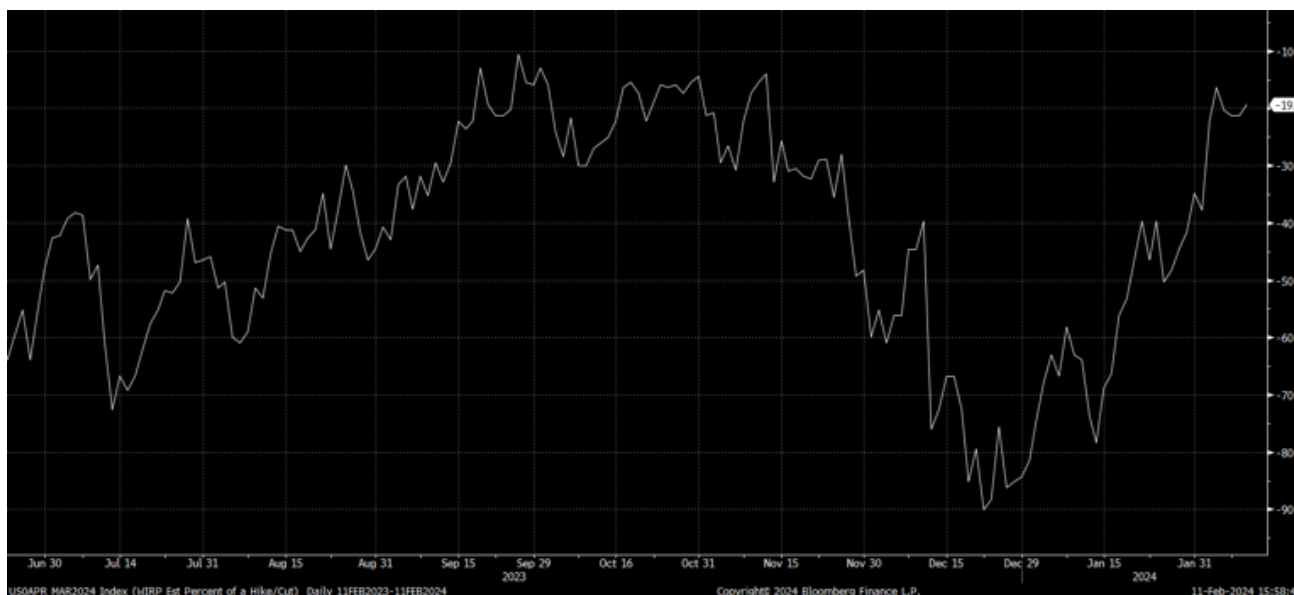


# Driehaus Emerging Markets Small Cap Equity Strategy Summary

JANUARY 2024

The main story thus far in the new year has been the recalibration of expectations surrounding the timing of Fed interest rate cuts. At the beginning of the year, interest rate futures markets were pricing in an 84% probability of a March cut. However, by the end of January, the odds declined to 35% (Exhibit 1). Against this backdrop, global equity markets have remained resilient, while economic data continue to paint a picture that is conducive to a soft landing, with inflation generally trending lower, while the labor market is not showing any signs of acute weakness.

## Exhibit 1. US Futures Estimated Percent of Hike/Cut Priced Into Forward Curve Structure



Source: Bloomberg

While emerging market (EM) equities are coming off a year of underperformance relative to global equities, many interesting developments are occurring beneath the surface.

First, India's equity market dramatically outperformed China's in 2023 (Exhibit 2). Given the size of China's weighting in the MSCI Emerging Markets Index, this phenomenon acted as a drag on the overall performance of EM equities. India continues to attract substantial inflows of foreign portfolio investment, while experiencing robust economic and capital market activity.

