



A Dollar Saved Is a Quarter Earned

By Richard Thies

Global equities declined during the third quarter in U.S. dollar terms despite a positive showing by the U.S. The MSCI All Country World Index lost 2.05% during the period, which distorts what were generally stronger returns in many foreign markets in local currency terms. The strong rally in the U.S. dollar, in part, detracted from U.S. dollar-based returns of non-U.S. equity holdings. The dollar rally was one of two major themes for the quarter and it strongly influenced investor sector and country preferences. The other main theme was the weakening of key global economic data alongside early signs of an end to the recent depressed levels of volatility.

United States

The positive returns generated by the broad U.S. market during the third quarter obfuscated a quarter whose pleasantness depended greatly on one's perspective. For example, an investor with only a small cap equity portfolio understandably would not

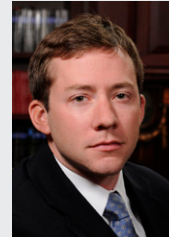
celebrate the 1.13% advance of the S&P 500 Index. Investors' rejection of small caps was truly an historic occurrence with the Russell 2000 Index losing 7.36% (Exhibit 1).

Similar to the wide dispersion in returns based on capitalization, sector-based returns varied significantly. The second quarter's best performer, the energy sector, was the third quarter's worst performer (-8.62%) as the sharp correction in oil prices weighed on shares. The correction in the West Texas Intermediate (WTI) crude price came from a combination of an increasingly unfavorable supply-and-demand backdrop alongside a sharp dollar rally. Elsewhere, the early stages of more defensive posturing were evident as the health care (+5.46%) and telecommunications (+3.07%) sectors were among the market leaders, joined by companies in the information technology space (+4.77%). Similarly, in a reversal of recent trend, consumer staples companies broadly outperformed those in the discretionary sector.

Exhibit 1: The Russell 2000 Index gave back its relative outperformance over the Russell 1000 Index since December 2012 in one quarter



Source: Bloomberg



About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. Also, at the request of portfolio managers and analysts, he provides in-depth analysis of specific events and potential scenarios at the region, country and sector levels.



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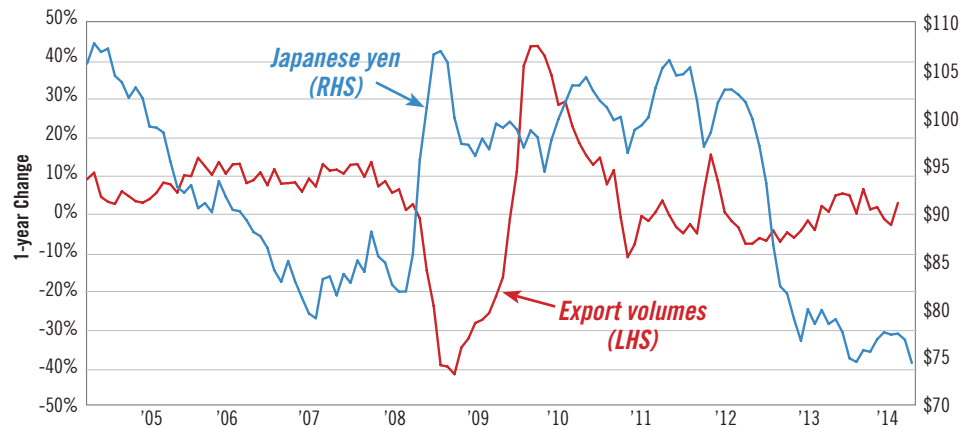
Market weakness was the prevailing trend outside the U.S., which was only magnified for U.S. investors by cross-the-board currency losses. The one developed market with positive returns in USD in the third quarter was Israel, which is hardly representative given the country's 65% weighting in pharmaceuticals. Within the weakness, Japan was a relative outperformer on a generally positive earnings season and some evidence that companies were starting to see more earnings leverage from a depreciating yen. However, Japanese firms have not yet fully capitalized on their currency advantage to gain market share as indicated by a relatively stable share of global exports (Exhibit 2).

