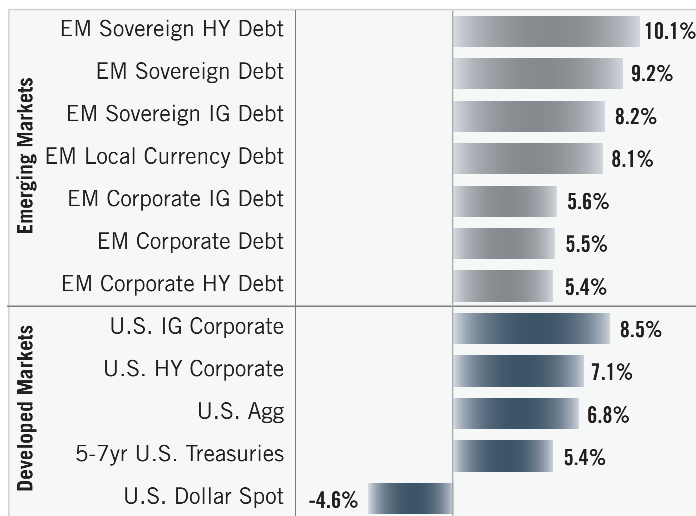
MARKET REVIEW

Emerging markets (EM) debt rebounded in Q4 as stabilizing inflation and the prospect of an easing in U.S. monetary policy turbocharged performance. Lower bond yields in developed countries, tempered inflation expectations, and a weaker U.S. dollar drove the improvement in performance. In December, the Federal Reserve (Fed) maintained its policy rate, recognizing that long-term inflation expectations had anchored helped by tighter monetary policy, while employment remained robust. The Fed's decision signaled potential rate cuts in 2024. A widespread rally ensued across EM external debt (sovereign and corporate), EM currencies and domestic bond markets. A key factor underpinning the more optimistic outlook for these markets was the leading role of EMs in disinflation.

FIGURE 1. TOTAL RETURNS IN Q4 BY SECTOR



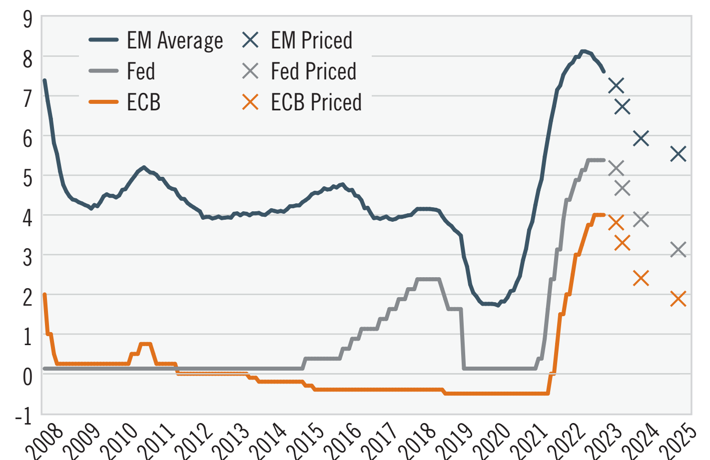
Past performance is no guarantee of future results. As of December 31, 2023. Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners.

Emerging markets led developed markets (DMs) in inflation moderation in 2023 due to four key factors. First, many EM central banks began hiking cycles earlier than their developed peers. Second, EMs faced greater pressure to establish policy credibility through restrictive monetary policies. Third, the heavy weighting of commodities in EM consumer price indices caused EMs to suffer more than DMs during the commodity spike but benefit more recently from price declines. Fourth, more fiscally conservative COVID policies resulted in earlier EM slowdowns and muted demand pressures.

Collectively, these factors underscored in Q4 the improved fundamentals of many EM countries and their ability to respond to external shocks. Solid fundamentals of emerging economies have been supported by fiscal strength and prudent policymaking, which have in turn helped to produce healthy primary fiscal balances and stabilize debt-to GDP ratios.

With faster disinflation and, in many countries, weaker economic momentum, EM countries have led the rate cutting cycle. For example, Brazil began hiking in March 2021 and raised its policy rate from 2% to 11.75% as of this writing, after reaching a cyclical high of 13.75% in June 2023. Mexico hiked its policy rate from 4% in June 2021 to 11.25% as of this writing. Across EMs, policy rates have already turned down with more expected cuts for 2024.

