Fourth Quarter 2019

Emerging Markets Debt: Hello Again

Strategy Spotlight: Emerging Markets Debt

Key Points

- Emerging markets debt ("EMD") has become an increasingly popular asset class for institutional investors around the globe, though many investors still have a lower allocation than we believe is warranted.
- Emerging markets ("EM") countries are poised to benefit from longer-term secular trends, in our view, including higher growth rates compared to developed markets, as well as lower inflation rates and debt levels than in the past.
- EMD has performed well over time, offering a better risk/reward profile than both EM equities and US high yield bonds over the past 20 years.
- In the current "lower for longer" interest rate environment, EMD offers significantly higher yields and more income opportunities than developed markets ("DM") government bonds, where low and negative yields have become the norm.
- EMD offers strong alpha potential for active managers, and we believe investment processes that incorporate environmental, social and governance ("ESG") factors can add further value.

Why Exposure to EMD Matters

Emerging markets debt ("EMD") continues to offer opportunities for investors seeking to capture the growth story of emerging markets ("EM") countries. While likely not new to many institutional investors, EMD may still be a misunderstood asset class. We think it's time to "reintroduce" EMD and take a closer look at its potential benefits, particularly amidst low and even negative yields of developed markets ("DM") government bonds. In the global hunt for yield, we believe EMD can provide liquid income with greater transparency versus other fixed income alternatives.

EM countries, also called developing economies, currently represent nearly 60% of global GDP.[1] Despite broad geographic and demographic differences, EM countries tend to feature increasing populations and growing middle classes. Historically, wealth in many EM countries has been concentrated at the top, with small numbers of elites controlling vast riches, while many people toiled in poverty. That dynamic has been shifting as many EM countries have built up their middle classes, leading to higher and broader growth as these countries consume more goods and services. In addition, EM countries as a whole have proven more resilient to external shocks than in the past, with a greater ability to navigate defaults, geopolitical tensions and volatility in oil and other commodity prices.

Many institutional investors have recognized the attractiveness of EM countries and have added exposure to these countries through allocations to EM equities. However, some investors are still missing out on EMD's benefits due to small allocations to EMD or no strategic allocation at all. There are two major arguments that we often hear from investors and consultants about why they maintain underweight positions to EMD. First, some investors still believe that EMD is a niche category. Second, investors tend to think that their EM equity allocation provides full exposure to developing economies. While we understand that EMD is not right for all investors, we see flaws in these particular arguments.

First, EMD indices have been around since the 1990s, and assets in these indices are now twice as large as those in the investable US high yield market.[2] As a result, investors with little or no EMD exposure are missing out on a vast and liquid fixed income universe that we believe has strong alpha potential. As for the second argument, EM equities and EMD exhibit

[1]Source: International Monetary Fund. Measured on a purchasing power parity (PPP) basis. [2]Source: J.P. Morgan

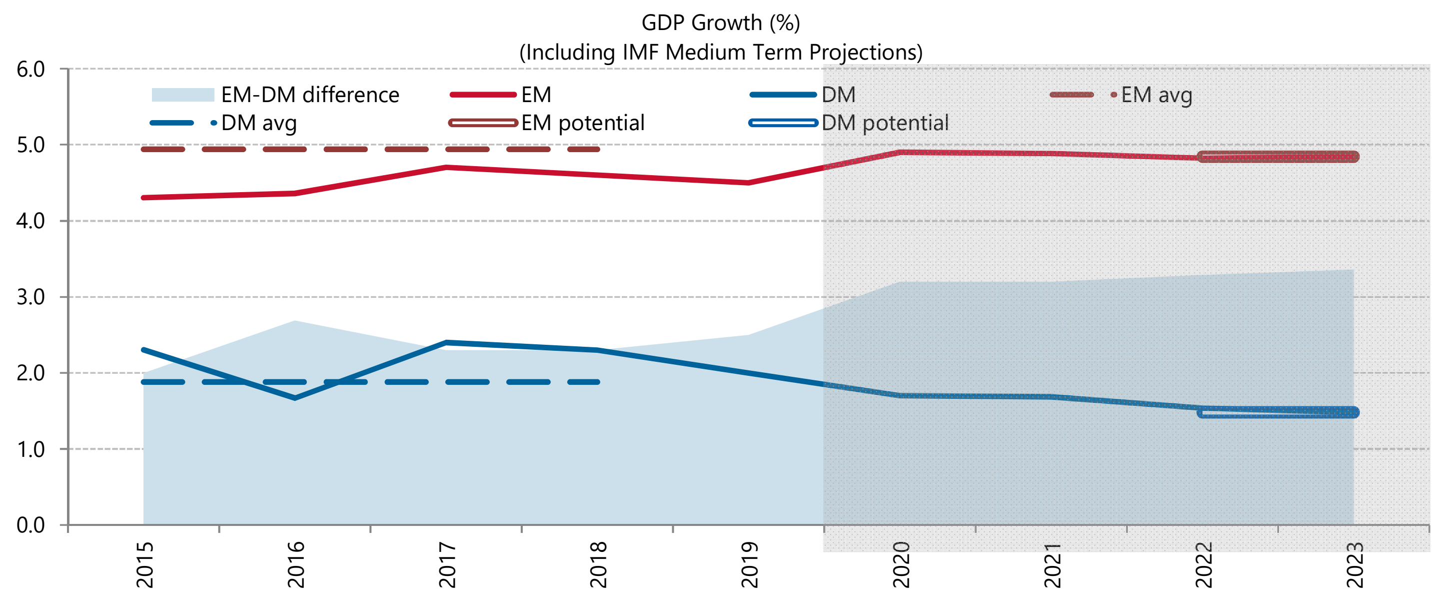
strikingly different risk and return profiles, and are not really comparable aside from their shared geography. Like EM equities, EMD taps into the growth of developing countries, but with less volatility and with much higher income potential.

