Outlook January 2019

AZTLAN
Equity Management, LLC

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Overall 2019 shows supportive fundamentals for global equites but not without increased volatility. This will be particularly favorable for sound active strategies as compared to passive investing. Basically, valuations are close to average (i.e. not expensive) in places where macro conditions are still relatively stronger while the global risk outlook is just marginally higher, leaving some room to the upside.

As for the economic cycle we see the US and Canada, China, and the Eurozone at late stage, with Japan slightly ahead. The US however still presents supportive macro tailwinds, while Europe and China will require policy support to ameliorate economic deceleration. In China and Europe we see a slowdown and not a recession.

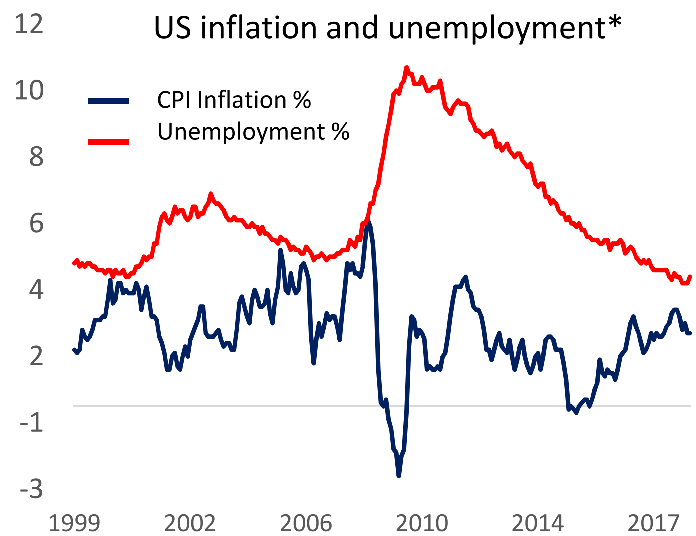
2019 Key SMID Cap Themes
US “health care tech” names
Puerto Rico recovery
Selective Nordic exposure
Japan SMID caps and currency
Canada/Energy/commodities
In EMF OW Brazil, Russia, Egypt, Vietnam, SK - UW China
Turkish exporters / weak lira beneficiaries

2019 Risk Outlook Themes
Severe China slowdown
Recession in Europe
Domestic US politics
Ukraine-Russia escalation
South China Sea tensions
Brexit, Turkey, Italy destabilizing the EU
Excess leverage in US HY corporates
Global rise of inequality and populism

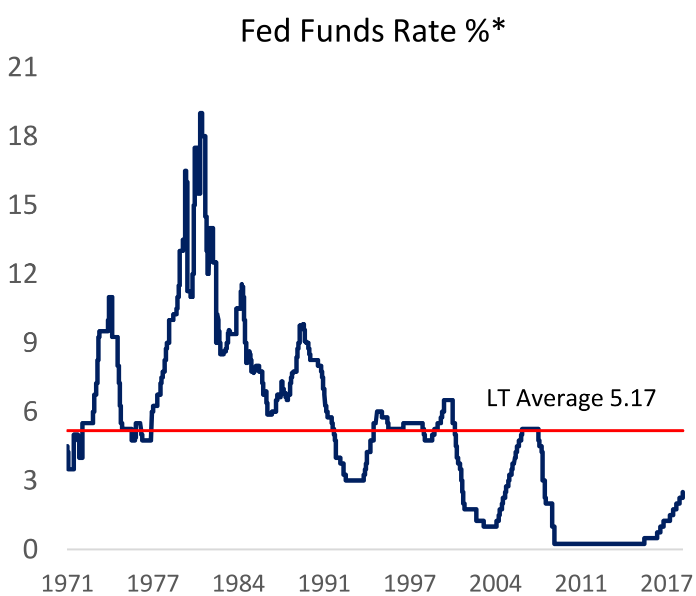
For currencies we expect some weakening in the US dollar later in 2019 as the tightening adjustment takes place and as the US tackles its deficits and other domestic issues. This outlook is favorable for commodities, especially energy after the 4Q18 crash in oil prices, and in general favorable for EMs; these factors will be countered by the magnitude of the slowdown in China and Europe as well as other macroeconomic and geopolitical developments in 2019. Shorter term we expect a favorable resolution to the US-China trade dispute to be supportive of risk assets but we see this as a minor element within a broader and more complex power struggle between the world’s 2 largest economies.

