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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

NOVEMBER 2022

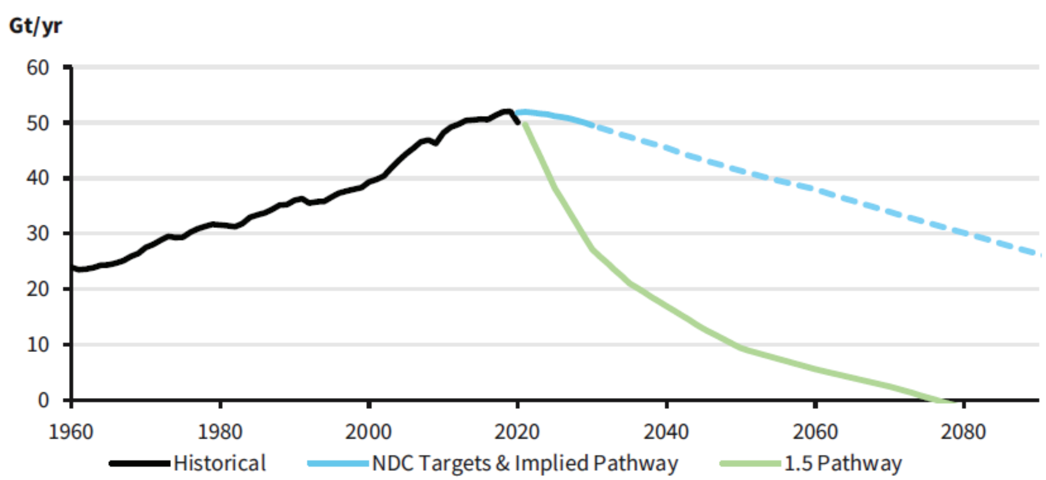
Following the conclusion of COP27 (the United Nations Climate Change Conference) in November, this month's commentary reflects on the implications of ongoing volatility in energy markets and climate conditions across emerging markets (EM), while highlighting the considerable investable opportunity in areas associated with the environment and the energy supply chain.

Coming off of last year's COP26, which garnered a significant amount of hype as various countries pledged to achieve net-zero emissions by 2050, this year's conference in Sharm El-Sheikh, Egypt yielded relatively less attention and featured little in the way of major announcements.

That said, our view has been that the heavy lifting in terms of climate action is likely to be conducted predominantly by private sector participants, and the side discussions and nuanced policy changes are of more importance than the political fanfare associated with so-called breakthroughs achieved by forums such as COP27. On this front, there remains much more to be done. According to MSCI's Net Zero Tracker, listed companies are on track to warm the planet by 2.9°C by the end of the century. Of the 36% of companies with decarbonization targets, only 46% have committed to a net-zero target.

With the Paris Agreement objective of limiting global warming to 1.5°C starting to look increasingly challenging through current commitments (Exhibit 1), policymakers feel a heightened sense of urgency to step up spending on the environment. The International Energy Agency's (IEA) World Energy Outlook calls for a tripling of spending by 2030 to $4 trillion to achieve alignment with the pathway to 1.5°.

