Stone Harbor INVESTMENT PARTNERS
A Virtus Investment Partner

MARKET REVIEW

In Q3, rising yields and weakness in China's economic data in July and August drove returns and sentiment on emerging markets (EM) debt. The increase in yields of U.S. Treasuries (USTs) and Bunds detracted from returns of external EM debt. Local currency debt returns also turned lower as the U.S. dollar appreciated. In China, a piecemeal effort to support a slowing economy raised market concerns over a potential larger downturn in growth not only for China but also for the broader set of EM countries.

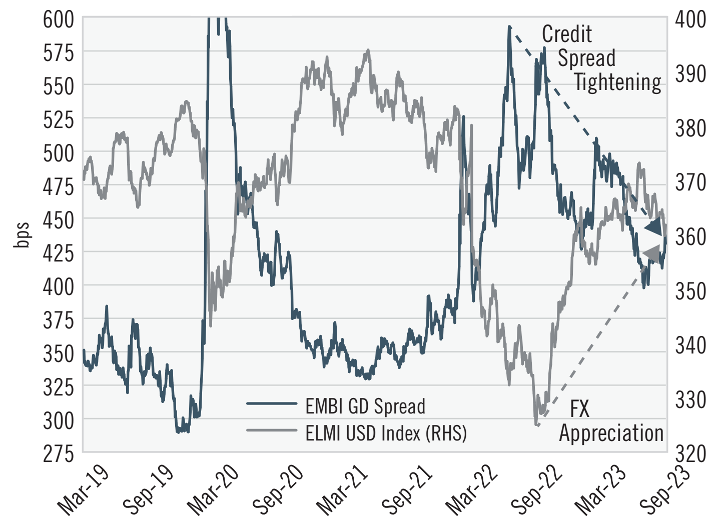
Together these developments created a challenging backdrop for EM debt portfolio flows. According to EPFR, the flow tracking service, investors withdrew US$13 billion from EM debt funds in Q3.

We question how long this weakness will persist. While keeping open its option for policy rate hikes in the future, the U.S. Federal Reserve recognized the significant slowdown in inflation over the past year in its pause in September. Stronger growth may keep UST yields elevated for longer than markets had earlier expected, but better-than-anticipated economic activity in the U.S. may also result in improved outcomes for emerging markets countries, particularly those that rely on U.S. growth for exports, and those that benefit from geopolitical tensions between the U.S. and China.

China's economic data softened in July and August; however, in September reports on credit growth, industrial production and retail sales surprised to the upside, suggesting a stabilization of the economy, if not a bottoming. Despite the slowing of China growth this year and the modest downturn in EM debt performance this quarter, EM financial conditions measured by credit spreads and currency prices have recovered from stressed levels a year ago. See Figure 1.

In our view, one of the most important developments in EM debt this year has been a shift in the market's assessment of default risk. A year ago, seven EM countries were in default and debt of 19 countries traded at spreads of 1,000 basis points or more, effectively cutting access to external financing for those countries. The benchmark spread for sovereign EM debt was 559 basis points on

FIGURE 1. EM FINANCIAL INDICATORS

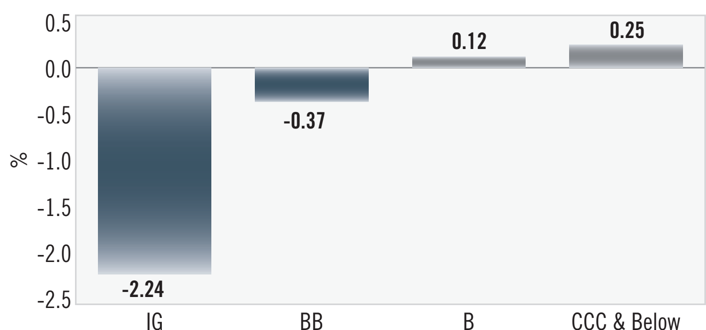


As of September 30, 2023. Sources: J.P. Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

September 30, 2022. As of the end of Q323, the benchmark spread has narrowed to 430 basis points. While seven countries remain in default, bonds of 15 countries trade above the 1000 basis points spread threshold and no EM countries have defaulted this year.