### Exhibit 2. MSCI India Relative to MSCI China

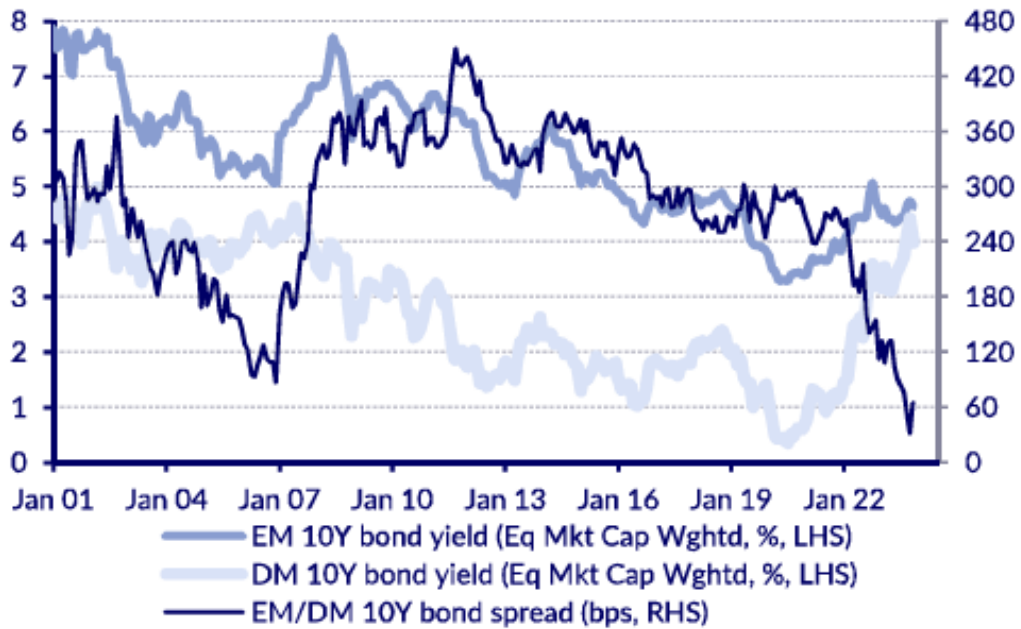


Source: Bloomberg

Second, EM small caps not only outperformed the broad EM equity index, but were also relative outperformers in a global context, with the 24% return of the MSCI EM Small Cap Index exceeding both the MSCI World Small Cap Index (17%) and MSCI US Small Cap Index (18%). This reflects not only the large index weighting in India, but also the strength of small caps in countries such as Brazil, Mexico, and Taiwan, which are benefiting from themes discussed in greater detail in the Positioning and Outlook section of this commentary.

Third, EM sovereign bonds have substantially outperformed developed market (DM) sovereigns, a trend that has been in place since 2020, but accelerated in the last year (Exhibit 3). The evolution of fiscal and monetary policy around the pandemic marked a turn from what we have observed in the past, as EM economies did not engage in the same degree of largesse as DM. Moreover, EM policymakers were ahead of the curve in the normalization of policy in 2021, while DM has been in catchup mode on the monetary side, while continuing to run significant fiscal deficits. While EM equities have underperformed DM, this has diverged from the relative performance of sovereign bonds, implying an incrementally more stable macro backdrop for EM, despite the headwind from a lagging China equity market (Exhibit 4).

Exhibit 3. EM Over DM 10-Year Bond Spread (Equity Market Cap Weighted)



Source: CLSA, Bloomberg, MSCI

Exhibit 4. EM vs. DM: Sovereign Bonds and Equities



Source: CLSA, S&P, JP Morgan, Bloomberg, Refinitiv. \*JPM GBI-EM Diversified local currency sovereign bond (US dollar) index / S&P global developed sovereign bond (US dollar) index. ^MSCI EM US dollar total return index / MSCI World US dollar total return index.

**Driehaus Emerging Markets Small Cap Equity Strategy**

Taken together, we continue to hold a positive outlook for EM small cap equities, observing an improvement in the breadth of performance across various countries, sectors, and themes.

**Performance Review**

The Driehaus Emerging Markets Small Cap Equity Strategy outperformed its benchmark for the month of January. The strategy returned 1.24%, net of fees; while the benchmark, the MSCI Emerging Markets Small Cap Index returned -1.73% and the MSCI Emerging Markets Small Cap Growth Index returned -2.76% during the same period.<sup>1</sup>

**Positioning and Outlook**

In addition to the widely discussed strength of Indian equities, the strategy continues to find attractive opportunities in Brazil, Mexico, and Taiwan.

Brazil has been the posterchild for the normalization of monetary policy referenced in the commentary above, moving quickly to raise interest rates in 2021 as COVID-era monetary policy was no longer deemed appropriate and inflationary pressures built in the economy. The policy rate peaked last year as inflation was brought under control, and further interest rate cuts appear likely in the months ahead (Exhibit 5). With the caveat that no two market backdrops are identical, and accordingly past performance cannot be extrapolated, history nonetheless suggests that the onset of easing monetary policy should provide a tailwind for Brazilian small caps, as the 2005-2006 and 2016-2017 periods both saw strong absolute and relative performance for the MSCI Brazil Small Cap Index. The strategy continues to favor interest rate sensitive stocks in Brazil, including a leading transmission and distribution company, a homebuilder focused on affordable housing, and a rail infrastructure company with a specialization in agricultural commodities.

**Exhibit 5. Brazil Policy Rate (Yellow) and Inflation (White)**



Source: Bloomberg

<sup>1</sup>The performance data represents the strategy’s composite of emerging markets small cap equity accounts managed by Driehaus Capital Management LLC (DCM) (the composite). These returns are estimated for the period as the underlying accounts’ data is yet to be reconciled to the custodian bank. 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. The performance data shown above represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted.

**Driehaus Emerging Markets Small Cap Equity Strategy**

Mexico's economy continues to benefit from its proximity to the US, alongside meaningful shifts in global foreign direct investment trends. 2023 saw declining foreign direct investment in China for the first time in the history of the dataset, which dates back to 1998. Mexico has been a beneficiary of this trend through a wave of nearshoring activity. The strategy is positioned in three Fibras (Mexico's version of REITs), all of which are focused on the acquisition, ownership, leasing and management of industrial real estate properties in the country, providing direct exposure to nearshoring.

While the strategy in aggregate is underweight Taiwan, we have maintained significant exposure to companies that benefit from the proliferation of artificial intelligence (AI) as supply chain beneficiaries. A standout in the early days of 2024 has been a supplier of thermal components such as fans and heat sinks. The company is benefitting from robust growth in AI servers and advanced processors which require more thermal component content. The company is increasing its capacity with an expansion in Vietnam to meet the rising demand. Another prominent position is a company focused on chip design, which is rapidly moving up the value chain. The investment bank Jefferies estimates that the Taiwanese chip design industry will see a 4.5x increase in its total addressable market through 2030, driven largely by the growth of AI.

As we noted in our year-end commentary for 2023, India is a centerpiece of the case for an allocation to EM small cap. However, as shown with these examples, this segment of EM equities maintains numerous attractive investment opportunities, and the broadening out of these themes is a trend that we expect to continue in 2024.

Until next month,



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

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