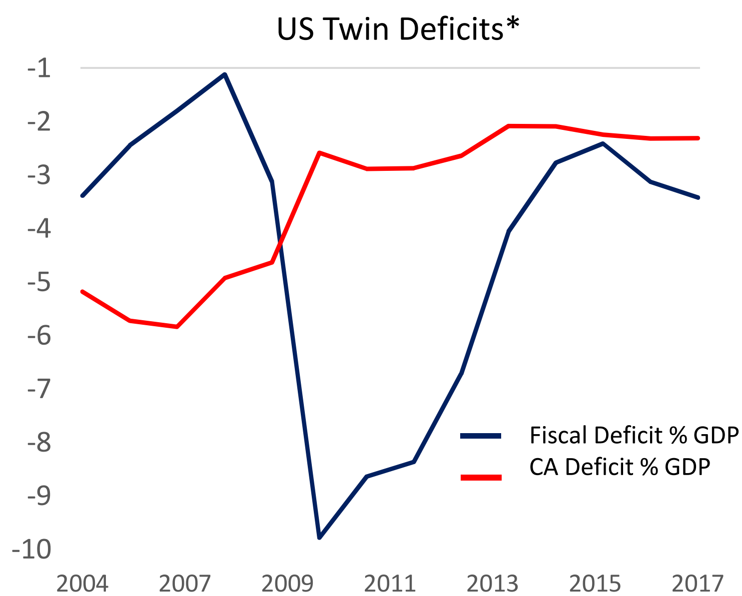
Basic Drivers

2019 presents an interesting investment puzzle for global small caps: the global economy is still in a late-stage expansion (strong and prolonged by historical measures), supported by coordinated stimuli, but that hasn't resulted in higher inflation. Interest rates are still at historically low levels but paradoxically should probably be higher despite persistent low inflation. At the same time the recent correction in the US equity market brings valuations closer to average but still far form cheap while the growth outlook remans stable. Europe and Japan equities on the other hand did poorly all through 2018, as did EMs, and are all now clearly in cheap territory relative to historical valuations but the macro backdrop seem less favorable there; global small and mid caps underperformed in 2018 but retain their premium valuations relative to the main indices.



On monetary policy and interest rates we expect a tighter stance but at a moderating pace, more as means to prevent hidden asset bubbles and provide ammunition for future recessions than to address immediate inflation or unemployment concerns, as both remain well behaved in in the US. This should be conducive to a weaker dollar, especially as the American economy deals with its expanding twin deficits.

