DRIEHAUS
CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

MAY 2022

"Somebody's got to pay…ain't going to be me!"
– Harry Lynch, Wall Street

As events that have unfolded over the past several months (Russia-Ukraine war, China's maintenance of zero COVID policy) continue to disrupt supply chains and cause dislocations in global markets, shortages of various commodities have become increasingly apparent and impactful. Thus far, market participants have focused primarily on the first order impact of these developments, namely persistent inflation and rising interest rates, while, in our view, underappreciating the second order impacts.

On May 12, within hours of each other, the following headlines came across our terminal:

- Spain will impose a natural gas price cap of €40 per megawatt hour (MWh) from tomorrow until the end of the year, the country's prime minister announced this morning. European benchmark TTF gas is trading currently at €106 per MWh.

- Pelosi: Bill to let President make gas price increases illegal

The confluence of underinvestment in the energy sector, along with the direct impact and threat of potential further curtailment of supply resulting from the Russian invasion of Ukraine, has led to a sharp spike in fuel prices, along with reports of diesel shortages in parts of the world.

While Europe's benchmark natural gas price is only slightly above pre-war levels, it is more than 600% higher than it was in January of 2020 before COVID spread throughout the world. Moreover, there is a palpable sense of unease, as a recent shutdown of an entry point into the gas transport system that flows through Ukraine led to a curtailment of flows to end users in Europe, who need to be building storage in order to have adequate supply for the winter heating season.

Europe's bold plan to displace Russian gas, REPowerEU, incorporates aggressive assumptions surrounding new technologies, some of which are yet unproven and potentially not scalable enough to achieve the desired impact. Consequently, the call on liquefied natural gas (LNG) is likely to rise significantly in the years ahead. However, execution issues associated with these long duration projects, and security issues in major prospective producing countries such as Mozambique, call into question the ability of LNG to fill the gap.

As more questions than answers arise from an analysis of the developed world's energy policies, it is perhaps no surprise that policymakers in Spain and the US are turning to price controls. The more the pain can be eased for consumers, the greater the likelihood of these politicians being reelected, so the logic goes. However, there is no free lunch. The burden of the consumer ultimately gets transferred to the state. While this may be manageable, at least in the short-term, for countries that are part of the world's reserve currency mix, this is not the case for some of the more vulnerable developing countries, which are inevitably saddled with foreign exchange reserve depletion, currency devaluation, and rising risk of default.

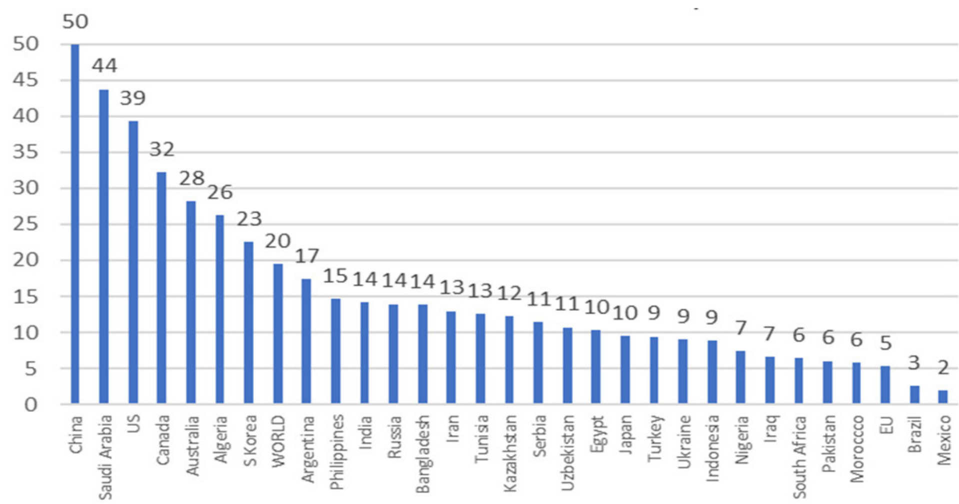
Tragically, for countries across the Middle East, North Africa, and South Asia that are large wheat importers, risks of food shortages will grow, as India was the second largest wheat exporter in the world. A recent Reuters article demonstrates the desperation of the situation in Sri Lanka, quoting Mohammad Shazly, a part-time chauffeur, who noted "Without gas, without kerosene oil, we can't do anything. Without food we are going to die."