Exhibit 1: Current Climate Commitments Relative to 1.5°C Pathway

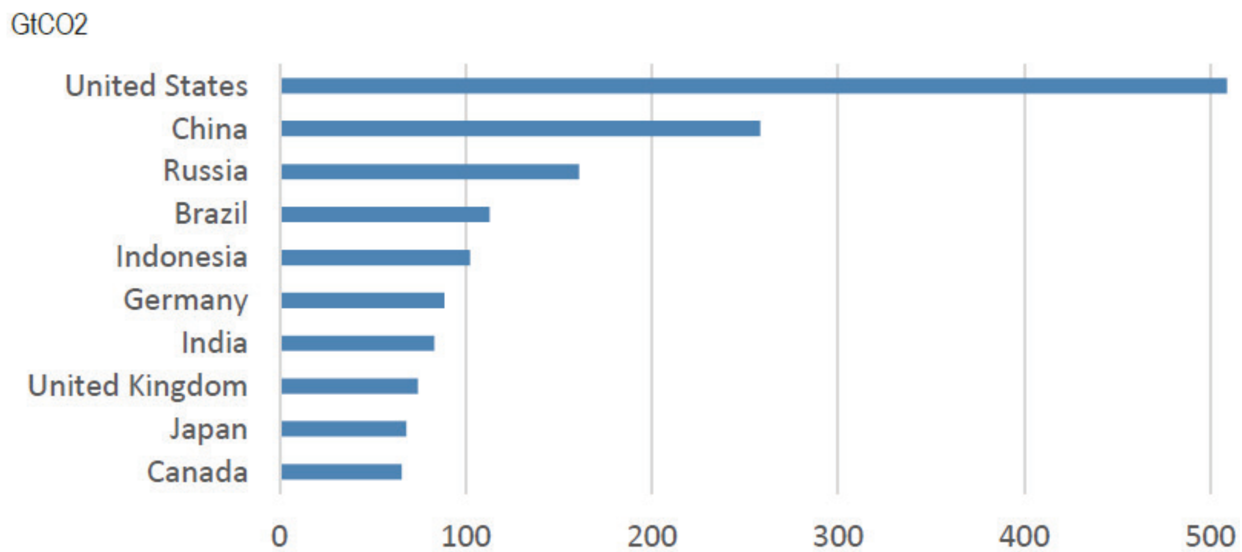


Source: Climate Action Tracker

In an EM context, the IEA asserts that $2-3 trillion of this capital needs to be deployed in developing countries. EM countries have been hit particularly hard by escalating energy costs and severe weather over the course of 2022. China experienced its most extreme heat wave on record this summer, while India and Pakistan recorded their hottest March and April temperatures. This preceded historic flooding in Pakistan, which experienced 500-800% more precipitation than a normal monsoon, leaving damage that has been estimated at 10% of GDP.

COP27 saw the creation of a "loss and damage" fund, which will focus on developing countries that are particularly vulnerable to climate change. The remaining unknowns are who will provide the funding, and who will be the beneficiaries. EM countries point to the sizable cumulative emissions of the US (Exhibit 2) as evidence that the developed world should shoulder the burden of commitments. Large emitters such as China, along with heavy fossil fuel producing nations such as Saudi Arabia, are hesitant to contribute to the fund, as they are still classified as developing countries, and further discussion around the implementation of the fund will be a hot topic for COP28 next year in Dubai.

Exhibit 2: Cumulative Emissions (Gigatons of CO_2)



Source: Carbon Brief

The other meaningful takeaway from COP27 from a market perspective is the potential inflection point that could result from new language to boost carbon markets. International Monetary Fund (IMF) Managing Director, Kristalina Georgieva, stated that the global carbon price needs to reach $75/ton by 2030 in order to achieve global climate goals, while US climate envoy, John Kerry, introduced the Energy Transition Accelerator (ETA), which entails selling carbon credits to some of the world's largest companies and using the proceeds to fund new clean energy projects in developing countries.

In an EM context, Brazil could take a leading role in carbon markets, and McKinsey believes the country could supply roughly 15% of the global carbon credit market, which it expects could reach $50-100 billion by 2030. President-elect Lula da Silva was present at COP27, promising to turn environmental policy “180 degrees” from that of his predecessor. Brazil represents 3% of global emissions, and Lula seeks to reinforce the protection of the Amazon, which has become an important political issue in Brazil. The Strategy remains invested in Brazil’s leading operator of landfills, a company that is benefiting from Brazil’s nascent Sanitation Law, which calls for 40% of the industry that operates open dump sites to be curtailed by 2024. Not only does this significantly expand the company’s market opportunity, but ancillary sources of revenue from the landfills (recycling, biogas, and biomethane) generate carbon credits for the company, which are likely to be monetized in rising quantity and price in the coming years, with incremental profits falling directly to the bottom line.

Elsewhere in EM, India (7% of global emissions) submitted its Long-Term Emission Development Strategy, with ambitions to be a green hydrogen hub, increase its nuclear power capacity by 3-fold, increase electric vehicle (EV) penetration, and reach 20% ethanol blending by 2025. India is one of 28 countries that updated its Nationally Determined Contribution (NDC) at COP27, committing to reducing its emissions intensity of GDP by 45% by 2030 (vs. 2005 levels), up from 33-35% in its previous NDC. While India is the world’s third-largest emitter, both its cumulative and per capita emissions rank considerably lower on the global scale. On a per capita basis, India’s emissions have actually been falling over the past two years. Further, the country strives to generate 50% of its cumulative installed capacity of power from non-fossil-fuel based sources by 2030.

The Strategy is invested in a leading 2-wheeler company in India, which has carved out an increasing presence in EVs. Additionally, the Strategy owns shares in an India-based manufacturer of equipment for next generation ethanol and biogas. These companies are likely to be at the forefront of India’s efforts to contain emissions in the coming years.

Given the various disruptions to global energy markets stemming from the Russia-Ukraine war, years of cumulative underinvestment, and recovering demand as the service sector rebounds from COVID, policymakers are likely to prioritize energy security alongside, if not above, the environment. That said, we reassert that private sector participation in energy transition and environmental protection is likely to yield a structurally expanding opportunity set for investors, encompassing renewable energy technologies and supply chain beneficiaries, metals that play a critical role in EVs and renewables, as well as conventional energy companies that are realizing improving pricing power. We expect rising spending on energy and the environment to provide a long-term tailwind for well-positioned companies in these areas, which feature prominently in the Strategy’s positioning.

