Stone Harbor
Investment Partners

Letter from the CIO:

Our Outlook for 2017

Two thousand and sixteen was some year! Donald Trump, the supporters of Brexit and Leicester City were the clear winners although equities and credit markets were also on the podium. Trump and Brexit were both startling political surprises which, if they occurred, were forecast to cause turmoil in the markets. Both happened and neither did!

By the middle of 2016 our focus had begun to shift towards what we perceived as growing political pressure for an end to austerity. We noted that the U.K. vote for Brexit was arguably won by the votes of those left behind by globalization and that this was an important trend explaining the popularity of non-mainstream parties and candidates around the world. The success of Donald Trump in the U.S. election, the loss of Matteo Renzi in Italy and the decision not to stand for re-election by Francois Hollande in France all point to the continuation of this trend. Among major European and American political figures supporting globalization, only Angela Merkel remains in office and she stands for re-election in 2017. It is very easy to expand this anti-globalization trend into a narrative of global change. We might describe it as an inflection point in the role of the political classes and existing parties in the management of economies. We may be entering a world in which politicians increasingly lean towards Keynesian style fiscal intervention and larger government, accompanied by a global move towards populism. As enticing as this argument seems, it may be too simplistic.

I wanted to use our most recent Fixed Income Forum to explore this issue in more depth, especially in light of some of the secular themes that we have identified and written about in my previous letters. In fact our discussions went further. In many ways 2016 has come to be seen, by us, as a year of learning where age-old beliefs may have been laid to rest and new paradigms recognized and adopted.

Enduring Secular Themes

As I have noted before, the two major secular themes that most concern us are the lack of working age population growth coupled with low productivity growth. Has 2016 seen a marked change in these forces? The short answer is no but perhaps the sands may be shifting, albeit modestly.

Demographic issues have not changed; maintenance of working age populations in the developed world requires immigration and not just highly skilled, well remunerated immigration. Any efforts to limit immigration will limit trend growth. The jury is out on how much immigration is reduced in developed economies but we should be very wary of its impact on trend growth.

Productivity growth remains subdued. We continue to argue that investment and education are keys to improving productivity. On a positive note, promises of reduced corporate tax rates in the U.S. and U.K. may spur investment. The potential for U.S. federal deregulation by the Trump administration may bolster investment further. Unfortunately we see little appetite for real deregulation elsewhere, especially in Europe, where many of the new political movements often focus less on reform and more on what many of us see as old politics. No developed country is adequately focussed on the need for meaningful educational reform in our view. On balance we may, in 2017, see some moves to improve productivity growth in the U.S., although the impact of these may not be registered for a few years.

This may help modestly improve prospective global trend growth. It will likely further differentiate winners from losers and thereby create potential investment opportunities.

So overall we see little in 2016 that encourages us to believe that we are shifting towards a new secular growth paradigm. Our assumption of low levels of trend real growth will continue to frame our understanding of markets. Despite this expectation of slow trend growth, cyclical forces can have an overriding impact during specific time periods.

Of Stories Old and Stories New

"It's the economy, stupid." While James Carville gets credit for this quote we can trace the origins of this attitude to Margaret Thatcher in 1979. Growth was paramount and it was believed that a rising tide would lift everybody. Globalization was key to generating growth and it was assumed that any dislocations would be short term in nature. Now, after 30 years of globalization, these beliefs are being questioned if not thrown out. There have been long term losers from global trade. Real incomes in developed markets have not improved for two decades for many voters. We may come to view 2016 as the year in which we learned that for now, "It's the political economy, stupid!"

What are the implications of this? Firstly, as I noted in my last letter, an end to austerity. Some of my colleagues argued that this might better be described as a return to multi-tool macro management where both fiscal and monetary policies have their roles. The first glimpses of this can be seen – the European Commission, encouraged by the European Central Bank, has argued for a relaxation of fiscal rules to allow an expansion of budgets at the national level; post Brexit, the U.K. has adopted a slower pace of fiscal tightening; and in the U.S., President-elect Trump has promised increased infrastructure and military spending. Is this a significant rebalancing away from monetary policy or recognition that more tools are available and needed? Some colleagues argued that there is no need for tightening of monetary policy across much of the globe and even in the U.S. the need is likely limited. With growing concerns about the efficacy of further monetary easing, the use of fiscal policy as a macro tool is likely to grow. As fiscal policy is linked to the political process, we are likely to see politics have a greater impact on markets over the coming year.

