STONE HARBOR EMERGING MARKETS DEBT OUTLOOK

David Oliver, CFA

Steffen Reichold, PhD

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Global Economic Outlook

US economic growth has stabilized at a moderate pace, supported by exceptionally low interest rates and more Quantitative Easing. The housing market outlook has been improving and moderate job growth continued in recent months. However, substantial uncertainty about the fiscal cliff has prevented further improvements in investor sentiment. Assuming the fiscal cliff can be avoided—our base case is a compromise resulting in moderate fiscal consolidation in 2013—we expect to see a continuation of the recovery in 2013. Nevertheless, Fed rate hikes still remain unlikely in 2013, given the specific conditions spelled out in the last FOMC statement.

In Europe the key event in recent months has been the announcement of the European Central Bank's Outright Monetary Transactions program. In our view this has significantly reduced near-term tail risks. However, Spain still has not made a request for a formal bail-out program as Spanish politicians are concerned about the potential domestic political backlash, which has been further complicated by a series of regional elections. Political tensions have also come to the fore in Italy with the announcement of Prime Minister Mario Monti's resignation and the call for early elections. This highlights the political risks to austerity and reform oriented governments in Southern Europe. However, even if the process of gradual reforms and fiscal adjustment can continue, we believe the growth outlook remains weak as the deleveraging process still has a long way to go and fiscal austerity continues to weigh on demand.

A potential Greek exit from the Eurozone looks less likely in the near term. European leaders and the IMF increased the bailout package to finance private debt buy-backs and the gaps that emerged from a deeper recession and slower fiscal consolidation. However, the longer-term outlook remains highly uncertain in light of the continued economic contraction.

In China we believe risks of a hard landing have faded to some extent as economic activity data has stabilized and showed a gradually improving trend in recent months. We raised our growth forecast to 7.8% in 2012 and 8.0% in 2013. Inflation pressures remain low in China and selective easing policies remain in place, which provide some support. In addition, the housing sector has shown some tentative signs of strength, supporting our China outlook.

Emerging Market Country Economic Outlook

Growth in most emerging markets (EM) has slowed in 2012 driven by past monetary tightening in EM and weaker growth in developed markets. Inflation pressures have declined supported by broadly stable commodity prices and weaker activity, allowing many central banks to cut policy rates. However, that process has come to an end in most EMs. We are now seeing some signs that activity is accelerating again, but the pace will likely remain moderate until the recoveries in the US and China gain more momentum. In our view, fiscal positions remain strong in most EM countries with little fiscal adjustment needed in 2013. From a regional perspective, we believe Latin America and Asia are best positioned to weather the European sovereign crisis, with Eastern Europe much more exposed to the problems in Western Europe.

Local Currency Debt Markets Outlook

Since the start of the fourth quarter of 2012, EM currency spot (EMFX) markets have been range trading, with most currencies posting small gains or losses against the US dollar. The two exceptions have been the Brazil Real and the South African Rand, both of which faced country specific pressures; the Real depreciated nearly 5% while the Rand was down over 8% versus the US dollar at their weakest recent levels. In Brazil's case, the central bank succeeded in weakening the Real through intervention and easier monetary policy in an effort to boost economic activity. Markets tested the Real as various options expired at USD/BRL levels of 2.08 to 2.10 in recent weeks. In South Africa, news of strikes in the mining sector and worries of the stability of the political regime led to the decline of the Rand. By mid December, however, both currencies had recovered much of their earlier losses.

We think that many local currencies are still priced at attractive levels given our outlook on EM growth. So far this year, relative to the strong total returns of JP Morgan's GBI-EM Global Diversified, the recovery in EM currencies has been mild. Spot EMFX has appreciated 2.8% year-to-date, compared to a 16.6% index return as of 20 December 2012.[1] In some countries, including Brazil and Indonesia, explicit policies to weaken currencies have capped currency appreciation. So far these policies have helped depreciate currencies, but they have not yet translated into higher growth. If EM growth rebounds, we believe several EM currencies have room to appreciate.