From a humanitarian perspective, it is difficult to overstate how urgent the situation is becoming in a growing number of developing countries. Past periods of sharply rising commodity prices have resulted in social unrest in both the emerging and developed world, with some of the more notable examples including the Arab Spring protests in the early 2010s and the more recent gilets jaunes protests in France in 2018.

From an investment perspective, the interplay between commodities, geopolitics, and markets is likely to intensify in the months ahead. Against this backdrop, it is notable that China, while a large commodity importer, has taken steps to help insulate the country from the commodity shocks being felt around the world.

First, China has maintained a large stockpile of wheat, built up over the past two years. In terms of weeks of consumption, China's 50 weeks are substantially higher than most countries, as shown below in Exhibit 1.

Exhibit 1: Wheat Stockpiles (Weeks of Consumption)



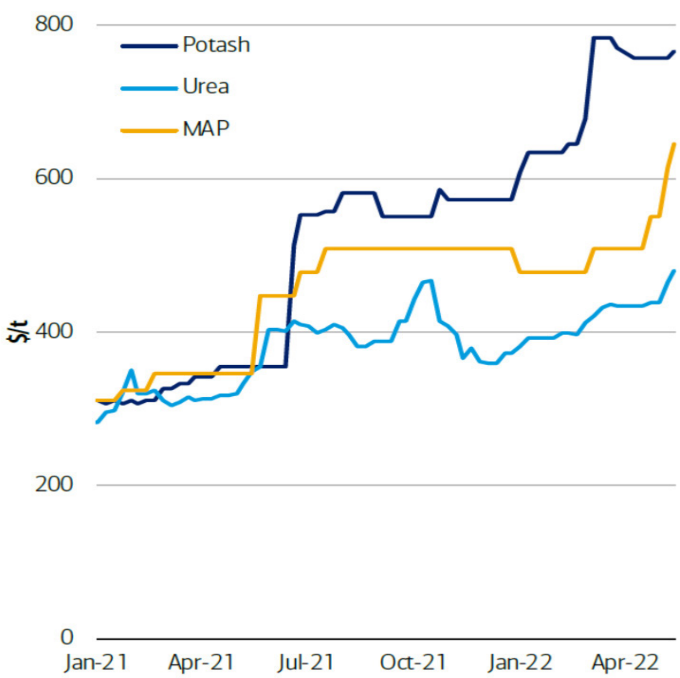
Source: US Department of Agriculture, Renaissance Capital

Additionally, China proactively reduced export quotas of diesel fuel, as well as phosphate and urea fertilizer. China's diesel exports peaked at 2.8 million tons in March 2021, and declined to 447 thousand tons by April 2022. Diesel prices have spiked globally in the aftermath of the Russian invasion of Ukraine, while shortages have been reported in parts of the US, raising the price for industrial users and the transportation of goods. Relative to the rest of the world, it is likely that China maintains a much higher inventory buffer of diesel, which will help mitigate cost increases for industrial users as activity in the country inevitably normalizes following the current wave of COVID.

Structurally, China is oversupplied in phosphate and urea fertilizer, but cyclically, as conditions tightened, China curtailed its exports in order to maintain adequate supply to local farmers. Year-to-date through April, China's urea exports are down 66% year-over-year. The price of nitrogen fertilizer products, such as urea, are largely a function of the price of natural gas, the key input, and China's move to restrict exports has further tightened global markets, while available stockpiles are re-rerouted to domestic consumers. Phosphate fertilizers tell a similar story, with China's year-to-date exports down 41% year-over-year through April.