In this paper, we highlight some of the positive secular characteristics of EM countries, provide a more detailed look at the EMD indices, compare EMD to other asset classes and discuss why we believe now is an attractive entry point. Finally, we discuss how incorporating environmental, social and governance ("ESG") factors into EMD investing can provide an even more attractive approach to the asset class. Overall, we believe that institutional investors with little or no exposure to EMD should consider increasing their allocation to this asset class.

Compelling Characteristics of EM Countries

EM countries have grown significantly over the past several decades, both in terms of economic progress as well as in the sophistication of their institutions, including central banks. This has resulted in generally faster-growing economies with strong long-term potential. With a few exceptions in the 1980s and 1990s, EM countries have outpaced the growth of DM countries over time, as shown in Figure 1. In particular, EM countries served as a global growth engine after the Global Financial Crisis of 2008/2009 pushed DM countries into deep recessions. While the EM growth advantage has declined some since that time, the growth rate of EM countries still appears poised to outpace DM countries into the next decade.

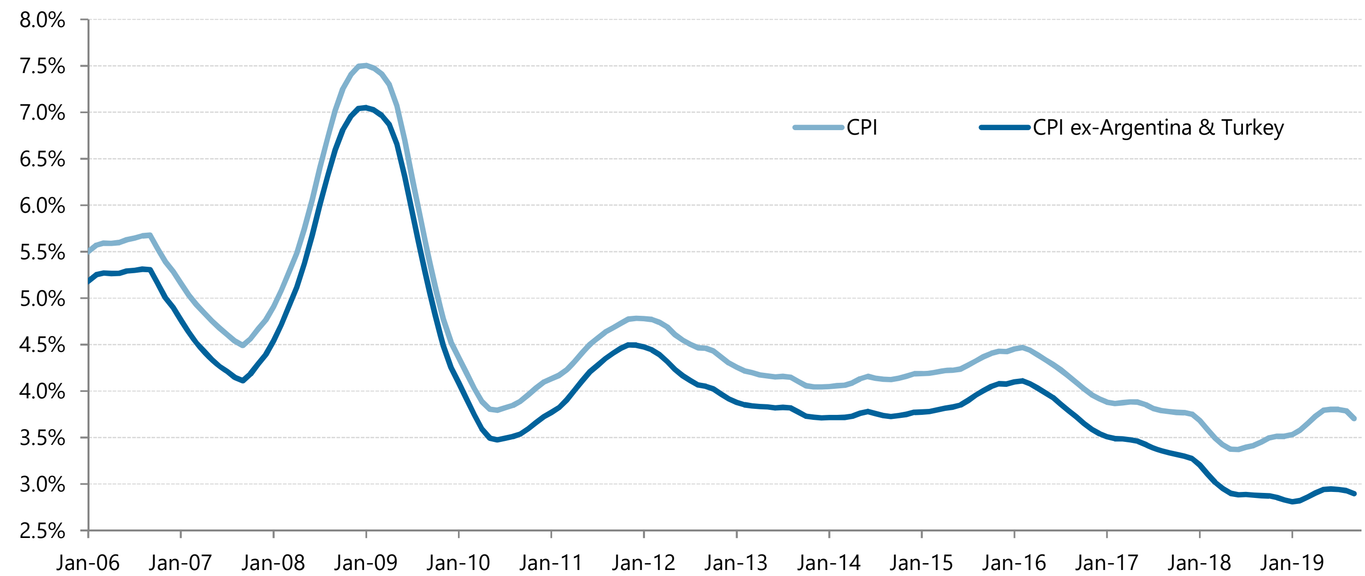
Figure 1: EM Countries Have Higher Growth Rates than DM Countries



As of 30 September 2019. Source: Haver Analytics, IMF WEO, Stone Harbor Investment Partners LP. Information contains forecasts. For illustrative purposes only.

