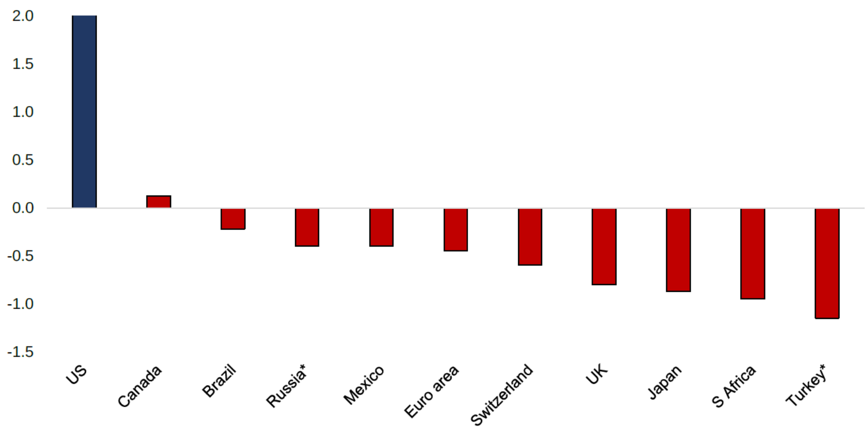
DRIEHAUS
CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

FEBRUARY 2021

After a strong start to the year, emerging markets (EM) and growth stocks that benefited during the pandemic struggled during the second half of February. As we cautioned last month, the relative size of the US fiscal stimulus carries implications for the growth differential between the US and the rest of the world, representing a near-term headwind for emerging markets by way of a stronger US dollar and rising interest rates. More recently, the pace of COVID-19 vaccinations in the US has also surprised to the upside, adding further growth momentum relative to the rest of the world, as shown below (Exhibits 1 and 2).

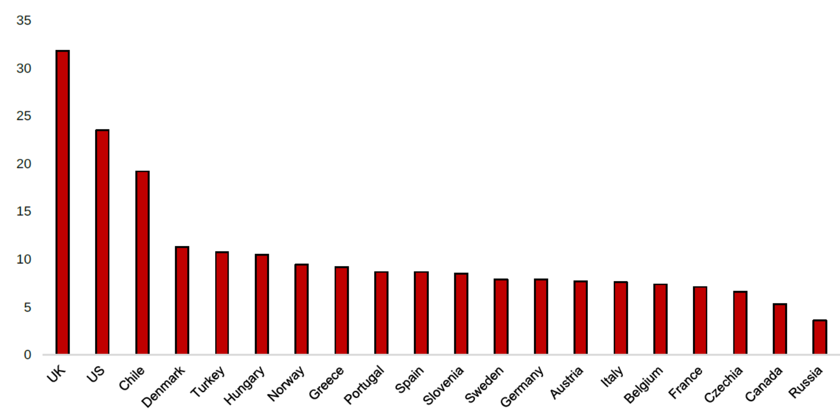
Exhibit 1. Consensus Year-To-Date GDP Growth Revisions



*% change in median Bloomberg consensus 2021 real GDP forecast since January 1st. Calculated as the change in expected cumulative q/q% growth from Q1 to Q4, except Turkey and Russia, which are calculated as the change in expected y/y% growth in Q4 2021.

