DRIEHAUS
CAPITAL MANAGEMENT

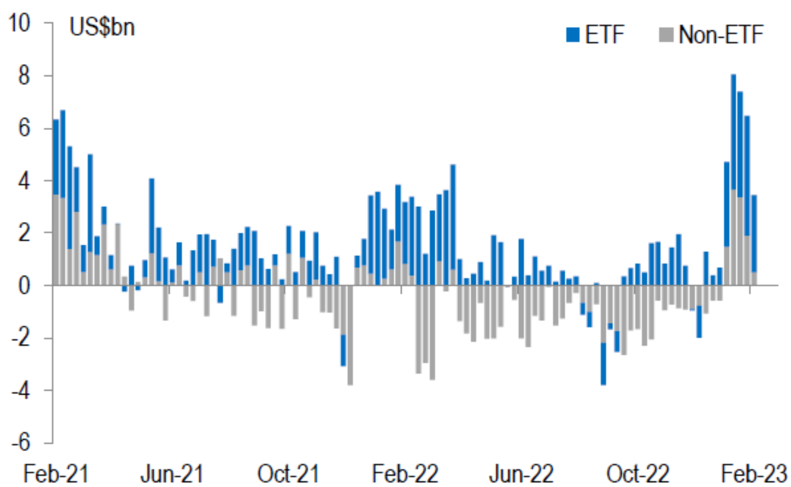
Driehaus Emerging Markets Small Cap Equity Strategy Summary

JANUARY 2023

We close the first month of 2023 with a more constructive tone than we had for much of the preceding year, as notable macroeconomic headwinds have begun to dissipate. As has been the case for much of recent history, monetary policy lies at the center of this shift in tone. Having gone through a massive and coordinated global monetary tightening cycle, an inflation shock, and the lingering disruptions from the pandemic, investors have begun to glimpse a flicker of light at the end of the tunnel.

Emerging market (EM) equities began the year on strong footing, with flows picking up notably as the nascent weakness in the US dollar followed through to the downside throughout January, while optimism surrounding China's reopening led investors to embrace a more sanguine growth outlook (Exhibit 1).

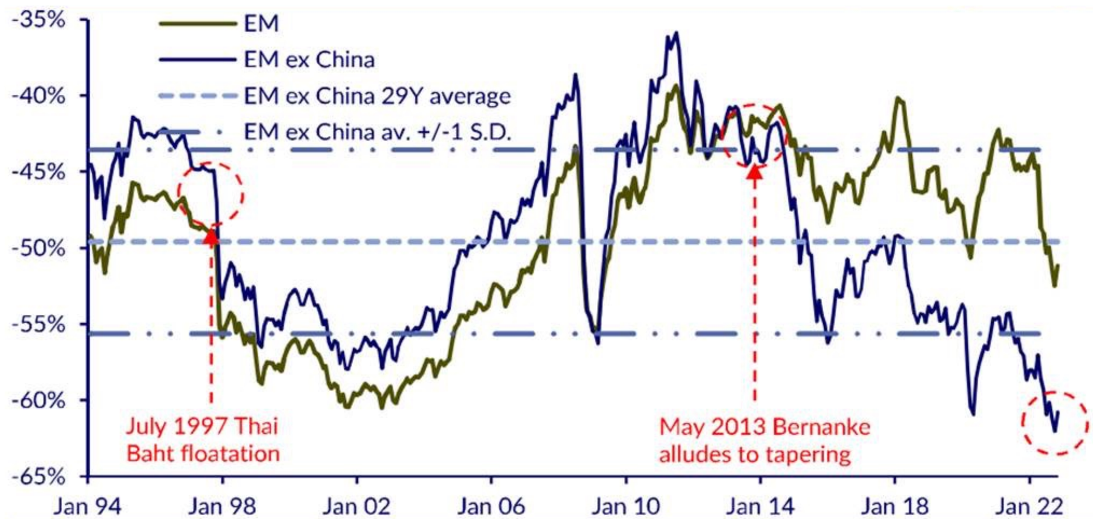
Exhibit 1: Weekly EM Equity Flows



Source: EPFR Global

Against this backdrop, many EM currencies remain depressed, with valuations near levels not seen since the late 1990s Asian Crisis, while the basic balance of payments and real interest rate differentials have improved markedly for EM economies in recent years (Exhibit 2).

