Emerging Markets Debt:

The Credit Picker's Guide to 2016

Stone Harbor Investment Partners

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2015 was a difficult year for investors as very few asset classes delivered significant positive returns. Oversupply in commodities and worries about emerging markets have been key themes but the slower-than-expected recovery in the U.S. has also played a role. Emerging markets ("EM") performance was mixed, with local markets sharply lower driven by foreign exchange ("FX"), and hard currency sovereign and corporate markets eking out small positive returns, though still out-performing many other fixed-income asset classes.

The tumultuous start of 2016 seems to be driven again by the same themes and in fact bears a strong resemblance to the market dynamics in August last year, when global risk markets were shaken by the news of China's currency devaluation, the crash in the A-share market and weaker oil prices. But it would be wrong to simply expect more of the same. We believe 2016 will prove to be quite a different investment environment, not least because of the adjustment in valuations over the past years.

Global Macro Backdrop

So what do we expect for 2016? Advanced economies are continuing their long slow recovery from the financial crisis. The U.S. is moving steadily closer towards full employment but we see no signs of further acceleration, despite the stronger labor market, stronger household balance sheets, improvements in the housing sector, and lower energy prices. GDP growth appears to be running above estimated potential growth, which has been kept low by weak productivity growth. We believe the U.S. Federal Reserve ("Fed") is on track to deliver more gradual rate hikes but it will likely proceed carefully, at least until we see more signs of inflation. At this point, risks relate to the slowing corporate profit cycle, weaker corporate balance sheets, and rising default rates. Nonetheless, we see low near-term recession risks, given the continued growth of household real incomes, labor market improvements, and accommodative monetary policy, despite the recent rate hike. Europe and Japan are also on track to continue the gradual expansion. Both regions benefit from lower commodity prices supporting real incomes but also from extending deflationary pressures which will keep monetary policy biased towards more easing.

China continues to play a pivotal role in global markets. Our baseline outlook calls for gradually slower growth as the economy rebalances. The industrial sector has already slowed down sharply while the service sector held up much better. However, China's industrial sector is more strongly linked to the rest of the world and thus draws more attention from global markets. Given the moderate recovery in advanced economies and China's size, we do not believe externally-led growth that was seen in the past will be a source of future growth. The challenge for policymakers is to gradually rebalance away from investment and towards more consumption and to wean the economy off its high reliance on credit. That is a very difficult task, given the size of the imbalances and we believe there is a risk that this process will become disorderly, resulting in a much sharper downturn. Though policymakers have outlined long-term goals and the future direction of structural reforms, we see a strong trade-off between structural reforms and macro stimulus in order to prevent a sharper slowdown. This includes areas such as state-owned-enterprise reform, reducing excess capacity, financial sector reform, and opening the capital account. Given these difficulties and the often ambiguous or conflicting policy goals, it is not surprising that markets have reacted highly sensitively to any news or policy action that might signal policy makers' true intentions and their ability to control the economy. In addition, given concerns about possible

data manipulation, markets have reacted more strongly to bad news while discounting good news.

The latest market fears on China have shifted somewhat away from the housing and shadow banking sectors and toward capital outflows, the CNY exchange rate, and equity market volatility. We believe capital outflows from China have a structural element. China remains one of the highest-saving economies in the world and given reduced incentives for domestic investment, (housing overhang, excess capacity, and gradual SOE reforms) increased capital exports are the natural consequence. In addition, the long-term plan to open the capital account and allow more currency flexibility exacerbates depreciation expectations and thus increases the incentives for near-term outflows. China's central bank is pursuing the conflicting goals of limiting volatility and, at the same time, limiting predictability of changes in the USD/CNY exchange rate. As a result, we believe bouts of volatility followed by heavier intervention will continue for some time. However, we see an overall bias towards more CNY depreciation.

Given the subdued global growth outlook and the current level of oversupply, we expect commodity markets to remain under pressure. Supply adjustments are usually slow and thus prices tend to overshoot while markets wait for commodity demand to catch up with supply capacities. Eventually, we believe the supply will decline due to lower investment. It is hard to say how far along we are in that process, but we think we are more likely to see higher, rather than lower, oil prices by the end of the year.