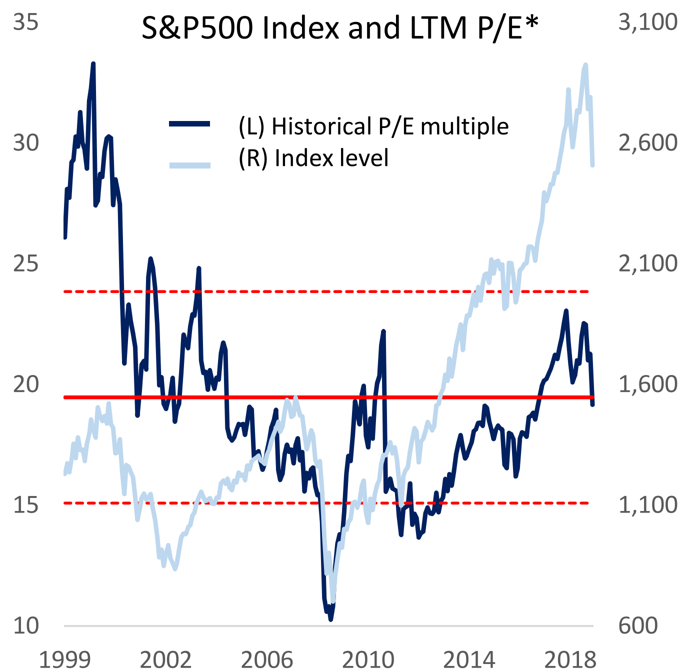




* Source: Thomson Reuters Datastream and AZTLAN Research

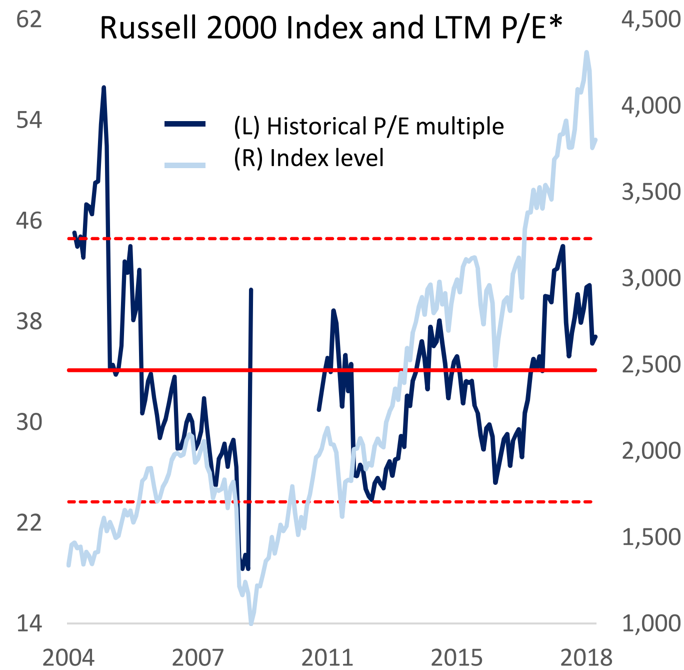
US and Canada

The tightening in monetary conditions should result in additional compression to valuation multiples but the macro outlook should still support earnings growth. The US market as measured by P/E for the S&P500 was on the pricier side going into the December downdraft (PE of 22x) and begins 2019 right around the 20-year historical average of 19.5x: valuations had reached such high levels only 4 times in the last 15 years.



Small caps in the US (using the Russell 2000 index as proxy) were even more expensive as of December 2018, close to one standard deviation above their 7-year historical average P/E multiple; for small caps, multiple compression started earlier in October resulting valuations adjusting to their 7-year average going into 2019.

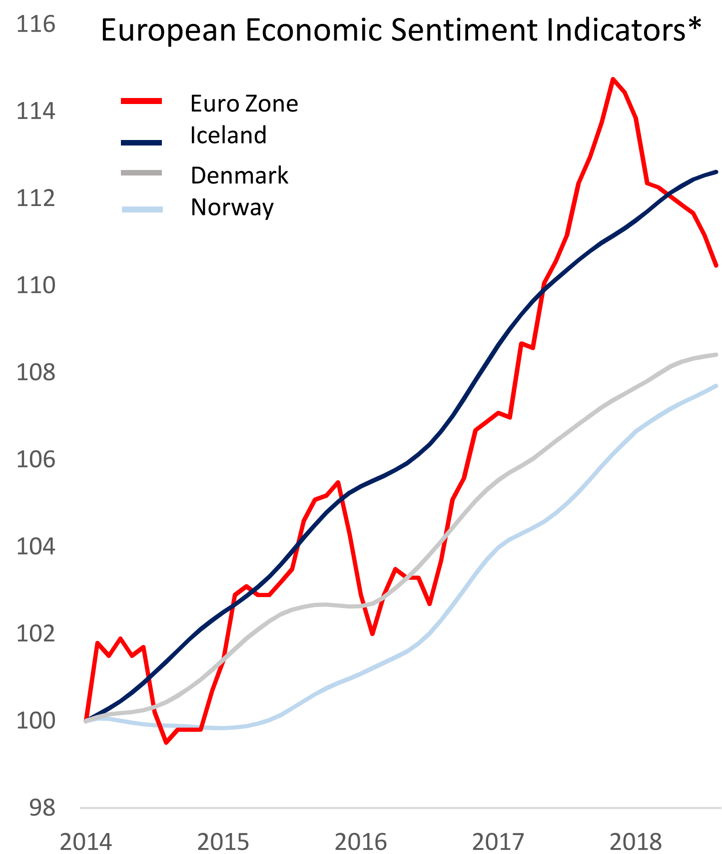
Small caps retain their premium valuations relative to the S&P 500 but now at lower more attractive levels. The dividend yield for the S&P 500 stands at 2.0% and 1.35% for small caps.