The biggest test for more active fiscal policy is likely to be in the U.S. Increased infrastructure spending and military spending combined with tax cuts all suggest stronger growth and larger budget deficits. Low levels of unemployment suggest that wage inflation could rise relatively rapidly although my colleagues felt that the labor force participation rate might increase in response to higher quality jobs. If this is the case, then non-inflationary growth, perhaps as high as 4% per annum for two years, might be achievable. Beyond this we would expect secular constraints to begin to weigh again. Perhaps the role of the political economy will only have a limited shelf life…we shall see.

I asked my colleagues to assess whether we are seeing an end to globalization. It was observed that while Donald Trump has threatened to use tariffs very aggressively it has mostly been in the context of achieving a fairer set of trade deals. If trade deals are unbalanced, and we would argue that in many instances they are, then rebalancing them may prove supportive for U.S. and global growth. This assumes some willingness to renegotiate on the part of key U.S. trade partners, in particular Mexico and China. But there is a larger rebalancing implied by this. The U.S. has a history of accepting unbalanced trade deals in an attempt to maintain and enhance its sphere of influence. Fairer trade deals may come at the cost of less influence. Further, some colleagues argued that the pressure that this may exert on the Chinese should not be underestimated.

Rebalancing the Chinese economy towards increased consumption and less investment likely requires a transfer of wealth from the State to the private sector. This means challenging vested interests. President Xi Jinping may well be attempting this but it is a slow and complex, if not dangerous, process. In the meantime we believe the trade surplus is an essential escape

valve, allowing growth to be maintained during the transition. To challenge China's trade patterns may well be to challenge its stability. These impacts take time to play out and the actual timetable is uncertain. The need to monitor these events is critical given their potential impact on world markets. Away from the U.S. it was noted that Europe shares little of the U.S.'s concerns about trade given its overall surplus. The U.K. government has gone further and justified a move away from the E.U. as an opportunity to increase trade with the rest of the world.

Deregulation, particularly of the financial sector in the U.S. will likely be a priority of the Trump administration. Global capital flows have shrunk materially following the financial crisis as investors have sought the security of home while regulators have moved to imbed this bias in regulation. The decline in global trade may be due to the maturing of supply chains but it is likely also to have been impacted by the decline in global capital flows. If deregulation succeeds in easing some of the impediments to global capital flows then global trade may improve. It might just be easier for trade agreements to be revised against this backdrop. One concern highlighted was whether U.S. financial deregulation would spark similar moves elsewhere or would trigger an increase in financial services regulation outside the U.S. as regulators prioritize risk averse regulation over global competition. While regulators, being regulators, may attempt to achieve this, the reality of the leakages in the global system would likely force their hands, in our view, and generate a more competitive environment.

Economic Momentum Versus Political Achievement

Brexit has perhaps provided us with a few takeaways that we should not forget in current circumstances.

In the wake of the Brexit vote the U.K. economy did not crash, the world did not fall apart and we all carried on and kept calm. In truth the Brexit vote came at a juncture where U.K. growth momentum was positive, perhaps more so than commonly recognized. The hype concerning uncertainty failed to acknowledge that while the political decision to leave the E.U. will bring meaningful changes, those changes will take a long time to implement. The recent U.S. presidential election may provide a parallel situation. U.S. growth momentum has improved recently. While investors may focus on concerns about trade and the potential inflationary impact of increased fiscal spending, we believe the actual impact of any changes will be felt over an extended period of time.

Economic momentum tends to fluctuate within a market cycle and it is likely that the next six months would, policy initiatives aside, have seen a modest moderation based on our outlook. At the same time, the next six months will likely see a rise in political uncertainty throughout the developed world. The Trump administration takes office on January 20th. How much tax reform, deregulation and fiscal expansion will Trump be able to deliver and what form will it take? How will China and Mexico respond to trade negotiation pressures? How supportive will the Republican-led Congress be if fiscal expansion challenges budget control or Trump maintains a more open stance towards Russia? What about Brexit negotiations in the U.K.? My U.K. colleagues could not easily define what the U.K. government wanted (except to have its cake and eat it too!) What does Europe want? How does it balance the desire to retain the basic rules of the single market (freedom of movement of goods, services, capital and labor) and not in the process trigger turmoil in the City of London which is in so many ways Europe's source of finance? And all of this will develop simultaneously with Dutch and French parliamentary elections followed by the German general election in September.

