June 2018

Why Now Is a Good Time to Invest in Emerging Markets Debt

By: Steffen Reichold, PhD, *Stone Harbor Investment Partners LP*

Timing "turning points" in market sell-offs is notoriously difficult. However, we see very good reasons why we believe emerging markets debt (EMD) should perform well with attractive risk-adjusted returns versus other credit asset classes.

Market sentiment has turned negative; however, we view these concerns as mostly overblown, resulting in an attractive entry point for long-term investors to increase EM debt allocations.

Following strong performance across EMD markets in 2016 and 2017 and a good start to 2018, market sentiment has turned negative more recently. Several factors have played a role; U.S. interest rates moved higher, the U.S. dollar strengthened, and global data surprises turned negative as high frequency activity indicators fell short of elevated expectations. Meanwhile, the Trump administration stepped up adverse trade measures and has not yet reached agreement on the North American Free Trade Agreement (NAFTA).

In particular, the move in the 10 year U.S. Treasury yield towards 3% in April revived memories of the 2013 "taper tantrum" and triggered pressures on perceived vulnerable Emerging Markets (EMs) in light of broader USD strength and higher funding costs. Similar to the "taper tantrum" episode, countries relying on substantial capital inflows to finance current account deficits have been under pressure, notably Argentina and Turkey with projected current account deficits of about 5% of GDP. But pressures have also extended to Mexico, mainly on account of worries about the renegotiation of NAFTA and the policy direction after the July election, and to Brazil, fueled by concerns over the prospects of much-needed fiscal adjustment in light of election-related populist pressures. In fact, while the broader global theme of growing populist pressures threatening orthodox, pro-trade and pro-integration policies has gained traction in certain developed countries, it is now also playing a role in EMs.

However, we view these concerns as mostly overblown and we believe this sell-off has created an attractive entry point for long-term investors to increase EM debt allocations. Timing turning points is notoriously difficult but we see very good reasons why we believe EM debt should perform well going forward.

Strong policy reaction to market pressures

As market pressures have increased we have seen decisive policy reactions in certain EM countries. Argentina raised the policy interest rate in two steps from 27.25% to 40%, allowed the currency to depreciate about 25% from mid-April levels before stepping in with large FX interventions, and has quickly negotiated a USD 50 billion support program with the IMF. The program includes policies to address the main vulnerabilities: foremost, a faster fiscal adjustment to support efforts to contain inflation, the reduction of the current account deficit, and the stabilization of public debt ratios. This is an impressive move, especially considering that IMF involvement remains politically difficult in Argentina.

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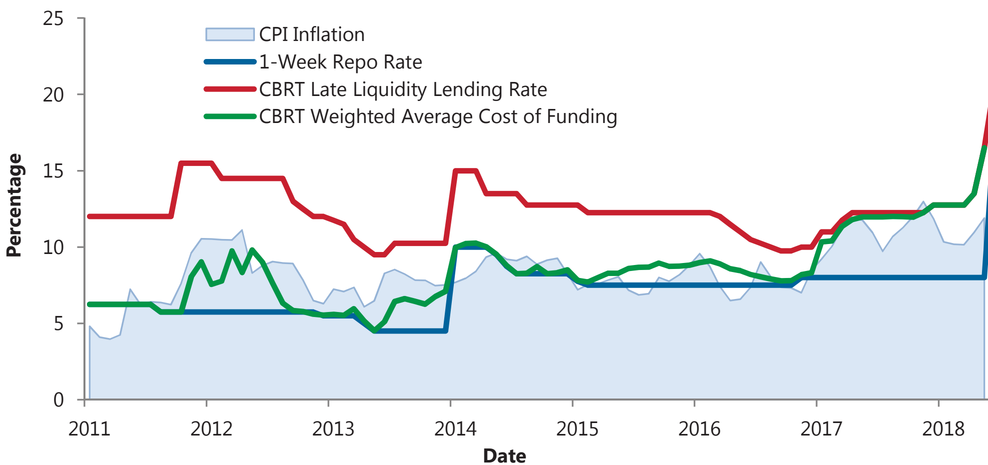
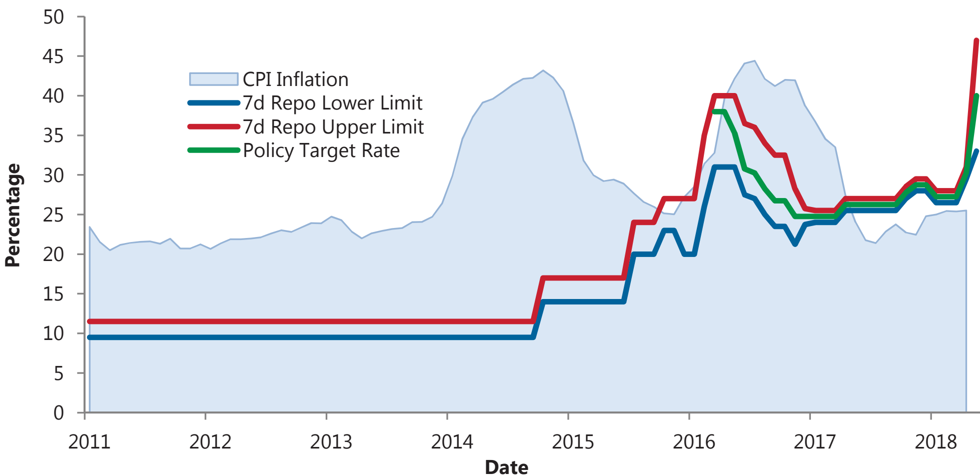
Turkey: Inflation and Policy Interest Rates



