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SMALL & MIDCAPS
Looking Beyond The Cover

July · 29 · 2020

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Looking Beyond the Cover

There are books of which the backs and covers are by far the best parts…

(We were not talking about this report); We just love to start with a Dickensian quote.

For our cover we select an image that at a first glance could very possibly represent the future coming at us, at vertiginous speed, perhaps a complex circuitry enabling some sort of artificial intelligence; then, a closer look reveals an urban setting, buildings worth thousands of square meters of commercial real estate, a true relic - it would seem - in the current C19 era of social distancing, a look at the past receding from us at an equally dizzying pace.

In this report we posit our thesis that what we have experienced, thus far in 2020, across equity markets, developed and emerging, through geographies and sectors, represents a divergence in business and market dynamics between the past and the future. A divergence in economic value potential that will not only remain as a secular characterization for years to come, but one that is rapidly accelerating. High innovation and change was already present during the first two decades of the XXI century, in many ways reminiscent of what happened 100 years earlier at the dawn of the XX century. But now it seems like a secondary effect from the current quarantine/pandemic is an even faster acceleration towards innovation fueled by a shockingly sudden exposure of the inefficiencies the global economy is still carrying from the past. The Small and Mid-cap space is fertile ground for this innovation.

To evaluate this thesis we ponder on the following:

- ❑ Is the rally a dynamic between flight to safety vs risk-on or secular divergence between new and old? To what extent, is this supported by a change in earnings expectations, either a gradual improvement scenario or a more fundamental improvement in economic conditions?
- ❑ How much of this rally is sustainable in the short term, considering we continue to see global case spikes as we enter a second wave? Can we actually see an increase in 'Index' earnings over the next twelve months?
- ❑ Is it simply a case of a liquidity-driven decoupling of financial markets from the tangible economy, in part from index compositions diverging from the economy composition?
- ❑ What is the best way to position our strategies in this environment in the face of differing/conflicting medical research on the pandemic resolution, i.e. short duration of resistances/antibodies, long term effectiveness of end-game vaccines, and similar characteristics for future pandemics?

The widening discount between developed markets relative to emerging markets, as measured by forward 12-month P/E, helps the Cheap EM narrative. Will we see a re-rating in these markets, as the present discounts are among the steepest in the past 15 years? Arguably, Small-Midcaps have always been more important than the large caps, in moving the innovation cycle, ideas and create the opportunities for the creative destruction that underpins growth. They also have an outsized impact for employment and encompassing development. In EMs, they are the link to institutionalization of the unorganized segment; in DMs, they are an investors best avenue to see capital focusing on specific innovations.

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We undertook a composite study of the listed companies (aggregating close to 20,000 companies), within our universe. We assessed the structural compositions differences between the index and real economy. We have evaluated the latter from the perspective of employment and revenues. Long term investing requires us to consider the economy/recovery conditions also and should be agnostic of sector or index composition. With the level of interconnectedness the world is in today, broad global trends will dictate individual region policies and performance.

Top Performing Segments	Large	Mid	Small	Aggregate
Developed Markets				
Life Sciences Tools & Services	14%	33%	315%	132%
Gold	34%	102%	125%	106%
Internet Services & Infrastructure	109%	112%	9%	68%
Health Care Equipment	13%	48%	107%	63%
Motorcycle Manufacturers	-25%	29%	155%	57%
Biotechnology	106%	61%	39%	54%
Emerging Markets				
Health Care Supplies	298%	130%	179%	185%
Health Care Equipment	120%	120%	101%	110%
Biotechnology	88%	77%	103%	91%
Life Sciences Tools & Services	57%	69%	91%	75%
Health Care Technology	133%	57%	28%	55%
Interactive Home Entertainment	53%	65%	42%	53%

Worst Performing Segments	Large	Mid	Small	Aggregate
Developed Markets				
Airlines	-48%	-54%	-49%	-51%
Hotel & Resort REITs	-28%	-52%	-54%	-51%
Oil & Gas Equipment & Services	-48%	-50%	-49%	-49%
Mortgage REIT's	-29%	-48%	-46%	-46%
Oil & Gas Exploration & Production	-40%	-43%	-43%	-42%
Integrated Oil & Gas	-40%	-61%	Na	-42%
Emerging Markets				
Hotel & Resort REITs	Na	-38%	-36%	-37%
Specialized REITs	Na	-32%	-35%	-34%
Managed Health Care	-29%	-36%	Na	-33%
Airlines	-21%	-21%	-38%	-29%
Apparel Retail	7%	-34%	-26%	-28%
Thrifts & Mortgage Finance	-26%	-30%	-26%	-27%

Source: Aztlan, Refinitiv

*- Classification made on ending market cap [as on 10th July 2020] | Performance: Avg. YTD USD price returns

Large Cap: > USD 5 Bn. | Mid Cap: USD 500 Mn- usd 5 Bn. | Small Cap: USD 100 Mn. - 500 Mn. |

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A Glance Back at the Year, *thus far*

At the outset, we will look at the price action or more specifically, differential in the segments under review for both DM and EM. The EM rally at the start of the July has resulted in DMs having underperformed EMs this year. An initial simplistic take would imply a general increase in risk-on trades. Yet the valuation differential, measured by forward NTM P/E, would still indicate the widest discount for EMs in the past 15+ years, while a further drilldown shows that this has not been a blanket move.

EM outperformance has been mostly carried by China and specifically as the index differences in compositions come to fore. Is this trend a simple risk-on move or a secular shift towards innovation?

Relative Performance (DM-EM)+/-

	YTD	1 Yr
Standard (LC+MC)	-0.34%	0.19%
IMI (LC+MC+SC)	-1.02%	-0.18%
Large Caps	-0.30%	-0.18%
SMID	-2.08%	1.09%

Source: Refinitiv; Pricing as on 10th July 2020

DM SMID (using MSCI terminology for Small & Mid-caps) have underperformed EMs by a wider margin. Surely this reflects the markets believe the impacts of C19 are going to be less than what macros indicate. Most DMs have already seen a huge hit in the first wave and for the most part, seem to be in a down trend. EMs adopted a differing approach – the ones with the toughest stringency measures ('ex reported China') initially see no respite.

A closer look at DMs would, however, indicate a flight to quality, essentially big tech, as large caps have generally outperformed SMIDs across the board, with the differential looking way better due to USA. So yes, we could say that index composition has completed the decoupling from the economy, at least in the USA.

DM Gross Return (Large Caps - SMID) +/-

	YTD	1 Yr
World	8.05%	8.85%
World Ex USA	1.67%	-1.41%
USA	11.19%	14.65%
Canada	1.20%	-0.35%
Europe	0.76%	-4.01%
Nordic	2.26%	-1.47%
Japan	4.89%	4.46%

Source: Refinitiv; Pricing as on 10th July 2020

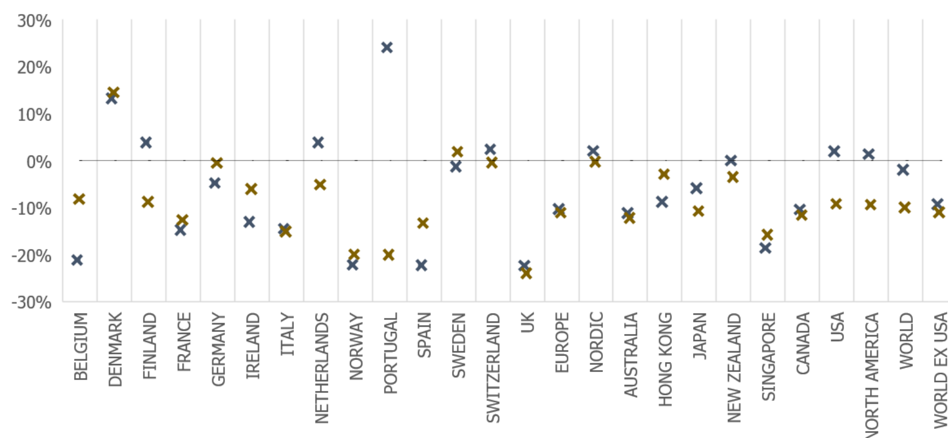

Figure: Relative Performance of Large Caps and SMIDs by region

Large Caps: Blue Cross
SMIDs: Yellow Cross

Source: Refinitiv, MSCI; Pricing as of 10th July 2020

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Within the context of what has happened, most DM markets have seen similar performance, with modest outperformance by large caps. Portugal remained the big exception and to a lesser extent, USA.

In EMs, no such clear across the board trend exists. Europe has performed comparatively well for SMIDs, though down close to 9%. LatAm has been brutal (30%+ decline), so a modest outperformance by large caps is meaningless. Asia is up, in absolute terms YTD and in no small measure, due to the benchmark heavyweight China. The outperformance of SMIDs could be attributed to risk trades and better sectoral composition.

Tech names in EM is carried across multiple sectors; so a simple GICS break-down may not truly indicate the outperformance. On the other end, the crash of energy prices seems more significant.

EM Gross Return (Large Caps - SMID) +/-

	YTD	1 Yr
EM	6.27%	10.12%
EM Asia	3.58%	10.88%
EM Europe	-16.32%	-13.61%
EM Latam	2.46%	-2.60%
China	-5.99%	-2.02%

Source: Refinitiv; Pricing as on 10th July 2020

The EM index is being carried by China and Taiwan, the two benchmark heavyweights (accounting for ~53% of the index). Barring these two, there is no clear and consistent bias towards any size. In previous cycles a 'Flight to Safety' vs 'Dash for Trash' patterns have been driven by liquidity waves first gravitating towards large cap names, as earnings visibility and trading liquidity are key allocation factors. Today we don't see any clear evidence of this in EMs, rather this New vs. Old dichotomy seems to be taking hold.

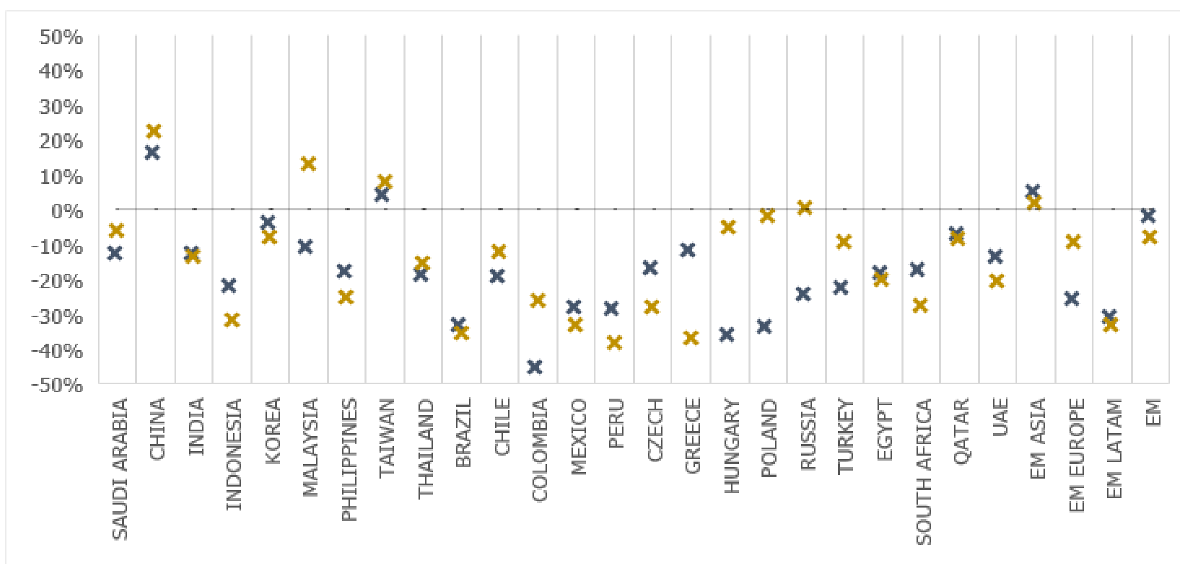

Figure: Relative Performance of Large Caps and SMIDs by region
Large Caps: Blue Cross | SMIDs: Yellow Cross
Source: Refinitiv, MSCI; Pricing as of 10th July 2020

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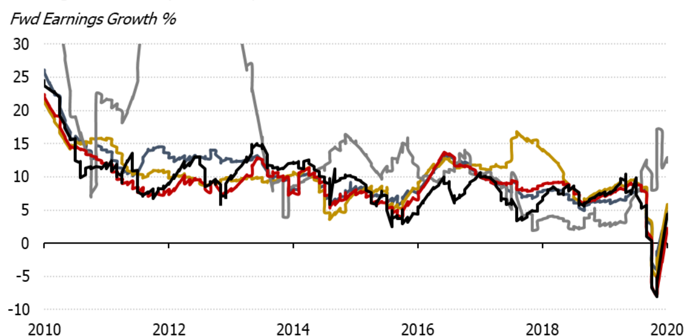
DISSECTING THE RETURNS

Region

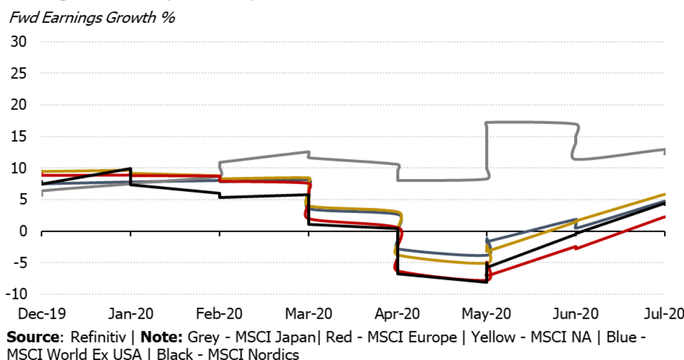
Developed markets, across market cap segments, have presented a trajectory in performance pretty much in line with headline C19 evolution and policy responses. Economic policy responses have mostly been quite consistent with a 'throwing money at the problem' approach. However, in terms of the sanitary contingency responses the approach has varied quite significantly, from the very stringent and orderly like Japan and Germany, to the more liberal but orderly like Sweden, to the outright cavalier like the USA. As we mentioned in our revised outlook (published April), Europe remains our primary area of concern – particularly on the mode adopted for demand generation/recovery. The countries worst hit also have the worst fiscal room. A lot will be expected from the EU. At the same time, the 'frugal' or 'pragmatic' countries (always a matter of perspective) are unlikely to waver in their resolve not to cut blank cheques. At the time of publication, we have seen the broad contours of the deal that has been worked out. We will now wait to see the fine points. In general, we try to remain agnostic to these policy responses and focus on our core approach on bottom-up analytics while we remain avoidant to any direct exposure in any of the more stressed countries in Europe.

Within DM we see a downward trajectory in earnings revisions momentum and quantum ex Japan, where the growth is more optical - TTM EPS declines have helped - rather than forward EPS trajectory.



