STONE HARBOR EMERGING MARKETS DEBT UPDATE

David Oliver, CFA

Steffen Reichold, PhD

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Global Economic Outlook

We expect growth to slow in most parts of the world. US data had been better than expected earlier this year but then softened somewhat recently. We still expect annual growth in 2012 slightly above 2% but continued deleveraging, the still weak housing market, and tighter fiscal policy limit the strength of the recovery. We believe that more quantitative easing remains a possibility if growth surprises on the downside.

The European debt crisis is unlikely to be resolved any time soon. The core Euro zone countries continue to stick to their strategy of keeping pressure on the periphery to implement fiscal adjustment and structural reforms. Following the French elections we expect some attempts at softening that stance with a stronger emphasis on growth measures but we do not expect a substantial change in the overall austerity strategy. Increases in the "fire walls" of available European and International Monetary Fund (IMF) resources have raised the likelihood of IMF programs with Spain and possibly Italy, given the reluctance of the European Central Bank to play a larger role in backstopping peripheral sovereign debt markets.

The status of Greece's position in the European Union is still evolving. The probability of a Greek exit from the Euro has increased following recent parliamentary elections, the failure to form a government and the decision to hold new elections in June. Banking sector liquidity and solvency concerns and related market volatility have also risen. While Greece's exit alone would not change our outlook on the global economy, we are factoring in rising probabilities of a failure of European policy makers to prevent contagion to other fiscally weak European nations and potentially strong pressures on peripheral European banking systems.

In the meantime, we expect the process towards more fiscal integration among the Euro zone countries to continue, but that is a slow process. In any case, fiscal adjustment continues throughout the Euro zone and banks are expected to delever to help meet tougher capital requirements. As a result, we expect negative growth in the Euro zone in 2012.

Growth is also slowing in China, but we do not expect a hard landing. We currently forecast 8.0% growth in 2012 as we do not see specific impulses that could push up growth above 8.5% in the second half of the year. With lower inflation pressures we have seen a shift towards selective easing of macro policies in China but we have not seen and do not expect to see aggressive policy action this year. The policy bias towards easing should provide some support though questions remain regarding the effectiveness given lower loan demand. Relatively tight restrictions in the housing sector remain in place as the price adjustment continues. Recent sales numbers suggest that we are not facing an acceleration of price declines. However, we would expect more aggressive policy measures if the housing downturn were to accelerate significantly.

Emerging Market Country Economic Outlook

The growth outlook has slowed in most emerging market (EM) countries driven by past monetary tightening in some EMs and weaker growth in developed markets. Inflation is starting to decline and we expect that to continue as commodity prices have trended gradually lower and economic activity is slowing. However, EM currency weakness has been slowing the disinflation and is preventing some central banks from lowering rates. In fact, some central banks in Eastern Europe have been tightening with a view to support their currencies. However, in most EMs central banks have an easing bias and we expect this to persist in 2012. Fiscal positions remain strong in most EMs and little fiscal adjustment is needed in 2012, in our view. 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 declining growth and deleveraging in Western Europe.

Local Currency Debt

Over the past few months, EM local currencies have underperformed due to several factors including, but not limited to:

1. more aggressive than expected intervention from central banks;
2. slower growth in China;
3. lower commodity prices;
4. increased concerns about Greece exiting the Euro; and
5. potential restructuring of Spanish banks.

We think many EM local currencies are priced at attractive levels. Currency valuations have become more competitive recently and, we believe, central banks have become more willing to support their currencies during periods of heightened volatility. We also believe that the growth outlook for the second half of 2012 and for the first quarter of 2013 will improve as a result of monetary easing over the past year. Weaker currencies may also help spur growth.

However, near-term performance of local currency debt markets remains strongly related to the global macro outlook, and especially to developments in Europe. In local fixed income, we believe the prospect of more monetary easing creates value in several markets. We broadly prefer Latin America and Asia over Eastern Europe.

Hard Currency Sovereign Debt

Credit spreads have recently widened reflecting, in our view, concerns about global growth and declining risk sentiment due to European debt concerns. We continue to expect compression of EM sovereign debt spreads relative to US Treasuries based on improving credit quality and strong relative growth in many EMs. Technical factors such as limited supply and high institutional demand for EM sovereign debt also remain supportive. We believe total returns on the sector will be negatively impacted by a rapid increase in US interest rates, but we see little risk of this event in the near term.

We believe spread tightening in 2012 will be led by some of the sector's highest beta credits such as Argentina, where sovereign capacity and willingness to repay debt is, in our view, underappreciated by the market. Recent news from Argentina has not been constructive for markets. The Argentina government, for example, re-nationalized YPF, a major oil and gas producer in May. But Argentina has limited debt service requirements in 2012 and growth remains strong. We also expect spread tightening from select, investment grade credits that have lagged the market in recent months either due to trade linkages with a slow-growing US (Mexico) or concerns of rising political risk (Russia). We believe spread levels in both of these countries are attractive given continuation of prudent fiscal policies.

Corporate Debt

Strong investor demand and increased allocations to the asset class have enabled issuance of over $120 billion in EM corporates year-to-date.[i] While in the short term, returns in the sector remain vulnerable to downturns in risk sentiment driven primarily by events in developed Europe, we believe that EM corporate fundamentals remain strong and we view depressed valuations as a result of Europe-related selling as a buying opportunity.

In our view, the medium- to long-term opportunity in the sector is compelling. We continue to like commodity producers in the oil & gas and metals & mining industries. Despite the volatility in developed markets and its potential impact on global growth, we continue to see favorable supply and demand dynamics in certain commodities. Our portfolios currently favor lower volatility investments in Indonesian coal and Russia domestic gas, as examples.

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[i] As of May 17, 2012, Source: JP Morgan. Includes quasi-sovereign and corporate debt. The quasi-sovereign debt included in this figure includes companies that are not fully owned by the respective government.

We are also focused on domestically-oriented industries in countries benefiting from growth in consumption and of the middle class. Examples of these industries include shopping mall operators, wireless telecom companies, Cable/Pay TV companies and electric utilities.

While we have recently added to positions in investment grade credits, we believe valuations of EM corporate high yield (HY) debt are becoming increasingly compelling following the recent downturn in the market. We will consider tactically increasing our exposure to core HY positions, particularly if we believe that selling pressure is unrelated to credit quality and creates exceptional bond valuations as it did in September 2011.

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