But not all currencies are likely to appreciate, in our view. Countries where we see a higher likelihood of depreciation relative to the US dollar over the next twelve months include Hungary, Poland and Turkey, all countries with close ties to the Euro zone.

The largest gains in the local currency debt markets came from carry and capital appreciation from falling interest rates in 2012. As interest rates have fallen in most EM countries, we believe that current markets for bonds at the long end of domestic yield curves may be mispricing the prospect for rising inflationary pressures. As a result, our portfolios are now underweight duration relative to the benchmark in every country except Colombia. In addition, while we do not anticipate a sharp rise in inflation in the near term, we have increased exposure to inflation-linked debt in bond markets where break-even inflation rates have fallen below realized inflation rates. We currently hold linkers from Brazil, Colombia, Mexico, Poland, Thailand and Turkey as of this writing.

[1] JP Morgan, Bloomberg

External Sovereign Debt Outlook

External sovereign debt spreads have tightened further since the end of the third quarter. Ongoing demand for high quality sovereign debt combined with strong EM credit fundamentals have been key drivers of continued outperformance of hard currency sovereign debt, in our view. Of the $85 billion inflows expected this year, over 75% have been designated for hard currency debt, according to JP Morgan. We believe that the low level of developed market yields along with the US Federal Reserve's signaling that it will keep policy rates low for the foreseeable future have further enhanced demand for higher yielding emerging markets debt.

We also believe that spread compression is likely to continue, for both technical and fundamental reasons. Technical factors remain very favorable, in our view, as most major EM countries have manageable fiscal deficits and do not need to access external capital markets to a significant degree. We calculate issuance needs in 2013 for the countries in the JP Morgan EMBI Global Diversified will amount to a gross supply of approximately $77 billion. Net supply – the difference between gross issuance and estimated amortizations and coupon payments from existing debt – is likely to be less than $9 billion.[2] Given current demand for sovereign debt, we believe that these figures are constructive for spreads.

At the index level, spreads remain wide of the tightest historical levels despite today's stronger country fundamentals, and, in our view, also appear attractive relative to comparably-rated US fixed income alternatives. Total returns on the sector are likely to be negatively impacted by an increase in US interest rates, but we see little risk of sharply rising rates in the near term. We believe the JP Morgan EMBI Global Diversified spread can tighten by 50-75 basis points over the next twelve months.

During the past quarter, we reduced exposure to some of the market's highest beta credits, including

[2] JP Morgan, "Emerging Markets Outlook and Strategy for 2013," 21 November 2012

Argentina, Iraq and Venezuela. Valuations as well as idiosyncratic developments motivated these decisions. Despite Argentina's strong willingness and ability to pay, we believe the unresolved legal battle over payments to holdouts from Argentina's 2005 and 2010 debt exchange reduced the attractiveness of Argentina's bonds. We have reduced our Argentina position effectively to neutral relative to benchmark. In Venezuela, we remain overweight, but have sold down the position into strength and remain in short duration bonds. Hugo Chavez, who was re-elected as President in October, remains ill with cancer. No one knows for certain when Chavez will die, but his demise seems more imminent now and the uncertainty surrounding an eventual transition government has risen. We also reduced our overweight in Iraq as bond prices continued to rise in the fourth quarter to levels that, in our view, gave us a good opportunity to trim exposure and wait for better prices to add.

Current low yield levels in most EM sovereigns provide less protection against volatility, in our view, and augur for lower active risk in the near term. As a result, we have increased external sovereign exposure to countries with stronger balance sheets. Russia, our largest overweight, is a good example. External debt as a percentage of GDP is under 30%; public debt is less than 10% of GDP. Russia holds international reserves of over $525 billion and enjoys surpluses in both its current and fiscal accounts. Spreads have already collapsed since June and remain lower than at the end of September 2012. But at current levels of oil prices and spreads we see value in Russian debt.