In Q3, as in the prior quarter, bonds rated CCC or below—the countries most vulnerable to default—were the largest positive contributors to benchmark returns. See Figure 2.

FIGURE 2. Q323 TOTAL RETURN BY RATING CATEGORY, EM HARD CURRENCY SOVEREIGN DEBT

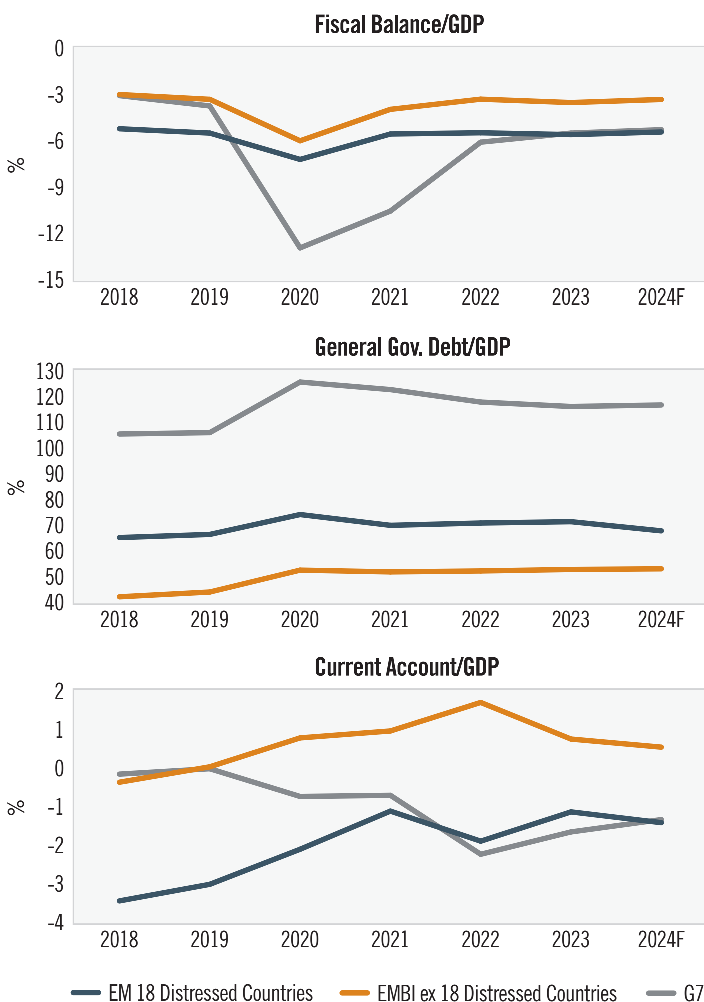


Past performance is no guarantee of future results. As of September 30, 2023. Sources: J.P. Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

A key reason for the reassessment of EM default risk, in our view, is that fundamentals have improved for many countries. EM credit metrics, on average, remain strong compared to developed countries, particularly when the

most vulnerable countries, comprising only 11% in market value of the J.P. Morgan EMBI Global Diversified, are excluded from the calculations. Figure 3 outlines changes in the fiscal deficits, debt levels and current account balances as percentages of GDP for emerging markets since 2018. The charts show time series for these metrics for the 50 non-distressed EM countries (orange lines) in contrast to 18 distressed EM (blue) and G7 countries (gray). Even though debt stocks have increased in many EMs, fiscal deficits and debt levels still are significantly lower in EMs than in DMs. On average, the stronger set of EM countries have current accounts that are in surplus, in sharp contrast to deficits in developed countries. See Figure 3.

FIGURE 3. KEY CREDIT METRICS FOR EM VS DM



As of September 30, 2023. Sources: Haver, Moodys, Stone Harbor Investment Partners. For illustrative purposes only. Distressed countries include: Angola, Argentina, Bolivia, Ecuador, Egypt, El Salvador, Ethiopia, Gabon, Kenya, Mozambique, Nigeria, Pakistan, Tunisia. Defaulted countries: Lebanon. Ghana. Sri Lanka. Suriname. and Zambia.

