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CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

JANUARY 2021

A new year is upon us, and those who hoped that the change in calendar year would bring a return to normalcy are undoubtedly disappointed, as January proved every bit as volatile as 2020. As a market observer on Twitter aptly summarized, "2020: anything can happen, 2021: anything goes." We will neither rehash nor opine on the numerous events that underscored January 2021, but rather we heed the words of Macquarie's Head of Asian Strategy, Viktor Shvets, who notes "Capturing zeitgeist (or the spirit of the age) is one of the most important tasks for politicians and investors. Those that are successful reap rewards of an energized political career and/or garner excess returns on investments. The importance of zeitgeist is particularly pronounced at the critical turning points."

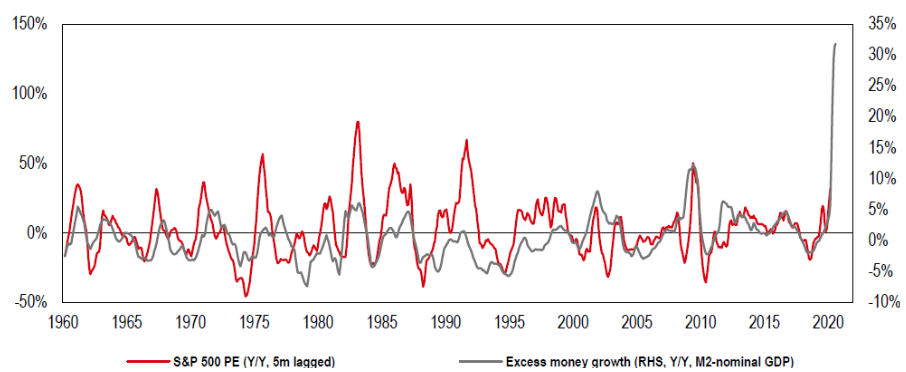
The spirit of today's age is encapsulated by the Wall Street Journal headline on January 3, "Welcome to the Era of Nonstop Stimulus." Indeed, the global response to the pandemic has been nothing short of remarkable. A recent virtual conference featured a conversation with one of the industry's titans, during which he noted the following points:

- The 2020 recession was five times the magnitude of the average recession since World War II, but it occurred in 25% of the duration.
- During a time in which 11 million people were unemployed and the US was amid an economic downturn, personal income increased by the largest amount in 20 years, albeit due to the massive policy response.
- In the span of three months, the US increased its deficit more than it did during the combined responses to the last five recessions.
- In the span of six weeks, the Fed bought more Treasuries than they did in 10 years under Ben Bernanke and Janet Yellen.
- Since 2018, the ratio of M2 to nominal GDP has grown by 25% in the US, while in China, the ratio is roughly flat over the same period.

The following chart from HSBC shows the enormous increase in the US money supply relative to GDP (Exhibit 1). This excess liquidity has fueled a boom in asset prices of all types, from equities to cryptocurrencies to baseball cards, and everything in between.

Exhibit 1. US M2/Nominal GDP vs. S&P 500 Price/Earnings Ratio 5 Months Lagged

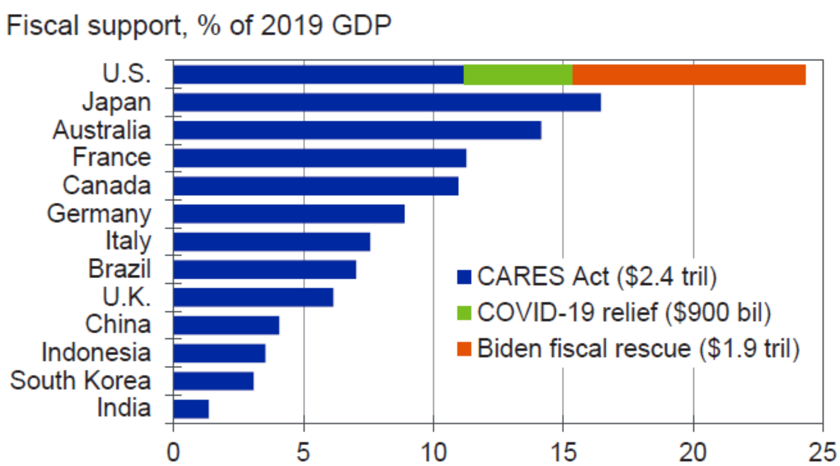
(Year-Over-Year Growth)