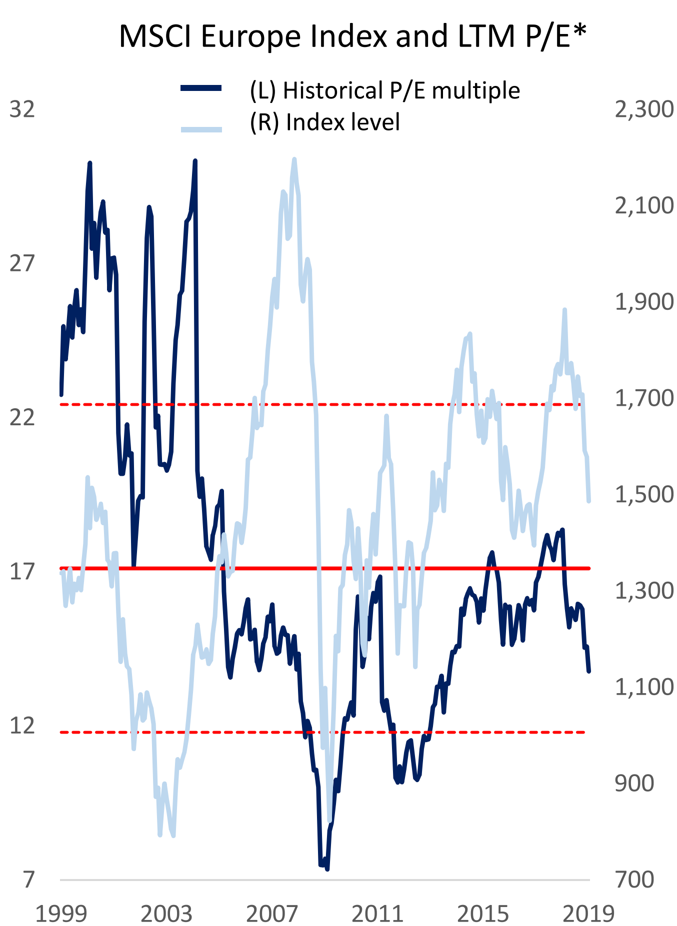


Canadian stocks underperformed in 2018 driven by weaker energy prices and weaker commodities: a weakening US dollar could be supportive for Canadian stocks in 2019.

Europe

Being underweight European equities worked well in 2018 as the MSCI Europe equity index corrected by 15%, trending down steadily through the year. On valuations European equities now trade at a 28% discount relative to the US market based on PE multiples (Europe at 13.8x trailing, 12.4x forward PE*) and with a 3.77% dividend yield. Normally these valuations would make European equities very attractive but then there's the Brexit uncertain outcome on top of deteriorating macroeconomic conditions that seemed to have gain negative momentum for the core Euro zone during the 4th quarter.



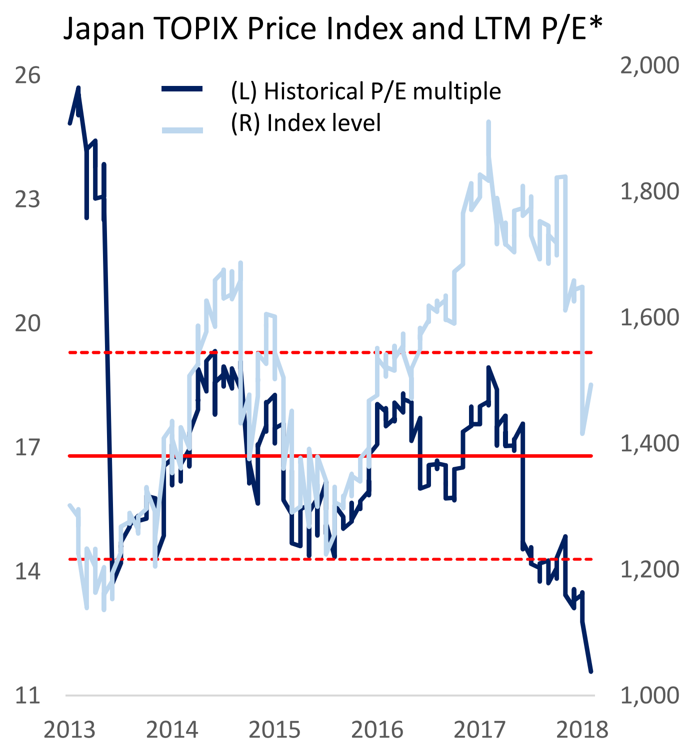


Within a generally negative macro context for Europe we do find some exceptions, specifically in the periphery, including some of the Nordic countries where economic conditions appear relatively stronger and where we find attractive valuations at the stock level. Iceland is an interesting "hybrid" equity market for us, as it is part of the Nordic block but is expected to be classified as Frontier by FTSE* in 2019: it's a small market but liquid enough and with free cash flow generating companies presenting attractive valuations. Norway, Finland and Denmark also present attractive bottom-up opportunities, with better positioned currencies.