FIGURE 2. GLOBAL POLICY RATES

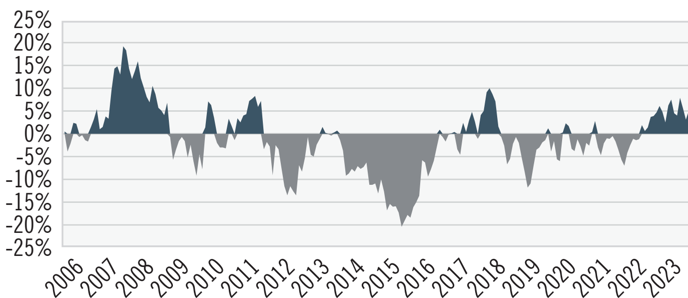


As of December 31, 2023. Sources: Bloomberg, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

At the same time, the International Monetary Fund (IMF) and other multinational financial institutions have financed EMs with more fragile economies. In December, the IMF approved a 50% increase in quota resources for the lending to EMs. The increase raised IMF lending capacity by approximately US$314 billion and aims to shift the composition of the IMF's lending resources to more permanent programs, while maintaining the overall lending capacity at about US$ 1trillion. During Q4, the IMF either approved or was in process of approving new lending or disbursements from existing loans to Benin, Ivory Coast, Kenya, Paraguay, Sri Lanka, Suriname, Ukraine, and Zambia.

The combination of EM resilience and lower expected returns from the U.S. dollar led to improved returns from local currency assets this quarter. On a rolling 1 year basis, the total return of the local currency benchmark has exceeded returns from hard currency sovereign debt for over a 12-month period for the first time since 2017. In the past fourteen years, the JP Morgan GBI EM Global Diversified has outperformed the JP Morgan EMBI Global Diversified in three years: 2011, 2017 and 2023. In each year, a key factor in this outperformance was the positive performance of EM currencies relative to the U.S. dollar. Further appreciation, in our view, will require slower growth, but not recession in the U.S., stronger growth in Europe, and stability in China.

FIGURE 3. ROLLING 1-YR RETURN, GBI EM GLOBAL DIVERSIFIED LESS EMBI GLOBAL DIVERSIFIED



Past performance is no guarantee of future results. As of December 31, 2023. Sources: Bloomberg, JP Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

Strong returns from EM debt in Q4 came despite continued weakness in China's economy. Residential property sales by volume and construction activity have declined by roughly 20% year-over-year in 2023 and remain substantially below their peaks in January 2021. The slowdown has forced the government to increase policy support to try to offset this weakness. Examples of policy initiatives include approval of RMB 1 trillion in government bond issuance to fund infrastructure and social programs, front-loading of local government bond quotas, relaxation of property market restrictions, plus interest rate cuts and intervention to support the yuan.

So far, however, these actions have had limited impact on growth momentum in China. In our view, China under Xi Jinping will refrain from large-scale bailouts and debt restructurings. The recent Central Economic Work Conference concluded in December without meaningful new initiatives and reiterated previous statements of the intention to gradually resolve property risks and to facilitate stable and healthy development. Nevertheless, we have increased our projection of China's GDP growth rate in 2024 to 4.4% from 4.0% at the end of Q3, reflecting the policy moves already made. Most analysts now expect the official growth target of ~5% for 2024.

In external sovereign debt, the high yield (HY) sector outperformed investment grade bonds by 194 basis points, driven by sharp rebounds in stressed credits. The main contributors to HY outperformance included Argentina and Pakistan, both delivering over 30% excess returns as bond prices gained from deeply stressed levels at the end of Q3. Strong bond price recoveries also occurred in Egypt, Turkey, Dominican Republic, Nigeria, Colombia, Kenya, and Mexico. Domestic policy developments in each of these countries played major roles in the recoveries. Venezuela debt also generated strong total returns this quarter (+85%) following the lifting of U.S. sanctions on trading of the country's bonds.

At end of 2023, eight benchmark countries had defaulted on approximately US$67 billion face value of index-eligible external sovereign debt obligations and sought debt relief. Ethiopia became the latest entry to this group after it defaulted on debt payments in December. Despite a delay in negotiations with creditors in Zambia after the country's bilateral lenders turned down a restructuring proposal from private creditors, returns on many of the defaulted bonds remained robust. Ethiopia's debt gained 3.6% in the month the country defaulted. Zambia returned 13.4%. While bond prices fell in Ghana, Lebanon, and Ukraine, bonds from the remaining five defaulters (Sri Lanka, Suriname, Zambia, Venezuela, and Ethiopia) posted positive returns, suggesting that markets remain optimistic on recovery values for most of the defaulted countries.