Source: Refinitiv | **Note:** Grey - MSCI Japan| Red - MSCI Europe | Yellow - MSCI NA | Blue - MSCI World Ex USA | Black - MSCI Nordics

In the DM space the first thing we note is the divergence in earnings growth expectations between Japan and the West. We also note that DMs (ex US) have been relatively successful in the initial C19 containment and should be in a relatively better position to kick start their economies. We don't discount the possibility of intermittent bursts, which we expect to be resolved by additional localised containment strategies. As we'll review later in this report, DMs appear to be ahead in earnings revisions, having been cut more sharply relative to EMs, with the standard deviation spiking above 1.



Source: Refinitiv | **Note:** Grey - MSCI Japan| Red - MSCI Europe | Yellow - MSCI NA | Blue - MSCI World Ex USA | Black - MSCI Nordics

We have seen forward EPS declines on a steeper curve. While not comforting, there is upside once recovery timelines take shape. We also note that most regions are only slightly above the 2.5 SD. range. Multiples have not expanded at the same pace.

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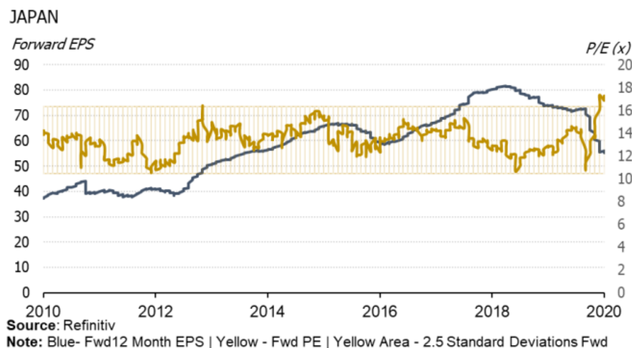
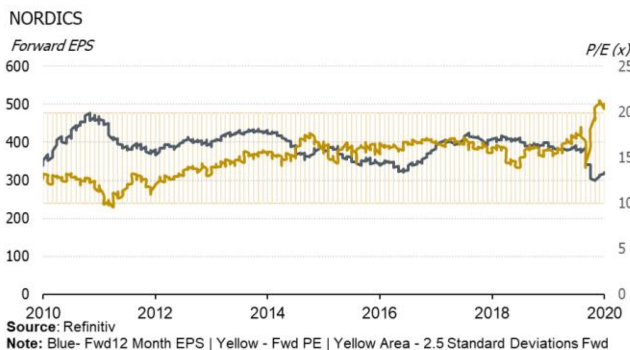
We have excluded Oceanic in this comparison. Similar to the caveat raised earlier on Japan, the forward earnings change partly reflects the contraction that companies might have seen in the denominator TTM EPS. Nonetheless, we use this metric as a general yardstick to measure if the broad market estimates changes met our macro beliefs. We have seen more sharp changes/trends in forward growth in DMs which appear ahead of the curve compared to EMs.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd

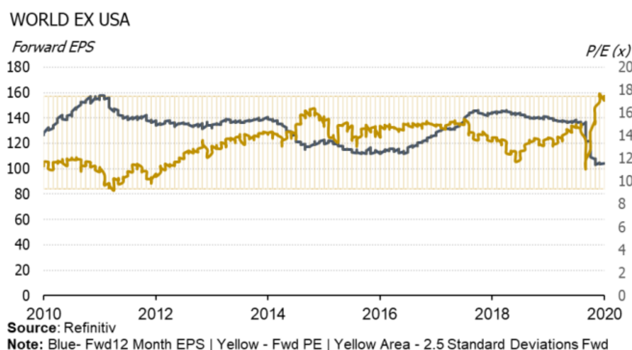


Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd

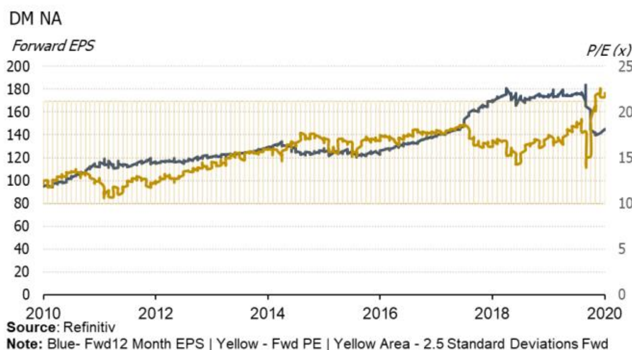
Multiples have risen to 10-year highs and this has been a secular trend across all markets. At a first glance this has to be put in context of the substantial monetary stimulus, i.e. earnings yields compared to reference rates (in the face of negative yields, *any* earnings yield level will appear attractive!)

In DM valuation ranges have exceeded the 2.5 standard deviation mark, across markets.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd

To make comparisons and reduce the number of index values dished out in this report, we have used MSCI North America.
For USA alone, we have typically tended to use either the S&P or Russell indices but that wouldn't facilitate the cross region comparisons that we wanted to make in this report. Secondly, MSCI North America is ~96% USA – so it helps to serve our objectives to bring in a regional comparison while also helping us to segregate USA.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd

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Sectors

In DM we have seen price actions YTD less driven by the bellwether USA and a broader participation of Canada, Europe, and Japan in the post-March rally. We also note the diffusion between "real" economy and index weights as slightly less divergent relative to EMs. Here the main divergence stands in outsized impact of IT, compared to underweight (relative to employment or revenues) status of industrial and consumer discretionary. We also see this playing out in macros being reported. Consumer discretionary and industrials have close to 45% of the employment generation. This stress will continue to weigh down economies until the recovery has come full circle.

	Sector Weight - MSCI DM	By Employment*	By Revenue**
Communication Services	8.8%	5.1%	7.0%
Industrials	10.1%	22.6%	19.8%
Consumer Staples	8.3%	11.4%	13.0%
Materials	4.3%	6.0%	8.0%
Consumer Discretionary	11.0%	21.3%	19.4%
Information Technology	21.3%	10.8%	8.9%
Financials	12.7%	10.8%	
Health Care	14.1%	7.4%	8.7%
Energy	3.2%	1.6%	9.6%
Real Estate	3.0%	0.9%	1.7%
Utilities	3.3%	2.1%	3.9%

*- Calculated as full time employed % in Large and Mid-cap companies [> 500 Mn. Listed companies]
** - Calculated as Large+Mid cap revenues % of all universe listed companies >100 Mn. (Market Cap) [Excluding Financials]

Consumer Discretionary contribute close to a fifth of employment and revenues in the DMs, while having a significantly lower weight in the benchmark indices. We also see the sectors positive price action being driven by a few sub-sectors while many of the usual segments are hurting. We don't see any particular surprises in the sub-sectoral price action and our positioning has always reflected this. We have been positively biased towards education services and believe that this segment should continue to do well. Mid-caps have thus far underperformed the large caps in this space and we expect the Small and Mid-caps, online or offline, to catch up. Why offline also? As most DMs are not expected to hit the daily peaks of the first wave in subsequent waves, education and particularly as next term comes into play, we expect a combination of reduced capacity schooling resumption to be a top priority. We expect online platforms to benefit significantly to cover the gaps while offline will remain at current levels (unlike other spending items, education spending might increase as government disbursements are likely to address this on priority).
When looking at purely from an employment perspective, auto (and ancillary industries) would still account for roughly a third of the sector employment and would clearly be the initial beneficiary of any demand stimulus. Ex-auto manufacturing (deliberately excluded for analytical reasons), employment is still largely based in large/mid-caps names (~90%).

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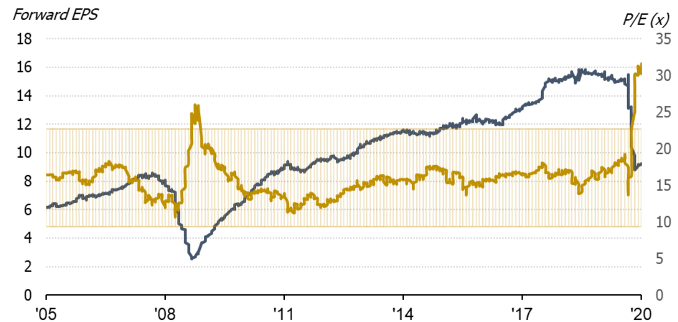
In the DM Discretionary sector valuation multiples have spiked to well above standard deviations and we believe this is a factor of markets believing the recovery is likely to be faster than originally discounted as opposed to a prolonged cycle; we have seen a similar situation play out during GFC, but we note that the earnings revisions this time are not as sharp as then.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Consumer Discretionary	**4.5%**	**-9.5%**	**-7.3%**	**-6.3%**
Apparel Retail	-16.8%	-31.6%	-40.0%	-33.6%
Apparel, Accessories & Luxury Goods	-11.6%	-38.4%	-12.2%	-20.5%
Auto Parts & Equipment	-20.2%	-15.0%	-31.2%	-23.6%
Automobile Manufacturers	14.4%	-25.3%	30.5%	7.9%
Automotive Retail	0.7%	-12.1%	-10.2%	-9.5%
Casinos & Gaming	12.4%	5.3%	2.7%	5.9%
Computer & Electronics Retail	-9.8%	-14.6%	-14.4%	-14.1%
Consumer Electronics	-7.8%	-10.7%	-5.6%	-7.5%
Department Stores	-36.0%	-44.3%	-18.1%	-36.6%
Distributors	-5.5%	-8.9%	-15.1%	-12.1%
Education Services	89.4%	13.1%	-1.2%	12.7%
Footwear	4.3%	-34.3%	-36.2%	-24.1%
General Merchandise Stores	10.6%	3.0%	35.4%	15.0%
Home Furnishings	-48.3%	-8.1%	-10.9%	-11.5%
Home Improvement Retail	11.3%	24.4%	13.9%	17.6%
Homebuilding	-10.9%	-11.9%	-6.2%	-9.6%
Homefurnishing Retail	22.6%	-16.7%	-8.7%	-6.2%
Hotels, Resorts & Cruise Lines	-42.8%	-35.9%	-39.2%	-38.5%
Household Appliances	0.7%	12.1%	-16.5%	-4.1%
Housewares & Specialties	-17.8%	-10.8%	19.6%	8.9%
Internet & Direct Marketing Retail	59.2%	41.3%	37.3%	42.8%
Leisure Facilities	-17.5%	-27.3%	-30.8%	-28.7%
Leisure Products	14.1%	4.2%	46.4%	23.5%
Motorcycle Manufacturers	-24.9%	29.1%	155.3%	57.4%
Restaurants	-11.7%	-25.0%	-18.0%	-20.3%
Specialized Consumer Services	-18.7%	-11.2%	-25.1%	-21.6%
Specialty Stores	-6.5%	-16.9%	-1.8%	-8.9%
Textiles		-20.6%	-17.8%	-18.3%
Tires & Rubber	-14.5%	-22.9%		-21.1%

*- Classification made on ending market cap [as on 10th July 2020]

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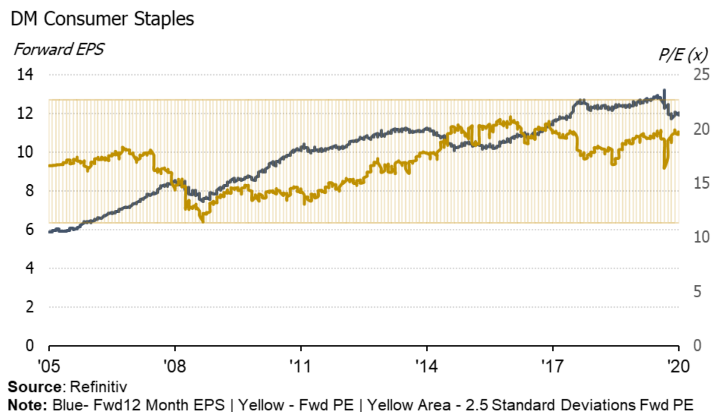
Consumer staples are trading below their peak multiples, during mid-decade. Revisions have also been modest. This trend combined with what we see in discretionary, would simplistically tell us that much of the movement is not necessarily a flight to safety but a risk-on as markets expect a fast recovery trajectory for most DMs. What is interesting, during this period, is that small caps have done reasonably well with average performance inversely proportional to size. Part of this has been led by the fact that trade and distribution has become more challenging and localised players in select industries have benefited, likely taken share.

DM Consumer Staples



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Consumer Staples	**-0.5%**	**-1.5%**	**4.3%**	**1.0%**
Agricultural Products	-19.6%	-1.1%	-8.7%	-6.5%
Brewers	-9.5%	-8.2%	-9.2%	-9.2%
Distillers & Vintners	-7.8%	-16.8%	-13.5%	-12.6%
Drug Retail	14.1%	25.6%	-8.5%	14.7%
Food Distributors	-38.8%	-4.1%	-13.8%	-11.0%
Food Retail	1.9%	16.6%	6.8%	9.1%
Household Products	14.8%	1.2%	116.6%	46.4%
Hypermarkets & Super Centers	18.0%	-14.7%	-9.7%	0.8%
Packaged Foods & Meats	-0.5%	-7.6%	7.7%	-0.2%
Personal Products	-6.6%	-8.5%	-9.6%	-8.6%
Soft Drinks	-5.4%	5.5%	17.0%	3.7%
Tobacco	-10.0%	-12.2%	-31.3%	-12.7%

*- Classification made on ending market cap [as on 10th July 2020]

Healthcare, without doubt and for obvious reasons, has been the primary beneficiary. With the exception of HC facilities and to an extent Managed care names, most sub-segments have done well. Price action has been less sharp than their EM counterparts, but healthcare technology has benefited. Even prior to the current pandemic, we have been a strong advocate for this sector as expressed in sector our positioning, from inception, across our strategies.