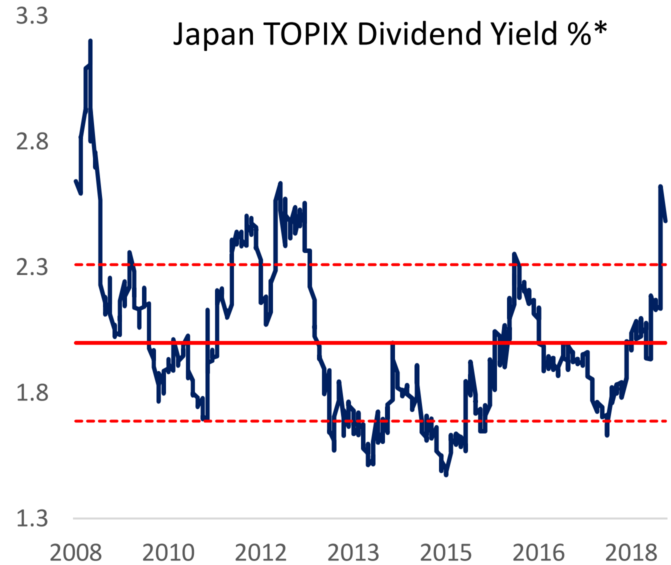
* Source: Thomson Reuters Datastream and AZTLAN Research

Japan

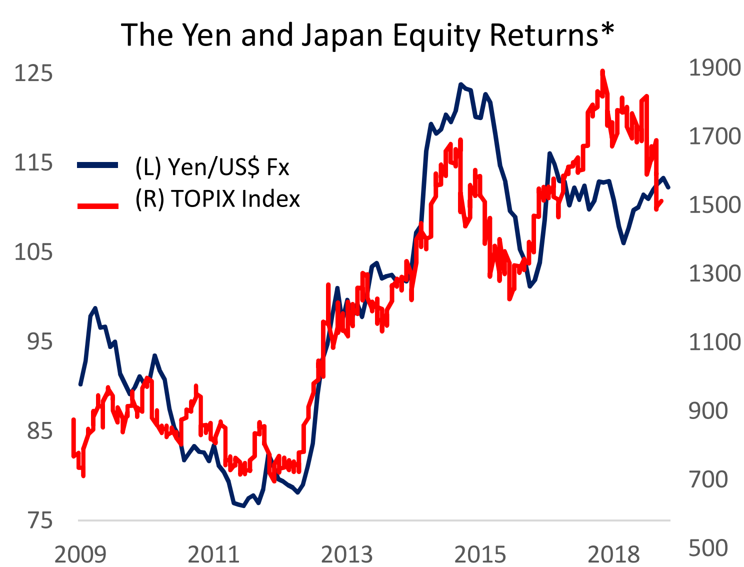
Japan equities were also good to avoid in 2018 as the correction there was more than 25% from the peak in January 2018. With this underperformance and looking ahead valuations actually appear very cheap as PE multiples are now at a 10-year trough while the dividend yield in aggregate is close to 3%.



Clearly, economic conditions drive corporate earnings which in turn determine valuations, so we are cautious in our assessment but it is remarkable that valuation levels had not reached such steep discounted levels in the recent past, with PE multiples collapsing well below one standard deviation vs average and the dividend yield shooting straight up.

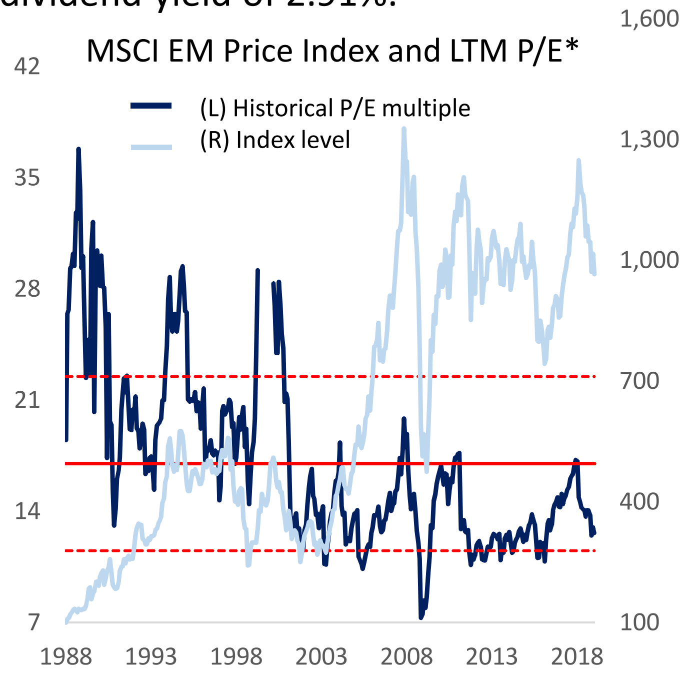


An interesting aspect regarding Japan's investment outlook is the currency: historically the Yen has maintained a negative correlation with equities. This time around and barring an economic recession, cheap valuations in the context of heightened global risk sentiment with the Yen as a safe heaven asset (with Japan as the world's largest sovereign creditor) could see an inflection in 2019 with simultaneous strength in both equities and the Yen.



