



FRANKLIN TEMPLETON
INVESTMENTS

Emerging Markets Overview

JULY 2009

By Dr. Mark Mobius, Executive Chairman, Templeton Asset Management Ltd.

Overview

After a breather in June, emerging markets continued on an upward trend in July. The MSCI Emerging Markets index returned 11.3% in US\$ terms. This brought the year-to-July return to 51.6%. Strong portfolio inflows and higher confidence in emerging market equities drove prices. Asian markets were the strongest performers during the month as the region continued to attract significant fund inflows. Indonesia, South Korea, Singapore, and the Philippines were among the top performing markets in the region. In Latin America, high commodity prices and stronger domestic currencies supported the region's uptrend. Eastern European markets also recorded double-digit gains with Poland, Hungary and the Czech Republic outperforming their regional peers. South Africa, however, underperformed its emerging market peers with a 5.1% return in July.

Regional Update

Asia

GDP growth in **China** accelerated to 7.9% y-o-y in the second quarter of 2009 from 6.1% y-o-y in the first three months of the year. Fiscal stimulus measures and an expansionary credit policy supported the economy. This brought the growth for the first half of 2009 to 7.1% y-o-y. Key drivers included investment in fixed assets and infrastructure as well as consumer expenditure. Foreign exchange reserves increased 17.8% y-o-y to US\$2.1 trillion in June, making China the first country to exceed the US\$2 trillion mark. Consumer prices remained on a downward trend with prices declining 1.7% in June. This compared to a 1.4% contraction in May. In June, a Chinese trade and investment promotion mission visited Europe where a number of agreements were signed with Italy, Finland, Portugal and Sweden. This was the country's fourth such mission this year as China continued to look to expand trade and economic cooperation with European economies.

South Korea reported encouraging economic data in July. The economy grew 2.3% q-o-q, accelerating from the 0.1% q-o-q growth in the preceding quarter as government efforts to stimulate growth continued to produce results. Growth in private consumption, gross fixed capital formation and manufacturing output drove economic growth during the period. Moreover, inflationary pressures continued to ease with consumer prices increasing 2.7% y-o-y in May, the lowest increase in more than a year. Foreign exchange reserves reported a record monthly increase of US\$14.3 billion to US\$226.8 billion in May, an increase of 7.0% m-o-m. Aimed at boosting bilateral relations, President Lee Myung-Bak visited Poland and Sweden in July. Politically, the ruling Grand National Party announced plans to push for a parliamentary vote which could lead to amendments in media and labor regulations.

MARKET VIEWS

Latin America

In **Mexico**, the Central Bank implemented its final interest rate cut in July, marking the end of the current expansionary monetary cycle, as it balanced efforts to curb inflationary pressures and revive economic growth. The Bank cut the benchmark interest rate by 25 basis points (0.5%) to 4.5%, bringing the total reduction for the first seven months of the year to 375 basis points (3.75%). The Bank also expects the economy to strengthen in the second half of 2009. While inflation eased to 6.0% y-o-y in May, from 6.2% in April, prices remained higher than the Bank's 2%-4% target. Politically, the ruling Partido Acción Nacional (PAN) experienced the worst defeat in its party's history in the July legislative elections. PAN won 28.0% of the votes, losing to the opposition Partido Revolucionario Institucional (PRI), which won 36.7% of the votes. PRI's alliance with the Green Party (PVEM) gives them a majority in the Lower House.

The Central Bank of **Brazil** signaled an end to monetary easing in July as the economy began to show signs of recovery. The Bank cut its key interest rate by 50 basis points (0.5%) to a record low of 8.75%. Since January, the interest rate has been cut by 500 basis points (5.0%). Inflation fell to 4.8% y-o-y in June, its lowest level since November 2007, mainly due to a weak domestic economy and relative lower commodity prices. In an effort to accelerate recovery in the domestic economy, the government extended tax breaks and stimulus measures. Initiatives included tax cuts on 70 products as well as subsidized loans to support the ailing capital goods sector.

Africa

International ratings agency, Moody's, upgraded **South Africa's** foreign currency credit rating by one level to A3 from Baa1, in view of the country's resilience to the global financial crisis. This will lower the cost of servicing the country's foreign debt. Its local currency rating was, however, reduced by one level to A3 from A2. Improving investor appetite for emerging markets saw portfolio and foreign direct investment flows into South Africa turn positive in 2009. Portfolio inflows totaled US\$2.2 billion in the first five months of 2009 while FDI inflows reached US\$1.3 billion in the first quarter. Foreign exchange reserves also increased to US\$30.4 billion as of end-March 2009.

Europe

Economic data released during the month signaled a possible bottoming in **Russia's** economic decline. After three consecutive months of decline, industrial production grew 4.5% m-o-m in July. This reduced the y-o-y decline to 12.1% y-o-y from 17.1% y-o-y in June. Moreover, manufacturing output contracted 16.0% y-o-y, an improvement from the 23.7% y-o-y decline in June. The Central Bank maintained an expansionary monetary policy by cutting its benchmark interest rate by 50 basis points (0.5%) to 11% due to easing inflationary pressures and efforts to support the economy. Consumer prices rose 11.9% y-o-y in June, an 18-month low. U.S. President Barack Obama met his counterpart in Russia, where both sides signed an agreement on nuclear arms reduction. Meanwhile, Foreign Minister Sergei Lavrov visited Vietnam where both countries vowed to boost trade and increase cooperation in the energy, telecommunications and technology sectors.

