September 2018

Emerging Markets Update - Signs of Overshooting

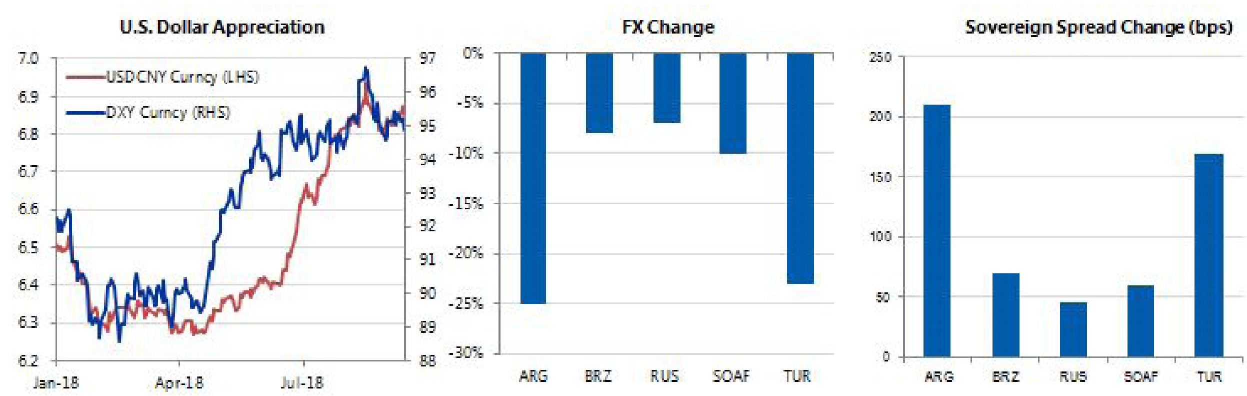
"The reports of my death are greatly exaggerated." M. Twain

In our most recent white paper ("Why Now is a Good Time to Invest in Emerging Markets Debt" June 2018), we argue that emerging markets' ("EM") fundamentals remain strong, their ability and willingness to pay is high, and some of the most vulnerable countries, particularly Argentina, are taking sufficient policy actions to stabilize their economies and secure funding to avert the threat of a near term default. Since June, we have not seen any broad data that makes us change our fundamental views. And yet, valuations are cheaper after a brief market bounce in July.

The market downturn in August was precipitated by several factors. First, the deterioration in U.S.-China relations led to a spike in USDCNY that intensified fears China was using currency depreciation as a trade weapon. Second, rising political tensions in Italy boosted Italian bond yields as doubts grew over solvency in Europe's second largest bond market. Third, concerns about the negative impact of U.S. dollar strength on EMs, coupled with potential trade wars and quantitative tightening, heightened negative media coverage.

In addition to these macro concerns, several EM country developments further weighed on market sentiment. Argentina's renegotiation of its $50 billion Stand-By agreement with the International Monetary Fund ("IMF") damaged local confidence and led to further dollarization and exchange rate pressures. In South Africa, U.S. President Trump inflamed an already heated debate over land redistribution by tweeting that he had asked his Secretary of State to study land reform and seizures. Turkey's refusal to release an American pastor prompted the U.S. government to impose sanctions in response. In Brazil, election polls showing imprisoned former President Lula leading the polls led to rising uncertainty over the upcoming presidential election. Finally, renewed fears of additional Russian sanctions developed as the U.S. Congress introduced a bill that could affect investors' ability to invest in Russian sovereign and corporate debt.

Figure 1: Macro Events and Select EM Country Developments Impacted EM Currencies and Bond Spreads in August



As of 31 August 2018
Sources: Stone Harbor Investment Partners LP; Bloomberg. For illustrative purposes only.

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As we state in our June paper, timing turning points in market sell-offs is notoriously difficult. However, we believe that emerging markets currency and bond valuations show clear signs of overshooting relative to fundamentals. Moreover, when combined with strong recent policy actions by many countries (see Figure 2) we believe the return prospects for many emerging markets assets are attractive.