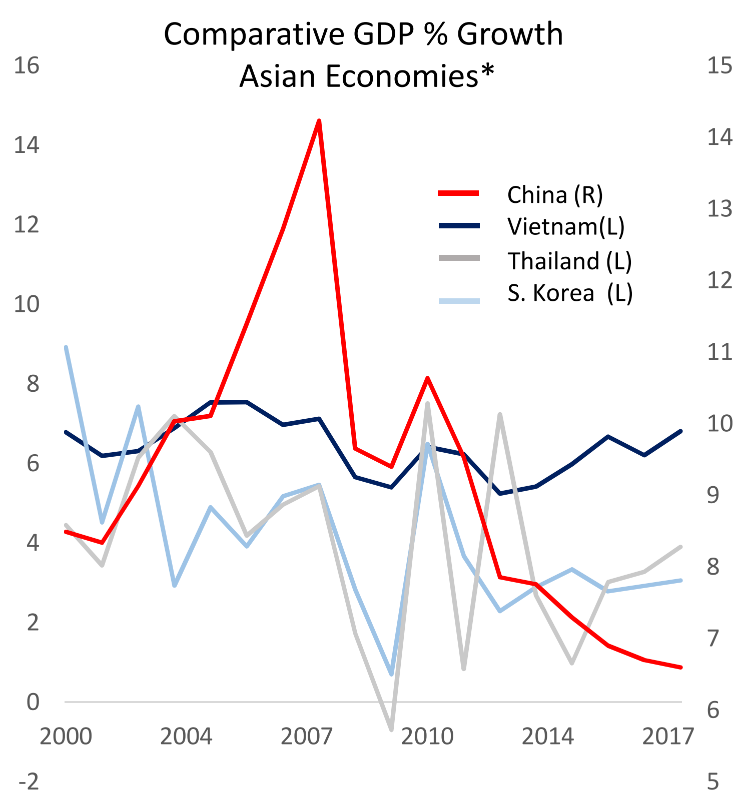
Emerging Asia

Emerging markets equities peaked at the beginning of 2018 and underperform developed markets through October; since then EMs have shown more resiliency, fairing relatively better during the Dec/18 correction. On valuation multiples EMs have not yet experienced a rerating to the levels seen prior to the financial crisis of 2008 when the PE multiple briefly touched 18x; EMs have persistently traded at a discount to DMs since the recovery. At the end of 2018 the trailing PE ratio for EM was just a tad below 12x (10.5x forward) with a dividend yield of 2.91%.



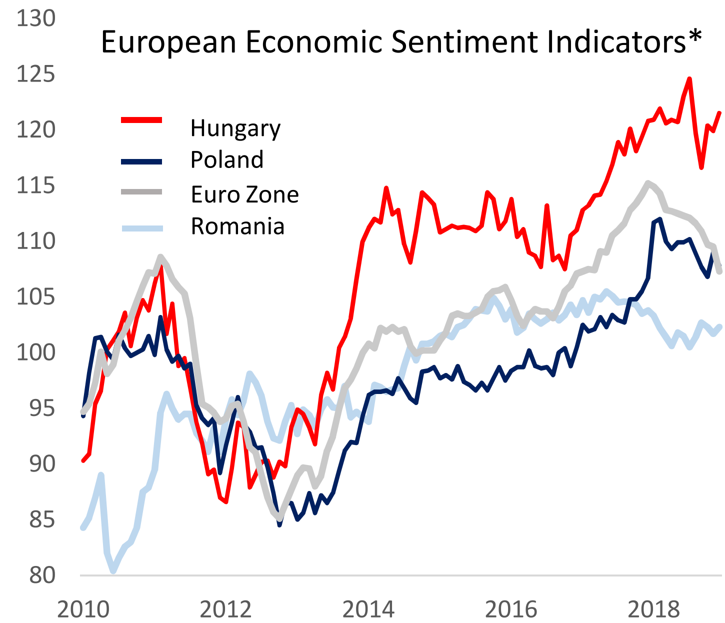
In Asia China dominates the MSCI EM index with close to 30% country weight. There we see a less favorable outlook with an economy that is showing signs of deceleration and some notable economic and demographic imbalances, on top of the ongoing trade dispute with the US.

