

## *Overview*

The global economic picture did not improve during the month of February 2009. Many countries, particularly those in Europe, reported rapid economic slowdowns, rising unemployment rates and problems in their banking systems. Interest rate cuts did not seem to have the desired effect and governments in the U.S. and the UK had to step in to shore up a number of large corporations to minimize systemic risk. As we would expect in this environment, stock markets declined across the board. Emerging markets were not spared even though markets like China and India continued to show signs of growth.

The MSCI Emerging Markets index declined 5.6% in US\$ terms. Part of this decline was due to weakness in emerging markets currencies as short-term and wary money continued to seek out safer havens. Stock markets in Eastern Europe were the weakest performers during the month. European banks with significant exposure to Central and European countries experienced substantial corrections as concerns about the financial state of the Baltic countries triggered worries about a collapse of Europe's banking system. Turkey underperformed its emerging market counterparts, in part due to a weaker Lira. While the South African Rand strengthened against the U.S. dollar in February, equities still underperformed during the period as lower commodity prices and weak global demand led the economy to record its first contraction in more than a decade.

Latin American markets were the top performers with Brazil and Chile outperforming their regional peers. Mexico, however, underperformed due to its dependence on the U.S. economy, its largest trading partner. In Asia, the Taiwanese market rebounded in February after recording a double-digit decline in January, while Pakistan was the top regional performer with a 16.6% return in US\$ terms. Chinese equities also outperformed their peers as strong credit growth and continued improvement in China's Purchasing Manager's Index (PMI) over the last few months signaled a possible bottoming in the country's manufacturing sector. On the other hand, the South Korean market was the worst major emerging market performer in February largely due to a weakening Won and concerns about the financial state of its banking sector.

## *Regional Update*

### **Asia**

The **Chinese** government continued to implement measures designed to support the economy. Aimed at bolstering the light industry and petrochemical sectors, a stimulus package which included tax incentives, export rebates and increased credit support, was announced in February. A series of subsidies and tax cuts was also announced to support the automobile, steel and textile industries. Credit growth accelerated in January, reaching a record high as government efforts to boost lending continued. The government's expansionary fiscal policy also led the country to record a US\$16.2 billion fiscal deficit in 2008, as expenditure surged in December as a result of the November fiscal stimulus package. China is also expected to continue to use its vast foreign exchange reserves foster growth by helping domestic companies

expand internationally and to secure the continued supply of resources. Recent investments included a US\$19.5 billion investment in Australia's Rio Tinto and a US\$1.7 billion investment to acquire Oz Minerals, the second largest zinc miner in the world. Loan agreements with Russia and Brazil were also signed in exchange for the provision of future energy supplies. During U.S. Secretary of State, Hillary Clinton's visit to China, cooperation on overcoming the financial crisis was made a priority.

In **South Korea**, the government announced plans to create a US\$13.2 billion recapitalization fund to support the banking sector. US\$8 billion will be injected into commercial banks in March to strengthen their balance sheets which have been damaged by rising bad debt provisions and deteriorating asset values. While South Korea's net external liabilities increased in the final three months of 2008, its overall debt level decreased. In a bid to improve its foreign exchange liquidity, additional currency swap arrangements totaling US\$78 billion were made with the U.S. Japan and China, while the International Monetary Fund (IMF) also offered South Korea a short term credit facility which could amount to another US\$22 billion. Moreover, with foreign exchange reserves in excess of US\$200 billion, the country is in a strong position to meet its financial obligations. The Central Bank continued to adopt a loosening monetary policy by cutting its benchmark interest rate by 50 basis points (0.5%) to 2.0%.

### Latin America

The **Mexican** economy weakened 1.6% y-o-y in the final quarter of 2008 due to declines in the manufacturing, services and trade sectors. This brought the full-year growth to 1.3% y-o-y. The Central Bank lowered its key interest rate by 25 basis points (0.25%) to 7.5% in view of slowing growth in the U.S. economy, Mexico's main trading partner, and to ease inflationary pressures. The Bank expects GDP to decline between 0.8% and 1.8% in 2009. Weak U.S. demand for Mexican products led exports to fall 31.5% y-o-y in January. The trade deficit, however, narrowed to US\$1.6 billion in January, from US\$1.8 billion, due to a 30% y-o-y decline in imports. Consumer prices eased to 6.3% y-o-y, from 6.5% in December, mainly due to a decline in food and energy prices.

