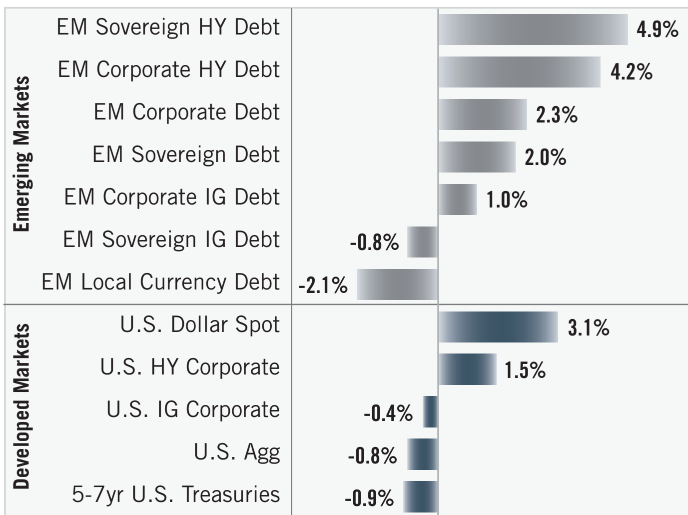
Q1 24 # EMERGING MARKETS DEBT
MARKET REVIEW AND OUTLOOK

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

MARKET REVIEW

Following strong gains in the fourth quarter of last year, the global backdrop was more challenging for fixed income investors in the first quarter of 2024. Upside surprises to U.S. economic growth and inflation readings led to upwards pressure on core bond yields, as market participants scaled back expectations for Federal Reserve (Fed) easing over the balance of 2024. However, despite higher core bond yields, external debt returns in emerging markets remained positive, largely due to a continued compression in risk premia for high yield emerging markets (EM) sovereign and corporate issuers. EM fundamentals have been supported by continued disinflation, together with on-going policy easing, which have in turn supported an improvement in growth prospects. Local currency EM debt returns were hurt by renewed strength in the U.S. dollar, although local yields were broadly unchanged during the quarter, notwithstanding the increase in U.S. Treasury yields.

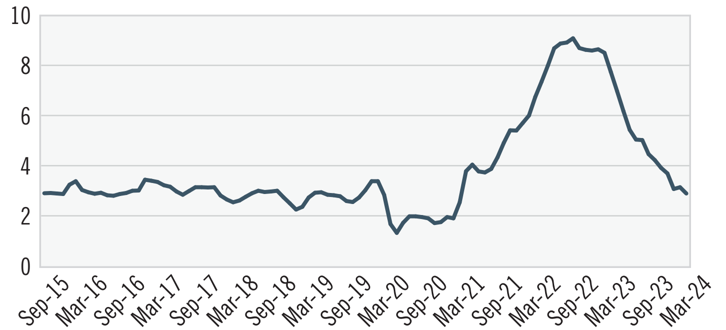
FIGURE 1: TOTAL RETURNS IN Q1 BY SECTOR



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

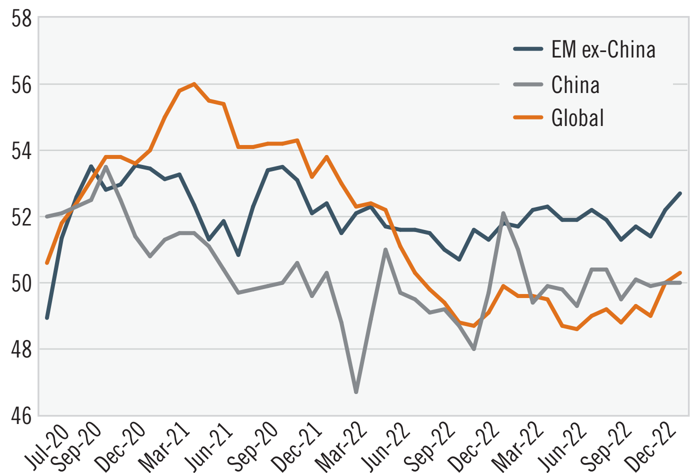
Despite some disappointment in the pace of inflation improvement in the U.S., inflation continued to fall across most major emerging markets, enabling further monetary policy easing. Rate cuts continued in several major EM countries including, Brazil, Chile, Colombia, Hungary, Peru, Poland, and Uruguay. In China, further easing of reserve requirements to add liquidity to the economy also seems to be bearing fruit in terms of some improvement in economic activity that had been hit by the turmoil in the property market. The Chinese authorities also announced higher fiscal spending in order to improve the chances of meeting the GDP growth target of "around 5%" unveiled at the National People's Congress annual legislative session. The combination of some improvement in Chinese economic momentum, and lower rates within the EM space has led to a pick-up in economic momentum across the region, which should help to support credit fundamentals. Purchasing manager indices back-up this improved impulse, with strength being led by improvements in India, Indonesia, and Mexico.