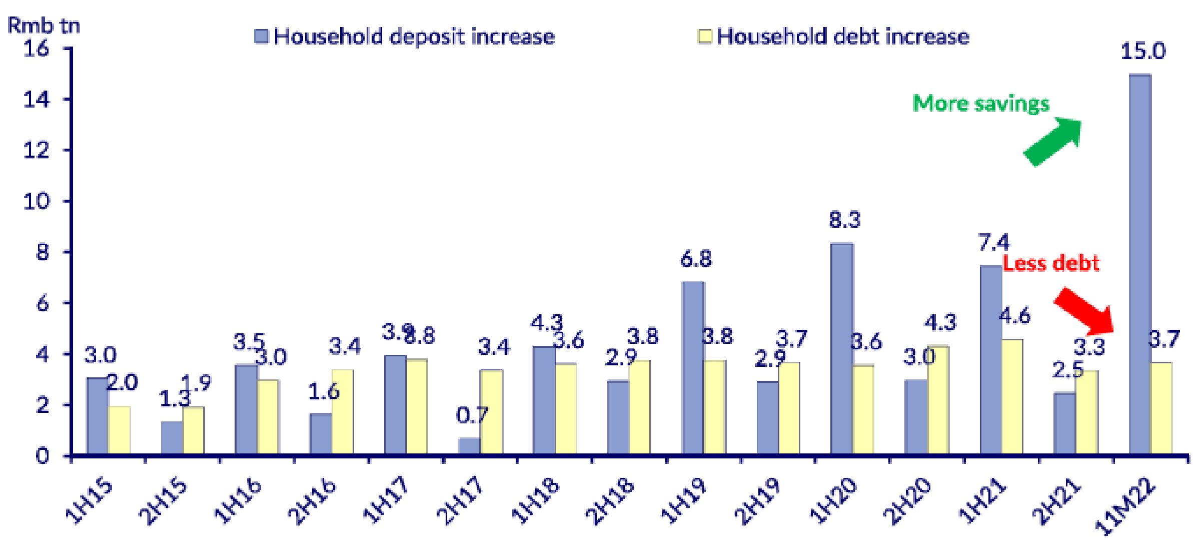
Exhibit 2: EM Currency Valuations – Deviation from Purchasing Power Parity



Source: CLSA, Oxford Economics, Refinitiv

China has been at the forefront of the positive inflection point in EM. Credit growth was strong in China in January, as new credit registered an upside surprise, at nearly Rmb6 trillion on the month, the second highest month on record. This occurred on the back of China's Central Economic Work Conference last December, sending a pro-growth, pro-business signal in the country for the first time since 2020. Household balance sheets are also in good shape, as Chinese households saved Rmb15 trillion in net new deposits amid the zero-COVID policy, nearly double that of 2021 (Exhibit 3).

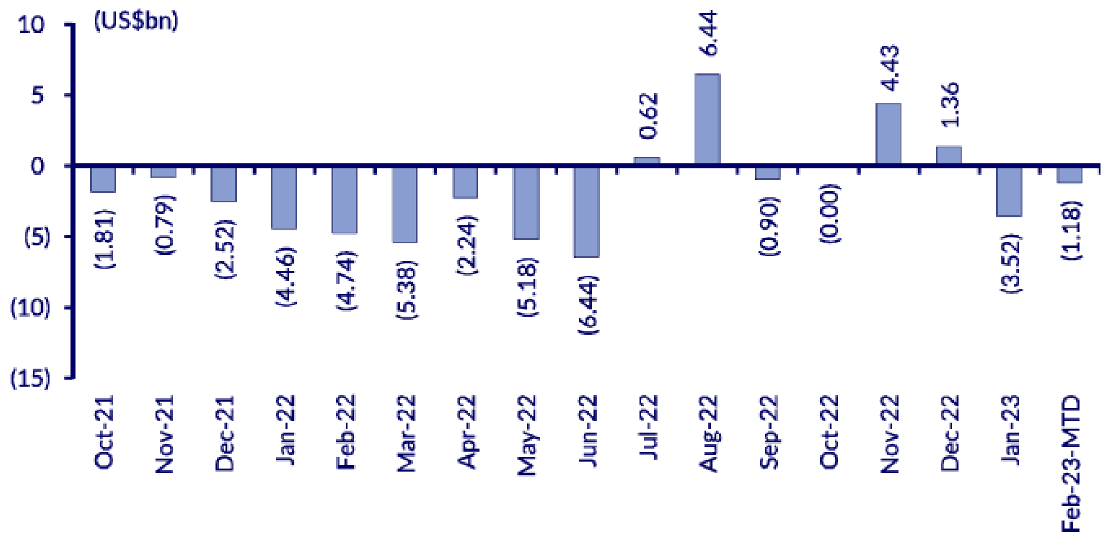
Exhibit 3: China Household Balance Sheets



Source: CLSA, PBOC, WIND

Central to the case for EM remains the potential for a meaningful recovery of pent-up demand in the largest economy in the asset class. Consequently, while it is no surprise that China performed well during the month of January, it also remains the case that many EM-dedicated investors continue to use India as a funding source for increased China allocations (Exhibit 4).

