Stone Harbor INVESTMENT PARTNERS

2021 Emerging Markets Debt Outlook

By Jim Craige CFA Co-CIO, Head of Emerging Markets

2020 Market Review

Last year was marked by large disruptions in the financial markets and an unprecedented level of volatility across risk assets triggered by the coronavirus pandemic, followed by a gradual recovery in global growth and strong performance across credit markets. While credit markets have experienced similar market dislocations before—for example, during the 2008 and 2009 global financial crisis—the magnitude and velocity of the March/April 2020 selloff was much more dramatic. During the March/April decline, the CBOE Volatility Index soared to 83 from 14 at the end of 2019, and the S&P 500 Index fell over 30%.

Ultimately, some developing countries, including Ecuador and Argentina, restructured their external sovereign debt; and others, including Lebanon and Zambia, are in the process of doing so. However, as has happened in virtually every significant volatility event in emerging markets ("EM") over the past 30 years, EM debt staged a significant recovery as the fear subsided. The widespread defaults that markets were pricing in March failed to materialize, and by year-end, EM debt returns turned positive for the year in hard currency, local currency, and corporate debt.

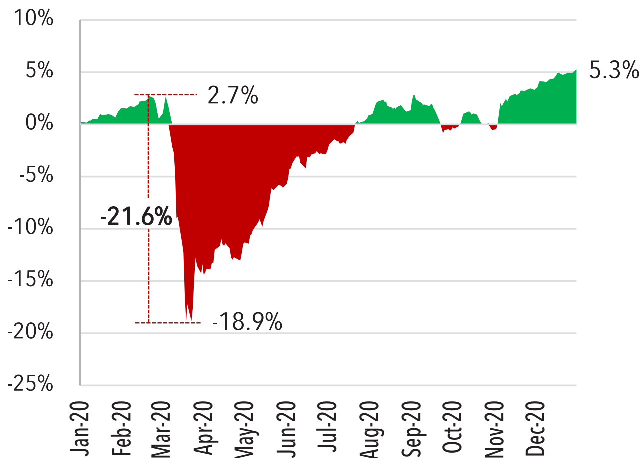
Rapid and comprehensive government and central bank intervention globally played a critical role in helping to mitigate some of the economic damage. Fiscal support targeting pandemic relief amounted to roughly 6% of global Gross Domestic Product ("GDP")—approximately four times the amount expended during the global financial crisis in 2008/2009. The US Federal Reserve ("Fed") implemented aggressive monetary easing, including corporate bond purchases, and set in motion various crisis era liquidity facilities. At the same time, the European Central Bank accelerated the purchase of government bonds, while the Bank of Japan increased its asset purchases. In other advanced economies, central banks that had policy rates above zero moved to cut them.

Across emerging markets, policy makers also implemented monetary easing by cutting rates significantly and in many cases intervened to support proper market functioning. Since inflation remained low in most EMs, EM central banks were in a better position than in prior crises to cut policy rates and avoid the vicious cycle of tightening domestic liquidity to defend exchange rates. The subsequent recovery in global financial markets, while not uniform due to various country-specific pandemic factors, was in large part supported by substantial policy support.

What we continue to anticipate is that as economies recover, global demand will improve, which will further benefit EMs. In addition, as global financial conditions improve, this should have positive growth implications for EMs. As the economy recovers, we anticipate that non-investment grade assets should outperform investment grade issues as relative spread levels are still more attractive than we have experienced during prior crises. We believe further spread compression, and therefore capital gains, are likely to develop in the months ahead.

Durring the March/April decline, emerging market credit spreads, interest rates, and currencies suffered large drawdowns. Peak-to-trough during the month of March the average total return on external sovereign debt declined roughly 22% as spreads widened 433 basis points ("bps"). The high yield ("HY") segment of that market widened 723 bps for a -29% total return. The market recovery, however, has been strong since the depths of the crisis with the overall market and high yield segment ending the year with positive returns (figure 1), and only 61 bps and 121 bps wider respectively, for the year.

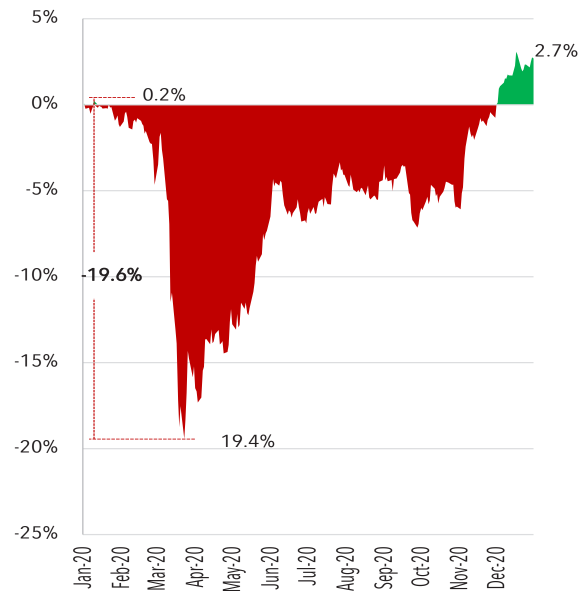
Figure 1: **EMBI Global Diversified (USD Sovereign) Total Return**



As of 31 December 2020.
Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners LP
Benchmark: J.P. Morgan EMBI GD
Past performance is not a guarantee of future results.

In local currency debt, after a 141 bps selloff during March, yields recovered to end 2020 at a record low of 4.22%. EM foreign exchange ("FX") declined approximately 16% during the selloff, recovering some to end the year still down over 5%. After generating negative returns for most of 2020—with over a 19% decline in March. By December, EM local market returns had moved into positive territory for the year (figure 2).

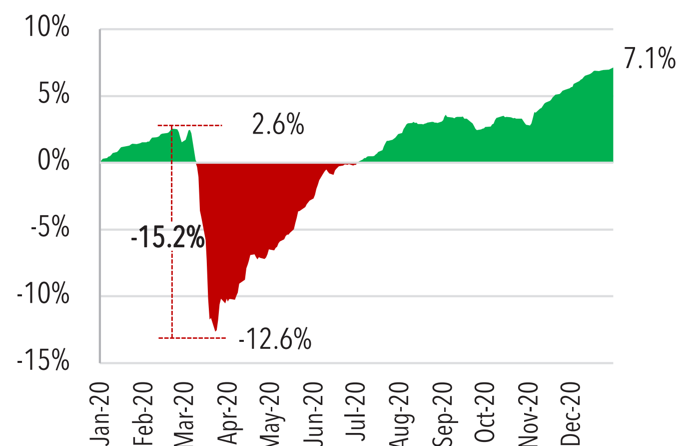
Figure 2: **GBI-EM Global Diversified (Local Market) Total Return**



As of 31 December 2020.
Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners LP
Benchmark: J.P. Morgan GBI-EM GD
Past performance is not a guarantee of future results.

EM corporate debt experienced 401 bps of widening (-15% total return) during the selloff, with the HY sector widening 650 bps (-23%). The recovery was significant, however, with spreads of the broad index and high yield portion of the index recovering 382 bps and 614 bps, respectively. This spread retracement lead to positive returns of 7.1% for the index and 6.6% for HY (figure 3). For the year, EM corporate debt again exhibited less volatility than US HY.