Argentina: Inflation and Policy Interest Rates



As of 11 June 2018
Sources: Haver Analytics

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Turkey has been more reluctant to take strong measures ahead of the June 24 general elections but nevertheless managed to raise the effective policy interest rate by 500 basis points (bps) from 12.75% to 17.75% since late April, while finally returning back to an orthodox monetary policy framework. The upper end of the interest rate corridor was raised by 800 bps. This leaves Turkey with substantially positive real interest rates for the first time since the global financial crisis. Given that Turkey has maintained a strong fiscal position with gross public debt below 30% of GDP and a well-capitalized banking system, we believe that this move will be successful in restoring market confidence.

While market pressure on other EMs has been less severe, we have nonetheless seen a variety of proactive policy moves ranging from preemptive rate hikes in Indonesia to large auctions of foreign exchange ("FX") swaps in Brazil to allow market participants to hedge FX exposures.

The global economic backdrop is actually supportive for EMs

The threat of global trade wars triggered by the Trump administration's aggressive anti-trade rhetoric has been weighing on markets for some time now. Most prominently, it

has affected Mexico, which is more dependent on trade with the U.S. than any other EM. Progress has been made in renegotiating NAFTA, but some key issues remain outstanding and time is running out to get a potential deal approved during the current U.S. Congress. But the earlier threat to announce the U.S. exit from NAFTA has not materialized and we believe NAFTA will remain in place until it gets replaced by a renegotiated version. Meanwhile, the focus of U.S. efforts to change global trade has shifted to China and tensions with the European Union (EU) have also picked up. But this leaves the largest part of the investable EM debt universe mostly outside of the main reach of U.S. trade threats.[1]

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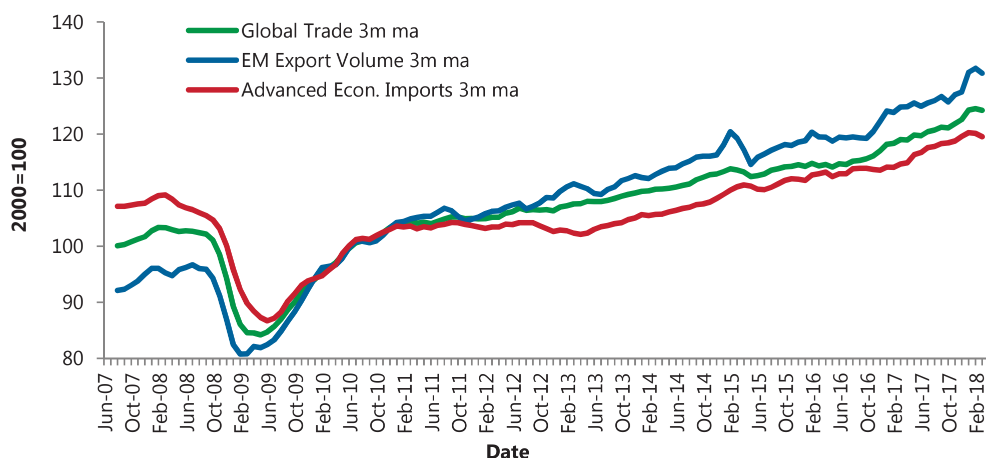
More importantly, the reality of global trade shows a rather positive picture, in sharp contrast to the rhetoric, in our view. World trade volume growth has accelerated since Trump took office and exceeded 4% year-over-year (y/y) every single quarter since Q1 2017. EM export growth has even exceeded growth in overall global trade volumes. Mexico's exports to the U.S., for example, have grown 8.9% y/y in Q1 2018 in USD terms. Meanwhile, commodity prices remain supportive, which helps commodity exporters among the EMs. For example, Russia has added more than USD 200 billion to its FX reserves over the past three years despite being sanctioned by the U.S. and the EU.