Source: Credit Suisse, Bloomberg

Exhibit 2. COVID-19 Vaccinations Administered as a Percentage of Population

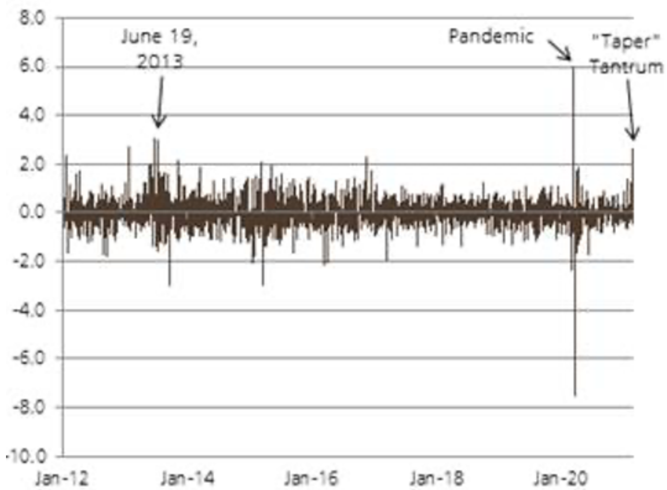


Source: Credit Suisse, OWID

Against this backdrop, the combination of an easy base effect, recent commodity price increases, pent-up demand for services, and supply chain bottlenecks, creates the potential for upside risks to inflation estimates in the months ahead.

In response, the rapid rise in real interest rates has caused some observers to draw parallels between the current environment and that of the "taper tantrum" of 2013 (Exhibit 3).

Exhibit 3. US 10-Year Real Yield (Volatility-Adjusted Move)



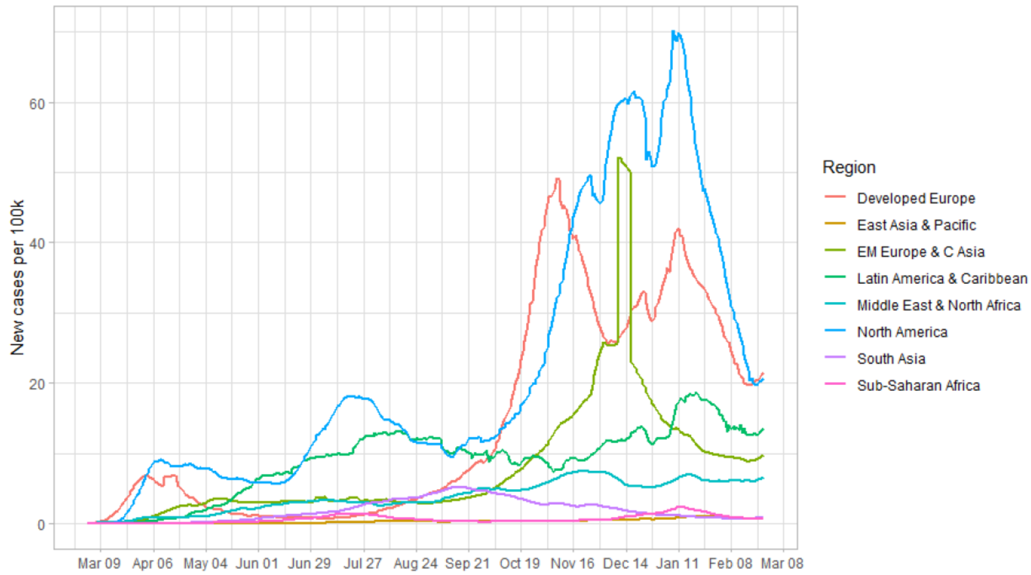
Source: UBS

While both episodes entailed sharp and painful rises in interest rates, there are some key differences between the current backdrop and the taper tantrum. First, the recent increase in interest rates is largely a function of a recovering global economy, resulting from stimulus and the stronger than expected pace of vaccinations.

Conversely, the taper tantrum resulted from an incremental tightening of monetary policy by the Federal Reserve (Fed) following several rounds of quantitative easing. Given the Fed's current imperative to revive growth following the COVID-induced collapse, along with the flexible average inflation targeting policy, which seeks an average of 2% inflation over time, it appears unlikely that the Fed will tighten policy in the near-term.

Second, a number of emerging economies were on fragile footing during the summer of 2013, due to excessive fiscal and current account deficits, and were highly vulnerable to interest rate increases and tightening US dollar liquidity. Since many emerging markets exhibited a swift response to COVID-19 (Exhibit 4), and a number of export oriented economies benefited from the strength in tech hardware and US goods demand during 2020, the fiscal response to the pandemic by emerging markets has been more measured, relative to developed economies. This provides increased confidence in the sustainability of EM leverage ratios, while the stronger global growth impulse from US fiscal stimulus will also benefit emerging economies.

