Emerging Markets Local Currency Debt:

Our Views on the Asset Class

Stone Harbor Investment Partners

February 2015

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Summary

After two years of low returns and high volatility in EMDLC, we address several of the questions institutional investors are asking. The key issues include: the reasons for recent underperformance of EMDLC; the validity of the sector as an asset class; and the sector's outlook. We also look into the impacts of lower commodity prices and changes in the US Federal Reserve's (Fed) policy rate on returns. In our view, the case for EMDLC remains as valid as ever and, at current valuations, EM local currency bonds are set to outperform other fixed income sectors in the years ahead.

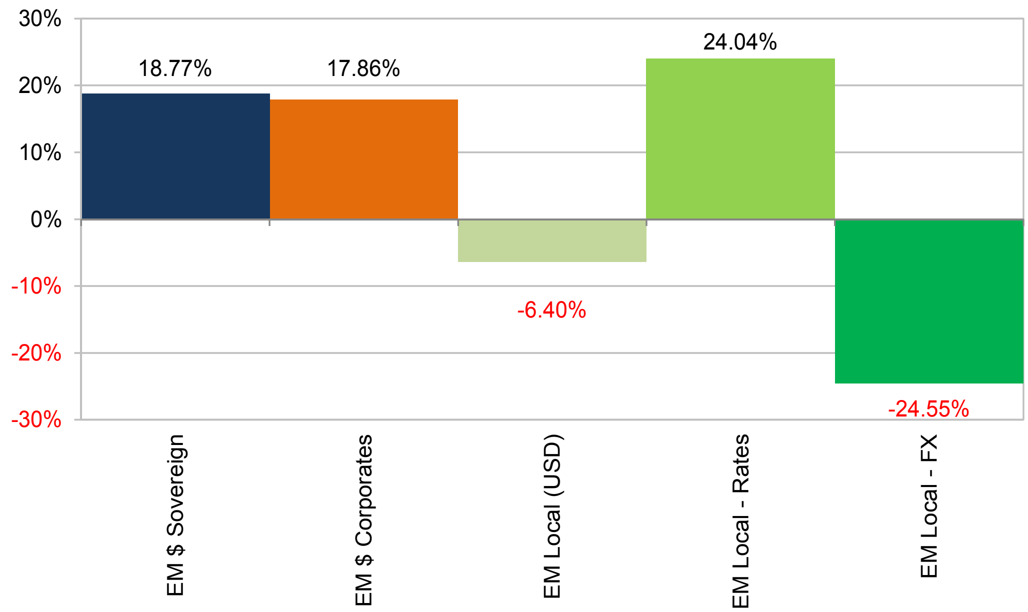
Why has EMDLC underperformed over the last two years?

After the 2008 financial crisis most emerging countries implemented large fiscal and monetary stimulus programs to counteract the effect of the slowdown in the developed world. China was the leader in the process of enabling developing country growth to decouple from advanced economies. This growth divergence, though, did not last. By 2012, the ability of policy makers in emerging markets (EMs) to stimulate their economies began to fade, in some cases due to debt accumulation, in others due to inflationary pressures. While EMs continued to grow faster than most developed countries, growth disappointed expectations. The announcement by the Fed of its intention to terminate quantitative easing (QE) coincided with this growth slowdown, and led, for the first time in a decade, to large outflows from the asset class during the latter half of 2013, primarily from retail investors.

Other events contributed to the pessimism and added unusual levels of volatility, particularly in foreign exchange (FX) rates. Some of the largest emerging countries, including Brazil, China, India, Indonesia, South Africa and Turkey, held important elections or leadership changes more or less at the same time, which naturally tended to reduce risk appetite and focused media attention on these countries. Widely publicized demonstrations in Brazil, Turkey and Thailand impacted market sentiment toward EMs. Geopolitical tensions related to the Russian annexation of Ukraine's Crimea in 2014 and the economic sanctions imposed by the US and Europe afterward helped to consolidate the market feeling that something was abnormally wrong with emerging economies. Finally, the halving of the market price of oil in the second half of 2014 created further concerns about the ability of EM local debt markets to recover from recent underperformance.

