

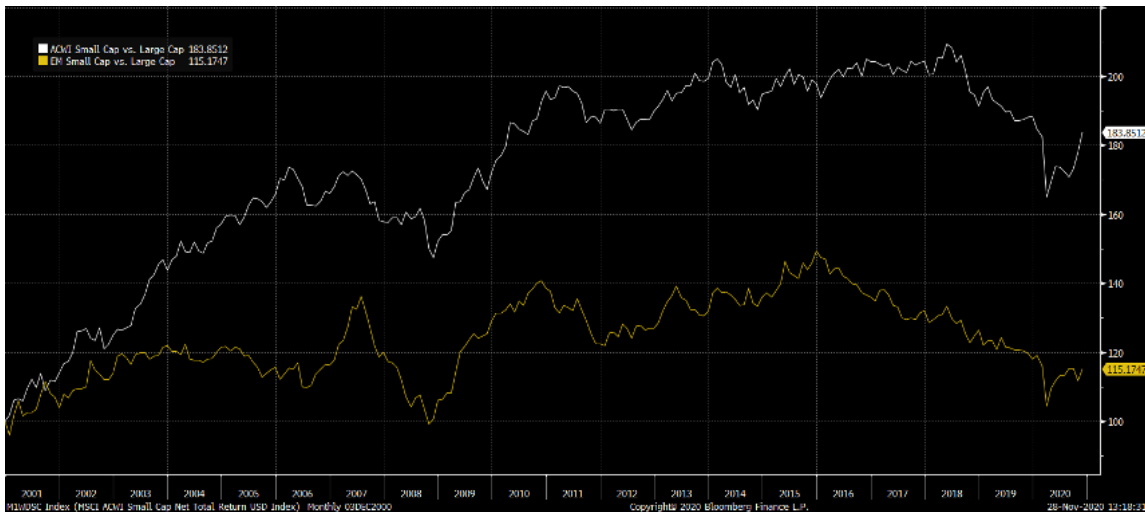
DRIEHAUS EMERGING MARKETS SMALL CAP EQUITY STRATEGY

# Beyond China – Growing Opportunities Within Emerging Markets Small Cap

Over the last four years, emerging market (EM) small caps have struggled relative to large caps, in-line with a trend that has also materialized on a global basis. As shown below, the MSCI All Country World Index has been led by large caps since 2018, while EM small caps topped

out relative to large caps in 2016 (Exhibit 1). Notwithstanding recent performance trends, small caps in both EM and globally have outperformed large caps over the past twenty years, despite undergoing cyclical fluctuations.

**Exhibit 1. Small Cap Relative Performance Against Large Cap**



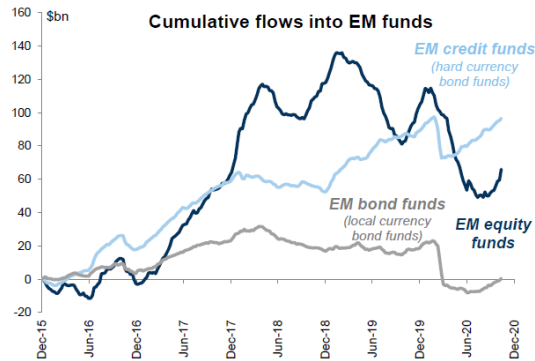
Source: Bloomberg

After enduring their longest stretch of underperformance on record, we believe one can argue that EM small caps are increasingly well positioned to return to a period of outperformance.

First, the starting point for an investment in EM small caps is favorable relative to its history. As shown in the following two tables, the MSCI EM Small Cap Index trades at a 12.8x forward price/



