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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

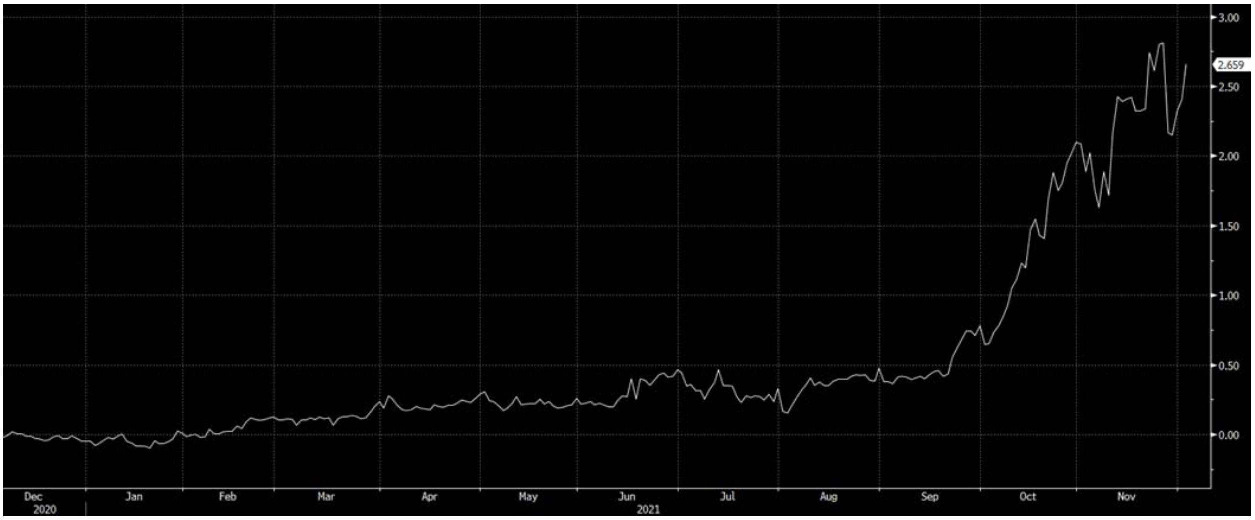
NOVEMBER 2021

As boxing legend Mike Tyson once quipped, "everybody has a plan until they get punched in the mouth." This quote rang true for asset allocators and policymakers during the final days of November, as the emergence of the Omicron variant of COVID dashed hopes of a quiet Thanksgiving holiday and subdued end to the year.

The Federal Reserve Board's (Fed) plans have also taken various twists and turns throughout the year, with the most recent one coming at Chairman Jerome Powell's Congressional testimony, where he articulated that it was time to "retire" the word "transitory." Ironically, this about-face comes at a time when the base effect for inflation becomes more challenging, particularly into the second half of 2022, and breakeven inflation rates and the yield curve had already begun to collapse in the wake of the Omicron news.

With inflation having become a significant concern for the US populace in advance of 2022 midterm elections, the Fed's monetary policy appears to be increasingly interwoven with politics. Thus, the risk of a perceived policy mistake seems to be growing, as market participants now expect two to three interest rate hikes in the next twelve months (Exhibit 1).