Within Europe, while not the third quarter laggard in absolute terms—that honor goes to Portugal (-24.89%)—the underperformance of German equities (-11.17%) caused the most consternation. The disappointing returns came largely from market data looking much better for growth entering the third quarter than they did leaving it. Real economic data disappointed as did the leading indicators. As external forces were largely blamed, it was somewhat surprising that the laggards within Germany were domestically-focused consumer companies. Elsewhere, weakness was pronounced in energy and materials producing nations, including Australia (-7.92%), New Zealand (-8.67%) and Norway (-7.35%).

Emerging Markets

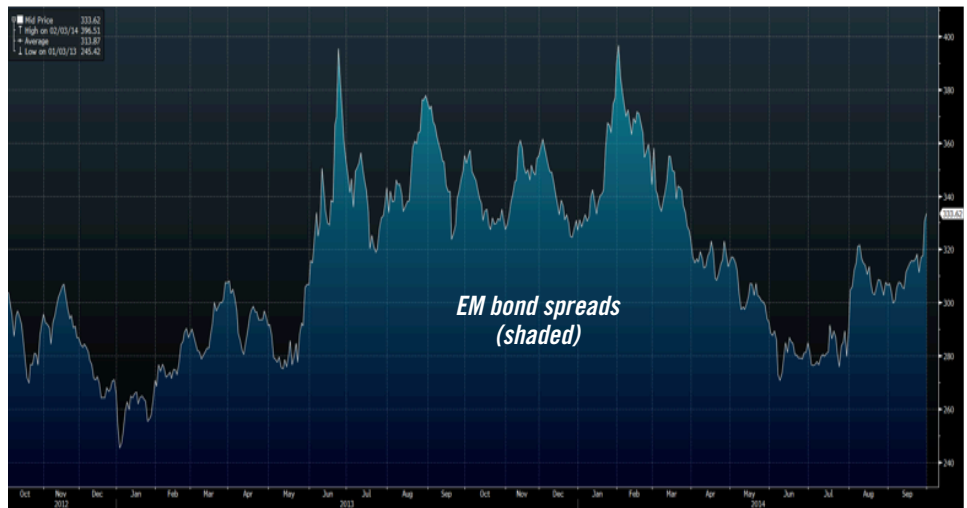
What started as another positive quarter for emerging market equities abruptly ended with the asset class giving up its early gains to end the third quarter down 3.36%. The change in trend had a few causes but the primary ones were deteriorating risk

Exhibit 2: The Japanese yen on a real, trade-weighted basis (blue, RHS) is as cheap as it has been in the last 25 years. Export volumes (red, LHS) have stabilized but have yet to make a strong acceleration



Source: FactSet, Driehaus Capital Management

Exhibit 3: Emerging market bond spreads widened significantly in the final weeks of the quarter



Source: Bloomberg

sentiment globally causing a widening of EM bond spreads and broad selling of higher risk markets (Exhibit 3). Aside from the change in global risk sentiment, there were a few drivers of the selling specific to emerging markets. The weakening cyclical data in China, particularly the monetary data released in

early September, left investors feeling that not only was China weak but policy support was not yet evident (Exhibit 4). This further adversely affected sentiment regarding the commodity complex, which weighed on a number of commodity producers.

There were significant variations in country performance during the period. The majority of the top performing countries were found in the Middle East, where investors looked past the hydrocarbon exposure and focused on the safety of U.S. dollar-pegged currencies and attractive domestic demand and earnings growth. The leaders were Egypt (+28.21%), United Arab Emirates (+22.92%) and Qatar (+17.69%). The laggards were Greece (-20.01%), Russia (-15.07%) and Turkey (-11.77%), each of which showed some level of exposure to either slowing European growth, adverse global risk sentiment or lower oil prices, and in the case of Russia, all three (Exhibit 5).