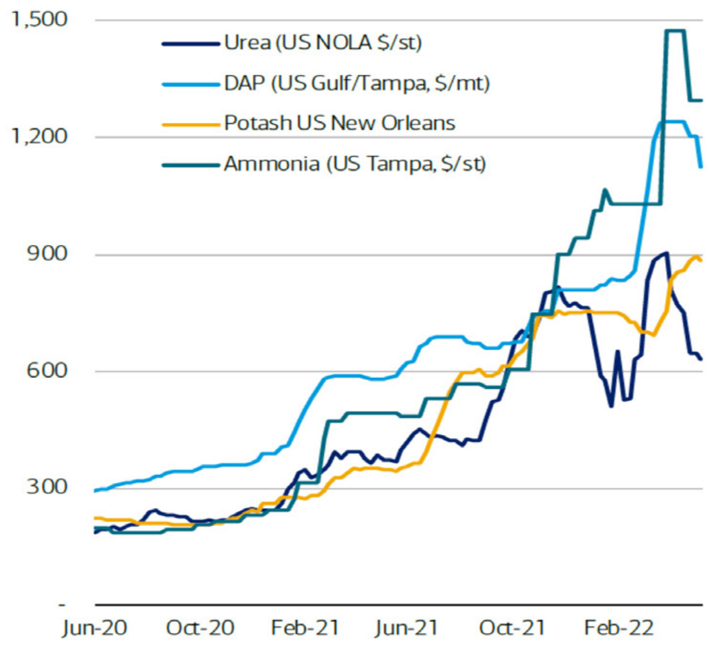
With Russia accounting for 15-25% of the global trade of nitrogen, phosphate, and potash fertilizers, farmers around the world have responded to price hikes and supply constraints by reducing applications and repositioning their acreage toward soybeans, which require less fertilizer. If prolonged, the consequences of these moves will be to suppress yields and further exacerbate the tight grain supply. While China will not be totally insulated from the price increases, again the country finds itself in a position of relative strength vis-à-vis much of the rest of the world (Exhibits 2-3).

Exhibit 2: China Fertilizer Prices ($/ton)



Source: CNICC, BofA Global Research

Exhibit 3: Global Fertilizer Benchmark Prices ($/ton)



Source: CRU, Bloomberg, BofA Global Research

As the world copes with the ongoing supply and demand shocks associated with COVID and the war, we are likely to see divergent paths in terms of policy and macroeconomic fundamentals across the emerging markets landscape. These factors are always important considerations in emerging markets, and likely to take center stage in the months ahead as investors seek to mitigate risks amid a rapidly changing global backdrop, while positioning in countries that are able to weather the storm.

Performance Review

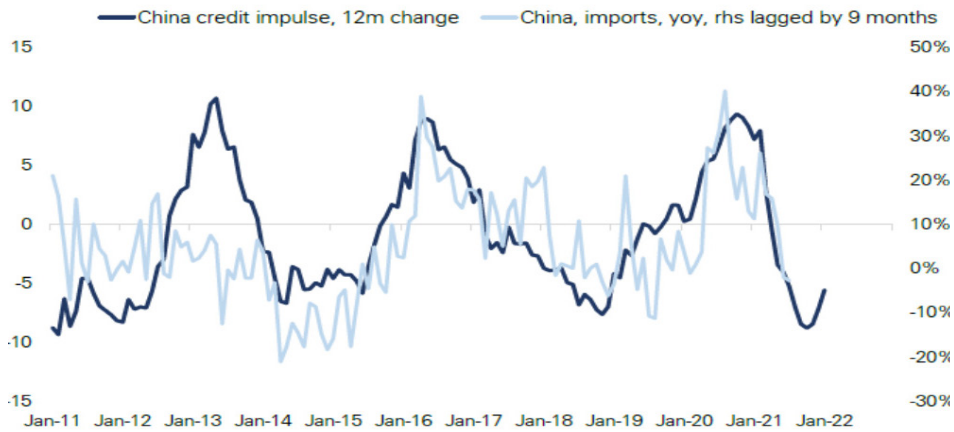
At the sector level, the most significant contributors to returns were information technology and industrials. Real estate and financials detracted the most value. At the country level, China and Taiwan were positive contributors to performance for the month, India and Vietnam were notable detractors from performance.

Positioning and Outlook

The spread of COVID in China has become an increasingly impactful development in recent weeks, as large cities have experienced lockdowns and mass testing measures, serving to constrain economic activity and exacerbate tight supply chains. Consequently, the consensus 2022 GDP forecast has been revised down to 4.7% (with some individual forecasts well below this level), lower than the government's stated target of "around 5.5%" issued in early March. At this point, it looks unlikely that the official growth target will be met, given the challenges associated with COVID. However, the Chinese government has accelerated economic stabilization policies since the Politburo meeting at the end of April.

On May 23, China's State Council announced 33 measures covering fiscal, financial, investment and industrial policies to stimulate its economy. Alongside these measures, China will promote the healthy development of platform companies, which are important for job creation and suffered significant underperformance over the last 18 months due to a regulatory crackdown. China will also accelerate infrastructure development and stimulate industries such as autos and home appliances. Quietly, China's credit impulse has also recently troughed, a development that tends to be a leading indicator of improving domestic demand (Exhibit 4).

