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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

APRIL 2022

> "I know it's important. I do. I honestly do. But we're talking about practice, man. What are we talking about? Practice? We're talking about practice, man! We're talking about practice! We're talking about practice..."
> —Allen Iverson

This month marks the twenty-year anniversary of one of the most memorable sports press conference rants, courtesy of former Philadelphia 76ers star Allen Iverson. Responding out of frustration to repeated questions from reporters about his practice habits, Iverson unloaded, repeating the word "practice" 22 times, resulting in a viral video clip that is still remembered by basketball fans today.

Policymakers and investors may be inclined to harken back twenty years for some practice on navigating the current macro and market environment. The Federal Reserve (Fed) embarked on its first interest rate hike of 50 basis points since 2000, seeking to reinforce its inflation fighting credentials amid headline inflation rates that have not been this high since 1981. As the Fed tightening is happening in tandem with Japan's struggles to maintain its yield curve control policy, while Europe faces a direct hit to its economic growth prospects as a result of the Russia-Ukraine war, the US Dollar Index has broken out to a 20-year high as well.

The Bloomberg Commodity Index is at similar levels as 2002, before the breakout and multi-year ascent, which lasted until mid-2008. Investors could be forgiven for being out of practice in their analysis of commodity markets, as an end to the previous supercycle was followed by 10 years of steady commodity price declines. While high quality companies with wide economic moats have been dramatic outperformers over much of that same timeframe, the reality is that the strongest earnings revisions have been found in the energy and materials sectors for the past year and a half.

While we are not predicting a 2008-style financial meltdown, we have emphasized over the past several months that lessons from the commodity spike that preceded the Global Financial Crisis may be instructive in the current backdrop. Certain economies that have benefited significantly from falling commodity prices over the last decade may face more challenging conditions going forward, given the disruptions in global energy markets, as well as the lingering effects of persistent food price inflation.

In a global context, Credit Suisse notes that "For Germany, $27 billion worth of commodity imports (mainly energy imports) supports a whopping $2 trillion worth of economic activity." In effect, this "commodity leverage" derived from a prolonged period of cheap natural gas procured largely from Russia has come to an end, and in fact looks to be reversing rapidly. While Europe has formed a bold plan to displace Russian gas, it is also heavily reliant on technologies that are either not at scale today or provide stopgap solutions. Consequently, the call on liquefied natural gas (LNG) is likely to grow significantly.

In an emerging markets (EM) context, many countries throughout Asia have benefited from the same disinflationary trends in commodities, albeit without the same type of direct leverage to Russian natural gas as Germany. However, in an environment of higher energy prices, the beneficiaries of the last decade may find themselves on shakier ground in the years ahead, as Asian economies are likely to compete directly with Europe to procure the marginal ton of LNG, paying a higher price than they have been accustomed to in the past.

As the adage goes, "the cure for high prices is, high prices," and this can manifest through a supply response or demand destruction, or a combination of the two. Unfortunately, the near-term indications point toward demand destruction, akin to the mid-2008 conditions when consumers could no longer afford to absorb $150/barrel oil or $7/bushel corn. With tomorrow's energy needs being increasingly met by sources such as LNG, nuclear power, and green hydrogen, the long lead times associated with such projects point to a prolonged period of investment before an adequate supply response becomes apparent.

Though it may be tempting to point to a grim conclusion from this analysis, one must also consider that the 2008 commodity spike ultimately gave way to the development of shale oil and gas, and advancements in technology resulted in a wave of new supply, bringing about the commodity disinflation of the 2010s. A similar period of disruption may be forthcoming, with potential winners including next generation nuclear power, green hydrogen, and geothermal energy, in addition to the continued advancements being made in existing technologies such as offshore wind, solar power, and energy storage solutions. While today we are undoubtedly witnessing the greatest period of upheaval in over a decade, punctuated by the ongoing impacts of the pandemic and now the consequences of war, this will likely open the door to a new wave of innovation and advancement in the years ahead, with energy at the forefront.

Performance Review

At the sector level, the most significant contributors to returns were consumer staples and health care. Industrials and financials detracted the most value. At the country level, Brazil and Taiwan were positive contributors to performance for the month, China and Hong Kong were notable detractors from performance.

Positioning and Outlook

The Strategy continues to hold a positive view on China, as the country continues to shift into pronounced policy easing. In late April, President Xi Jinping called for an "all-out" effort to stimulate the economy through infrastructure investment. China's economy has struggled amid property market stress, as major developers have faced solvency concerns, leading prospective buyers to adopt a tentative approach to buying property. Overall consumption has been further stymied by China's continued COVID-zero policy, which has resulted in lockdowns and vast testing measures for large tier-1 cities. While policymakers have been hesitant to stimulate the property market directly, the intensification of policies designed to stabilize the economy has grown. Across the emerging markets opportunity set, we believe that China holds the strongest potential for a positive growth inflection in the months ahead and continues to accumulate positions in the country amid bouts of market turbulence.

While the Strategy has long held a positive view on India, we have shifted our positioning to a more cautious stance in recent months. A perfect storm in commodity markets does not bode well for India, as one of the largest commodity importers across emerging markets. Further, the growth of retail equity investment in the country, while serving as an important factor to support the market, has also driven valuations to levels that are unattractive in both a historical and relative context. With the catalyst of rising interest rates, which has now come into play after a recent unexpected interest rate hike by the Reserve Bank of India, we view the current setup as one that likely portends future underperformance by Indian equities.

The most notable change in the portfolio in recent months has been the emergence of an increasing slate of bottom-up driven ideas, which are less tied to macro drivers. Examples include a Vietnam-based provider of IT services, an Indian beverage distributor, a Korean shipbuilder with a focus on environmentally friendly ships, and a Brazilian waste management company that is well positioned to take advantage of the generation and sale of carbon credits. Amid the macro turbulence, investors are distinguishing between companies that had previously re-rated based on thematics or low cost of capital, and those with resilient business models that can thrive despite rising macro risks.

While the macro and geopolitical events over the past two years have been difficult, if not impossible to predict, and have certainly brought turbulence to risk assets, we remain optimistic on the long-term trajectory of emerging markets. Inevitably, opportunities will emerge out of periods of upheaval such as the present moment, for those who are open-minded enough to identify them.

Until next month,

Chad Cleaver, Lead Portfolio Manager
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