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Overview

Emerging markets surged in the third quarter of 2009. The MSCI Emerging Markets index rose 21% in US\$ terms during the period. This brought the year-to-date return to 65% in US\$ terms. Part of this return was due to weakness in the U.S. dollar. Strong portfolio inflows and higher confidence in emerging market equities continued to drive prices.

Regional Update

Premier Wen Jiabao signaled that **China** would maintain a loose monetary policy to support the economy's recovery. While bank lending slowed down recently, it totaled US\$1.2 trillion in the first eight months of 2009, exceeding market expectations and accounting for nearly 70% of the total for all of 2008. The country also continued to report robust macroeconomic data during the quarter. GDP growth accelerated to 8% y-o-y in the second quarter of 2009 from 6% 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% y-o-y. Foreign exchange reserves increased 18% y-o-y to US\$2.1 trillion in June, making China the first country to exceed the US\$2 trillion mark. Value-added output grew 12% y-o-y in August, higher than the 11% y-o-y growth in July and its strongest increase so far this year. Retail sales were up 15% y-o-y in August as government-led initiatives drove consumer demand.

The **South Korean** economy grew at its fastest pace in more than five years in the second quarter of 2009. Revised data showed GDP growth of 3% q-o-q, compared to minimal growth in the first quarter of 2009. Government efforts to stimulate growth continued to produce results as domestic demand improved as a result of tax incentives and easier access to credit. Growth in private consumption, gross fixed capital formation and manufacturing output drove economic growth during the period. Private consumption increased 4% in the three months ended June 2009, significantly higher than the increase in the first quarter. The Bank also maintained its benchmark interest rate at 2%, a record low, to support the economy. Paving the way for the completion of a free trade agreement between South Korea and the European Union, all outstanding differences were resolved during President Lee Myung-Bak's trip to Europe in July. An agreement is expected to be finalized in February 2010. Once completed, this agreement will be South Korea's second largest trade deal, the biggest one being the accord signed with the U.S. in 2007.

In **Mexico**, GDP contracted 9% y-o-y in the first half of 2009 as a result of the global economic crisis and swine flu outbreak. Declines in the manufacturing, construction and retail sectors negatively impacted GDP. Although industrial output continued to decline, signs of recovery remained evident. Output fell 7%

y-o-y July, an improvement from the 10% y-o-y decline in June and 13% y-o-y fall in February. The Finance Ministry forecasted GDP to contract 7% y-o-y in 2009 due to the weak first half. The country is expected to return to growth in 2010 with the Ministry expecting a growth of 3% y-o-y for the year. 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 (0.25%) to 4.5%, bringing the total reduction thus far this year to 375 basis points (3.75%). Politically, the ruling Partido Acción Nacional (PAN) experienced the worst defeat in its party's history in the July legislative elections. PAN lost to the opposition Partido Revolucionario Institucional (PRI). PRI's alliance with the Green Party (PVEM) gives them a majority in the Lower House.

More than a year after **Brazil** was awarded investment grade status by international rating agencies Standard & Poor and Fitch Ratings, Moody's upgraded the country's sovereign debt to investment grade in September. Brazil's stable macroeconomic fundamentals and strong fiscal and monetary policies also allowed the economy to return to growth after recording two consecutive quarters of contraction. GDP grew 2% q-o-q in the second quarter of 2009, as tax breaks, monetary easing and lower inflation boosted consumer expenditure. Private consumption rose 3% y-o-y, compared to a 1% y-o-y increase in the first three months of the year. The Finance Minister expects the economy to grow about 1% and 4% y-o-y in 2009 and 2010, respectively. The Bank cut its key interest rate by 50 basis points (0.5%) to a record low of 8.75% in July. Since January, the interest rate has been cut by 500 basis points (5.0%). With the economy showing signs of recovery, the Central Bank also signaled an end to monetary easing. The International Monetary Fund (IMF) commended Brazil's strong macroeconomic foundation which allowed the country to "increase its resilience to the global economic crisis" and maintain financial stability.