### Exhibit 4. Cumulative Flows Into EM Funds

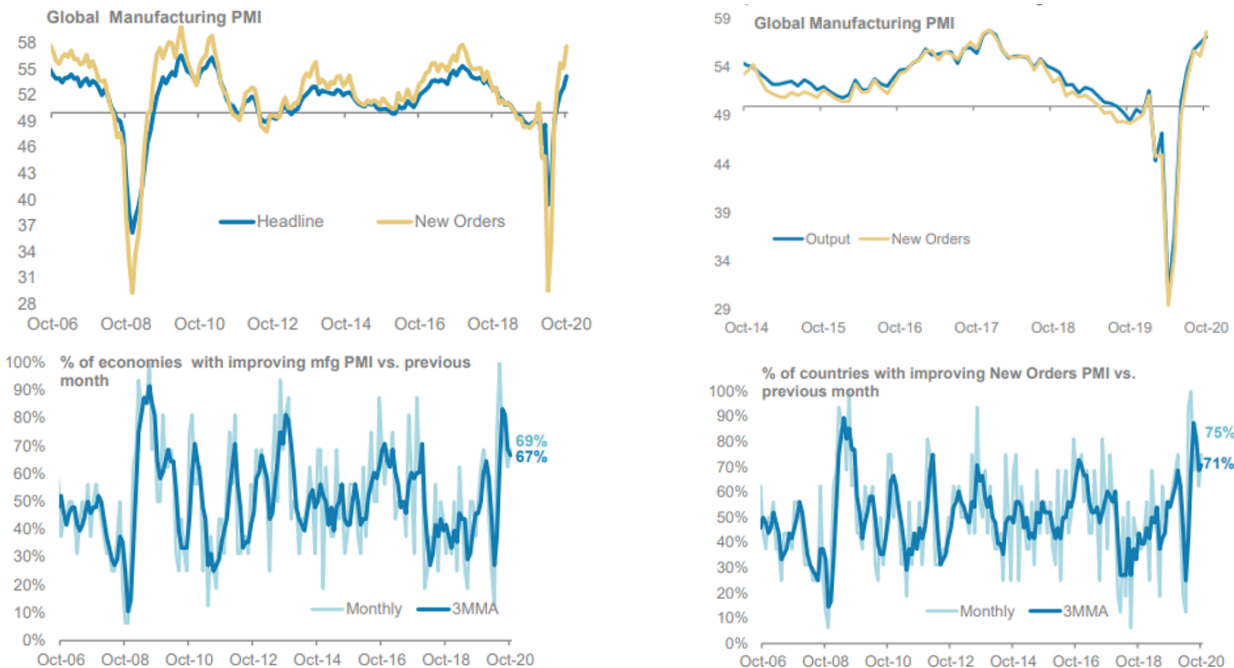


Source: EPFR, Goldman Sachs Global Investment Research

Third, the Driehaus Emerging Markets team sees an improving macro backdrop for EM equities. We consider a series of economic indicators that inform our view of broad macro trends as well as those of individual economies.

If we look at an aggregate of manufacturing PMIs, we see that we have recently reached a new cycle high of 54.2 in the October data (Exhibit 5). In fact, the aggregate headline measure is approaching previous cycle highs. Some 83% of the economies in observation set have headline PMI measures in expansionary territory; the picture is very similar if we look at the new orders component.

### Exhibit 5. Global Manufacturing PMI



Source: EPFR, Goldman Sachs Global Investment Research

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The aggregate picture shows the recovery from the troughs of the pandemic induced recession (Exhibit 6).

If we look at the data on a more granular level, we see dispersion and can get a sense of relative strength across economies (Exhibit 7). We note particular strength in India (the largest move

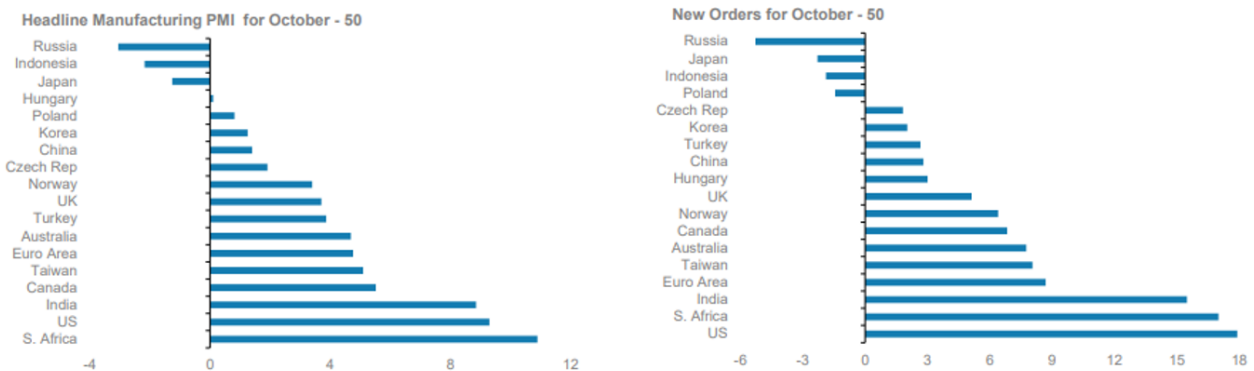
off of the pandemic in our dataset below with the largest move in the last three months and one of the strongest PMI and new order levels), Brazil (similar story to India on the three month momentum and move off the trough with the highest manufacturing PMI in our data at 66.7), and South Africa (similar story to Brazil).