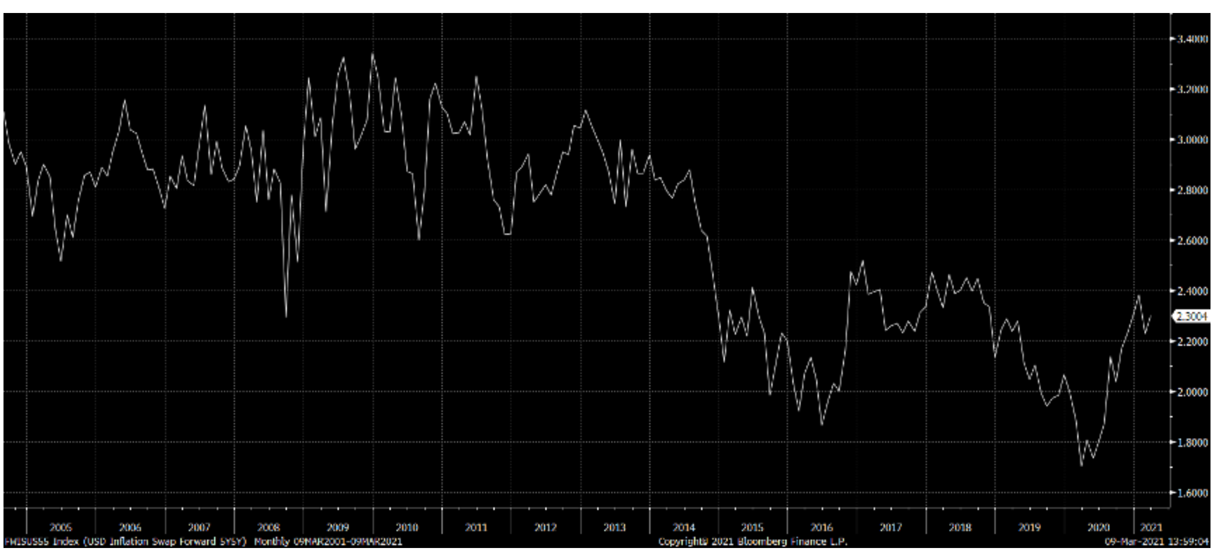
Exhibit 4. New COVID-19 Cases Per 100k People



Source: Credit Suisse

While interest rates have responded appropriately to a stronger global growth backdrop and rising near-term inflation, market participants are currently pricing in a benign longer-term path for inflation, as shown by the US 5-year, 5-year forward inflation swaps.

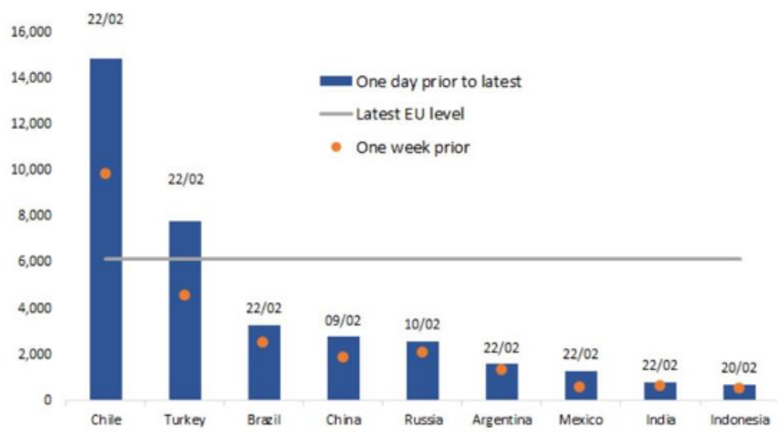
Exhibit 5. US 5-Year, 5-Year Forward Inflation Swap



Source: Bloomberg

Further, despite the US and UK leading the way in terms of vaccinations at the moment, there are a number of encouraging signs in EM as well. Chile and Turkey are running ahead of the EU with respect to doses administered (Exhibit 5). Additionally, surveys point to a high degree of confidence in vaccines in most EM countries, and based on reported data, the pace of vaccinations is picking up. For example, in India, the daily rate of vaccinations has risen by more than three-fold in recent weeks to 1.4 million, and it is important to note that India is also the second largest vaccine manufacturer globally.