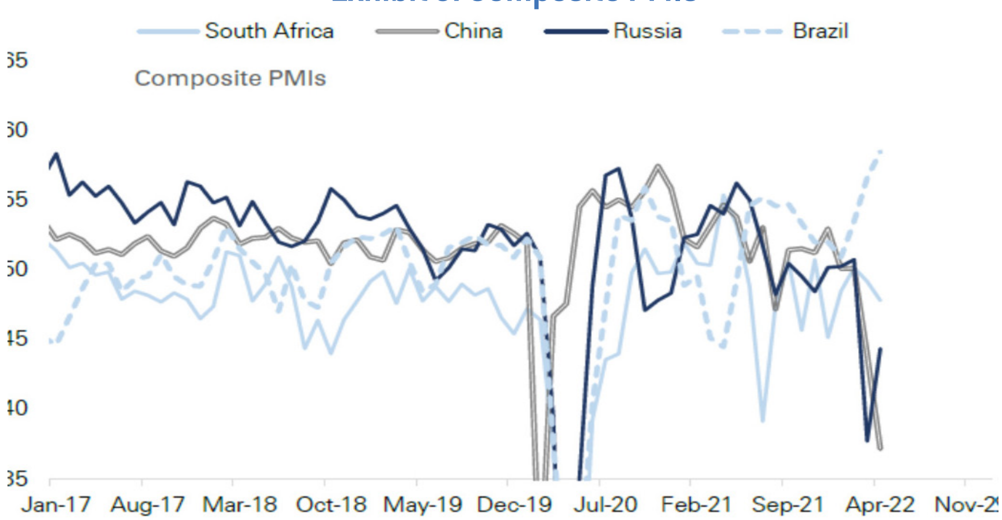
Exhibit 4: China Credit Impulse (12 Month Change; LHS) vs. Imports (Y/Y Growth, 9 Month Lag; RHS)



Source: Deutsche Bank, Haver Analytics

One of our messages to investors over the years has been that EM is not a homogenous asset class, and this has been reflected by year-to-date divergences in the fundamental picture for economies such as Brazil, which have shown an accelerating Purchasing Managers Index (PMI), at the same time China and Russia have shown sharp deteriorations (Exhibit 5).

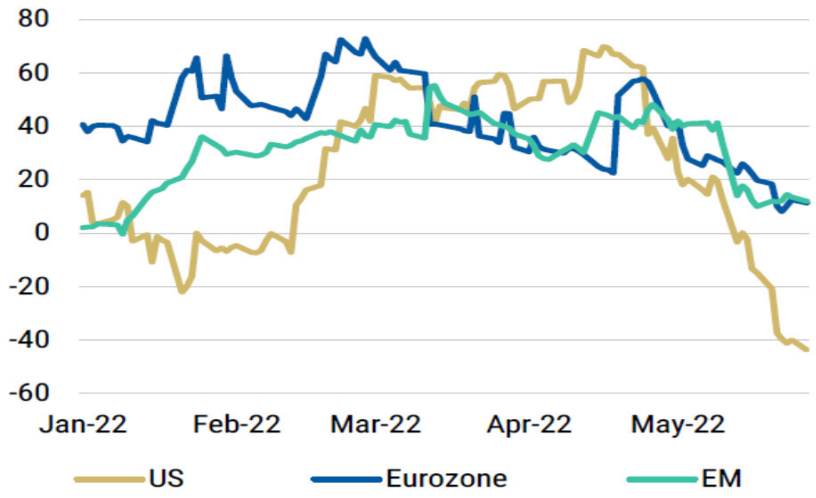
Exhibit 5: Composite PMIs



Source: Deutsche Bank, Haver Analytics

While two large index constituents (China and Russia) have dragged EM growth lower, it is notable that US data surprises have begun to falter at a much faster rate than both EM and Eurozone data (Exhibit 6). If China is even remotely successful in stimulating its economy and registering any improvements in its control of COVID, then economic growth differentials could turn increasingly in EM's favor in the months ahead. In turn, this should underpin a stronger fundamental outlook for EM capital flows and currencies.