**Exhibit 6. Percentage of Countries With Manufacturing PMI Above Pre-pandemic Levels**



Source: Markit, Haver Analytics, IMF, national sources, Morgan Stanley Research

**Exhibit 7. PMI and New Order Levels**



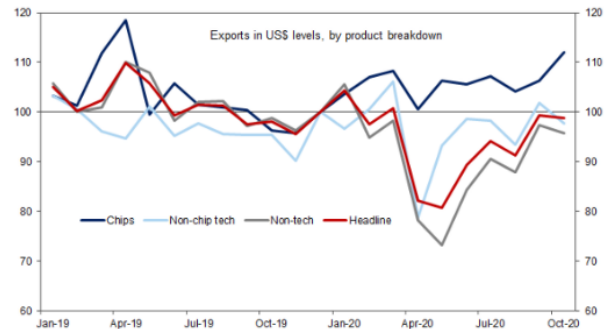
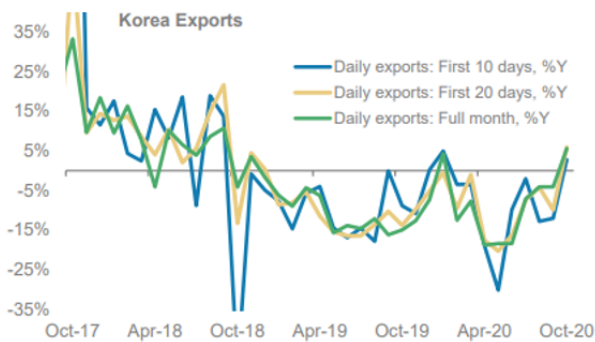
Source: Morgan Stanley

The pandemic has introduced certain thematic trends related to the virus itself and the changes in consumption that resulted from the imposition of social distancing measures globally. Exports from Asian economies have been a beneficiary of these trends (a shift to durable goods from services in the consumption bucket), as we can see in the data shown below in data from Korea

(Exhibit 8). We see export volumes growing alongside an increasing dispersion between chips and the rest of the export categories.

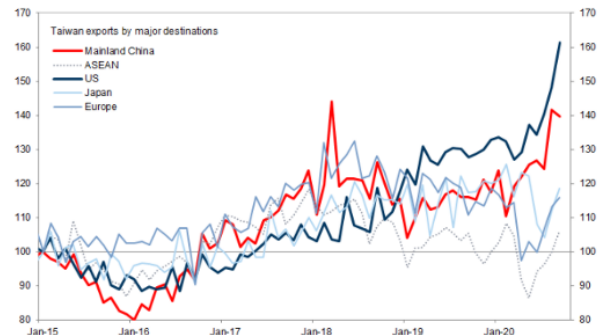
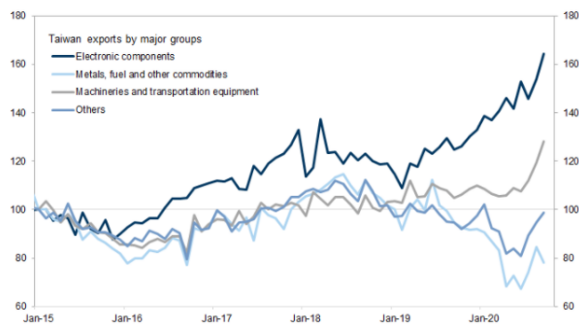
Taiwan export data show a similar picture, as shown in exports by group and destination (Exhibit 9).

**Exhibit 8: Korea Export Data**



Source: Ministry of Trade Industry and Energy

**Exhibit 9: Taiwan Export Data**

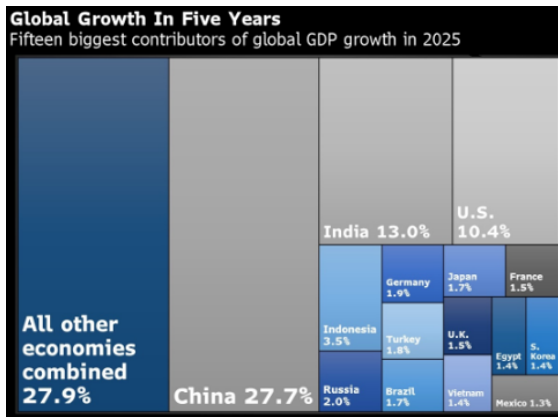


Source: Ministry of Finance, Haver Analytics, Goldman Sachs Global Investment Research

No consideration of EM economies would be complete without highlighting trends in data from China (Exhibit 10). In today's world, positive GDP numbers are exceedingly rare, leaving the

Chinese GDP particularly interesting. In the most recent policy 15-year vision, President Xi Jinping has targeted a doubling of GDP over the coming 15 years (implying 4.7% annual growth).

### Exhibit 10. China Economic Growth



Source: Bloomberg

We also highlight recent trends in foreign exchange markets relative to the US dollar. The Chinese yuan serves a central role in reflecting economic realities and impacting EM investor returns. Recently, the yuan has appreciated

markedly amid strong fundamentals and a weak USD backdrop (Exhibit 11). The fundamental strength of the yuan is particularly relevant for EM investors as it is closely related to the performance of many peer currencies.