As their economies have grown, central banks in EM countries have become more sophisticated, allowing for better economic management as well. For instance, the periods of rapid inflation experienced in some EM countries seem to be relics of the past (with some notable exceptions). As shown in Figure 2, inflation rates of EM countries have plummeted over the past 10 years. Excluding Turkey and Argentina—both of which have experienced stubbornly high inflation rates due primarily to political upheaval—inflation in EM countries reached new lows in 2018 and has remained low in 2019. The lower inflation rates reflect the successful implementation of improved monetary and fiscal policies, including explicit inflation targets, set by independent central banks in EM countries. Although not all countries have been successful in combatting inflation, the overall trend has been clearly positive across the EM universe.

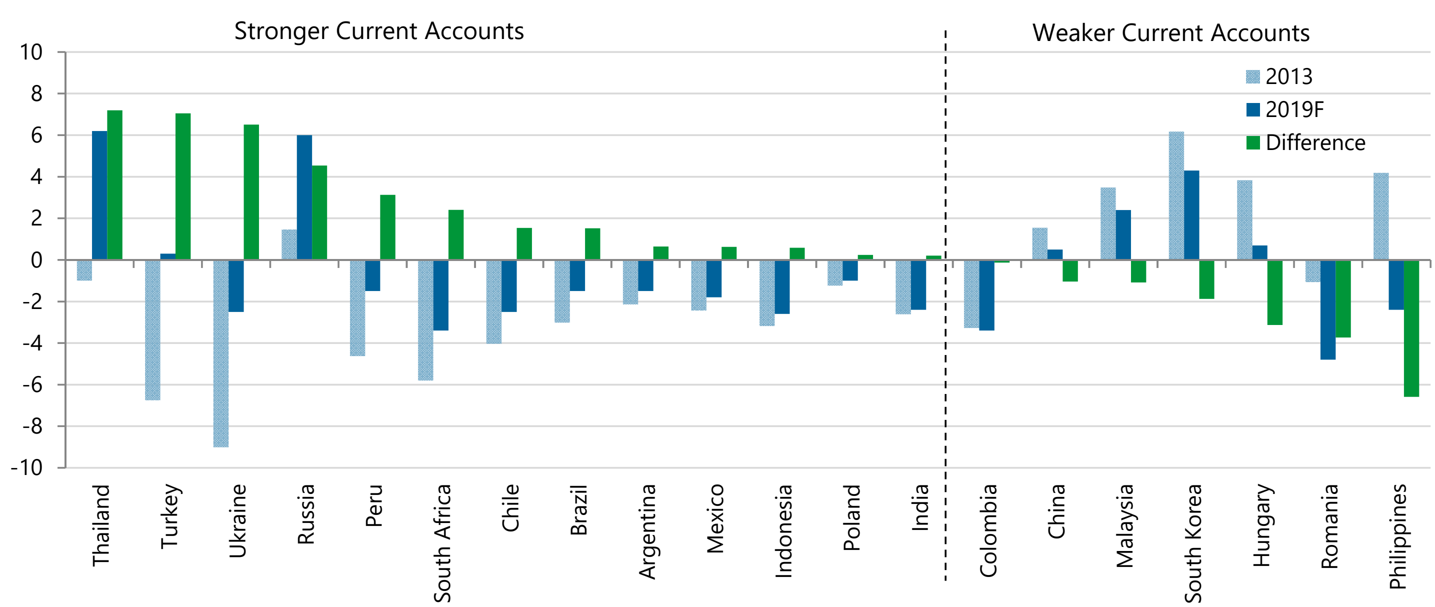
Figure 2: Inflation Rates in EM Countries Have Fallen



As of 30 September 2019. Sources: Haver Analytics, J.P. Morgan, Stone Harbor Investment Partners LP. Benchmark: J.P. Morgan GBI-EM Global Diversified. The CPI numbers in the chart reflect the average CPI of the countries in the GBI-EM GD Index and are weighted according to the countries percentage of the benchmark. Data reflects year-over-year 12 month moving averages. For illustrative purposes only.

Along with helping to manage lower inflation rates, central banks in EM countries have generally been able to place their countries in better position relative to their capital reserves. As shown in Figure 3, many EM countries have improved their current account position over the past six years, even as many DM countries have drastically increased their debt loads to stimulate their economies. The higher capital reserves should help allow EM countries to weather short-term issues better than in the past and should increase their ability to repay debt—factors that should support EMD over time, in our view.