Outlook for Emerging Markets

How will the rest of EM fare in this environment? Currently, it is much easier to find countries with significant economic problems than to find improving success stories. Low commodity prices have hurt the commodity exporters and are forcing them to adjust. But other countries have also suffered from the global slowdown and the drop in capital flows to EM. Reflecting this trend, the ratings momentum has been negative. Several countries have lost or are under threat of losing investment grade status while upgrades are few and far between.

We still believe that average EM growth will be slightly higher in 2016 than in 2015. However, rather than expecting a broad rebound, this result is driven by specific countries that contracted sharply in 2015 and are unlikely to continue to slow at the same pace, in particular Russia, Ukraine, and Brazil. With some stability in other EM countries, this results in slightly better average growth. Over time, we expect to see evidence of a break in the EM growth slowdown that has started in 2011 which will benefit the asset class. However, we do not see near-term catalysts for sharp improvements in the EM growth outlook.

With this macro outlook, we expect valuations and market technicals to be key drivers of the EM debt asset class in 2016. In our view, the selloff has created pockets of value in sovereign and corporate credit, currencies, and local rates. However, we believe fundamentals have deteriorated. The global environment for EM countries has clearly become more challenging. This is especially true for commodity exporters, but also, to a lesser extent, for other EM countries. From a historical perspective, many assets look cheap. However, we think some countries will get into more trouble, while others are making the necessary adjustments to ultimately weather the challenging environment. It will thus be critical to select the right countries, sectors, and credits. We think it is always important to base investment decisions on sound fundamental analysis, but this approach becomes even more important in a market environment that is characterized by large price dislocations from technically-driven market moves and the lack of broad directional trends (in which case investment results are often dominated by portfolio beta management rather than fundamental analysis).

We think 2016 will be a "credit-picker's" market. The key to success will be to take advantage of some attractive entry levels in countries and credits where the negative market sentiment and technical selling pressure have overshot the fundamental deterioration. We have already seen some of that in 2015, even though the

year was dominated by broad directional market moves. Some key outperformers were sovereign credit in Venezuela (especially short duration bonds), Argentina, Kazakhstan, and credit and local rates in Russia. We believe selecting the right credits and sectors will be even more important for the remainder of 2016.

But it is not just a matter of identifying mispriced credits. Markets have been less liquid and the volatility has created challenging market technicals. As investors are trying to adjust positions in poor liquidity conditions, we can see significant market imbalances that only clear slowly. It will be very important to take this into account when building positions in specific assets.

EM Sovereign Credit

One example of an attractive opportunity is sovereign credit in Brazil. Fundamentals have deteriorated sharply as a result of poor policy choices in the past and a severe political crisis that has so far prevented the needed policy adjustments. The country is in the middle of what could become the worst recession in more than 100 years. Not surprisingly, S&P and subsequently Fitch downgraded Brazil's sovereign credit to below investment grade, triggering a sharp sell-off in sovereign bonds. In our view, this situation presents a buying opportunity. While Brazil has a serious fiscal problem and a fast rising debt stock, the country also has a high stock of foreign reserves which vastly exceeds its sovereign external debt. External debt is only a small share of the public debt stock and thus an external default would do little to improve Brazil's cash flows. In our view, external bond spreads have significantly overshot fundamentals. Currently, Brazil's bond spreads trade very close to Honduras and less than 100 basis points ("bps") inside of Pakistan, two B-rated credits with arguably much weaker fundamentals.

We also believe there are attractive sovereign credits in Africa. Commodity exporters, particularly oil producers, have justifiably sold off. While the near-term external bond amortization schedule looks fairly light for many countries, commodity exporters need to take steps to adjust to the new commodity price environment in order to maintain the ability to service debt in the future. This is where we see large differences across countries. Some are taking said steps while others are delaying key decisions, jeopardizing future debt sustainability. Careful credit and political analysis is needed to identify those countries that will make it through these challenges. However, with bond spreads at close to 1000bps or higher in many countries, we see opportunities in specific credits.