DM Healthcare

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

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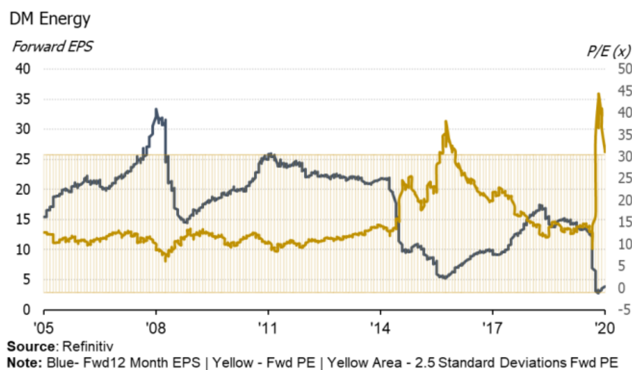
We believe the current pandemic will help in accelerating some of these company business model adoptions. Valuations have not gone into unchartered realms yet, multiples are still below 15 year peaks. This has also been the sector with one of the most secular growth trajectories.
The relative price action has meant Healthcare index weights are, to a good extent, disconnected with the employment or revenue generation. Having said that, we don't see any stress in the sector and we can actually see the segment being a net generator of employment over the coming years, not just because of the pandemic, but the demographic profile of most DMs. This is also one of the reasons we continue to like asset-light managed care/facilities despite its or their relative short term underperformance.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Health Care	30.4%	32.5%	46.4%	38.5%
Biotechnology	105.6%	60.9%	39.5%	53.7%
Health Care Services	6.0%	-8.2%	1.0%	-1.6%
Health Care Distributors	-0.1%	12.5%	0.8%	6.8%
Health Care Equipment	12.9%	47.9%	107.2%	63.0%
Health Care Facilities	-21.9%	-25.1%	-26.9%	-25.6%
Health Care Supplies	26.5%	17.4%	5.9%	14.6%
Health Care Technology	124.4%	26.1%	33.0%	37.4%
Life Sciences Tools & Services	14.3%	32.5%	314.6%	131.8%
Managed Health Care	3.5%	-12.7%	-4.7%	-2.8%
Pharmaceuticals	0.1%	7.8%	7.2%	6.1%

*- Classification made on ending market cap [as on 10th July 2020]

Energy and **Materials** have had differing performances this year. As expected, energy names have been hurt by the collapse of oil prices earlier in the year and this extended across the board. Lower demand scenarios have also hurt unilaterally. Materials, on the other hand, enjoyed a degree of positive price actions, helped in no small part from precious metals. While multiples have expanded, we would be cautious to enter at this stage as upward revisions are likely to be muted. Price increases from the current levels are going to be a factor of when full recovery is likely to happen. We also don't foresee sharper production cuts to shore up the prices for most commodities for the latter part of the year. Material earnings revisions are not yet close to GFC lows; Select commodities are likely to be in a better position helped by technology hardware needs.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

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We would expect Energy and Materials to do well short term as the second round of stimulus announcements with more specifics in the details coming in. This will likely be driven more by EM markets compared to DMs as we see DMs focusing more on consumption stimulus, as opposed to capital formation.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Energy	**-37.1%**	**-41.5%**	**-40.3%**	**-40.3%**
Coal & Consumable Fuels		-12.1%	-25.2%	-21.7%
Integrated Oil & Gas	-40.2%	-60.8%		-41.5%
Oil & Gas Drilling		-66.8%	-29.5%	-41.0%
Oil & Gas Equipment & Services	-47.9%	-49.8%	-48.9%	-49.2%
Oil & Gas Exploration & Production	-40.2%	-42.8%	-42.7%	-42.4%
Oil & Gas Refining & Marketing	-26.6%	-29.3%	-23.9%	-27.1%
Oil & Gas Storage & Transportation	-32.5%	-42.7%	-42.9%	-40.9%
Materials	**-4.1%**	**5.6%**	**28.9%**	**14.6%**
Aluminum	-21.7%	-26.6%	-15.2%	-23.0%
Commodity Chemicals	-26.9%	-16.2%	-10.3%	-14.2%
Construction Materials	-16.7%	-22.4%	-22.9%	-21.9%
Copper	-0.8%	-4.4%	-11.1%	-6.6%
Diversified Chemicals	-16.1%	-10.9%	-7.0%	-11.4%
Diversified Metals & Mining	-14.5%	12.4%	57.4%	40.0%
Fertilizers & Agricultural Chemicals	-15.8%	-15.1%	-16.0%	-15.7%
Forest Products	19.2%	-3.0%	-16.1%	-7.0%
Gold	33.6%	101.5%	125.2%	106.3%
Industrial Gases	1.2%	-1.6%	-10.8%	-1.3%
Metal & Glass Containers	-5.4%	-11.3%	2.9%	-7.4%
Paper Packaging	-14.6%	-7.6%	-7.2%	-9.6%
Paper Products	-13.6%	-16.6%	-25.0%	-19.3%
Precious Metals & Minerals	39.8%	59.4%	30.1%	41.7%
Silver	36.8%	9.6%	-3.8%	9.6%
Specialty Chemicals	-0.6%	-10.5%	-0.4%	-4.7%
Steel	-20.3%	-26.0%	-30.3%	-27.1%

*- Classification made on ending market cap [as on 10th July 2020]

Communication services and **IT** are top beneficiaries of technology platforms benefiting in the current normal – be it for productivity or entertainment. Unlike EMs, where the IT/Communication services majors have a disproportionate weight in the index, DMs are more balanced. Apple, Microsoft, Amazon, Alphabet/Google and Facebook have a combined lesser weight in MSCI World than just Tencent and Alibaba in EM. We have seen multiples breach the 2.5 standard deviation but we also expect the pace of upward revisions to increase in the coming months. Structurally, we also expect 5G to help some of these majors be able to offer differentiated products, depending on the need. There will also be a strong push to loosen Net Neutrality laws to achieve this goal as there will be a thematically justifiable narrative now.

Despite their size, the tech 'and allied' bellwethers have significantly lower weights than their EM counterparts in their respective benchmark indices.

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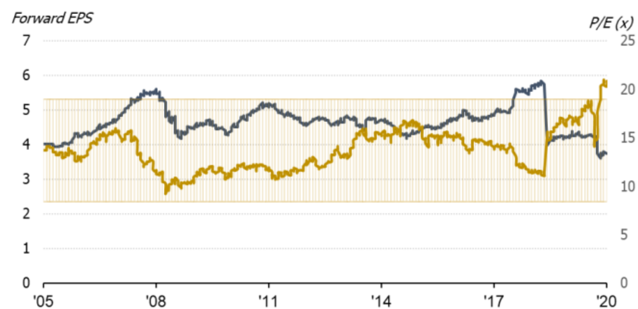
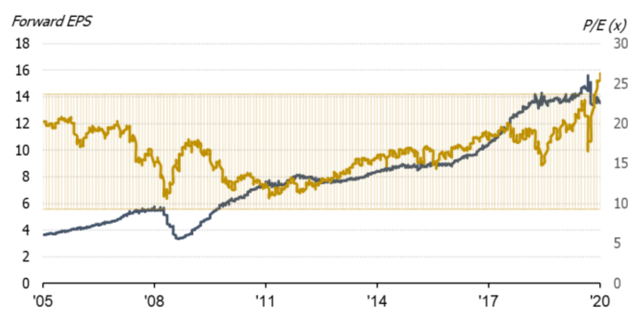


Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Information Technology	**24.1%**	**7.8%**	**2.5%**	**8.5%**
Application Software	43.9%	21.8%	13.4%	22.1%
Communications Equipment	2.4%	5.5%	-2.5%	0.4%
Data Processing & Outsourced Services	12.0%	-13.7%	-5.6%	-2.6%
Electronic Components	-5.1%	-19.5%	-18.2%	-16.9%
Electronic Equipment & Instruments	2.0%	-7.1%	-8.9%	-7.1%
Electronic Manufacturing Services	-13.0%	-23.9%	3.4%	-9.0%
Internet Services & Infrastructure	109.5%	111.5%	8.7%	68.1%
IT Consulting & Other Services	6.4%	8.4%	2.9%	5.3%
Semiconductor Equipment	36.0%	14.1%	17.5%	19.9%
Semiconductors	9.9%	9.0%	10.4%	9.7%
Systems Software	43.0%	9.5%	4.9%	15.4%
Technology Distributors	-16.0%	-4.2%	-15.6%	-11.0%
Technology Hardware, Storage & Peripherals	-13.0%	-10.8%	-1.9%	-7.4%

*- Classification made on ending market cap [as on 10th July 2020]

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Communication Services	**6.5%**	**-6.9%**	**1.4%**	**-0.2%**
Advertising	-24.0%	-9.0%	-15.1%	-14.7%
Alternative Carriers	-0.8%	7.4%	11.6%	7.9%
Broadcasting	-38.4%	-29.1%	-29.8%	-30.0%
Cable & Satellite	-7.7%	-21.8%	-40.2%	-17.2%
Integrated Telecommunication Services	-7.1%	13.3%	17.2%	5.3%
Interactive Home Entertainment	61.9%	33.0%	34.7%	39.6%
Interactive Media & Services	16.8%	-0.4%	7.9%	8.0%
Movies & Entertainment	11.5%	-33.1%	10.2%	-0.9%
Publishing	-1.5%	-17.7%	-16.0%	-14.8%
Wireless Telecommunication Services	2.4%	-9.9%	-29.2%	-9.0%

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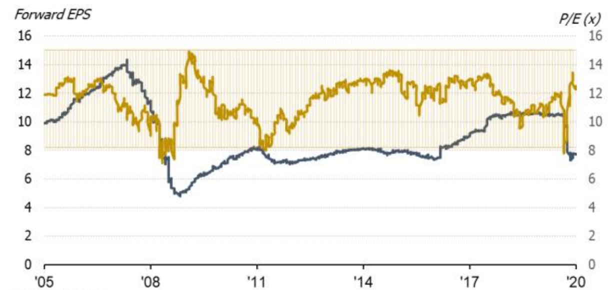
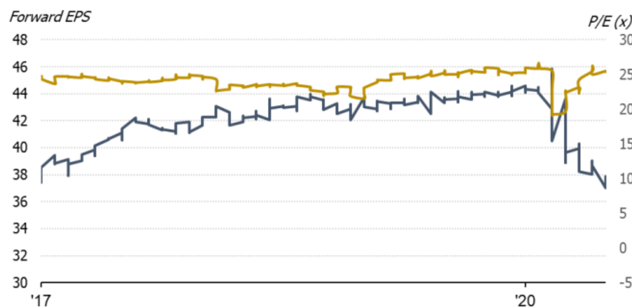
We don't expect DM **financials** to have a significant level of stress in large part thanks to policy actions and positioning form lessons learned form GCF: earnings impact might be significantly lower as we have not seen the same level of squeeze as then. Policy makers have acted fast to prevent any form of domino effect at a systemic level, but bottom-up we avoid the sector as lower rates plus higher NPLs could result in a prolonged earnings recession.

DM Financials



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

DM Real Estate



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Post results, we won't be surprised if the sector relatively outperforms though, as valuations vs. short term expectations seem misaligned.

Real Estate might find an extended period of pain as they are likely to be late cyclical in the present situation. With forced capacity reductions, we also expect significant demands for rental reductions.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Financials	**-17.7%**	**-19.6%**	**-23.2%**	**-20.8%**
Asset Management & Custody Banks	-7.1%	-11.6%	-17.7%	-14.1%
Consumer Finance	-29.0%	-13.5%	-17.6%	-17.3%
Diversified Banks	-27.4%	-22.4%	-22.6%	-24.5%
Diversified Capital Markets	-10.7%	-33.0%	-0.8%	-15.1%
Financial Exchanges & Data	15.4%	13.4%	1.4%	11.2%
Insurance Brokers	0.5%	14.4%	-4.3%	4.3%
Investment Banking & Brokerage	-7.2%	20.2%	-8.0%	4.7%
Life & Health Insurance	-26.2%	-22.8%	-19.6%	-24.2%
Mortgage REIT's	-28.8%	-47.9%	-46.0%	-46.2%
Multi-line Insurance	-26.3%	-14.2%	-16.2%	-20.2%
Multi-Sector Holdings	-4.1%	-18.9%	-10.1%	-12.6%
Other Diversified Financial Services	-25.9%	-13.1%	-19.7%	-20.0%
Property & Casualty Insurance	-18.4%	-14.2%	-21.4%	-17.5%
Regional Banks	-29.6%	-30.3%	-30.5%	-30.4%
Reinsurance	-27.2%	-16.3%	17.2%	-17.8%
Specialized Finance	-9.1%	-8.0%	-5.9%	-7.1%
Thrifts & Mortgage Finance		-33.8%	-27.4%	-30.6%
Real Estate	**-18.1%**	**-19.3%**	**-22.6%**	**-20.3%**
Diversified Real Estate Activities	-30.4%	-12.0%	-15.5%	-15.9%
Diversified REITs	-29.1%	-28.9%	-25.1%	-27.2%
Health Care REITs	-26.3%	-19.5%	-27.2%	-21.9%
Hotel & Resort REITs	-28.5%	-52.2%	-53.9%	-50.7%
Industrial REITs	8.2%	4.3%	-19.2%	3.2%
Office REITs	-27.6%	-26.5%	-21.3%	-25.3%
Real Estate Development		-13.2%	-26.9%	-21.1%
Real Estate Operating Companies	-7.8%	-13.4%	-15.9%	-13.9%
Real Estate Services	-34.0%	1.9%	-23.1%	-11.4%
Residential REITs	-17.0%	-12.2%	-19.3%	-15.6%
Retail REITs	-43.2%	-32.4%	-40.4%	-35.6%
Specialized REITs	-1.3%	-13.1%	-16.3%	-9.8%

*- Classification made on ending market cap [as on 10th July 2020]

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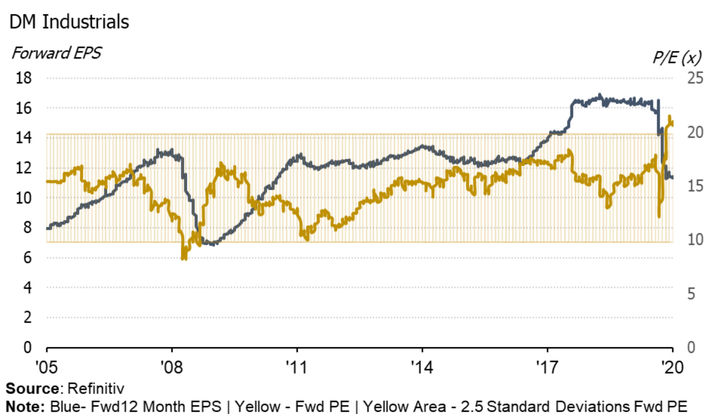
Presently, we see **Utilities** remaining in a holding pattern that it has been for most of this year. DM utilities have less concern on market interference by policy makers/regulators than their EM counterparts. We have seen multiples retrace post the March correction while earnings expectations have remained flattish. This lends some support to a risk-on argument.
What has been encouraging is the relative outperformance of renewables YTD. A market focus on ESG? We think so.

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Utilities	**-6.6%**	**-5.2%**	**8.0%**	**-3.3%**
Electric Utilities	-6.3%	-10.8%	-5.0%	-8.1%
Gas Utilities	-6.3%	-14.2%	-5.2%	-9.8%
Independent Power Producers & Energy Traders	-5.7%	-9.1%	0.6%	-6.4%
Multi-Utilities	-10.1%	-20.6%	8.7%	-13.6%
Renewable Electricity	8.6%	19.0%	35.8%	23.7%
Water Utilities	-4.3%	-5.8%	-12.5%	-8.1%

*- Classification made on ending market cap [as on 10th July 2020]

Industrials have seen the most acute declines, across all its sub-segments.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Saving for the last, **Industrials** – which remains the largest by employment and topline. We have seen earnings downward revisions to the tune of a third though multiples have also doubled from the lows of March. Industrial Machinery and construction are the two largest sectors and from an employment perspective – they are likely to get localized boosts; like we mentioned earlier, we don't see any grandiose capital formation stimulus in most DMs - the worst thing for a demand recovery would be crowding out effect. Notwithstanding, we are likely to see small scale localized projects to shore up employment. We may also see pass-on benefits from increased technology driven capex to offset the non-sector declines. These are still driving factors from our end and forms the basis of how we position our DM strategies. For ground realities, we await further commentary from results.