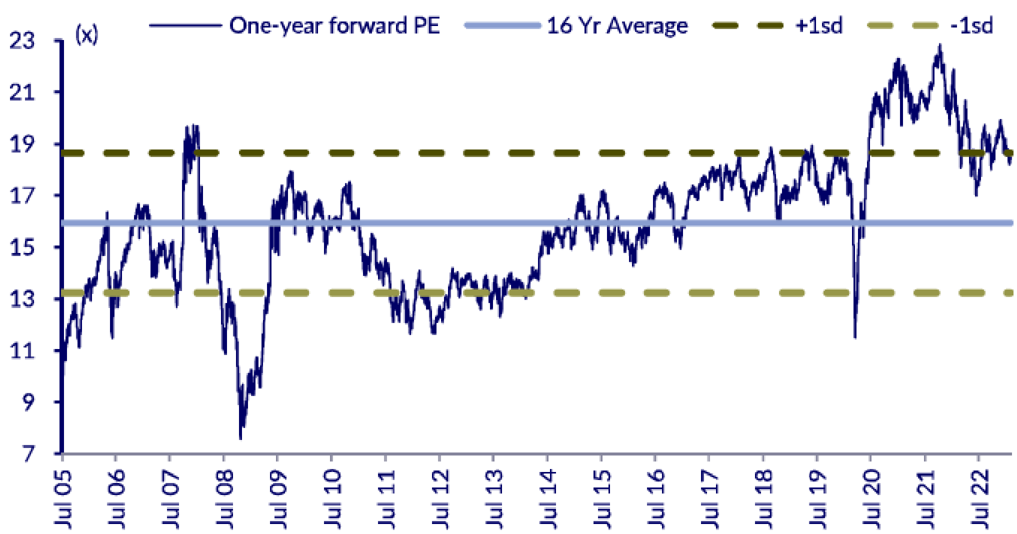
Exhibit 4: India Foreign Institutional Investor Flows



Source: Bloomberg, CLSA

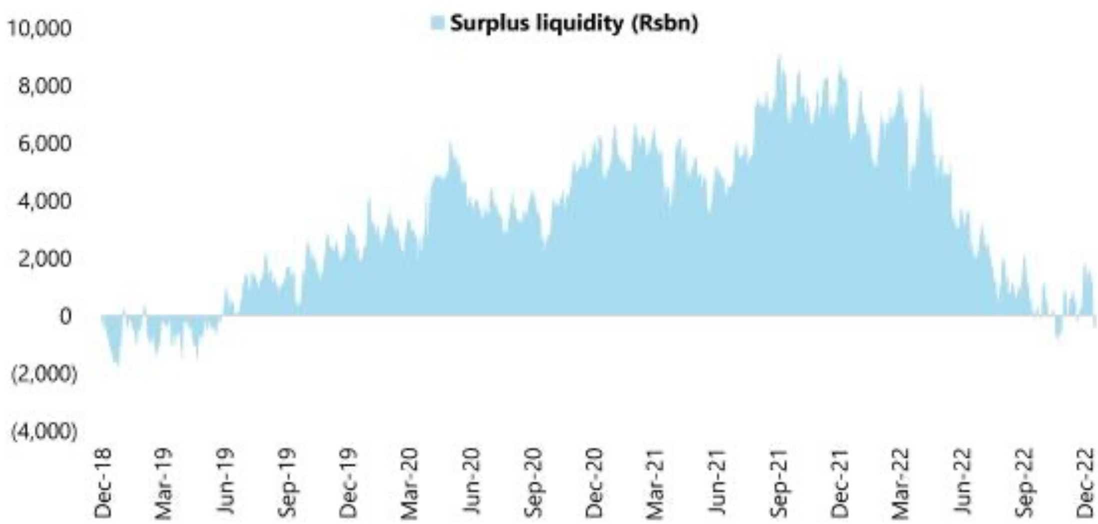
India is perceived by some investors as suffering from expensive valuations and tightening liquidity, and should China's pro-growth policy shift result in higher commodity prices, a key vulnerability of India's economy could be exposed (Exhibits 5-6).

