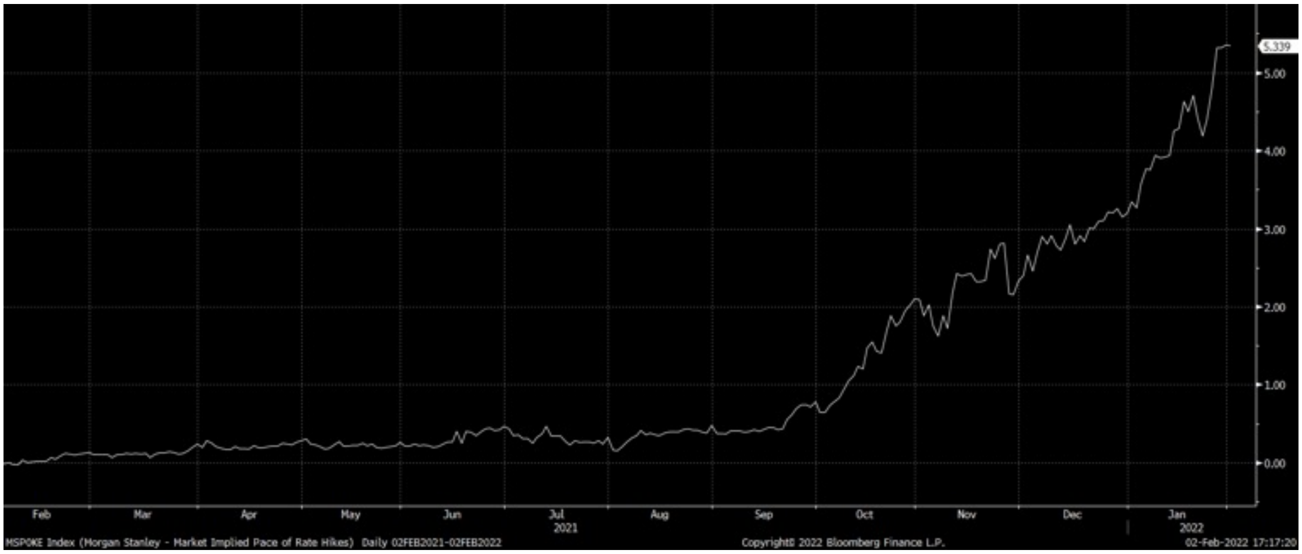
DRIEHAUS
CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

JANUARY 2022

Risk assets have started the year on shaky footing, as the result of increasingly restrictive financial conditions as the Federal Reserve (Fed) appears set to embark on a tightening cycle. This has led Wall Street economists to continually revise up expectations of interest rate increases over the last several months. Market expectations now imply five rate hikes in the next twelve months (Exhibit 1), up from only one as recently as last October. Multiple upward revisions to consensus rate hike expectations led one well-known market strategist to begin a recent missive with a tongue-in-cheek remark that he now expects twenty-five rate hikes this year.

Exhibit 1. Market Implied Pace of Interest Rate Hikes in the Next Twelve Months



Source: Bloomberg, Morgan Stanley

To set the stage for a further discussion about the current backdrop, we turn to some of our first monthly commentaries, written eight years ago.