Looking Ahead

Before turning to our outlook for asset markets for the remainder of the year and beyond, it's essential to put these views in context. As we've discussed over the past few years, we believe the global economy remains caught between the healthier fundamental backdrop in the U.S., the ongoing deleveraging of the European economy, and a Chinese economy that is in the final innings of a very sharp but slowing leveraging up cycle. Taken together, we have a global economy still prone to the short and more subdued cycles we have seen since 2010. In sum, the U.S. alone is not enough to push the world onto a more robust, sustainable path. That leaves us with an American economy on sounder footing than peers, but

Exhibit 4: The weak Chinese monetary data in August contributed to negative emerging markets sentiment



Source: FactSet, Driehaus Capital Management

Exhibit 5: In addition to poor equity performance in local currency terms, the Russian ruble depreciated a stunning 18% against USD in the third quarter



Source: Bloomberg

whose trajectory will be deeply affected by its surroundings.

Divergences

Turning to the present, a major topic of discussion the past several months has been the increasing level of divergences in

the global economy and the potential for that to create volatility. While this discussion has focused mostly on the diverging directions of the world's central banks (i.e., the Federal Reserve and Bank of England likely moving toward tightening while the European Central Bank and Bank of Japan continue to ease policy), it's also true of growth. The beta of the U.S. economy to the global economic cycle has lessened and even the correlation between changes in actual growth rates between major global peers has declined (Exhibit 6). This long-discussed divergence finally manifested itself into the sharp U.S. dollar appreciation for which everyone has been waiting (Exhibit 7).

The dollar rally significantly affected asset prices across the world. In addition to equity returns, the dollar strength was an accomplice in the selloff in commodities. It also helped crush inflation expectations in the U.S., and with it left investors reconsidering the Fed's actions in the coming year. Given that consensus is overwhelmingly bullish on the greenback, it is fair to say the case for a stronger U.S. currency is pretty clear. The main underpinnings of the argument include the improving current growth relative to peers, higher potential growth than peers, a structurally narrowing current account deficit, and rising interest rates. We agree with these points from a longer-term perspective. Given the speed of the recent appreciation, the extremely one-sided positioning in the trade, and the extent to which recent strength has been exacerbated by 'risk-off' conditions, we are much more cautious tactically but believe we're only mid-way through a lengthy period of dollar strength.

Exhibit 6: The correlation of global growth rates reduced meaningfully recently
Quarter-over-quarter GDP growth, two quarter moving average



Source: FactSet, Driehaus Capital Management

Exhibit 7: The U.S. dollar rallied on the perception of divergences in central bank policies



Source: Bloomberg

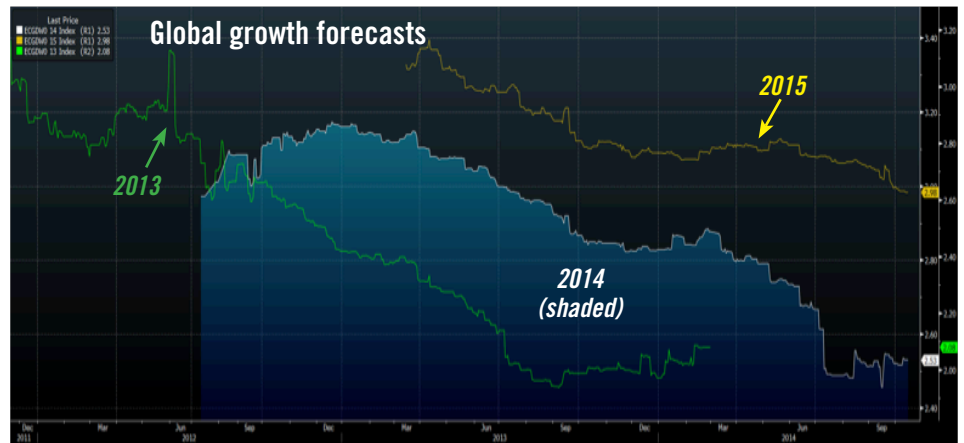
The global cycle

Ross Perot used to bemoan the weak dollar as a sign that our economy (and nation...) was weak. Unfortunately, the recent rally in our currency says more about the weakness of other nations than it does anything else. The third quarter was very disappointing for growth globally, and industrial data hinted at the risk of a renewed recession in Europe and that investors have still not adequately

factored the Chinese slowdown into their assumptions (Exhibit 8). What began as a softening in leading indicators early in the period became clearly negative hard data by the time September rolled around. The chief disappointment came from Europe. German industrial data, which often sets the tone for investor preferences, was softer during the quarter and ended September in outright contraction. The mystery to many market participants is that Europe appeared on more solid footing with financial conditions having eased significantly and deleveraging becoming less intense. However, the most recent data suggests that the weaknesses in Chinese capital goods demand and concerns about the Russia/Ukraine situation has been enough to at least temporarily derail the upswing (Exhibit 9).