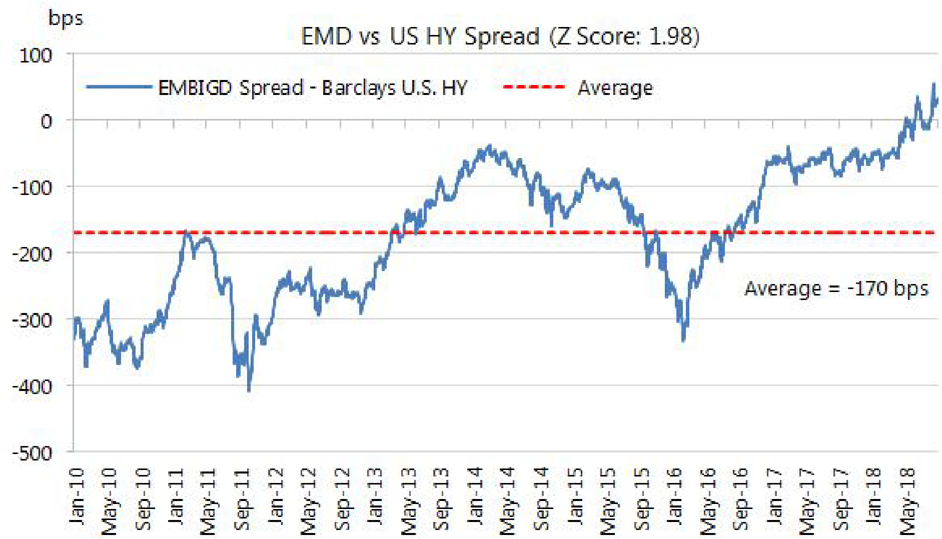
Figure 2: Strong Reactions from Several Emerging Market Countries to Support Markets

Country	Fiscal measures announced/expected	Technical measures announced	Policy rate hikes (bp)
Angola	Reduced capital expenditures. Improved efficiency in civil servant payrolls. 2019 VAT to be implemented	Established Policy Support Instrument w/ IMF. Devalued FX by 40%. Reduced USD shortages	
Argentina	Established IMF credit line. Tightened fiscal and monetary policies. Increased reserve requirements.	Engaged with the IMF for US$50bn financing, Tightened policy rate by 32.75% since April 25th. Committed to reduce primary deficit to zero by 2019. Increased reserve requirements by 16%	3275
Brazil	National Treasury increased limits of floating-rate bonds in the annual financing plan	Removed net $0.575bn of USD liquidity via repo lines since April 2018. Reversed some of the $8bn injected in Dec 2017	0
China	Nothing directly related to market selloff, but fiscal support expected	Announced a 20% reserve requirement on FX forward transactions. Re-introduced countercyclical adjustment factor to anchor CNY expectations	0
Costa Rica	Fiscal Bill aims to deliver between 1.1-1.9% fiscal adjustment. Approved 2% VAT on basic goods		
Ecuador	New Finance Minister oversees 2-2.5% GDP adjustment. Reduced capex and cut energy subsidies	Engaged in Article IV w/ IMF. Renegotiated oil pre-sale contracts	
Egypt	Fiscal consolidation continues. Cut fuel and water subsidies. Reduced fiscal deficit by 1.1% in 2018/19 budget		
Ghana	Created fiscal rule. Cut capex. Beginning to implement tax reform	Graduating from IMF program in December 2018, but in discussions to continue with policy support	0
India			50
Indonesia	Deferring imports and delaying infrastructure investment		
Ivory Coast	Tax hikes boosted revenues by 0.5% GDP. Hiked fuel prices and reformed the cocoa sector to avoid subsidies		
Mexico		NAFTA agreement in principle with the U.S.	25
Romania			25
Turkey		CBRT cut the RRR and ROM coefficients to supply FX liquidity	1125
Ukraine		Passed ACC Court Bill. Announced hike in domestic gas price. Discussed extension of current IMF program	350

As of 31 August 2018
Sources: Stone Harbor Investment Partners LP. For illustrative purposes only.