Exhibit 1. Market Implied Pace of Rate Hikes

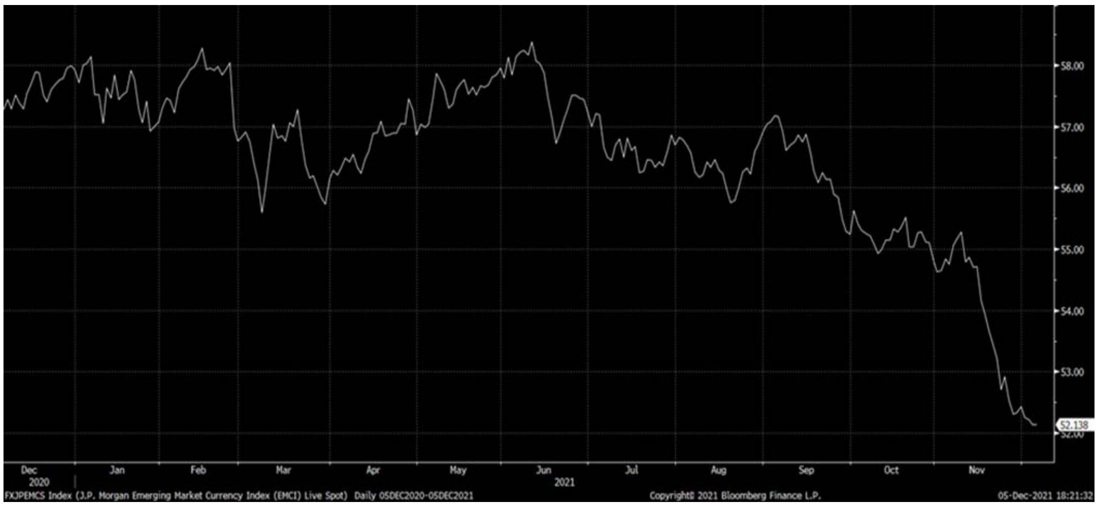


Source: Morgan Stanley, Bloomberg

Tightening financial conditions and a flattening yield curve have generally portended negative developments for emerging markets in the past, and it is not surprising to see the recent decline in the JP Morgan Emerging Market (EM) Currency Index coincide with these macro headwinds (Exhibit 2).

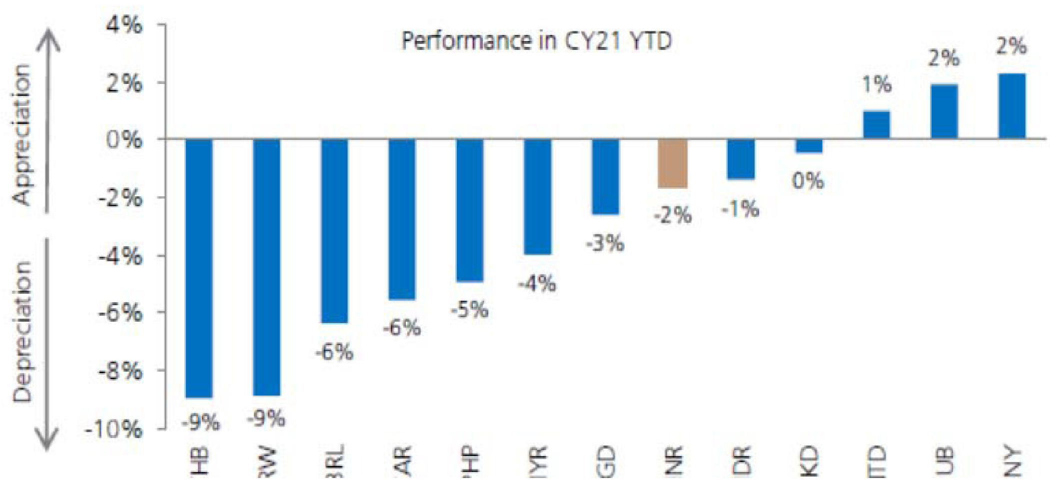
However, a nuanced view is required, as not all EM currencies have been under pressure. The Chinese yuan and Taiwanese dollar have remained on strong footing, reflecting the strength of the export sectors in these economies, as well as China's strategic desire to foster the development of its domestic service sector and consumer base. The Indian rupee has remained within a wide trading range for much of the year and has been somewhat stronger than many other EM currencies of late, reflecting both the relatively closed nature of India's economy, as well as the continued appetite for foreign portfolio investment in the economy (Exhibit 3).

Exhibit 2. JP Morgan Emerging Markets Currency Index



Source: JP Morgan, Bloomberg

Exhibit 3. EM Currency Performance



Source: Bloomberg, UBS

While 2021 has largely been a year to forget for emerging market investors, 2022 could mark a year of policy and growth divergence in favor of EM, as China appears on the cusp of an easing cycle and many other EM economies have already tightened monetary policy during 2021. Meanwhile the US is on the verge of tightening monetary policy and restrictive lockdowns continue to pervade much of Europe in response to new variants of COVID.

Performance Review

At the sector level, the most significant contributors to returns were information technology and health care. Consumer discretionary and industrials detracted the most value. At the country level, Taiwan and India contributed most to performance for the month, while Hong Kong and Turkey were notable detractors from performance.