The **Brazilian** government announced fiscal stimulus measures which included a 12% increase in minimum wages and policies aimed at tackling poverty. These measures could support domestic demand going forward. Retail sales growth, however, slowed to 3.9% y-o-y in December from 5.1% y-o-y in November, as tighter credit conditions led consumers to defer purchases of items such as motor vehicles. Lower commodity prices and weak external demand led Brazil to record a trade deficit of US\$500 million, its first monthly trade deficit since March 2001. Exports declined 22% y-o-y to US\$9.7 billion while imports contracted 12.6% y-o-y to US\$10.3 billion. Brazil secured financing from China to support the country's efforts to develop recently discovered offshore oil and gas reserves. Brazil will receive loans totaling up to US\$10 billion, in exchange for the provision long-term oil supplies to China.

### Africa

GDP growth in **South Africa** shrank by an annualized 1.8% q-o-q in the final three months of 2008, its first contraction in more than a decade. This was mainly due to a 21.8% q-o-q decline in the manufacturing sector. This compared to a GDP growth of 0.2% q-o-q in the third quarter. Lower commodity prices and slowing demand for raw materials could further affect economic growth. GDP growth for the year was 3.2% y-o-y, a five-year low. Finance Minister Trevor Manuel lowered his 2009 GDP growth forecast to 1.2% from 3.0%. A 787 billion Rand (about US\$80 billion) fiscal stimulus package, which entailed plans to increase government spending on infrastructure, education and health in the next three years, was also announced. This would lead to a budget deficit of 1% in the fiscal year 2008-9 and 3.9% in 2009-10. The Central Bank also cut its benchmark interest rate by 100 basis points (1.0%) to 10.5% to stimulate the domestic economy.

### Europe

The **Russian** economy grew 5.6% y-o-y in 2008, according to preliminary government estimates compared to GDP growth of 8.1% y-o-y in 2007. Continuing efforts to strengthen the banking sector, the government announced plans to inject up to 1,000 billion Roubles (US\$28 billion) to recapitalize state banks. International rating agency, Fitch Ratings downgraded the country's sovereign rating to BBB. Key reasons provided for the downgrade were the decline in foreign reserves and lower commodity prices. The reduction in reserves has been mainly due to efforts to limit excessive fluctuations in the local currency, the Ruble. Foreign exchange reserves remained a respectable US\$387 billion at the end of January. The Central Bank adopted a tightening monetary policy in February in an effort to ease downward pressure on the Rouble. The Bank raised its key lending interest rate by 100 basis points (1.0%) to 10.0%. Russia and China signed an agreement to loan US\$25 billion to Russia to support construction plans for an oil pipeline from Eastern Siberia to China and the Asia Pacific region, in exchange for the provision oil supplies for 20 years to China.

In view of the difficult economic conditions and tight credit conditions, the Central Bank of **Turkey** maintained a loose monetary policy. The benchmark borrowing interest rate was cut by 150 basis points (1.5%) to 11.5%, a historically low, in February. The Bank has reduced the rate by a total of 525 basis points (5.25%) in the last four months. Measures to improve the foreign exchange liquidity in the banking sector were also announced. Consumer prices eased to a 10-month low of 9.5% y-o-y in January as a fall in commodity prices and weaker domestic demand eased inflationary pressures. Unemployment increased to 12.3% y-o-y in November, from 10.9% y-o-y in October. Industrial production contracted 17.6% y-o-y in December due to weakening export and domestic demand for Turkish products. This compared to a 13.2% y-o-y decline in November.

