Perspective from
Franklin Templeton Emerging Market Equity

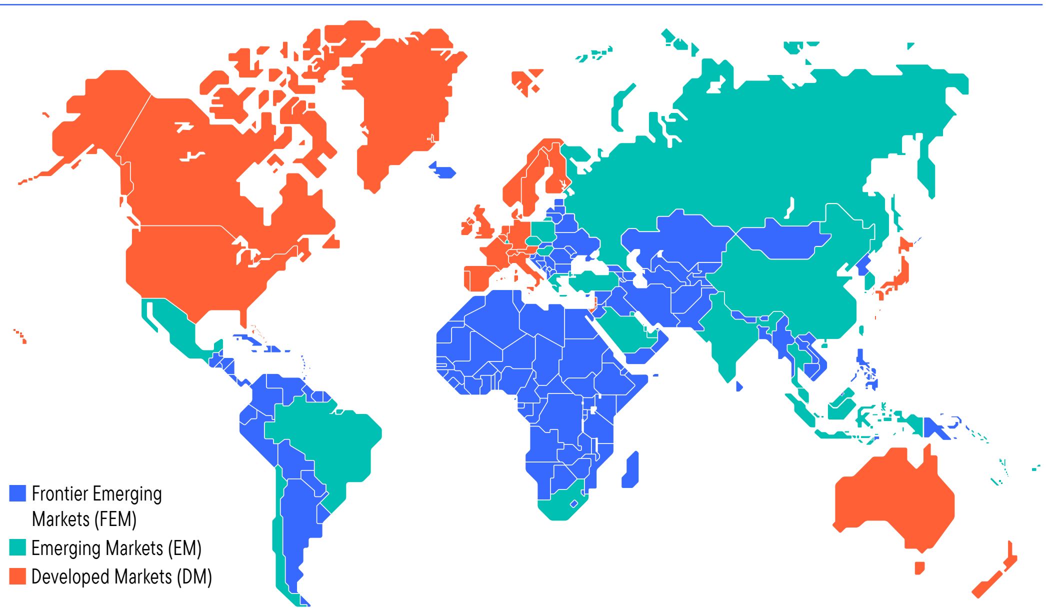
Frontier emerging markets: An untapped investment opportunity

August 2024

Frontier emerging markets (FEMs) encompass over 130 diverse and heterogenous nations. They are generally smaller, less developed and less accessible than their emerging market peers, yet account for 19 of the 20 fastest-growing nations globally.[1] Their population is expected to grow by 37% by 2050.[2] We believe this rapid growth sets the foundation for solid development, which will make them a larger part of the global economy, representing an attractive investment opportunity.

Exhibit 1: Global Equity Markets Map

As of March 2024

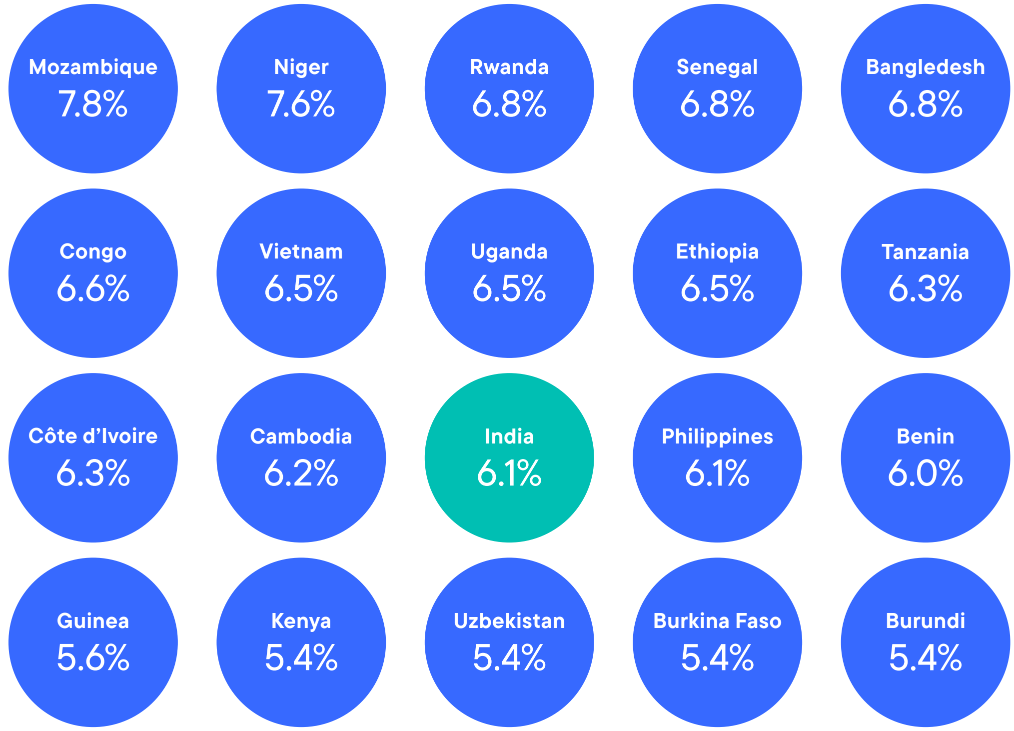


Notes:
i) This graph is by no means an exhaustive list of markets defined as FEM.
ii) FEM includes Colombia, Egypt, Peru and the Philippines which are also constituents of the MSCI EM Index.
iii) Russia is included in EM; it is unclassified by a number of major index providers.

Source: Franklin Templeton Emerging Markets Equity Definitions used for FEM, EM and DM.

Exhibit 2: Of the World's 20 Fastest-Growing Economies, 19 Are Expected to be Frontier Emerging Markets

As of April 2023



Sources: World Economic Outlook Database. International Monetary Fund. This ranking is based on real gross domestic product growth and excludes countries with a population of less than 10 million as well as Iraq and Afghanistan.

There is no assurance that any estimate, forecast or projection will be realized. **Past performance is not an indicator or a guarantee of future performance.**

In this report, we focus on investable early-stage developing FEMs. They are often said to be at the stage of development that today's emerging markets were at 25 years ago, with many of them having the same characteristics as emerging markets including India, Brazil and China.

While the more widely used MSCI Frontier Markets Index includes 21 of these markets, our definition is wider and also includes the smaller and often neglected tail-end of the MSCI Emerging Markets Index.[3] This group includes emerging markets such as Peru and the Philippines, and forms part of the MSCI Frontier Emerging Markets Index.