Positioning and Outlook

2021 was a challenging year for investors in China, due to significant regulatory headwinds across several sectors, a deterioration in the property market after policy tightening exposed long developing weakness in the sector, and a power crunch dented the growth outlook in the industrial economy. Recent signals from the Chinese authorities point to a stance of incremental easing as we head into 2022, with potential for more aggressive easing following Lunar New Year and the Winter Olympics.

Specifically, the China Banking and Insurance Regulatory Commission (CBIRC) stated that they would provide a range of support to the property market, including prioritization of mortgage demand from first-time homebuyers and supporting social housing. Vice Premier Liu He similarly made supportive comments in late November regarding support for high quality housing. Similar policy signals related to the property market precipitated the onset of an upturn in the credit cycle in periods such as 2012 and 2016.

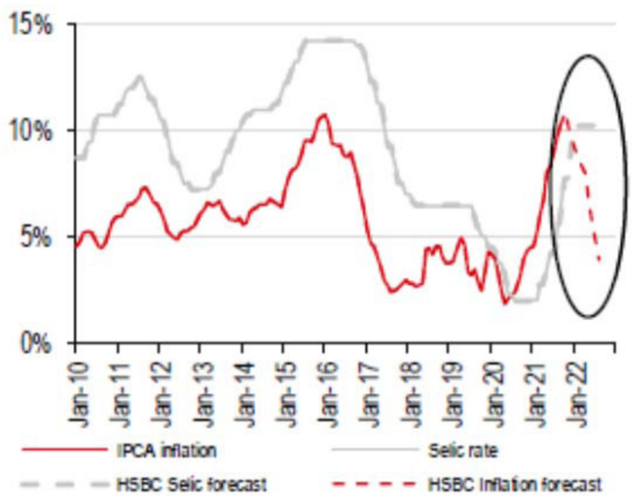
High level commentary from Chinese officials is no longer restrictive, as it was in late 2020. Last December's Politburo meeting mentioned the phrases "anti-monopoly" and "curbing the disorderly expansion by capital" for the first time, prior to the intensification of the regulatory campaign in 2021. This language was absent from the recent Politburo meeting, and instead replaced by the phrase "stability is the top priority," along with "proactively boost investment." While this policy shift is unlikely to result in a return to the economic growth rates observed over the 2000s or even the first half of the last decade, the message of stability and growth should be welcomed by investors as the Hang Seng China Enterprises Index sits at the bottom end of a decade-long trading range (Exhibit 4).

Exhibit 4. Hang Seng China Enterprises Index

Source: Bloomberg

China is likely to be a prominent part, if not be the centerpiece, of any bull case for EM in 2022. However, it is also worth noting that several EM economies were forced to tighten policy throughout 2021 as inflation rose, and this pressure could be relinquished if inflation peaks in 2022. As shown below, Brazil maintained negative real interest rates during the year, despite a series of hikes in the country's policy rate, the Selic (Exhibit 5). A favorable term of trade, with booming agricultural commodities and iron ore touching $200/ton at one point, was one of the few factors preventing the Brazilian real from weakening even further amid the negative real interest rate backdrop.

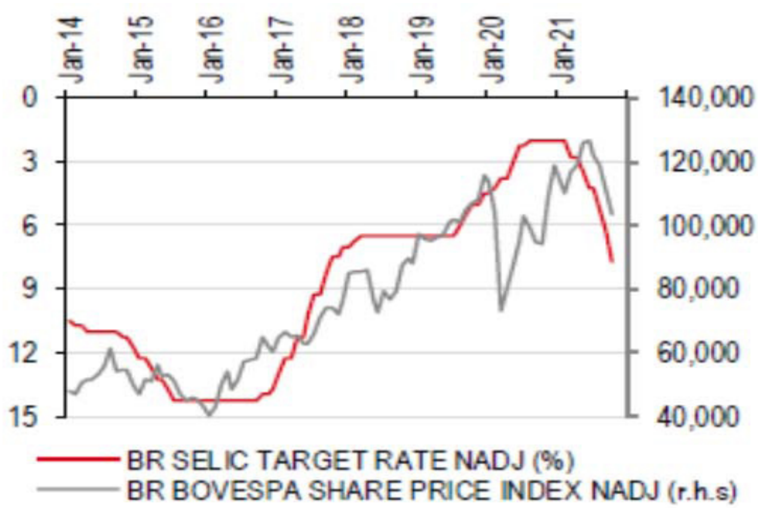
Exhibit 5. Brazil Inflation and Policy Rate



Source: Refinitiv Eikon, HSBC estimates

Moving into 2022, economists expect year-over-year inflation readings to peak, restoring positive real interest rates and taking pressure off the central bank. As shown below, Brazil's equity market has been closely correlated with the Selic over time (Exhibit 6).