In addition, in Q3, positive developments in the restructuring of debt supported returns on some of the most vulnerable credits. Defaulted bonds from Ghana, Sri Lanka, and Suriname posted returns of 3.5%, 5.7% and 13.5%, respectively, as markets reacted to progress on debt negotiations in each country. While returns on Zambian defaulted debt were -5.6% for the quarter, prices of the country's bonds moved higher in September in anticipation of discussions with external creditors. Market expectations for post-restructuring valuations shifted higher to approximately 60% of par claims on average; a year ago, estimated recovery values were significantly lower.

A major factor behind these improvements has been support provided to the weakest countries from donors and the International Monetary Fund (IMF). Except for Venezuela, whose bond prices increased 30% on average in Q3, all countries with double-digit total returns this quarter have significant backing from the IMF or improving prospects for it, including El Salvador (+23.0%), Lebanon (+24.9%), Pakistan (+11.0%), Suriname (+13.5%) and Ukraine (+21.1%). During the quarter, the IMF agreed to new lending programs with Honduras, Kenya and Pakistan and concluded reviews of existing arrangements with Suriname, Argentina, Kenya, Mozambique, and Zambia.

EM debt benchmarks posted gains in July followed by downturns in August and September in each of the major sectors. Benchmarks for hard currency sovereign and corporate debt and local currency bonds returned -2.23%, -0.26%, and -3.26%, respectively. In comparison, U.S. investment grade bonds posted an average total return of -3.2%, while U.S. high yield corporate debt returned 0.5%.

In external EM debt, non-investment grade bonds (HY), particularly the lowest-rated or unrated segment, outperformed investment grade (IG) debt. On average, high yield debt spreads tightened more than investment grade debt spreads while the negative impact of rising UST yields was larger for IG bonds than for HY.

The outperformance of EM corporate debt is notable given the widely reported downturn in the Chinese property sector this year. The largest negative contributors to returns on EM corporate debt this quarter and year-to-date have been bonds of real estate companies from China. Together, these

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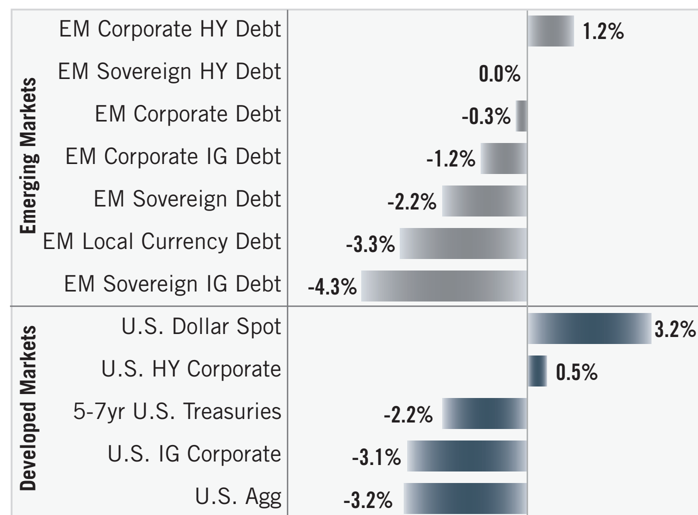
companies make up 0.5% in market value of the J.P. Morgan CEMBI Broad Diversified and returned -24.6% as a group in Q3. Nevertheless, corporate debt from several countries made positive contributions to benchmark returns, including gains from companies from Turkey, Ghana and Colombia.

An important support for corporate debt in many major EM countries has been access to local financing. Local currency financing provides several advantages over external debt issuance, including reduced asset liability currency mismatches and no foreign currency hedging costs. Access to domestic markets has been particularly important in recent months as the U.S. Federal Reserve hiked policy rates leading to higher UST yields and higher external borrowing costs. Accordingly, we believe this access has helped many EM companies lower near-term default risk. The EM corporate default rate so far this year declined to 2.1% from 5.7% last year.

Though local currency debt has outperformed external sovereign and corporate debt year-to-date, domestic bonds underperformed in Q3. The key forces behind the underperformance were U.S. dollar strength and the move higher in bond yields in concert with developed country yields. EM currencies, on average, depreciated by 2.6% relative to the U.S. dollar, which also appreciated against developed market currencies.

