December due to higher demand as a result of the global economic recovery. For the year, the trade surplus totaled US\$41.0 billion, the largest on record. Manufacturing output increased 18.6% y-o-y in November due, in large part, to higher capital investment. In 2009, consumer prices increased 2.8% y-o-y, less than the 4.7% y-o-y in 2008. For the three-year period, 2007-9, consumer prices rose by an average of 3.3%, within the Central Bank's target range of 2.5% to 3.5%. For the subsequent three-year period, the Bank increased its inflation target to 2% to 4%. Unemployment, however, rose to 3.7% y-o-y in 2009, compared to 3.2% y-o-y in 2008.

The Indian government unveiled its budget for fiscal year 2010-11 with a deficit of 5.5% of GDP, lower than the targeted 6.9% for the current fiscal year and 7.8% for the previous year. The government took back some of the concessions by increasing excise duties marginally, while the oil sector duty increases could result in more inflation. However, the Finance Minister made some welcome changes to keep personal taxation rates low as well as extended benefits to small enterprises. Industrial production remained robust with output increasing 16.8% y-o-y in December, its third consecutive month of double-digit growth. Foreign direct investment inflows totaled US\$38.0 billion in 2009, a decline of less than 10% from US\$41.2 billion in 2008 despite the global financial crisis. Inflows in 2009, however, remained higher than that recorded in the preceding years. The country remained an attractive investment destination due to its skilled labor force, huge consumer base and low costs.

Latin America

Private consumption in Brazil remained robust with retail sales increasing 9.1% y-o-y in December. This compared to growth of 8.6% y-o-y in November. Key drivers included strong sales of construction materials, motor vehicles and furniture. Inflation reached its highest in seven months with consumer prices increasing 4.6% y-o-y. This was mainly due to higher food and transport costs. Politically, Brazil's ruling Partido dos Trabalhadores (PT) disclosed Dilma Rousseff as its presidential candidate for the upcoming elections in October 2010. President Lula's civil chief of staff, Rousseff was widely expected to be his successor. If elected, Rousseff is expected to continue the government's current macroeconomic policies.

Africa

Growing at its fastest pace in more than a year, GDP growth in South Africa accelerated to 3.2% y-o-y in the final quarter of 2009 from 0.9% y-o-y in the third quarter. This strength is expected to continue as greater demand for commodities and a recovery in domestic demand should support the economy. A key contributor to economy growth, the manufacturing sector continued to improve with value-added output increasing 10.1% y-o-y in the fourth quarter. This compared to an increase of 7.6% y-o-y in the third quarter. While retail sales were still down when compared to a year earlier, the pace of decline, eased to 3.7% y-o-y from 6.6% y-o-y in November.

Europe

Russia's economy contracted 7.9% y-o-y in 2009, better than government forecasts for an 8.5% y-o-y decline. This followed growth of 5.6% y-o-y in 2008. The decline in GDP was the result of lower investment, consumption and oil exports. The government expects the economy to grow 3.1% y-o-y in 2010. Capital inflows turned positive in the later part of 2009 after significant outflows in the first nine months of the year. Inflows totaled US\$11.6 billion in the final quarter of 2009, compared to outflows of US\$64.0 billion in the first three quarters of 2009. Inflationary pressures continued to ease in Russia with consumer prices increasing 8.0% y-o-y in January 2010. This allowed the Central Bank to maintain an expansionary monetary policy as part of efforts to stimulate the domestic economy. The Bank cut the key benchmark interest rate by 25 basis points (0.25%) to 8.5%.

International ratings agency, Standard & Poor's raised Turkey's credit ratings in February. The country's long-term foreign and local currency sovereign credit ratings were upgraded to BB and BB+, respectively, due to Turkey's improving economic policies. Industrial output surged 25.2% y-o-y in December, after recording a 2.3% y-o-y decline in November partly due to a low base of comparison. Manufacturing output rose 28.0% y-o-y in December. This compared to an increase of 13.1% y-o-y in November. Inflationary pressures continued to increase with consumer prices reaching a one-year high of 8.2% y-o-y in January in part due to higher taxes on fuel and cigarettes. Turkish government officials met with counterparts in China and Bangladesh in February to boost bilateral trade and economic relations.