FIGURE 2: HEADLINE EM INFLATION % Y/Y



As of March 31, 2024. Sources: JP Morgan, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

FIGURE 3: EM PMIs IMPROVING



As of February 29, 2024. Sources: Haver, Stone Harbor Investment Partners. For illustrative purposes only.

Taken together, there are encouraging signs that the credit quality of emerging markets are now improving after weathering the impact from the COVID shock and the conflict in Ukraine. Ratings actions for sovereign and

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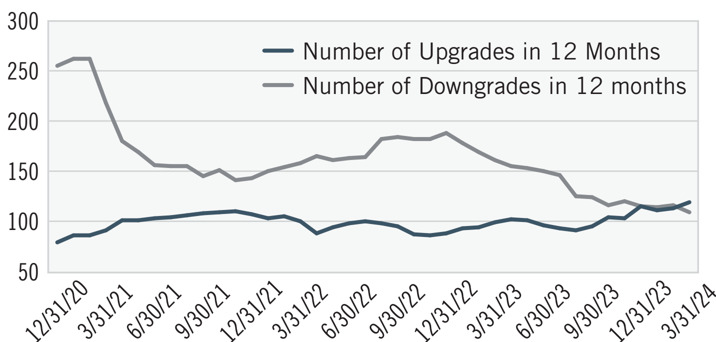
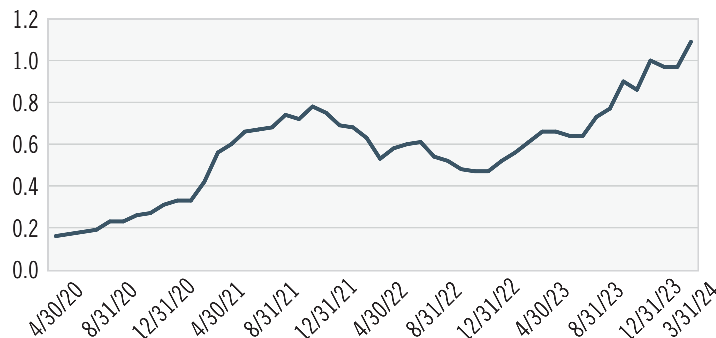
corporate issuers in EM over the past year have now tilted towards more upgrades than downgrades. Post-pandemic and the Ukraine war, the vast majority of moves by ratings agencies were in negative directions as EM issuers struggled to cope with the spikes in inflation and debt levels. However, the pre-emptive nature of policies taken across emerging markets in response to the shocks appear to now be bearing fruit. This has been both monetary policy—where EMs responded much earlier than developed markets—and fiscal policy responses which have generally been orthodox, reflecting the discipline of needing to attract capital at a time of higher core rates. Developed market Central Banks are still likely to ease policy rates over the balance of 2024, which, we believe, should help to improve access to funding for EM's as they benefit from their orthodoxy.

FIGURE 4: UPGRADES AND DOWNGRADES

Rolling 12 Month Total of Sovereign and Corporate Upgrades and Downgrades



Rolling 12 Month Total Rating Upgrade/Downgrade Ratio



As of March 31, 2024. Sources: JP Morgan, S&P, and Stone Harbor Investment Partners. Benchmarks: J.P. Morgan EMBI Global Diversified, J.P. Morgan CEMBI Broad Diversified. For illustrative purposes only.

