Letter from the CIO:

Our Outlook for 2015

Stone Harbor
Investment Partners

Twice a year the Stone Harbor investment team spends two days offsite to discuss our outlook. We aim to focus on the issues which may potentially have the greatest impact on the upcoming stage of the investment cycle. Our most recent meeting coincides with a period of heightened uncertainty, elevated geopolitical tensions, disarray in energy markets, disappointing Chinese growth, and rising deflation risks in Europe. All of these factors are at play even as strong evidence emerges of improving US growth. These uncertainties and the different perspectives of our various investment teams generated a particularly robust debate. Let me share with you some of our thoughts on these issues and how they may impact markets over the coming year. But first, a brief review of 2014.

In many ways 2014 was a year of two halves. The first six months of the year were supportive for credit markets and for fixed income generally. Ten-year US Treasury yields fell 50 basis points generating a return of 2.72%. This Treasury rally was aided by especially cold, snowy winter weather resulting in a first quarter US GDP decline of 2.1% at an annualized rate. Credit markets looked beyond this temporary slowdown. Second quarter US growth came in at 4.6%, and spreads contracted. Investment grade spreads narrowed by 15bps and high yield spreads by 45bps generating duration adjusted excess returns of 1.45% and 3.42% respectively. The emerging markets debt (EMD) complex was the best performing fixed income asset class with hard currency spreads narrowing by 39bps generating a duration adjusted excess return of 4.80%. Total return for EMD hard currency was 8.66% for the first half of the year, closely followed by local currency EMD which returned 5.99%.

Summer saw the start of a reversal of fortune for all except the Treasury market that lasted through the balance of the year. Deflation risks in Europe, geopolitical tensions centered on conflict in the Ukraine, slower growth in China, and a severe fall in oil prices combined to cause a resurgence of risk aversion. Government bonds performed well as the European Central Bank ("ECB"), faced with a growing risk of deflation, edged closer to what many perceive as an inevitable resort to quantitative easing . Credit markets suffered however. By year-end spread widening in US corporate bonds - both high yield and investment grade - had effectively wiped out all the excess returns from the first half of the year. In the case of the high yield market this largely reflected the impact of falling oil prices on US shale producers and oil service companies. Spread widening in hard currency EMD also resulted in the loss of the first half of the year's duration adjusted outperformance. In absolute terms local currency EMD fell by 11% over the six months through December as oil producing countries, led by Russia, came under pressure. The Russian ruble dropped sharply following a move to a floating exchange rate system. That move was largely forced upon the Russian central bank which found itself in the midst of both commodity and political storms.

So 2014 proved to be a year when the positive returns in fixed income markets were largely attributed to the decline of government bond yields, offset in part, by credit spread widening. High yield, EMD hard currency and investment grade corporate bonds all underperformed similar duration US Treasuries in 2014. EMD local currency declined 5.72% for the year as currency volatility overwhelmed the attractive yields in the asset class. We expected EMD to outperform in 2014 but we thought that would reflect stronger credit returns given the improved growth outlook for the US. Indeed US growth looks set to average in excess of 3% annualized over the last three quarters. It seems clear to us that the impact of GDP growth issues in Europe

and China as well as the decline in oil prices has dominated sentiment and the prospect for sentiment on these issues was central to our offsite deliberations on the outlook for 2015.

Will the ECB Deliver QE? Will It Help?

In our view, the short answers to these questions are: yes the ECB will deliver, and yes it will help, but not much. Headline inflation has fallen to 0.4% in Europe from 1% at the end of 2013 and 2.3% at the end of 2012. Large output gaps throughout Europe indicate downward pressure on inflation is likely to continue. In addition, the weakness of the Yen together with sanctions on Russia will likely put growing pressure on German exports and economic activity, increasing the likelihood of an intensification of deflationary pressures. Another major factor, the decline in energy prices, has yet to feed through to final prices and should push inflation lower still. At the very least, it seems the ECB will find itself facing zero inflation at some stage over the coming months.

The ECB has indicated that it will review the case for an extension of non-conventional monetary tools early in 2015. While the decline in the Euro should provide some upward pressure on inflation, we suspect that weak levels of economic activity will trump currency softness in determining the overall level of inflation. With that in mind, it was notable that President Draghi also stated that the ECB staff had been asked to speed up their assessment of the available policy tools. This indicates a sense of growing urgency at the ECB.

Whatever actions the ECB takes are ultimately likely to be only stop-gap measures. It seems to us that no amount of QE will change fundamental problems which afflict Europe: a lack of common fiscal policy or at least a mechanism for substantial fiscal transfer; over–regulation, particularly in labor markets; and a German economic model based on excess savings leading to insufficient consumption. Interest rates and credit spreads are low in Europe - limiting the domestic channels through which QE can enhance growth. This indicates that the ECB's version of QE, as in Japan, will work by creating a weaker currency. Euro weakness will likely put upward pressure on inflation through import prices and encourage some degree of substitution away from imports to domestically generated goods. On the other hand, it encourages an export-driven recovery likely benefiting Germany more than other European countries. Unfortunately, German policy is unlikely to be directed toward increased consumption. Indeed German policy-makers' determination to prescribe their export-driven model to the rest of Europe may be encouraged. The ECB leadership seems very aware of these issues but as chairman Draghi has observed, they have a legal requirement to target inflation. To do otherwise in order to increase pressure for reform would not meet their legal obligations. The ECB has little choice but to act and hope that European policy makers follow. We suspect that longer term progress on the core issues will be slow and complicated by up-coming elections and the rise of fringe political parties in many countries. The appetite for meaningful reform just does not appear to exist at this juncture. So we should anticipate some form of ECB QE but it likely provides symptomatic, not systemic relief.