Feature of the Month: Emerging Markets Q&A

What are the pros and cons of investing directly in emerging market equities and bonds as opposed to companies based in developed markets with emerging markets operations?

By directly investing in emerging market equities you obtain full exposure to emerging markets while with investing in developed market companies with emerging market operations, you don't get that full exposure and you also get slow moving markets with lower growth potential mixed in. One advantage of some developed market companies is that they could have a global coverage thus giving the investor a more diversified coverage. Of course, there are also some emerging market companies that have that kind of coverage as well.

How probable is further tightening of monetary policy in China within the near future - and what would that step look like?

It is highly probable that there will be tightening of monetary policy in specific areas and not as a general policy. The Chinese have made it clear that they want to ensure that economic growth continues at a high pace and that means that they would want to keep liquidity and money supply at a high level with the proviso that if inflation increases then they would restrict lending and money supply to some degree. They will try their best to avoid taking any measures which would jeopardize the country's growth and therefore any tightening will be specific and targeted to inflation in certain areas.

What is your outlook for Africa?

We believe that the outlook for Africa is very good for three main reasons: (1) abundant natural resources, (2) a young population, and (3) heightened interest from rich emerging market countries. Africa has some of the world's greatest deposits of natural resources, and only a fraction of those resources have been tapped. In addition, it has a young and growing population who could improve their education and skills to become a major asset to expanded manufacturing and mining enterprises. These factors have stimulated the interest of countries like China and India, who require more natural resources for their growing economies, as well as countries like Russia and Brazil, who look to expand their enterprises into global operations. Countries around the world are showing growing interest in manufacturing within Africa for the African market, particularly emerging countries that have the capabilities to operate in challenging political and economic environments.

Africa is an interesting region. In South Africa, efforts by local companies to expand their international market share, as well as the presence of capable management teams, can assure investors of finding bargains here. Higher global demand for commodities, a recovery in domestic demand and the preparations for and hosting of the 2010 World Cup should further support economic growth this year.

In addition to South Africa, we have been taking a look at the lesser-known frontier markets in Africa, some of which are very large countries, such as Nigeria. Regional markets such as Egypt and Kenya are also beginning to look attractive, and we are seeing the growth of new markets in this region. Libya, for example, already has a stock market and is encouraging the privatization of state-owned enterprises - a development being repeated in a number of African countries.

Some commentators are saying that frontier markets represent some of the best contrarian investments at the moment – do you agree with this and why?

Yes, that is certainly the case. For example, many people would never invest in Nigeria or even might not even visit the country for fear of confronting violence but actually there are excellent investment opportunities. So there are opportunities simply because those opportunities are not attractive to other investors since they are not familiar with the possibilities.

Qatar, Kazakhstan and Nigeria are among those countries being cited as ones to watch this year – why do you think this is?

Those are some countries that are cited as being watched but we should add a number of others such as Vietnam, Romania and a number of others. Qatar, Kazakhstan and Nigeria are all being watched because of their natural resources: Qatar - gas, Kazakhstan - oil, and Nigeria - oil.

Are there any particular sectors within frontier markets that you think will perform better than others?

We employ a bottom-up, value oriented, long-term approach. As we look for investments, we focus on specific companies rather than sectors or regions. However, during our analysis, we also consider the company's position in its sector, the economic framework and the political environment.

Our focus continues to be on two key themes: consumers and commodities. With rising per capita income and strong demand for consumer goods, the earnings growth outlook for these stocks is positive. Commodity stocks also look good because we believe commodity prices will trend upwards, partly because of weakness in the U.S. dollar, and also because we expect the global demand for commodities to outgrow supply over the long term.

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