FIGURE 4. TOTAL RETURNS IN Q3 BY SECTOR



Past performance is no guarantee of future results. As of September 30, 2023. Sources: J.P. Morgan, Bloomberg, Stone Harbor Investment Partners.

TECHNICALS

Sovereign primary market issuance for the quarter was US$15.2 billion and was concentrated in the investment grade segment of the market as countries with higher refinancing costs stay on the sideline. Sovereign issuance year-to-date (YTD) stands at US$112 billion. The largest sovereign issuers YTD include Hong Kong, Mexico, Poland, South Africa, and Turkey, which have issued a combined total of US$47.4 billion. Notable countries that will likely tap the primary market by year end include Chile, Mexico, South Africa, and Turkey.

Corporate primary market issuance for Q323 was US$59 billion, which is well below the five-year average of US$100 billion despite September having the largest issuance so far this year at US$36 billion. Corporate issuance YTD totaled US$139 billion, the lowest level since 2012. Net financing for the year remained negative at US$124 billion because of low primary market issuance. 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 Q3 2023, totaling approximately US$13 billion. Local currency portfolios recorded outflows of US$1.8 billion, while hard currency funds experienced outflows of US$11 billion.

PERFORMANCE

External Sovereign Debt Benchmark Returns

Investment grade: The IG sovereign benchmark posted a total return of -4.34% in Q3, including returns from changes in UST yields and spread return of -4.9% and +0.5%, respectively. Rising UST yields drove the downturn in every country, while return contributions from spread changes and yield were positive in 14 of 18 countries. Spreads tightened for 11 out of 18 countries, and index spreads tightened three basis points, on average. The largest contributors to benchmark spread returns were Qatar, Saudi Arabia, and Romania, with spread returns of 1.1%, 0.8%, and 1.6%, respectively. Total returns for these countries were -5.1%, -3.9%, and -3.4%, respectively. The largest detractors from benchmark total returns were Chile,

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Indonesia, and Mexico with total returns of -6.5%, -4.2%, and -6.1%, respectively. Spread returns for these countries were +0.4%, +0.6%, and +0.1%, respectively.

Sub-investment grade: The total return of the sub-investment grade index was -0.03%. As in Q2, the largest returns came from countries in the lowest rating categories. Bonds from Venezuela and Lebanon generated returns of 29.6% and 24.9% respectively, as bond prices in both countries moved higher from single-digit levels. In Venezuela, international news agencies reported that the U.S. government discussed with Venezuela authorities easing sanctions in exchange for holding competitive elections in 2024. We also believe the price increase on Venezuela bonds reflected the renewal of domestic production by Chevron. Lebanese bonds remained in default with no progress on debt negotiations with creditors. In its review of recent economic developments and progress on key reforms in September, the IMF noted that the country had not undertaken urgently needed reforms. Nevertheless, markets remained optimistic over new leadership at the central bank, the potential for political compromise to elect a new government, and discovery of offshore gas fields that may contribute to government revenues. Gains in Lebanon this quarter contributed to the 40% increase in Lebanese bond prices so far this year.

El Salvador and Ukraine continued gains from prior quarters. While the circumstances are different, markets hope that financial support from multilateral lenders and donors will be significant for both countries. The increase in Ukraine bond prices reflected a constructive update from the IMF on debt sustainability and stronger consensus among market participants that the IMF's sustainability targets under the 4-year US$15.6 billion Extended Fund Facility (EFF) program could be met without a principal haircut on outstanding debt, assuming solid GDP growth. Ukraine bonds have returned 44.7% YTD and 21.1% this quarter. El Salvador bonds have generated an average total return of 94% YTD and a Q3 return of 23%. The market gains on higher expectations of an eventual loan from the IMF and potential access to either bilateral or market funding have created, for now, a virtuous cycle in El Salvador with lower credit risk that may broaden financing flexibility and potentially attract more foreign investment.