While volatility in emerging markets asset prices during periods of global stress is understandable, it is rare for EM hard currency sovereign bonds to trade at wider spreads than U.S. High Yield debt. As shown in Figure 3, the spread between the JP Morgan EMBI Global Diversified and the Barclays Bloomberg U.S. High Yield Index is currently trading at the decade's highs, representing nearly a 2 standard deviation movement in this spread relationship. We believe better valuations versus competing assets will support flows into EM debt as global fixed income investors take advantage of the relative value opportunity.

Figure 3: EM Sovereign Debt Trades at a Wider Spread than U.S. High Yield



As of 31 August 2018
Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP Benchmark: Bloomberg Barclays U.S. High Yield, J.P. Morgan EMBI Global Diversified. For illustrative purposes only.

Given recent spread widening, the total return of the JP Morgan EMBI Global Diversified has declined over 5% from its recent peak. We analyzed past drawdowns of this magnitude and observed a strong historical tendency toward rapid recovery thereafter. As noted in Figure 4, since 1998, the average return in the subsequent 12 month recovery periods has exceeded 18%. While we cannot entirely dismiss the chance that markets will behave differently this time, our analysis does not lead us to that conclusion.

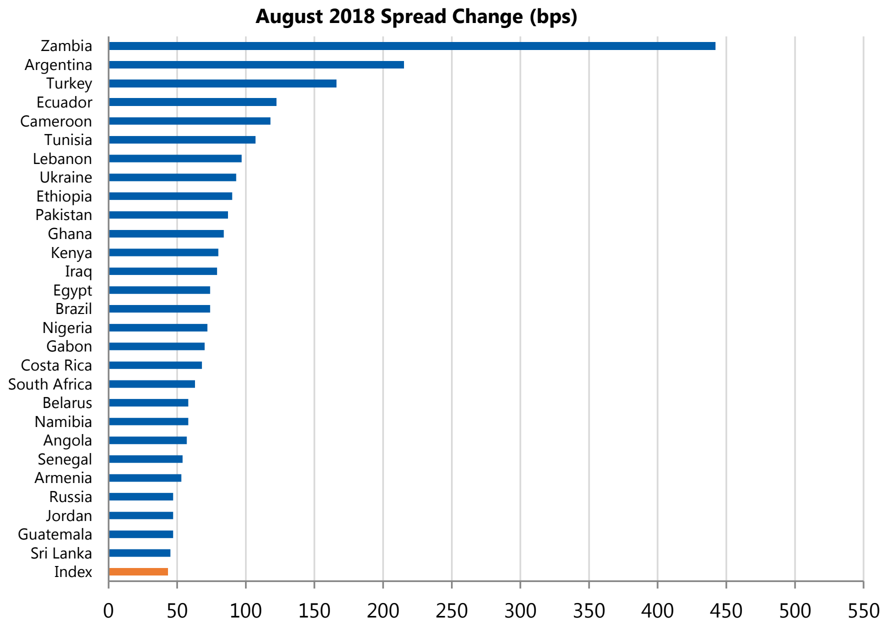
Figure 4: EM Sovereign Hard Currency Debt: Significant Margin of Safety

	Post Drawdown Return (%)		
Drawdown >5%	**6 months**	**12 months**	**24 months**
Aug-98	22.6	31.1	64.9
Jul-02	16.2	27.5	41.8
May-04	12.5	18.4	26.7
Sep-08	-3.5	18.7	37.8
Jun-13	2.7	11.6	12.2
Nov-13	8.8	10.5	10.8
Nov-16	7.8	10.9	
Jun-18			
Average	9.6	18.4	32.4

As of 31 August 2018
Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners LP. Benchmark: J.P. Morgan EMBI Global Diversified. Past performance is not a guarantee of future results. For illustrative purposes only.

