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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

APRIL 2023

The concept of de-dollarization has been hotly debated and one of the most frequently asked questions by investors in recent months. This month's commentary offers perspectives on de-dollarization.

Moves toward de-dollarization began several years ago, but the concept has gained traction in the wake of Russia's invasion of Ukraine. The proximate cause for this wave of activity was the G7 sanctions on Russia's foreign exchange reserves, leading some to question whether policymakers have overreached in their use of currency as a "weapon."

Debates around de-dollarization tend to take an all-or-nothing type of stance, with one side arguing that US dollar hegemony will remain, as there are no viable alternatives of sufficient scale and liquidity to replace it. The other side argues that throughout history, world reserve currencies fail to sustain indefinitely, and the recent spate of activity around de-dollarization marks a turning point in the status of the US dollar. While intelligent views support both sides of the highly polarized debate, it is likely that the path forward will be much more nuanced.

The supremacy of the US dollar began in the post-World War II era, as the US became the dominant global economy, and under the Bretton Woods framework, all currencies were to be pegged to the dollar, while the dollar, in turn, would be convertible into gold at a fixed price. Like other currency pegs, this proved unsustainable, and the link to gold was broken in 1971. Nonetheless, the US dollar ascended in its role in cross-border transactions and reserves, topping out at over 80% of the world's reserve currency mix.

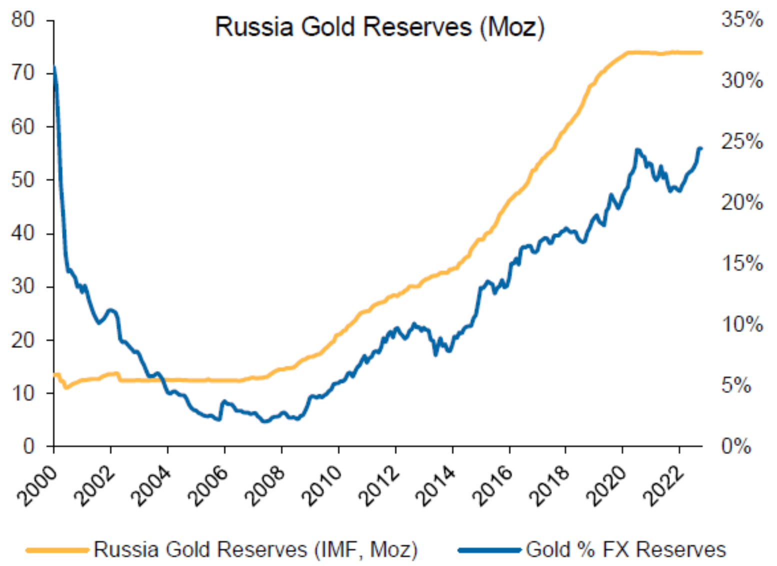
In recent years, the composition of global reserves has been changing, with the dollar's share steadily declining (Exhibit 1).

Exhibit 1. US Dollar Composition of Global Foreign Exchange Reserves (%)

Source: Bloomberg

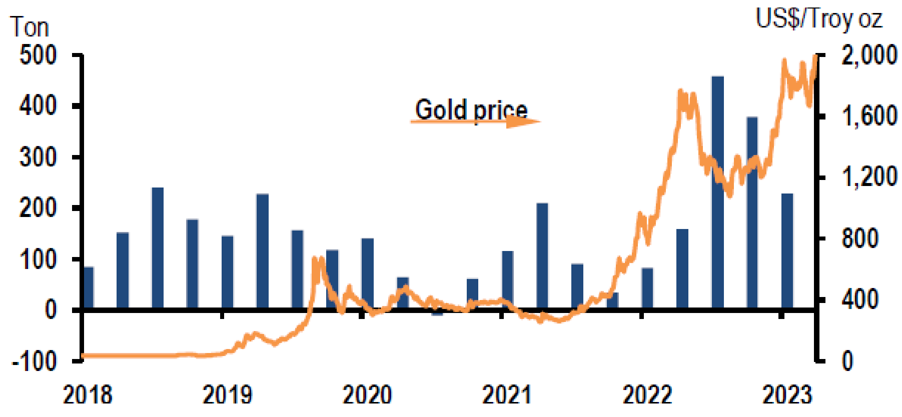
Russia's shift toward gold within its foreign exchange reserve mix throughout the 2010s has been followed by increasing allocations to gold by other countries in recent months (Exhibits 2 and 3).

