Driehaus Emerging Markets Small Cap Equity Strategy Summary

OCTOBER 2024

Macro and political events have been the dominant drivers of near-term returns in Emerging Markets (EM), as has been customary during numerous periods throughout the history of the asset class, with the US elections and China economic stimulus influencing relative performance dynamics across markets and themes.

While the US election result contained surprises relative to polling, it is important to note that markets, as well as the strategy's positioning, had already begun adjusting well in advance of November 5th. Our view has been that the first order response to a Trump victory would be an appreciating US dollar. This dynamic was very clear in price action following the results, but we would consider the total effect as having started a month or two ago when he began to rise in the polls. From that vantage, we've already seen an appreciation of 4-5% in the broader dollar.

Relatedly, within a backdrop of tepid global growth (the IMF projects a "stable yet underwhelming" 3.2% for 2025), a Trump presidency is likely to shift growth differentials in favor of the US economy. The domestic yield curve has also steepened significantly over the past few months, while several cuts have been priced out of the implied Fed Funds trajectory.

The combination of a stronger dollar and a steeper yield curve with an FOMC that is now likely to be less dovish has important implications for EM, as most central banks will follow the Fed's path and cadence. Top down, this type of backdrop favors economies with relatively more insulated domestic activity, such as India, as well as those with idiosyncratic reform stories, including the likes of Argentina and South Africa.

Bottom up, this remains an attractive environment for stock picking given the potential policy nuances that will evolve as the administration takes shape. For example, we have observed positive reactions from Korean shipbuilding stocks, as well as companies with ties to defense spending. For the market in general, trade policy and the new administration's geopolitical stance will have the most pronounced impacts.

In addition to the factors considered above, the other important variable hanging in the balance is the Chinese economy.

Following our August commentary on China, which outlined a continued cautious view and underweight allocation to the country, the Chinese government embarked on a meaningful policy shift. This led to a sharp rally in local equity markets, while potentially setting the stage for improving earnings in the coming quarters.

Since mid-September, China has introduced a series of measures to address mounting local government debt and slowing growth. The most notable move was a large-scale debt swap program, where local governments will be able to raise special bonds to swap out hidden debt.

Local governments derive a large portion of their revenue from land sales. In late 2020, the "Three Red Lines" regulation introduced by the Chinese government resulted in a deleveraging of the property sector, with many private sector developers facing severe stress. These firms lacked both the appetite and ability to increase their land banks, leading to a cascading impact on local government finances.

This dynamic led to an inability of local governments to pay public servants, as well as an elongation of receivables for construction companies, who consequently lacked the means to pay their suppliers and subcontractors. This downward spiral contributed to the chilling effect on consumer confidence we have observed in recent years. It also made previous attempts to stimulate the economy ineffective, as consumers simply saved any benefits accrued through economic stimulus.

The Chinese government has also discussed potential fiscal stimulus, designed to support domestic economic growth and provide a buffer against external uncertainties, particularly in the wake of a new US administration. Market participants await further details of the composition and scale of fiscal support, with the closely watched Central Economic Work Conference (CEWC) in mid-December potentially carrying more information on fiscal support into 2025.

In addition to economic policies, China has committed to stabilizing property and capital markets. This is an important signal and shift in tone, as the government has previously targeted a deleveraging of the property sector and has lacked a sense of urgency around the substantial underperformance of Chinese equity markets from 2021-2023.

We do not expect a return to the type of property market stimulus witnessed during the 2010s, but rather a move to improve consumer confidence, particularly in tier-1 cities. With many developers facing impairments to their balance sheets, we do not expect a significant inflection point for new property starts, but rather an increasing focus on secondary sales and completions of properties that are already under construction.

Early signs of capital market stability were found earlier in 2024, as Chinese companies increasingly emphasized dividends and stock buybacks, as a significant valuation discount and lack of opportunities to deploy capex naturally led to a greater focus on shareholder returns.

The market has been anxiously awaiting policy announcements, with the expectation that the US election result will lead to a more aggressive fiscal response, given the prospect of heavier tariffs from a Trump administration. The details and implementation in this announcement have the potential to support the recent signs of positive sentiment towards Chinese stocks. If the announced policy steps disappoint, a possibility given the potential constraint imposed by a strengthening US dollar, we expect sentiment towards the Chinese market to deteriorate.

In October, the strategy neutralized its China weighting to be more in-line with the benchmark at 9.53%. Recent additions to the portfolio include a cement company and a producer of hydraulic pumps and valves. Within our growth bucket framework, the majority of the strategy's exposure lies within the Cyclical and Recovery buckets.

The notable exception to this is a long-held position in a leading biotech firm. Since May 2024, this company has achieved significant milestones in its oncology pipeline. In September, the company reported that Phase III trials demonstrated superior efficacy over its multinational competitor for first-line treatment of non-small cell lung cancer, reducing the risk of disease progression or death by 49%.

While regulatory concerns have impacted other players within this sector, this company has bucked this trend, entering into a collaboration and license agreement in 2022 with a US-based company, granting exclusive rights to develop and commercialize its oncology therapy in the United States, Canada, Europe, and Japan, in return for an attractive up-front payment and royalty.

While China has proven challenging for many investors to navigate, we expect that the recent change in policy stance should augur more favorably for growth in the quarters ahead. That said, we do not meaningfully deviate from the conclusions outlined in our August commentary longer-term. We continue to anticipate meaningful challenges from changing demographics, protectionism, and excess capacity in certain industries, and on a structural basis, we continue to favor other countries and themes within emerging markets.

Until next month,

Chad Cleaver, Lead Portfolio Manager
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