In our view, it was not so much any individual event but the confluence of weaker than expected growth, capital outflows, heightened foreign exchange volatility and political and geopolitical tensions that contributed to the poor performance of EM local markets, particularly of the FX component of returns. In the three year period ended 30 January 2015, nominal EM FX returns were down 25% versus the US dollar and down 12% against the Euro. (See Chart 1.) Most of the factors that contributed to the drawdown were cyclical in nature and, in our view, are unlikely to be repeated in the near future. At the very least, if they do occur, they are unlikely to happen with the same intensity. While some of these issues still remain to be resolved, strong long term fundamentals and a healthy re-pricing of assets allow for more attractive returns for the sector going forward.

Chart 1 - Three Year Performance (Cumulative): 31 January 2012 - 30 January 2015



As of 30 January 2015
Source: Bloomberg

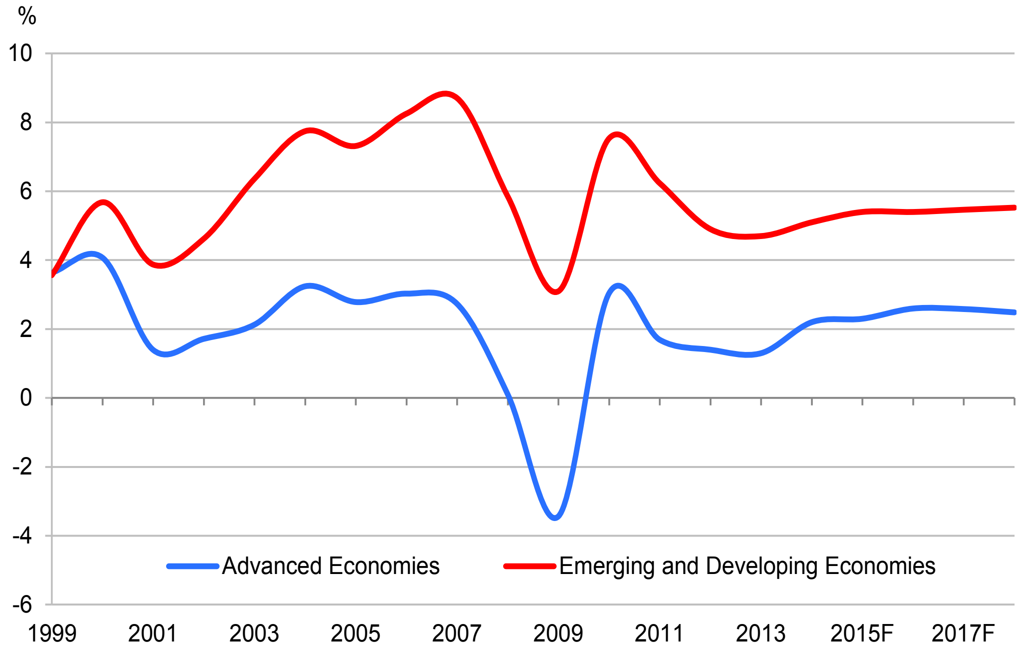
Is the slowdown in emerging countries growth structural or cyclical?

Growth in EMs has slowed significantly since the pre-crisis peaks (2004-2008) and the post-crisis recovery in 2010. This slowdown clearly had a structural component. In particular, productivity growth has declined as some countries, led by China, have outgrown their ability to rely on export-led growth. Moreover, major developed markets, in particular the US, are generally no longer willing to run rising current account deficits and thus absorb growing imports from EMs. As a result, the time of double-digit real growth rates in some EMs has passed.