Figure 3: **CEMBI Broad Diversified (USD Corporate) Total Return**



As of 31 December 2020.
Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners LP
Benchmark: J.P. Morgan CEMBI BD
Past performance is not a guarantee of future results.

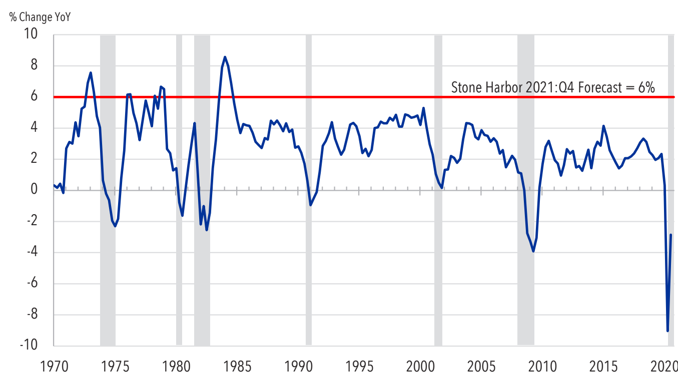
2021 Developed Markets Backdrop

Economic activity remains heavily dependent on the success of the vaccine rollout over the next several months. Latest indications suggest that after a slow start, the pace of vaccination has picked up, and we believe that improvements will likely continue. Even without everyone vaccinated, the pace of deaths is likely to slow as the portion of the population at highest risk of contracting the virus is inoculated first, and that could help activity moving forward.

In addition, the prospect of meaningful additional fiscal stimulus in the US, beyond the US$900 billion already passed in late December, is supportive. The new round of stimulus could include additional aid to state and local governments, as well as further extensions and supplements to unemployment insurance.

Our current base case assumes a slow growth that transitions to a sharp vaccine-led rebound, bolstered by additional fiscal spending. Central to this outlook is that even if activity slows further during the winter months due to rising virus cases, we anticipate catch up growth as vaccine rollout gains momentum. By Q4 2021, we forecast year-over-year (YoY) real GDP growth of 6%, the fastest pace in nearly four decades (figure 4). We see similar, although not quite as strong, growth potential in other developed market economies.

Figure 4: **Forecast 6% Growth Would Be Fastest in Nearly Four Decades**



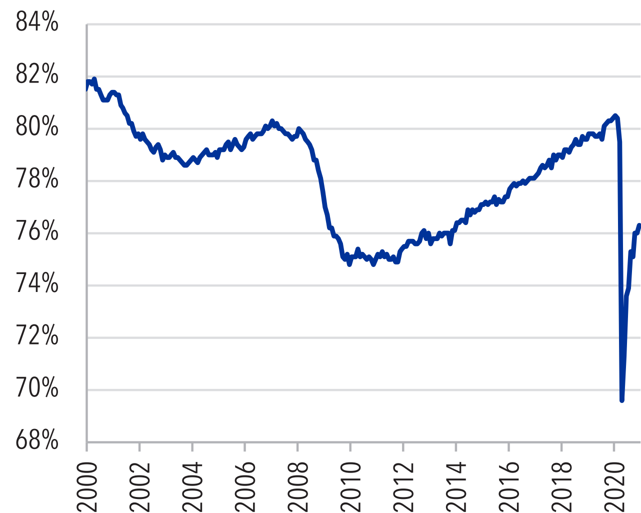
As of 31 December 2020
Sources: BEA, Haver Analytics, Stone Harbor Investment Partners LP
Grey bars represent periods of recession

As we consider the path of US economic recovery, we see some similarities to how growth unfolded in the 1980s. In that environment, the high rates needed to curb inflation restrained economic activity; and when rates were loosened, the economy experienced a rapid acceleration. In the current environment, the restraint is Covid-19, and in our view, vaccination could similarly loosen the restraint, leading potentially to robust growth.

One key component we continue to watch closely is the US labor market. Chairman Powell recently described the labor market that the US Fed is looking to duplicate: the one that existed in December 2019, before the coronavirus shock. To get there will take some time, even with very rapid job growth relative to history.

Headline measures, such as the unemployment rate, currently understate the full impact of the economic slowdown. As seen in figure 5, employment-population ratios remain significantly depressed as labor force participation has shrunk due to the suppressed activity levels in industries most affected by virus restrictions – e.g., airlines, hotels, and restaurants.

Figure 5: **Employment-Population Ratio: 25-54 Years (SA, %)**



As of 31 December 2020
Sources: BEA, Stone Harbor Investment Partners LP
For illustrative purposes only. The information above contains forecasts

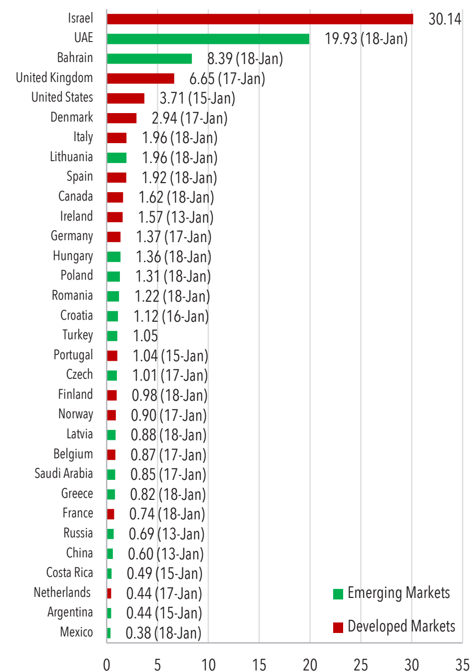
Achieving the Fed's goal of returning to the pre-pandemic labor market will require not just making up the jobs lost, but also those that normally would have been added over the past year. In other words, the needed employment growth is two-fold: 1) gain 2 million jobs to offset the jobs lost during the course of the pandemic, and 2) add approximately 160 thousand jobs per month until we reach the 2019 year-end level. During the recovery from the last recession, the single best 12-month period of growth saw job gains that averaged approximately 260 thousand per month, with most monthly average gains closer to 200 thousand per month. At that pace, it would take until 2031 to reach the pre-Covid-19 labor market.

If the pace of job gains doubles to 500 thousand per month, we could potentially reach the pre-pandemic labor market in late 2023. Could the economy do even better? During the early 1980s recovery, the US economy maxed out at 400 thousand jobs per month, equivalent to about 650 thousand jobs per month now. That sort of very robust labor market growth would take the labor market back to the desired level by late 2022. This assumption underscores the broad expectation that policy rates are going to remain pegged at zero for quite some time, in our view.

2021 Emerging Markets Backdrop

Covid-19 infection and death rates remain much lower in most EMs relative to DMs. ***Importantly, as coronavirus vaccines are rolled out across the globe, EMs are not being left behind.*** In fact, two of the top three countries in terms of per capita vaccinations are EMs (figure 6). Two regions also stand out: Central and Eastern Europe (CEE), and the Middle East. CEE countries have seen the highest Covid spread among EMs and have managed to secure supplies of the first available vaccines approved for distribution (i.e., Pfizer, Moderna) in developed markets. Middle Eastern countries have relied more on collaboration with China and are now deploying several Chinese vaccines. In addition to these countries, several large EMs are moving ahead with their own vaccines, notably China, Russia, and India; while Brazil has also collaborated with China and is planning to produce 1-2 million doses per day.