Preliminary presidential elections in Argentina and Ecuador generated opposing market results in Q3. While both election tallies favored market-friendly candidates, Ecuador bonds rallied 8.6% and Argentina debt prices fell 14.3%. In Ecuador, the combination of low levels of government debt, stronger oil prices and the success of Daniel Naboa as a candidate for the 15 October runoff election, boosted market sentiment and bond returns. Naboa ran on a platform of fiscal prudence against Luisa Gonzalez, a protegee of former leftist president Raphael Correa. Argentina's Javier Milei will head to a 22 October runoff election against Patricia Bullrich and the current government candidate Sergio Massa, who placed third in the primary. Both Milei, the front runner, and Bullrich espouse pro-business policies and fiscal restraint. However, until the election, Argentina markets have focused on the pre-election spending of the existing government, including a bill to cut income taxes, which heightened market concerns over Argentina's large debt levels and fiscal deficits.

Local Currency Debt Benchmark Returns

Currencies: EM currencies depreciated against the U.S. dollar by 2.6% on a spot FX basis. All but three currencies—the Colombian peso, Egyptian pound, and South African rand—depreciated in Q3. The peso gained 3.2% vs. the U.S. dollar as the Colombian central bank kept its policy interest rate at 13.25% in the face of 11% year-over-year headline inflation. Egypt's pound was unchanged against the dollar, supported by a 100-basis point increase in the central bank of Egypt's overnight lending rate, currently at 20.25%. While the rand appreciated 0.3% versus the U.S. dollar, the currency weakened steadily from July through the end of the quarter as economic data remained soft.

At the regional level, African currencies outperformed, led by the pound and the rand. The average return of EM Asian currencies was -2.9%. Currencies from Indonesia, Philippines, and Thailand depreciated by 2.4% to 3.3%, while the Chinese renminbi and Malaysian ringgit each declined by approximately 0.6%; central bank intervention supported the latter currencies.

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Currencies from Europe underperformed, with the largest depreciations vs. the U.S. dollar in Hungary (-6.8%) and Poland (-6.9%). The Euro's depreciation vs. the dollar of 3%, was the primary driver of the downturn in Eastern European currencies.

Latin American currency performance was mixed, with the Colombian peso's strength offset by a -10.2% depreciation of the Chilean Peso. The FX move in Chile, we believe, reflects the Central Bank's decision to continue to cut interest rates earlier than markets had expected as well as strength in the U.S. dollar.

Interest rates: The benchmark yield increased 44 basis points to 6.76%, as UST and Bund 10-year yields increased by 73 basis points and 45 basis points, respectively. While yields in most countries increased this quarter, returns from yield carry and interest rate movements were positive in nine of 20 benchmark countries. At the regional level, Eastern Europe, led by Poland and Hungary, outperformed as yields fell on weak economic activity and easing inflation. High yielders from Africa, led by Egypt, generated positive returns on average from carry, despite rising bond yields. South African bond yield increased on average by 56 basis point to 12.11%; Egypt's average domestic bond yields increased 12 basis points to 23.84%. Both Latin America and Asia delivered negative returns with wide dispersion. Brazil, China, Malaysia, and Uruguay posted positive returns from domestic interest rates.

Corporate Debt Benchmark Returns

EM corporate bonds returned 0.26%, consisting of total returns of -1.25% and +1.16% from the IG and HY market segments, respectively. The benchmark spread tightened eight basis points, comprising spread tightening from IG and HY bonds of three basis points and six basis points, respectively. The increase in UST yields drove the relative underperformance of the IG sector.

At the industry level, one of the most important developments was the outperformance of bonds of independent oil exploration and production companies, particularly from Colombia and Ghana. While the overall contribution to EM corporate debt returns from E&P companies was modest at 0.36%, this result was a function of negative returns from partially state-owned enterprises from China, Kazakhstan, Saudi Arabia, and Thailand. Bonds from independent producers Tullow Oil and Kosmos Energy (Ghana) and Geopark and GTE (Colombia) generated total returns ranging from 5.7% to 27.7%.