FIGURE 4. RESTRUCTURING PROGRESS FOR EIGHT SOVEREIGN DEFAULTS

Country	Date of Default	Official Creditor Agreement	Private Creditor Agreement	Gov't. Exchange Offer	IMF Program	Average Sovereign Bond Price
Suriname	Mar 2021	complete	complete	complete	complete	$87
Sri Lanka	Apr 2022	complete	in progress	complete	complete	$50
Zambia	Oct 2020	in progress	in progress	in progress	complete	$60
Ghana	Dec 2022	in progress	in progress	incomplete	complete	$45
Ukraine	Aug 2022	incomplete	incomplete	incomplete	complete	$29
Ethiopia	Dec 2023	incomplete	incomplete	in progress	in progress	$67
Venezuela[1]	Nov 2017-May 2018	incomplete	incomplete	incomplete	incomplete	$12
Lebanon	Mar 2020	incomplete	incomplete	incomplete	incomplete	$6

● complete ● in progress ● incomplete

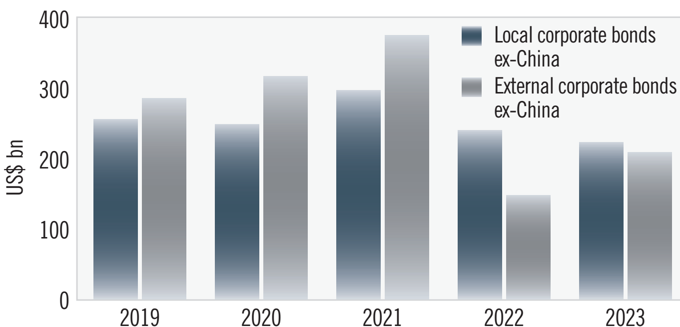
As of December 31, 2023. Sources: Bloomberg, Stone Harbor Investment Partners. For illustrative purposes only.

continued

EM corporates underperformed sovereign and local currency debt in Q4. A key factor in the underperformance was the lower duration of most corporate debt relative to sovereign bonds. Nevertheless, corporate debt spreads tightened in most countries. Furthermore, despite the increase in the outstanding amount of corporate bonds from developed countries over the past decade, the JP Morgan CEMBI Broad Diversified has delivered higher total and volatility-adjusted returns over the past three-, five- and ten-year periods relative to sovereign bonds.

We believe the availability of local funding sources is a key factor in this result as it has reduced market concerns over the burden of maturity payments that many EM companies face in the coming years. The reasons for the growth of local funding differs by country, but several of the factors supporting it include broadening financial inclusion that expands local bank lending, maturation of bond markets, and declining inflation expectations, which has improved confidence in domestic assets. Figure 5 shows that since 2021, local corporate bond issuance from EM countries outside of China has exceeded external corporate bond issuance from the same countries.

FIGURE 5. LOCAL CORPORATE BOND ISSUANCE VS. EXTERNAL ISSUANCE, EX-CHINA



As of December 31, 2023. Sources: J.P. Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

TECHNICALS[1]

EM sovereign and corporate debt issuance totaled US$67 billion in Q4, down from US$75 billion in the prior quarter but a 28% increase over Q4 a year ago. Total issuance for 2023 was US$377 billion, an increase of 18% from the prior year.

Sovereign debt issuance for the quarter totaled US$21.4 billion, with 75% of the issuance from investment grade companies. The largest sovereign issuers for 2023 included Saudi Arabia, Poland, Turkey, Romania, and Mexico, which issued a combined total of US$58.7 billion. All of these countries except Mexico issued in Q4.

Corporate primary market issuance for Q4 was US$45.9 billion, well below the five-year Q4 average of US$74 billion. A 52% decline in issuance from China compared to the prior year explained this result. EM ex-China issuance recovered moderately from 2022 lows. Net financing for the year was negative at US$157 due to low primary market issuance and large amortizations. As with sovereigns, investment grade corporate issuers dominated initial public debt offerings this quarter and comprised 78% of total issuance YTD.

According to flow tracker EPFR Global Data, EM debt portfolios posted outflows for Q4 2023, totaling approximately US$15 billion. Local currency portfolios recorded outflows of US$6 billion, while hard currency funds experienced outflows of US$8.4 billion. Outflows from funds with blended benchmarks totaled US$1.0 billion. Total outflows for 2023 were US$31.7 billion, comprising outflows of US$27.8 billion from hard currency portfolios and the remainder from local currency funds.