The FEM opportunity

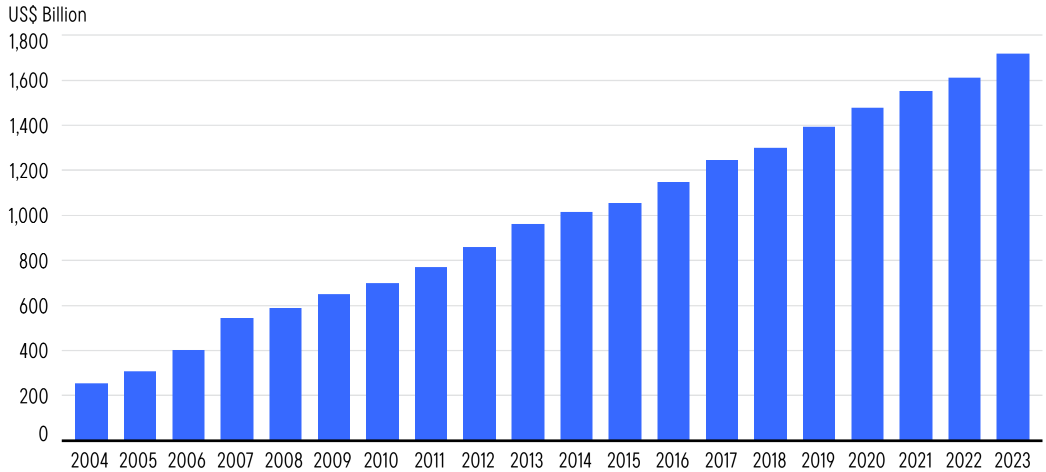
Unlike their larger developed and emerging market counterparts, FEMs tend to be more domestically focused. They offer investors exposure to companies benefiting from young and growing populations, financial and social reforms, strengthening macroeconomic fundamentals and rapid technological catch-up. These positive characteristics have attracted foreign direct investment (FDI) inflows, which have risen sharply in the last two decades.

Attractive demographics

FEMs have a large, young and growing population, which by 2050 is expected to grow by 37%, compared to an increase of 10% in emerging and 3% in developed markets.[4] This translates to population growth of 462 million people versus 452 million and 28 million people in emerging and developed markets, respectively.[5]

Exhibit 3: Stock of Inward Foreign Direct Investment (US$ billion)

2004–2023



Note: Based on countries in the MSCI Frontier Emerging Markets Index and data availability. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

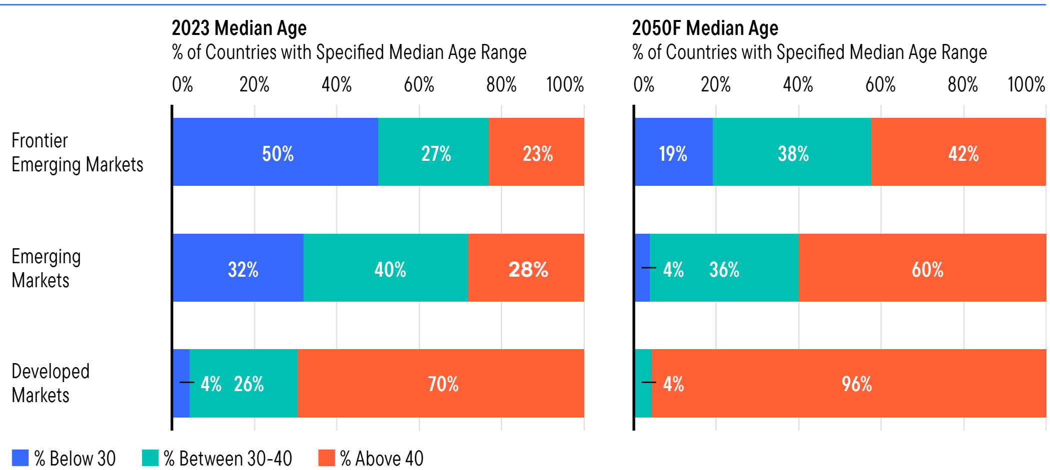
Sources: UNCTAD, IMF, International Financial Statistics, United Nations, World Investment Report, Bank of Estonia, National Bank of Serbia.

Another key advantage is the attractive age demographics in FEMs. In 2023, 50% of the countries in FEMs had a median age of below 30, and over 75% had a median age of 40 or below.[6] This is in line with the demographic breakdown in emerging markets. By 2050, however, the population in FEMs will be much younger than those in emerging markets. An estimated 57% of the countries in FEMs are expected to have a median age of 40 or below, versus 40% in emerging markets.[7]

The rapid rise in the young population in FEMs—and its sheer size—is expected to create demand for goods and services, boosting consumption as well as driving productivity. Over time we expect "economic convergence" as property rights are better protected and human, physical and financial capital is more efficiently mobilized. However, the success of FEM economies relies, in part, on their ability to absorb this fast-growing population into the workforce.

Exhibit 4: Young Population to Drive Consumption and Productivity

As of March 31, 2024



Sources: UNDESA, Macrobond. UN World Population Prospects 2022. There is no assurance that any projection, estimate or forecast will be realized.

Domestic consumption

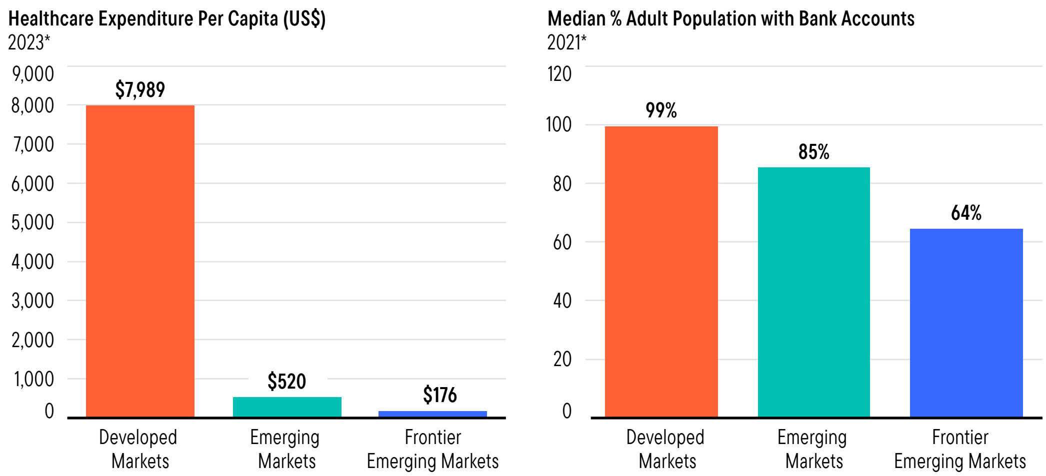
Consumption is a key contributor to economic growth in FEMs. Close to 70% of gross domestic product (GDP) is derived from consumption.[8] This is higher than emerging and developed markets.[9] In markets such as Egypt and Pakistan, private consumption is even higher at over 80% of GDP.[10] As a result, over two-thirds of corporate revenue in FEM is generated domestically.[11]

A key determinant of purchasing power is income. In FEMs, average per capita income is expected to grow 30% between 2023 and 2028, which is likely to increase the pace of consumption growth.[12]

The under-penetration of goods and services in FEMs bodes well for the asset class's future growth potential, in our view. Under-penetration occurs when a product or service has not reached its full potential, with consumption or usage relatively lower than its estimated market size. This situation is evident in many sectors, offering potential growth opportunities. Key areas include health care, financial services, education, technology and infrastructure. In the health care sector, for example, the per capita expenditure on health care services was less than US$200.[13]

Exhibit 5: Low Health Care Spending and Early Stages of Financial Inclusion

As of December 31, 2021



Sources: Macrobond, EIU. *Left-side scale: EIU, based on countries included in the MSCI EM, DM and FEM indexes and data availability. Right-side scale: World Bank.