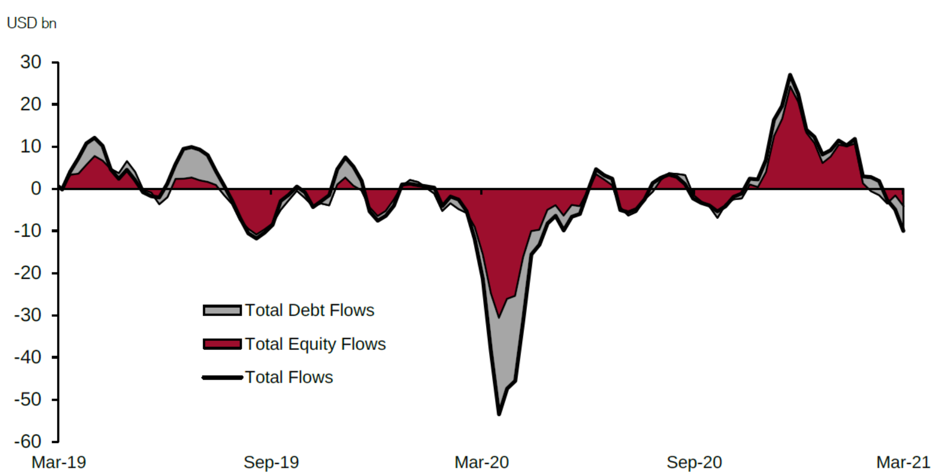
Exhibit 5. Vaccines Administered Per 100k People



Source: Exante Data, OWID
Note: Dates above the bars show the date prior to the latest reported data.

As a result, despite the recent changes in growth differentials, bond yields, and inflation expectations, capital outflows from EM have been modest thus far (Exhibit 6).

Exhibit 6. EM Capital Flows



Source: Credit Suisse, IIF

Overall, we see a number of differences between the taper tantrum and the recent bout of interest rate volatility, and remain encouraged by the growth outlook in EM, using the recent selloff as an opportunity to add to our highest conviction positions.

Performance Review

At the sector level, the most significant contributors to relative returns were communication services and real estate. Industrials and consumer staples detracted the most value. At the country level, Vietnam and Brazil contributed most to performance for the month, while China and Taiwan were notable detractors from relative performance.

Positioning and Outlook

During the recent selloff, the strategy added to select positions where we maintain a high degree of bottom-up conviction in the forward earnings outlook, as well as positions that are tied to some of our favorite themes across EM. Many of these are focused on North Asia, the region which we continue to see as leading the broad trend of innovation in EM.

These companies include a Taiwan-listed provider of power management integrated circuits used in 5G, data centers, and auto electronics, that is benefiting from the trend of localization within the technology sector. Within Taiwan, we also continue to favor a local producer of connectors used in a variety of different end markets, including wind turbines, agricultural equipment, and medical devices.

In China, we established a new position in a company focused on industrial automation, which is improving its technology and enhancing its value proposition after acquiring a German competitor. We also started a position in a multi-brand restaurant chain operator, which is growing its earnings in excess of 60% per year.

We continue to observe strong bottom-up fundamentals across a number of industries and themes in small cap companies within emerging markets. Despite the recent market volatility, we maintain a positive outlook on the asset class as the combination of stimulus and vaccinations lifts global growth assumptions.

Until next month,

Chad A Cleaver

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