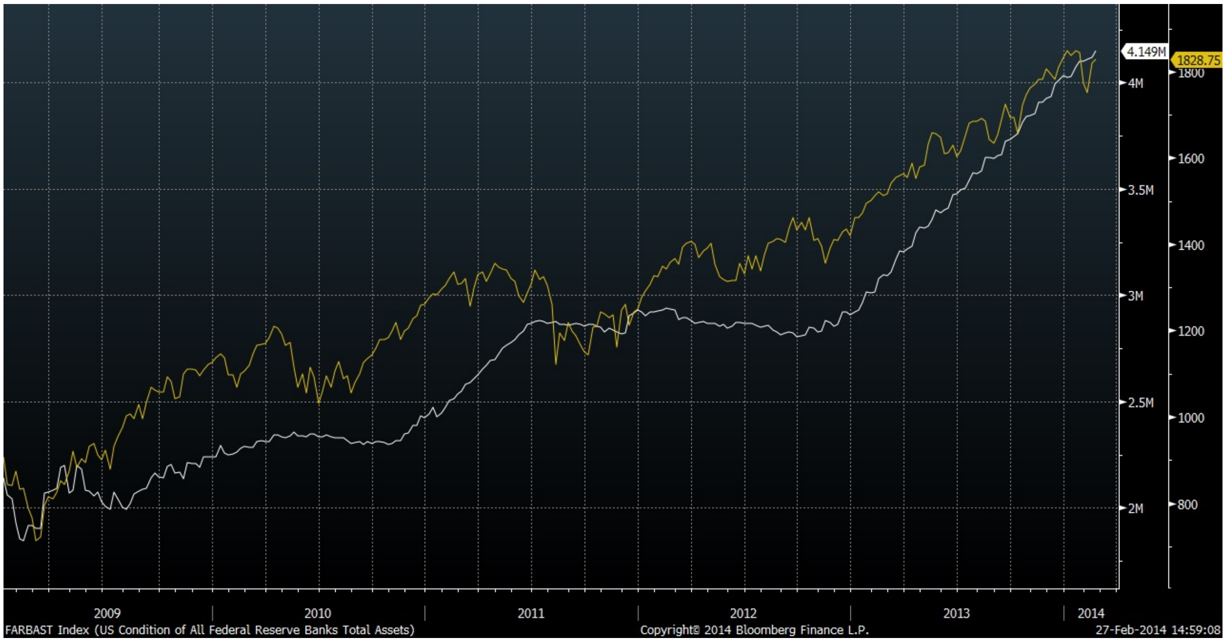
February 2014 Commentary

"Former University of North Carolina coach Dean Smith was recently awarded the Presidential Medal of Freedom, the nation's highest civilian honor. In addition to Coach Smith's dedication to excellence, he was universally recognized as running a classy college basketball program, and importantly, one that preached selflessness.

Among the traditions Coach Smith popularized was "pointing to the passer." After a player makes a great play, rather than celebrate the individual effort, the player points to the teammate who passed him the ball, in recognition of the assist.

March of 2014 brings about the five-year anniversary of the onset of quantitative easing in the US. As depicted below, the unprecedented expansion of the Fed's balance sheet over this period has coincided with a powerful bull market in US equities.

Exhibit 2. Fed Balance Sheet vs. S&P 500



Source: Bloomberg

As we discussed in December, it is our view that coordinated central bank intervention beginning in 2012 with the European Central Bank's Long-Term Refinancing Operations, further followed by additional rounds of QE by the Bank of Japan, created depressed volatility conditions. This low volatility regime has further reinforced the positive backdrop for risk assets.

Holders of developed market equities should certainly "point to the passers" – Ben Bernanke, Janet Yellen, Haruhiko Kuroda, and Mario Draghi – who have given them an assist over the past five years."

March 2014 Commentary

"The adage of the hedgehog and the fox dates as far back as 680 BC, to Greek poet Archilochus. It was popularized in modern times by philosopher Isaiah Berlin in his 1953 essay "The Hedgehog and the Fox." The basic idea is that people fall into one of two groups. Hedgehogs tend to view the world through one overarching idea, while foxes draw on a variety of experiences in forming their worldview, which is flexible and fluid.

Archilochus and Berlin have more recently inspired political scientists, psychologists, economists, and market practitioners. Philip E. Tetlock's "Expert Political Judgement" and Nate Silver's "The Signal and the Noise" are contemporary works that expand on the concept of the hedgehog and the fox. Silver suggests that while hedgehogs tend to make better television personalities, with their bold views, foxes actually have a better track record of making predictions, as their adaptable approach better appreciates nuanced, complex situations.

The hedgehog knows one thing very well. He is "all-in" on one big idea, and new information is viewed within the prism of the overarching idea. Hedgehogs tend to be confident in their views, perhaps too confident, and have little patience for those that disagree. As Silver says, they "are type A personalities who believe in Big Ideas – in governing principles about the world that behave as though they were physical laws and undergird virtually every interaction in society."

In contrast, foxes know many small things which then feed into a more dynamic view of the world. They tend to be nimble and flexible, unsure of their own predictive ability, and skeptical of the very notion of even making predictions. In Silver's words, foxes "are scrappy creatures who believe in a plethora of little ideas and in taking a multitude of approaches toward a problem."

Hedgehogs' predictions often fail as a result of their tendency to ignore new information if it conflicts with their view. In contrast, foxes value observation over theory, and appreciate that the world is complex and unpredictable. These concepts resonate well with us as portfolio managers, particularly in emerging markets, where currencies, interest rates, and geopolitical developments can change quickly."

Connecting the Dots

It is no longer a matter of debate that unconventional monetary policy has created an enormous tailwind for risk assets since it was first deployed in the aftermath of the global financial crisis. The pandemic has brought about an asynchronous, uneven economic recovery across the globe, as policy divergences with respect to both the economy and public health have contributed to supply chain bottlenecks, underinvestment in the productive capacity of critical raw materials and energy, challenges in forecasting, and an inability to swiftly respond to changing conditions in supply and demand.