Earnings growth linked to GDP growth

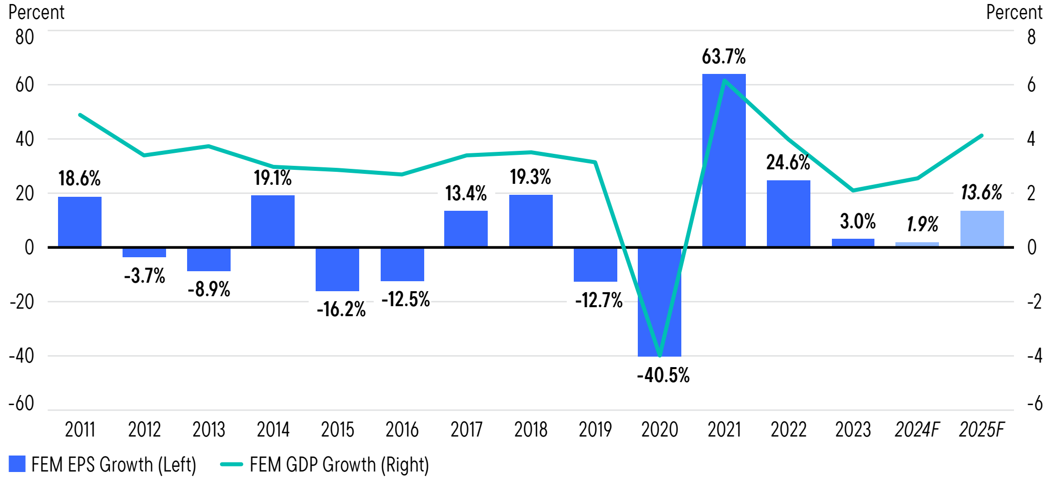
Since FEMs have a high share of consumption in GDP, they tend to be less sensitive to the global trade cycle. As a result, GDP growth has a greater link with corporate earnings. During economic upswings, increased consumer spending and heightened business activity tend to result in improved corporate earnings. Conversely, during recessions or periods of slower GDP growth, weakened demand adversely impacts earnings.

Technological advancement

FEMs have accelerated their development by embracing technology and digitalization. In many cases, this has included "leapfrogging" their developed and emerging market peers, enabling FEMs to grow faster. Increased digitalization in government services and payments has helped formalize the parallel economy in some countries.

Exhibit 6: GDP Growth Is Translating to Earnings Growth

As of July 2024



Sources: MSCI, Bloomberg. Based on the MSCI FEM Index. Earnings-per-share (EPS) is based on before exceptional items (XO). 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 a guarantee of future results.** There is no assurance that any projection, estimate or forecast will be realized. See www.franklintempletondatasources.com for additional data provider information.

A major fintech company in Kazakhstan is a great example of the digitalization of an entire consumer ecosystem. The company has become one of the most innovative and disruptive companies in Central Asia, as well as dominating payment, marketplace and consumer finance in Kazakhstan.

Portfolio diversification

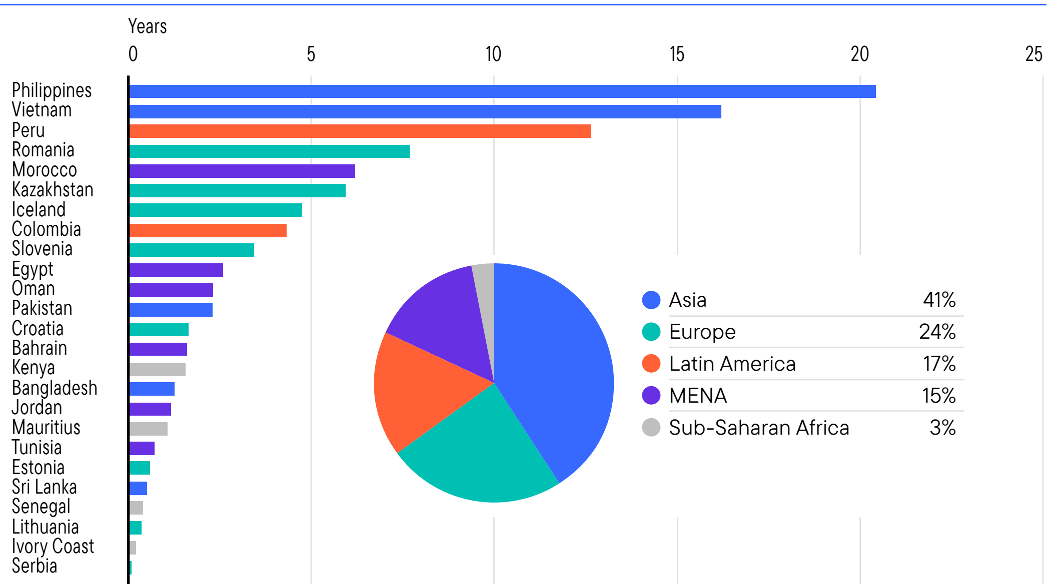
The addition of FEMs to a global portfolio brings a number of advantages, including diversification and reduced volatility to investors.

A diverse asset class

FEMs can be an attractive diversification tool for global investors. The MSCI FEM Index investment universe offers exposure to Asia, Middle East, Latin America and Africa.

Exhibit 7: MSCI Frontier Emerging Markets Index Composition

As of May 31, 2024



Sources: MSCI, FactSet. 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 a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

Low intra-country correlation

It is important to note that FEMs are a heterogeneous asset class. As such, although an individual market may have higher volatility at a given time, overall they exhibit low correlation to each other. We have found this typically results in lower overall portfolio volatility, providing global investors with an efficient means of diversification.

Reasons for this low correlation include: diverse and domestically-oriented economies, under-ownership by global investors and a low market-capitalization-to-GDP ratio.

For example, a portfolio with investments in Vietnam and Romania has a correlation of only 0.11.[14] This is because developments impacting returns in Vietnam are largely unrelated to events affecting Romania. In contrast, the correlation in developed markets is much higher. These larger markets tend to move in tandem with each other as they are more interlinked, due to similar global economic drivers and investor sentiment. For example, a portfolio investing in Australia and Switzerland has a correlation of 0.73, indicating an elevated correlation between both markets.[15]

Exhibit 8: Three-Year Equity Market Correlations

April 2021–March 2024

Frontier Emerging Markets Correlation

	Philippines	Kazakhstan	Morocco	Bahrain	Nigeria	Colombia	Kenya	Romania	Peru	Vietnam
Philippines	1.00									
Kazakhstan	0.21	1.00								
Morocco	0.23	0.23	1.00							
Bahrain	0.19	0.14	0.11	1.00						
Nigeria	-0.01	-0.05	0.02	0.06	1.00					
Colombia	0.33	0.21	0.11	0.16	0.04	1.00				
Kenya	0.18	0.04	-0.01	0.25	0.07	0.20	1.00			
Romania	0.29	0.49	0.28	-0.05	-0.09	0.28	-0.02	1.00		
Peru	0.31	0.14	0.09	0.05	0.00	0.43	0.05	0.32	1.00	
Vietnam	0.27	0.07	0.21	0.21	-0.06	0.14	0.13	0.11	0.05	1.00

Developed Markets Correlation

	US	Japan	UK	France	Canada	Switzerland	Germany	Australia	Netherlands	Spain
US	1.00									
Japan	0.57	1.00								
UK	0.64	0.54	1.00							
France	0.66	0.51	0.87	1.00						
Canada	0.76	0.59	0.79	0.71	1.00					
Switzerland	0.72	0.53	0.82	0.84	0.74	1.00				
Germany	0.65	0.55	0.83	0.95	0.68	0.81	1.00			
Australia	0.67	0.72	0.73	0.67	0.83	0.73	0.65	1.00		
Netherlands	0.75	0.62	0.71	0.84	0.65	0.78	0.85	0.69	1.00	
Spain	0.58	0.41	0.83	0.87	0.70	0.74	0.86	0.57	0.69	1.00