Source: HSBC, Bloomberg, Refinitiv Datastream, Federal Reserve

The industry titan correctly notes that China did not engage in the same type of extreme stimulus as the US. In fact, across emerging markets, most policymakers provided appropriate backstops for economies that were damaged by COVID-19, while refraining from any type of panic stimulus (Exhibit 2). This carries two major implications in the early days of 2021.

Exhibit 2. Fiscal Spending *(% of Gross Domestic Product)*



Source: Moody's Analytics

First, the combination of fiscal and monetary stimulus in the US may lead to an outsized growth impulse in the US economy relative to the rest of the world, particularly in conjunction with the disbursement of the COVID-19 vaccines in the US. This growth differential could support a counter-trend rally in the US dollar, marking a reversal from the weakness observed in the second half of 2020.

Second, from a longer-term perspective, this enormous amount of excess US dollar liquidity points to a growing likelihood of a renewed downtrend in the US dollar, particularly once populations in emerging markets are vaccinated and growth improves in the rest of the world. With this in mind, it is unsurprising that we enter 2021 with our largest pipeline of investable opportunities in the Strategy's history. We elaborate on the expanding opportunity set in greater detail below.

A volatile start to the year is a reminder that political transitions and vaccine announcements will not lead to an immediate return to normalcy. While we see a strong micro backdrop for EM companies across numerous industries, the macro landscape remains an equally important driver of returns. Identifying major turning points and employing a nimble and flexible approach will be critical to navigating the market environment over the course of 2021.

Performance Review

At the sector level, the most significant contributors to returns were information technology and industrials. Consumer discretionary and materials detracted the most value. At the country level, China and Taiwan contributed most to performance for the month, while India and South Korea were notable detractors from performance.

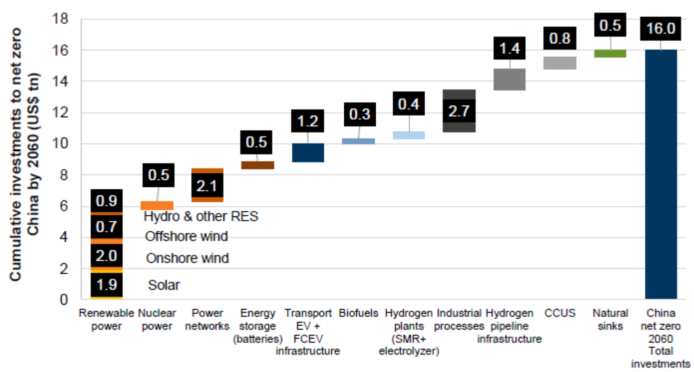
Positioning and Outlook

We continue to observe an expanding opportunity set across numerous markets within EM. A few of the themes and trends we are most excited about include the acceleration of investments in renewable energy and electrification, the increasingly pro-growth policy stance in India, and the wave of IPOs across emerging markets.

The megatrends of electrification and renewable energy have yielded a number of opportunities across markets in areas such as the electric vehicle supply chain, solar farm operators and suppliers, wind turbine producers, and companies developing technologies that are linked to the hydrogen economy. China's aggressive policy push has driven much of the increased investment in this area, and the various contributors to the country's target of net zero emissions by 2060 are depicted below (Exhibit 3).