Figure 3: EM Countries are in Better Financial Shape than in the Past

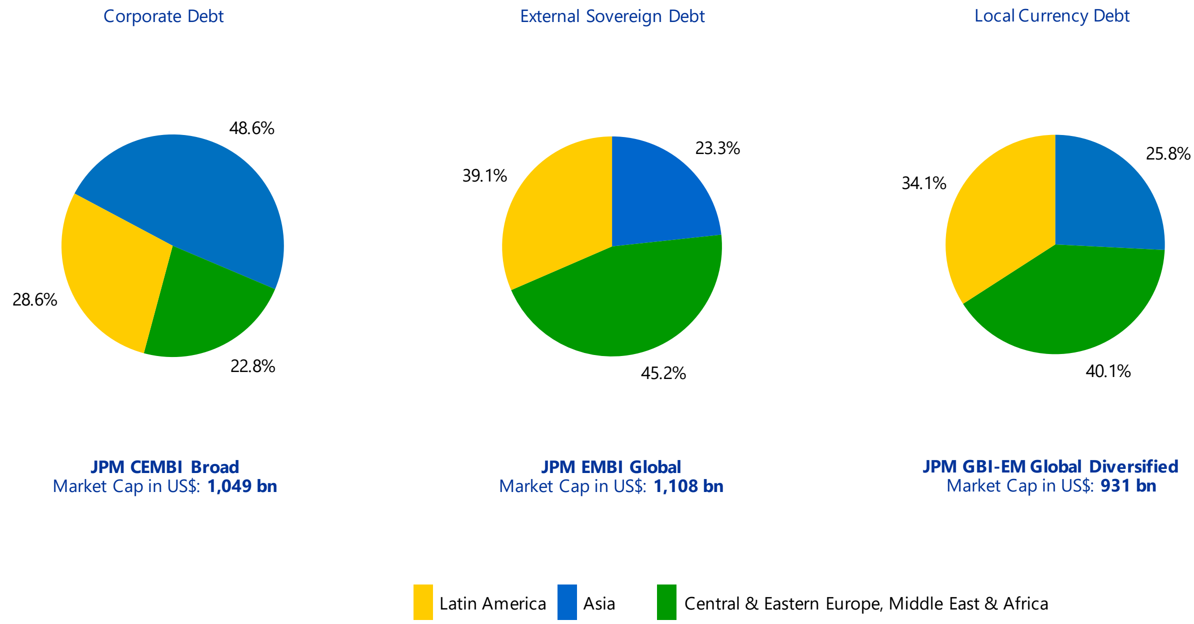


As of 31 May 2019. Source: Bloomberg, Stone Harbor Investement Partners LP. For illustrative purposes only.

EMD: A Closer Look

While EM countries offer compelling characteristics, many investors are not fully exposed to the depth and breadth of the fixed income markets in these countries. EMD includes debt issued by governments, government-sponsored enterprises and corporate issuers in these developing countries. The market includes sovereign bonds denominated in US dollars or other external ("hard") currency debt, sovereign bonds denominated in local currencies, and bonds issued by corporations domiciled in emerging markets. Since the first EMD index was launched in 1990, the EMD investable universe has grown to represent more than US$3 trillion and includes 70+ countries, more than half of which have investment grade ratings.[3] Figure 4 shows the characteristics of the three major EMD indices. Of note, two of the three indices have average credit ratings above investment grade, which reflects the broader trend of more EM countries receiving investment grade ratings. Moreover, the indices represent only a subset of the total outstanding EMD universe, which was estimated at almost US$25 trillion as of year-end 2017. However, not all of that debt is easily accessible by foreign investors.[4]

Figure 4: Geographical Breakdown and Characteristics of the Three Major EMD Indices



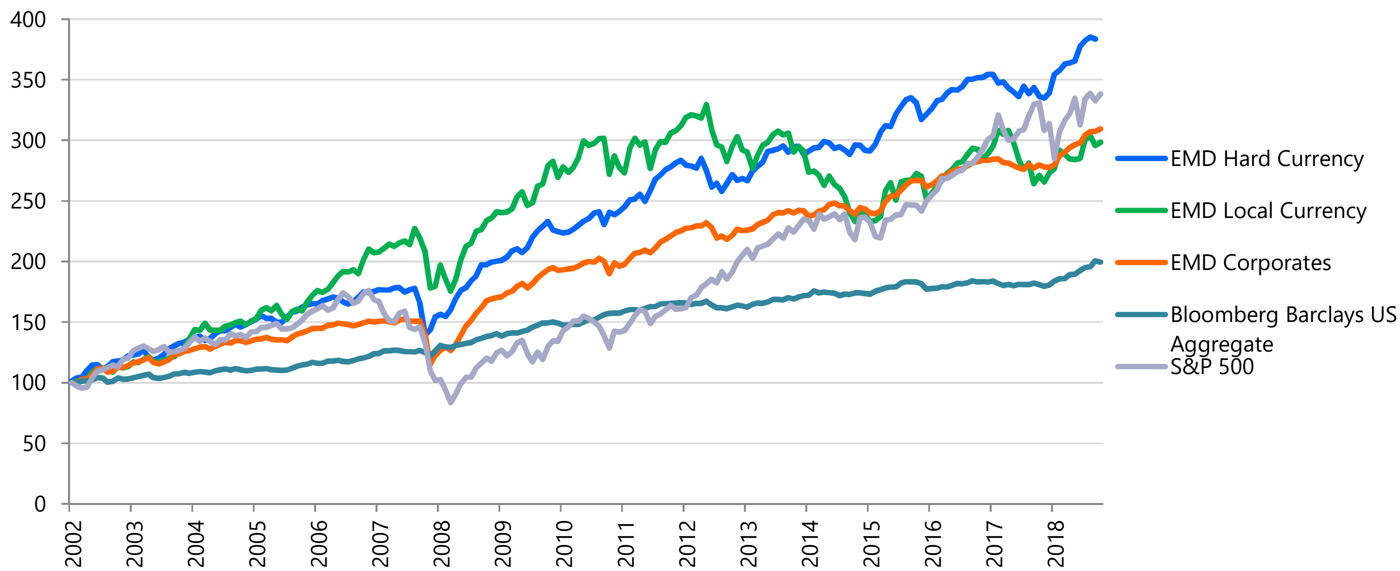
	Corporate Debt	External Sovereign Debt	Local Debt Currency
Number of Issuers	673	171	19
Number of Countries	53	73	19
Investment Grade/High Yield Split (%)	58/42	54/46	77/23
Average Credit Rating	BBB-	BB+	BBB+
Duration (Years)	4.5	7.4	5.5