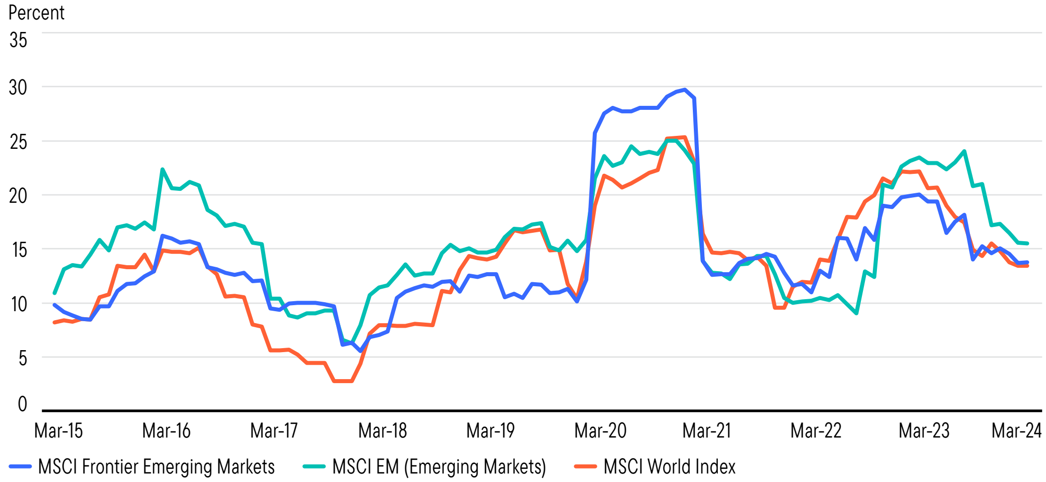
Sources: FactSet, MSCI, FEMs based on the MSCI FEM Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Volatility

As an asset class, FEMs tend to be less volatile than their emerging market peers due to lower intra-country correlation and minimum overlap between frontier and emerging markets. Of the 25 markets in the MSCI FEM Index, only four markets (Colombia, Egypt, Peru and the Philippines) overlap with the MSCI EM Index (accounting for 1% of the latter index).[16] Investing in FEMs complements broader emerging markets investments, lowering overall portfolio volatility and increasing risk-adjusted returns.

Exhibit 9: Annualized One-Year Rolling Volatility Frontier Emerging Markets vs. Emerging and Developed Markets

March 2015–March 2024



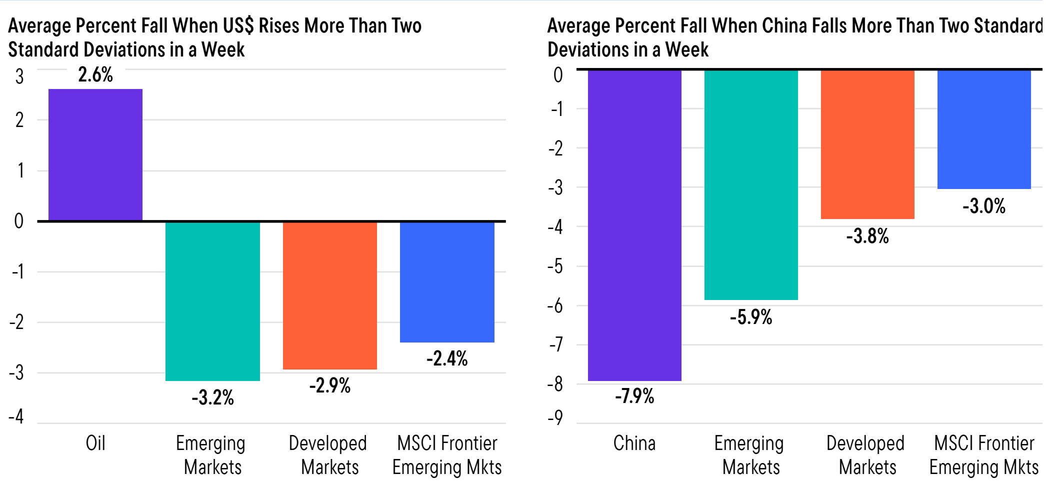
Sources: MSCI, FactSet. Rolling one-year volatility based on rolling (monthly) annual standard deviation of the respective indexes. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Sensitivity to global factors

FEMs as a group are also less sensitive to global factors such as US dollar strength and price movements in China's equity market because of their local ownership and domestic economic skew. When the MSCI China Index falls by more than two standard deviations in a week, a 7.9% decline resulted in a 5.9% fall in emerging markets.[17] However, FEMs declined by a smaller 3.0% in the same period.[18]

Exhibit 10: Frontier Emerging Markets Are Less Sensitive to Global Factors

October 2008–March 30, 2024



Sources: Bloomberg, FactSet, MSCI. Frontier emerging markets as defined by the MSCI Frontier Emerging Markets Index; Emerging markets as defined by the MSCI Emerging Markets Index; Developed markets as defined by the MSCI World Index. 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 a guarantee of future results.**

Similarly, when the US dollar rises by more than two standard deviations in a week, FEMs fall by a smaller 2.4%, versus declines of 3.2% and 2.9% in emerging and developed markets, respectively.[19]

Lower drawdown than emerging markets

Investors may perceive FEMs decline more than emerging markets during times of market stress. This perception may be related to lower liquidity and a smaller representation from institutional investors, who typically have a longer-term investment horizon.

Our analysis of drawdowns in frontier and emerging markets since 2020 over three-, six-, and 12-month periods indicates that this perception is incorrect. We analyzed market performance from the start of four market events during this overall period: the surge in COVID-19, the peak in Chinese equity market performance, the Russian invasion of Ukraine and the US inflation scare in the summer of 2023.

The average drawdown in emerging markets was greater than in FEMs in the three and six months after the market event. After 12 months, both posted gains of a similar amount.

Exhibit 11: Drawdowns in Frontier and Emerging Markets Since 2020

As of May 31, 2024

			Market performance in following months	
	Date of Event	Time Period	MSCI Emerging Markets	MSCI Frontier Emerging Markets
2020 COVID	February 19, 2020	+3 Months	-17%	-24%
		+6 months	0%	-17%
		+12 Months	29%	-5%
2021 China Mkt peak	February 17, 2021	+3 Months	-10%	-3%
		+6 months	-12%	1%
		+12 Months	-14%	9%
2022 Ukraine Invasion	February 24, 2022	+3 Months	-10%	-8%
		+6 months	-14%	-9%
		+12 Months	-15%	-10%
2023 US Inflation Scare	July 1, 2023	+3 Months	-4%	1%
		+6 months	4%	6%
		+12 Months	9%	14%
Average market performance during the four drawdowns since 2020		+3 Months	-10%	-8%
		+6 months	-6%	-5%
		+12 Months	2%	2%

Sources: MSCI, FactSet. MSCI Frontier Emerging Markets Index; MSCI Emerging Markets Index. 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 a guarantee of future results.**

Attractive valuations

FEMs provide investment opportunities with sustainable earnings power at a discount to their peers in emerging and developed markets. At a price to earnings ratio of 9.7×, FEMs trade at close to a 25% and 50% discount to emerging and developed markets, respectively.[20] Moreover, return on equity is higher than in emerging markets and in line with that in developed markets, while FEMs also have a higher dividend yield, providing investors with increased income.