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YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Industrials	**-7.0%**	**-13.1%**	**-9.6%**	**-10.6%**
Aerospace & Defense	-21.4%	-19.6%	-1.3%	-14.7%
Agricultural & Farm Machinery	-18.8%	-16.5%	19.2%	0.7%
Air Freight & Logistics	14.9%	-2.1%	-14.6%	-1.8%
Airlines	-48.1%	-53.8%	-48.7%	-51.5%
Airport Services	-32.8%	-31.5%	-39.2%	-34.2%
Building Products	0.5%	-9.1%	-6.6%	-6.5%
Commercial Printing	-20.3%	-25.1%	-11.2%	-16.3%
Construction & Engineering	-15.5%	-11.9%	-15.7%	-14.1%
Construction Machinery & Heavy Trucks	21.8%	-18.6%	-30.2%	-13.4%
Diversified Support Services	-7.0%	-25.6%	-20.1%	-21.4%
Electrical Components & Equipment	-5.2%	19.0%	10.2%	11.5%
Environmental & Facilities Services	5.7%	-22.6%	43.6%	17.5%
Heavy Electrical Equipment	-9.1%	69.4%	22.9%	32.6%
Highways & Railtracks	-19.3%	-25.0%	-19.6%	-21.0%
Human Resource & Employment Services	-20.1%	-20.5%	-25.2%	-23.0%
Industrial Conglomerates	-10.0%	-7.5%	-28.7%	-13.5%
Industrial Machinery	-5.7%	-17.8%	-7.1%	-11.7%
Marine	-14.8%	-31.7%	-28.6%	-29.0%
Marine Ports & Services		-18.3%	-16.9%	-17.6%
Office Services & Supplies		-28.4%	-26.4%	-27.3%
Railroads	-14.8%	-20.6%	-24.8%	-18.4%
Research & Consulting Services	6.3%	7.7%	-9.7%	-1.7%
Security & Alarm Services	-3.9%	-38.7%	-14.8%	-26.9%
Trading Companies & Distributors	-4.3%	-17.8%	-20.2%	-17.4%
Trucking	3.0%	19.0%	-6.5%	6.5%

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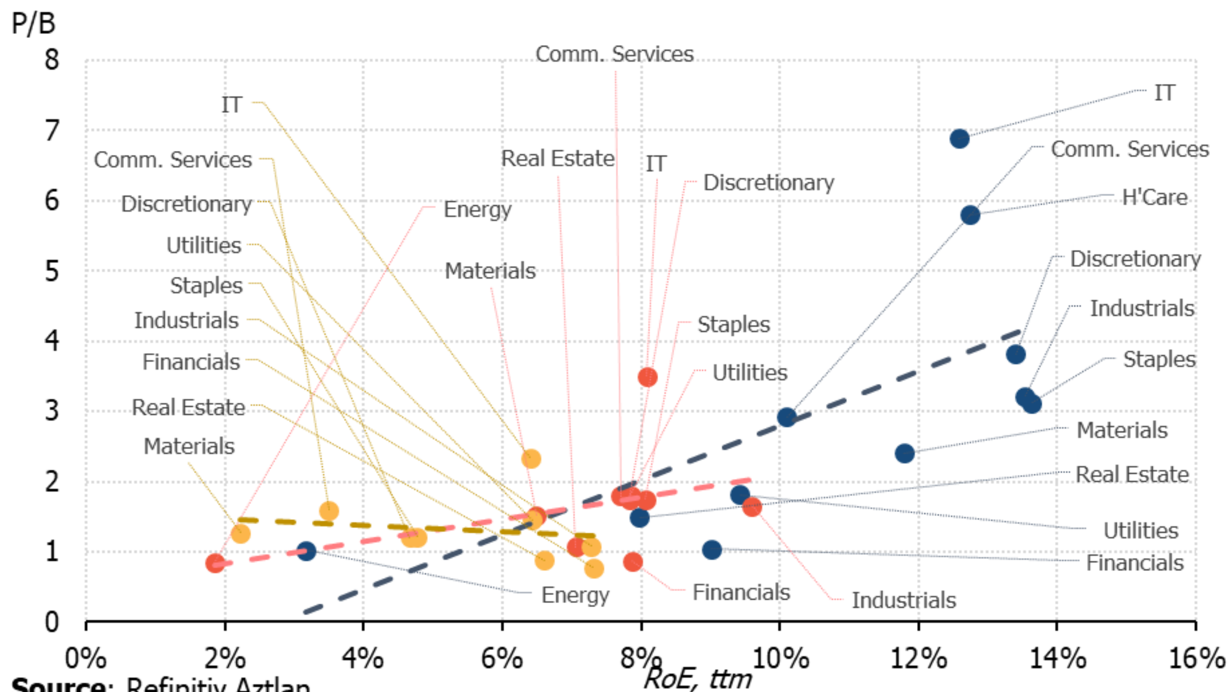
One Chart for them All…



Source: Refinitiv,Aztlan
Note: Blue Circles- Large Caps | Red Circles - Mid Caps | Yellow - Small Caps.

In DMs, we find the correlation between the size and valuations holding up fairly strong. There is a strong relationship between RoE, size and valuations, as indicated by the slope of their trend lines. As size of the firm increases, we see the steepness expanding, implying a higher 'relative valuation' co-efficient. We are surprised by how nicely the relationships fit when the composite list is used. In part, we would see this as a flight to safety especially towards sectors that are more capital efficient. We see that capital intensive industries enjoy lesser multiples and fall typically below the line. This also highlights out the fact that the distinct difference between liquidity for asset classes vs. liquidity for capital formation. We would hypothesize that markets believe that capital intensive industries will not cross the threshold capacity utilization in the medium term.
The diffusion of RoEs is remarkably large at large caps; Currently, our composite has negative/immaterial ROEs for healthcare in small/midcap – hence these have been excluded [for the purpose of comparison, we have gone with reported earnings and not adjusted ones].

In DM, there is a strong relationship between RoEs and Valuations, especially at large caps

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EMERGING MARKETS

SMALL & MIDCAPS
Looking Beyond The Cover

July · 29 · 2020

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ARE EMS UNDERVALUED?

The discount (NTM PE) is at its steepest since 2005. EMs enjoyed a significant re-rating in the first half of the 2000s, backed by an emergent interest into BRICS, commodity boom and domestic growth. Since the GFC and the start of QE, we have seen this discount inch back up, slowly and steadily. The discount remains within the +/- 1 SD range. The only times they have breached this has been during the Asian Financial crisis and during the tech bubble + Rongji reforms.

Local currency performance has been positive in many markets but on a USD basis, most markets underperformed LTM. Currency has been a massive headwind for most.

Valuation multiples have spiked up as liquidity pumps and a crashing cost of capital allows for near-medium term C19 impact to be brushed aside. The index heavyweights (China, South Korea, Taiwan), nearly half of the index, are in a far better shape to recover from C19 than many of their EM counterparts. At the same time, these markets have, at least in count, more SOEs, Chaebol or Asset heavy cyclical names – all of which traditionally warrant a lower multiple.

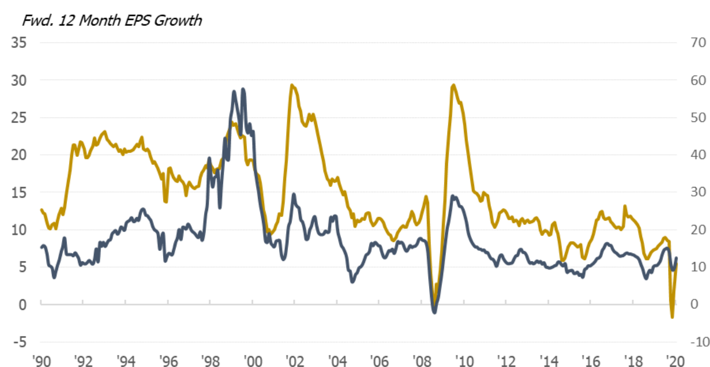
Contrary to expectations, revisions have not been as brutal as expected. We remain wary of the headline growth numbers especially as it increasingly looks out of sync with the real economy.

Secondly, we have noticed that, for a period of such uncertainty, the standard deviation in the estimates have not spiked materially in EMs. Of course, while a part of this can be explained by staleness, a part of it is also due to limited China revisions.

Forward P/E Multiple Implied EM Discount have spiked to steepest since 2005

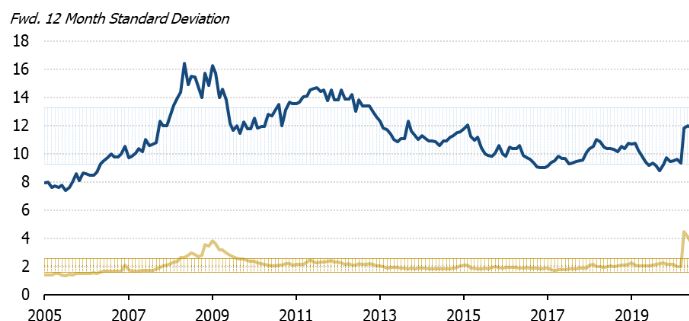
Source: Refinitiv
Note: Blue Line(lhs): EM |Yellow line(lhs): DM |Blue Area (rhs) Growth is defined as NTM EPS/TTM EPS | Light Blue (rhs) indicates 1 standard deviation

EM estimates have been in a tight pattern the decade gone by



Source: Refinitiv
Note: Blue: EM |Yellow: DM |Growth is defined as NTM EPS/TTM EPS |

EM Estimates have not seen much volatility, compared to DM or GFC



Source: Refinitiv
Note: Blue: EM |Yellow: DM |1 Standard Deviation of Index Forward 12 Month EPS in area |

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What about the Small-Midcap space?

Currently, the index Forward EPS (next 12 months over the past 12) for EM SMID is still 35%+ and the revision pace is also lower than Developed Markets Ex USA. We exclude USA to make a more granular comparison. While we have dished out a few numbers in the table, the key point remains we are more confident in DM ex USA numbers even if it is a decline compared to the EM growth ones.
All this leads us to believe that we are, prima facie, basing the EM discount, to a large extent, on stale estimates.

DMXUS	TTM EPS	Fwd EPS	Book Value	Earnings Growth	Revision to Jun'20
01-Jun-19	81.5	91.7	871	13%	-23%
01-Dec-19	83.6	92.2	900	10%	-24%
01-Jun-20	79.4	70.2	958	-12%	

EMF	TTM EPS	Fwd EPS	Book	Earnings Growth	Revision to Jun'20
01-Jun-19	81.5	108.8	948	34%	-19%
01-Dec-19	78.1	108.6	927	39%	-18%
01-Jun-20	65.2	88.6	927	36%	

Source: MSCI; Fundamental data calculated using multiple data provided

The changing composition of the indices, nonetheless, have helped – as Tech/Healthcare/Discretionary become larger. The fact that the multiples have not hit the pre-GFC numbers is indicative of the systematic de-rating/stress that the traditional EM sectors (Energy/Financials/Materials/Utilities) face. During our interactions with company management over the past 3 months, the one singular element that seems to permeate is the complete lack of visibility into how things will pan out. Most companies have withdrawn their guidance.

And a Word Ex-China...

China's strong price actions this year have added the gloss to the overall set for numbers. We present a look at ex-China aggregates based on average price performance across sectors on our composite list of companies. The results seem to fall firmly into the broad perspective of outperformance of New Economy vs Old Economy with modest gains for communication services, IT and staples – all of which are more resilient in the current pandemic. We don't expect any major impact for these firms in most durations.

Healthcare has been the key outperformer - again not a major surprise as things stand out. This is the only sector that has outperformed across all size classifications and this extends to most o its sub-segments. We would add in a caution that for many companies in this space, valuation multiples themselves have moved out of +2.5 standard deviation, considering both 12/18-month cycle (on consensus numbers). This presents a clear challenge to a mean-reversion thesis in absolute terms, without regard to the relative cost of capital.

YTD USD Price Performance, Ex CHINA	Large Cap	Mid Cap	Small Cap	Total
Communication Services	2.5%	5.5%	13.1%	8.8%
Consumer Discretionary	-7.3%	-6.8%	-2.4%	-3.8%
Consumer Staples	3.1%	2.2%	2.4%	2.4%
Energy	-23.1%	-20.0%	-20.3%	-20.7%
Financials	-23.1%	-19.5%	-6.9%	-14.7%
Health Care	91.4%	43.7%	69.2%	62.4%
Industrials	-14.6%	-8.5%	-7.0%	-7.7%
Information Technology	7.0%	21.7%	13.1%	15.0%
Materials	-10.8%	-1.9%	-1.9%	-2.6%
Real Estate	-2.8%	-16.5%	-12.4%	-13.6%
Utilities	-10.1%	-11.7%	-3.7%	-8.8%
Aggregrate	**-5.1%**	**-1.8%**	**5.1%**	**2.1%**

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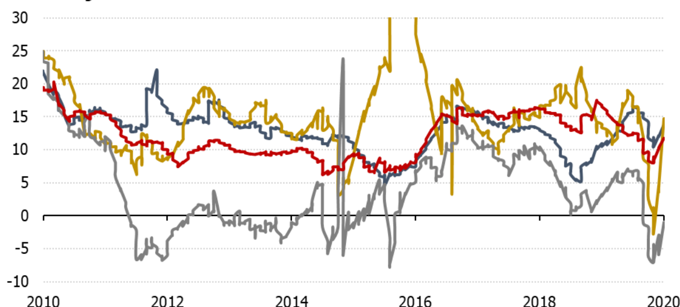
DISSECTING THE RETURNS

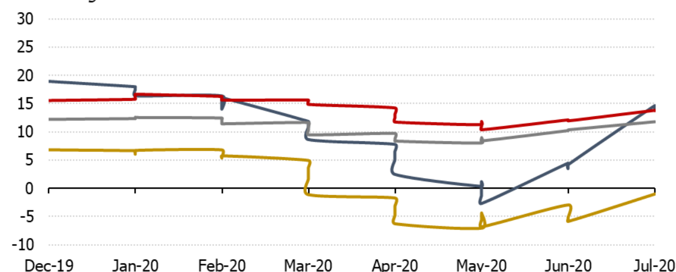
Region

In EM, index EPS revisions have, by and large, been driven largely by energy/commodity price falls and what we can see, limited impact of C19. As postulated earlier, this can be attributed, in part to the index composition. EMEA has seen the sharpest revision cycle, due to impact of energy prices on ME. LatAm revisions have inched up sharply by mid-May.
EM Asia has been in a low-mid teens holding pattern. We are seeing a good stress in the economy and currently, these estimates have stopped being a proxy of the ground conditions which underpins our New vs Old investment view. LatAm has also seen the maximum divergence in estimates, spiking to decadal highs. This has typically led to the market underperforming, during previous cycles.

Energy prices have had a greater impact on earnings estimates this year compared to demand. In addition, the cavalier attitude by bellwethers in LatAm also led to negative revision cycles there.