***Feature of the Month: Mark Mobius, Executive Chairman, Templeton Asset Management Ltd., Shares his Views on China***

On February 4th, China and Chinese all over the world celebrated the entry into the Year of the Ox. We would prefer to call it the Year of the Bull because we believe that 2009 will be the year that the emerging stock markets should witness a substantial recovery and China should lead the way to that recovery. The investment prospects and long-term outlook for China is excellent for a number of reasons: (1) the Chinese leadership is intelligent, resourceful and enlightened with an interest in maintaining growth with a better standard of living for all Chinese, (2) that leadership has the organizational skills and policies capable of ensuring that China continues to achieve the highest GDP growth of any major country in the world, (3) China has the financial resources to undertake this gargantuan task with the world's largest store of foreign reserves and (4) China has one of the healthiest banking systems in the world and most individuals have little borrowings.

Undoubtedly, China will not be able to achieve the double digit growth of 2008 but they can certainly achieve high single-digit growth. In order to maintain growth, the government is undertaking a number of massive stimulation programs targeted at the domestic market, which is designed to replace export-led growth by the domestic market-led growth. The key driver therefore will be domestic consumption. The government is also taking measures to boost consumer spending by tax cuts and consumption coupons. Therefore, any sector related to domestic consumption will be favorable. China's economic growth is expected to be driven predominantly by fiscal stimulus and monetary easing.

Since 15 September, 2008, the People's Bank of China has cut lending interest rates by 216 basis points (2.16%) with additional cuts expected. In order to stimulate bank lending, the reserve requirement ratio for banks were lowered four times and loan quotas, which were in 2008 designed to restrain banks from lending, will probably be unofficially abandoned.

Inflation eased to its lowest level in more than two year with consumer prices increasing 1.0% y-o-y in January. With strong declines in inflation, policy makers in china have become more confident and have been cutting interest rates aggressively. One of the constraints to inflation has been the crunch in trade financing which became a global problem but as a result of new support from Beijing this problem seems to have eased.

The Chinese currency, the Renminbi, is currently undervalued on a price parity basis. There is thus pressure for it to strengthen against the US\$. However, the Chinese are concerned of further erosion of export businesses and thus are proceeding cautiously regarding any further appreciation. Structurally, this would be a good opportunity for China to introduce further reforms on the opening of its capital account and currency convertibility. With the Renminbi taking a bigger role in the international market, it could become another reserve currency after the US\$ and Euro.

In November 2008, the government announced a stimulus package and should be able to spend up to RMB4 trillion (or US\$586 billion) in new investment programs. The package is scheduled to be spent before the end of 2010 in ten key areas, including transport infrastructure, rural electricity and gas facilities, low-rent housing, agricultural subsidies and minimum income support. There are also other supplementary programs geared towards promoting incomes and consumption. Funding is certainly not a problem for the Chinese government as the government is in fiscal surplus and has the largest fiscal reserves, currently at US\$1.95 trillion, in the world. Moreover, given the high savings rate and low loan to deposit ratio with the banking system, there is ample room for the government to raise debt.

There are now signs of recovery in the China economy with the government's infrastructure projects beginning to have an impact and as the Purchasing Managers new orders index rebounds. The December PMI rebounded to 41.2, 2.4 percentage points higher than the previous month, which represents the first meaningful rebound since March 2008.

The current 2009 GDP growth forecast for China is 7.4%. The fiscal stimulus and interest rate cuts are expected to have a continuous positive impact. Of particular interest is the rise in orders for infrastructure-related material and machinery orders. This reflects the effects of the government's fiscal stimulus measures. There are signs that the slowdown in

China's industrial production growth is showing signs of recovery with new orders, input prices and even new export orders recovering from their lows. Moreover, stocks of major inputs and finished goods are stabilizing.

There are, of course, risks in Chinese investing. Currently unemployment is on the rise and labor activism is increasing. Therefore, there are risks of disruptions which could impact stock prices. Employment has dropped to a record low of indicating stress in the job market. While the official unemployment rate was just 4%, it is believed the actual number could be as high as 10%, with most unemployed being migrant workers in the coastal areas and new college graduates. Compared to last down cycle, the government now has greater fiscal strength to handle the situation. Farm ownership reform and wider social security coverage shall help ease impact on social stability.

The benefits, however, far outweigh the risks of investing in China and as the fastest growing major country in the world with the largest population; clearly China must be an investment destination for any intelligent investor.

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