Exhibit 12: Attractive Relative Valuations and Dividend Yields

As of June 1, 2024

	Frontier Emerging Markets	Emerging Markets	Developed Markets
Price/Earning (P/E)	9.7x	12.6x	19.2x
Price/Book Value (P/BV)	1.5x	1.6x	3.1x
Return on Equity (ROE)	14.8%	12.4%	15.0%
Dividend Yield	4.9%	3.0%	1.9%

Sources: Bloomberg, MSCI. Frontier emerging markets as defined by the MSCI Frontier Emerging Markets Index; Emerging markets are defined by the MSCI Emerging Markets Index; Developed markets are defined by the MSCI World Index. 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 a guarantee of future results.** There is no assurance that any projection, estimate or forecast will be realized. See www.franklintempletondatasources.com for additional data provider information.

Equity market growth

We have seen several frontier markets including Kuwait, the UAE and Qatar reclassified as emerging markets, reflecting their successful implementation of reforms, liberalization of financial markets and adoption of global regulatory standards.

A nation's stock market facilitates investment, capital flow and economic development, benefiting both businesses and the economy as a whole. The ability of any country to attract capital flows is partially dependent on the classification and development of its equity markets. Similarly, its market capitalization and liquidity can also benefit from greater investor interest. The upgrade of a country also tends to result in a re-rating in the market's valuations.

In this regard, active and passive global institutional investors widely track and benchmark indexes provided by leading global index providers such as MSCI, FTSE Russell and S&P. A country's inclusion in the index typically results in increased fund flows from investors that are following that benchmark.

The market capitalization of the MSCI EM Index is more than US$7,200 billion, while that of the MSCI FEM Index is close to US$200 billion.[21] In view of the substantially larger investment universe of emerging markets compared to frontier markets, the "graduation" of a country from frontier to emerging provides it with access to a much larger investor pool, which in turn leads to significantly higher fund inflows. Although the weighting of the market may be smaller in the emerging market benchmark versus the FEM benchmark, a smaller allocation of a larger pie exceeds a larger allocation to a smaller pie. As investors, we can benefit by investing in markets that are at the early stages of development.

Investor enthusiasm relating to index upgrades can push stock prices to elevated valuations in the short term. This can provide active investors with the opportunity to benefit from this increase, realize gains and invest in more undervalued opportunities in the asset class. This ensures that existing investors in frontier markets benefit from the upgrade cycle as countries continue to develop and progress.

Likely candidates for reclassification from frontier to emerging market status include Vietnam and Romania. Vietnam has a self-established 2025 deadline to be an emerging market.[22] Since September 2018, FTSE Russell has had Vietnam on the watchlist for possible reclassification to secondary emerging market status.

Romania, on the other hand, already meets MSCI's economic development and accessibility criteria for emerging market status. However, it does not meet the market liquidity requirement. Romania is making progress, with the listing of the country's largest electricity company in 2023 representing an important step on the path to reclassification.[23]

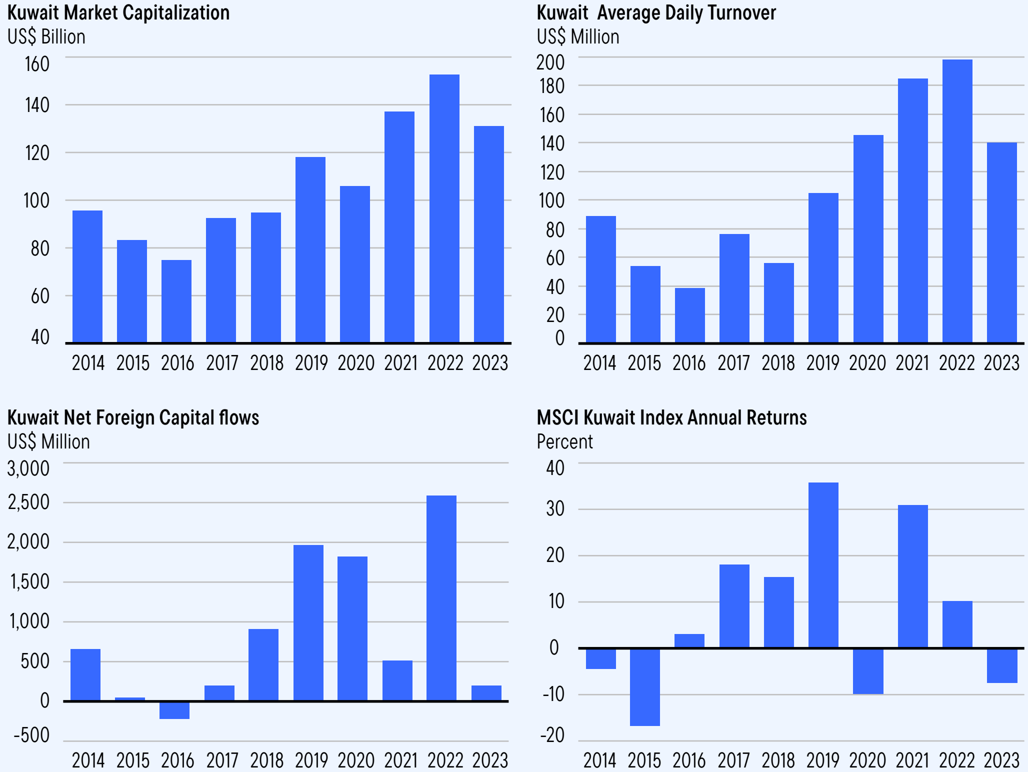
Case study

Kuwait

Recognizing the successful market reforms undertaken by Kuwaiti regulators, FTSE, S&P and MSCI reclassified Kuwait to emerging market from frontier market status between 2018 and 2020.[24] Improvement in the market dynamics of the Kuwaiti market, including market value, liquidity and capital flows in the run-up to and following the reclassification benefited early investors in the market. From a structural perspective, the reforms led to improved market access, transparency and accountability.

Exhibit 13: Kuwaiti Equity Market, Capital Flows and Return Trends

2014–2023



Sources: Bloomberg, Kuwait stock exchange, EFG Hermes.

Growth potential

Under-represented, under-researched and under-owned

FEMs make up a small portion of global assets. Market capitalization measured as a percentage of GDP is one way to gauge the financial development of an asset class. In 2023, the market capitalization of FEMs as a percentage of GDP as a group was 27%, compared to 84% for emerging and 138% for developed markets.[25] In comparison, 25 years ago, the market capitalization of emerging markets as a percentage of their GDP was 23%.[26] The trajectory of this ratio in emerging markets over the period could provide investors with a glimpse into the future for FEMs.