But we believe this is only part of the story. EMs' policy reactions to the global financial crisis were to run countercyclical policies which propped up growth during 2009-2011. One of the results was increased leverage. However, as the US recovery remained sluggish and the Eurozone went into recession in the wake of the euro crisis, EMs lacked the external demand to sustain those growth rates. Moreover, a broad slump in confidence further exacerbated that slowdown. A significant number of central banks had to tighten policies in order to protect their FX rates in light of changing portfolio flows. The result, in our view, was a cyclical slowdown in EMs during 2012-2014.

What does this imply for growth prospects going forward? We believe EM growth will pick up over the coming years as the growth cycle turns in an increasing number of countries. However, this is not a synchronized process across countries. While growth headwinds still prevail in some large EM economies—e.g. Brazil which is still tightening monetary and fiscal policy in 2015, or Russia which is headed into a severe recession—others are beginning to show signs of improvement. Mexico is probably the best example but we expect that process to continue in a growing number of countries over the coming years. Low global inflation pressures will be supportive, as well as gradually improving growth in developed economies. As a result, we believe the multi-year period of continued disappointments and downward revisions in EM growth will gradually turn into a period of better performance. From an investment point of view, this means we expect a better backdrop for EM currencies in the coming years.

Chart 2 - GDP Growth, Advanced Economies vs. Emerging and Developing Economies



Source: IMF, WEO, October 2014

Is EMDLC Still a Valid Asset Class?

EMDLC consists of claims on sovereign government bonds payable in domestic currency. Local currency debt investors are exposed to a combination of risk factors, namely currency, duration and ultimately the credit risk of the sovereign. The importance of growth for EM local markets returns is a hallmark for the asset class and in many ways distinguishes EM local markets, as we see it, as one of the few income asset classes which will benefit as growth recovers, even in an environment of extraordinarily low core fixed income yields.

The poor performance and heightened volatility of EM FX has led many investors to question the validity of EMDLC as an asset class. We think this view is misguided. Emerging markets are volatile and as long as the economies, institutions and policies are "emerging", their assets are also likely to remain volatile. It is precisely this volatility, we believe, that creates attractive risk premium in the sector. When coupled with generally sound fundamentals, volatility generates investment opportunity. Indeed this was the case in 2009 and 2012 when sharp declines in EMs were followed by more significant recoveries.

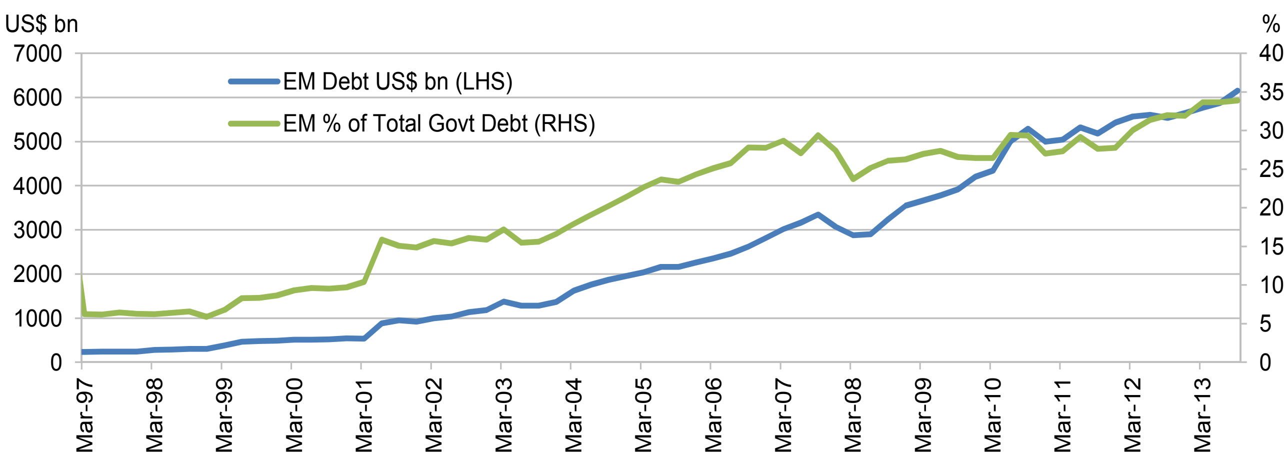
In our view none of the key sources of volatility over the past two years, namely the Fed tapering and weak global growth, meaningfully challenges the validity of the asset class. In the narrative of the 2013 taper tantrum, the end of the Fed's asset purchase program would lead to higher US rates and capital outflows. Indeed there was a sharp reaction as US rates sold off following Ben Bernanke's suggestion in May 2013 that the Fed may reduce its bond buying program. The magnitude of this sell off was more than three times the normal historical reaction but the source of the selling was important. Retail investors reduced exposure through holdings in emerging market debt mutual funds, but institutional investors, in aggregate, held or increased their positions in the sector. Therefore, the large unwind of foreign positions in EMs never materialized and foreign ownership of local bond positions in 2013 continued to increase. We believe that the negative reaction in markets was exacerbated by a combination of a high degree of leverage in interest rates markets and rich valuations for much of EM fixed income at that time.