Source: Refinitiv
Note: Grey - MSCI EM EMEA | Red - MSCI China | Yellow - MSCI LatAm | Blue - MSCI Asia



Source: Refinitiv
Note: Grey - MSCI EM EMEA | Red - MSCI China | Yellow - MSCI LatAm | Blue - MSCI Asia

To clarify on the forward earnings growth chart, this compares with Forward 12-month estimate to the trailing 12 month (TTM) EPS. Some news/negatives are likely already baked in to TTM EPS. Hence a growth/pick-up is not necessarily an indication of 'modest euphoria'.
Having said that, during the quarter gone by - we have held numerous management conversations with our invested companies and prospects: by and large, the observations have been that things were improving from the start of the Q2. Of course, the singular factor in this has been the moderation that we saw in cases during wave 1. With cases spiking up again and policy makers still emphasising lockdowns (not as stringent as wave 1), we wonder how companies are going to deal with relapses. It is one thing to expect a sharp fall, compared to an extended period of uncertainty in demand/investment cycle.

Against this backdrop, re-rating has been driving the market returns, to 10-year highs. Some of the multiple expansion is not liquidity driven but an expectation that much of this EPS revisions is still temporary and a return to normalcy is factored in. On the same token, we note that EM Asia has seen the most re-rating, considering its modest revisions against the multiple expansion. In part, this can be explained by the bellwether names – 8 of the top 10 names (as of end June) have a strong tech/internet connection, either directly (Alibaba, Tencent etc.) or by implication (Reliance, Naspers).

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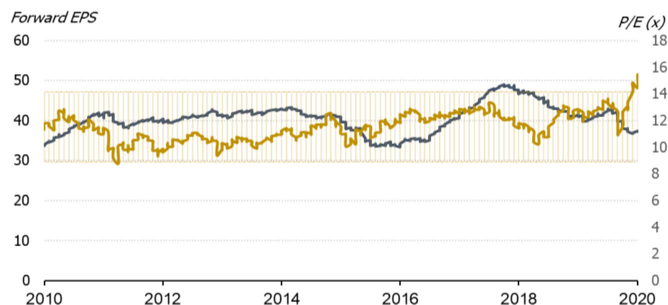
EM ASIA

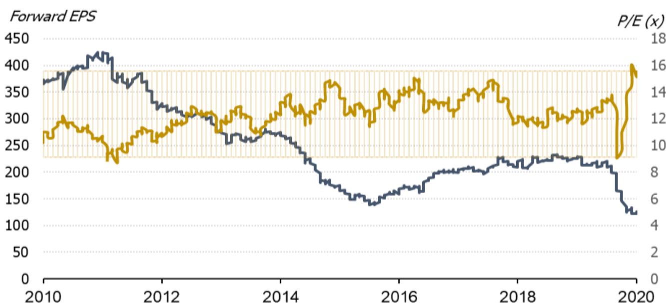


Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Asia didn't see any major negative earnings revision momentum but this is mostly due to China, Taiwan and to a lesser extent – Korea.
LatAm, however has seen sharper revisions due to demand contraction and commodity price declines

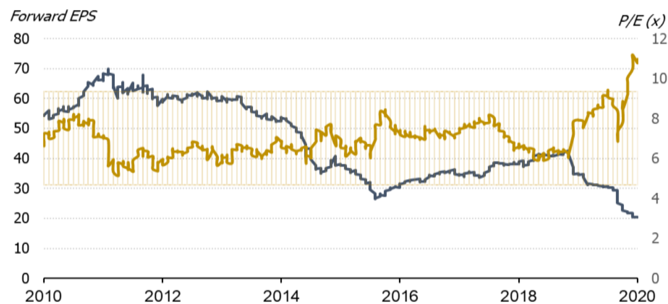
Most regional valuations have also breached the 2.5 standard deviations, not to make mention, decadal highs. Forward Earnings Revisions have been sharper in LatAm and EMEA.

EM LATAM



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

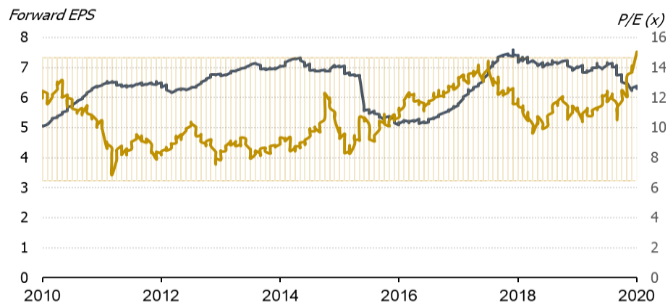
EM EMEA



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

In EMEA, Earnings revision has been sharp - in part – due to ME impact. Energy price declines have had a noticeable and sharpest impact on revisions this year (thus far).

EM CHINA



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

China has seen a multiple expansion and is at decadal highs though still below previous highs during the Pre-GFC EM/BRIC rally. Tech has been the main driver, especially as tech-linked stocks transcending GICS sectoral classifications on the back of expectation that secular growth will be driven by high innovation.

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Sector

Top down sector valuations are hard for inferences, as company operations are increasingly more fluid than the rigid sector classifications that we are accustomed to. Within primary classifications, we are going to find materially different progressions especially depending on how the lockdowns restrictions and post lockdown imposed capacity constraints operate in each region. In general, we would expect the degrees of freedom to gravitate towards the success/failure of the most relaxed regimes as we head towards the exit of this calendar year.

Post our note on how valuations and estimates have trended, we would try and take a look at some top down numbers for each sector/sub-segment, to present a picture on the real economy impact.

Industrials, Financials and Discretionary form the main pillars of EM economies while IT and Communication Services hold a significantly higher weight and valuations in the indices.

	Sector Weight - MSCI EM	By Employment*	By Revenue**
Communication Services	13.5%	5.4%	4.7%
Industrials	4.7%	17.5%	17.8%
Consumer Staples	6.5%	11.3%	6.7%
Materials	6.9%	8.1%	10.7%
Consumer Discretionary	17.4%	14.4%	10.7%
Information Technology	16.9%	10.1%	10.3%
Financials	19.1%	16.4%	-
Health Care	4.3%	3.8%	2.7%
Energy	6.0%	5.8%	16.9%
Real Estate	2.6%	4.8%	5.7%
Utilities	2.3%	2.5%	4.2%

*- Calculated as full time employed % in Large and Mid-cap companies [> 500 Mn. Listed companies]
** - Calculated as Large +Mid cap revenues % of all universe listed companies >100 Mn. (Market Cap) [Excluding Financials]

Source: Aztlan, Refinitiv, MSCI

At the cost of a slightly cluttered chart (next page), we wanted to highlight a severe contraction is also expected in the 'energy' segment as such directly in line with the energy price crash. Financials are also expected to be weak, but as estimates stand, this presumes that no major stress in the system is expected, which we find hard to concur with. Financials are likely to experience the most stress in the system – considering economy stress are likely to translate into increased credit costs/NPLs and this could extend till the rest of the sectors recover. The lower cost of credit means less if the underlying repay-ability/cash flows are still impacted. In general, that would mean relaxation of the capital criteria's/buffers or more capital infusion/dilution in this segment. Incidentally, the estimates seem to indicate far lesser sectors are going through the same stress compared to previous global crises.

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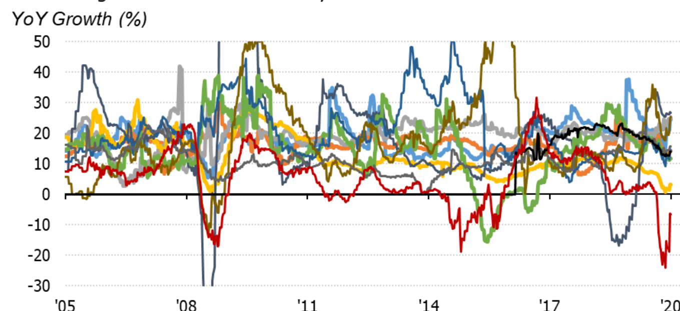
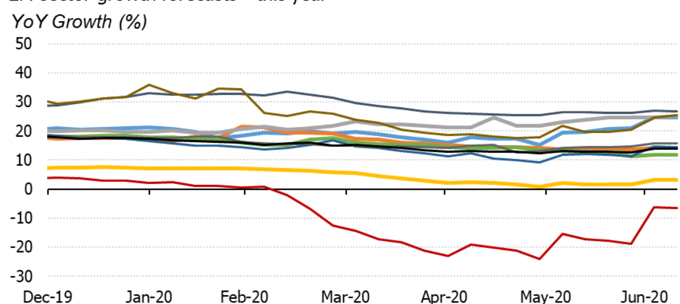
During the GFC, we saw sharp corrections in IT/tech names – this time, tech is mostly the growth driver. Support services will be hurt as IT budgets will be slashed/put on hold. Direct to consumer tech have benefited but as valuations soar, it is imperative to take valuation multiples into investment consideration.
We are not expecting an instant brew of 'new normal' but the current situation will likely continue to play for the foreseeable future (perhaps into mid-late next year). We will evaluate investments in this space as we see how growth and innovation continue to pan out.
This time around – we are seeing more stacking of growth estimates and in general, the bounce expectations are more pronounced. In short 'Old Economy' (e.g. oil/internal combustion) in a secular lag vs Tech which in turn has regional implications as ~60% of the 'New Economy' weights in EM are tilted towards China, Taiwan and South Korea.

EM sector growth forecasts over the years



Source: Refinitiv.
Note: See Legend* Below

EM sector growth forecasts - this year



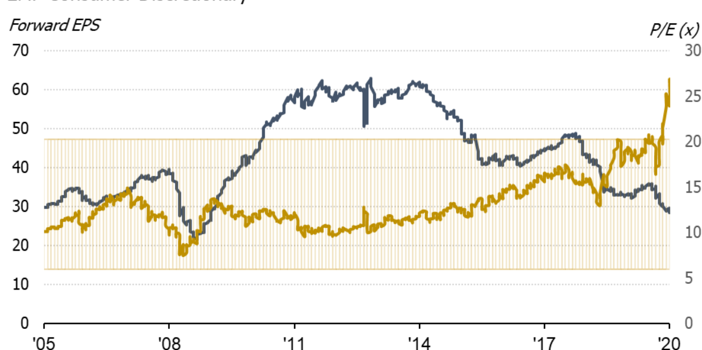
Source: Refinitiv.
Note: See Legend* Below

Regional imbalances came to fore in EM indices this year. The innovation trends towards tech and healthcare further benefit Asia, compared to LatAm and EMEA.

Consumer Discretionary | Consumer Staples | Health Care
Financials | IT | Utilities
Industrials | Materials | Communication Services
Real Estate | Energy

Consumer Discretionary stocks have re-rated significantly, in fact multiples today stand at more than 2.5 deviations over its 15-year average. While downward pace of revisions are still below GFC, multiples have shot up significantly. We don't see demand pick-up to be so strong over the coming months. In fact, at current valuations, the sector is already factoring blue sky. Pockets of discretionary are unlikely to recover quickly in the coming 12-18 months and we see major structural changes/business model changes in the space.

EMF Consumer Discretionary



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

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Consumer Discretionary remains a key employer within EM. As we discuss this greater detail in latter sections of this report, when we compare if the index has decoupled from the real economy, its impact is even more pronounced within small and mid-caps. Our analysis of listed companies indicates close to 70% of employment within the consumer discretionary space originating from small/midcaps. If we exclude autos, this becomes even more acute. We haven't included the black-hole i.e. the 'informal economy' in EMs but empirically we note that a substantial chunk of it would be classified in this sector.
Our broad market analysis of price action check indicates large caps, among the segment, have done reasonably well while small caps have been worst hit. Most of the sub-segments have performed in-line with broad expectations, there are a few outliers which warrant a closer attention.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Consumer Discretionary	**15.5%**	**11.2%**	**-3.8%**	**3.1%**
Apparel Retail	6.7%	-33.5%	-26.2%	-28.1%
Apparel, Accessories & Luxury Goods	-12.3%	-6.6%	-10.9%	-9.5%
Auto Parts & Equipment	8.5%	16.2%	-4.8%	3.8%
Automobile Manufacturers	0.1%	6.7%	3.1%	3.8%
Automotive Retail	19.4%	17.6%	-18.4%	-3.1%
Casinos & Gaming	-20.7%	-23.3%	-30.8%	-25.7%
Computer & Electronics Retail	10.6%	5.0%	-8.0%	-1.1%
Consumer Electronics	52.6%	28.1%	20.5%	27.9%
Department Stores	-24.2%	16.4%	-18.5%	-0.3%
Distributors	63.8%	3.0%	-3.2%	1.1%
Education Services	65.3%	29.7%	-1.3%	13.1%
Footwear	7.0%	-20.0%	-14.2%	-17.3%
General Merchandise Stores	151.3%	19.7%	-3.6%	42.9%
Home Furnishings	10.6%	13.6%	-4.1%	3.2%
Home Improvement Retail	7.0%	-7.3%	-18.4%	-7.7%
Homebuilding		-5.0%	-21.1%	-14.5%
Homefurnishing Retail		7.9%	-10.4%	-5.8%
Hotels, Resorts & Cruise Lines		-5.0%	-13.8%	-11.1%
Household Appliances	-2.2%	12.0%	-3.5%	3.2%
Housewares & Specialties		64.8%	31.6%	36.3%
Internet & Direct Marketing Retail	55.9%	31.0%	1.5%	20.2%
Leisure Facilities	6.6%	-10.3%	-13.2%	-10.3%
Leisure Products		29.1%	-3.9%	10.5%
Motorcycle Manufacturers	-9.2%	47.5%	-11.7%	20.8%
Restaurants	10.1%	-21.9%	-16.8%	-17.8%
Specialized Consumer Services		12.4%	3.7%	7.1%
Specialty Stores	59.9%	-17.5%	7.8%	7.0%
Textiles		59.8%	28.4%	38.2%
Tires & Rubber		1.9%	-6.3%	-2.5%

*- Classification made on ending market cap [as on 10th July 2020]
Source: Aztlan; Refinitiv

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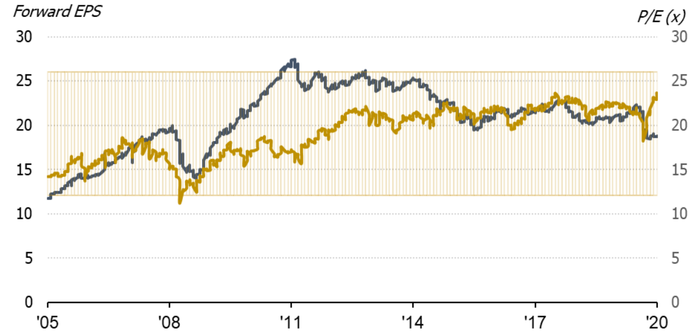
Staples, within EM, is dominated by large caps and to a lesser extent mid-caps. Small-caps would be less than 10% of either employment or revenues. Historically Staples have been relatively more resilient to economic downturns and we would expect the sector to tide over the current phase within a narrow valuation range. Thus far, that seems to be the case. Again, the revision pace has been considerably slower than 2008 and while multiples expanded to recent highs, it has remained within 1 SD. The biggest employment comes from the Packaged Foods & Meats sub-segment, which many countries have classified as essential services and operating mostly BAU. Among the sub-segments, at risk would have been soft drinks, tobacco and brewer/distillers.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Distillers had a good year in EM, posting strong price action YTD, though to a large extent, attributable to Chinese names.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Consumer Staples	**21.8%**	**19.2%**	**1.1%**	**11.3%**
Agricultural Products	28.5%	18.4%	-9.2%	4.2%
Brewers	6.3%	-6.1%	2.6%	-0.6%
Distillers & Vintners	33.0%	23.5%	-1.2%	16.9%
Drug Retail	37.4%	2.2%	27.9%	15.3%
Food Distributors	-29.7%	-6.2%	-7.3%	-8.4%
Food Retail	12.8%	18.7%	7.4%	15.1%
Household Products	0.6%	17.3%	87.0%	50.6%
Hypermarkets & Super Centers	43.0%	6.1%	-25.2%	11.4%
Packaged Foods & Meats	32.2%	21.8%	-2.7%	11.1%
Personal Products	-6.2%	55.7%	5.9%	19.9%
Soft Drinks	-25.1%	-9.2%	6.4%	-2.5%
Tobacco	-20.1%	-15.8%		-17.0%

*- Classification made on ending market cap [as on 10th July 2020]

Healthcare remains the market favourite, for all the right reasons. Multiples have moved significantly above the 2.5 standard deviation of 15 year forward multiples. Going even further, the markets have typically not rewarded the segment with such multiples during previous pandemics. Then again, this one is unique in its spread/dispersion attributes, even if it has scores lower on fatality. We remain cautious on many of the names, mostly on the product/solution side, particularly exit multiples are also looked stretched, even assuming a 3-year cycle. Short-Medium term fundamentals of consumables companies, particularly those with directional exposure to C19 needs, have done well in these markets. We expect this to continue into next year.