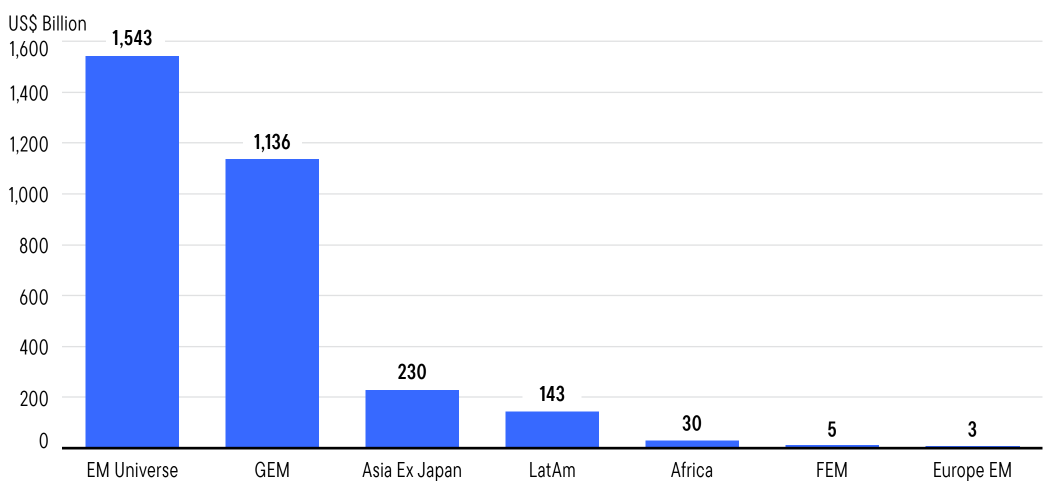
We have found that FEMs are under-represented in global portfolios because many investors focus on larger, more established markets. This, however, creates an opportunity in smaller, younger FEMs.

Companies in FEMs tend to receive less attention from the international research community, with analysts and portfolio managers more focused on emerging and developed markets. As a result, there is a higher likelihood of discovering undervalued and attractive investment opportunities in FEMs.

Despite the positive economic developments and capital market liberalization in FEMs in the past decade, the asset class remains under-owned. FEMs tend to have a relatively low level of foreign ownership as institutional investors dedicate a smaller portion of their assets to these markets. As of March 31, 2024, the assets under management (AUM) in dedicated global emerging market equity funds stood at more than US$1.1 trillion, dwarfing the US$5 billion in FEMs.[27] Even dedicated assets in regional funds like Asia ex-Japan and Latin America far exceeded those in the more global FEMs group. This limited ownership creates opportunities for those willing to explore beyond the traditional market groupings.

Exhibit 14: Assets Under Management for Dedicated Global Emerging Markets Equity Funds is US$1.1 Trillion, Dwarfing Those of FEM at US$5 Billion

As of March 31, 2024



Sources: Morningstar. Respective regions' AUM as per Morningstar's Global Category classification: Global EM (GEM) Equity/Asia ex-Japan Equity/Latin America Equity/Africa Equity/ Europe EM Equity. FEM AUM segregated via Morningstar Category "EAA Fund Global Frontier Markets Equity."

Global supply chain diversification

In recent years, FEMs have benefited from an acceleration in global supply-chain diversification amid geopolitical tensions and increased trade tariffs. Rising labor costs in China and efforts by global companies to reduce trade dependency on the country have also played a role in the movement. Drawn by factors such as low labor costs, large and young populations and strategic geographic locations, companies have been adding manufacturing bases in FEMs.

In Asia, FDI inflows to Vietnam doubled to US$23.2 billion in 2023, from US$11.5 billion in 2013,[28] as companies shifted production bases to the country. In January 2024, one of the world's largest food and beverage companies announced plans to double its processing capacity of high-quality coffee products at one of its factories amid plans to make Vietnam a high-value coffee production and supply center for the global market.[29] The country is already the second-largest coffee exporter in the world.[30]

In Africa, Morocco has become a leading car producer and the second-largest automobile exporter to the European Union.[31] In an effort to maintain its strong market position in the automobile sector and meet growing European demand for electric vehicles, the Moroccan government remains focused on accelerating infrastructure development and training workers to attract investment from manufacturers looking for production bases to expand their electric vehicles supply chain. Efforts to attract electric battery manufacturers to Morocco have been successful, with several Chinese electric battery producers announcing plans to build battery cathode factories in the country.[32]

FEM outperformance

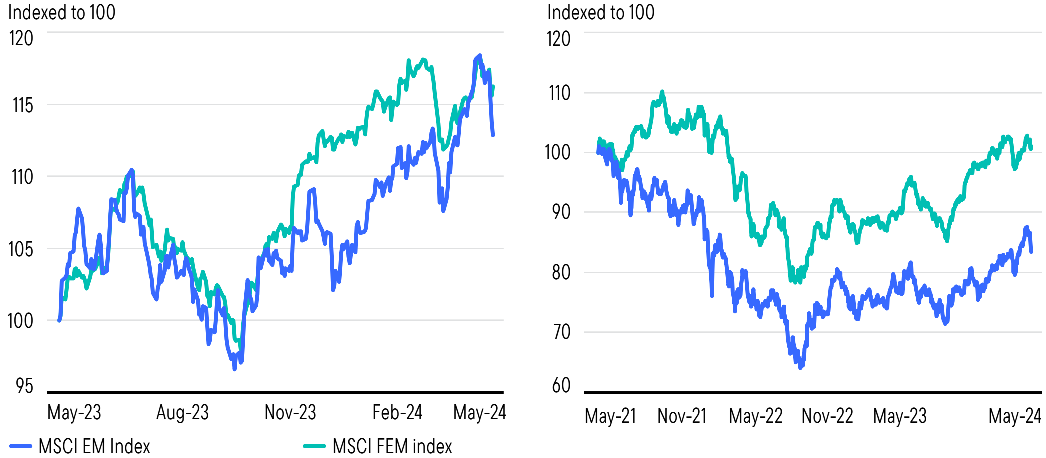
FEMs' outperformance of emerging markets demonstrates their significant growth potential, benefiting from higher insulation to global events and dependence on their domestic economy than their larger developed and emerging market counterparts.

Exhibit 15: Frontier Emerging Markets Have Outperformed Emerging Markets in Recent Years

As of May 31, 2024

Frontier Emerging Markets vs Emerging Markets
One-Year Return
Indexed to 100

Frontier Emerging Markets vs Emerging Markets
Three-Year Return
Indexed to 100



Sources: MSCI, FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
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Risks

Key risks for FEMs include political, currency and financial risk. Market access and liquidity risk, as well as transparency and corporate governance are also concerns.

Political and currency risk

FEMs often experience political instability due to factors such as civil unrest, regime changes and geopolitical tensions. These uncertainties can impact investor confidence and affect market performance. It is important to stress that not all markets can be placed in the same "basket." Although political instability is more prevalent in sub-Saharan Africa, the situation in markets such as the Philippines and Romania is relatively stable.

Currency risk could result in exchange rate fluctuations and these fluctuations have the potential to derail the investment potential in certain markets. The Egyptian equity market, as represented by the EGX 30 Index, rose 54% in local currency terms for the one-year period ending May 2024.[33] But a 38% devaluation in the Egyptian pound/US dollar exchange rate in March 2024 effectively erased gains for foreign investors, resulting in an essentially flat performance in US dollar terms.[34]

Exhibit 16: Egypt EGX30 Index Equity Returns

As of May 30, 2024

Source: Bloomberg. 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 a guarantee of future results.