Second, the declining growth trend of EM economies and narrowing growth differential with the US led to continued outperformance of the US dollar relative to EM currencies. While we would have liked to have seen better growth, and in fact had expected it, acceleration in EM growth did not materialize. As a result, the performance of EM currencies relative to the US dollar behaved in many cases as it should have, given the pro-cyclical return profile of EM FX.

Another important factor to consider is that the EM domestic debt bond market has reached, in our view, critical mass. The total stock of domestic debt has increased to approximately US$12 trillion. This figure represents a threefold increase over the past decade and the sector now accounts for a third of the total global sovereign domestic debt stock. (See Chart 3.) Globalization of fixed income ownership has allowed for increasing foreign ownership of EMDLC. In our view, the historically high current levels of nonresident holdings of EM domestic bonds makes sense given the more attractive valuations and supportive fundamentals available in emerging markets relative to developed country bond market alternatives.

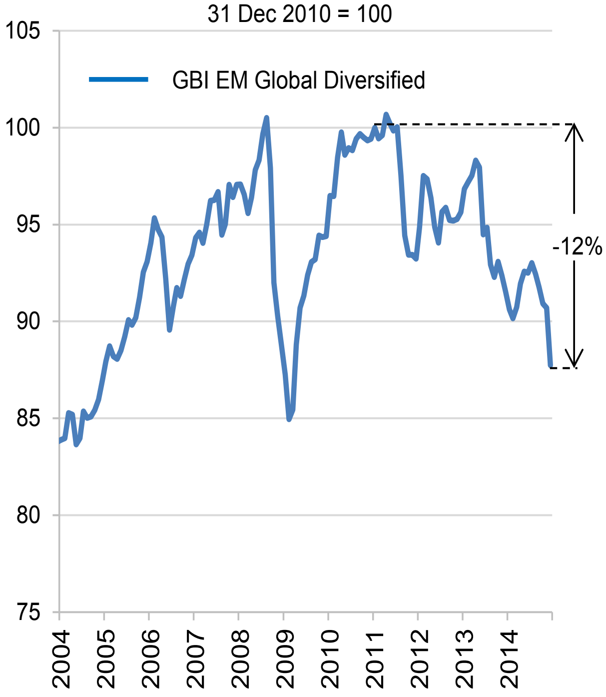
Finally, the recent underperformance of EMDLC, especially for investors who are funded in US dollars, has resulted in value creation. Using the JP Morgan GBI-EM Global Diversified as a guide, the real effective exchange rate of EM currencies has declined by 12% since the end of 2010. (See Chart 4.) While the decline in commodity prices, especially oil, has led to a negative terms of trade shock in some countries, this is not the case in aggregate. As a result, we think EM currencies are significantly more attractive today versus major currencies. Moreover, average EM bond yields have underperformed developed market (DM) alternatives. Currently the yield of the JP Morgan GBI-EM Global Diversified is 500 bps wide of its DM counterpart. This gap is the widest of any period other than during the height of the 2008-09 global financial crisis. (See Chart 5.)