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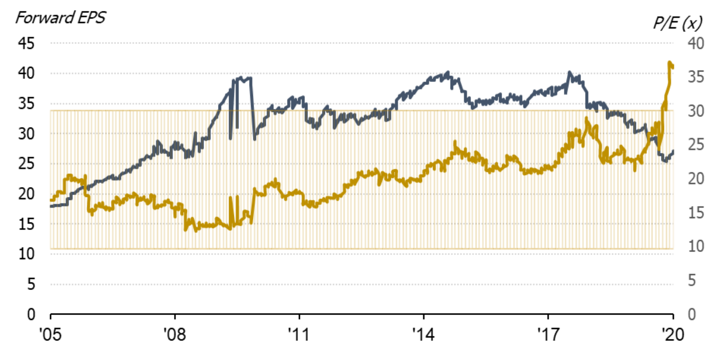
Healthcare, by employment or revenues, is not a big chunk for most economies. The space is typically dominantly by mid-caps, accounting for half of employment and roughly 40% of topline. Among all the sub-segments, we have seen Managed Care but this could also be a factor of country specific issues (all of them are Brazilian names) – an out of control pandemic is never good for this segment.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

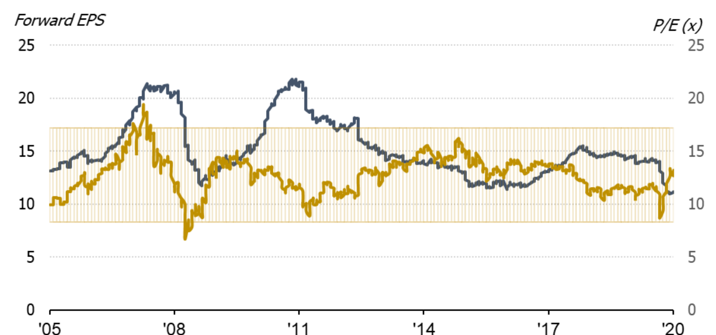
'Elementary' ?

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Health Care	91.7%	50.0%	55.0%	56.4%
Biotechnology	87.7%	77.3%	102.9%	91.1%
Health Care Services	31.3%	6.1%	1.6%	7.1%
Health Care Distributors	24.5%	15.0%	7.7%	13.5%
Health Care Equipment	120.1%	120.3%	100.6%	110.3%
Health Care Facilities	47.8%	-4.7%	-9.3%	-3.3%
Health Care Supplies	297.9%	130.1%	178.6%	184.9%
Health Care Technology	132.6%	56.9%	28.1%	55.0%
Life Sciences Tools & Services	57.3%	68.5%	90.7%	75.2%
Managed Health Care	-28.8%	-36.5%		-32.7%
Pharmaceuticals	60.7%	37.7%	22.8%	33.7%

*- Classification made on ending market cap [as on 10th July 2020]

Industrials is where the divergence from the index is largest. Accounting for nearly a sixth of revenues and even employment, the segment is currently less than 5% of the EM indices. The sector multiples have, over the past decade, remained in a fairly tight range, but earnings have steadily fallen off, in part from currency, slowing capex and industrial production cycles. During the current pandemic, we have seen earnings estimate fall off significantly as transportation, general construction activities take a big hit. Multiples still remain below Pre-GFC numbers.

As we exit current pandemic and policy makers look at a fiscal expansionary program/stimulus, this segment could see a substantial boost. We also expect a lowering of refinancing costs, deferment of liabilities and in some cases, more capital unlocking (asset securitizations) led by policy makers. This segment is the primary focus expansion in of aggregate demand and at the same time, it may not move the needle much, index-wise.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

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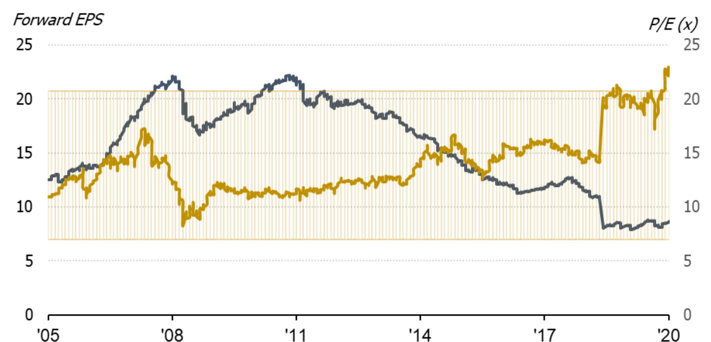
YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Industrials	**11.2%**	**14.1%**	**-4.4%**	**5.1%**
Aerospace & Defense	51.4%	22.2%	1.5%	20.9%
Agricultural & Farm Machinery		37.6%	7.5%	20.1%
Air Freight & Logistics	32.4%	9.9%	2.7%	7.2%
Airlines	-21.3%	-21.1%	-38.4%	-28.8%
Airport Services	-16.9%	18.1%	-38.5%	5.5%
Building Products	79.9%	20.6%	-12.4%	3.2%
Commercial Printing		6.6%	-8.0%	-3.1%
Construction & Engineering	-6.6%	4.0%	-9.7%	-4.1%
Construction Machinery & Heavy Trucks	0.7%	11.8%	-8.5%	4.0%
Diversified Support Services		44.2%	24.7%	36.4%
Electrical Components & Equipment	51.7%	27.8%	9.7%	20.0%
Environmental & Facilities Services	55.6%	15.9%	2.9%	10.3%
Heavy Electrical Equipment	3.8%	17.9%	-0.8%	9.8%
Highways & Railtracks	-17.9%	-12.6%	-16.7%	-14.0%
Human Resource & Employment Services		-4.7%	-14.8%	-9.7%
Industrial Conglomerates	-14.0%	-17.7%	-16.7%	-16.7%
Industrial Machinery	47.8%	27.4%	-1.5%	12.3%
Marine	-15.1%	-9.9%	-10.6%	-10.5%
Marine Ports & Services	-3.7%	-4.1%	-8.2%	-5.8%
Office Services & Supplies	20.8%	37.0%	-3.6%	20.1%
Railroads	-21.4%	4.1%	-33.8%	-3.5%
Research & Consulting Services	56.8%	14.9%	6.2%	11.3%
Security & Alarm Services		-12.7%	0.6%	-7.4%
Trading Companies & Distributors		10.5%	-10.0%	0.3%
Trucking	-30.4%	10.8%	-22.7%	-7.7%

*- Classification made on ending market cap [as on 10th July 2020]

Construction and Engineering remain a primary employer. From a size perspective, the segment is mostly dominated by large/midcaps, in both revenues and full-time employment. Small caps account for ~13% of employment (though this is likely to be much higher when considering contract/wage earners; we estimate north of 40%) and 10% of revenues. While small-caps have been hurt during the current crisis, we note that the segment has broadly done well, under current conditions. Though if we exclude China, the story is not that great. To illustrate, the overall +11% in large caps turns out to a negative 15% ex-China.

Communication Services is the diametric opposite. Relative to employment or revenues, this segment has an outsized weight in the index. Tencent accounts for half of the weight of this segment. So one could argue, ex-Tencent, the segment is relatively in-line. The segment has seen some reclassifications from the earlier Telco nomenclature, as such, over the past few years. So like for like historical comparisons are a bit more elusive.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

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The Telco segment is also dominated by large caps, both in employment and revenues. While Tencent may lead the segment in indices, the real economy metrics is dominated by telcos – wireless and to a lesser extent, the integrated ones. This segment may be the surprise horse exiting the year, we would like to see if 5G roll-outs (and subsequently mm waves and Rel17) can offer a new path for telcos to emerge from the dumb pipes they had become over the past decade. Also, we don't expect any more sense-numbing spectrum auctions /monetization in the future. This should help the telcos make the necessary push to move from a utility play back to consumer/Tech play. We expect, in general, content producers, particularly gaming names, to revert to mean as we head out of the year. Good IP/Titles will still get a premium, particularly in gaming as we head to next gen consoles.

Having 'killed' the Telco goose across many EMs, policy makers have limited or eliminated the window to raise some quick & much needed capital through spectrum sales as we head into first phase of 5G roll-outs.

5G will also usher in a new set of content/functionality development in quality/latency/criticality – how much will Telcos benefit will depend on a broad relaxation in net neutrality prevailing in many markets.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Communication Services	**15.8%**	**17.5%**	**4.9%**	**12.2%**
Advertising	64.1%	26.7%	-6.8%	17.1%
Alternative Carriers		27.2%	4.3%	13.1%
Broadcasting		0.6%	2.6%	1.7%
Cable & Satellite	62.9%	7.5%	-9.8%	5.9%
Integrated Telecommunication Services	-13.3%	5.8%	-0.8%	-0.5%
Interactive Home Entertainment	53.3%	64.6%	42.3%	53.3%
Interactive Media & Services	74.6%	10.9%	-16.7%	3.1%
Movies & Entertainment	45.1%	-0.8%	-6.2%	-1.8%
Publishing	88.8%	11.9%	-1.7%	9.5%
Wireless Telecommunication Services	-6.4%	-8.2%	10.5%	-5.3%

*- Classification made on ending market cap [as on 10th July 2020]

Energy is typically dominated by large cap players in EM, mostly in the in integrated space. Stating the obvious, the energy price crash in March (Russia-OPEC tiff) crashed prices significantly – reflecting in the sharp earnings revisions. The sector saw the sharpest down revisions. The multiple expansion we have seen in unwarranted, at this time, unless we see more supply cuts. A catch-22 situation for some of the economies dependant on oil to tide over this pandemic. While this sector makes modest contribution to employment for most EM markets, its dominant status for macro conditions makes the sector vital for policy makers. We could see an increased governmental intervention in local pricing as economies recover. Also as it is dominated by large caps, investable opportunities for SMIDs are more limited. SMIDs in this segment are typically more driven by the capex/investment cycle – which we believe ´will take more time in recovery. Regardless of the precise timing, loner term for sure, we see this sector in a secular trend towards an eventual phasing out as new energy sources continue to be adopted globally.

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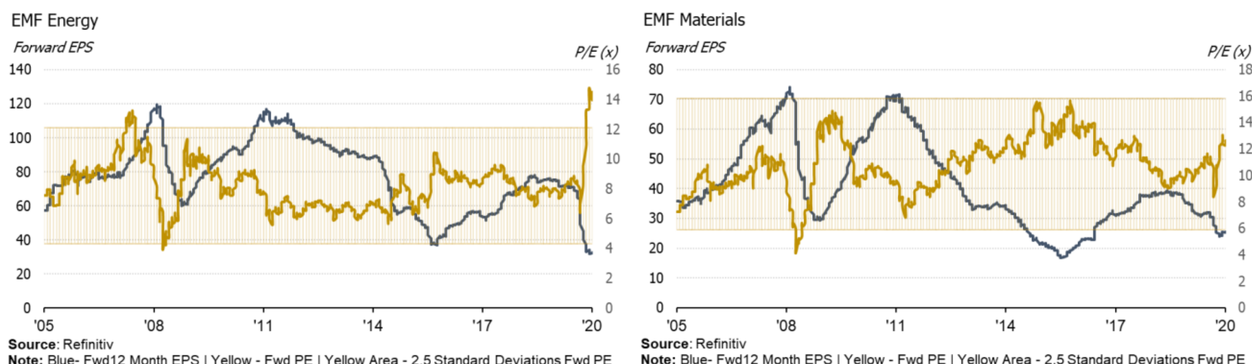
Materials present a different conundrum: as a larger employment generator compared to energy (close to 1.5x); the sector is a recovery cyclical play. In years earlier, this would have been driven by the China production cycle, but we find the current trade wars presenting an artificial impasse. This should in turn hurt the 'commodity' economies like Indonesia and South Africa. We expect prices to firm up depending on how fiscal stimulus/government spending shapes over the near-medium terms to prop up short term demand. Private capital formation, at least in EM, will take upwards of a year to recover, in our view.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Energy	**-21.8%**	**-10.1%**	**-16.9%**	**-14.5%**
Coal & Consumable Fuels	-18.0%	-5.0%	-18.9%	-11.7%
Integrated Oil & Gas	-25.9%	-24.4%	-16.9%	-24.6%
Oil & Gas Drilling	-22.8%	-3.5%	-35.5%	-24.4%
Oil & Gas Equipment & Services	7.8%	-10.9%	-23.0%	-17.4%
Oil & Gas Exploration & Production	-31.5%	-18.5%	-17.3%	-19.8%
Oil & Gas Refining & Marketing	-18.9%	-21.7%	-4.1%	-13.8%
Oil & Gas Storage & Transportation	-12.3%	5.2%	-19.3%	-4.5%
Materials	**1.0%**	**14.5%**	**-2.0%**	**5.7%**
Aluminum	-15.7%	26.0%	-6.6%	11.4%
Commodity Chemicals	5.5%	16.4%	2.2%	9.0%
Construction Materials	2.3%	1.3%	-1.3%	0.0%
Copper	-4.0%	-7.6%	-19.0%	-13.6%
Diversified Chemicals	-24.4%	8.7%	-7.5%	-0.1%
Diversified Metals & Mining	0.2%	6.0%	-13.8%	-0.2%
Fertilizers & Agricultural Chemicals	-4.4%	12.7%	4.8%	8.6%
Forest Products		46.5%	-22.6%	-2.8%
Gold	36.7%	33.3%	5.0%	21.7%
Industrial Gases		46.0%	-22.4%	16.7%
Metal & Glass Containers		5.6%	-7.0%	-3.6%
Paper Packaging	46.0%	20.8%	8.0%	14.0%
Paper Products	-14.4%	9.6%	-8.0%	-2.3%
Precious Metals & Minerals	-22.0%	3.8%	-26.9%	-8.8%
Silver			-23.4%	-23.4%
Specialty Chemicals	19.0%	34.4%	4.8%	19.7%
Steel	-13.6%	2.9%	-7.5%	-3.5%