The **South African** economy contracted 3% q-o-q in the second quarter, its third consecutive quarterly decline. It was, however, a significant improvement from the 6% q-o-q decline in the first quarter of 2009. The manufacturing, wholesale and retail trade and hospitality sectors were the major culprits. Conversely, growth in construction and mining activity, ahead of the upcoming 2010 World Cup, and a recovery in Chinese demand for commodities, had a positive impact on GDP. The South African Reserve bank left its benchmark interest rate unchanged at 7% in September, as inflationary pressures continued to ease. This followed a 50 basis points (0.5%) cut in August. Consumer prices reached a two-year low of 6% y-o-y in August. The Bank has cut its key interest rate by a total of 500 basis points (5.0%) since December 2008 to support the domestic economy. 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. Signaling the likelihood of improved relations between the U.S. and South Africa, U.S. Secretary of State Hillary Clinton visited South Africa in August where she also met President Jacob Zuma.

Russia's GDP declined 11% y-o-y in the second quarter of 2009. This compared to a contraction of 10% y-o-y in the first three months of the year. Major reasons for the economy's performance included weak external demand, investment and consumption. The Economy Ministry forecasts GDP to grow 1.6% y-o-y in 2010, as signs of recovery emerged in recent months. The Central Bank maintained an expansionary monetary policy by cutting its benchmark interest rate by 100 basis points (1%) to 10.5% during the quarter, due to easing inflationary pressures and efforts to support the economy. A 21-month low, consumer prices rose 11.6% y-o-y in August. 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. Moreover, Russia and Turkey signed energy agreements as well as a customs accord to improve trade relations while Russia has also approved a nuclear energy deal with Turkey.

In **Turkey**, fiscal stimulus measures coupled with monetary easing supported economic recovery with GDP decline shows signs of bottoming. GDP contracted 7% y-o-y in the second quarter of 2009, compared to a 14% decline in the preceding three-month period. Consumption recovered significantly, with private consumption contracting just 1% y-o-y, compared to a 10% y-o-y decline in the previous quarter. Moreover, the Central Bank maintained an expansionary monetary policy during the third quarter to support the domestic economy. The Bank cut its benchmark borrowing interest rate by 150 basis points (1.5%) to 7.25%. Inflation continued to ease with consumer prices increasing 5% y-o-y in August, well below

the Bank's target for the end of the year. Turkey and Chile signed a free trade agreement in July to boost bilateral trade and economic relations. Trade between the two countries is expected to double as a result of the accord. Turkey and Russia signed energy agreements as well as a customs accord to improve trade relations while Russia has also approved a nuclear energy deal with Turkey.

Outlook

While the global economic crisis did interrupt some of the emerging markets growth momentum, we expect the long-term growth of these markets to continue. 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. Most important for value investors, the current valuations of emerging markets remain attractive. Selective markets such as Russia and Hungary are down to single-digit P/Es, making them especially appealing. In addition to emerging markets, we think frontier markets are looking interesting and could become tomorrow's emerging markets.

Emerging markets offer a number of important advantages to investors and there are very good reasons why a positive long-term view of these markets should be adopted. Most important, emerging markets are still expected to grow at a much faster rate than developed markets. Although the slowdown in the global economy has had an impact on these markets, emerging economies are becoming more domestically driven. Government expenditure in areas such as infrastructure as well as private domestic consumption will, at least partially, offset the decline in growth resulting from slowing exports. Looking at the stability and safety of emerging markets, it is important to note the accumulation of foreign exchange reserves which puts these economies in a strong position to weather external shocks.

Feature of the Month: Warsaw, Poland

Warsaw, Poland's capital is always an important research investment stop for us. After Russia, Poland has some of the largest and most important companies in Eastern Europe. Equity investing is not new to the city since the first stock exchange was established in 1817 and continued trading until World War II. The exchange was re-established in 1991 following the end of the post-war communist control of the country and the return to a free-market economy. As with other markets in the region, the Warsaw stock market has had its share of volatility but has recovered nicely and is now up over 100% in US\$ terms from its recent low point in February of 2009.

There are a number of fascinating and beautifully restored historic places in and around Warsaw. This is quite amazing considering Warsaw was almost completely destroyed by the incessant bombing during World War II. You realize the amount of work and money that went into those restorations when you see some of the "before and after" pictures.

Culture is everywhere in the city. During the summer, there are indoor and outdoor concerts. Frederic Chopin's music, among my favorites, is most prevalent during these concerts. He helped develop a Polish national music style with his many piano preludes, mazurkas, polonaises and waltzes during his very short 39-year life which ended in 1849. We attended a free concert by a top American pianist performing in one of Warsaw's beautiful parks with the audience sitting and lying on the lawn overlooking a stage situated above a small lake. At a street cleared of all traffic in the old part of the city, there were three pianists from different parts of the world, including one top Japanese pianist playing Chopin on small stages spaced along the street.