BENCHMARK PERFORMANCE

External Sovereign Debt

Investment Grade: The IG sovereign benchmark returned 8.2% in Q4 as declining U.S. Treasury (UST) yields boosted performance. Spreads tightened 12 bps on average, with gains across most countries. Hungary (+10.9%), Mexico (+10.9%), and Indonesia (+10.1%) led the sector in total return. Panama underperformed (+2.5%) on mine closure concerns. Each region benefitted from the decline in developed market yields and spread compression.

Non-Investment Grade: The HY sovereign index gained 10.1%, led by sharp rebounds in stressed credits. Argentina (+38.4%) rallied on newly-elected President Javier Milei's announcement of cuts to state spending and peso devaluation. Pakistan (+34.6%) benefitted from IMF support despite political uncertainty. Tunisia (+21.2%) saw gains from surging tourism and exports. Venezuela outperformed with an 80.2% return on lifting of U.S. sanctions. At the regional level, recovering commodities revenue supported returns from Latin America. However, escalating geopolitical tensions weighed on Lebanon (-26%) and Ukraine (-7.3%), and declines in exports from the mining and natural gas sectors underscored Bolivia's 13.5% decline.

[1]Source: JP Morgan, EPFR Global Data

continued

At the regional level, HY sovereigns outperformed IG bonds in Asia by 6.27% (14.37% vs 8.10%) but underperformed in Gulf States/Middle East by 1.99% (5.93% vs 7.92%). IG bonds from the Gulf States, which tend to issue debt with long-duration, benefitted most from the decline in UST yields.

Local Currency Debt

Currencies: EM currencies appreciated relative to the U.S. dollar by 3.2%. Eastern Europe outperformed, led by the Polish zloty and Hungarian forint. Latin America gained 3.0%, led by the Brazilian real and Colombian peso. Laggards included the Turkish lira on inflation differentials, the Dominican Republic's peso on a surprise October policy rate cut and the Uruguay peso, which suffered from the drag coming from a 50% depreciation of Argentina's peso.

Interest Rates: Local bond yields fell 57 basis points to an average yield of 6.2% as yields on 10-year USTs and Bunds declined. Latin America saw the largest declines with yields falling over 120 bps in Brazil, 160 bps in Colombia and 94 bps in Mexico. In Eastern Europe, yields dropped 158 bps in Hungary. South Africa also fell 84 bps on slowing inflation. Asia yields declined 24 bps; however, there was a 21 bps rise in the Philippines.

Corporate Debt: EM corporate bonds returned 5.5%, consisting of equal total returns from the IG and HY market segments. The benchmark spread tightened 20 basis points.

In IG bonds, the tightening in UST yields drove performance, while spread compression was the primary driver of returns in HY. At the industry level, the oil and gas sectors continued outperforming despite lower oil prices. Independent operators in Ghana and Colombia, in particular, befitted from liability management exercises completed during Q4. At the country level, key outperformers included Argentina, Mexico and South Africa. The presidential election outcome in Argentina drove strong performance in corporates on the prospect of political and fiscal reform. Zambia was the only country in the index with a negative return for the quarter, as Panama's government closed First Quantum's copper mine in Panama in reaction to social protests.

OUTLOOK

Our base case (35% probability) assumes that inflation continues falling globally, growth slows and the Fed cuts rates to normalize real yields and avoid a recession in the U.S. If we are wrong, we believe the two most likely scenarios will lead the Fed to cut policy rates more aggressively, either to contain an economic downturn (25% probability), or to keep up with falling inflation while growth remains robust (30% probability). All three scenarios point to lower U.S. policy rates. Another scenario leads the Fed to hike policy rates as inflation remains elevated. We assign a 10% probability to this outcome.

For external debt, yield and carry continue to support strong, positive projected returns. The yield on the JP Morgan EMBI Global Diversified has declined to 7.9% from 8.6% a year ago but remains 250 basis points above the benchmark's average yield over the past decade. For the CEMBI Broad Diversified, yields have declined 47 bps to 6.8% or 140 bps above the ten-year average yield. Negative returns on sovereign and corporate debt would require a combined shift higher in spreads and UST yields of 127 bps and 185 bps, respectively.