*- Classification made on ending market cap [as on 10th July 2020]

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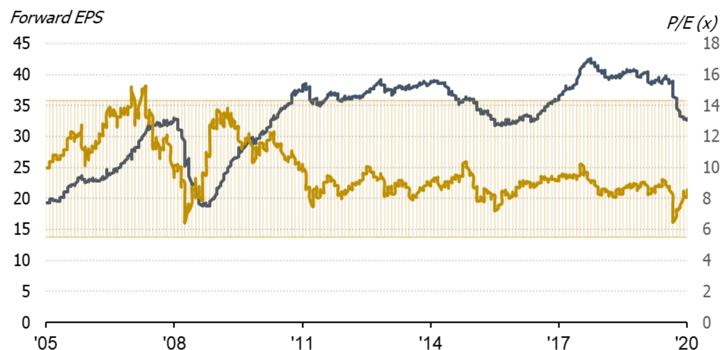
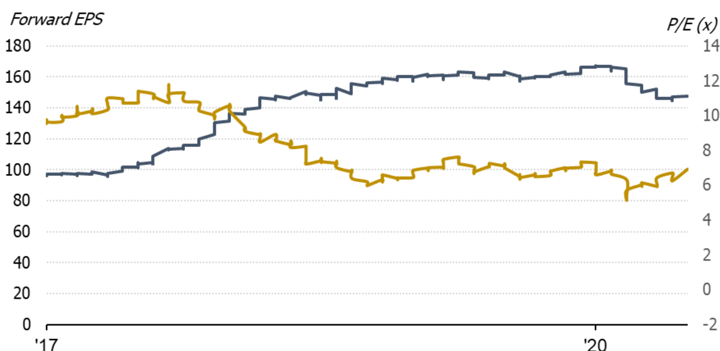
Financials and **Real Estate** form the biggest chunk of index weights. We remain wary of the sector presently and the market seems to concur. In general, we have not seen the same level of multiple expansion – so if liquidity was the only driver behind the current expansion, then the sector should have benefited. EM financials are, for the most part, in a quagmire. We don't understand the extent of new financial stress, in terms of non performing loans compounding on compressed margins and spreads. Heading into the pandemic, the credit cycles were already slowing or struggling with resolutions.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

From an employment perspective, it remains one of the largest contributors, only behind Industrials. Unlike the latter, most of the firms and therein employment remains concentrated in large caps. With current monetary conditions and expansion, we don't see any of them going under. The first victim of the present crisis is Moral Hazard. We should expect more refinancing/ever-greening with tacit blessing from above.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

Real Estate in EM are primarily property developers –could the current pandemic see more operating assets carved out? Moreover, is the new normal of distance working, learnings, socializing exposing a more substantial and long-term supply/demand imbalance?

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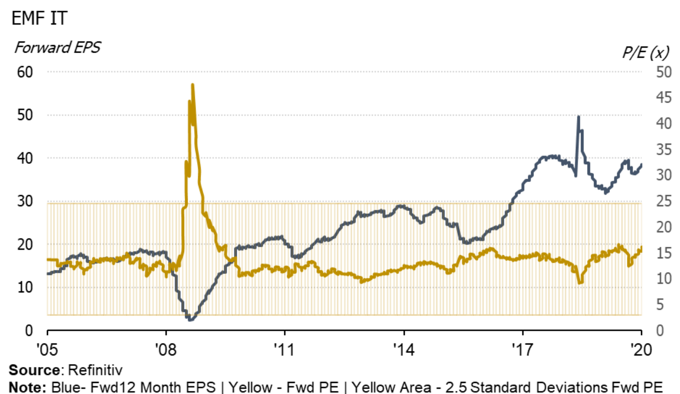
YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Financials	**-6.7%**	**-14.6%**	**-6.5%**	**-9.9%**
Asset Management & Custody Banks	-16.0%	-15.8%	-2.1%	-7.6%
Consumer Finance	4.7%	-16.2%	-18.6%	-16.9%
Diversified Banks	-21.4%	-21.8%	-20.3%	-21.4%
Diversified Capital Markets	-14.6%	-11.8%	-38.2%	-18.8%
Financial Exchanges & Data	50.9%	14.0%	11.7%	18.9%
Insurance Brokers		89.0%	-17.2%	9.4%
Investment Banking & Brokerage	31.2%	0.5%	12.1%	13.7%
Life & Health Insurance	-11.1%	-12.9%	-21.1%	-15.0%
Mortgage REIT's				
Multi-line Insurance	-22.0%	-10.7%	8.2%	0.3%
Multi-Sector Holdings	-9.1%	-22.4%	-9.6%	-15.7%
Other Diversified Financial Services	-17.5%	-8.5%	-23.2%	-15.3%
Property & Casualty Insurance	4.0%	-18.7%	-5.4%	-7.6%
Regional Banks	-5.8%	-7.1%	-12.0%	-8.4%
Reinsurance	-22.3%	-45.8%	2.6%	-16.3%
Specialized Finance	-12.0%	-16.6%	-2.6%	-10.0%
Thrifts & Mortgage Finance	-25.8%	-29.6%	-26.3%	-27.2%
Real Estate	**3.1%**	**-2.9%**	**-9.5%**	**-5.8%**
Diversified Real Estate Activities	6.6%	9.0%	-11.7%	0.1%
Diversified REITs		-19.0%	-10.7%	-13.2%
Health Care REITs			-0.5%	-0.5%
Hotel & Resort REITs		-38.3%	-36.3%	-36.6%
Industrial REITs		-18.8%	-6.5%	-13.2%
Office REITs		-20.2%	-11.6%	-12.4%
Real Estate Development	0.4%	-2.8%	-14.4%	-7.9%
Real Estate Operating Companies	8.9%	-6.8%	8.6%	2.6%
Real Estate Services		11.9%	4.0%	8.5%
Residential REITs		28.2%	33.2%	31.5%
Retail REITs	-23.0%	-23.8%	-23.1%	-23.4%
Specialized REITs		-32.2%	-35.2%	-34.2%

*- Classification made on ending market cap [as on 10th July 2020]

IT looks promising to us presently. The sector has seen a positive momentum in earnings while multiples have been broadly in line. We think the tech war has added an additional layer of complexity to the proceedings though the structural themes, driven by 5G, IOT and networking/cloud, remain robust. Most of the focus have gone, as expected, on the front end/consumer facing names – which, for the most part, is now well spread across multiple sectors/domains.



Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

The hardware and manufacturing/infrastructure will also see a sustained uptick, in our view. New normal or otherwise, the current pandemic has seen demand spikes for services. Investments have to be made to meet this. Present valuations could further support additional upside to the sector.

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At an aggregate level, employment is dominated by large caps though we can attribute this primarily to the Indian IT Services names. Ex IT, the space is equally split across Large and Mid-space while Small caps account for less than 10% of employment. From a productivity perspective (Rev/Employee), Midcaps and Large caps are almost at similar levels. The other factor working in sector's favor is, for the most part, either immune to how the pandemic plays out or a net beneficiary in some subsegments. It also has an outsized impact to many regions insofar as export earnings are concerned.

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Information Technology	**48.1%**	**27.3%**	**9.9%**	**20.5%**
Application Software	99.3%	38.4%	22.9%	38.9%
Communications Equipment	31.0%	21.9%	3.8%	14.8%
Data Processing & Outsourced Services	-23.4%	59.4%	2.4%	20.5%
Electronic Components	41.0%	22.8%	6.0%	16.4%
Electronic Equipment & Instruments	47.6%	24.8%	6.4%	16.5%
Electronic Manufacturing Services	19.6%	5.7%	3.6%	7.0%
Internet Services & Infrastructure	51.7%	58.9%	21.4%	43.0%
IT Consulting & Other Services	4.5%	23.8%	10.0%	16.6%
Semiconductor Equipment	64.1%	49.4%	20.2%	29.2%
Semiconductors	68.7%	34.4%	14.2%	28.8%
Systems Software	27.4%	22.9%	9.7%	18.2%
Technology Distributors	58.2%	9.1%	-7.4%	-2.1%
Technology Hardware, Storage & Peripheral:	33.7%	13.9%	10.6%	15.1%

*- Classification made on ending market cap [as on 10th July 2020]

Lastly, **Utilities.** We have seen some modest downward revisions while multiples, for the most part, have been steady. Currently, the sector remains the best value pick within the EM space. However, we must remain cognizant of the risks presented by populist governments. Free Market pricing is going to be a victim. We have already seen payment waivers and extensions being announced, a trend that may well accelerate as the pandemic continues. In short, we don't expect P&L to be impacted much, but cash flow definitely will be.

Source: Refinitiv
Note: Blue- Fwd12 Month EPS | Yellow - Fwd PE | Yellow Area - 2.5 Standard Deviations Fwd PE

YTD USD Price Performance, by subsegment	Large Cap	Mid Cap	Small Cap	Total
Utilities	**-10.3%**	**-4.2%**	**-6.1%**	**-5.5%**
Electric Utilities	-17.4%	-11.4%	-10.4%	-12.0%
Gas Utilities	-9.6%	-5.1%	-0.8%	-4.1%
Independent Power Producers & Energy Trac	-11.6%	0.3%	-4.2%	-2.5%
Multi-Utilities	0.6%	-15.7%	-4.9%	-8.3%
Renewable Electricity	11.4%	2.4%	-5.0%	1.0%
Water Utilities	-17.7%	-1.5%	-9.0%	-4.8%

*- Classification made on ending market cap [as on 10th July 2020]

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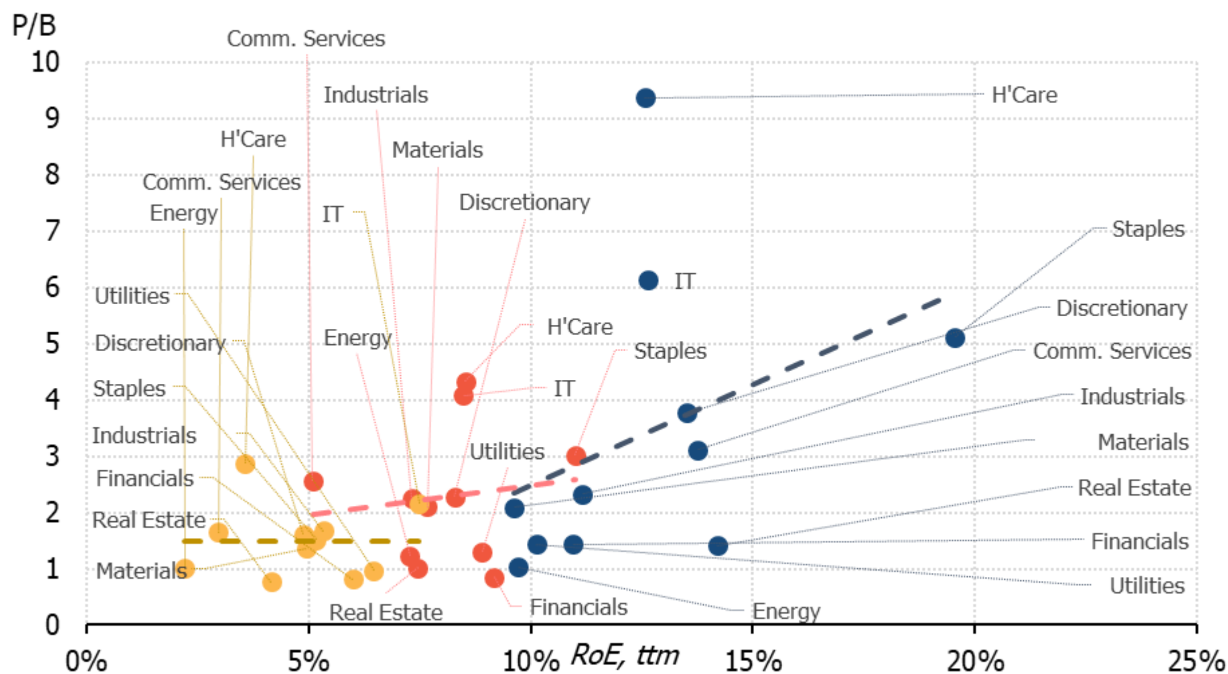
One Chart for them All…



Source: Refinitiv,Aztlan
Note: Blue Circles- Large Caps | Red Circles - Mid Caps | Yellow - Small Caps.

In a simplistic manner, this chart tells us that markets tend to reward a higher multiple for better return on equity as size increases, across sectors in EM (evidenced by the slope for each size). Ex-China, EMs have generally rewarded better ROE profiles across the board. This gives us the confidence that bottom-up research will drive the alpha, especially in small/midcap names.
It is also worth noting that the trend lines increase in a similar fashion to DMs, indicative of a premium relative given to size.
The other takeaway would be the relative premium/discounts enjoyed, depending on the capital intensiveness of the industry. More capital intensive have, for the most part, fallen below the line. Having said that, this relationship is less distinguished, compared to DMs.

In EM, valuations and capital efficiency are directly linked to economies of scale and size; Strong fundamental stories will tend to drive a move up the re-rating slope, in addition to the intrinsic growth.

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AZTLAN STRATEGIES AND POSITIONING VIEWS

SMALL & MIDCAPS
Looking Beyond The Cover

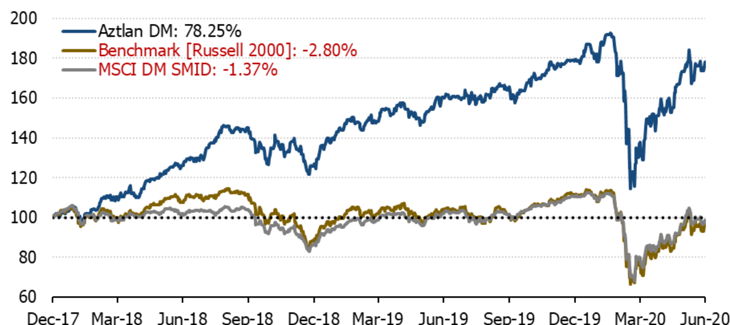
JULY · 29 · 2020

DEVELOPED MARKETS

Aztlan's DM SMID strategy is modestly down (56 bps) YTD, compared to its primary benchmark Russell 2000's ~13% decline during the same time frame. We remain fairly confident in the overall portfolio names based on the many management interviews and meetings that we have sustained over the past few months, since the C19 pandemic quarantine effects began to emerge: on the ground realities seem stronger than originally discounted, for the most part.