In external sovereign debt, the high yield sector once again outperformed investment grade bonds, as previously stressed credits moved closer to regaining market access as well as re-engaging with IMF support. High yield spreads tightened 93 basis points during the first quarter, while investment grade spreads were little changed. Gains were led by Ecuador, where the newly elected President Daniel Noboa responded strongly to the deteriorating security situation, boosting his popularity, and enabling the passage of some tax reforms and a re-opening of dialogue with the International Monetary Fund (IMF). Argentina continued its strong performance in the first quarter on hopes for more market-friendly policies by President Javier Milei. Sharp cutbacks in fiscal spending have been encouraging, although his ability to pass reforms remains compromised by a divided Congress. Egypt also enjoyed strong gains, as steps were taken to devalue the currency and address foreign exchange backlogs as the authorities secured large-scale investment pledges from the UAE, and upsized its existing IMF program. Pakistan was also able to get its IMF program back on track following somewhat contentious elections, boosting bond prices.

Among the restructuring candidates, Zambia succeeded in completing its restructuring process, posting returns of around 20% for the quarter. This fed optimism in other candidates for restructuring, with Ethiopia, Ghana, and Sri Lanka all posting double digit returns. Ukraine also enjoyed strong gains, despite delays in the funding package from the U.S., as the authorities are likely to seek to reprofile their external bonds ahead of the freeze in debt-servicing expiring later this summer. Returns in Venezuela was more muted than in the previous quarter following the removal of sanctions on secondary trading. Progress towards free and fair elections later this year in Venezuela remains slow, but with trading restrictions on Venezuelan debt unlikely to be re-imposed, JPMorgan has announced that they would be re-included in the benchmark over the coming months, which may lend some support from index-based investors.

EM corporate external debt outperformed the sovereign index marginally, largely due to the shorter duration and better spread performance of its investment grade portion. High yield corporate spreads tightened by 87 basis points during the quarter, while investment grade corporate spreads tightened by 24 basis points—compared with little change to investment grade sovereigns. External spreads continue to be supported by increased access to local market funding for EM corporates, which has reduced concerns over the burden of maturity payments that many EM corporates face over the coming years.

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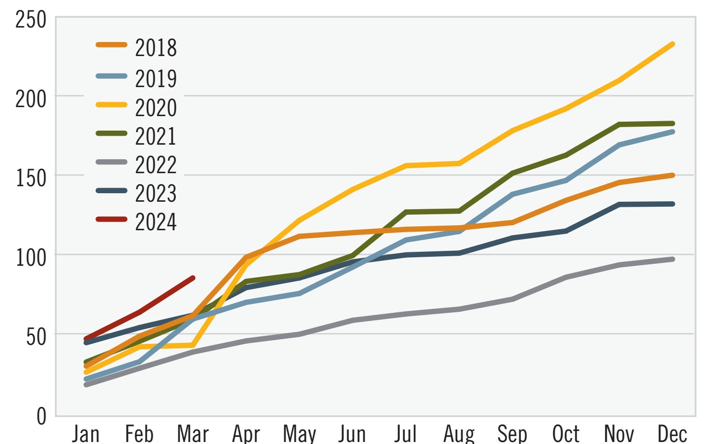
Local currency EM debt underperformed during the quarter, reflecting the strength of the U.S. dollar, which was supported by the scaling back of rate cut expectations in the U.S. over the balance of this year. There were significant devaluations in both Egypt and Nigeria during the quarter. In both cases, over-valued currency regimes that had led to a build-up of FX backlogs needed to be cleared. Central Banks in both of these countries hiked interest rates in order to combat any inflationary spillover from the currency move. In Turkey, policy orthodoxy continued to prevail—notwithstanding the ruling party's poor showing in the March local elections. The Central Bank of Turkey hiked rates by a further 750 basis points to 50% during the quarter, as they continue to try and rein in an inflation rate that continues to hover uncomfortably high at 68.5%. Elsewhere, policy easing continued for most of the larger markets, with Colombia beginning its interest rate cutting cycle during the quarter. Asian foreign exchange rates led the weakness, reflecting lingering concerns over growth in China. Asian currencies were also harmed by the weakness of the Japanese yen, which continued to hit new lows during the quarter, despite the Bank of Japan finally ending its negative interest rate policy and abandoning yield curve control. Latin American currencies were more resilient, helped by the Mexican peso, which continued to benefit from on-shoring flows and some improvement in growth prospects.