Figure 6: **Covid-19 Vaccination Doses Administered per 100 People**



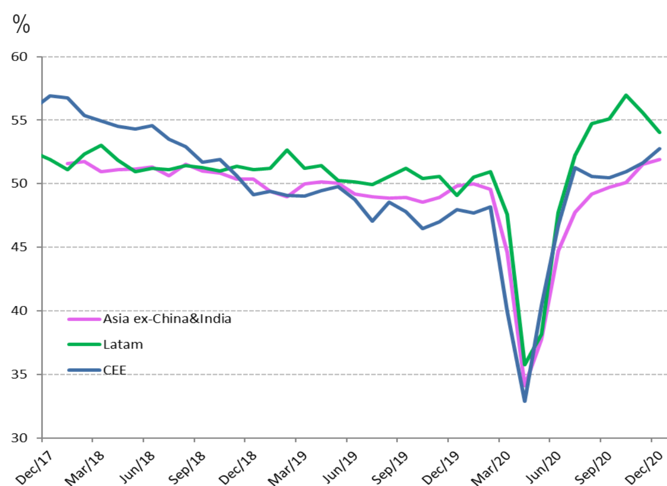
As of 18 January 2021
Counted as a single dose per 100 people, and may not equal the total number of people vaccinated
Sources: Johns Hopkins University, Our World in Data, Stone Harbor Investment Partners LP
For illustrative purposes only

Once additional one-dose vaccines with less stringent cooling requirements become available later this year, we expect significant further progress across EMs.

With vaccine progress underway, recovery dynamics – not Covid-19 – will be the dominant economic driver in 2021, in our view.

Sensitivity of economic activity to virus spread has already declined sharply across the globe. Based on the latest available data, we have seen no notable impact from the winter Covid-19 wave on manufacturing Purchasing Managers Index ("PMIs") in CEE so far (figure 7). In Latin America, economies expanded sharply in Q3 even as Covid-19 spread intensified. Nevertheless, output gaps remain wide in many EMs, providing runway for further improvement in activity.

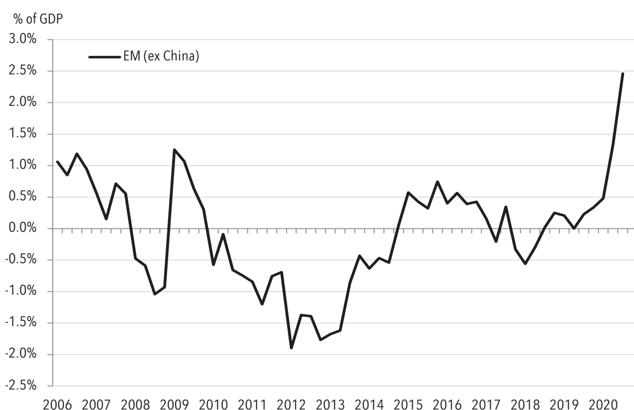
Figure 7: **PMIs: EM**



As of 31 December 2020
Sources: Bloomberg, IBGE/H, INEGI, CSO/H, Haver, Stone Harbor Investment Partners LP
For illustrative purposes only

The average current account balance for emerging market countries (ex-China) improved by 2% of GDP in 2020, raising the surplus to 2.5% from Q1 to Q3, the highest level in at least 15 years (figure 8). This development is remarkable considering the loss of revenues from tourism and oil for some countries. External positions have improved in several countries, including Mexico, Brazil, South Africa, Poland, Ukraine, Malaysia, Indonesia, and Philippines, as a result of competitive EM currency valuations and fiscal and monetary stimulus in key DMs. Current account surpluses further reduce external financing requirements for EM sovereigns, an additional support for EM debt, in our view.

Figure 8: **Current Account Balance**

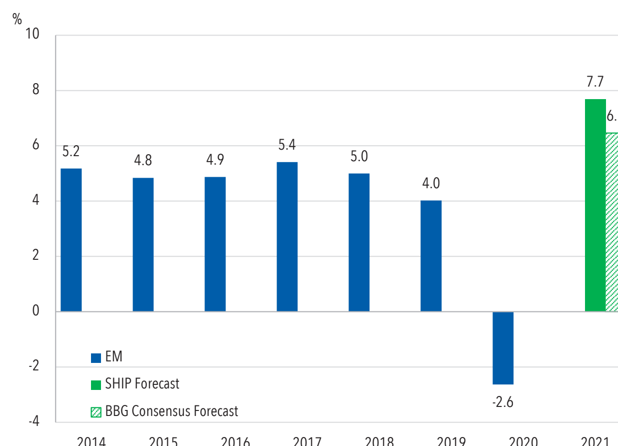


As of 31 December 2020
Sources: Bloomberg, Haver, Stone Harbor Investment Partners LP
For illustrative purposes only

The global backdrop remains very supportive in light of strong expansion in DMs, continued monetary and fiscal stimulus in DMs, strong economy in China, and supportive commodity prices.

We forecast a strong EM recovery in 2021—above current market consensus, and project annual growth of 7.5-8.0% (figure 9). EM growth consensus forecasts have barely changed since the summer (from 6.0% to 6.5%) despite stronger data and we believe consensus will eventually move in line with our expectations. While Covid-19 trend and vaccination progress will affect the timing, we believe EM recovery will remain on track in 2021. The stronger growth will enable positive feedback loops and provide support for fiscal adjustment, in our view.

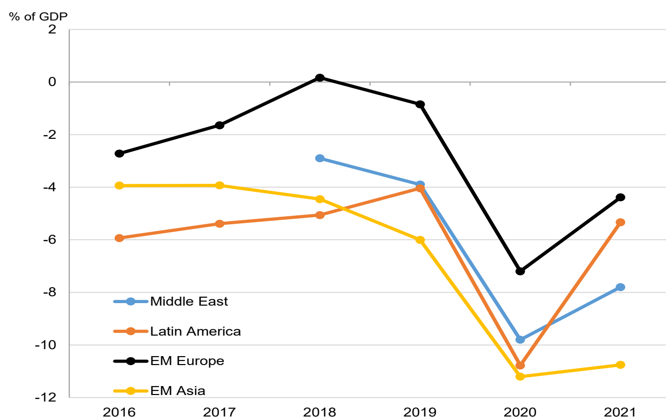
Figure 9: **EM GDP Growth**



As of 31 December 2020
Sources: Bloomberg, Haver, Stone Harbor Investment Partners LP
For illustrative purposes only. The information above contains forecasts

A key priority for many EMs in 2021 is fiscal adjustment. As a result, we anticipate government fiscal balances to improve significantly this year (figure 10). In addition, we expect the fiscal picture to improve as emergency spending programs moderate. Relative to the International Monetary Fund's ("IMF") World Economic Outlook ("WEO") forecast, we project better growth performance based on the view that oil prices will likely run well ahead of the WEO forecast of US$47 in 2021, and that less fiscal adjustment will be needed in Asia, driven mostly by China.