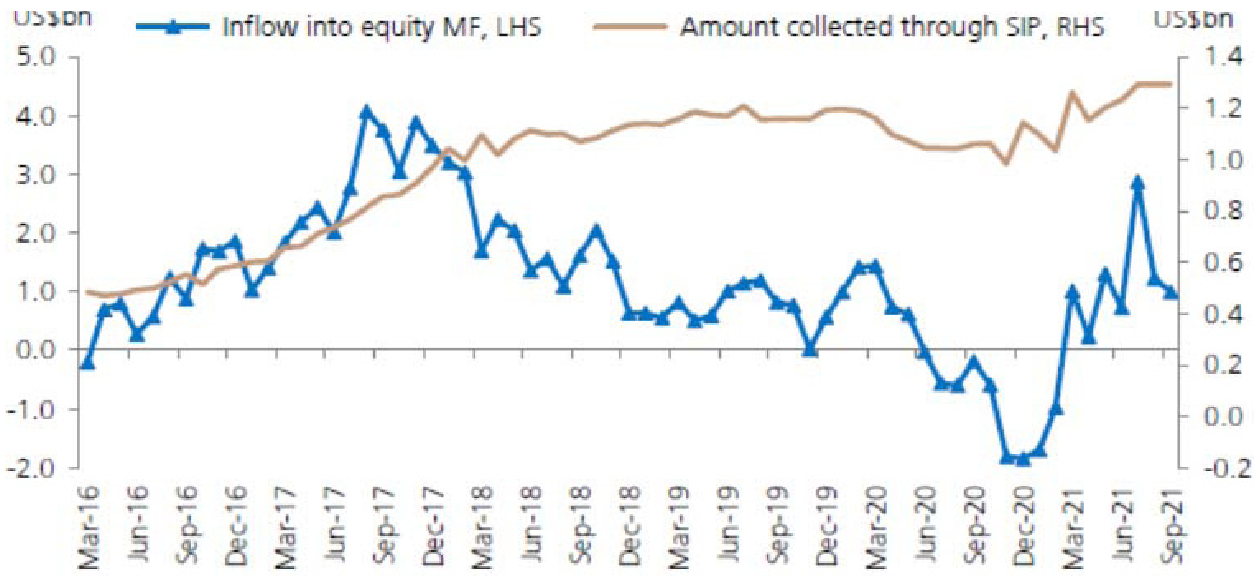
Exhibit 6. Brazil Bovespa Index and Policy Rate



Source: Refinitiv Eikon

Despite the macro and regulatory headwinds throughout the year, China and Brazil have been strong sources of bottom-up investment ideas, and both countries represent overweight positions for the strategy. The third key overweight has been India. Numerous drivers and themes have emerged within India in recent years, and a tailwind of increasing local allocations to equities has helped the Indian market overcome a severe second wave of COVID and a spike in oil prices, which has historically posed a challenge for the country as a large energy importer (Exhibit 7).