FIGURE 6. 12-MONTH TOTAL RETURNS FOR EXTERNAL BOND BENCHMARKS

EMBI GLOBAL DIVERSIFIED

Spread Change			U.S. Treasury Yield Change						
	Change (bps)		-75	-50	-25	0	25	50	75
		Spread Level	3.13	3.38	3.63	**3.88**	4.13	4.38	4.63
	-75	308	17.1	15.5	14.0	**12.5**	10.9	9.4	7.8
	-50	333	15.6	14.0	12.5	**10.9**	9.4	7.8	6.3
	-25	358	14.0	12.5	10.9	**9.4**	7.8	6.3	4.8
	0	**383**	**12.5**	**10.9**	**9.4**	**7.8**	**6.3**	**4.8**	**3.2**
	25	408	10.9	9.4	7.8	**6.3**	4.8	3.2	1.7
	50	433	9.4	7.8	6.3	**4.8**	3.2	1.7	0.1
	75	458	7.8	6.3	4.8	**3.2**	1.7	0.1	-1.4

CEMBI BROAD DIVERSIFIED

Spread Change			U.S. Treasury Yield Change							
	Change (bps)		-75	-50	-25	0	25	50	75	
		Spread Level	3.13	3.38	3.63	**3.88**	4.13	4.38	4.63	UST 10yr Yield
	-75	206	12.4	11.5	10.6	**9.7**	8.8	7.9	7.0	
	-50	231	11.5	10.5	9.6	**8.7**	7.8	6.9	6.0	
	-25	256	10.5	9.6	8.7	**7.8**	6.9	6.0	5.0	
	0	**281**	**9.5**	**8.6**	**7.7**	**6.8**	**5.9**	**5.0**	**4.1**	
	25	306	8.6	7.7	6.8	**5.8**	4.9	4.0	3.1	
	50	331	7.6	6.7	5.8	**4.9**	4.0	3.1	2.2	
	75	356	6.7	5.7	4.8	**3.9**	3.0	2.1	1.2	

As of December 31, 2023. Sources: Bloomberg, JP Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

continued

In local markets, we expect gains from currencies relative to the U.S. dollar in two scenarios with a combined probability of 65%. Under these scenarios, we favor currencies from Brazil, Colombia, South Africa, Indonesia, and Mexico. In both recession and higher growth/higher rate scenarios, we project EM currencies to depreciate relative to the U.S. dollar.

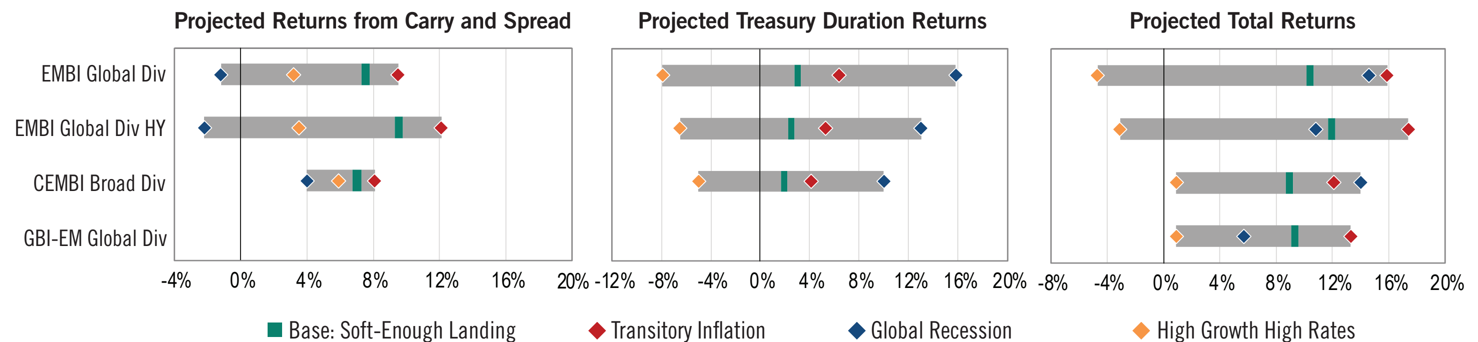
In all the four scenarios, we see positive returns from EM local bond duration, given the ongoing disinflation in many EM economies. This view worked well in Q4, and we will be looking for relative value opportunities to take advantage of exposure to countries experiencing declining inflation and where bond yields may have lagged during the end of 2023 rally.