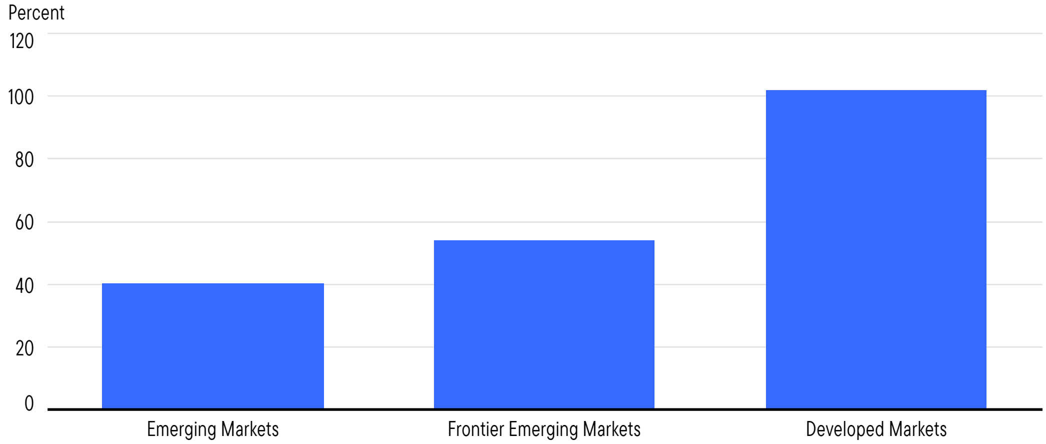
Nevertheless, the devaluation has led to greater flexibility in the foreign exchange market, effectively unifying the official and parallel exchange rates. The International Monetary Fund (IMF) agreed to increase Egypt's loan program to US$8 billion, while the UAE also committed to a US$35 billion investment.[35] Taking a longer-term view, the currency devaluation and subsequent investments have the potential to significantly increase exports and tourism.

Financial risk

Public debt levels have increased globally, as low interest rates have enabled developed, emerging and frontier governments to increase borrowing to finance spending. Contrary to perceptions that FEMs are much more heavily indebted than their peers worldwide, the public debt/GDP level of FEMs collectively is less than half that of developed markets and only slightly higher than that of emerging markets.[36]

Exhibit 17: 2023 Public Debt/GDP

As of December 31, 2023



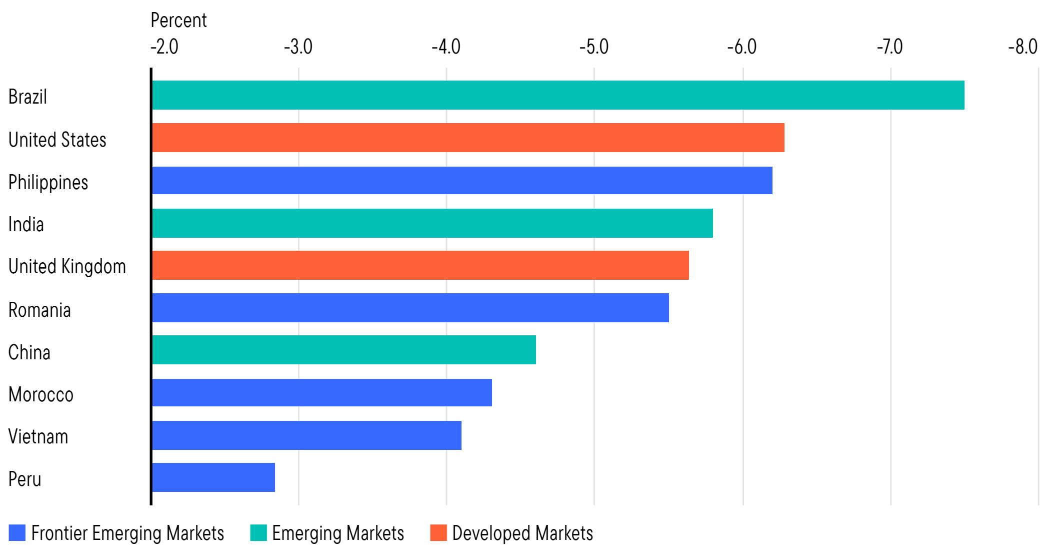
Source: Economist Intelligence Unit (EIU).

Active management can help mitigate the risk by focusing on FEM countries where governments have demonstrated fiscal responsibility (low debt-to-GDP ratios and/or manageable budget deficits) or where central banks have adopted flexible foreign exchange regimes or a comfortably defendable fixed exchange rate.

For example, after peaking at 4.1% in 2023, Vietnam's budget deficit is forecast to gradually decline over the following five years to 2.3% of GDP in 2028.[37] Similarly, Romania's budget deficit is expected to decline from 5.5% of GDP in 2023 to 3.6% in 2028.[38]

Exhibit 18: 2023 Budget Balance Percent of GDP

As of December 31, 2023



Source: EIU.

Market access and liquidity

Market access and liquidity is an additional area of concern for investors. While these factors may be greater concerns in FEMs relative to emerging markets, the current level in most FEMs is far from being too illiquid or impractical for investment. Additionally, we note that liquidity in several markets has also improved in recent years. We are also seeing regulatory bodies in these markets undertake market reforms to improve access and liquidity, including increasing foreign ownership limits and privatization.

We have also seen a gradual increase in initial public offerings (IPOs), which deepen frontier capital markets and liquidity. In Vietnam, several leading companies, including one of the country's largest tourism and entertainment companies and a major conglomerate's retail unit, are considering IPOs.[39]

Transparency and corporate governance

Investors may also face challenges related to corporate governance, transparency, investor protection and enforcement of regulations. Availability of data and company disclosures may be more limited in FEMs compared with those in developed and emerging markets. However, we are encouraged by the efforts made by governments, regulatory bodies and corporations to improve in these areas. A growing reliance on foreign capital has further incentivized governments and corporations in FEMs to elevate their profiles as destinations for institutional capital.

Increasing support from international finance Institutions such as the World Bank and IMF has resulted in operational frameworks that set fiscal, bureaucratic and governance targets that aim to improve the financial and economic profile of FEMs.

Moreover, we have seen increasing transparency and disclosure by FEM corporates in recent years, in addition to increased adoption of better anti-corruption and anti-money laundering best practices.

Summary

Domestically focused, with large and young populations, FEMs continue to record strong GDP growth, and we see this growth translating to corporate earnings. Consumption has been a key driver of growth, and we expect this trend to continue. Our analysis of correlation, volatility and market drawdowns indicates that these risks are lower than investors may expect, driven in part by the greater weight toward domestic demand in FEMs, relative to their emerging market peers. Technological advances, foreign investment and economic reforms further support the progress in FEMs.

Moreover, the changing trade landscape and geopolitical instability has benefited FEMs with international companies adding/shifting their manufacturing base to these markets. In addition to foreign investment inflows, these countries are also benefiting from access to skills, expertise and technology, and from job creation and improved infrastructure development.

From an investment perspective, FEMs are trading at a significant discount to their global peers while providing a greater income stream. Their characteristics make their addition to a global portfolio especially attractive, as it would generally increase diversification and lower overall portfolio volatility, we believe, due to its lower intra-country correlation and sensitivity to global factors.

While we have discussed some of the key challenges facing FEMs in this report, it is important to also note the progress many governments have made in addressing these issues. We believe that active management, supported by specialist, on-the-ground presence and an extensive research team, is the most effective way to help investors add value, navigate risks and capitalize on information inefficiencies in these markets.

The Franklin Templeton Emerging Markets team believes that FEMs are an under-represented, under-owned and under-researched investment opportunity. In our view, growth in investment and consumption coupled with attractive demographics will eventually see FEMs become tomorrow's emerging markets, potentially rewarding early investors in these markets with higher returns.