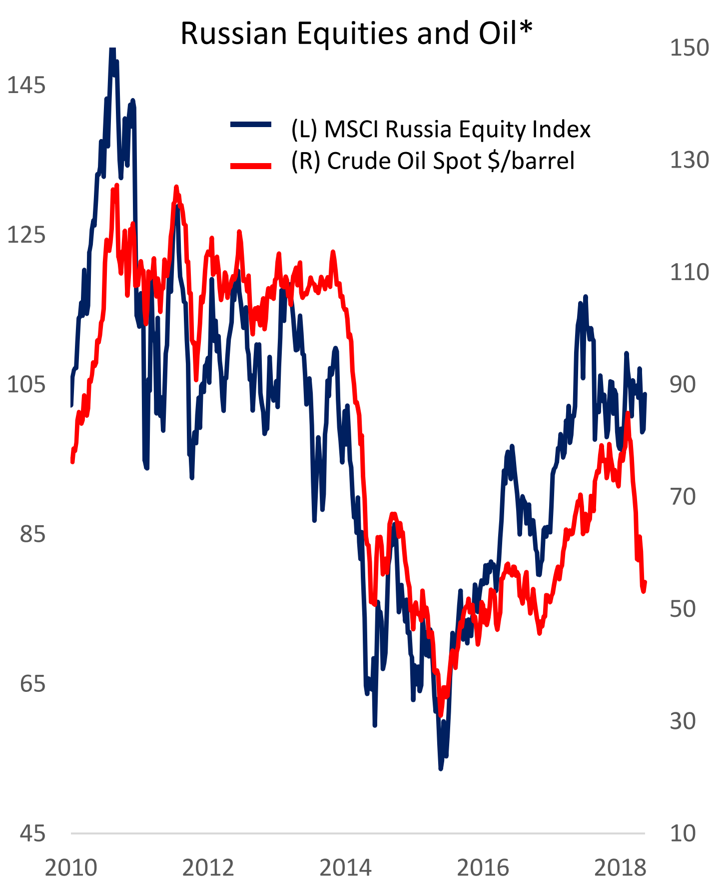
Regarding the geopolitical front, we think the bilateral commerce negotiation with the US may be solved short term but has the potential to escalate longer term as China asserts its rising position as a top economic and military power. We do not see any immediate red flags, and the trade dispute with the US might as well be solved in the short term -providing strong support to EM and Chinese equities- but overall China is slowing down while other economies in the region like South Korea, Thailand and Vietnam could benefit from a shift in manufacturing exports while India presents a more balanced demographic and macro outlook providing for a long runway for growth.



EEMEA

Within the EEMEA group (Easter Europe, the Middle East and Africa) Russian equities quietly outperformed in 2018 notwithstanding a brief military action warning by the US in Syria after a suspected poison attack, a warning that quickly faded away back in April. We do not believe the historical Russia-risk discount will dissipate any time soon but earnings valuations this low could be defensive in the context of higher volatility. Moreover, what has been as remarkable as intriguing is the break in correlations between Russian equities and oil which had been historically strong and was completely absent during the 4Q18 correction in energy prices.





Elsewhere in Eastern Europe places like Romania, Hungary and Poland present healthier macro conditions compared to core European economies with equally attractive market valuations; however, recent banking regulations and taxes bring significant uncertainties.

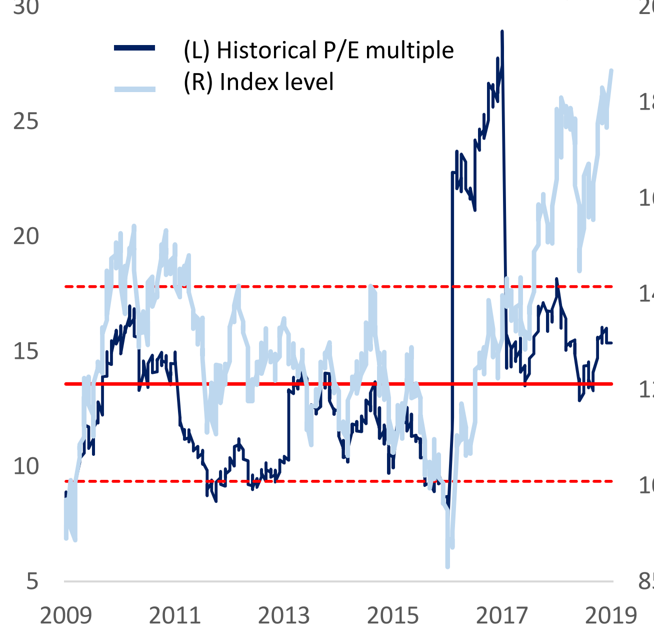
Egypt stands out as a recovering economy with attractive opportunities that will hinge on the continuation of recently instrumented sound macro policies. Higher rates should help bring down inflation while remittances and FDI support the currency. Countries struggling to follow orthodox policies, like Turkey, are unlikely to stabilize in the short term. In Africa we also see attractive opportunities in places like Nigeria where elections will be held later this year and as the financial industry consolidates after the Access-Diamond Bank merger, which should finalize in 1Q19.