Figure 10: **Fiscal Balance**



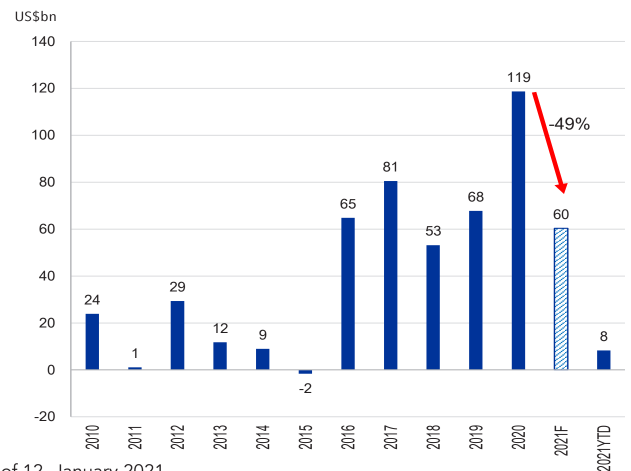
As of 31 December 2020
Sources: IMF WEO, Stone Harbor Investment Partners LP
For illustrative purposes only. The information above contains forecasts.

The combination of better growth and prioritization of fiscal adjustment will, in our view, result in improved fiscal balances in 2021.

EM USD Sovereign Debt – Outlook

Our USD sovereign debt outlook combines the expectation of improving fundamentals with attractive technical conditions in the months ahead. A rebound in growth from pandemic levels, we believe, will enhance government revenues, supporting capacity to pay. The attention to fiscal consolidation from many EM governments will further demonstrate willingness to pay and is likely to translate into tighter sovereign credit spreads. The average fiscal balance is projected to improve by 2.5% of GDP in 2021 vs 2020, with 85% of EM sovereigns forecasted to have a better fiscal balance in 2021 than in 2020. This in turn is projected to lead to a 49% decline in net external debt financing for 2021 (figure 11).

Figure 11: **Net Financing**

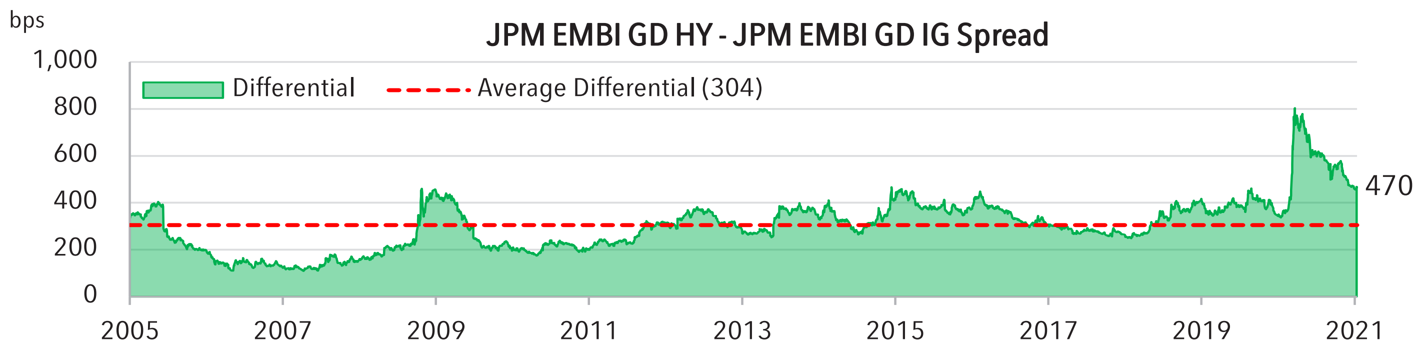


As of 12 January 2021
Sources: J.P. Morgan, Stone Harbor Investment Partners LP
Net Financing = Net issuance less coupons and amortizations on existing debt
For illustrative purposes only. Data above contains forecasts

The HY segment experienced a more significant dislocation during 2020 compared to the investment grade segment ("IG") and HY valuations remain compelling. While IG spreads have mostly recovered, HY spreads have lagged and are significantly wider than IG with relative spreads still wider than the 2008/2009 crisis peak (figure 12).

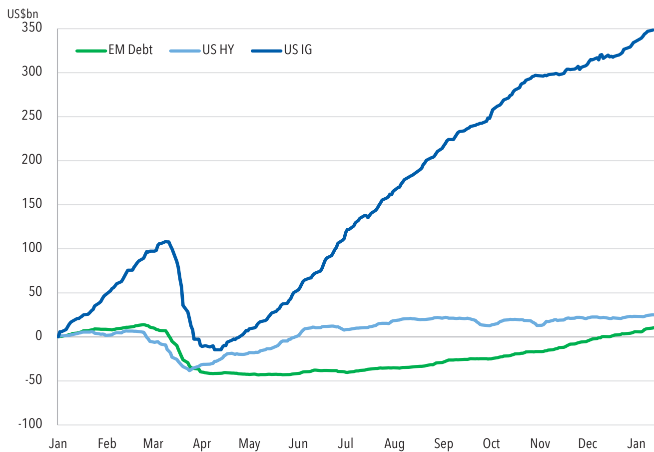
In terms of EM debt technicals, portfolio inflows gained momentum late in 2020—ending the year at US$20 billion—but have lagged flows to US HY and US IG corporates. In the first two weeks of January 2021, however, inflows into EM debt funds exceed US$5 billion. Given the low yield environment, we expect that this trend will continue and anticipate inflows significantly above average for 2021 (figure 13).

Figure 12: **Significant Dislocation between EM Sovereign HY and IG Sectors**



As of 19 January 2021. Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP
Benchmark: J.P. Morgan EMBI Global Diversified HY, J.P. Morgan EMBI Global Diversified IG
Please refer to endnotes for benchmark definitions. Past performance is not a guarantee of future results. For illustrative purposes only.

Figure 13: **Portfolio Flows 2020 and 2021 YTD**

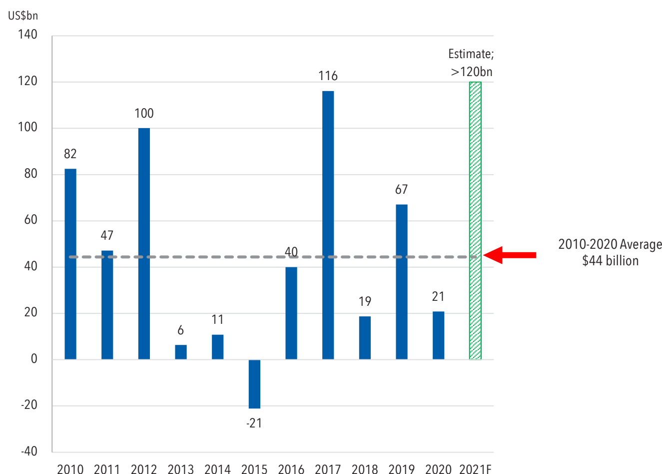


As of 13 January 2021
Sources: EPFR Global, Stone Harbor Investment Partners LP
For illustrative purposes only

Factors that we believe support 2021 EM debt inflows include: 1) EM vs DM growth advantage, 2) EM vs DM yield advantage, and 3) stronger commodity prices, which favor EM terms of trade.