Exhibit 2. Russia Gold Reserves (millions of ounces, left; % of foreign exchange reserves, right)



Source: IMF, Bloomberg, Macquarie Strategy, Nov 2022

Exhibit 3. Global Gold Demand From Central Banks



Source: World Gold Council, J.P. Morgan

Accompanying this increased allocation to gold by central banks has been a growing amount of bilateral trade deals using the Chinese yuan (CNY) as a currency for trade settlement. Those who dismiss the notion of de-dollarization tend to point to the lack of convertibility of the CNY, questioning why any trading partner of China would want to hold CNY. There are two counterpoints to this view.

First, those CNY proceeds could be used to purchase Chinese goods. China maintains 15% share of global exports, and commodity trading partners such as Argentina and Brazil could turn around and import products from China rather than hold onto CNY-denominated reserves. Of note, China is Brazil's largest trading partner and Argentina's second largest (Exhibits 4 and 5).

Exhibit 4. China Exports to Brazil

Source: Bloomberg

Exhibit 5. China Exports to Argentina

Source: Bloomberg

Second, the CNY has been fully convertible into gold on exchanges in Shanghai and Hong Kong since 2017. While we are unlikely to see meaningful liberalization of China's capital account, the CNY's convertibility into gold improves the viability of the currency for foreign holders, while offering alternatives to the US dollar.

Before we get too excited about de-dollarization and the implications, it is important to consider the heft of the US dollar. For example, the Eurodollar market stands at an estimated $15 trillion. Further, while the US dollar has declined in the global currency reserve mix, it still stands at 58%, making it the most prominent currency for reserve managers. Despite the wave of attention being paid to de-dollarization, the CNY's share of global payments remains only 2.3%, fourth behind the US dollar, euro, and yen.

While the pace of activity around de-dollarization shows no sign of slowing, the US dollar is unlikely to be supplanted as the dominant reserve currency, with its unparalleled size and liquidity. The path forward is likely to increasingly encompass bilateral trade relationships, particularly in commodity-linked trade, where the CNY can be used to purchase Chinese goods or converted into gold. This may result in increased adoption of the CNY, while preserving the US dollar's dominance as a reserve asset.

Performance Review

At the sector level, the most significant contributors to returns were health care and materials. Industrials and information technology detracted the most value. At the country level, India and UAE were positive contributors to performance for the month, China and Taiwan were notable detractors from performance.

Positioning and Outlook

The good news for China watchers is that GDP forecasts have been revised up by a number of economists over the past couple of months. The bad news is that China's recovery has been uneven, as the service sector has rebounded strongly, while fixed asset investment in infrastructure and property has continued to lag. The authorities remain hesitant to stimulate the property market, and consequently, land sales, a key source of local government revenue, remain weak. This lack of stimulus runs counter to the behavior observed during much of the 2010s, and points toward a slower, yet higher quality, rate of economic growth.

The strategy has maintained an overweight position in China, on the view of a strengthening growth impulse, at the same time that much of the rest of the world struggles to grow. That said, in light of the growth disparity across key sectors in the economy, we have reduced or exited positions where the expected earnings growth is struggling to materialize. We continue to favor themes such as health care and domestic consumption, but have reduced the cyclical gearing, as well as the exposure to the renewable energy theme, which is struggling due to a lack of investment in transmission and distribution capacity, as well as a volatile global regulatory backdrop.

Stylistically, we continue to increase the weightings in positions with dynamic or consistent growth profiles. Amid a backdrop of disinflation and credit tightening, we favor resilient business models with visible earnings streams amid an increasingly uncertain macro backdrop. Examples of recent additions include positions in an Indian beverage company that continues to improve its competitive position amid an underpenetrated market, a Thai hospital operator that is seeing a strong pickup from medical tourism, and a Mexican logistics and infrastructure provider, benefiting from the wave of reshoring in the country.

Overall, despite the rotational backdrop in equity markets year-to-date, we continue to find a strong opportunity set within EM small cap. On this point, we reference the strategy commentary from October 2022 seen here, which discusses the unique opportunity set within EM small cap, as well as the broadening out of growth in emerging markets.

Until next month,

Chad Cleaver, Lead Portfolio Manager
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