Chart 3 - EM Debt in US$ Billions and as a Percentage of Total Government Debt



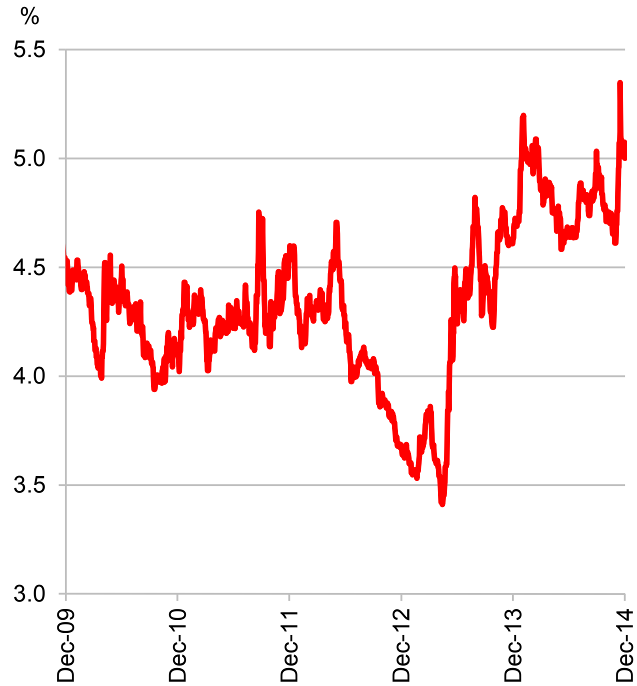
Source: Bank of International Settlements

Chart 4 - EM Real Effective Exchange Rate



As of 31 December 2014
Source: BIS, Bloomberg, Stone Harbor Investment Partners LP

Chart 5 - GBI EM Global Diversified - DM Bond Yield Spread[1]



Source: Bloomberg, JP Morgan, Stone Harbor Investment Partners LP
[1]JP Morgan GBI EM Global Diversified Yield (Bloomberg ticker: JGENVHYG); DM Bond Yield = JP Morgan GBI Global Yield (Bloomberg ticker: JPMYGLBL)

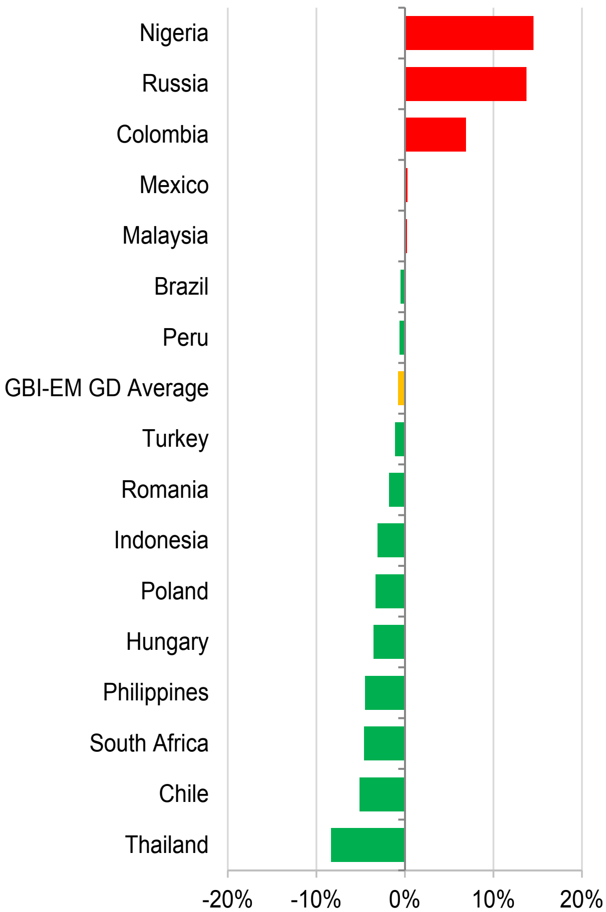
How correlated are EMDLC returns to commodity prices?