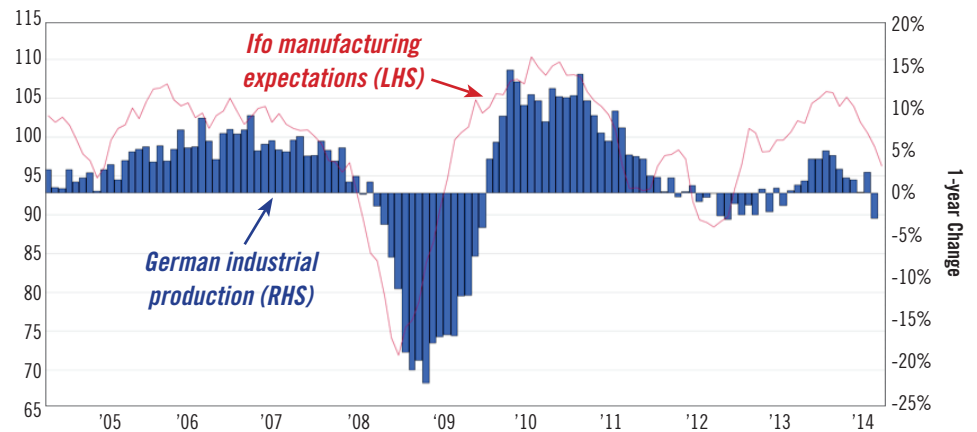
Whatever the specific causes of this disappointment, they confirm to us that the negative outlook from global leading indicators continues. Similar to the dollar discussion, we believe the trend on global leading indicators has a profound effect on asset prices, investor preferences, and specifically on long-duration interest rates (Exhibit 10). We note that despite a Fed moving to the exits, long duration U.S. interest rates have been well behaved this year. While there are many potential explanations out there, one factor is missing this year that was present in the 'taper tantrum.' In May 2013 the global economy was in the early stages of a coordinated expansion, which was a major factor in the bond selloff. How profoundly the current slowdown affects the U.S. growth trajectory remains an open question. Our central assumption, however, is that leading indicators will begin to turn more negative in the U.S. as well, which holding all else equal tends to be the case following sharp commodity

Exhibit 8: Global growth expectations continue to be steadily downgraded, in part due to a failure to account for Chinese weakness



Source: Bloomberg

Exhibit 9: Weakness in German data highlighted late quarter fears over a global growth slowdown, which looks set to continue



Source: FactSet, Driehaus Capital Management

Exhibit 10: Global leading indicators have a clear relationship with long duration interest rates



Source: Bloomberg

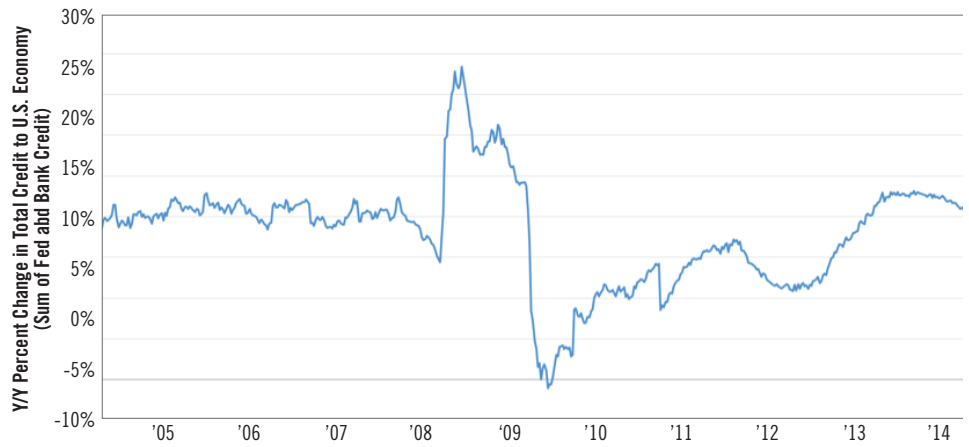
price declines. Additionally, we see the total credit being provided to the U.S. economy in the form of commercial bank lending and Federal Reserve asset purchases suggesting a slowdown (Exhibit 11).