As of 30 September 2019 month end idex rebalance. Sources: J.P. Morgan, Stone Harbor Investment Partners LP. Market Cap represents unconstrained version of index. For illustrative purpsoses only.

Figure 5 shows the long-term performance of the three EMD indices compared with other broad equity and fixed income indices over the same time period. As shown in Figure 6, EMD's strong long-term results are particularly compelling to us when compared with other asset classes with similar investment objectives. For instance, when compared to US high yield bonds—which many investors use to generate income—external currency EMD has exhibited 11% less volatility and 28% greater total return than US high yield bonds over the period since 2000. For investors seeking exposure to broader emerging markets, EMD has a decidedly more attractive risk and reward profile than EM equities. Since 2000, external currency EMD has exhibited 62% of the volatility of EM equities while generating more than 30% greater total return. Figure 6 shows the risk and return dynamics over various time periods for these asset classes, demonstrating the consistent strong risk-adjusted performance of EMD over a wide range of market cycles. EMD also has demonstrated less volatility than other asset classes, as measured by return dispersion.

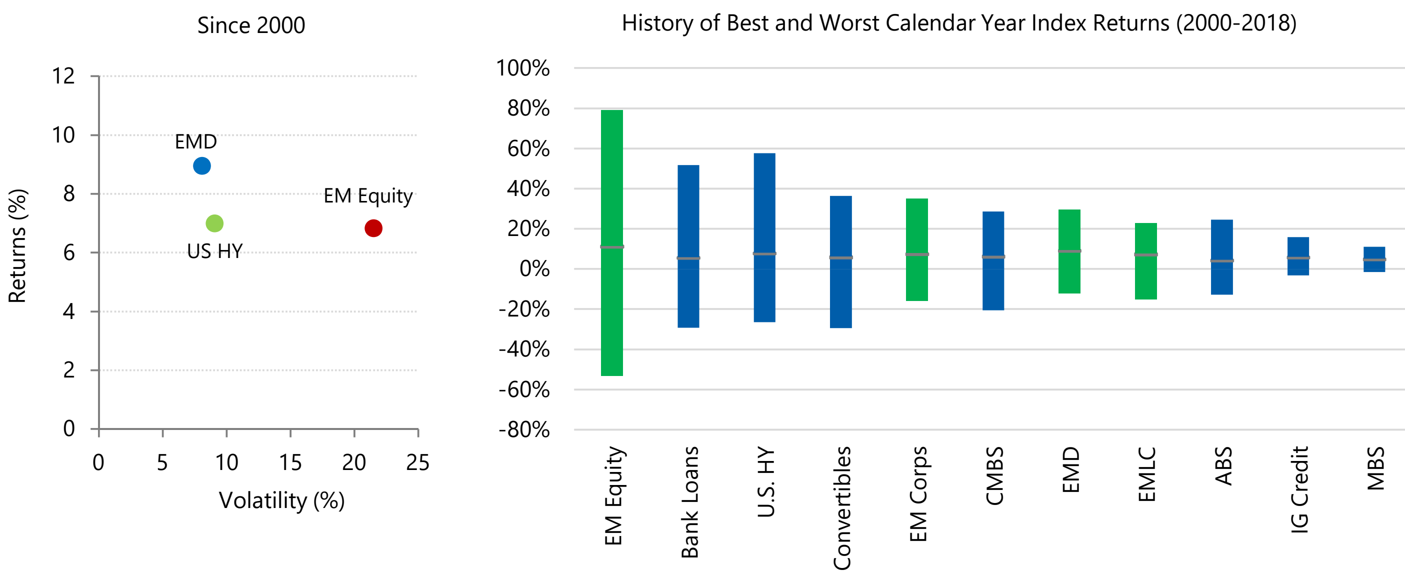
[3]Source: J.P. Morgan. [4]Source: Bank of America Merill Lynch.