Returns from Macau, Turkey, and Ukraine also deserve comment, in our view. The ongoing recovery in gaming bonds from Macau contrasted with the drawdown in Chinese corporate bonds in Q3. Gaming company debt makes up over 98% of the benchmark bonds from Macau and posted an average return of approximately 1% this quarter and 5.8% YTD. Turkey's total return of 3.7% reflected the positive shift toward conventional macroeconomic policymaking following President Erdogan's re-election in May 2023. In Ukraine, the announcement that agricultural producer MHP had obtained external financing boosted market sentiment for the company's debt, which posted total returns ranging from 16.8% to 21.1%.

OUTLOOK

We incorporate the prospect for higher-for-longer U.S. interest rates in our macroeconomic scenario analysis. In our base case (45% probability), we see the current higher rate environment keeping U.S. growth below potential. In this scenario, China's growth stays subdued amid the continuing housing slump and weak global activity. Cuts in policy interest rates and solid domestic demand in many EMs support growth outside of China, offsetting the drag from slower growth in advanced countries. Our base case is still that China will avoid a sharp downturn triggered by housing and amplified by high leverage.

Recent strength in the U.S. economy lowers the probability of global recession, to 25% from 35% at the end of 2Q, in our view. We also see scope for core inflation to continue to moderate, allowing the Federal Reserve (Fed) and other central banks to lower policy rates in the near term, but assign a 15% probability to this outcome. Finally, we add a scenario in which the housing slowdown translates into a more significant decline in China's growth rate from 4% in our base case to 2% (scenario probability 15%).

Lower growth in China and higher bond yields in the U.S. weigh on market sentiment for EM debt. A prolonged downturn in China's real estate sector could continue to constrain demand for industrial metals and energy,

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reducing prices of key EM exports and U.S. dollar revenues for EM countries and companies. We expect that China's high debt levels prevent the aggressive use of stimulative credit policies to boost activity levels and market confidence. The weaker China scenario would result in lower returns on bonds from EM countries and companies that export commodities to China.

Higher bond yields in the U.S. also pose a competitive threat to EM debt markets. For the near term, high policy interest rates support the U.S. dollar, the strength of which weighs against the performance of EM currencies and local debt markets. Higher U.S. yields may also reduce demand for hard currency EM debt.

Nevertheless, default risk remains a key factor in our assessment of EM sovereign bonds, and on this metric, we see improvement. The increase in prices of defaulted bonds over the past year from Ghana, Sri Lanka, Suriname, Ukraine, and Zambia highlight this point. See Figure 5. For countries that have made progress in debt restructuring negotiations with creditors, market expectations for recovery values have also increased over the past year, showing improved confidence among emerging market debt investors.

FIGURE 5. AVERAGE PRICES AND PRICE CHANGES OF SELECT EM DEFAULTED SOVEREIGN DEBT

	Average Prices ($)		Price Change
	10/31/2022	9/30/2023	%
Ghana	34.8	46.5	**33.5%**
Sri Lanka	22.5	46.9	**108.5%**
Suriname	71.2	85.1	**19.5%**
Ukraine	17.1	30.4	**78.0%**
Zambia	37.2	53.2	**42.9%**

Sources: Stone Harbor Investment Partners, Bloomberg LP.

