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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

AUGUST 2023

As we assess the year-to-date performance of the asset class and the strategy, we look back to the start of the year, noting the high degree of optimism in investor expectations surrounding the potential positive turning point in China's economy, as government authorities relinquished the zero-COVID strategy, which had weighed on economic growth in recent years.

At the same time, India's equity market was coming off of several years of strong performance, and in the aftermath of allegations of a corporate governance scandal associated with one of the largest local conglomerates, the local equity market appeared to many investors to be vulnerable to a rotation.

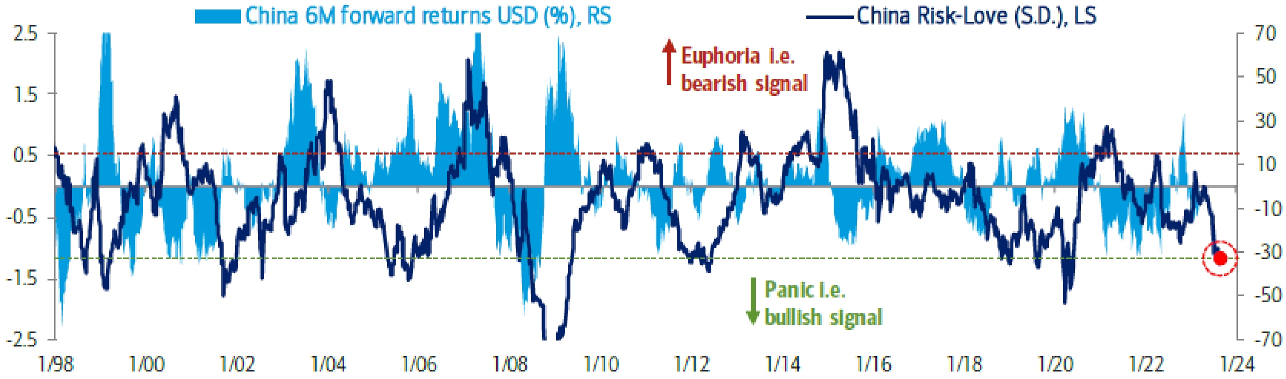
To borrow a line from a well-known fund manager, the world of investing is filled with irony and paradox, for after staging a 56% rally from the low point last October, the MSCI China Small Cap Index topped out in early February and has subsequently declined by 32%. Conversely, the MSCI India Small Cap Index returned -2% and +27% over those same periods.

Reflecting on our own expectations at that time, the strategy moved to an overweight position in India in January for the first time in eight months, as the resilience in both the earnings and performance of small caps in India suggested to us a potential inflection point for the market after a transitory period of relative weakness. This decision has helped the strategy generate positive returns year-to-date despite the significant underperformance of Chinese small caps.

Our anticipation of an improving growth impulse in China has not materialized year-to-date, and the strategy's relative performance has been negatively impacted by the maintenance of an overweight position in China. Following the declines in the equity market between February and August, Chinese small caps have given back the vast majority of their absolute performance since the market bottomed last October, with the MSCI China Small Cap Index up only 6% between 10/31/22 and 8/30/23, underperforming the MSCI EM Small Cap Index by 2,000 basis points over the same period.

At this point, investor sentiment toward China is near multi-year lows, with Bank of America's "Risk-Love" indicator showing similar readings to the onset of COVID and other notable periods of macro stress over the years. While authorities began stimulating the economy in piecemeal fashion throughout July and August, investors reacted negatively to announcements of fresh stimulus, selling into the news as they generally perceived the announced stimulus as insufficient to stem the tide of a slowing property market.

Exhibit 1. China Sentiment Indicator

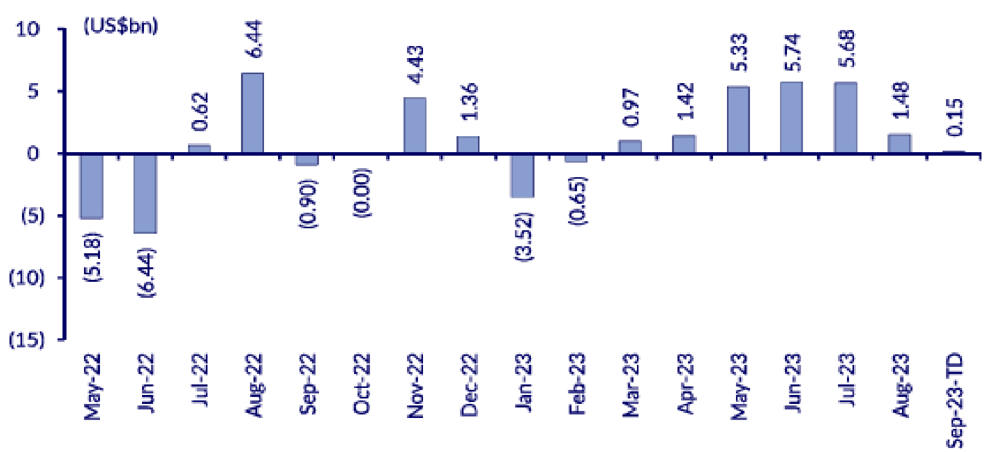


Source: BofA Predictive Analytics, FactSet

While we acknowledge the challenging backdrop for China's economy, we also believe the bar for incremental positive surprise is low at this point, while the policy response is shifting from the piecemeal stance to a more credible approach, punctuated by the first nationwide property policy relaxation since 2015. While China remains vulnerable to a prolonged period of valuation compression longer-term, the near-term potential for earnings and economic growth has improved, in our view.