What will happen with oil?

The recent sharp decline in the price of oil has triggered a broad debate about its primary causes. Some argue that the weakness is primarily demand-driven. This position aligns with declines in global growth expectations but is less consistent with US and UK growth. Others highlight supply imbalances and focus on current calculations of 1.5-2 million barrels per day of excess supply. The market also speculates on political objectives, dominating producer behavior, with the suggestion that Saudi Arabia is positioning for market share gain over price stability. However, what we do know is that all of these factors will play out iteratively as markets establish a new equilibrium price level over time. Let's not forget that there is no better cure for low prices than low prices. Weak oil prices will eventually cause a reduction in supply and it can only be a matter

of time before new projects are cancelled and eventually, production is cut.

At the same time, there are numerous beneficial effects of low oil prices. Current oil prices will encourage GDP growth in oil importing countries as it simultaneously lowers inflation. Estimates of the impact vary, but in our view, point to an increase in growth in developed economies on the order of 0.3-0.5%. With higher growth will come increased oil demand and the next phase in the price discovery process will commence. We expect production cuts and higher economic growth to appear in the second half of 2015. In the meantime, markets will have to navigate a period of low and volatile oil prices, raising default risk for oil producers (countries and companies) and for oil servicers. At this stage it is hard for the market to discriminate between the ultimate winners and losers, but in hindsight we believe this environment will likely be seen as offering great - if selective - opportunities.

Over the next six months we may well see a divergence of response to oil prices across major central banks. We expect that the Federal Reserve - and likely the MPC in the UK - both with economies approaching full employment and showing tentative signs of a pick-up in wage inflation, will focus primarily on the impact of oil prices on growth and employment and may well be forced to revisit the case for interest rate hikes sooner rather than later. Conversely, we think it is likely that the ECB will focus on the decline in inflation that lower oil prices bring and the risk that this filters into longer term inflation expectations. Because the ECB will likely want to avoid this, lower oil prices seem to increase the likelihood of earlier adoption of QE in the Eurozone.

What is happening in China?

"There are known knowns … there are known unknowns … but there are also unknown unknowns…" Donald Rumsfeld could have been speaking of China. We know that China's population is aging and its trend rate of growth is slowing. We know that growth has to rebalance towards consumption and away from ineffective over-investment. We know that policy initiatives to achieve this rebalancing are fraught with political risk. But we also know that we do not know the exact path that China will follow. It is highly likely that the market will go through periods of believing that authorities are following one path and then another. The Chinese leadership is faced with a daunting challenge. To rebalance too slowly is to continue misallocating capital and resources and likely would eventually lead to a sharp slowdown. To rebalance too quickly is to challenge vested political interests. At the moment it would appear that we are in a strong phase of clearing those vested political interests which should make future reforms more successful, but others might argue that President Xi is, in reality, overseeing a transfer of vested power.

The strong surge in the stock market over recent months does raise a concern about known unknowns. The banking and shadow banking systems are overextended in our view. Each additional unit of credit generates less additional GDP than the prior unit. This portends a rising bad debt problem. But the economy is slowing and to recognize those bad debts risks a collapse in confidence. The recent rise in the stock market suggests that we may have reached a stage in China where monetary easing no longer benefits the housing market but rather benefits stocks. If this is so, the management of the economy has just become a lot more difficult. This year may be a crucial period of transition for China. A year in which bad loans will increasingly need to be recognized, investors will need to take haircuts to balance speculative risk and reward, political vested interests will still need to be addressed and monetary policy will need to adjust to lower inflation and declining growth. The challenges are clear but the path to success is not.

Internationally we should perhaps not fixate too much on Chinese GDP growth for two reasons: First, the process of rebalancing suggests the rate of growth of consumption - which should be higher than GDP growth

if rebalancing is to be achieved - will be key for developed markets. Second, lower Chinese GDP should keep commodity prices subdued, removing a brake on developed market consumers that has existed in recent years.

Conclusions

So how do we think that all these themes will play out over this year? The ECB will likely commence QE in the first quarter in an attempt to head-off any potential deflationary impact on inflation expectations. The credibility of this move will likely be enhanced, even if temporarily, by improving growth prospects on the back of low oil prices. European bond markets may experience setbacks with ECB announcements of QE as happened in the US.

At the same time, the Fed is expected to begin the steady drumbeat of rate increase signals in anticipation of a policy rate increase towards the middle of the year. Treasury yields are too low, in our view, for a combination of an increased Fed Funds rate and stronger growth forecasts. Portfolios need to be positioned cautiously from a duration perspective.

A repeat of the credit widening seen with the "taper tantrum" two summers ago seems unlikely because credit spreads will be entering this period of rising rates after a period of stress in the latter half of 2014. It is likely that corporate spreads will behave as they have in the early stages of previous tightening and in fact narrow over time in recognition of a combination of a still accommodative monetary stance and positive growth outlook. With a lag, improved growth will lead to stabilization and improvement in the commodity markets. Eventually current cheap valuations in credit markets will be rewarded, but, in our view, this may lag into the second half of 2015.

While we remain cautious on the level of government bond yields, we enter 2015 with a more positive view on credit spreads than at any time since late 2011.

Let me take this opportunity to wish you all a very prosperous New Year.

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