World Trade Volume



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Sources: Haver Analytics

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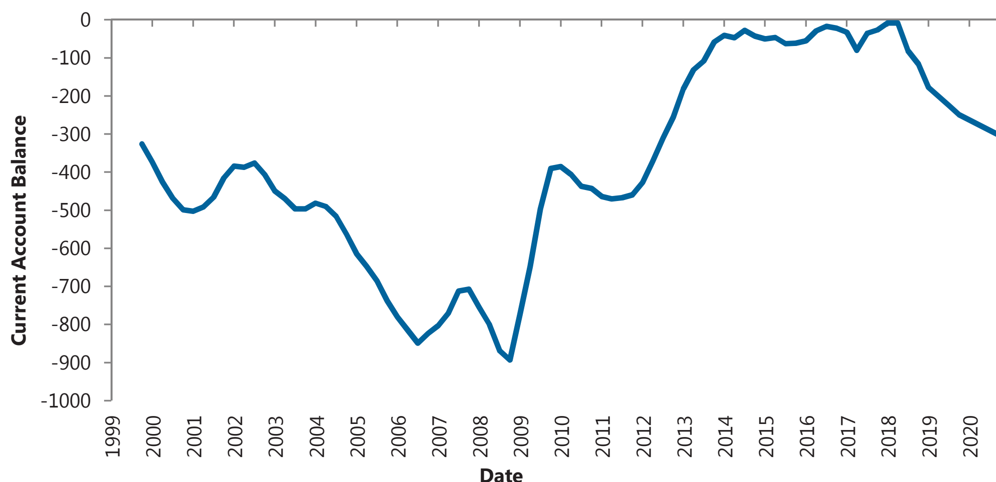
The economic reality is that GDP in major advanced economies is growing above potential and the expansion of domestic demand is pulling in more imports from EMs. This is particularly evident in the U.S. where total imports grew by 9.2% y/y in Q1 2018 in USD terms. The IMF is forecasting the annual U.S. current account deficit to widen by more than USD 300 billion over the next three years, driven by above-potential growth and large pro-cyclical fiscal stimulus. And while the EU's current account surplus might rise slightly over the same time, the net effect is still a massive widening of developed markets current account deficits. It is important to note that, we believe, trade policy has very little power to change this basic trend. That is unless it becomes sufficiently disruptive to meaningfully slow down U.S. economic growth. But in this scenario, political pressures in the U.S. would likely trigger a reversal of anti-trade policies.

Historically, periods of widening advanced economy current accounts have been closely related to strong returns in EMD markets. The last time we saw a widening of similar scale was from 2002 to 2008 when we also saw strong performance across EMD assets. And it is worth pointing out that this also happened during a period of rising U.S. interest rates: U.S. Federal Reserve (Fed) hiked rates by 425 bps between 2003 and 2007. In this current cycle the Fed has so far hiked 150 bps and markets are pricing in roughly another 100 bps.

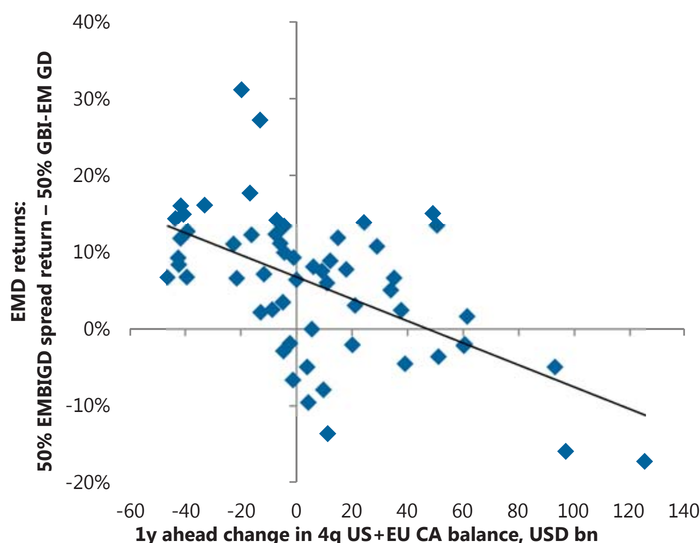
[1] Regarding the recently imposed U.S. steel and Aluminum tariffs, Argentina, Brazil and Korea have been exempted after they accepted quotas, in contrast to Canada and the EU.

