Letter from the CIO:

Our Outlook for 2016

Stone Harbor Investment Partners

As many of you know, twice a year the Stone Harbor investment team spends two days offsite to discuss the outlook for economic activity, political risks and markets. We aim to focus on the issues which may have the greatest impact on the upcoming stage of the investment cycle. Our recent meetings provided us with an opportunity to take stock of the recent past. We reviewed where we are, what we got right and wrong and determined how, as events unfold, we might set our course for the coming year.

Global Macro Backdrop

They say that a year is a long time in politics, well six months in these markets can feel like a few lifetimes. Let's recap developments over the past six months: the Chinese have devalued their currency and altered the regime; the European Central Bank ("ECB") introduced further quantitative easing and market participants continue to demand more; the U.S. Federal Reserve ("Fed") seemingly reached the point of tightening in September only to step back before finally tightening in December; and copper prices declined more than 20%, roughly in line with the move in Chinese equity markets. Underlying this, economic growth varied globally: reported Chinese GDP growth averaged 6.9%; U.S. growth weakened in the second half of 2015 to end the full year at 2.4%; Europe recorded 1.4% growth annualized over the second and third quarters and finished the year at 1.5%. Core U.S. inflation has edged up to 1.9% year-over-year while Eurozone inflation has remained subdued. Credit markets performed poorly, especially the high yield market, which saw a 9% under performance relative to equal duration Treasuries in the second half of 2015.

When economies, markets and policies are this multi-directional it is tough to look back at views held six months ago and record a clean score sheet. As I pointed out to the team, we had a number of correct calls; we expected a moderate developed market growth cycle with the U.S. performing better than Europe; and we highlighted the risks that a shortfall in China GDP growth might pose. Despite that, we did not anticipate the Chinese devaluation nor the impact that concerns about Chinese growth might have on the Fed and potentially the ECB. What is essential during these volatile periods is that our investment team adapts its strategy to events as they unfold while maintaining a longer term perspective. We have navigated our way through this period by adjusting risk profiles both at the macro level with more cautious asset allocation, and at the micro level by focusing on industry allocation and adopting more conservative positioning within certain industries.

One of my concerns as CIO is to ensure that our offsite meetings focus on a thorough and broad ranging analysis of trends while also addressing topics of immediate concern. Clearly one of the pressing issues of the moment is the outlook for Chinese growth and the risks it presents both within and beyond China's national boundaries. I wanted the team to also focus on some of the underlying global issues that may play out over the longer term but are likely having an impact today, and to address from a bottom-up perspective the cyclical market behavior that is emerging.

China and the Emerging Markets

Let's deal with China first. The August devaluation came as a shock to markets and dramatically raised uncertainty. The uncertainty was heightened by conflicting rationales for the devaluation. One motivation for devaluation could be to stimulate export growth at a time when the domestic economy has been weak. While a devaluation will stimulate export growth, the impact on the overall economy will likely be modest. If this was the motive, we believe the strength in the trade weighted Renminbi and ongoing economic softness will

likely lead to more periodic devaluations. Macro policy tools used once are rarely shelved.

An alternative argument is that the devaluation may have been a prelude to a move into the SDR, suggesting increased flexibility from the authorities in their currency policy. This is certainly possible, but if this was truly the motive, why not just widen the bands and allow a higher degree of flexibility in the daily fixing? It seems this would most certainly have avoided confusion about policy intent.

Confusion about policy intent may give us insight into the most likely reason for the devaluation. Attempts to loosen monetary policy were being met with increased capital outflows, requiring authorities to drain liquidity to maintain the currency peg. This is an age old problem reminiscent of the ERM, Bretton Woods and the Gold Standard. If China had truly free capital flows it likely would have been forced, in short order, to float the Renminbi. Existing capital controls permit the Chinese authorities to periodically revalue downwards to help address policy conflict, suggesting that over the longer term a series of devaluations may become the norm. Following each devaluation we would expect to see a period of stable or improving growth. However, we believe the dynamics of moving the Chinese economy from credit-driven investment growth to consumer-led growth will likely provide policy conflicts leading to future devaluations.