We believe the current market disruption has also created relative value opportunities within the emerging markets universe. In our view, recent spread widening in hard currency-denominated sovereign bonds has been excessive in some countries and has increased the potential for alpha generation from country selection. See Figure 5.

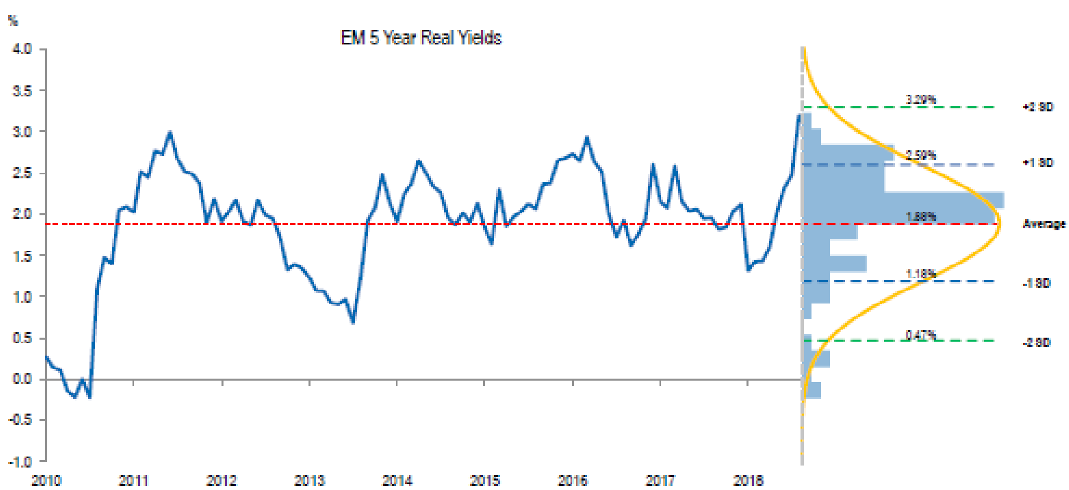
Figure 5: Recent Spread Widening Has Created Opportunities in Select Credits



As of 31 August 2018
Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP
Benchmark: JPM EMBI Global Diversified. For illustrative purposes only.

Local market valuations have improved as well, in our view. On average, real yields of domestic bonds from EMs have risen significantly and are at post financial crisis highs, providing a cushion for investors against currency shocks. As shown in Figure 6, real yields have exhibited a strong tendency to revert toward the average. From current levels, this mean reversion would result in strong potential capital gains from local currency bonds, in our view.

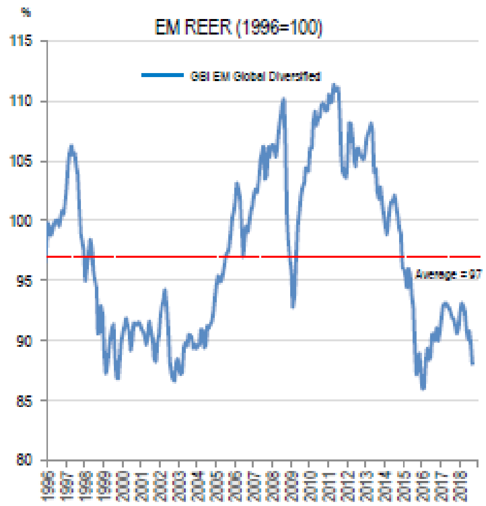
Figure 6: EM Real Bond Yields at Post-Crisis High