Exhibit 3. China's Path To Net Zero Emissions

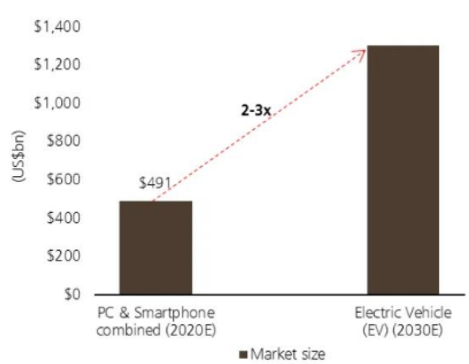
(Cumulative investment opportunity across sectors for China net zero by 2060(US$))



Source: Company data, Goldman Sachs Global Investment Research

Electric vehicles have the potential to amass significant scale, with the market size potentially outstripping that of PCs and smartphones combined by 2-3x by 2030 (Exhibit 4). Improvements in battery technology are leading to investment ideas such as a Chinese company that has developed a battery with higher energy density at a lower cost relative to key competitors. These improvements in technology and cost led a large European auto manufacturer to partner with this company, potentially accelerating its roll-out.

Exhibit 4. Potential Size of Electric Vehicle Market



Source: UBS

Hydrogen has the potential to decarbonize parts of the economy that are difficult to electrify, with applications in buses, commercial vehicles, shipping, heating, and steel manufacturing. China and Korea have been early leaders in developing technology, forging partnerships, and aggressively incorporating hydrogen into their broader renewable energy policies. China is the world's largest hydrogen producer, and two of the Strategy's holdings have partnerships with China's leading manufacturer of heavy-duty trucks, as the company plans to roll out fuel cell electric vehicles (FCEVs) in the coming years. Korea has also been aggressively promoting its hydrogen policy, aiming to increase the number of FCEVs for passengers and commercial use, while also installing utility fuel cells with a capacity target of 8 gigawatts by 2040. The Strategy is invested in Korea's leading producer of fuel cells, which has a dominant position in stationary power applications.

Elsewhere, we are optimistic about the increasing number of companies in India that are slated to benefit from the pro-growth policies of the central government. Every year, a considerable amount of time is devoted by economists and analysts in India to parsing through various aspects of the government's budget, which is released early in the calendar year. After the hoopla dies down, the budget is often described as a "non-event" or as one local broker more bluntly put it, "a waste of time." Not this year. India's government set forth ambitious plans to invest in road, railway, and power infrastructure, while continuing initiatives such as affordable housing. A particularly interesting aspect of the budget was a nearly $7 billion expenditure on a rural water initiative known as Jal Jeevan, which saw an approximate five-fold expansion from prior years. The Strategy recently invested in one of India's leading producers of pipe, and we expect the company to benefit from the increasing investment in water infrastructure. We are optimistic that the improving growth profile of the Indian economy will benefit the Strategy's holdings in domestic cyclicals such as banks, cement companies, and producers of cables, lighting, and air conditioners. Further, we remain excited about the structural opportunity associated with the growth of the Internet, faster connectivity, and rising e-commerce penetration, and expect current incumbents to benefit alongside a growing potential pipeline of new listings in this part of the market in the years ahead.

On that note, we have seen a pronounced pickup in IPOs over the last year as capital markets have been increasingly supportive of new listings. For context, in a market like Brazil where interest rates have fallen from 14.25% to 2% in the last five years, local asset allocation has shifted meaningfully from fixed income to equities. A number of retail and e-commerce companies that listed in 2020 have performed well, and another round of IPOs is currently unfolding, featuring a number of interesting companies that we will discuss in more detail in future commentaries. This activity is not confined to Brazil, and in fact a Kazakhstan-based financial technology company and an India-listed restaurant chain have been strong contributors to the Strategy's performance, following our participation in both IPOs in 2020.

Despite the volatility observed in January and the risk of a near-term headwind from a counter-trend rally in the US dollar, we continue to believe that the outlook for emerging markets is bright. We see a number of rapidly growing companies in the small cap segment of the market that are positioned to benefit from a number of exciting themes and trends that are unfolding in EM, and continue to position the portfolio to capture the growth in these areas.

Until next month,

Chad A Cleaver

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