Exhibit 5: India Price/Earnings Multiple



Source: Bloomberg, CLSA

Exhibit 6: India Surplus Liquidity (Rs billions)

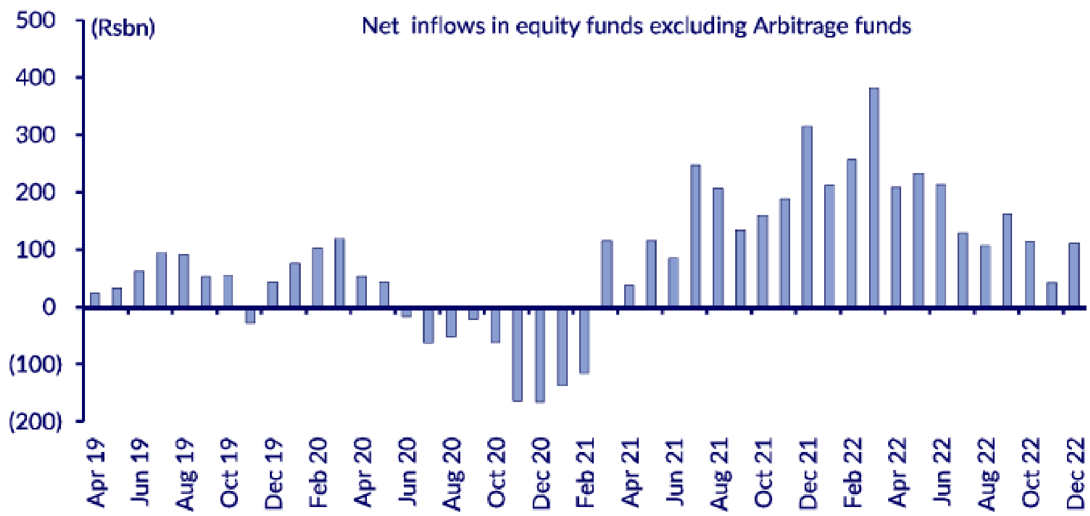


Source: Factset, Reserve Bank of India, Jefferies

Adding further to the pressure on India was a short seller report that was published on January 24th focusing on a large Indian conglomerate group. We will not delve into the details of the report here, but there were several varieties of impropriety and governance related issues within the 88 questions posed to the company. The group responded in kind with 413 pages of textual refutation of the argument. Given the heft of the promoter group's reputation, this report garnered headlines and attention and left the equities linked to the group down anywhere from 27% to 62% from the publication of the report. In addition to the potential idiosyncratic impacts on specific listed group companies, this is a further headwind to a market that was already under some pressure.

While domestic investors continue to absorb the selling pressure from foreign reductions in equity allocations, these flows have slowed alongside surplus domestic liquidity (Exhibit 7).

Exhibit 7: India Domestic Mutual Fund Flows



Source: AMFI, CLSA

Against this backdrop, one may be inclined to ask, is China's gain also India's loss? In fairness, we too have held somewhat of a cautious view toward Indian equities in a historical context and vis-à-vis the MSCI Emerging Markets Small Cap Index, having moved to an underweight position in March 2022, with the magnitude of the strategy's underweight position peaking at just over 700 basis points in June 2022. That said, we have begun to see investors more appropriately discount the relative macro outlooks for both China and India in recent months. In fact, Indian small caps have given up their entire outperformance relative to Chinese small caps in the span of three months since November (Exhibit 8).

Exhibit 8: MSCI India Small Cap Relative to MSCI China Small Cap

Source: Bloomberg

Additionally, while investors braced for the knock-on effect of margin calls and selling pressure following the allegations from the short seller report, this has not materialized. In fact, investors have become more discerning regarding corporate governance policies and earnings quality in the aftermath of the report. If anything, this has benefited a number of high quality companies in the small cap space within India.

While the strategy remains more optimistic about small caps in China than India on a twelve-month view, the recent relative underperformance of India has afforded us an opportunity to close the gap of the strategy's underweight position versus the index. If the recent inflection point for EM equity flows continues to run its course, India stands to benefit as a large EM constituent.

Further, over a medium-term horizon, we remain excited about the evolution of India's economy and equity market. We note the unparalleled depth of India's market, which is underscored by a number of attractive themes, including the onset of the corporate capex cycle, the transformation of India's information technology sector, and the shift of India's labor force into manufacturing. Additionally, India maintains attractive demographics, supportive of domestic consumption trends, and a relatively closed economy, a potentially attractive attribute amid a volatile geopolitical environment.

While the current backdrop may be more conducive to stock selection rather than emblematic of a rising tide that lifts the entire market, 2022's "China or India" trade-off may well turn into a "China and India" allocation in 2023 as EM equities garner inflows.

Performance Review

At the sector level, the most significant contributors to returns were information technology and materials. Real estate detracted the most value. At the country level, China and Taiwan were positive contributors to performance for the month, India was a notable detractor from performance.

Until next month,

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