Letter from the CIO:

An update on 2015

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 mid-year meetings often serve as a check on our thoughts from the beginning of the year and offer us the chance to review where we are, what we got right and wrong, whether events are unfolding as we expected and how we might want to set course for the rest of the year.

At the beginning of this year we felt fairly clear about our outlook. Weak commodity prices, especially oil, were likely to boost consumer activity resulting in trend to above-trend growth in the energy consuming sectors of the developed world. Prospective QE from the European Central Bank would add further impulse to this growth profile. Enhanced growth prospects are generally positive for corporate bonds. Beyond the first quarter of 2015 we felt that stronger growth would boost demand for oil and the decrease in the drilling rig count would likely limit supply. This suggested that as we moved through the year oil prices would stabilize and then move higher, helping the emerging markets stabilize. The two risks we discussed were variables surrounding the Federal Reserve's tightening of monetary policy and the uncertain growth outlook in China. We argued that any Fed tightening would likely be cautious and that weak growth in China would, arguably, be positive for developed market growth through the channel of lower commodity prices.

As we reach mid-year we are able to see where we were correct and where we were either wrong or possibly early. Developed market growth in Europe has indeed surprised on the upside and corporate bonds, particularly high yield, have performed well. At the time of writing the US High Yield market has outperformed duration equivalent US Treasuries by nearly 3%. After early year weakness, the oil market has found a more stable footing with the price of West Texas crude seeming to settle around $60 over recent weeks. After merely matching duration equivalent US Treasuries during the first quarter, US dollar denominated emerging markets debt (EMD) has recently outperformed US Treasuries by some 3%. EMD local currency debt still lags, reflecting strength of the US dollar. On the negative side, we were wrong to expect a strong start to the year in the US and to anticipate that the Federal Reserve would likely move in June to tighten policy. Weak first quarter growth has pushed expectations for the Fed back to September or later. More recent inflation and consumption data have supported that expectation and it is likely that growth data will improve somewhat from here. Perhaps this was more a case of being a little too early rather than wrong!

At this mid-year juncture we like to revisit our thinking for the period ahead. At our offsite I particularly wanted to challenge our economists

and portfolio managers to consider some of the longer term secular issues that we have discussed over recent years. When policy is at an inflection point it is important to consider these issues and their implications for the likely range of policy changes going forward. Economies - whether developed or emerging - have been growing GDP below trend for some time. The specifics of slow growth vary by country and region, but we spent considerable time reviewing its causes and trying to understand its implications for financial markets. We found it useful to question whether we are experiencing a cyclical slowdown with recovery delayed by the scale of the 2008 crisis or whether we are in an extended period of sub-par growth for additional secular reasons.

The US and the UK

The US and UK economies appear to be closest to a change in the direction of monetary policy. Both have exhibited strong labor markets and early signs of wage inflation but have also recorded disappointing recovery data for some time. In the US in particular, there are some important changes taking place in labor markets which have lowered labor force participation and negatively affected potential growth while there has also been relatively slow productivity growth. This suggests that the growth disappointment has been due to some mix of demographic and productivity related issues. We concluded that it was hard at this stage to argue for a sudden surge in productivity and there was a general caution about assuming that technological advances were not being reflected in the data, a speculative argument that we increasingly hear. More significantly it was felt that the easy availability of credit through the middle part of the last decade led to a misallocation of capital which we are still working our way through. Compounding this, high levels of debt suggest the political reality that the public ability to borrow for future investment is low and will remain so for quite some time.

A further issue that our UK colleagues highlighted was that following the financial crisis and oil price collapse there has been a sharp reduction of jobs in these two traditionally high productivity sectors. Oil related jobs will re-emerge at some stage but the ongoing increase in banking regulation suggest that future productivity gains in the financial sector will likely be hard to achieve. Therefore of the three drivers of trend growth - investment, productivity and the labor force only the latter is functioning in a traditional manner. Indeed, as my UK colleagues pointed out, labor market reforms over the past few years may mean that the UK may be able to drive the lower bound of unemployment below the level of previous cycles. Despite this we should recognize that the Fed places the output gap at only 0.7% and the Bank of England suggests 0.5%. We concluded that the evidence pointed to the US and UK economies likely displaying normal cyclical behavior but at a lower average rate of growth than in previous cycles. The path of the coming round of expected Federal Reserve monetary policy tightening is likely to reflect this.

There was some conjecture about how one might project interest rate levels in this low growth environment. It was observed that prior to the financial crisis the mid cycle level for Fed Funds seemed to hover around 5% and that prior to the bursting of the dot com bubble in 2000 it was closer to 7%. After each cycle the developed world's economies emerged with increased leverage and that has happened again. Indeed the

BIS estimated a 50% rise in debt outstanding in the world's 12 largest economies post 2007. With higher debt levels, economies can only sustain themselves at a lower level of interest rates. As a result, we expect peak interest rates in this cycle to be well below prior peaks.

Europe

Turning to Europe our conclusion was that the picture is less encouraging than that of the US and UK. Economy-wide levels of leverage remain high although consumer debt levels are lower. Populations are aging in the larger countries and this will limit their future growth profile. Investment and productivity trends are discouraging. All of this points towards low levels of trend growth but does not argue for a lack of cyclical behavior. Indeed this year has seen unemployment decline in Europe with growth at sub two percent. Trend growth is very low and likely to trend lower and this argues that rates will stay low for longer and that perhaps, the cyclical pattern of rates in Europe will be less pronounced than in the US.

