MARCH 27, 2020

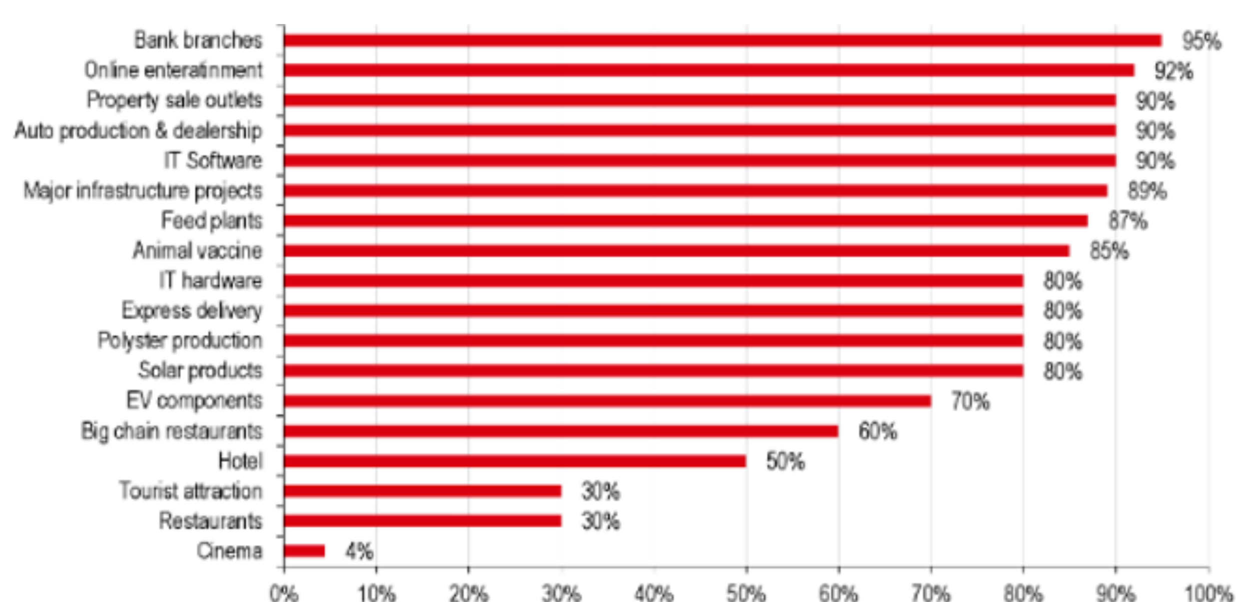
DRIEHAUS EMERGING MARKETS TEAM

CURRENT THOUGHTS AND OUTLOOK

WHAT ARE YOU HEARING AS IT RELATES TO CHINA AND BUSINESS OPERATIONS? WHAT STEPS HAS THE CHINESE GOVERNMENT MADE TO STIMULATE THE ECONOMY?

We are hearing consistent feedback across industries and sources that the return to normalcy has begun. While by no means operating at full capacity, the country appears to be about 80% back to work with major differences across industries. While that's good in a global sense, it is also not exactly a glowing picture in its own right. Given what has happened in the rest of the world in recent weeks, the impact of the collapse in the external sector has largely yet to be felt. In the end, that will have a significant impact on growth and employment in its own right independent of what's happening with the domestic economy otherwise. Most companies we speak to with domestic-facing businesses are starting to see some rebound in activity in March and are generally optimistic about the rest of the year, despite dealing with elevated inventory levels and an uncertain demand outlook. We see the government's response as being fairly clear. After moving fairly successfully past containment and lifting domestic travel restrictions, they are starting to focus both on stimulus and on stimulating areas they see as being in the national interest longer-term. Specifically, there have been targeted efforts to accelerate the 5G buildout, increase cloud adoption across the business sector, increase investment in the country's air freight network, re-accelerate electric vehicle adoption, and many more things. In China, there has never been a clear delineation between monetary and fiscal policy (similar to what we see happening in developed markets now) and the only external constraint on their fiscal policy was the currency. That constraint is fading with the policies of the Federal Reserve and the US Treasury and we expect a huge rebound in infrastructure stimulus and local government and state-owned enterprise (SOE) bond issuance in the very near-term.