Our inflow estimate for 2021 excludes potential allocations from underinvested institutional investors, and our US$120 billion estimate may turn out be conservative (figure 14). The timing of inflows reflects the process of manager searches and board approvals. Current inflow momentum suggests that existing investors are adding to their EM debt exposure now.

Figure 14: **Annual EMD Flows and 2021 Estimates**



As of 13 January 2021
Sources: EPFR Global, Stone Harbor Investment Partners LP
For illustrative purposes only

The combination of portfolio inflows and elevated cashflows from existing debt provide steady sources of reinvestment into EM bonds. Furthermore, gross issuance and net financing of external sovereign debt will decline this year compared to 2020 on the back of lower fiscal needs as pandemic spending eases, providing a supportive technical backdrop. Our base case for 2021 forecasts the overall index to return 8.3% with the HY sector generating 12.7% returns (figure 15).

Figure 15: **12-Month Projected Returns for External Sovereign Debt**

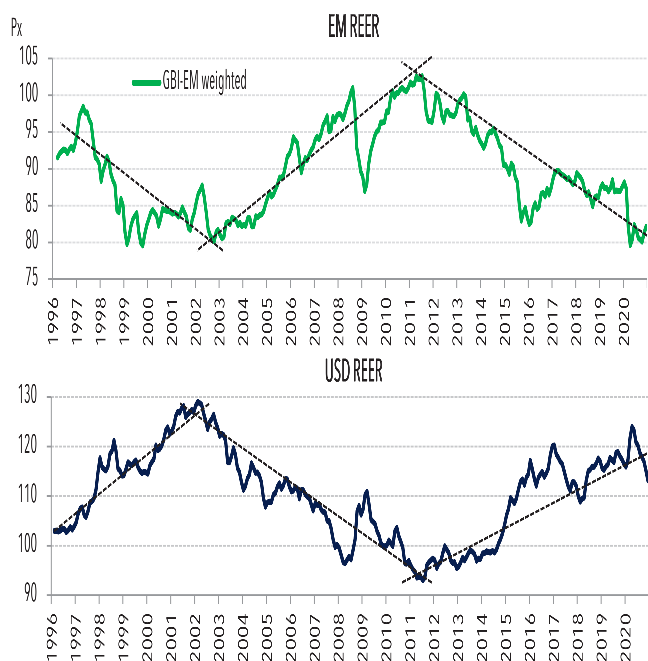
12-Month Projected Returns for External Sovereign Debt				
	Yield	Current Spread	Forecasted Spread	Total Return
EMBIG	4.8	358	315	8.3
HY	7.2	622	540	12.7
IG	2.9	152	145	3.5

As of 19 January 2021. Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP
These return projections should not be viewed as a prediction of the performance of any Stone Harbor strategy or managed portfolio. The projected returns represent the Stone Harbor portfolio management team's base case return scenario estimates for each hard currency sovereign debt market included in the J.P. Morgan EMBI GD based on our analysis of several scenarios. The base case return projections summarize the 12 month return projections of the management team for the hard currency sovereign debt market based on our analysis of several scenarios. The returns of the index, and the issues that comprise the index, may be substantially lower than our estimates, and may be negative. Past performance is not a guarantee of future results. Provided for illustrative purposes only.

EM Local Currency Debt – Outlook

A weaker US dollar and low global rates provide significant support for EM local markets. Against this backdrop, however, we experienced underperformance in emerging market FX during 2020 (-5.2%). We believe the majority of this underperformance was related to risk-off fears due to the pandemic. Currently, EM real effective exchange rates ("REER") are at multi-decade lows (figure 16), and EMFX has not seen the full benefit of the recent global FX trend. We anticipate the fundamental push from the macro improvement and weaker USD, and the valuation pull given the FX depreciation make EM local markets attractive.

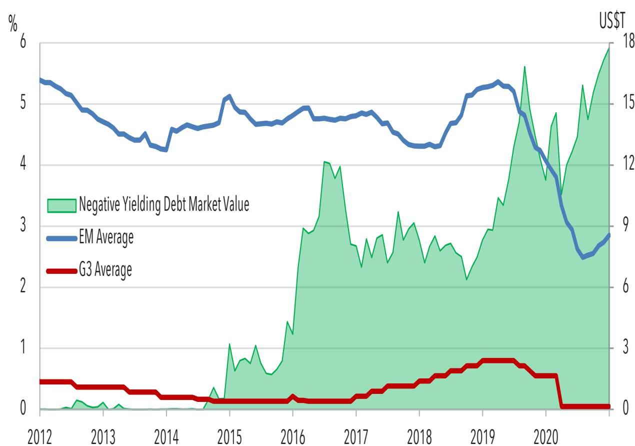
Figure 16: **EM REER vs USD REER**



As of 31 December 2020
Sources: Bloomberg, Haver, Stone Harbor Investment Partners LP
For illustrative purposes only. Past performance is not a guarantee of future results

We also believe EM rates are attractive. Low inflation has allowed significant central bank rate cuts and bond purchases in both the DM and EM markets. Helping EM rate attractiveness is the fact that, DM policy rates have moved to and in some cases past zero, which has increased the negative yielding debt stock significantly. EM policy rates, which have not kept pace with the DM move, have room for further rate declines (figure 17).

Figure 17: **EM vs G3 Policy Rates And Negative Yielding Debt**

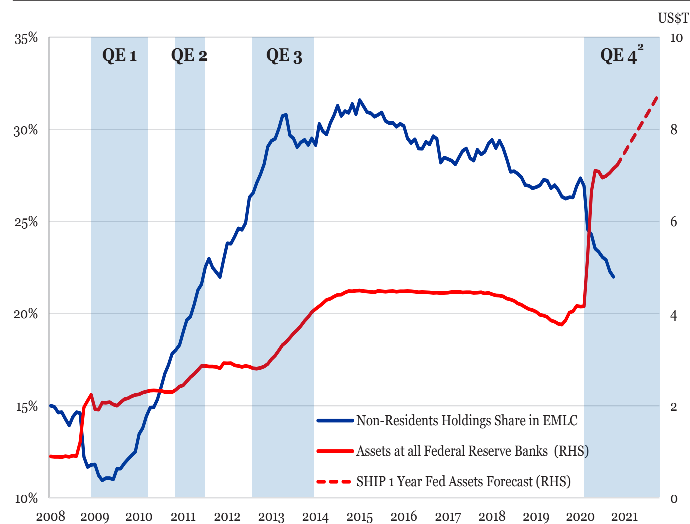


As of 31 December 2020
Sources: Haver, J.P. Morgan, Stone Harbor Investment Partners LP
Benchmark: J.P. Morgan GBI-EM Global Diversified
For illustrative purposes only

Similar to the hard currency market, we also anticipate a favorable technical environment and believe foreign investor positioning for local currency debt is light but is set to increase.