For example, Angola's spreads widened by 260bps so far this year, reaching almost 1100bps. The country has already made significant adjustments to public spending, reduced subsidies, and depreciated the currency by 50% over the past year. Additionally, FX reserves significantly exceed total external sovereign debt, coupled with a light amortization schedule in the coming years. Another example is Ghana, which arguably has missed many opportunities to improve its fundamentals. However, spreads have widened by 360bps so far this year, reaching more than 1300bps. In our view, the market is clearly overstating the risk of default. The country has only one $0.5 billion external bond maturity over the next five years while maintaining support and new funding from multilateral institutions. Zambia's spreads have also widened more than 300bps this year reaching more than 1300bps. While the country imports oil, it exports copper and has suffered from the price decline. Again, fundamentals have deteriorated but Zambia's repayment schedule is very light through 2020 and we believe prospects are good for significant policy improvements after the elections this summer.

African commodity importers have also been hit hard by the market selloff. Some countries have fundamental problems but others are in good position to take advantage of lower import prices and can perform well, even if global economic and market conditions do not improve. This year, Kenya and Ethiopia's spreads have widened 130bps and 140bps respectively, reaching a level of 600bps and 750bps. In both cases, their terms-of-trade have improved following the drop in oil prices, growth remains solid, and the external debt maturity profile is light in the coming year.

Local Markets

We believe value has also been created in many local markets and identifying those markets with the best prospects to improve the outlook will be critical for investment success. The reversal of capital flows in recent years has led to significantly cheaper currencies. In some cases we believe these valuations are justified, while in others, we see markets overshooting the fundamental deterioration. In inflation-adjusted and trade-weighted terms, EM currencies have fallen back to the lows of the early 2000s after currencies had sold off following a series of EM crises. Already, we are seeing the economic results of cheap currency valuations. On average, external current accounts have started to improve, despite weaker commodity prices and only modest advanced economy growth. We expect this trend to continue gradually over the coming years. However, unlike external debt that matures at par in hard currency if there is no default, eventual returns in local bonds depend on future FX movements which are highly dependent on market sentiment. In particular, the growth outlook remains critical. Given our global macroeconomic outlook we are not expecting near-term catalysts for a broader rebound. We believe, however, that the outlook will slowly improve and offer opportunities to benefit from current cheap valuations.

Again, selecting the countries with the best potential to surprise on the upside will be important. We believe Mexico, Indonesia, and Colombia also offer good opportunities for investors willing to see through the near-term volatility. All three countries have been implementing sound economic policies and are taking the right steps to adjust to the current global economic environment, which puts them in a strong position to perform well as markets stabilize.

EM Corporates

Alongside sovereign bonds, EM corporate bonds have been negatively impacted by falling commodity prices, lower global growth and FX volatility. Following two major sovereign downgrades, there was a slew of associated corporate downgrades in Russia and Brazil. Generally, markets with strong support from local investors outperformed in 2015, such as Russia and Asia. As we look at 2016, we see value in several areas. Brazilian corporate valuations are already compelling, particularly for iron ore/steel, pulp and paper and protein exporters. At this time, selling pressure continues as the widespread corporate and political bribery investigations continue and the political noise shows no sign of abating. However, we would see any conclusion to the political uncertainty in the country, specifically a resolution of the impeachment process, as a signal to buy.

We believe specific quasi-sovereign credit risk is also mispriced in the current environment and will present buying opportunities in 2016. In EM, quasi-sovereigns typically include a "national champion" that produces a large portion of the country's most important natural resource and is at least partially owned by the central government. As financial markets have repriced in the current context of commodity prices, we have seen spreads for many of the quasi-sovereign issuers trade at historically wide levels to their underlying sovereign parent. While a lower commodity price backdrop is affecting credit metrics, EM commodity producers are at the lower end of the cost curve and FX depreciation has cushioned the impact on some producers. Finally, the quasi-sovereign producers are often key elements of the government's economic development plans and consequently benefit from some levels of implicit government support. We also see value in corporate bonds that have been hit by contagion from the U.S. high yield market. Technical selling pressure from cross-over U.S. high yield investors have driven certain Latin American high yield corporate issues to new lows despite little real change in underlying fundamentals.

These are some examples that highlight our approach to sovereign and corporate credit and local markets in the current global market environment. We believe market dislocations are creating investment opportunities. The best performing positions will be among countries that have sold off sharply. However, sound credit and market analysis will be critical in order to focus on the countries and companies that will succeed despite a difficult global environment.

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