A key component of the outlook for emerging markets ("EM") is the demand for commodities that Chinese growth generates. While the trend in Chinese growth is declining, a key by-product of that growth is demand for exports from other EM countries. Our EM economist pointed out that growth in the primary and secondary sectors of the Chinese economy has declined and that the service sector has been the primary driver of current growth. Whether this suggests that the rate of decline in demand for commodities has bottomed remains to be seen. We do not expect a significant rebound in demand for commodities under any circumstances, leaving countries like Brazil and Russia facing their own challenges. It does appear that the current challenges facing EM economies are predominantly endogenous. We believe this should favor country selection strategies as economies become increasingly differentiated. The primary exogenous consideration for EM appears to be Fed policy.

The Federal Reserve, the ECB and Demographics

After a series of false starts, the Fed raised rates in December. We originally anticipated a rate hike in September but concerns about Chinese growth after the devaluation of the Renminbi kept the Fed on hold. Following that decision, the members of the Federal Open Market Committee ("FOMC" or "Committee") appear to have lowered the growth hurdle for tightening. This has been evident firstly in a down playing of the requirement for increased inflation pressures. The Fed believes that lower employment will lead to higher wage growth and, in turn, higher inflation. The Phillips Curve is alive and well, according to the Fed. Secondly, the required level of job growth for the Fed to act seems to have shifted to a monthly non-farm payroll number of 150,000. This suggests that we are closer to the Fed's perception of full employment than we thought a few months ago. Our Chief Economist believes that the Fed sees a 4.75% unemployment rate as being effective full employment.

With a lower hurdle rate for tightening, we would still, absent a material softening of growth, expect to see three or four additional moves of 25 basis points ("bps") in the Fed Funds rate during 2016. In our view, the yield curve does not reflect this path of rates. Given underlying inflation dynamics as the U.S. approaches full-employment, we find fair-value yields on the U.S. Government ten year closer to 3% rather than today's 2%. However, messaging from the Fed will reflect a compromise between the dovish members of the Committee and the other members. This suggests to us that the range of market expectations is likely to oscillate between 25bps tightening per half year and 25bps per quarter. Our longer term expectation for the terminal rate of Fed Funds is still 3.5%, reflecting an economy that has not materially deleveraged and a growing challenge from demographic changes described below.

Interestingly, these demographic changes may favor the U.S. over other large countries.

Arguably, Europe has been generating above-trend growth in recent quarters although perhaps only modestly so. Certainly, the Eurozone unemployment rate has declined. Against this backdrop inflation has remained subdued with headline inflation just above zero and core inflation around 1%. While there are signs that bank lending channels are loosening, in our view there is little data to suggest that the ECB will reach its 2% inflation target anytime soon. Tentative signs of a slowdown in Germany indicate that the European output gap will remain elevated and disinflationary concerns will remain. The risks of a second round effect of low inflation will increase the longer inflation remains low. The recent moves from the ECB were disappointing and we would expect further action in 2016 but it is important to recognize that the ECB may be approaching the end of its easing cycle. We believe yield differentials with the U.S. should continue to widen, reducing support for the Euro. Investor short positions in the Euro have increased, but they do not yet appear to be at a level which represents a warning sign.

Looking further ahead we concluded that there is a very strong structural case for extremely low interest rates for a protracted period of time going forward. Deleveraging remains an elusive goal in the developed economies. Developed market leverage has shifted towards the public sector but we believe the need to maintain budget control indicates that resources will be diverted to debt servicing and the option to increase leverage will be constrained. In China, the economic efficiency of expanded credit as a driver of GDP growth has been on a downward path for some time. This implies that loosening monetary policy to enhance growth will result in a disproportionate rise in the debt level in China. In the longer term, we believe this type of policy requires a greater and greater diversion of resources to service that debt, resulting in lower growth and a need for a low rate environment to support this. In some ways this is very reminiscent of China 20 years ago.