### Exhibit 11. US Dollar / Chinese Renminbi Spot Exchange Rate



Source: Bloomberg

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As shown in the following table from Bank of America, net US Treasury supply is set to meaningfully outstrip the Fed's current trajectory of bond purchases in the coming quarters (Exhibit 12). In an environment in which foreign official

flows into US Treasuries remain muted, this suggests the potential for additional monetary stimulus in order to contain bond yields, further reinforcing a weakening trend for the US dollar.

**Exhibit 12. Net Treasury Supply and Fed Treasury Purchases**

	Net Treasury Supply (\$bn)	Fed Treasury Purchases (\$bn)
3Q '20	504	233
4Q '20	625	237
1Q '21	597	240
2Q '21	618	240
3Q '21	572	240
4Q '21	584	240

Source: BofA Global Research, Federal Reserve

Looking to historical precedent to observe relative performance of asset classes during

periods of US dollar depreciation, we note the strong performance of EM equities (Exhibit 13).

**Exhibit 13. Asset Returns During Declining US Dollar Regimes**

Chart 21: US asset & equity returns 1970s

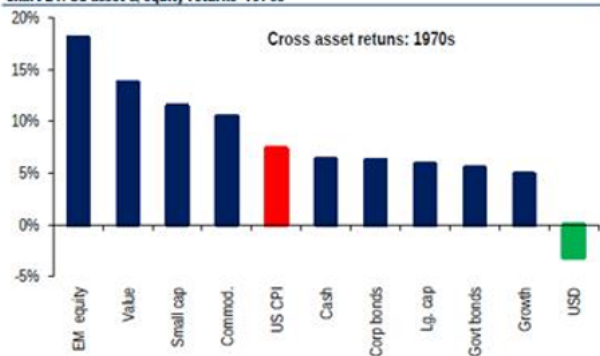


Chart 22: US asset returns 2000s



Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data, Homer and Sylta "A History of Interest Rates." (2005)



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Considering the potential topping pattern exhibited by the broad US dollar index, the improving macro data highlighted in the discussion above, and the relatively better job that emerging economies have done in combating

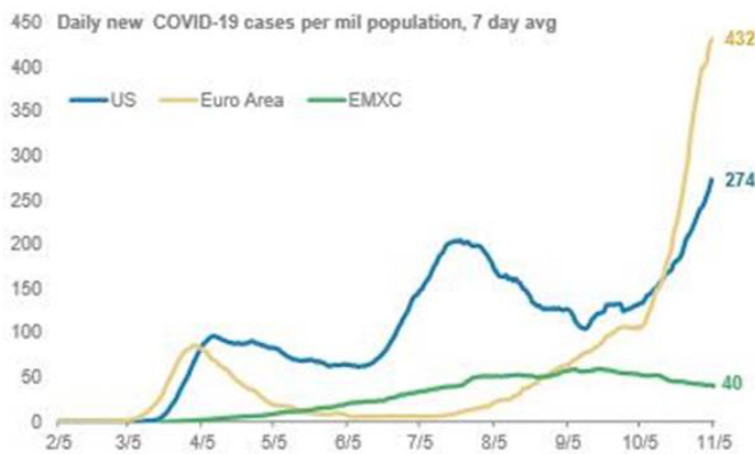
COVID-19 compared to the US and Europe, we see a growing likelihood that EM equities break their decade-long period of underperformance against developed markets (Exhibit 14, 15 and 16).

Exhibit 14. US Dollar Index



Source: Bloomberg

Exhibit 15. New COVID-19 cases



Source: Johns Hopkins University, WHO, CEIC, Haver Analytics, Morgan Stanley Research



### Exhibit 16. MSCI Emerging Markets relative to MSCI World (Developed markets)



Source: Bloomberg

In an environment of improving macro and performance trends, alongside an attractive starting point, we believe that a broadening out of participation in emerging markets will support the relative attractiveness of the small cap segment of the asset class. We have already

begun to see a strong environment for stock selection over the last two years, and we continue to be excited about the large opportunity set of rapidly growing companies in this underinvested segment of EM equities.



#### ABOUT THE AUTHOR

**Chad Cleaver**, is the lead portfolio manager of the Driehaus Emerging Markets Small Cap Equity strategy and a portfolio manager for the Driehaus Emerging Markets Growth and Driehaus Emerging Markets Opportunities strategies. His idea generation, security selection, portfolio construction, and risk management responsibilities, and macro-level analysis, are leveraged across the three strategies managed by the Driehaus Emerging Markets Team.

Mr. Cleaver began his career with the Board of Governors of the Federal Reserve System and joined Driehaus Capital Management in 2004. He received his A.B. in economics from Wabash College in 2000 and his M.B.A. from the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill in 2004. Mr. Cleaver is a CFA charterholder.