Emerging markets are often perceived as highly commodity dependent and the recent decline in commodity prices has caused concern among investors. The key questions, in our view, are: how dependent are EM currencies on commodity prices, and what are realistic performance expectations during a period of sluggish commodity prices?

The diversity of commodity exposures within developing economies supports a more optimistic outlook. Some countries are net exporters, others are net importers. The composition of countries in the asset class, therefore, is critical. It might be surprising to some that the countries in the JP Morgan GBI-EM Global Diversified Index are on average net oil importers to the extent of about 0.75% of GDP despite the inclusion of major oil producers such as Colombia, Malaysia, Mexico, Nigeria, and Russia. (See Chart 6.) Thus, on an index level, lower oil prices benefit the asset class economically. We get similar results with respect to other commodities. In fact, as commodity prices have fallen since 2013, the terms of trade for many EM countries have improved. (See Chart 7.)

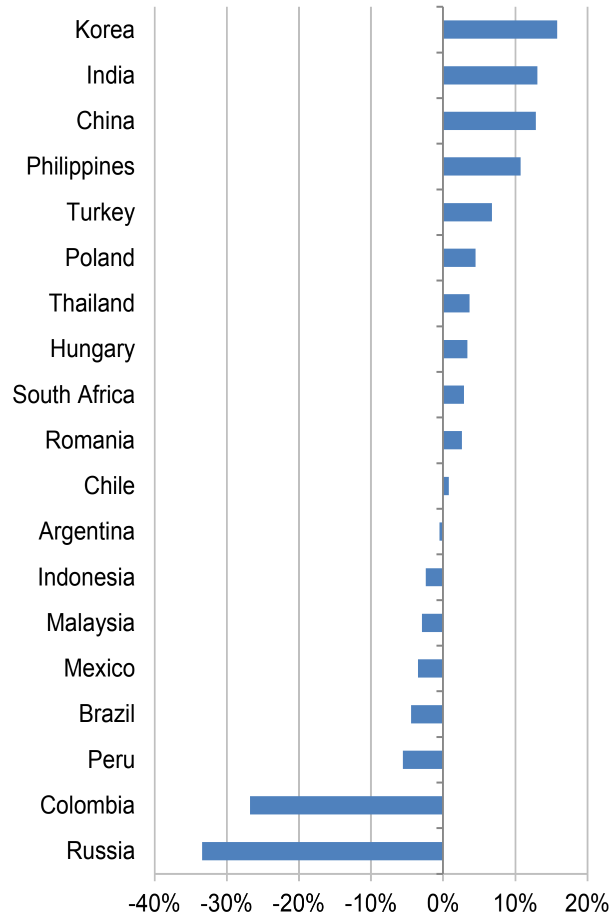
In our experience, markets do not always appreciate this fact and knee-jerk market reactions often suggest higher commodity exposures. However, in our view, fundamentals ultimately dominate and short-term market dislocations create opportunities for investors with a focus on fundamentals. Differentiation will be critical given the large differences between EM countries and will create opportunities to generate excess returns.

Chart 6 - Net Oil Balance (% of GDP)



Source: JP Morgan, Stone Harbor estimates

Chart 7 - Change in Commodity Terms of Trade Since 2013



Source: Bloomberg, Citi, Haver Analytics, Stone Harbor Investment Partners LP

How will EMDLC perform when the US Federal Reserve hikes rates?