Figure 5: Long-Term Performance of EMD and Other Indices



As of 30 September 2019. Source: Stone Harbor Investment Parners LP, Bloomberg. Benchmarks: EMD Hard Currency: J.P. Morgan EMBI Global Diversified; EMD Local Currency: J.P. Morgan GBI EM Global Diversified. EMD Corporates:: J.P. Morgan CEMBI Broad Diversified. Past performance is not a guarantee of future results. For illustrative purposes only.

Figure 6: For Long-Term Investors, EMD Compares Favorably to Other Asset Classes



Left-hand figure as of 30 June 2019. Right-hand figure as of 31 December 2018. EM Corps begins 2002. EMLC begins 2003. Indices - EM Equity: MSCI EM Markets Index; Bank Loans: S&P/LSTA Leveraged Loan Index; US HY: BofA Merrill Lynch U.S. High Yield Index; Convertibles: Global 300 Convertible Index; EM Corps: J.P. Morgan CEMBI Broad Diversified; CMBS: Bloomberg Barclays CMBS ERISA-Eligible Index; EMD: J.P. Morgan EMBI Global Diversified; EMLC: J.P. Morgan GBI-EM Global Diversified; ABS: Bloomberg Barclays Asset-Backed Securities (ABS) Index; IG Credit: Bloomberg Barclays U.S. Credit Index; MBS: Bloomberg Barclays Mortgage Backed Securities (MBS) Index.

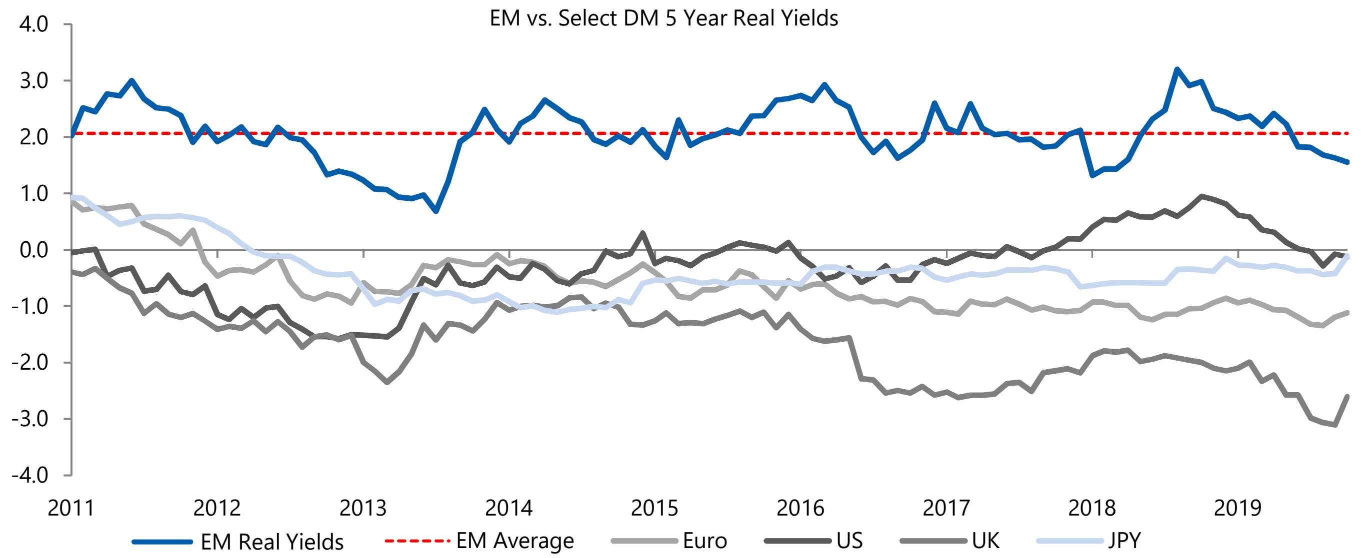
Why is Now a Good Time for EMD?