* Source: Thomson Reuters Datastream and AZTLAN Research

LatAm

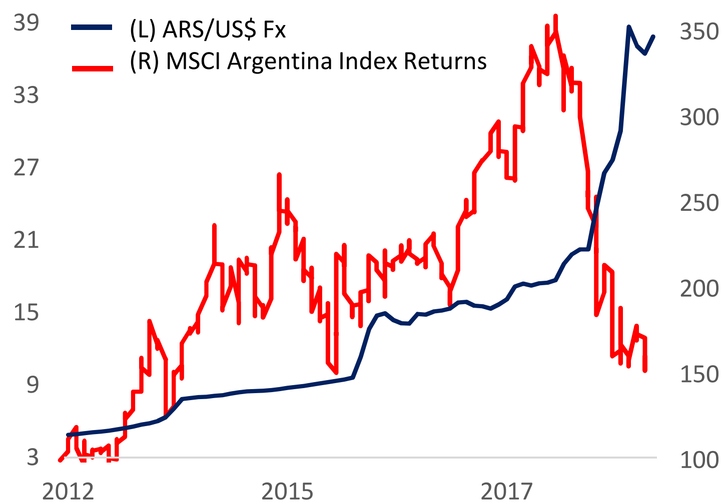
In Latin America the two largest economies, Brazil and Mexico, had presidential elections in late 2018 and start 2019 with new administrations at completely opposite extremes of the political and ideological spectrum: in the case of Brazil far-right Bolsorano brings a pro-business agenda to be implemented as the economy continues to emerge from a protracted and deep recession. In Brazil the implementation of pension and tax reforms followed by much needed measures to promote industrial competitiveness will be paramount to support equities longer term, as much of the positive sentiment seems to be priced in after the recent rally. In Mexico, leftist/populist president AMLO brings a retrograde agenda that we find unlikely to be supportive of equities despite lower valuations after the post-election selloff.

MSCI Brazil Price Index and LTM P/E*



In Chile the Piñera administration has the complicated task of moving forward with Chile's labor and pension reforms while the economy may see tailwinds under a lower USD scenario in which copper prices may strengthen.

ARS/US$ FX and MSCI Argentina Equity Index*



Argentina has de-risked to a large degree after both the currency and equities collapsed by 53% in 2018, but the economy still faces persistently high inflation and policy continuation will be tested as presidential elections take place later in 2019. In Puerto Rico, a hybrid US-LatAm play, we expect a much stronger economic expansion bolstered by the deployment of US/FEMA disaster recovery funds -about $7bn out of $15bn, still to be disbursed in 2019- with additional public and private investment funds cascading into the economy as the island restructures its long-term public finances.

* Source: Thomson Reuters Datastream and AZTLAN Research

Our Firm January 2019

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Introduction to AZTLAN

AZTLAN Equity Management, LLC is an independent investment adviser specializing in global small and mid cap equity strategies. AZTLAN was founded in 2016 and is an exempt reporting adviser registered in the state of Virginia; we have presence in Monterrey, Mexico and Hong Kong.

Our firm manages individual funds as well as separately managed accounts across two discrete strategies: **Emerging and Frontier (EMF) and Developed Markets (DM)**

Investment Philosophy

We are passionate about investing in free cash flow generating businesses. We select stocks by determining relative attractiveness based on **fundamental analysis seeking high and sustainable**: free cash flow generation, competitive advantages, earnings growth, capital returns, balance sheet quality, corporate governance standards.

We strictly adhere to classic **valuation principles**: Buy-sell actions determined by assessing intrinsic value and margin of safety.

Investment Process

We follow a disciplined investment process: 1) Proprietary quantitative screens and models to identify stocks that exhibit our targeted investment characteristics, 2) Intensive fundamental research, analysis and valuation on a narrow cross section of stocks. 3) Pick stocks to build concentrated portfolios with a business co-ownership approach and a long-term investment horizon. 4) Rebalancing and long-term constructive engagement with portfolio companies.

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