Combined U.S. & EU Current Account Balance including IMF Forecast, 4Q Total, USD



Contrary to common perception, EMs on average are not running current account deficits.

U.S. & EU Current Account vs. EMD Blend Returns, 1999-2018



As of 11 June 2018
Sources: Haver Analytics; Bloomberg; Stone Harbor Investment Partners, LP

Long term EM fundamental prospects remain strong

Most EM economies have adjusted significantly since the "taper tantrum" in 2013.

This brings us to the question of how EMs can fundamentally withstand higher U.S. rates. The commonly heard argument is that EMs will struggle to finance current account deficits and pay back external debt in an environment with tighter global financing conditions. The recent troubles in Turkey and Argentina seem to point in that direction.

But it is important to note that these two countries clearly stand out among EMs in terms of vulnerabilities with current account balances around 5% of GDP and substantial external debt burdens. Most other EM economies have adjusted significantly since the "taper tantrum" in 2013. For EM-ex-China, the average current account adjusted from a deficit of 1.5% of GDP to about balance. Contrary to common perception, EMs on average are not running current account deficits. Many EMs with previously high current account deficits have gone through large adjustments, e.g., Brazil moved from a deficit of 4.2% of GDP in

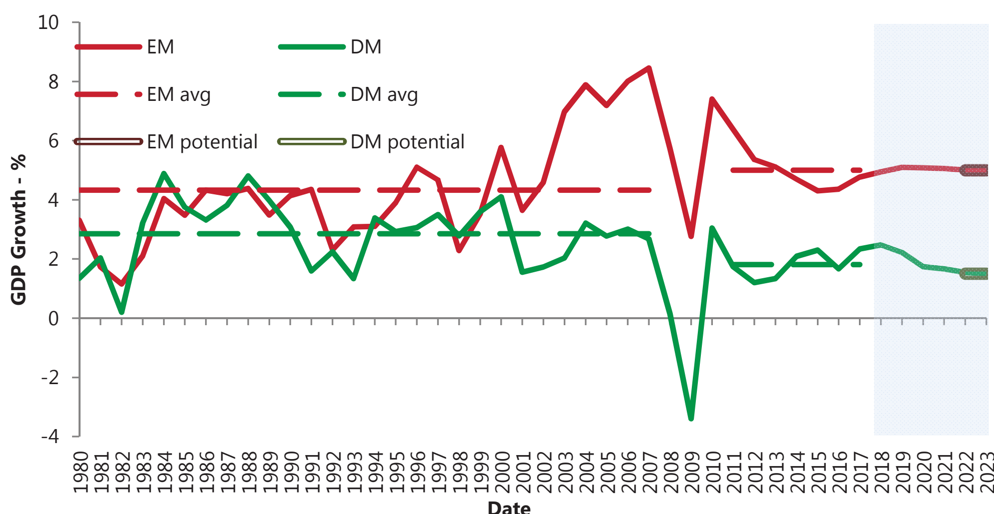
2014 to 0.5% last year; South Africa from 5.8% in 2013 to 2.5% last year; India from 5.1% in 2012 to 1.5% last year; Indonesia from 3.2% in 2013 to 1.7% last year; and Colombia from 6.3% in 2016 to 3.3% last year and likely below 3% this year. With the exception of South Africa, foreign direct investment flows fully cover the remaining current account deficits in all these countries listed above.

Most EM countries have also improved their debt structure with a higher share of domestic funding of the government and longer maturity profile. Record low inflation across EMs has reinforced this trend as it has opened local currency funding markets and allowed domestic borrowers to extend duration at reasonable rates. External corporate debt has increased, but the management of currency mismatches has improved with much reduced FX borrowing by sectors without FX receipts. Moreover, FX reserves exceed near-term debt servicing needs (public and private) in most EMs. Turkey and Argentina are exceptions, in this regard.

As a result, we believe that the anticipated rise in U.S. interest rates is not sufficient to cause broader funding problems across EMs.