Exhibit 6:Economic Surprise Index



Source: Bloomberg, Morgan Stanley Research

The strategy continues to build positions in China, favoring cyclical and recovery growth stocks. We continue to add to positions that we view as beneficiaries of fiscal stimulus, including machinery, renewable energy, and consumer stocks, while adding new positions in innovative healthcare companies that have been victims of indiscriminate selling amid the litany of negative newsflow tied to China's economy and regulatory backdrop.

While China may indeed miss its "around 5.5%" GDP growth target, the direction of travel is increasingly positive. Historically, investor sentiment toward China has swung dramatically from exuberance to pessimism, and the erosion of asset values over the last 18 months has led many investors to a point of deep pessimism. With stimulus measures becoming more pronounced and the credit impulse bottoming out, we believe investors are anchored to the negative developments, creating an opportunity to accumulate fundamentally sound companies with scope for positive earnings revisions.

Until next month,

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

FIRM DEFINITION
Driehaus Capital Management LLC (DCM) is a registered investment adviser with the United States Securities and Exchange Commission (SEC). DCM provides investment advisory services using growth equity and credit strategies to individuals, organizations, and institutions. The firm consists of all accounts managed by DCM (the Company).

DCM claims compliance with the Global Investment Performance Standards (GIPS®).

COMPOSITE DESCRIPTION
The Emerging Markets Small Cap Equity Composite (the Composite) was created in February 2016. An account is considered to be an emerging markets small cap equity account if it seeks to maximize capital appreciation through active investment primarily in a portfolio of emerging market traded equity and equity-convertible securities of smaller capitalization companies with perceived high growth potential.

PERFORMANCE RESULTS
Net of fee returns reflect the payment of advisory fees and in some instances, other fees and expenses such as administrative and custodian fees while the gross of fee returns do not. Both are net of brokerage commissions charged to the accounts and reflect the reinvestment of income and other earnings.

Valuations and returns are computed and stated in U.S. dollars. Returns are presented on a pretax basis.

Past performance is not indicative of future results. All investments have risks and you could lose money.

Additional information regarding policies for valuing investments, calculating performance and preparing GIPS Reports are available upon request. A list of composite descriptions and a list of broad distribution pooled funds are available upon request. Please contact our sales, marketing and relationship management department at 312-932-8621.

TAX EFFECT
Income tax may be withheld on income depending on the tax laws of each country and its treaty, if any, with the U.S. Such withholding taxes are reflected in the performance of accounts.

INDICES
The Morgan Stanley Capital International Emerging Markets Small Cap Index (MSCI Emerging Markets Small Cap Index) is a market capitalization-weighted index designed to measure equity market performance of small cap stocks in global emerging markets. Data is in US Dollars. The net dividend (ND) index is calculated with net dividend reinvestment.

The MSCI Emerging Markets Small Cap Growth Index is a subset of the MSCI Emerging Markets Small Cap Index and includes only the MSCI Emerging Markets Small Cap Index stocks which are categorized as growth stocks. Data is in US Dollars. The net dividend (ND) index is calculated with net dividend reinvestment.

The most recent annual GIPS Report is available here.

TERMS
Active share represents the share of portfolio holdings that differ from the benchmark index holdings. **Alpha** is the measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. **Beta** is a measure of a portfolio's volatility. A beta of 1.00 implies perfect historical correlation of movement with the market. A higher beta manager will rise and fall more rapidly than the market, whereas a lower beta manager will rise and fall slower. **Information Ratio (IR)** measures a portfolio manager's ability to generate excess returns relative to a benchmark, but also attempts to identify the consistency of the investor. This ratio will identify if a manager has beaten the benchmark by a lot in a few months or a little every month. The higher the IR the more consistent a manager is and consistency is an ideal trait. **R-Squared** is a statistical measure that represents the percentage of a fund or security's movements that can be explained by movements in a benchmark index. For fixed-income securities, the benchmark is the T-bill. For equities, the benchmark is the S&P 500. **Sharpe Ratio** is calculated by finding the portfolio's excess return and then dividing by the portfolio's standard deviation. **Standard Deviation** is a measure of the average deviations of a return series from its mean; often used as a measure of portfolio volatility. A large standard deviation implies that there have been large swings or volatility in the manager's return series. **Tracking Error** is a divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark. This is often in the context of a hedge or mutual fund that did not work as effectively as intended, creating an unexpected profit or loss instead.

For more information about Driehaus Capital Management LLC, please contact us at 312.932.8621.