STONE HARBOR EMERGING MARKETS DEBT OUTLOOK

David Oliver, CFA

Steffen Reichold, PhD

October 2012

Stone Harbor
Investment Partners

Global Economic Outlook

Growth has been slowing down in most parts of the world in 2012. The US recovery remains sluggish, despite somewhat better US data recently, triggering the third round of quantitative easing by the Fed. We still expect annual growth in 2012 below 2% based on continued deleveraging and still weak housing and labor markets. Going forward, we believe fiscal tightening is likely to weight on US growth in the coming years.

The European debt crisis remains unresolved despite the decision by the European Central Bank (ECB) to put in place a program to buy peripheral sovereign bonds under certain conditions. This has reduced tail risks at present, but the core Euro-zone countries continue to stick to their strategy of keeping pressure on the periphery to implement fiscal adjustment and structural reforms. We expect the next step may be a formal aid request by Spain but the Spanish government continues to avoid making that move. We expect 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 currently expect negative growth in the Euro-zone in 2012.

The status of Greece's position in the European Union is still evolving. All efforts appear to remain focused on keeping Greece in the Euro, but debt levels remain unsustainable and a decision on restructuring the official sector debt might have to be taken soon. The IMF already started to push in that direction but core European leaders face significant resistance at home in providing further support through loan extensions or restructuring. While a Greece exit alone would not materially change our outlook on the global economy, we are factoring in the possibility of a failure of European policy makers to prevent contagion to other fiscally weak European nations, which would be negative for global growth.

Growth continues to slow in China, but we still do not expect a hard landing. We currently forecast 7.6% growth in 2012 as China's industrial and materials sectors are in the middle of a de-stocking cycle. Inflation pressures are low in China and selective easing policies remain in place, which may provide some support. In addition, the housing sector has shown some tentative signs of strength, supporting our China outlook.

Emerging Market Country Economic Outlook

The growth outlook has slowed in most emerging markets (EM) countries driven by past monetary tightening in EM and weaker growth in developed markets. While recent increases in food and energy prices raise concerns of a rebound in price pressures this has been balanced, in our view, by falling inflation pressures as a result of weaker activity. However, EM currency weakness has been slowing the disinflation and is preventing some central banks from lowering rates more aggressively. Nevertheless, many EM central banks still have an easing bias but we believe this cycle may come to an end soon. In our view, fiscal positions remain strong in most EM countries with little fiscal adjustment needed in 2012 or 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 declining growth and deleveraging in Western Europe.

Local Currency Debt Markets Outlook

Emerging market local currencies (EM FX) have risen from end-of-May lows as global investors, in our view, became more hopeful that bond buying by the ECB and the Fed may support developed market economies and asset prices. The increase in EM FX valuations following the announcements of quantitative easing in late August and early September supported this view.

We think that many local currencies are still priced at attractive levels given our outlook on EM growth.

So far this year, the recovery has been mild; in aggregate, EM FX spot movements and FX carry have generated nearly 6% in total return, but nominal EM FX levels remain below their recent peak. See Figure 1.[1] Moreover, we have seen some central banks become more willing to support their currencies in case of further depreciation pressure. Brazil's central bank, for example, intervened to support the real after the currency sold off sharply in May and has dampened currency volatility through intervention over the past several months. This policy has led to underperformance of the real relative to the broader EM FX market during the recent rally. In Colombia and Indonesia, central banks have actively tried to weaken their currencies in order to ensure export competitiveness. In South Africa, investors wishing to reduce risk in light of the recent worker strikes at domestic mining companies have sold the rand, which has underperformed as a result. If our thesis that EM growth is in the process of bottoming is correct, we believe local currencies in several EM countries have room to appreciate.

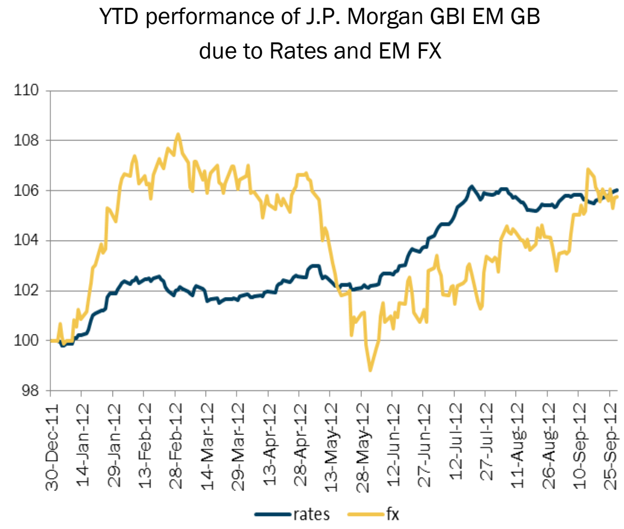
YTD performance of J.P. Morgan GBI EM GB due to Rates and EM FX

Figure 1: December 31, 2011 = 100
As of 30 September 2012
(Source: J.P. Morgan, Stone Harbor)

The near-term performance of local currencies and local debt markets, therefore, remains strongly related to the global macro outlook. The prospect of much higher inflation driven by rising commodity prices seems more remote as of this writing. Our view on local bond yields is more country-specific. We believe that the potential for more monetary easing is less likely in many EMs at this point, but higher yields in EM domestic bonds relative to developed market bonds still creates opportunities for capital gains from interest rates. We continue to find value in duration in Colombia, Mexico and South Africa. In most other countries, we have moved to underweight duration relative to benchmark. In addition, while we do not anticipate a sharp rise in inflationary pressure in the near term, we have increased our exposure to inflation-linked debt in bond markets where break-even inflation rates have fallen below current inflation rates.