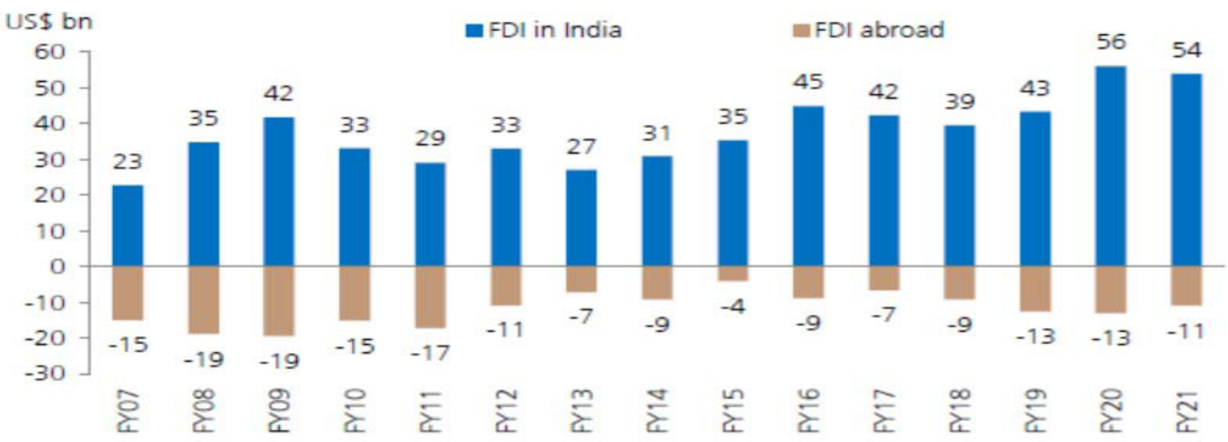
Exhibit 7. Inflows Into Equity Mutual Funds and Systematic Investment Products



Source: AMFI, UBS

Significant amounts of infrastructure spending have helped India move up the rankings in terms of ease of doing business, and production-linked incentives (PLI) for manufacturers have led to increasing amounts of foreign direct investment in the economy (Exhibit 8). With nearly 50% of the workforce still employed in the agriculture sector, there remains a long runway for a shift into manufacturing. The strategy is invested in two companies that have been prime beneficiaries of PLI, and as India builds out its local renewable energy and electric vehicle industries, additional leaders in manufacturing have begun to emerge.

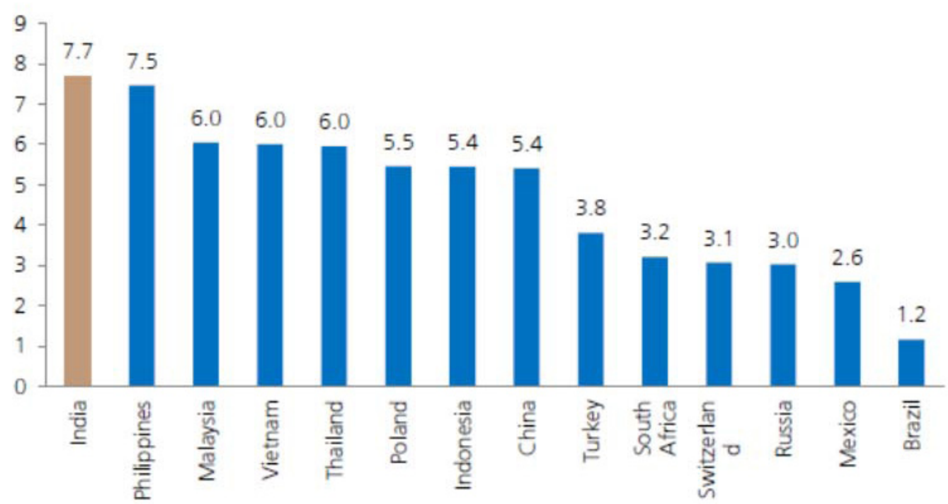
Exhibit 8. Foreign Direct Investment



Source: CEIC, UBS

While GDP and stock prices do not demonstrate a strong correlation, India's leading GDP growth rate has supported top line growth across several sectors (Exhibit 9). New ideas in the portfolio have emerged throughout the year in the hospital and diagnostics industries, intermediate chemicals for industries such as pharmaceuticals and agriculture, and the software industry. Increasingly, we see improving innovation by Indian companies, with a recent example being a local producer of "green" chemicals that substantially reduce water discharge and emissions associated with the production process. Industry-leading pricing power and cost control within this unique business have led to an eye-popping 70% return on invested capital for the company.

Exhibit 9. EM Real GDP Growth (UBS 2022 Forecasts)



Source: UBS Estimates

Shifting gears from the markets, I would be remiss if I did not reflect my gratitude to the organizers of the Alpha Challenge, a stock picking competition for top business schools held at the University of North Carolina, which I recently helped judge. I have been involved in various ways with the competition throughout its 17-year history, and Driehaus was among several firms that co-sponsored the event. The students that participated in this year's event put forth a significant amount of work and presented impressive pitches, and I have enjoyed watching the Alpha Challenge flourish and grow in prestige over the years.

Until next month,

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