Aztlan Developed Markets SMID Cap Strategy

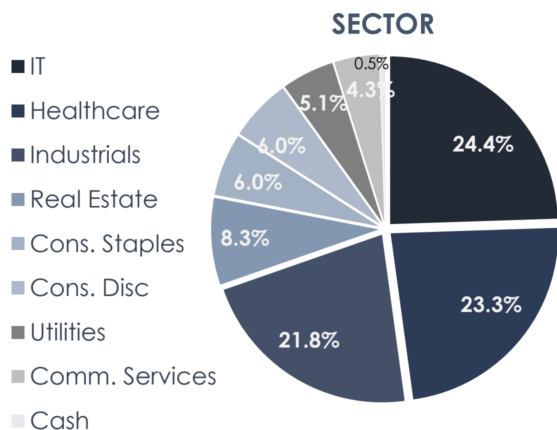
Rebased Index

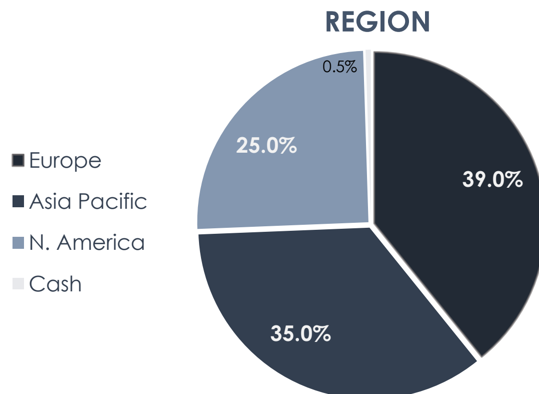


Source: Aztlan, MSCI, Refinitiv | Benchmark: Russell Index, Gross | Alternate: MSCI DM SMID, Gross
Note: Performance for the 12/31/17-06/30/20 period is shown in gross terms, before fees and taxes

We have been on a strong monitoring mode as the first signs of the current pandemic came out in January and have been articulating our views and processes since then, in our monthly letters and revised outlook. We have adopted extensive balance sheet checks and stress tests, considering various timelines. Our hypothesis for wave 1 remained a mid-summer phase out in a majority of our markets. This remains on track as we see more economies opening post the lockdowns. We have also seen concrete assessments by policy makers, tilting towards a more balanced view, especially as a stretching of the economic costs becomes untenable. With most regions having put in strong medical infrastructure and processes, we believe the tolerance limits for wave 2 will be significantly higher. Beyond these short term dynamics we believe high innovation combined with free cash flow generation is well articulated though our strategy.

DM	Weight
Health Care Technology	14.8%
Trucking	11.0%
Electric Component & Equip	8.0%
Life Sciences Tools & Svcs	7.9%
Health Care Services	7.4%
Health Care Facilities	6.6%
Application Software	6.4%
Data Proc & Outsrced Svc	6.1%
Interactive Home Entertainment	6.0%
Health Care Equipment	5.5%
IT Consulting & Other Services	5.0%
Industrial Machinery	5.0%
Technology Distributors	5.9%
Brewers	4.0%
Cash & Equivalents	0.5%





*- All data as of 30th June 2020

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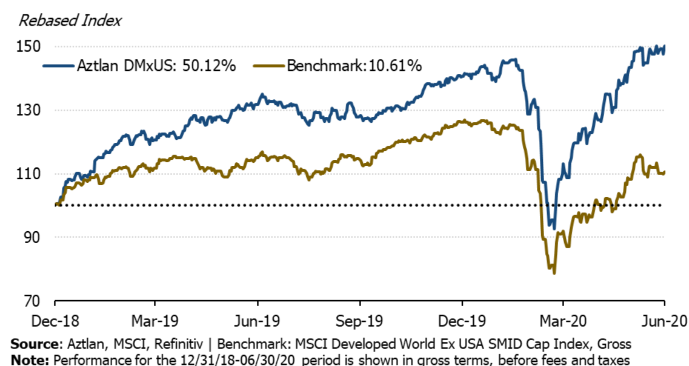
DEVELOPED MARKETS EX USA SMID

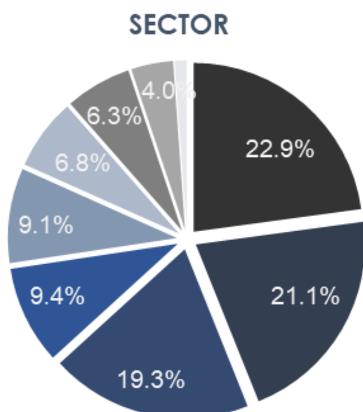
Aztlan's Developed Markets Ex USA SMID cap strategy [DMXUS] has had a good year, thus far. YTD, ending June'20 returns of 6.7% is outperforming the benchmark indices by ~19%. We have not made any changes to the names carried by the portfolio this year. We are, however, keen on expanding the geographical mix on the strategy. Currently, we don't foresee taking a hammer to the break the portfolio composition, from a sectoral point of view.

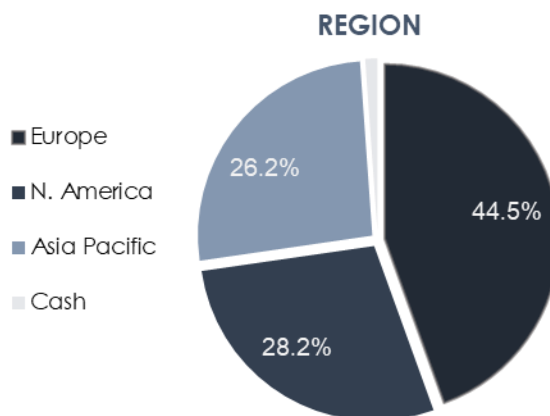


Source: Aztlan, MSCI, Refinitiv | Benchmark: MSCI Developed World Ex USA SMID Cap Index, Gross
Note: Performance for the 12/31/18-06/30/20 period is shown in gross terms, before fees and taxes

We believe our outlook, including the new paradigm shifts, are already captured, to a large extent, at a sub-sector level. Concurrently, any changes are primarily expected to be risk based and modest in magnitude. The strategy is designed to carry between 15-20 stocks and we are at the lower end of the scale presently. We will look at new bottom-up driven additions, as we tweak the weights of valuation outlier names.
We are looking at expanding our geographical mix with our research focusing on new potential names from the Oceanic markets, fitting our sectoral composition. This is a region that the strategy has not invested in but post management calls with prospective companies, we believe the region could be in a better position to kick start the growth/recovery dynamic.

DMXUS	Weight
Application Software	18.6%
Health Care Technology	12.4%
Trucking	12.1%
Real Estate Services	10.2%
Education Services	9.4%
Renewable Electricity	7.2%
Health Care Services	6.4%
Brewers	6.3%
Industrial Machinery	5.8%
Diversified Support Svcs	4.5%
Interactive Home Entertainment	3.7%
IT Consulting & Other Services	2.3%
Cash & Equivalents	1.1%





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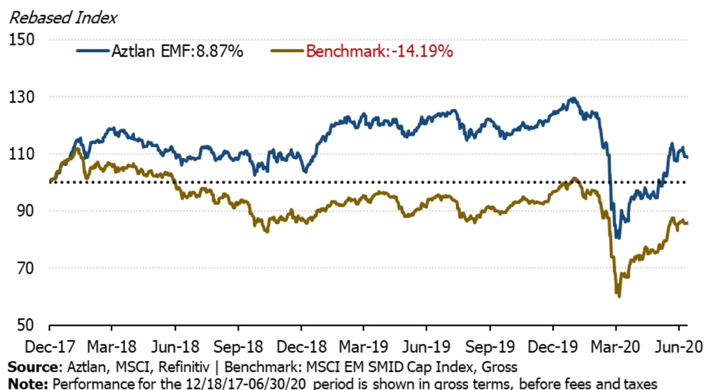
EMERGING MARKETS SMID

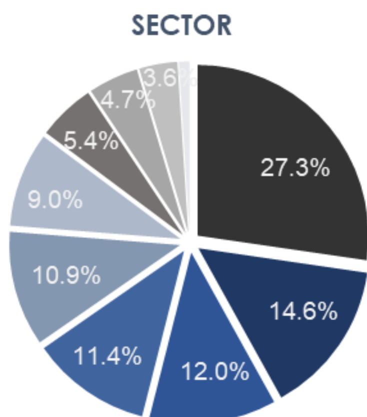
Aztlan's Emerging Markets SMID cap strategy [EMF] had an in-line year so far. The strategy ended June' 20 more or less in line with its benchmark MSCI EM SMID Cap Index. We didn't make any changes to any of the portfolio names in CY20 till the end of June. We have initiated the first set of changes in July that our research/investment process prodded us to do. Our Emerging Markets portfolio is where we will be making significant changes, part of which is already underway in July.

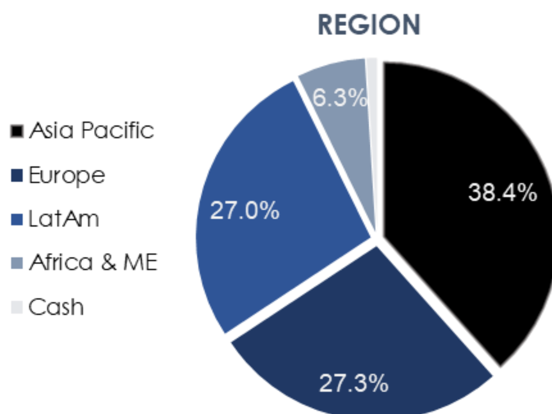


Source: Aztlan, MSCI, Refinitiv | Benchmark: MSCI EM SMID Cap Index, Gross
Note: Performance for the 12/18/17-06/30/20 period is shown in gross terms, before fees and taxes

As detailed in our newsletter, we have exited names where we see the new normal being harsh on growth, cash generation/bleeds and long term prospects. We have stayed away from making radical changes to the portfolio as we wanted to get a clearer sense on how policy makers will react/act. Early into the pandemic, we saw divergent stringency and policy measures adopted by individual EMs. Environments with such high degree of uncertainty is investing only for the next month and we have always shied away from this. The difference with DMs is that we believed that the latter has the infrastructure and fiscal/monetary room to help aggregate demand when push comes to shove.
We have been articulating our EM views with consistency in our monthly newsletters: we believe EMs now offer an interesting mix of companies with richly valued multiples but with substantial growth potential on one end, and deep value names whose business models are, at most, temporarily affected on the other.

EMF	Weight
Industrial Machinery	14.1%
Interactive Media & Services	11.8%
Data Proc & Outsrced Svc	9.2%
Packaged Foods & Meats	9.0%
Health Care Equipment	6.6%
Electronic Equipment & Instruments	5.6%
Auto Parts & Equipment	5.4%
Diversified Banks	5.0%
Electric Utilities	4.9%
Airlines	4.8%
Health Care Facilities	4.6%
Commodity Chemicals	3.8%
Education Services	3.5%
Brewers	2.8%
Railroads	2.8%
Air Freight & Logistics	2.6%
Electric Component&Equip	2.5%
Cash & Equivalents	1.0%





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EPILOGUE

SMALL & MIDCAPS
Looking Beyond The Cover

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One of the key factors that we have been keeping an eye out since the early days of the pandemic is the liquidity risk carried by the companies. The need to preserve cash, the need to save cash and the need to collect cash. We are particularly wary on the last risk. With the kind of system wide risks, this is a particular risk for small-mid caps. Delays in collection can have a spiralling effects, especially in underdeveloped factoring/lending markets. The costs of factoring/discounting might turn to be prohibitively expensive especially for industries with expanding cycle days and lower margins. In general, EMs have generally had long cycle days than DMs (on average, 25%) and this is particularly bad for Small/Mid-caps. As Q2 results come in, this is a metric we will continue to monitor this. We will get to see the collateral impact of the crisis.

On Average, EM have a longer receivable cycle – particularly among Mid and Small caps. This brings an additional source of liquidity stress to corporates.

EM Receivables Days LTM, Median	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	61	68	66
Consumer Staples	21	36	58
Energy	40	69	105
Materials	53	74	79
Health Care	90	103	91
Information Technology	82	133	90
Communication Services	73	95	93
Industrials	93	140	130
Utilities	68	73	77

DM Receivables Days LTM, Median	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	35	31	35
Consumer Staples	38	42	48
Energy	42	51	63
Materials	53	60	79
Health Care	70	70	81
Information Technology	65	74	78
Communication Services	62	59	60
Industrials	66	70	80
Utilities	56	56	45

Source: Aztlan, Refinitiv

EM Total Debt to Equity,% (LTM), Median	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	50%	41%	38%
Consumer Staples	44%	37%	30%
Energy	47%	65%	68%
Materials	64%	48%	44%
Health Care	21%	18%	24%
Information Technology	25%	20%	19%
Communication Services	40%	20%	20%
Industrials	55%	47%	44%
Utilities	89%	87%	83%
Real Estate	94%	76%	59%

DM Total Debt to Equity,% (LTM), Median	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	60%	56%	49%
Consumer Staples	76%	41%	33%
Energy	71%	74%	58%
Materials	56%	44%	17%
Health Care	47%	12%	10%
Information Technology	48%	26%	14%
Communication Services	90%	29%	17%
Industrials	79%	56%	38%
Utilities	143%	128%	75%
Real Estate	87%	87%	94%

We note that debt levels seem reasonable at an aggregate level. In fact, one could argue, for the most part, that corporate leverage is not a massive concern for most sectors [This may seem slightly counterintuitive to the point we made earlier about financial sector stress. For the latter, big picture means less and more related to specifics, after all capital ratios don't leave much room for high teens + stress]. In addition, this is one place where we expect more policy support to be forthcoming anyways. The two sectors, across both DM and EM, with higher debt levels are utilities and real estate. One could argue utilities and REITs should still have sufficient cash flow to meet their obligations. We also don't see any discernible difference in debt levels across caps.

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APPENDIX

SMALL & MIDCAPS
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BREAK-UP OF COMPANIES IN THE COMPOSITE

Number, EM	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	72	554	771
Consumer Staples	93	312	339
Energy	35	115	101
Materials	89	639	666
Health Care	89	395	359
Information Technology	119	645	689
Communication Services	56	198	172
Industrials	91	903	896
Utilities	45	209	113
Financials	180	355	331
Real Estate	51	304	362

Number, DM	Large Cap	Mid Cap	Small Cap
Consumer Discretionary	197	492	586
Consumer Staples	120	215	213
Energy	56	143	188
Materials	115	321	358
Health Care	192	491	551
Information Technology	217	420	528
Communication Services	110	163	228
Industrials	254	694	744
Utilities	80	101	39
Financials	235	545	581
Real Estate	91	358	252

Source: Aztlan, Refinitiv

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SMALL & MIDCAPS
Looking Beyond The Cover

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