External Sovereign Debt Outlook

External sovereign debt spreads tightened in the third quarter.[2] The market's highest beta credits including Argentina, Venezuela and Iraq were some of the market's leaders both in total return and spread tightening. US Treasury yield movements were a much smaller factor in generating total returns this period relative to the second quarter of 2012, when yields fell significantly on growth concerns. However, we believe that the low level of developed market yields and the Fed's signaling that US interest rates would be kept at very low rates for the foreseeable future, further enhanced demand for higher yielding emerging markets debt.

We continue to expect compression of EM sovereign debt spreads relative to US Treasuries based on improving credit quality and valuations. Spreads remain wide of the tightest historical levels despite stronger fundamentals, and also appear attractive, in our view, relative to comparably rated US fixed income alternatives. We believe technical factors

[1] Calculated using the USD hedged and USD unhedged daily levels of the J.P. Morgan Global Bond Index Emerging Markets Global Diversified, year to date as of 30 September 2012

[2] J.P. Morgan Emerging Market Bond Index Global Diversified

such as limited supply and high institutional demand for EM sovereign debt also remain supportive. Total returns on the sector likely will 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 spread tightening will be led by some of the sector's highest beta credits such as Venezuela, where sovereign capacity and willingness to repay debt remains strong and underappreciated by the market, in our view. The re-election of President Hugo Chavez will likely weigh on Venezuela bond prices in the near term in our opinion, and we are positioned in the short end of the Venezuela bond curve in anticipation of this result, with the view that longer duration securities may become more attractive in the fourth quarter of 2012. In addition, we remain positioned with overweights in high quality credits that continue to perform well, particularly Mexico, Russia and Qatar.

Corporate Debt Outlook

EM corporate debt recovered all of its losses in spread terms from May as spreads tightened through mid September and then widened on profit taking amid renewed concerns about global growth at quarter end.[3] However, even with the end of quarter widening, spreads remained tighter than they were throughout most of the prior quarter. New issuance during Q3 was heavy, with over $86 billion worth of new financings, up from the prior quarter and nearly equal to the record pace set in Q1. Demand for new corporate debt remained robust, aided by inflows into the market as well as over $23 billion in cash flows from existing debt.

As in external sovereign debt, we expect further spread tightening by year-end 2012 and believe low yields and quantitative easing in developed countries may further fuel a rally in risk assets. From a credit rating stand point, we have a more defensive posture than we held a year ago in unconstrained portfolios, but still favor high yield (HY) debt. We took advantage of demand during Q2 and Q3 to reduce HY positions in favor of investment grade bonds; we are now considering selectively increasing the HY portion of our portfolios given our more constructive outlook for emerging markets for the remainder of the year. A large new issue calendar may, in our view, create investment opportunities over the next several months. Regionally, we have reduced our overweights in Brazil which lowered our overall exposure to Latin America and expanded our positioning in Asia, principally in Singapore, Thailand and South Korea. In addition, we have added to defensive sectors such as utilities and telecommunications at the expense of metals & mining and steel, which are more exposed to a downturn in developed country growth. For the medium term, we expect that technical conditions will remain supportive.

[3] J.P. Morgan Corporate Emerging Bond Index Broad Diversified (CEMBI BD)

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.

Disclaimer

This material is solely for informational purposes and shall not constitute an offer to sell or the solicitation to buy securities. The opinions expressed herein represent the current, good faith views of the author(s) at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this material has been developed internally and/or obtained from sources believed to be reliable; however, Stone Harbor Investment Partners LP ("Stone Harbor") does not guarantee the accuracy, adequacy or completeness of such information. Predictions, opinions, and other information contained herein are subject to change continually and without notice of any kind and may no longer be true after the date indicated. Any forward-looking statements speak only as of the date they are made, and Stone Harbor assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. This material is directed exclusively at investment professionals. Any investments to which this material relates are available only to or will be engaged in only with investment professionals.

The value of investments and income from them can fluctuate and are not guaranteed. Investors may not get back the amount invested. Rates of exchange may cause the value of investments to go up or down. The value of investments will fall in the event of the default or reduced credit rating of the issuer. Past performance is not a guarantee of future results.

Investment services are provided by Stone Harbor and Stone Harbor Investment Partners (UK), LLP. Stone Harbor is an SEC registered investment adviser. Stone Harbor Investment Partners (UK), LLP, a limited liability partnership, is authorised and regulated by the Financial Services Authority.

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

October 2012

www.shiplp.com

Stone Harbor
Investment Partners