For now, we do not believe that by itself the easing in financial conditions provided by falling bond yields is enough to offset the implicit tightening of conditions that always accompanies a stronger dollar, given the lack of aggressive risk taking by corporates and households. However, the boost to consumption in the form of far lower energy prices will have a noticeable effect on personal consumption expenditures and thus the current conditions create disparate winners and losers.

What about our friends at the Fed?

Our last observation on the quarter is closely tied to the current weakening of cyclical indicators. We believe the market operates on narratives, and we must be cognizant of the risks presented when those narratives start changing. There has been a mentality in the U.S., Europe, and Japan in recent years that if anything threatens economic growth, the central banks will be there to prop things up. In the latter two countries, we are confident that remains the case. However, within the U.S. the strong improvement in the labor market that we discussed last quarter changes things. The Fed will be faced with a policy challenge if the deflationary trend seen abroad spreads and unanchors inflation expectations in the U.S. They would likely be confronted by quickly falling headline inflation alongside fairly steady core prices, making a policy response hard to justify. This scenario is not in our base case as of yet, but it is certainly something to monitor.

Exhibit 11: The total credit injection into the U.S. economy is a reliable leading indicator of activity, and it looks set to slow



Source: FactSet, Driehaus Capital Management

Implications

Despite what appears a more challenging backdrop than was seen over the past several quarters, many opportunities are created by the higher volatility. The recent sharp changes in expectations—such as the Fed timeline, growth estimates, oil price, currency forecasts, etc.—provide nimble, active managers the ability to capitalize on security-specific mispricings created by these changes. Specifically, we are still finding attractive opportunities in smaller capitalization companies globally that have been significant underperformers of late despite having less sensitivity to weaker global growth. In the U.S. those companies have less earnings coming from abroad and are less adversely affected by lower inflation. The drastic shifts in macro conditions, specifically in commodities and currencies in international markets, similarly provide new winners and losers. The emerging markets remain ripe with specific opportunities in the wake of interest rate fears abating, regardless of whether the more commodity-centric areas can rebound. One

factor common across asset classes is that in a growth-starved world, investors will continue to favor above-market earnings growth rates. We end with a final reminder that one upshot of the shorter, tamer cycles seen over the past several years is that

barring a destruction in confidence, the downturns are shorter and seem to end just when everybody has capitulated on economic momentum. As such, we wait for signals of the next turn.

Investment Team Promotions and Additions

Third Quarter 2014

Matthew Schoenfeld joined Driehaus as a senior analyst for the Driehaus Long/Short Credit and Event Driven strategies, focusing on merger arbitrage and catalyst-driven opportunities. He is responsible for idea generation and in-depth fundamental research. Before joining Driehaus, Mr. Schoenfeld was a member of the Special Situations Group at Morgan Stanley, where he focused on merger arbitrage and event-driven investing.

John Khym, CFA, joined the firm as a senior analyst for the Driehaus Long/Short Credit strategies. Mr. Khym is responsible for researching and evaluating new investment ideas, developing and maintaining financial models to monitor creditworthiness of portfolio companies, and conducting maintenance research on existing holdings to ensure they continually meet stated investment objectives. Prior to joining Driehaus, Mr. Khym was an investment analyst for Neuberger Berman's distressed debt funds, where he focused on U.S. European credit and equity opportunities.

Josh Rubin was named portfolio manager of the Driehaus International Discovery Fund. Previously, he was the fund's assistant portfolio manager. Mr. Rubin also now serves as a co-portfolio manager of the Driehaus Small/Mid Cap Growth strategy.

Max Heitner was promoted to managing director, risk management and research. Prior to this position, Mr. Heitner served as the director of risk management and associate director of research.

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