Exhibit 1: China's Workforce Back to Work Across Industries



Source: HSBC

WHAT ARE SOME OF THE OPPORTUNITIES YOU ARE FINDING ATTRACTIVE IN CHINA?

A lot of the growth companies we tend to prefer have only had their positions strengthened by this pandemic. Specifically, tele-medicine, online gaming, localization of tech hardware production and food delivery have been major themes in our Chinese investments and we have broadly been increasing exposure during this time. In addition to that, we are expecting a large fiscal stimulus in China and one that is likely to be focused on infrastructure, both transportation as well as network infrastructure. As a result, we are increasing some exposure to companies positioned to benefit from that large fiscal expansion.

AFTER CHINA, WHICH COUNTRIES ARE LOOKING ATTRACTIVE TO YOU FROM AN INVESTMENT PERSPECTIVE?

We currently are prioritizing exposures in countries without major external debt burdens, corporates without material USD-debt exposure and need for USD liquidity and countries with capacity to stimulate without wiping out the values of their local currencies. Fortunately, we were positioned largely this way heading into this crisis with big underweights in places like South Africa, and reduced exposure in Brazil and Indonesia. One market we think is particularly interesting is Russia. Despite the collapse in oil, Russia has largely become a self-subsisting economy in the wake of sanctions. Being cut off from international debt markets has left the country with very little external ties to financial markets, relative to EM peers, and so far a more contained outbreak. Valuations in Russia are particularly attractive now, a weaker ruble can actually help the earnings of a significant portion of the market, and the government has space to spend to try to offset the ongoing demand destruction.

WHAT ARE YOUR VIEWS ON INDIA GIVEN THE RECENT DEVELOPMENTS OF THE COUNTRY SHUTTING DOWN?

Prior to news of any infections in India, we had begun reducing our exposure there. The catalyst for that was seeing the early outbreak in the Middle East and realizing the close travel ties between cities like Dubai and the major cities in India. We felt there was enough evidence that higher temperatures alone would not be enough to stop the virus from spreading quickly in India once it arrived. Given the country's very poor hospital adequacy, very high urban density and subsistence wage-earning population, it was reasonable to assume it would be a major problem once it arrived. The caseload is currently increasing quickly but we have been encouraged that Prime Minister Modi has acted so quickly to lockdown the country; given the factors we mentioned, this was the only chance they have. The government has also responded nicely with stimulus and targeting things that actually matter for the lower-income earners (i.e. providing direct access to food), but ultimately this fiscal accommodation and a monetary one alongside it will further downside to the rupee in spite of the terms of trade windfall that has arrived via lower oil prices. The fall in Indian equities has, however, been very quick. Some of the best franchises in the country, which will no doubt persist after this crisis fades, are trading at multiples in line with those seen during the financial crisis; we see opportunity returning here.

HOW HAS YOUR MACRO ANALYSIS CHANGED IN THE RECENT ENVIRONMENT?

We believe that analyzing the interplay of macro and micro factors is always an advantage in emerging market investing and in recent weeks, the importance of macro analysis has definitely increased. The primary reason for this is that the outlooks for emerging market FX have changed rapidly, as have the local rates markets, all of which have differential impacts on local equity markets. Beyond that, countries have seen very different experiences with COVID-19 itself, with north Asia being a major outlier thus far in terms of having more successfully managed the outbreak. Every affected country has responded similarly in the sense of aggressively increasing fiscal accommodation but also easing monetary policy aggressively. This is not the typical response to crises in most emerging markets, as central banks have typically feared that doing so would weaken domestic FX enough to cause more problems than lowering rates would solve. The scale of the demand destruction ongoing in EM seems to have tilted the scale toward aggressive monetary accommodation, which is a defensible position. Unfortunately, not all countries are created equal with regard to their ability to effectively monetize a fiscal expansion and we expect that differential impact on FX to have a more pronounced impact on EM returns going forward. Coincidentally, the countries with the most capacity to manage this issue also seem to be the least affected by it domestically. Beyond this, there remains a lot of differentiation available at the security-specific level as well given how drastically different the impacts of this crisis are on different business models. In short, we see macro continuing to have a higher impact on EM returns for the time being but believe security-specific differentiation will be even more important once this period passes.