Investors justifiably worry that the volatility that surrounded the Fed's first attempt to discuss monetary policy normalization in May 2013 may re-emerge as the Fed is widely expected to hike rates this year or next. To be sure, there may be volatility around the event but we believe that EM local fixed income is much better positioned for that reality today than in 2013. First, retail investors, the drivers of the 2013 selloff, have already substantially reduced exposure to EMDLC and thus are likely to have less of an impact on returns going forward. Second, EM currencies have already significantly re-priced. We recognize that currency valuations can and often do overshoot, but currency devaluations over the past three years have been substantial in nominal and real effective terms. Third, market positioning in the sector appears to favor EM currencies as investors have purchased US dollars. As a result, we believe that the market volatility that resulted from the Fed's initial discussion of normalization of monetary policy in May 2013 is unlikely to be repeated when the Fed actually begins to raise rates.

Moreover, the impact of rising US rates on EMDLC will likely differ substantially across countries. Diverging monetary policies in emerging economies, we believe, have created significant opportunities within EM domestic fixed income. As in many developed countries, many EM central banks have eased monetary policies over the past two years to spur

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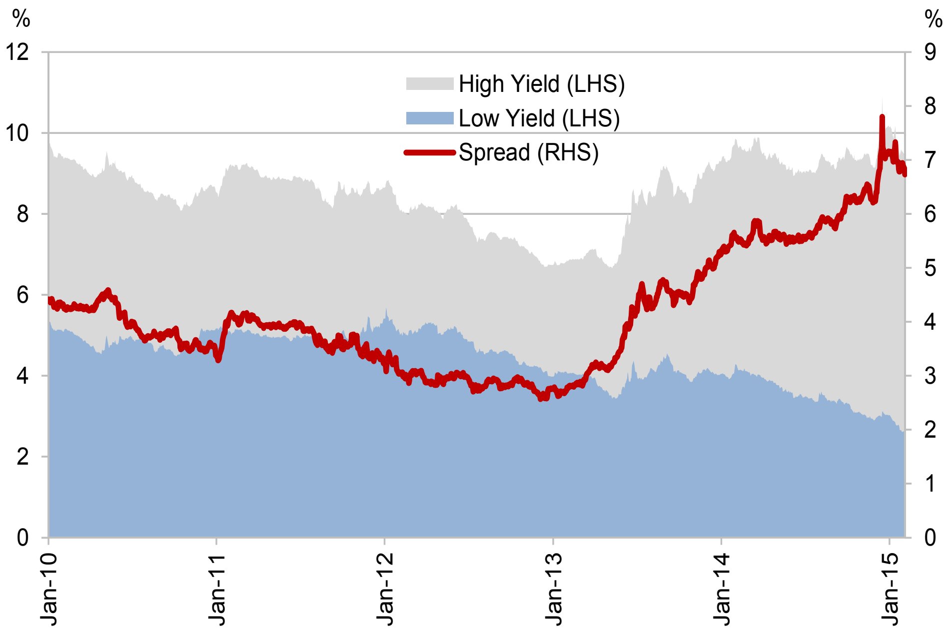
growth in a low growth environment. Others have hiked rates to offset inflationary pressures or to support their currencies, particularly Brazil and Russia. The yield spread today between countries at either end of the spectrum of these diverging policies is now historically wide. This leaves some countries' rates markets much less vulnerable to rising core yields than others. We think that one of the most interesting themes in the market today is the potential for this yield spread to narrow. (See Chart 8.)

Chart 8 - Local Currency Yields (High vs. Low Yielders)



As of 3 February 2015
Source: Bloomberg, Stone Harbor Investment Partners LP

What is the outlook for EMDLC returns?