Many of these factors contributed to rising inflation expectations throughout 2021, leading a number of well-known economists to make the rounds of Sunday morning political talk shows to proclaim that the Fed's monetary policy was dramatically behind the curve.

This broad rise in expectations of Fed tightening led thematic and unprofitable companies to underperform broad equity markets, with this underperformance accelerating and widening out in the early days of 2022. If the Fed is truly on the cusp of a significant reduction in monetary accommodation, then market participants may no longer be "pointing to the passer" for the first time in many years.

However, a key question for investors moving forward is whether the Fed is as behind the curve as certain hedgehogs believe it to be. While near-term inflationary pressures are undeniable, the 5-year forward 5-year breakeven inflation rate currently stands at 2.13%, hardly implying an inflationary spiral (Exhibit 3).

Exhibit 3. 5-Year Forward 5-Year Breakeven Inflation Rate

Source: Bloomberg

Notably, this metric peaked in October 2021, before oil prices ascended further to $90/barrel. Energy prices may prove challenging for the Fed to control through monetary policy, absent engineering an unintentional hit to aggregate demand.

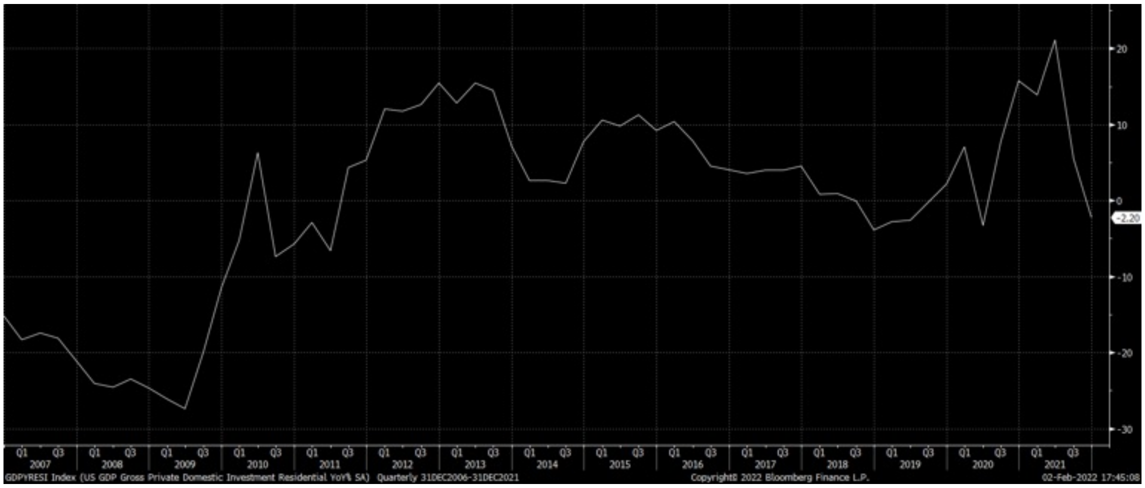
Second, while the US economy exhibited a strong recovery from the depths of the COVID-induced crisis, growing by 11.7% in nominal terms in the fourth quarter of 2021, unsustainable factors such as a historically high inventory build (Exhibit 4) and fiscal spending were key contributors to this growth. Many economies, including the US, will face a negative fiscal impulse in 2022 as the government spending in response to COVID fades.

Exhibit 4. US GDP Dollar Level Change in Private Inventories (Billions of USD)

Source: Bloomberg, Bureau of Economic Analysis

At the same time, higher frequency economic data have begun to roll over and show weakening internals. Private residential investment, which recovered strongly in the first half of 2021, has moved back into negative territory on a year-over-year basis and is unlikely to respond well to the five interest rate hikes expected by consensus (Exhibit 5).