As a result, we believe that the anticipated rise in U.S. interest rates is not sufficient to cause broader funding problems across EMs. Short-term tactical flows to EMs can be volatile, but it is important to distinguish them from longer-term strategic flows. Those tend to be driven more by fundamentals, in particular, economic growth prospects. And EM growth prospects remain good. The IMF forecasts that the growth differential between developed and emerging markets will rise by a full 1% in favor of EM over the next three to four years, resulting in EM growth that is three time higher than developed market growth by 2021.

GDP Growth including IMF Medium Term Projections



As of 11 June 2018
Sources: Haver Analytics, IMF WEO

Attractive valuations

In our view this is clear evidence of structurally superior risk premiums in EM debt.

Generally, markets have shown a pattern of over-estimating EM default risk and we believe this is still the case. Over long time periods (and through various episodes of market stress and EM crisis) EM hard currency sovereign debt has outperformed U.S. corporate credit by 149 bps annually for the investment grade (IG) segment and 318 bps annually for the High Yield (HY) segment.[2] In our view, this is clear evidence of structurally superior risk premiums in EM debt.

[2] J.P. Morgan EMBIGD IG versus Barclays US Agg Corp and EMBIGD HY versus ML US HY Master II, 1994 through May 2018.

Moreover, the recent sell-off in EMD has significantly improved valuations, both absolute and relative to other credit asset classes. Spreads in EM hard currency bonds have adjusted meaningfully. Both within the IG and the HY segments EM sovereign spreads are getting close to 10-year highs compared to U.S. corporate credit.

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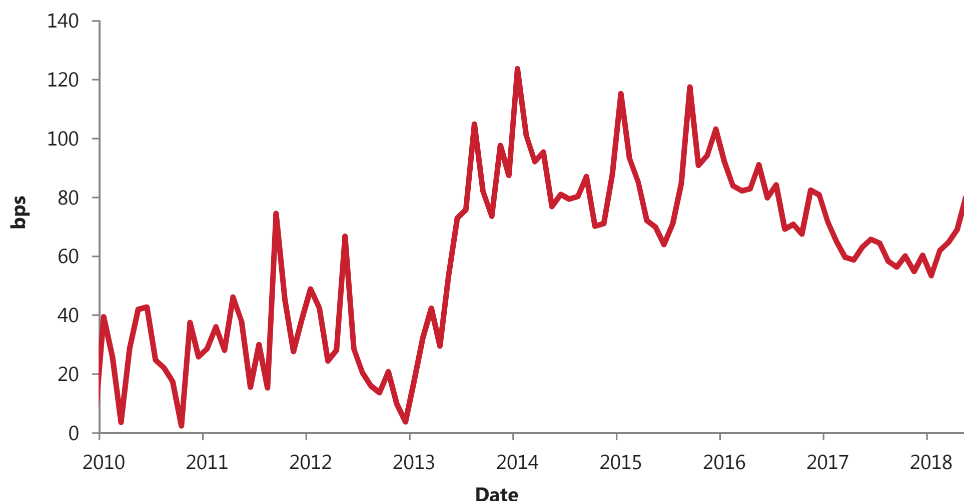
EMBIGD IG vs. U.S. Corp IG

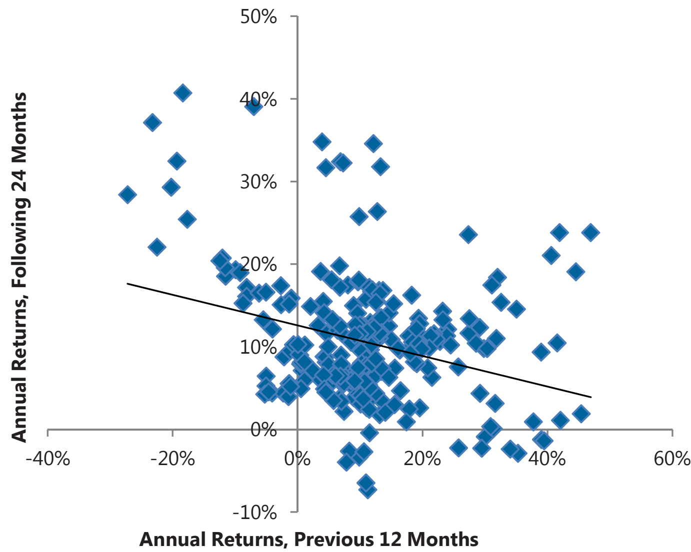


EMBIGD HY vs. U.S. Corp HY

As of 11 June 2018
Sources: Bloomberg

Given the tendency for mean reversion in spreads, historically EM Sovereign returns have tended to be strong after periods of underperformance. In fact, since 1994 whenever one-year returns have turned negative, they have always been followed by positive returns over the following two years, and in most cases, producing significantly above average returns.