Examples of domestic debt relative value opportunities may include adding Poland duration in lieu of Romania as the credit quality of Poland improves under Prime Minister Tusk, who has stronger relationships with the European Union than his populist predecessor. In another example, the yield spread of Peru local bonds over Chile has widened recently following the latter country's outsized rate cuts, potentially creating investment opportunities in Peru. While Colombia yields fell sharply in 2023, we see more upside depending on inflation and wage data in the months ahead.

Finally, while Turkey began normalizing monetary policy, its domestic debt yields increased over 17% in 2023. We may see opportunities to add to Turkey's local market if monetary policy continues shifting in a more orthodox direction.

FIGURE 7. MACROECONOMIC SCENARIO RETURNS (12-MONTH) AND ASSUMPTIONS

	Base Case	Alternative Scenarios		
	Soft-Enough Landing	Transitory Inflation	Global Recession	High Growth, High Rates & Inflation Still-Too-High
Probabilities	35%	30%	25%	10%
Macroeconomic Assumptions				
U.S. Real 4Q GDP (%)	1.25	1.75	-1.00	2.50
EM 4Q GDP (%)	4.00	4.25	1.75	4.50
China 4Q GDP (%)	4.50	4.75	3.00	5.25
Brent	$80 bbl	$80 bbl	$60 bbl	$95 bbl
U.S. Core PCE (%)	2.75	2.00	1.75	3.50
Fed Funds (%)	4.88	3.88	2.88	6.38
2yr U.S. Treasury (%)	3.90	3.25	2.00	6.00
10yr U.S. Treasury (%)	3.75	3.15	1.75	5.50
10yr Bund (%)	2.25	1.75	1.00	3.50
SHIP Return Forecasts fro Carry + Spread (%)				
EMBI GD	7.4	9.5	-1.2	3.2
EMBI GD HY	9.4	12.1	-2.2	3.5
CEMBI Broad Div	6.9	8.1	4.0	5.9
GBI-EM GD Local Rates[1]	8.1	9.8	11.2	3.5
GBI-EM GD FX[2]	1.0	3.5	-5.6	-2.6



Source: Stone Harbor Investment Partners. [1]GBI-EM projected returns are 12m carry and duration returns. [2]GBI-EM projected returns are 12m FX Returns. The projected returns are not a prediction of the future results of any Stone Harbor portfolio. The portfolio management team refers to the charts above as one of various factors when making allocation decisions. The charts demonstrate scenarios assumptions which Stone Harbor uses in analysis to determine projected returns. Unless otherwise specified, scenario assumptions and base case returns summarize the team's 12 month return projections and outlook. Data reflects the views of the portfolio management team as of the date hereof and is subject to change without notice. Our analysis does not guarantee performance results. For illustrative purposes only.

continued

Authored by:

The Stone Harbor Emerging Markets Debt Team

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The **J.P. Morgan CEMBI Broad Diversified** tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in emerging market countries and consists of an investable universe of corporate bonds. The minimum amount outstanding required is $350 mm for the CEMBI Broad Diversified. The CEMBI Broad Diversified limits the weights of those index countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. The **J.P. Morgan EMBI Global (EMBIG)** 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 **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. The **Bloomberg Treasury Index** tracks the obligations of the U.S. Treasury with a remaining maturity of one year or more. The **ICE BofA US High Yield Constrained Index** contains all securities in the US 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 index is calculated on a total return basis. The **Bloomberg U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **Bloomberg U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis. The **Bloomberg Global Aggregate Bond Index** measures the global investment grade fixed rate bond market. The index is calculated on a total return basis. The **U.S. Dollar Index** is a relative measure of the U.S. dollars strength against a basket of six influential currencies, including the euro, pound, yen, Canadian dollar, Swedish korner, and Swiss Franc. The **J.P. Morgan CEMBI Broad Diversified Investment Grade Index** tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in emerging market countries rated BBB and higher. The index uses a limited portion of the current face amount outstanding of larger countries within the CEMBI index. Minimum face amount outstanding required is $300 mm. The index limits the weights of countries with larger corporate debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding. The **J.P. Morgan CEMBI Broad Diversified High Yield** tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in emerging market countries and consists of an investable universe of corporate bonds that have a rating of BB and below. The **J.P. Morgan EMBI Global Diversified High Yield** tracks total returns for U.S. dollar-denominated debt instruments issued by emerging markets sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds that have a rating of BB and below. The **J.P. Morgan EMBI Global Diversified Investment Grade Index** tracks total returns for U.S. Dollar-denominated debt instruments issued by emerging markets sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds that are rated BBB and higher. The indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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