WHAT CHANGES ARE YOU MAKING WITHIN THE PORTFOLIO?

From a country perspective we have been adding to our holdings in China for several months alongside reductions in both India and Brazil. In both of these countries, however, we are currently assessing adding back given the large declines that have transpired in both markets. On a sector level we had reduced our exposure to financials most aggressively while continuing to favor communication services and technology companies. We have been spending more time of late assessing the opportunities in the "recovery growth" area of our focus list. Counterintuitively, we see the potential for some cyclical industries that have been out of favor in spite of the likely very weak demand outlook in the near-term. Many companies in these areas have very attractive valuations, but also resilient cash flows that will sustain the businesses during times of stress. Further, we see the potential for Chinese stimulus to boost these areas while also seeing the potential for upside in prices of primary inputs as countries around the world attempt to debase currencies as much as possible. These potential price increases could mean that relative earnings momentum would be stronger in these areas than in segments of the market more favored by investors of late.

HOW HAS COVID-19 IMPACTED LATIN AND SOUTH AMERICAN MARKETS? WHICH COUNTRIES DO YOU SEE BEING MOST IMPACTED BY THE VIRUS?

As discussed, we had been reducing our Brazilian exposure for many months on concerns of both valuation and that the currency was at increasing risk. Our view on the FX predated the coronavirus concerns and was based on declining real interest rates and a slowdown in fiscal reform momentum. The shock of COVID-19 has only exacerbated those vulnerabilities. The virus has spread fairly quickly throughout the rest of South America as well, with countries like Peru and Colombia being hard-hit early on. Colombia is particularly at-risk, coming into this crisis with collapsing terms of trade and wide twin deficits. We do not see value there. Peru should be more defensive given its fiscal and external positions are more stable but remains very vulnerable to a domestic slowdown as well. Should prices for commodities like copper stabilize, Chile and Peru will likely outperform on a relative basis. One market of more interest to us is Mexico where the hit has come both through domestic infection spread as well as from the collapse in oil prices. Interest rates remain high in Mexico and the currency has depreciated materially already. There is certain to be adverse economic impact, however, we don't envision the goods-producing areas of the Mexican economy to be permanently impaired; this dynamic could also serve as a differentiator long term as supply chains will start to become even further localized after this crisis settles down.

WITH THE U.S GOVERNMENT'S RECENT ANNOUNCEMENT OF A $2 TRILLION STIMULUS PACKAGE, WHAT IMPACT DO YOU ANTICIPATE THIS TO HAVE ON THE U.S DOLLAR AND INTEREST RATES?

We think this is an essential question and have seen it progressing in multiple phases. The initial phase we think has mostly passed already which was an initial spike in dollar scarcity, which adversely impacted EM FX pretty significantly. In short, we saw the need for dollars spike around the world and the supply mechanisms being temporarily clogged. The actions of the Federal Reserve have largely solved these problems, in our view, by freeing up a massive amount of excess reserves and more importantly, opening up the dollar swap lines in greater scale and to more central banks around the world – including some in EM that we never would have guessed would be included (Indonesia, for example). Solving this plumbing problem allows for a reversal in some of the extreme price action we've seen in FX and EM fixed income but doesn't solve any structural concerns on its own. As mentioned, EM central banks have largely cut rates in line with the Federal Reserve or more and have even embarked on domestic QE. EM FX will not broadly recover until there are signs that growth is stabilizing or inflecting, which we don't see as having happened yet. The short-term risk rally in some oversold currencies can continue, but ultimately it will be growth that drives returns for EM FX. That will eventually happen and when it does, the dollar will weaken very significantly. Given the scale of liquidity injections, it could unleash a secular bear market in the dollar, the likes of which we have not seen since before the financial crisis but it is too early to position for that. One element that could accelerate such a transition is that we think the COVID-19 situation in the US will unfortunately prove to be even worse than in many other large countries, which could mean growth momentum is even worse in the US in the coming year. Finally, capital inflow into the US has been a major driver of dollar strength over the recent years in spite of structural deficiencies that should have seen it weaken.

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