Exhibit 5. Year-Over-Year Growth in US Private Residential Investment



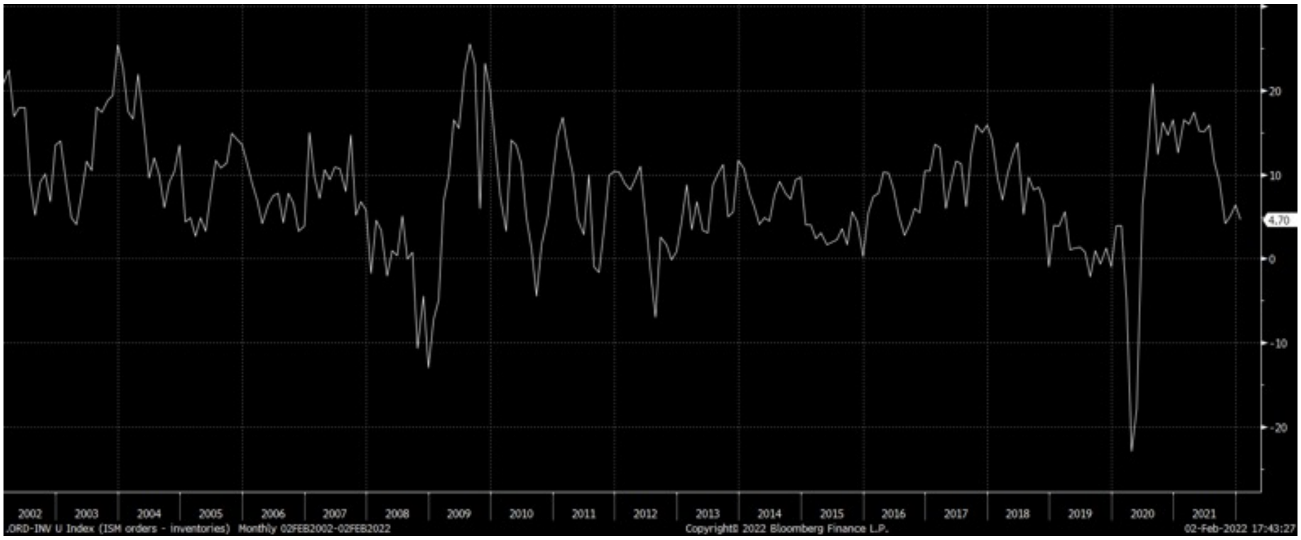
Source: Bloomberg, Bureau of Economic Analysis

While the US Manufacturing Purchasing Managers' Index (PMI) has held up reasonably well thus far (Exhibit 6), sitting well above 50, a look beneath the surface reveals that new orders have nosedived relative to inventories. This suggests that the forward outlook in the manufacturing sector may become more challenging, as orders are a leading indicator. This ratio of orders to inventories is at similar levels to late 2018, a period in which a similar market selloff led the Fed to reverse course on its multi-year tightening cycle (Exhibit 7).

Exhibit 6. US Manufacturing PMI

Source: Bloomberg, Institute for Supply Chain Management

Exhibit 7. US PMI Subcomponents (Orders – Inventories)



Source: Bloomberg, Institute for Supply Chain Management

Connecting the dots, the Fed appears to be signaling that it will tighten into a slowing economy, while market participants are one-upping each other with their forecasts of the magnitude of expected tightening.

That said, it is naïve to conclude that the Fed will simply reverse course as it did in early 2016 and late 2018, as inflation has become increasingly interwoven into US politics. Further, with US CPI now north of 7% on a year-over-year basis and likely to remain sticky for the first half of 2021, the Fed risks damaging its inflation-fighting credibility by doing nothing or simply relenting after a bout of market volatility.

While the hawkish pivot and concurrent risk asset selloff are understandable amid this backdrop, it is important to note that the Fed has spent nearly thirteen years trying to prevent a deflationary outcome, at times noting that it would remain deliberately behind the curve, welcoming any sort of inflation. As one well-known market analyst recently argued, a certain amount of inflation is tantamount to being a "feature, not a bug" within the Fed's policy arsenal. Inevitably, supply chain bottlenecks will improve, year-over-year inflation comparisons will become less challenging due to the base effect, and certain components of CPI may still prove transitory, albeit not as swiftly as the Fed or US politicians had desired when they first coined the ill-advised term.

Should the pockets of slowing economic data referenced above morph into a more concerning growth backdrop, the strength that the US dollar has exhibited over the last year may start to dissipate. Many emerging market central banks have already hiked interest rates in 2021 or maintain positive real interest rates, in contrast to the deeply negative real rates found in the US. Further, China has shifted its policy priorities to growth normalization, in contrast to the tightening measures undertaken throughout 2021. While the intersection between tighter Fed policy and slowing growth may continue to portend a choppy global market backdrop, the relative case for emerging markets looks increasingly appealing in such an environment.

Performance Review

At the sector level, the most significant contributors to returns were financials and energy. Industrials and Information Technology detracted the most value. At the country level, Brazil was the only positive contributor to performance for the month, China and India were notable detractors from performance.

Until next month,

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