In support of this view, we are perhaps at the beginning of a reversal of a 10-year dollar bull market and a long-term secular trend of dollar weakness against EM currencies. The shift by the US Fed from quantitative tightening to quantitative easing provides an attractive entry point in the medium-term. Foreign ownership of EM local currency bonds increase during periods of US quantitative easing. As a historical reference, the launch of QE1,QE2, and QE3 coincided with a sharp increase in non-resident inflows to local currency debt (with a lag of eight months). We project a similar increase of demand for local bonds in 2021 assuming the Fed expands QE4 (figure 18). Meanwhile, global growth should also support the rise in global trade. As we have seen in the past, strong trade growth carries the potential to drive a weaker dollar, which should benefit EM currencies.

Figure 18: **Non-Residents' Share in EM Local Government Debt and US Federal Reserve Assets**



As of 30 November 2020. Sources: Credit Suisse, Stone Harbor Investment Partners LP
Weighted by non-residents' dollar value of holdings (% of total). Includes Stone Harbor projections
QE1 Period: Dec 2008 – Mar 2010, QE2 Period: Nov 2010 – June 2011, QE3 Period: Sep 2012 – Dec 2013, QE4 Period: Mar 2020 – onwards
Shading above represents periods of increases in quantitative easing.
For illustrative purposes only.

In our 12-month base case projected returns for local currency debt, we anticipate a total return of 9.1%, comprising 4.2% from spot FX and 4.9% from carry plus duration (figure 19).

Figure 19: **12-month Projected Returns for Local Currency Debt**

12 Month Base Case Projected Returns for Local Currency Debt	
Spot FX	4.2%
Carry Plus Duration	4.9%
Total Return	9.1%

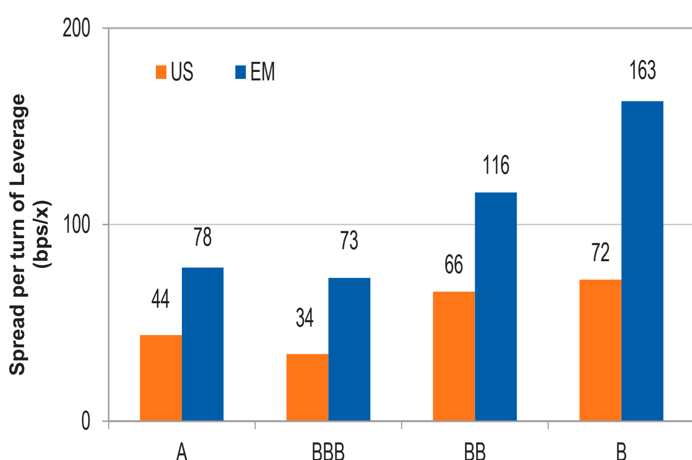
As of 19 January 2021. Sources: J.P. Morgan, Stone Harbor Investment Partners LP
These return projections should not be viewed as a prediction of the performance of any Stone Harbor strategy or managed portfolio. The projected returns represent the Stone Harbor portfolio management team's base case return scenario estimates for each local currency sovereign debt market included in the J.P. Morgan GBI-EM GD based on our analysis of several scenarios. The returns of the index, and the issues that comprise the index, may be substantially lower than our estimates, and may be negative. Past performance is not a guarantee of future results. Provided for illustrative purposes only.

EM Corporate Debt – Outlook

EM corporate debt has consistently provided excess yield over US HY with a better risk/return profile than US HY. Currently, the yield premium of 120 bps is wider than the five-year historical average and we believe is even more compelling in the context of historically low US Treasury rates.

Comparing EM corporates relative to US HY corporates, we also note EM corporates generally offer more spread relative to their leverage risk than US corporates. The spread for turn of leverage – a common credit metric – is higher for EM corporates relative to US HY (figure 20).

Figure 20: **Spread per Turn of Leverage (bps)**



As of 31 December 2020. Sources: Bloomberg, ICE BofAML, J.P. Morgan
Net Leverage = Total debt less cash and marketable securities divided by EBITDA
1 Fundamental data as of 30 June 2020. Spreads as of 31 December 2020. Based on an unbiased sample of ICE BofAML Global EM Corporate Bond index (EMCB), sample size is 730
Past performance is not a guarantee of future results. For illustrative purposes only.

What we believe is also compelling about EM corporates is that they have historical default rates less than half the level of US high yield while also exhibiting a similar level of recovery rates (figure 21). Further, EM corporates have demonstrated less volatility than their US peers over the past 15 years.

Figure 21: **Historical Default & Recovery**

	Historical Default Rates[1]	2020	2021F	Average Recovery Rate Since 2000
EM Corps HY	2.5%	3.5%	2.5%	38%
US HY	6.0%	6.8%	3.5%	40%
European HY	2.2%	3.3%	2.0%	32%[2]

As of 31 December 2020. Sources: Bloomberg, ICE BofAML, J.P. Morgan
Average default rate from 2006
Past performance is not a guarantee of future results. For illustrative purposes only.

In our view, EM corporates are well positioned to benefit from the macro themes we expect in 2021. We anticipate that the rebound of the global economy will provide a boost to economic activity in key emerging markets, as well as a boost to commodity prices. Additionally, a weaker US dollar and stronger local currencies, will serve to deleverage corporates that have been negatively impacted by weaker FX in 2020.

Given this backdrop and our base case outlook, we believe the spread of the EM corporate index will tighten 26 bps with the majority of the tightening coming from the HY sector. We project the overall index to return 5.4% over the next 12 months (figure 22).

Figure 22: **12-Month Projected Returns for EM Corporate Debt**

12-Month Base Case Projected Returns for EM Corporate Debt				
	Yield	**Current Spread**	**Forecasted Spread**	**Total Return**
CEMBI BD	4.17	266	240	5.4
HY	5.97	489	440	7.5
IG	2.95	163	155	3.4

As of 19 January 2021. Sources: J.P. Morgan, Stone Harbor Investment Partners LP
These return projections should not be viewed as a prediction of the performance of any Stone Harbor strategy or managed portfolio. The projected returns represent the Stone Harbor portfolio management team's base case return scenario estimates for each hard currency corporate debt market included in the J.P. Morgan CEMBI BD based on our analysis of several scenarios. The base case return projections summarize the 12 month return projections of the management team for the hard currency corporate debt market based on our analysis of several scenarios. The returns of the index, and the issues that comprise the index, may be substantially lower than our estimates, and may be negative. Past performance is not a guarantee of future results. Provided for illustrative purposes only.

Conclusion

We expect a strong recovery across the globe in 2021 in our base case assumptions. This is likely to be a synchronized global recovery after one of the worst global recessions we have faced since WWII. We anticipate 6% growth for the US and 8% for the emerging markets for 2021. This will help the top line numbers, certainly, but should also help risk sentiment and flows as well.

We also do not expect inflation to be an issue. DM central banks should look through the uptick in inflation we expect in Q2 as the year-over-year comparison vs 2020 will be viewed as a Covid anomaly. We expect inflation back below 2% by mid-summer. Central banks are likely to remain very supportive and will err on the side of being more willing to let their economies recover. This crisis needed a crisis response and we believe central banks will remain in this mode until the market dislocation is well behind us.

The Democratic victories in Georgia should lead to more, not less fiscal stimulus. We anticipate the first half of 2021 to bring a combination of employment increases, reduced savings rates and increased spending, evidence the positive vaccine effects are real, and fiscal and monetary stimulus. This is positive for growth and risk assets.