In most of our core EMD portfolios, we invested in local currency sovereign debt where we believed these out-of-benchmark positions had strong likelihoods of outperforming external sovereign debt. We gradually increased exposure to local currency bonds as we saw evidence of stabilization in growth in many EM countries. This exposure level is likely to increase if and when data on industrial production and other economic activity measures show sustained increases in the months to come.

On the other hand, we have reduced exposure to corporate debt by 1-2% by selling investment grade, low yielding bonds as well as some of the higher yielding positions. Our outlook for the corporate sector's performance relative to external sovereign bonds remains constructive. But we have repositioned in high quality BBB and BB-rated bonds that, we believe, have higher probabilities of outperforming the sovereign benchmark with lower downside risk.

Corporate Debt Outlook

Despite continued global growth uncertainty, EM corporate bonds posted strong returns year to date, benefitting from policy action from the ECB and Fed. Record new issuance increased the stock of EM corporate debt to over $1 trillion, another positive in the current market as demand for new financing remained strong. The new issue pipeline for investment grade EM corporates was robust with year to date issuance exceeding $115 billion along with a further $125 billion of quasi-sovereign financing. Total primary issuance for EM corporate is expected to surpass $310 billion in 2012, with the majority of this supply coming from Asia and Latin America. Returns of the high yield sub-component of the JP Morgan CEMBI Broad Diversified outperformed the investment grade sector by nearly 733 basis points, year to date as of 20 December 2012.

As we noted last quarter, we have reduced exposure to speculative credits, taking advantage of strong market bids, while adding to high conviction positions ranging in credit quality from single B to BBB+. We have also been very active in the primary issuance market, acquiring high quality credits at attractive prices without the normal trading friction costs of the secondary market. Based on our assessment of historical yield spreads between EM corporates and comparably-rated US corporate debt, we find most value in the BBB-and BB-rated sectors.

From a regional perspective, our portfolios are overweight Asia and Emerging Europe, underweight the Middle East and marketweight Latin America.

The largest recent regional shift in the portfolios was an increase in exposure to Asia, funded principally through a reduction in exposure to Emerging Europe. Our underweight to Israel accounts for most of the underweight in the Middle East.

China, Brazil and Russia remain our largest overweights by country. We added exposure in Malaysia, Singapore and Thailand, primarily driven by purchases of attractively priced new issues in the banking and electricity sectors. We also added in Turkey, through companies in the food, banking and retail sectors. Our portfolios now have a modest overweight exposure in Turkey.

Finally, we have further diversified our portfolios by industry. The largest underweight relative to the benchmark[3] remains the banking sector. However, we increased exposure to well-capitalized banks in countries which we deem to have strong bank regulatory frameworks and solid growth potential, including Singapore, South Korea, Thailand and Malaysia. Other significant industry overweights include the electricity and exploration and production sectors. The increase in exposure to these industries has been predominantly to well-regulated electricity companies in South Korea and Singapore and quasi-sovereign oil & gas companies in Asia.

[3] Benchmark equals JP Morgan's CEMBI Broad Diversified

David Oliver, CFA, is a portfolio manager for Stone Harbor's emerging markets debt portfolios. Prior to joining Stone Harbor in 2008, he was a managing director in emerging markets trading and sales at Citigroup. He received an MBA from the Amos Tuck School at Dartmouth College, an MA in History from the University of Delaware and a BA from Northwestern University. Mr. Oliver holds the Chartered Financial Analyst (CFA) designation and is a member of the New York Society of Security Analysts.

Steffen Reichold, PhD, is chief economist for emerging markets. Prior to joining Stone Harbor in 2009, he served as an economist for the Asia and Pacific Department as well as an economist for policy development and review at the International Monetary Fund. He attained an M.Phil in Economics from Johann Wolfgang Goethe-Universität in Frankfurt, Germany and an MA and PhD in Economics from Columbia University.

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31 W. 52nd Street, 16th Fl
New York, NY 10019

+1 212 548 1200

48 Dover Street, 5th Fl
London, W1S 4FF

+44 20 3205 4100

9 Temasek Boulevard
#09-03A Suntec Tower Two
Singapore 049909
+65 6550 9667