So despite our expectations of Fed tightening, we expect a continuation of low interest rates and slow growth. These trends seem reinforced by demographics in a way that seems secular rather than cyclical. It's no secret that outside of certain African countries, the world's population is aging. An aging population saves for retirement. This flow of funds will not prevent cyclical increases in yields but it strongly suggests that equilibrium interest rates will remain low. We see some efforts to offset these flows as governments increase retirement ages and some seniors continue to participate in the labor force. Nonetheless, the demographic impact on interest rates and trend growth seem clear. The best way to reverse this slowdown in trend growth, in our view, is to generate markedly higher productivity growth. Unfortunately highly leveraged economies have difficulty generating the credit growth necessary to support large scale productivity enhancing investment. Slower trend growth accompanied by lower equilibrium interest rates seems to be the inevitable conclusion. There will be marked differences across countries. In the developed world, Germany and Japan appear particularly exposed to the challenges of aging populations. The U.S. appears to have a more stable demographic profile. The current phase of relative U.S. outperformance, albeit against a soft global backdrop, appears both structurally and cyclically supported.

Credit Markets

An initial move higher in the yield curve is often accompanied by a tightening of credit spreads. Both are indicators of a strengthening economy. While we have some evidence of a pick-up in the U.S. economy, the U.S. high yield market has been a noted underperformer. Until recently this weakness could be explained by the collapse in commodity prices, especially oil. Currently, our High Yield team is highlighting some worrisome underlying trends, both technical and fundamental. M&A activity is running at very elevated levels. This has brought with it an increase in acquisition-related issuance. The credit quality of issuers and the term structure of issuance are not as poor as they were in 2007 and issuance is more acquisition-focused rather

than LBO-oriented. Nonetheless, we have noted a heavy increase in issuance that carries event risk with it. Additionally some of our analysts, particularly in Health Care and Technology, are seeing evidence of bottom line sensitivity to wage pressures. In some cases, this arises from minimum wage increases and in others from a dearth of skilled workers causing wages to be bid up. None of this is reflected in broad economy-level data but it does suggest a growing sensitivity of corporate profits to the employment level. With the Fed focused on employment, this is a concern that may persist. There was one final point that I stressed to the investment team. Defaults are on a cyclical upswing but a post-default recovery rate of 40% is not always what it seems. Recovery rates are expressed as a percentage of par value. In practice, many bonds in previous cycles were acquired with prices around 80, meaning that the real recovery rate was 50%. With yields so low today many bonds have prices significantly higher than 80. At a price of 120 the recovery rates falls to a third. From a security selection and asset allocation perspective investors should keep this in mind and tread increasingly carefully as we reach further and further into the credit cycle.

2016 Outlook

In early 2016 caution remains our byword. Impulses for monetary easing in Europe and Japan will be less frequent and arguably less strong. The Fed will likely embark on a slow but steady program of rate normalization. China will remain the gift that keeps on giving; unfortunately that gift will likely be bouts of uncertainty rather than positive growth surprises. Developed market growth will be respectable but within the context of lower trend real growth and by implication, nominal growth. With top line constraints and the Fed following a policy designed to maintain jobs growth and foster wage inflation, corporate profits will likely be under pressure. With some increase in late-cycle issuer behavior evident, corporate credit spreads will remain vulnerable. The positive news in our view, however, is that current valuation levels range from fair to cheap in a longer term context. This suggests that as we progress through the year we may see an environment where fundamental value starts to outweigh shorter term cyclical pressures in our analysis. We are not there yet, but I think 2016 will be the year when we make that transition.

Finally, let me extend my best wishes to you as we embark on this already eventful New Year.

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