In short, the outlook is good. We expect that EMDLC will generate around 6% returns in 2015 and 7% annual returns over a cycle of 3-5 years. The current range of valuations is as wide as we have seen in many years, which presents significant opportunities for investors. The yield gap between the highest yielding one-third of EM local bond markets and the lowest yielding one-third is 700 basis points, which has never been wider. This yield differential reflects the fact that all of the higher yielding countries at some point since 2013 hiked policy interest rates; in contrast, the lower yielding countries were able to ease and benefitted from the collapse in core market yields. However, this dynamic of 2013-14, we believe, is set to change in 2015.

With several major elections in the rearview mirror, fiscal reform in Brazil, India and Indonesia have taken center stage, while improved terms of trade are a tailwind for inflation and for the external accounts in Turkey and South Africa. Perhaps the most challenging environment in 2015 is for the Russian economy with the combination of lower oil prices and Western financial sanctions. While a stagflation environment in Russia this year is likely, the ruble has overshot all metrics of fair value, in our view. The December 2014 decision by the Russian Central Bank (CBR) to hike its policy rate by 650 basis points is likely to be rolled back as the ruble and inflation stabilize. Indeed, in January 2015, the CBR lowered its policy rate by 200 basis points.

Over the longer term, we expect the yield differential between EM and DM debt to compress and return to historically normal valuations. The prospects for growth in EMs and improved valuations argue for healthy absolute return potential for the asset class. We think the relative return prospects favor EM over DM sovereign debt by a wide margin. While the momentum of QE and global deflationary fears may continue to provide technical support for core market yields, EMDLC provides yield in a world in which over 50% of all government debts yield less than 1%.

While our base case for returns on EMDLC is positive, several scenarios could prevent the realization of our benign outlook. As noted earlier, chief among these risks is the continued appreciation of the US dollar. While we expect economic growth in China to continue slowing in the years to come, a more pronounced slowdown could also weaken investor sentiment toward emerging market risks. We also take into account the possibility that commodity prices fall dramatically further. Though we believe that the impact of lower energy prices has varied impact on emerging economies depending on their positions as net importers or exporters of energy products, more volatility in commodity prices, particularly sharp moves to the downside, may also detract from EM debt returns. Finally, an escalation of geopolitical tensions in Russia, in the Gulf and Middle East or in other countries, may also constrain investor appetite for EM exposure.

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Endnotes

The JP Morgan GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate domestic currency government bonds to which international investors can gain exposure. The JP Morgan GBI-EM Global Diversified is a subset of the GBI-EM and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within the GBI-EM Global Diversified. Return from FX is the difference between the JP Morgan GBI-EM Global Diversified total return (Bloomberg ticker JGENVUUG) and the GBI-EM Global Diversified in local currency terms (Bloomberg ticker JGENVLLG). Return from Rates equals the total return of the GBI EM Global Diversified in local currency terms (Bloomberg ticker JGENVLLG).

The JP Morgan Government Bond Index (GBI) Global is a composite index of the GBI Indices that provide a benchmark that tracks local currency bonds issued by developed market governments. The universe of countries for the GBI Global includes Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, United Kingdom and United States. As of May 2014, Japan and the United States comprised almost two-thirds of the index in market value. The index uses a traditional market-capitalization approach to determine the weight of each country's allocations; the GBI is weighted by the component countries' aggregate normalized market capitalization. The index includes only liquid, bullet, fixed-rate debt.

Assumptions for International Monetary Fund (IMF) and World Economic Outlook (WEO) Data
A number of assumptions have been adopted for the projections presented in the World Economic Outlook (WEO). It has been assumed that real effective exchange rates remained constant at their average levels during July 30–August 27, 2014, except for those for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to have remained constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies for selected economies, see Box A1 in the Statistical Appendix); that the average price of oil will be $102.76 a barrel in 2014 and $99.36 a barrel in 2015 and will remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 0.4 percent in 2014 and 0.7 percent in 2015; that the three-month euro deposit rate will average 0.2 percent in 2014 and 0.1 percent in 2015; and that the six-month Japanese yen deposit rate will yield on average 0.2 percent in 2014 and 2015. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through September 19, 2014.

Important Disclosures