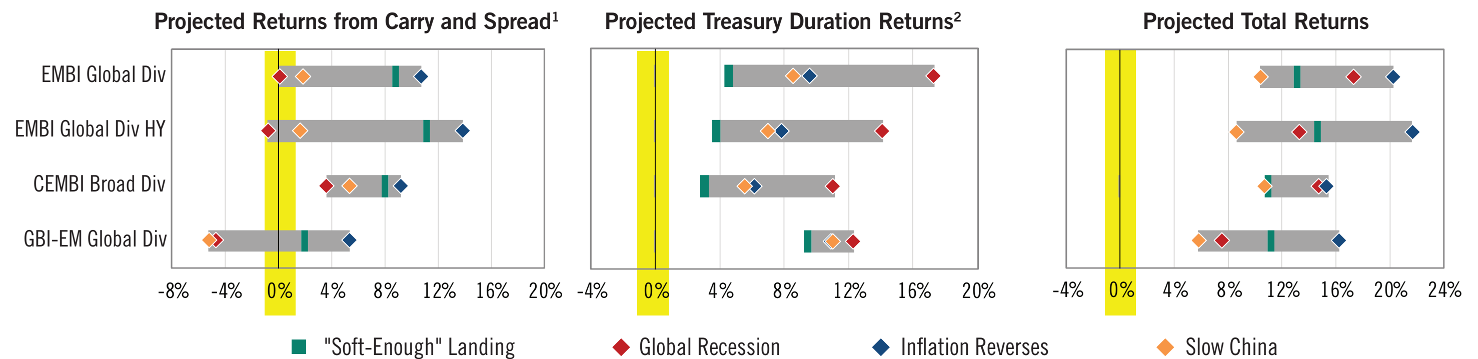
As we noted last quarter, we believe that EM corporate debt maturities are manageable, and local financing stays available, especially for high quality companies. We expect net issuance to be materially negative in 2023. For 2024, we expect more balance between local currency and hard currency funding in the primary markets. In addition, as shown by recent issuance from non-investment grade companies, U.S. dollar markets have begun to reopen for high yield issuers, rather than for only investment grade-rated corporates. This technical dynamic, combined with lower default risk than in 2022, underscores our optimism for active investment in the sector. The recent increase in commodity prices, particularly in energy, further enhances opportunities for well-financed commodity producers to boost free cash flow.

We continue to expect near-term gains from domestic debt as EM central banks cut interest rates. Disinflation is ongoing in many countries, including Brazil, Colombia, Chile, Czech Republic, Hungary, Indonesia, Mexico, Peru, Poland, Romania, South Africa, and Uruguay.

Our 12-month total return forecasts in our base case includes a 3.89% yield for the ten-year US Treasury note, down from 4.57% at the end of Q3. Our return expectations across our range of macroeconomic scenarios are show in Figure 6. In hard currency sovereign debt, we expect a base case total return of 13% for the JP Morgan EMBI Global Diversified, comprising an excess return of 8.7%. For corporate debt, we project a base case total return of 10.7%, including an excess return of 7.7%. In local currency debt, we project a total return of 11.1%, consisting of a spot FX return of 1.9% and a return from yield carry and duration of 9.2%. See Figure 6.

FIGURE 6. TWELVE-MONTH RETURN PROJECTIONS BY SCENARIO AS OF SEPTEMBER 29, 2023

	Base Case	Alternative Scenarios		
	Soft-Enough Landing	Global Recession	Inflation Converges Back to 2%	Housing Slowdown Pulls Down Chinese Economy
Probabilities	45%	25%	15%	15%
Macroeconomic Assumptions				
U.S. Real 4Q GDP (%)	1.25	-1.50	1.75	1.00
EM 4Q GDP (%)	3.50	1.75	4.25	2.00
China 4Q GDP (%)	4.00	3.00	4.75	2.00
Brent	$85 bbl	$60 bbl	$85 bbl	$70 bbl
U.S. Core PCE (%)	2.75	2.00	2.25	2.60
Fed Funds (%)	5.38	2.88	4.38	5.13
2yr U.S. Treasury (%)	4.65	2.00	3.25	4.50
10yr U.S. Treasury (%)	3.75	1.75	3.00	3.50
10yr Bund (%)	2.75	1.00	1.75	2.25
SHIP Return Forecasts (%)				
EMBI GD	13.0	17.3	20.2	10.4
EMBI GD HY	14.5	13.2	21.6	8.6
CEMBI Broad Div	10.7	14.7	15.3	10.7
Local Rates	9.2	12.2	10.9	11.0
EM FX	1.9	-4.7	5.3	-5.2



Source: Stone Harbor Investment Partners. [1]GBI-EM projected returns are 12m FX Returns. [2]GBI-EM projected returns are 12m carry and duration 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.

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Authored by:

The Stone Harbor Emerging Markets Debt Team

Stone Harbor Investment Partners is a global credit specialist with expertise in emerging and developed markets debt, with three decades of informed experience allocating risk in complex areas of the fixed income markets. The firm manages credit portfolios for clients globally.

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 indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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