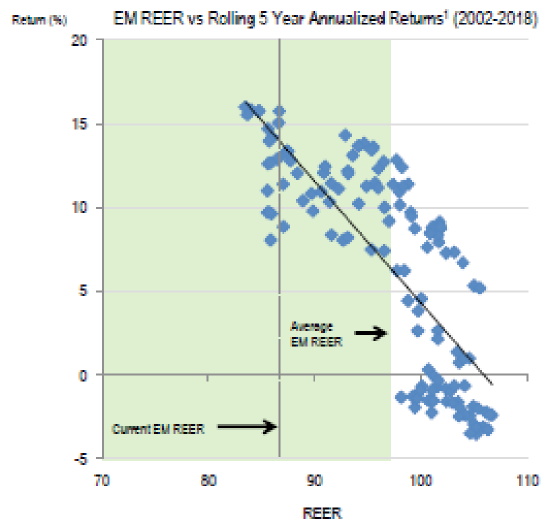


As of 31 August 2018.
Sources: Bloomberg, Stone Harbor Investment Partners LP. Using 1 year forward Bloomberg consensus inflation forecasts. For illustrative purposes only.

In real terms, EM currencies have considerably weakened amid USD strength and are trading at levels close to those of the early 2000's, a period when EM fundamentals where much weaker. As shown in Figure 7, EM currencies have typically generated strong annualized returns in subsequent periods after reaching current levels.

Figure 7: EMFX Valuations Back to Early 2000s Levels





As of 10 September 2018
Sources: BIS, Bloomberg, Haver Analytics
[1] Return of the J.P. Morgan GBI EM Global Diversified
Past performance is not a guarantee of future results. For illustrative purposes only.

Conclusion:

- Despite recent weakness in EM asset prices and "bad sentiment" towards the asset class, we believe fundamentals in most countries remain strong. In our view, there are clear signs of overshooting in EM asset prices.
- In our view, Argentina presents a compelling investment opportunity, given current valuation levels, combined with a strong support of the IMF and the government's commitment to fiscal adjustment.
- We continue to firmly believe that the ability and willingness to pay for the vast majority of emerging markets today is very high and that recent drawdowns in select countries are not necessarily representative of the broader EM investment universe.

Argentina – Case Study

While we see many specific EM country opportunities at the moment, we think Argentina is among the most compelling given current valuations, strong international support by the IMF, and the government's commitment to deliver a balanced budget in the next 2 years.

The election of President Mauricio Macri in late 2015 ended years of populist policies under Nestor and Cristina Kirchner. The new government restructured the defaulted debt, floated the exchange rate, and started to reduce distortionary taxes and subsidies. Access to international capital markets allowed for a more gradual fiscal adjustment and better growth, but resulted in higher levels of external debt, an overvalued exchange rate and lower but persistent inflation rates. As U.S. interest rates rose in early 2018, Argentine assets came under pressure when markets started to doubt the sustainability of the gradual approach in late April/May. A particular focus of markets was the country's large stock of domestic short-term debt.

Faced with volatile markets in June and large financing needs for 2019, the policy reaction was quick and comprehensive. Argentina's government negotiated a 3-year $50 billion Stand-By Agreement with the IMF, the largest program in history. The agreement requires Argentina to reach fiscal targets in each of the next several years, leading to a balanced budget by 2020.

Reacting to pressure on the peso relative to the U.S. dollar and market concerns about inflation policy, the government appointed a new Central Bank president in June. The Central Bank subsequently tightened monetary policy, increasing the overnight policy rate to 60% at the end of August, a cumulative rate hike of 32.75% from the beginning of the year. The Bank further assured tight monetary conditions by committing to maintain the same level of rates at least until December 2018. In addition, the Bank announced a program to reduce, and eventually eliminate, the large stock of peso- denominated short-term debt. This program is currently underway.

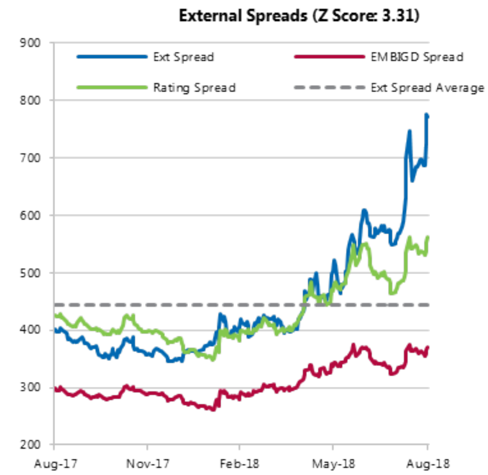
Despite these efforts, in an environment of general negative sentiment for emerging markets, confidence among investors remained low and asset prices continued to be under pressure. In particular, given the country's financial history and fears of much lower growth prospects, local savers and investors dollarized deposits, thus leading the peso to an all-time low despite efforts by the Central Bank to support the currency.