This mix of economic circumstances carries with it the prospect of ongoing political risk. In a world of very limited productivity growth, increases in real wages will be modest at best. Individual sectors will often only be able to gain through redistributive government policy. We already see the stress that this situation has created in Greece, and we see increasing evidence of swings to non-mainstream parties in other countries with Podemos in Spain and Le Pen in France. All of this makes reform harder to deliver and compounds the likelihood of slow productivity growth.

So for the developed markets our expectation remains for a cyclical upswing, accompanied by monetary policy tightening from the Fed but within the context of a moderated cycle. Outside of the developed markets, China was again a major concern.

China

While the absolute level of GDP growth in China far exceeds the level in the developed world, China's growth rate has slowed significantly. This slowdown helps explain the degree of stimulus that seems to be on the table. This raises two questions which were hotly debated by our team. First, will stimulus work in the near term? And second, does it compound the structural imbalances that already exist? The first question may seem a little odd in a state run economy but recent limited growth in lending despite central government encouragement suggests that policy traction can be limited. Reportedly, the government has instructed banks to lend to local government projects regardless of their ability to pay. The nature of this edict and the plethora of infrastructure investment announcements over recent days suggest real urgency. A pick-up in growth will likely follow. The multiplier effect of policy stimulus is diminished with each cycle, a fact that seems to be supported by the increasing credit creation necessary for each percent of economic growth achieved. Aggregate debt to GDP has quadrupled in China over the last ten years. This highlights the longer term issue that this debt accumulation pushes resources and credit creation further from an efficient rebalancing of the economy and will ultimately make the final adjustment all the more challenging. With previous cycles the Chinese authorities have been able to "extend and pretend" with bad debt, confident that nominal growth in the 10-15% range would soon hide the excesses. Unfortunately nominal growth

appears to be moving lower on a secular basis and this will be a hard trick to keep repeating. Credit growth rising at twice the rate of GDP growth is not compatible, in the long term, with slowing growth. Add an aging population and it is hard, in our opinion not to see the ambiguity of these policy initiatives but as our EMD team pointed out, they are of sufficient magnitude that growth will continue…for now.

The Fed and Valuations

Of more immediate importance, we came to a consensus that the Fed was likely to move in September but would move slowly. Yellen and other officials have highlighted the data dependency of their coming decision. Our secular view of below-trend GDP growth suggests that the hurdle rate for a rise in rates may not be especially high, indeed our economists felt that a 2.5% growth rate in GDP would be sufficient to warrant tightening especially if it came hand in hand with evidence of tighter labor markets. It was in this context that our asset class teams addressed valuation issues. The broad conclusion was that credit, from a spread perspective, looks to be reasonably attractive. Our valuation metrics point to spreads that are close to fair value in the context of the last ten years. However a number of participants pointed out that this analysis heavily weights the 2007-2009 financial crisis, probably giving a 25% weighting to an event with a sub 5% probability. Adjusting for this anomaly spreads look modestly cheap to their historical averages. An alternate approach that some argued for was simply to look back at similar historical periods, to the extent that they can be found, which drew a similar conclusion. Our credit analysts were vocal, arguing that with a few small exceptions, balance sheets are much better structured than they have been historically with debt refinancing walls less in evidence. With spreads at reasonably attractive levels and rates set to rise only modestly, the outlook for corporate credit is robust and may remain that way longer than we had anticipated at the start of the year.

Emerging markets debt, at least in US dollar terms, has belatedly joined in the rally but local currency debt, despite solid April performance, still lags. As an asset class EMD stands out as offering the most value among the major credit asset classes but it is clearly awaiting the catalyst of increased growth. As our EMD team observed, the bifurcation of yields within the market means that value is retained within the commodity linked markets. A pick-up in commodity prices during the year should translate into tighter spreads. We have seen individual countries perform well year-to-date, Russia for instance, but this has not been sufficient to create broader support for the market.

Oil Prices

Inevitably we refocused on the oil market in an attempt to gauge the outlook for the rest of the year. The oil drilling rig count is down some 55% over the last six months. This is not dissimilar to the 2008-2009 period when the rig count fell by just under 60%. We heard arguments that oil drilling productivity is far higher than last cycle and that therefore supply would stay high but we believe that such declines in drilling activity will result in declining production. We also reviewed data that suggested that with lower break-evens, the drilling rig count would rise rapidly if oil rose above $65 per barrel. Offsetting this potential rebound in production, we discussed whether the change in risk assumptions in business models at energy

producers would be severe enough to postpone increases in production. The demand picture seems clearer with stronger growth expected to feed in a linear fashion into demand for oil. EIA data points to an increased demand for oil and recent work from the commodities team at Barclays attributes 30% of recent price gains to growth in demand. In the near term we may see a correction in oil prices given the build-up in speculative longs in the futures market. We still anticipate further longer term upside in oil prices but it won't be a smooth one-way journey and there will be volatility.

Conclusions

In many respects our outlook for the remainder of 2015 remains in line with our thoughts from the beginning of the year: Corporate credit offers value; emerging markets sovereign debt offers perhaps more value but the timing is uncertain; duration is generally a risk best avoided, more so now given the proximity of Fed action; and the US dollar, among major currencies looks likely to benefit from monetary policies and improving growth. Where we have moderated our views it is to recognize that the rate cycle may be less aggressive than previously thought but this supports valuations rather than challenges them.

Peter J. Wilby, CFA
Chief Investment Officer
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New York

31 W. 52nd Street, 16th Fl
New York, NY 10019
+1 212 548 1200

London

48 Dover Street, 5th Fl
London, W1S 4FF
+44 20 3205 4100

Melbourne

Suite 3143, Level 31
120 Collins St
Melbourne
+61 3 9225 5064

Singapore

9 Temasek Boulevard
#09-03A Suntec Tower Two
Singapore 038989
+65 6671 9711

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