Performance Review

At the sector level, the most significant contributors to returns were information technology and materials. Communication services detracted the most value. At the country level, Taiwan and China were positive contributors to performance for the month, Brazil and Saudi Arabia were notable detractors from performance.

Positioning and Outlook

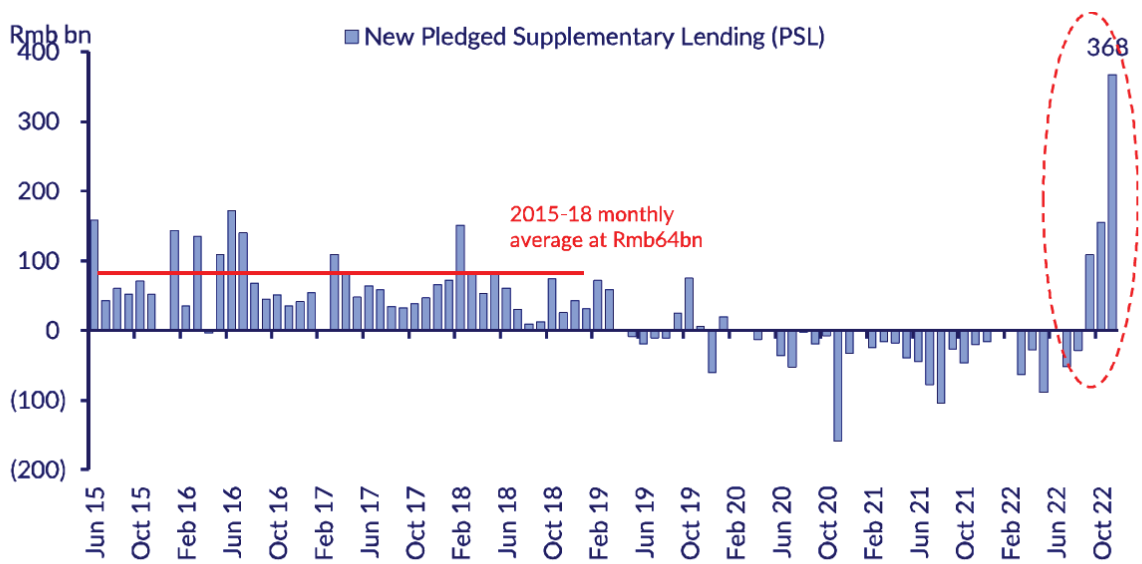
We continue to observe and position for the directional trend of easing COVID restrictions in China, accumulating recovery stocks where we expect the second derivative of earnings to improve, and the market is already discounting a pessimistic scenario. Recent developments on property easing, a senior vaccination drive, and positive signals from the National Health Commission COVID press conference reinforce this stance.

Authorities have noted that there would be consequences for over-tightening behavior at the local level, which may not portend a complete reversal of the zero-COVID policy, but still point to an incremental easing. Blaming the implementation instead of the policy directives is a pretty easy way to preserve posture for the policy itself. That said, directionally the second derivative is improving in China, and no longer worsening, for the first time in two years.

Fund flows confirm that capital is returning to EM, with $15 billion of net inflows into EM ex-China in November, representing a two-year high. Flows into Taiwan were positive for the first time in ten months, as North Asia was the prime beneficiary of the return of capital to EM.

In China, the central bank relaunched the pledged supplementary lending facility (PSL), a liquidity injection targeted at policy banks (Exhibit 3). This has historically been indicative of policy easing, as it provides direct central bank money to address risks within the property sector, using China's policy banks as a conduit. This, along with incremental optimism over a reopening of the economy, drove strong performance in Chinese equities during the month.

Exhibit 3: China Pledged Supplementary Lending



Source: CLSA

Putting together the signs of an improved second derivative of growth and earnings, liquidity injections in the largest market, and renewed fund flows, alongside a nascent weakening of the US dollar, it is notable that non-US equities have begun to break their relative downtrend for the first time in over a decade. This is represented in the chart below, which shows the ratio between MSCI World Ex-US equities relative to the broad MSCI World Index.

Exhibit 4: MSCI World Ex-US Index Relative to MSCI World Index

Source: CLSA

Amid this backdrop, the Strategy continues to position in recovery growth stocks, with a focus on areas that can benefit from an incremental improvement in growth visibility in China. This includes new positions in a condiments producer, which is tied to the growth of the domestic restaurant industry, a furniture company that stands to benefit as the outlook for consumer durables improves, and an auto distributor, all of which are 40-60% off their 52-week highs. Longer-term, we continue to favor thematically oriented positions in China, encompassing such areas as EVs, renewables, and import substitution, but we believe that the recent improvements in the trajectory of zero-COVID policy augur most favorably for recovery growth stocks within the country.

Until next month,

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