Case study

Vietnam

Vietnam is one of the largest markets in the FEM universe. The country has a young and dynamic population, with 67 million people in the working age group of 15 to 64.[40] Rapid urbanization and expansion of the middle-income class population has been driving domestic consumption, increasing demand for transportation, modern retail and branded consumer goods. A key beneficiary of competitive labor costs and, in recent years, supply-chain disruptions and geopolitical tensions, foreign investment in Vietnam has been on an upward trend.

A neutral diplomacy strategy has seen Vietnam improve relations and maximize trade with major global economies including the United States and China. Deepening cooperation on critical and emerging technology with the United States is expected to integrate Vietnam into the global semiconductor supply chain. This contributes to the transition of Vietnam's manufacturing sector from labor-intensive to high value-added.

Foreign ownership limits and slow government divestment from state-owned enterprises are among the main barriers holding back larger investments in Vietnam's equity markets. Capital market reform coupled with further progress toward improving corporate governance standards could support a potential rerating from frontier to emerging market status and attract global investors.

Vietnam has many fast-growing listed companies that our on-the-ground team analyzes. One example is a leading information technology services company, which is expected to be a key beneficiary of growing global IT demand.

This company has been developing software and IT solutions for its clients over three decades. Its telecommunications subsidiary has a market share of over 30% of the country's broadband internet sector. Another key area for the company is education. It provided 145,000 students with primary to postgraduate education in 2023, compared to less than 30,000 students in 2018.[41] There continues to be significant growth potential in this sector driven by the country's large population and low penetration rate in the private education sector.

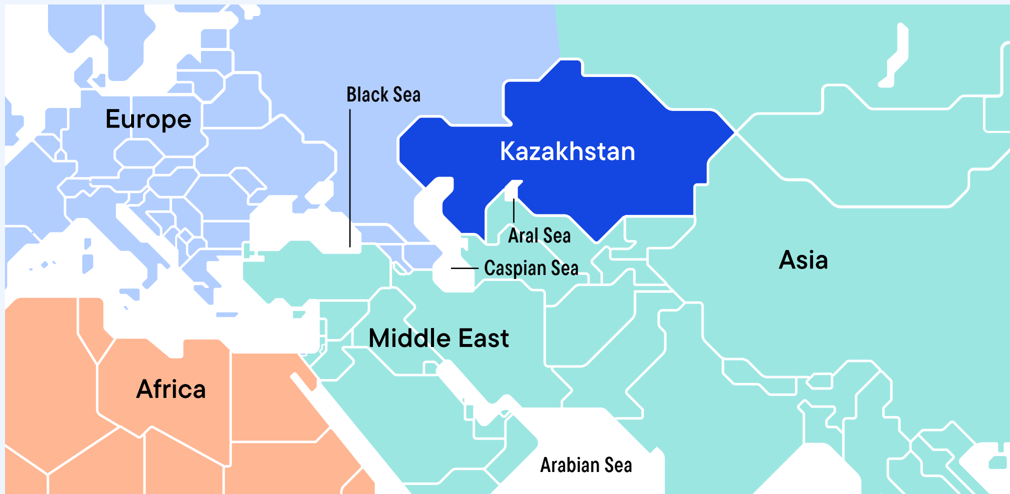
The company is well positioned to benefit from artificial intelligence (AI). It recently partnered with a major American semiconductor company to enhance its AI and cloud capabilities in service offerings and workforce training.[42]

Vietnam's fast-growing economy, supportive government policy and strengthening position in the global landscape further supports the company's expansion.

Case study

Kazakhstan

Kazakhstan joined the group of upper middle-income levels in 2015. It benefits from vast natural resources (oil, gas, coal and metal ores), and a strategic location adjoining Europe and Asia. It is at the early stages of financial market liberalization and has relatively stable politics with a centralized government structure.[43]



The country's fundamentals remain stable, with annual growth expected to average over 3%.[44] Reflecting its solid financial and economic standing, the country's sovereign credit rating is investment grade.

Kazakhstan is developing a domestic fintech ecosystem which is driving the digitalization of the domestic consumer and business environment.

Our team has identified a company that is responsible for reshaping the digital landscape in the country. Following success in digital payment services, it expanded its services to include mobile banking, marketplace, e-grocery and classifieds. In line with its mission to "improve daily lives by developing innovative, highly relevant and world-class mobile services," the company's app has become essential in facilitating daily life in Kazakhstan and is used by 70% of the population.[45]

After the success of this service, the company launched a merchant app in 2020. Similar to the consumer version, this app has enjoyed significant adoption in Kazakhstan, with close to 700,000 active merchants.[46] The new app helps merchants and small- and medium-size enterprises run and develop their business via a range of features including acquiring, billing, business-to-business (B2B) payment and instant invoicing.

Definitions*

The **MSCI Frontier Emerging Markets (FEM) Index** includes large- and mid-cap representation across 25 frontier emerging markets countries. The index includes 232 constituents, covering about 85% of the free float-adjusted market capitalization in each country.

The **MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI World Index** captures large- and mid-cap representation across 23 developed markets countries.

The **EGX30 Index** is a major stock market index in the Egyptian stock market, which tracks the performance of the 30 most liquid stocks traded on the Egyptian Exchange; it includes the top 30 companies in terms of liquidity and activity.

*As of 31 May 2024

Endnotes

1. Source: World Economic Outlook Database, International Monetary Fund. April 2023. This ranking is based on real GDP growth and excludes countries with a population of less than 10 million as well as Iraq and Afghanistan.
2. Sources: UNDESA, Macrobond. UN World Population. There is no assurance that any estimate, forecast or projection will be realized.
3. Source: MSCI, as of May 31, 2024.
4. Sources: UNDESA, Macrobond, UN World Population Prospects 2019; FEM population is about 1.3 billion. Data as of June 30, 2021. There is no assurance any estimate, forecast or projection will be realized.
5. Ibid.
6. Sources: UNDESA, Macrobond, UN World Population Prospects 2022. Data as of March 31, 2024.
7. Ibid.
8. Source: EIU. Frontier emerging markets as defined by the MSCI Frontier Emerging Markets Index; Emerging markets as defined by the MSCI Emerging Markets Index, including Singapore & Hong Kong; Developed markets as defined by the MSCI World excluding Singapore & Hong Kong. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
9. Ibid.
10. Source: CEIC, Egypt as of December 2023, Pakistan as of June 2024.
11. Source: MSCI, FactSet. As of March 31, 2024.
12. Source: Macrobond, IMF World Economic Outlook, October 2023.
13. Source: Macrobond, EIU. Based on MSCI EM, DM and FEM indexes and data availability.
14. Source: FactSet, MSCI. Frontier emerging markets based on the MSCI FEM Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
15. Source: FactSet, MSCI. Developed markets based on the MSCI World Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
16. Sources: MSCI, FactSet. May 31, 2024.
17. Sources: Bloomberg, FactSet, MSCI. As of March 30, 2024, since October 2008. Frontier emerging markets as defined by the MSCI Frontier Emerging Markets capped Index; Emerging markets are defined by the MSCI Emerging Markets Index; Developed markets are defined by the MSCI World Index. 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 a guarantee of future results.**
18. Ibid.
19. Ibid.
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45. Sources: Kaspi.kz 4Q & FY2023 Results Presentation. February 26, 2024. World Economic Outlook Database, International Monetary Fund. April 2024.
46. Source: Kaspi.kz 1Q 2024 Results Presentation, April 22, 2024.

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All investments involve risks, including possible loss of principal.

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Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks.

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