The **Turkish** Central Bank maintained an expansionary monetary policy in July as domestic investment and external demand remained weak. The Bank cut its benchmark borrowing interest rate by 50 basis points (0.5%) to 8.25%. Inflation remained relatively low at 5.7% y-o-y in June. Turkey and Chile signed a free trade agreement in July to boost bilateral trade and economic. Trade between the two countries is expected to double as a result of the accord. State Minister and Deputy Prime Minister Ali Babacan said that the government was in the process of finalizing a medium-term economic program which would include national strategy for 2010-2012.

Feature of the Month: Q&A on Emerging Markets with Mark Mobius

Is the recent rally in emerging market equities sustainable?

Although we are optimistic about the markets' upside potential, it is important to realize that volatility is still with us and will be with us for a while. This means that there will be down markets as well as up markets. We therefore must pay attention to valuations and long-term earnings growth prospects in order to avoid buying or holding expensive stocks as a result of dramatic price rises that we have seen. Current valuations are below the five-year high valuations and thus are not excessive.

Emerging market equity funds resumed net inflows, recording a record \$26.5 billion of investment in the 2nd quarter. Do you think emerging markets will continue to attract inflows?

In general, we expect inflows to continue, however, there could also be some volatility. We cannot expect to see net inflows every month or every week, but in general the trend should be positive. In the first seven months of 2009, net inflows (using weekly data from www.emergingportfolio.com) totaled US\$34.5 billion. This is more than 85% of the approximate US\$40 billion in outflows in 2008.

What are the reasons?

A return of confidence in emerging markets, the desire for higher returns, an increase in investor risk appetite, the search for undervalued companies and most importantly, attractive valuations in emerging market companies drove the inflows.

Within the emerging markets universe, where do you see the most attractive opportunities at this juncture?

Since it's usually possible to find at least a few bargains in most markets, all emerging market regions are looking exciting. Currently, our largest exposures are to Brazil, Russia, China, India and South Africa. In terms of sectors, commodity stocks also look good because some of them have declined significantly below their intrinsic worth and we expect the global demand for commodities to continue its long-term growth. Consumer stocks are also favored. With rising per capita income and strong demand for consumer and other goods, the earnings growth outlook for these stocks is positive.

The World Bank recently said that reduced capital inflows from exports, remittances and foreign direct investment means "increasingly grave economic prospects" for developing nations. Do you share the view and is it something to worry about?

The World Bank is normally "behind the curve" when it comes to economic projections. Economists tend to look through the rear view mirror and not ahead. While reduced capital inflows from exports, remittances and foreign direct investment could have a negative impact on emerging markets, we can expect to see increased inflows resulting from consumer and infrastructure spending growth compensate for this. This could allow markets to record positive economic growth. This is especially the case in markets such as China and India.

Are you still optimistic about Asia ex-Japan? Which markets are you most positive about?

Yes, Asia is the largest emerging market region in the world. Asian countries are also growing relatively fast. They include countries like China and India with very large populations whose per capita income is growing, and capital markets in those countries are undergoing rapid development. Economic growth remains relatively high, per capita incomes have been rising, valuations remain attractive and reforms continue, thus improving the region's business and investment environment. Our largest exposures are to China, India, South Korea and Thailand.

What are your views on the BRICs bloc? Is it a good investment proposition?

Yes, we remain optimistic about the long-term future of the BRIC markets. The BRIC countries are among the fastest growing economies in the world. Moreover, foreign exchange reserves in all four countries remain high. The four markets together account for more than 40% of the world population. Domestic demand growth also remains robust. China and India continue to register significant positive GDP growth rates in spite of the global slowdown. China continues to take great strides towards becoming a major global player. The Chinese economy is expected to grow about 8% in 2009 and its foreign reserves have surpassed US\$2 trillion. Moreover, Brazil and Russia are resource rich countries and although commodity prices have declined from their peak, the longer trend for commodity prices is up and these countries will benefit from global demand for oil, steel, aluminum, pulp, and other commodities.

Commodity prices have rebounded strongly and this has augured well for emerging markets. What are your views on commodities going forward?

The outlook for commodities remains positive. Strong demand from emerging markets coupled a more inelastic supply could lead to higher prices in the future. In general, we expect commodity prices to maintain a long-term uptrend. However, this will not be without corrections along the way. A number of emerging markets are major suppliers of various commodities as well as big consumers. For example, Brazil is one of the world's largest suppliers of iron ore, Russia is the largest supplier of natural gas, and so forth. Also, since emerging markets have the most people in the world the potential demand for commodities in those countries is also great. It is no surprise therefore that interest in such commodities is important.

in Securities (CIS) are generally medium to long term investments. The value of participatory interests may go down as well as up and past performance is not necessarily a guide to the future. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. CIS are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from Franklin Templeton Investment Funds ("FTIF"). Commission and incentives may be paid and if so, would be included in the overall costs. FTIF are priced on a forward basis and prices are calculated daily. A prospectus is available on request from FTIF. FTIF is regulated in Luxembourg and the FTIF sub-funds available for public sale in South Africa are approved by the Financial Services Board. FTIF is a member of the Association for Savings and Investments of South Africa (ASISA).