While we believe the long-term outlook for EMD is strong, we think that the current environment offers a particularly compelling opportunity to allocate to EMD. Developed markets have offered low and even negative yields, and that situation does not appear to us to be changing any time soon. In a "lower for longer" interest rate environment, EMD provides the opportunity for higher income than DM government bonds. Figure 6 shows this yield advantage, which has persisted over time and is likely to continue, particularly as more than US$14 trillion of global bonds now offer negative yields.[5]

[5]Source: Bloomberg

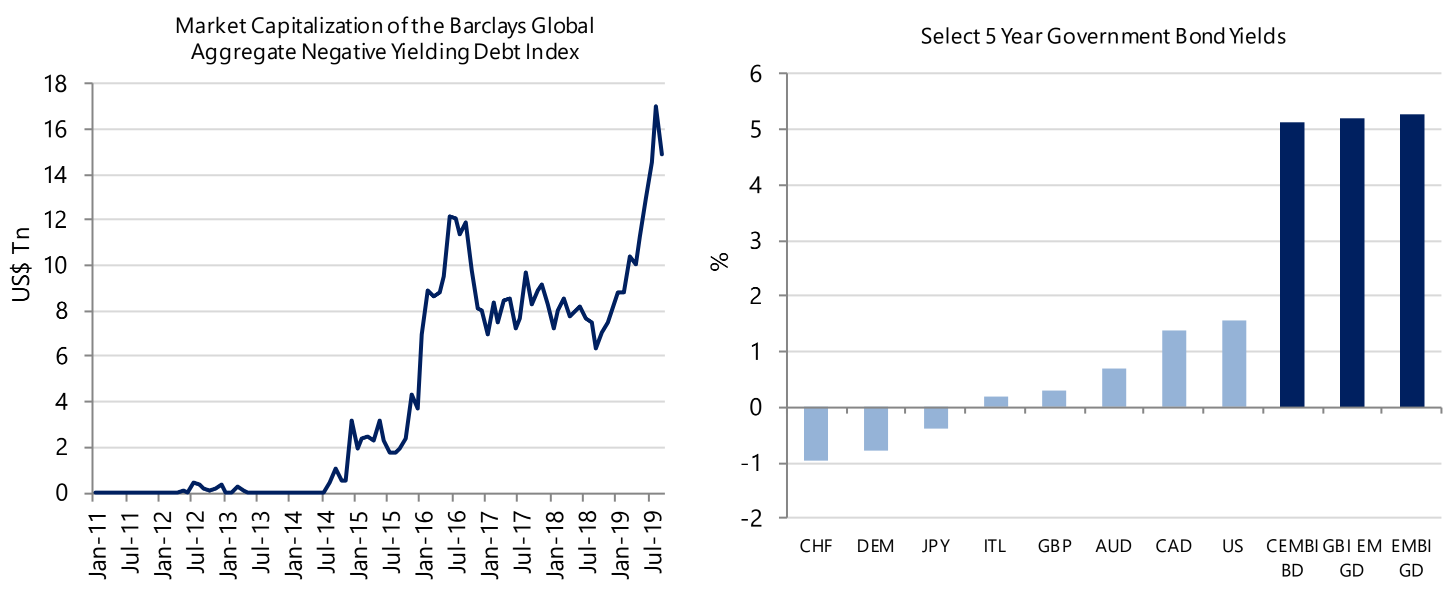
Figure 7 shows a snapshot of yields offered by several DM countries, as well as the three EMD indices as of September 30, 2019. For investors seeking income—and especially for those that do not want to potentially lose money by investing in negative-yielding DM government bonds—we believe EMD is a good fit. Figure 8 shows the recent spike in negative-yielding debt, reaching nearly US$17 trillion.

Figure 7: EMD Offers a Yield Advantage



As of 31 October 2019. Sources: Stone Harbor Investment Partners LP. Real yield = market-weighted sum of the real rates for each country in the JPMorgan GBI EM Global Diversified. Using 1-year forward Bloomberg consensus inflation forecasts. Developed market real yields = 5 yr real swap rates. For illustrative purposes only.