Annualized Total Returns, EMBIGD Index, 1994-2018

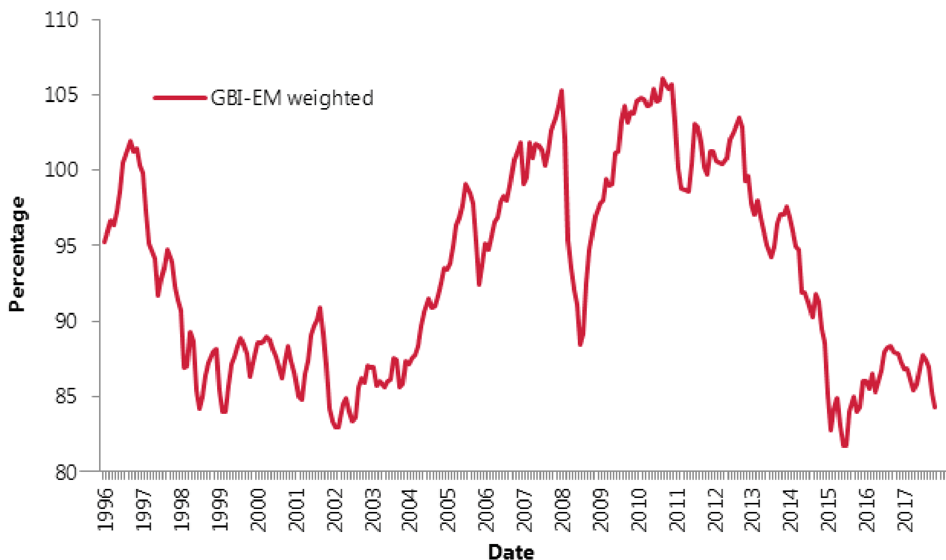


We believe the size of the adjustment in exchange rates and interest rates bodes very well for the long-run economic and market success for EMs.

As of 11 June 2018
Sources: Bloomberg, Stone Harbor Investment Partners, LP

EM local market valuations have arguably adjusted even more. EM currencies have depreciated back to the levels that prevailed in the late 1990s and early 2000s (inflation adjusted and trade-weighted). The strong performance on EM economies since then highlights the strong competitiveness of EM exchange rates at those levels. Similarly, local interest rates are at multi-year highs in real terms, substantially higher than at the peak of the 2013 "taper tantrum". In our view, both taken together bode well for the return outlook in EM local currency debt markets. While timing local market rebounds tend to be harder to predict than for hard currency markets, we believe the size of the adjustment in exchange rates and interest rates bodes very well for the long-run economic and market success for EMs.

EM Real Effective Exchange Rate Index



As of 11 June 2018
Sources: BIS, Bloomberg, Stone Harbor Investment Partners LP

They say Hindsight is 20/20; making decisions at the outset is more difficult than evaluating past choices with perfect clarity. We believe our experience managing this asset class allows us to understand the market patterns and investment cycles. Since the inception of the asset class nearly 30 years ago, Emerging Markets sovereign debt returns have tended to be strong after periods of underperformance. Could now be one of the most attractive entry points for long-term investors to increase EM debt allocations? We think so.

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.

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: 34.85 billion as of 31 March 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:

- 13 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

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

Chicago
10 S. Riverside Plaza
Suite 875
Chicago, IL
+1 312 492 4251

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

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

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

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Investments in emerging markets securities are subject to risks arising from political or economic instability, nationalization or confiscatory taxation, currency exchange restrictions and an issuer's unwillingness or inability to make principal or interest payments on its obligations. Investing in emerging markets may involve relatively higher degrees of volatility. Such investments are also subject to currency risk. The value of an emerging markets debt strategy's investments may fall as a result of changes in exchange rates. Because an emerging markets debt strategy generally may invest a portion of its assets in investments denominated in non-U.S. currencies or investments whose returns are linked to those currencies, such strategies are especially susceptible to currency risk. More generally, fixed-income investments are subject to certain risks such as interest rate, inflation, and credit risks. These risks and others may materially impact the ability of Stone Harbor to achieve its stated investment objectives for a given strategy. Stone Harbor's ability to achieve investment results consistently, in the aggregate or with regard to any particular country or region, depends significantly on a number of factors in addition to the accuracy of its assumptions. These include Stone Harbor's ability to identify a sufficient number and mix of suitable investments.