Finally, we believe developed market rates will remain low. Central bankers, and the Fed in particular, understand we have a long way to go to get back what was lost and we are still facing secular factors that are significant headwinds to any meaningful increase in rates. Population growth and demographic changes to name two are not likely to change for decades.

This is a good environment for risk assets, in our view, and a really good environment for the emerging markets.

As a result, we expect a weaker dollar and strengthening commodity prices, which should help EM foreign exchange. Our bias is to seek to take advantage of the selloff in EM FX in 2020. We also think lower-rated credits on average are likely to do well in this environment. It often pays to be defensive during periods after you have had the economic boom, low unemployment levels, and tight spreads. In our view, we are not there. We believe we are at the beginning of this recovery when higher yield historically outperforms lower yield.

Summary Observations and Expectations

- Strong recovery in GDP across the globe – synchronized
- Inflation is unlikely to be a problem – will bounce but not for long
- Continued monetary stimulus – very supportive central bank policies
- Continued fiscal stimulus – likely to increase
- Developed market yields to remain very low – search for alternative investments
- Strengthening commodity prices
- Strengthening EM FX
- Higher yield, lower-rated credits outperform lower yield, defensive credits
- Continued rotation into real return seeking assets
- Significant demand for Emerging Markets Debt

2021 Portfolio Strategy and Positioning

Based on our observations and expectations, the primary themes guiding our investment ideas across various EMD portfolios include the following:

- Neutral duration
- Overweight HY vs IG
- Overweight Latin America and Africa
- Underweight Asia and Europe
- Overweight local vs hard currency
- Underweight traditional corporates vs green bonds and hard currency sovereign

We also expect a shift into real return seeking assets including emerging markets debt. Savers, pension funds, benefit plans, and others still have income needs that are hard to meet with rates this low and in many cases negative. Given this outlook, we have the following position biases in the portfolios we manage:

2021 Investment Opportunities Highlights

Below are characteristics of our representative portfolio positioning across these EMD sectors:

	Yield (%)		Rating		Notable Deviations	
Strategy	Portfolio	Relative	Portfolio	Benchmark	O/W	U/W
EM Hard Currency Sovereign Debt	5.6	+1.6	BB	BB+	Angola, Argentina, Mexico, Romania	China, Philippines, Poland
EM Local Currency Sovereign Debt	4.5	+0.4	BBB+	BBB+	SOAF Duration, RUB, BRL	HUF Duration, THB, MYR
EM Corporate Debt	4.6	+1.0	BB	BB+	SOAF, Mexico, Malaysia	Qatar, Chile, Philippines
ESG	3.8	+0.4	BBB	BBB	Corporate green bonds, BRL, RUB	Saudi, Philippines, Brazil HC

As of 12 January 2021.
Sources: Stone Harbor Investment Partners LP
Representative portfolio positioning information is only current as of the date shown and is subject to change. Each client account is individually managed; actual holdings will vary for each client and there is no guarantee that a particular client's account will have the same characteristics as described above. For illustrative purposes only.

We are neutral duration – DM rates are fair in our view and we would rather allocate the risk into credit improvement themes we like.

In our blend portfolios we are now overweight local markets versus hard currency. It is not yet a significant allocation deviation at 5% for a 50/50 portfolio. This is because we still see upside potential there is still a lot of upside potential in a number of the hard currency credits we like and want to keep right now, but you know how we are leaning.

As you can imagine, given the part of the cycle we are in, on average, we are overweight high yield versus investment grade, which manifests itself in being underweight high quality Asia and Europe versus higher yield Latin America and Africa.

While we expect a more strategic shift into EM corporates from pension funds and other traditional US high yield buyers – EM corporates are attractive relative to US HY - we are underweight traditional EM corporate debt relative to green bonds and sovereign debt.

I hope that this outlook helps you understand our views for 2021. We are all hopeful for a return to normalcy and are confident it will happen this year. Until then, we hope you have a wonderful and safe 2021.

Sincerely,

Jim Craige

World Economic Outlook Database Assumptions and Data Conventions

The World Economic Outlook (WEO) database contains selected macroeconomic data series from the statistical appendix of the World Economic Outlook report, which presents the IMF staff's analysis and projections of economic developments at the global level, in major country groups and in many individual countries. The WEO is released in April and September/October each year.

Assumptions

A number of assumptions have been adopted for the projections presented in the World Economic Outlook (WEO). It has been assumed that real effective exchange rates remained constant at their average levels during July 24 to August 21, 2020, except for those for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to have remained constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies for selected economies, see Box A1 in the Statistical Appendix); that the average price of oil will be $41.69 a barrel in 2020 and $46.70 a barrel in 2021 and will remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on US dollar deposits will average 0.7 percent in 2020 and 0.4 percent in 2021; that the three-month euro deposit rate will average –0.4 percent in 2020 and –0.5 percent in 2021; and that the six-month Japanese yen deposit rate will yield, on average, 0.0 percent in 2020 and 2021. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would, in any event, be involved in the projections. The estimates and projections are based on statistical information available through September 28, 2020

Data Conventions

Data and projections for 194 economies form the statistical basis of the WEO database. The data are maintained jointly by the IMF's Research Department and regional departments, with the latter regularly updating country projections based on consistent global assumptions. Although national statistical agencies are the ultimate providers of historical data and definitions, international organizations are also involved in statistical issues, with the objective of harmonizing methodologies for the compilation of national statistics, including analytical frameworks, concepts, definitions, classifications, and valuation procedures used in the production of economic statistics. The WEO database reflects information from both national source agencies and international organizations.

Most countries' macroeconomic data presented in the WEO conform broadly to the 2008 version of the System of National Accounts (SNA). The IMF's sector statistical standards—the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6), the Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG), and the Government Finance Statistics Manual 2014 (GFSM 2014)—have been or are being aligned with the SNA 2008. These standards reflect the IMF's special interest in countries' external positions, financial sector stability, and public sector fiscal positions. The process of adapting country data to the new standards begins in earnest when the manuals are released. However, full concordance with the manuals is ultimately dependent on the provision by national statistical compilers of revised country data; hence, the WEO estimates are only partially adapted to these manuals. Nonetheless, for many countries the impact, on major balances and aggregates, of conversion to the updated standards will be small. Many other countries have partially adopted the latest standards and will continue implementation over a period of years.

Note: Many countries are implementing the SNA 2008 or European System of National and Regional Accounts (ESA) 2010, and a few countries use versions of the SNA older than that from 1993. A similar adoption pattern is expected for the BPM6 and GFSM 2014. Please refer to Table G in the Statistical Appendix, which lists the statistical standards adhered to by each country.

The fiscal gross and net debt data reported in the WEO are drawn from official data sources and IMF staff estimates. While attempts are made to align gross and net debt data with the definitions in the GFSM, as a result of data limitations or specific country circumstances, these data can sometimes deviate from the formal definitions. Although every effort is made to ensure the WEO data are relevant and internationally comparable, differences in both sectoral and instrument coverage mean that the data are not universally comparable. As more information becomes available, changes in either data sources or instrument coverage can give rise to data revisions that can sometimes be substantial. For clarification on the deviations in sectoral or instrument coverage, please refer to the metadata for the online WEO database.