Figure 8: Staying Positive in a Negative World

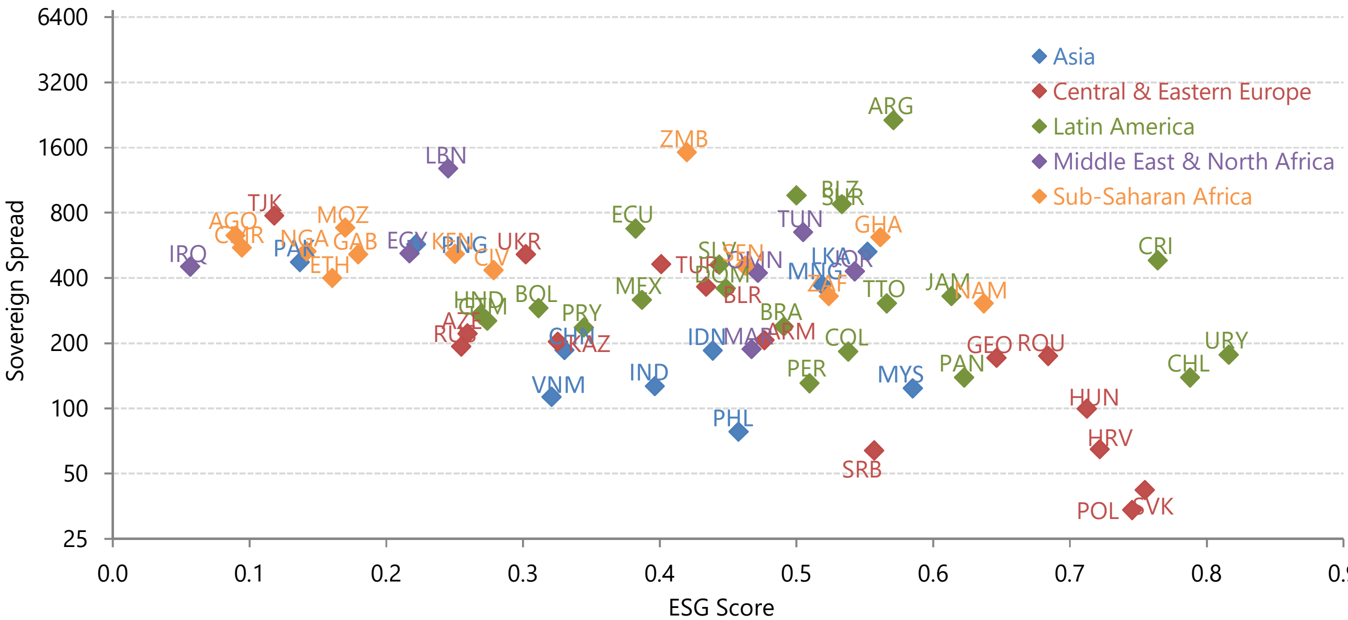


As of 30 September 2019. Source: Bloomberg. For illustrative purposes only.

Why ESG Matters in EMD

Along with other asset classes, there has been increased attention paid to ESG factors in EMD investing. According to the Global Sustainable Investment Alliance, more than 25% of professionally managed global assets—representing US$22.9 trillion—were managed following a sustainable or responsible investing process as of 2018. In EMD, ESG factors—which are composed of environmental ("E), social ("S") and governance ("G")—are highly relevant. As shown in Figure 9, there is an inverse relationship between ESG scores and a country's borrowing costs. In most cases, the lower a country's ESG score, the higher their borrowing cost, and vice versa.

Figure 9: ESG Risks are Priced into EMD Markets



As of 30 September 2019. Sources: Cato Institute, Transparency International, World Bank, Yale Center for Environmental Law, J.P. Morgan EMBI Spreads, Stone Harbor Investment Partners LP. ESG Scores are calculated and assigned by Stone Harbor Investment Partners LP. Higher ESG scores do not guarantee positive or higher performance results. For illustrative purposes only.

Of the primary ESG factors, governance is particularly important to bondholders, as institutions with improving accountability tend to lead to economic development. From a bondholder's view, the sovereign's commitment to political stability and security, as well as institutional support for the financial sector, should improve creditworthiness. For corporate issuers, particularly relevant considerations include management incentives to ensure that their actions do not disadvantage bondholders in favor of stockholders, the historical record of the treatment of bondholders, the structure of the board of directors, the nature of the shareholding structure and the reputation and track record of shareholders having dominant stakes. Social issues and environmental factors, while still relevant and important, are somewhat more narrowly applicable compared to the governance factor.

Improvements in ESG scores, particularly as they apply to governance, often correspond to better EMD returns as the market tends to price in the reduced risk. Therefore, the incentives for both issuers and investors to take actions to positively impact ESG scores are clear: improved ESG factors tend to be associated with lower spreads and thus better returns, benefitting bondholders; and countries and corporations that experience improving ESG scores also tend to undergo economic development and reduce their borrowing costs. As a result, we believe that ESG analysis should be an integral part of the EMD investment process.

Final Thoughts: EMD as an Alpha Opportunity

Along with the broad benefits noted above, EMD offers one final compelling feature: the potential for alpha generation. There is wide dispersion among EM countries in terms of growth outlooks, monetary and fiscal policies, inflation rates and a range of other fundamentals. As a result, we believe EMD tends to reward active managers that conduct intensive country and credit analysis. In addition, ESG analysis adds another tool to help investment managers navigate the EMD universe and seek further alpha. Overall, in an environment where even the opportunity for alpha can be elusive, we believe EMD offers the potential for active managers to add significant value.

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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) tracks total returns for U.S. dollar-denominated debt instruments issued by emerging markets sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds. The index 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.

The J.P. Morgan GBI-EM Global Diversified 15% Cap consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. However, the Investment Grade component of the index is capped at 15%. At rebalance, bonds must have at least 13 months remaining until maturity. Countries must be rated IG by S&P, Moody's and Fitch.

The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified version.

The ICE BofAML U.S. High Yield Constrained Index (HUC0) contains all securities in ICE BofAML U.S. High Yield Index but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face values of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. In the event there are fewer than 50 issues in the Index, each is equally weighted and the face values of their respective bonds are increased or decreased on a pro-rata basis.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of January 2009 the MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The S&P 500 is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Other index definitions are available upon request.

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Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets

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