As a result, the government is currently renegotiating a new IMF program with more ambitious and aggressive fiscal targets, including raising taxes on commodity exports. Although final details are not yet available as of this writing, we expect this new program to be completed soon, which we believe should increase market confidence of Argentina's ability to service its debt.

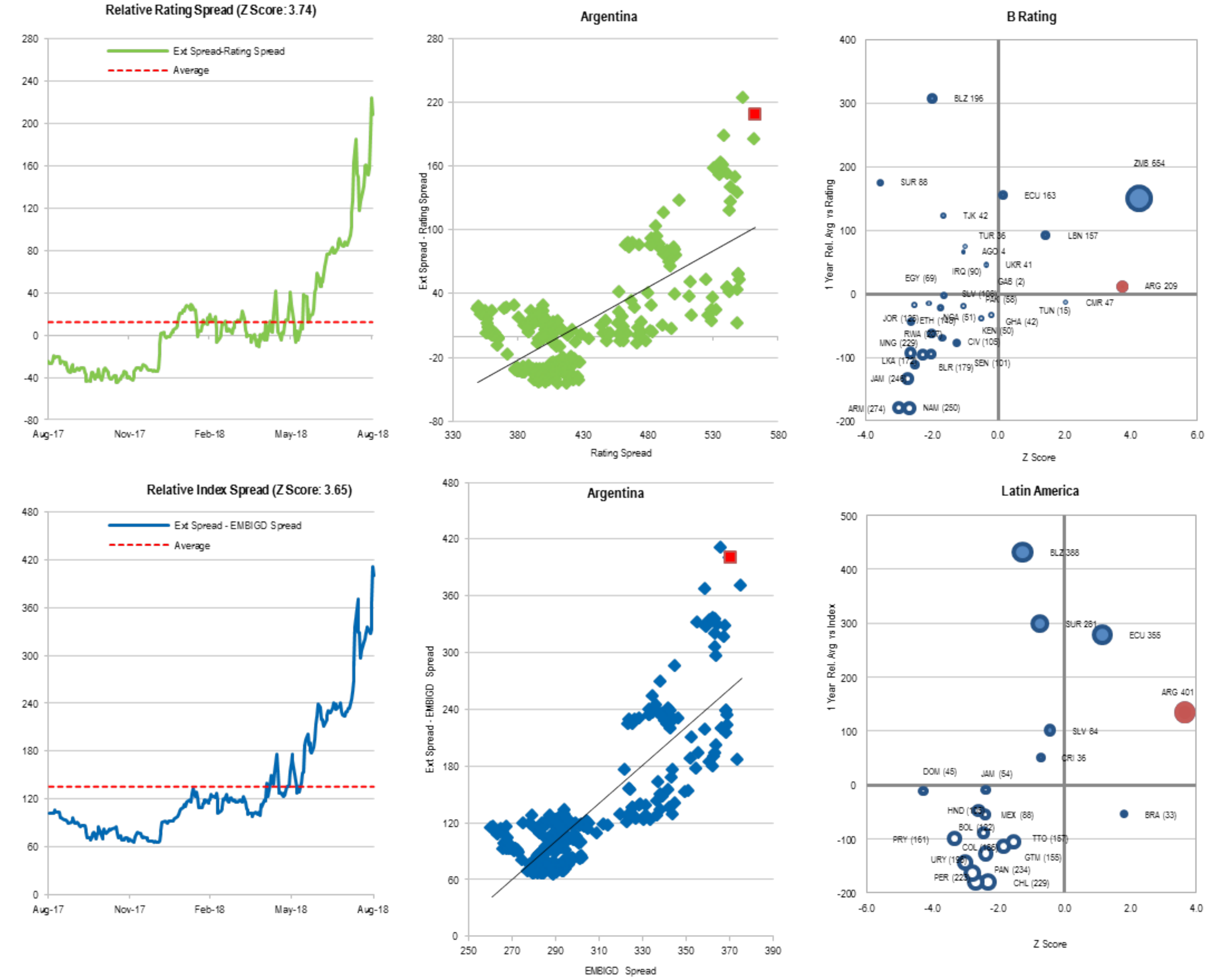
Our analysis and that of the IMF, has concluded that Argentina's debt is sustainable. The IMF support, which covers 100% of the country's 2018 funding needs, significantly reduces the risk that Argentina is unable to rollover local debt maturing over the next 12 months, in our view. Given this support and the current government's willingness to follow through on fiscal consolidation, we believe the probability of default is much lower than the level implied by current prices.