The following conventions have been used throughout the WEO:

- Domestic economy series are expressed in billions of national currency units
- External accounts series are expressed in billions of U.S. dollars.
- "Billion" means a thousand million; "trillion" means a thousand billion.
- Missing data are indicated by "n/a".
- Blank row means that data is not available or not applicable.
- "/" means between years or months (for example, 2017/18) to indicate a fiscal or financial year.
- Shading differences are used to distinguish historical results from IMF staff projections.
- Minor discrepancies between sums of constituent figures and totals shown reflect rounding.
- Data refer to calendar years, except in the case of a few countries that use fiscal years. Please refer to Table F in the Statistical Appendix, which lists the economies with exceptional reporting periods for national accounts and government finance data for each country.
- For some countries, the figures for 2017 and earlier are based on estimates rather than actual outturns. Please refer to Table G in the Statistical Appendix, which lists the latest actual outturns for the indicators in the national accounts, prices, government finance, and balance of payments indicators for each country.
- As used here, the terms "country" and "economy" do not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.
- Composite data are provided for various groups of countries organized according to economic characteristics or region. Unless noted otherwise, country group composites represent calculations based on 90 percent or more of the weighted group data.

Endnotes

Cash, and currency forward positions are assigned the AAA/Aaa rating.

Average Rating Methodology
Average bucket ratings are calculated by mapping security rating codes to numerical scores that are then weighted by security market value % within the bucket to determine a weighted average score which is then mapped back to a rating code.
The average S&P, Moody's & Fitch ratings are based on respective rating agency ratings where available. If for a particular column there is not a corresponding agency rating on any given security, a hierarchy is used to get a proxy for average rating calculation purposes. The hierarchy used is as follows: S&P ratings are used, if S&P is not available; Moody's ratings are used, if neither is available then Fitch ratings are used.
If there are no S&P, Moody's or Fitch ratings on any given security, Stone Harbor Internal Ratings (described below) will be used where available. If no rating is available for a given security, the average bucket rating calculation will treat the security as Not Rated which is "conservatively" assigned a score similar to a "D" rating.

Stone Harbor Internal Rating Methodology
1. Any existing rating from another rating agency.
2. Fundamental credit analysis – comparison of certain select credit metrics of an unrated issuer to those of a rated issuer with similar credit metrics and in the same country and/or industry, where applicable.
3. Sovereign rating of the domicile of the issuer – analysis of where the unrated issuer should be rated relative to the sovereign rating.
4. Relative subordination – in the event that we have invested in a security or loan that is unrated and senior or subordinated in the capital structure relative to other securities of the same issuer that are rated, we may adjust the senior rating up or down in a manner deemed appropriate.
5. Relative debt market pricing / spread analysis – comparing pricing & spreads of the unrated issue with those of comparable rated issues. Credit derivative pricing of unrated issues or companies may also be used to develop an internal rating.
6. Internal ratings are generally reviewed at least every quarter or more frequently subject to any issuer credit events.

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index. Unless otherwise stated, benchmark performance and characteristics are indicated in this material for information purposes only as the relevant strategy does not intend to track a benchmark. Fund performance and holdings can deviate from the strategy's indicated benchmark.

Benchmark Definitions:
The J.P. Morgan CEMBI Broad Diversified tracks total returns of US dollar-denominated debt instruments issued by corporate entities in emerging market countries and consists of an investable universe of corporate bonds. The minimum amount outstanding required is $350 mm for the CEMBI Broad Diversified. The CEMBI Broad Diversified limits the weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding.
The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.
The J.P. Morgan GBI-EM Global Diversified consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within this index.
The ICE BofAML US High Yield Constrained Index (HUC0) contains all securities in ICE BofAML US High Yield Index but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face values of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. In the event there are fewer than 50 issues in the Index, each is equally weighted and the face values of their respective bonds are increased or decreased on a pro-rata basis.

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- Each client's portfolio is individually managed and may vary from the information shown in terms of allocations, portfolio holdings, characteristics and performance. Current and future portfolio compositions and performance may be significantly different. Any securities, sectors or allocations referenced may or may not be represented in portfolios of clients of Stone Harbor or its affiliates, and do not

Endnotes

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- Investments in emerging markets securities are subject to risks arising from political or economic instability, nationalization or confiscatory taxation, currency exchange restrictions and an issuer's unwillingness or inability to make principal or interest payments on its obligations. Investing in emerging markets may involve relatively higher degrees of volatility. Such investments are also subject to currency risk. The value of an emerging markets debt strategy's investments may fall as a result of changes in exchange rates. Because an emerging markets debt strategy generally may invest a portion of its assets in investments denominated in non-US currencies or investments whose returns are linked to those currencies, such strategies are especially susceptible to currency risk. More generally, fixed-income investments are subject to certain risks such as interest rate, inflation, and credit risks. These risks and others may materially impact the ability of Stone Harbor to achieve its stated investment objectives for a given strategy.

- The base case return projections described herein summarize the 12 month return projections of the management team for the local currency sovereign debt market based on our analysis of several scenarios. Our base case return projections assign a 65% probability to the assumption that the economy endures a slow grind followed by a vaccine-led rebound. Our analysis can be provided upon request. Stone Harbor believes the targeted or projected returns set forth herein are reasonable based on a combination of factors, including the investment team's general experience and assessment of prevailing market conditions and investment opportunities. There are, however, numerous assumptions that factor into the targeted or projected return that may not be consistent with future market conditions and that may significantly affect actual investment results. Such assumptions include, but are not limited to, 1) current monetary policy, inflation expectations and other fundamental and technical factors determine interest rate levels in the local bond markets, 2) the direction of change in credit quality of a country may determine the direction of change in the country's currency valuation and 3) the extent of total return due to interest rate movements is also a function of changes in fundamental credit quality and real interest rate expectations as well as technical factors such as foreign and local investor flows into particular segments of a local bond yield curve. Assumptions for hard currency debt returns include but are not limited to 1) fundamental credit quality of sovereign issues including both willingness and ability to repay debt 2) technical factors in the current market place including supply of new debt, current appetite for risk among global credit investors, and funds flows and 3) the term structures and level of US interest rates. Stone Harbor does not make any representation as to the reasonableness of the assumptions or that all the assumptions used in calculating the target returns have been stated or fully considered. Stone Harbor's ability to achieve investment results consistently, in the aggregate or with regard to any particular country or region, depends significantly on a number of factors in addition to the accuracy of its assumptions. These include Stone Harbor's ability to identify a sufficient number and mix of suitable investments.

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Stone Harbor
INVESTMENT PARTNERS

CONTACT

Main Office - New York

31 W. 52 Street
16th Floor
New York, NY 10019
+ 1 212 548 1200

Chicago Office

10 S. Riverside Plaza
Suite 875
Chicago, IL
+ 1 312 492 4251

London Office

48 Dover Street
5th Floor London,
W1S 4FF
+ 44 20 3205 4100

Signapore Office

3 Killiney Road
Winsland House 1
Signapore 239579
+ 65 6671 9711

www.shiplp.com