As you can imagine, we had long and heated debates around these issues. It is easy to be prescriptive about what should be done but the truth we face is that we cannot prejudge these events. We can plan for different eventualities but we will need to monitor events as they unfold. Political achievement is not the same as electoral success. The next six months will see politicians, some of them very experienced businessmen, but inexperienced in the cauldron that is today's politics, embark on the process of delivering on their promises. There will be successes and failures,

setbacks and leaps forward. We cannot, nor should we, pretend, that we can forecast these events but we must continually monitor, analyze and respond to them.

Valuations

As always, our discussions brought us to valuations. In our experience, positive news is far more likely to move markets when valuations are cheap; negative news far more likely to move markets when valuations are expensive. Credit markets rebounded in 2016 after the challenges of the previous year. At the beginning of last year we wrote that valuations looked cheap, what now? At first cut, valuations overall look marginally rich to us but not so rich that we would adopt an extremely cautious approach. In our discussions we noticed that our credit analysts, with their bottom up focus, are somewhat more cautious than our asset allocation focussed portfolio managers. How to reconcile this? From a top down perspective, using U.S. High Yield as a proxy for markets more generally, today's spreads lie in a range where, historically, about 40% of the time the market has traded at that level or tighter. Our portfolio managers believe that the extraordinary period immediately prior to the financial crisis, a period of financially leveraged, artificially suppressed spreads, is unlikely to repeat itself. Notionally adjusting for this richens valuations but does not move them to very rich levels. In further discussions with our portfolio managers and credit analysts it became apparent that two concerns dominated the caution of the latter; firstly recovery rates will likely be lower going forward than has been the case historically due to higher leverage and, secondly, there is some concern that higher leverage may combine with rising rates to push default rates up through the next cycle. Against this, there was some increased bottom up confidence driven by the hope that credit positive M&A activity could follow deregulation, at least for a period. Taking all this into account we judge corporate credit markets to be perhaps on the order of one standard deviation rich to fair value. Not flashing-light territory but sufficient to us to suggest reducing risk into rallies and not overly focussing on good news.

On a relative basis we noted that the recent underperformance of emerging markets debt (EMD) credit has improved its valuation relative to high yield in our estimation. Trump campaign rhetoric, with its focus on trade, has pressured EMD. We believe that over the next six months expectations for fiscal expansion may be overdone and fears of imminent trade sanctions and tariffs may be excessive. While we are reluctant to forecast the precise policy moves of the next few months it does seem to us that the combination of reduced market valuation and possibly overstated policy concerns and expectations may be creating an opportunity to increase EMD exposure relative to U.S. High Yield.

Conclusion

Last year I was able to write, with some certainty, that I believed valuations were getting attractive and that opportunity would soon present itself. This year it is far harder to be confident in the outlook, and that is perhaps our key insight. Valuations are somewhat expensive but not prohibitively so. Volatility, at least as measured in the options market, is low and yet as I set out my thoughts for the year I could not but help think that this is a year with many uncertainties attached to it. Political structures and strategies are likely to be tested in the U.S., U.K. and Europe. Monetary policy seems less well positioned or able to help dampen concerns if they arise. For the moment this may be a time to tread carefully, focusing on relative value opportunities while holding some powder in reserve.

Let me end by wishing you all a happy and successful New Year from all of us at Stone Harbor.

Peter J. Wilby

Chief Investment Officer

17 January 2017

Stone Harbor
Investment Partners

New York	London	Melbourne	Singapore
31 W. 52nd Street	48 Dover Street	Suite 3122, Level 31	9 Temasek Boulevard
16th Floor	5th Floor	120 Collins Street	#09-03A Suntec Tower Two
New York, NY 10019	London, W1S 4FF	Melbourne	Singapore 038989
+1 212 548 1200	**+44 20 3205 4100**	**+61 3 9225 5064**	**+65 6671 9711**

Our Range of Institutional Investment Strategies

Investment Grade	High Yield	Emerging Markets Debt	Multi-Sector Credit

For more information, please visit **www.shiplp.com**

Important Disclosures

The opinions expressed herein represent the current, good faith views of the author(s) at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this material has been developed internally and/or obtained from sources believed to be reliable; however, Stone Harbor Investment Partners LP ("Stone Harbor") does not guarantee the accuracy, adequacy or completeness of such information. This material is solely for informational purposes and shall not constitute an offer to sell or the solicitation to buy securities. This material may include statements that constitute "forward-looking statements". Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to market, geopolitical, regulatory or other developments. Any forward-looking statements speak only as of the date they are made, and Stone Harbor assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. The views expressed herein are not guarantees of future performance or economic results and involve certain risks, uncertainties and assumptions that could cause actual outcomes and results to differ materially from the views expressed herein. The views contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated. This material is directed exclusively at investment professionals.