The main risk to this outlook is a political reversal in the October 2019 presidential election that would lead the country back to the pre-Macri policy era. We believe this outcome is unlikely. The recent indictment of former President Cristina Kirchner on corruption charges has significantly increased her negative image among the Argentine population, in our view.

Figure 8: Argentina Sovereign Spread Analysis



	ARGENTINA (B)								
	1 Year			3 Year			5 Year		
	Absolute	Rel. to Index	Rel. to Rating	Absolute	Rel. to Index	Rel. to Rating	Absolute	Rel. to Index	Rel. to Rating
Current	771	401	209	771	401	209	771	401	209
Avg	443	136	12	460	117	(33)	577	241	56
Off Avg	328	265	196	311	284	242	194	160	153
Median	402	114	3	453	116	(31)	515	150	10
1 Std Dev	99	73	52	69	57	65	175	183	131
Z Score	3.3	3.7	3.7	4.5	4.9	3.7	1.1	0.9	1.2
High	777	411	224	777	411	224	1,170	812	399
High Date	30-Aug-18	30-Aug-18	30-Aug-18	30-Aug-18	30-Aug-18	30-Aug-18	2-Sep-13	2-Sep-13	15-Oct-14
Low	346	65	(45)	346	(17)	(248)	346	(17)	(248)
Low Date	20-Dec-17	4-Dec-17	17-Nov-17	20-Dec-17	16-Feb-16	12-Feb-16	20-Dec-17	16-Feb-16	12-Feb-16



As of 31 August 2018. Benchmark: J.P. Morgan EMBI Global Diversified Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP
Our analysis does not guarantee performance results. Individual country spread analysis above has been provided for informational purposes only and is intended to illustrate the type of information that the investment team may review for countries in the relevant investment universe. Our analysis may vary depending on numerous factors. These countries are not presented as investment recommendations. For illustrative purposes only.

Stone Harbor Investment Partners

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation.
- 100% employee-owned
- Many team members have been together for nearly 30 years
- Offices in New York, Chicago, London, Singapore and Melbourne.
- Total assets under management: 30.78 billion as of 30 June 2018

Emerging Markets Debt management team, many of whom have worked together for nearly 30 years spanning a variety of market events and stages, have established a lengthy track record managing portfolios in emerging sovereign and corporate debt markets denominated in developed and local currencies. As a dedicated portfolio management team they are able to supplement intensive credit work with extensive travel to visit with decision makers in emerging markets. The 13 member portfolio management team averages over 20 years of investment experience. Resources include:

- 12 Portfolio Managers
- 4 Dedicated Emerging Markets Corporate Credit Specialists
- 9 Global Credit Industry Analysts
- 2 Economists (both developed and emerging markets)
- 11 Quantitative and Risk Analysts
- 2 Dedicated Emerging Markets Desk Analysts

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

Index Definitions

The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

The J.P. Morgan GBI-EM Global Diversified 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 this index.

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Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets

Important Disclosures