In many ways, China's loss has been India's gain. Foreign institutional investor (FII) inflows into Indian equities were negative in January and February, but as China's market topped out and growth concerns mounted, India saw strong inflows into its equity market.

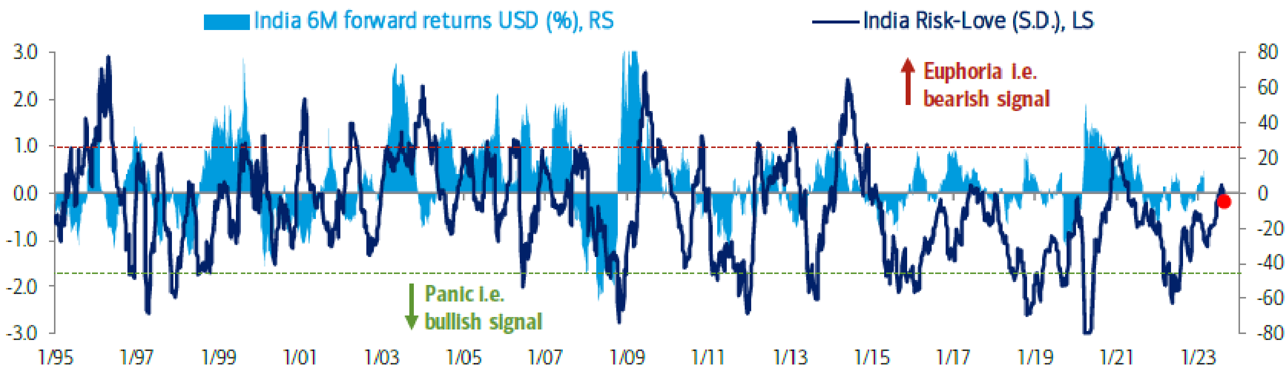
Exhibit 2. India Foreign Institutional Investor Flows



Source: Bloomberg, CLSA

This begs the question, if China is able to successfully stabilize the economy and revive sentiment, would India be vulnerable to another bout of underperformance? We expect that in this type of backdrop, a pause in the strength of Indian small caps would prove relatively short-lived. First, sentiment indicators for India have rebounded off of last year's lows but are only in neutral territory relative to historical trends. Additionally, India is undergoing significant structural change in areas such as manufacturing, tourism, domestic consumption, and underpenetrated sectors such as healthcare, all of which augur positively for small cap stocks in the country. Amid a relatively scarce growth backdrop for EM and global equities, we expect investors to continue to reward the outsized growth characteristics demonstrated by small cap companies in India.

Exhibit 3. India Sentiment Indicator



Source: BofA Predictive Analytics, FactSet

While the year-to-date performance dynamics have not materialized exactly as we expected in January, we end the month with a similar conclusion as we expressed then, as we noted that the past "China or India" trade-off may well turn into a "China and India" allocation.

Performance Review

At the sector level, the most significant contributors to returns were financials and information technology. Industrials and health care detracted the most value. At the country level, India and Vietnam were positive contributors to performance for the month, Hong Kong and Brazil were notable detractors from performance.

Positioning and Outlook

Over the balance of the year, we are watching the trajectory of inflation expectations and the US dollar, alongside the magnitude of China's growth impulse as factors that will likely dictate the direction of risk assets. On the inflation front, we have seen mixed evidence, as certain US economic data have started to deteriorate, while more pronounced downside surprises to economic data have been observed in Europe. At the same time, US labor market trends have largely remained resilient, while commodity prices, particularly within the energy complex, have reasserted in recent months.

Amid this backdrop, EM currencies continue to maintain a high degree of dispersion. The ongoing depreciation of the yen, as well as the weakness in China's economy, have led to broad weakness in North Asian currencies. However, proactive monetary policy and supportive terms of trade have bolstered the Brazilian real, while close ties to US economic activity and the strength of foreign direct investment related to nearshoring have supported the Mexican peso. Broadly, EM central banks maintained responsible monetary policy around the pandemic and are positioned to cut interest rates as inflation subsides.

As noted above, China's recovery following the relinquishment of the zero-COVID policy has been uneven and generally disappointing, although at this point, expectations on the part of market participants are extremely low, leaving room for positive surprise. While we will not see a return to the growth rates observed over the last decade, economic activity seems unlikely to deteriorate further from here, given the degree of stimulus over the past couple of months.

On balance, we expect that this backdrop of easing inflation, supportive policy dynamics, and economic stability in China will augur positively for EM equities. The strategy remains optimistic on areas that have shown resilient growth amid an uncertain global macro backdrop, including India, Brazil, Mexico, and Saudi Arabia at the country level, along with energy and technology at the sector level.

Until next month,

Chad A Cleaver

Chad Cleaver, Lead Portfolio Manager
Driehaus Emerging Markets Small Cap Equity Strategy