We visited the exquisite Lazienki Palace completed in 1793, called the Palace on the Water, commissioned by the last king of Poland, King Stanislaw August Poniatowski who, in his youth, was a lover of the princess who was to become Empress Catherine the Great. He only enjoyed the palace for a few years before he tragically had to abdicate in 1795 and leave for St. Petersburg while Russia, Prussia and the other European nations carved up Poland. When withdrawing from Warsaw, the Nazis set fire to it but now it's beautifully restored. It includes an elegant and richly decorated small ballroom enough to seat no more than 50 people with a stage for an orchestra. We had the pleasure to hear a Chopin concert where Chopin actually played so we could imagine ourselves transported back in history.

Although you might not think of Poland being a home of haute cuisine, Warsaw has some wonderful restaurants. The Ale Gloria is a striking restaurant owned by Magda Gessler; creative women who have recovered a part of Polish history by decorated the restaurant in Polish folk fashion featuring, colorful paintings, and strawberry motifs on the walls, embroidered table cloths and napkins against a sparkling white background. The restaurant is in the basement of a building near the Parliament building and as you go down the staircase you encounter white stained wood flooring and ceilings with gingerbread type carvings before sitting down to delicious Polish cuisine.

While in Warsaw, we visited a number of companies. The important development is the move of Polish companies diversifying into neighboring countries and even into the U.S. This internationalization is opening up new opportunities for many companies with an alcoholic beverage distributor expanding into Russia, the U.S. and other countries, a helicopter producer opening a venture in China, and a cinema operator expanding into other Eastern European countries. In addition, banks from Europe and other parts of the world are operating actively in the country.

At an alcoholic beverage distribution company, the ambitious American CEO told us that he expected growth to come from the Russian vodka market where he expects to duplicate the 30% market share they now have in Poland. Currently in Russia, the firm is the vodka market leader with a 20% share. Of course, that's of the legal market. Consumption of illegally produced vodka is estimated to make up 40% of total vodka consumption in Russia. But vodka consumption in Russia is expected to decline, even though it still has the world's highest per capita vodka consumption, so the company is looking to other growth sources. One trend is the move to premium and mainstream vodka brands at the expense of economy brands. The company is doing well in other items. It has a 50% market share of the Russian cognac market and 70% of the champagne market. Although there is increased sales of wine, beer consumption has already peaked out at 95 liters per capita. The firm is not restricting its operations to Poland and Russia but is also active in developed markets. Sale of the firm's vodkas is growing in the UK, France and the U.S.

Another company we visited runs various food franchises with a Kentucky Fried Chicken (KFC) franchise in Poland and a number of East European countries, a Burger King franchise in Poland and a Pizza Hut franchise in Russia. The company has an ambitious "3 X 3" plan which envisions tripling sales in three years which it achieved between 2006 and 2008. The plan calls for 50 new restaurants to be opened in Central and Eastern Europe in 2009. The firm has become an important tenant in shopping malls since with their multiple brands they are able to rent larger space areas and obtain lower rental rates. Their newest venture is a joint venture with Starbucks and they already have 11 Starbucks in Eastern Europe. Moreover, they recently purchase a casual dining restaurant chain in the U.S. which they eventually plan to bring to Eastern Europe.

One of the banks we visited is controlled by a Portuguese bank group and is now the market leader in Polish mortgages. It gained its market share mainly through very aggressive lending in Swiss Francs offering home buyers the lower Swiss Franc interest rates as compared to the higher Polish Zloty rates. About 57% of their loans are in Swiss Francs. Of course, the danger to their clients, and eventually their loan portfolio's health, is a possible devaluation of the Zloty against the Franc. This was a worry for us since if the Polish Zloty devalued markedly against the Swiss Franc, the Polish mortgage holders would have difficulty in paying their mortgages. The management claimed that although the Zloty has depreciated against the Swiss Franc, clients have not had problems with repayments. This was because most of the mortgages were granted when the Zloty was weak and also the lower Swiss Franc interest rates means lower interest rates which help offset the depreciation. Nevertheless we are always mindful of exchange rate behavior in view of what happened during the Asian crisis.

We continue to monitor developments and look for investment opportunities in Poland. It has a fascinating culture and history as well as excellent business prospects.

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