TECHNICALS

The first quarter witnessed a sharp pick-up in sovereign debt issuance at almost US$85 billion—the highest first quarter pace for at least 10 years. While the bulk of the issuance was from investment-grade names, market access was restored for select high yield sovereigns, with Bahrain, Benin, Brazil, Ivory Coast, Kenya, Paraguay, and Turkey all tapping the market. The record issuance of investment grade sovereigns did lead to some widening of investment grade sovereign spreads relative to Investment grade U.S. corporates. Corporate issuance was also strong at around US$110 billion during the quarter. Labelled bond issuance continued to form a significant portion of overall issuance, with US$25.3 billion of Green bonds, US$14.7 billion of Social bonds, US$28.5 billion of sustainability bonds, and US$1.15 billion of sustainability-linked bonds.

FIGURE 5: EM SOVEREIGN ISSUANCE
EM Sovereign External Bond Monthly Issuance (US$ bln)



As of March 31, 2024. Sources: J.P. Morgan, Stone Harbor Investment Partners. For illustrative purposes only.

According to flow tracker EPFR Global Data, EM debt portfolios posted outflows for Q1 2024, totaling approximately US$9.5 billion. Local currency portfolios recorded outflows of US$3 billion, hard currency funds experienced outflows of US$4.9 billion and blended accounts had outflows of US$1.7billion.

BENCHMARK PERFORMANCE

External Sovereign Debt
The J.P. Morgan EMBI Global Diversified delivered a total return of 2.0%. Total returns were driven by spread compression and carry, which contributed 3.2%. Average EM spreads tightened by 42 basis points (bps) to 341 bps. Spreads in every region declined, with spreads in Africa and Europe declining by 128 bps and 69 bps, respectively. Offsetting strong spread returns was the effect of rising U.S. Treasury yields, which detracted -1.2% from total returns. The U.S. 10-year Treasury yield increased by 32 bps over the period.

Investment Grade: The IG sovereign debt segment of the benchmark delivered a total return of -0.8% as rising U.S. yields detracted from the more interest rate-sensitive segment of the benchmark. Despite rising yields, average spreads tightened by 6 bps as the majority of countries in the IG segment had positive spread performance. Romania (+0.7%), Kazakhstan (+0.7%), and China (+0.5%) led the sector in total return. Peru (-1.6%), Philippines (-1.5%), and Uruguay (-1.4%) were the largest underperformers on a total return-basis.

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Non-Investment Grade: The high yield segment outperformed IG bonds, on average, as the less interest rate-sensitive portion of the benchmark was not as impacted by rising U.S. rates. HY bonds, on average, posted a total return of 4.9% for the quarter and a return contribution from spread tightening and carry of 5.7%. Ecuador (+51.5%), Pakistan (+27.3%), and Argentina (+25.9%) were the top performers for the quarter. Ecuador's bonds rallied as the government engaged with the IMF on a new program and passed legislation to raise tax rates. Argentina outperformed as President Javier Milei remains committed to fiscal reform including spending cuts. Pakistan saw gains on IMF and external funding support.

The largest underperformers were South Africa (-3.1%) and Senegal (-3.1%), both on political and election volatility. Colombia (-2.4%) also underperformed.

Local Currency Debt

The J.P. Morgan GBI-EM Global Diversified delivered a total return of -2.1%, comprising spot currency returns of -2.8% and returns from duration and carry of +0.7%. The U.S. dollar appreciated by 3.2% relative to its largest trading partners.

Currencies: EM currencies depreciated relative to the U.S. dollar by -2.8%, on average. Currencies from the Middle East and Africa region were the largest underperformers and depreciated by -4.9%, on average. Egypt was the largest underperformer as the central bank devalued the currency in pursuit of an IMF deal. Egypt exited the index at the end of February. Currencies from Chile (-11.0%) and Turkey (-8.7%) also depreciated. Currencies from Latin America outperformed the index average FX returns, with Latin American currencies depreciating by 1.1%. The top performing currencies were from Mexico, Colombia, and Uruguay whose currencies appreciated by 1.9%, 0.2% and 3.9%, respectively and were the only currencies to post positive returns for the quarter.

Interest Rates: The benchmark yield followed U.S. Treasury yields higher, increasing by 9 bps to 6.27%, on average. Bond yields from Asia declined by 11 bps, led by China and Malaysia whose yields declined by 23 bps and 1 bp, respectively. Yields increased in all other regions for the quarter. The largest increase in benchmark yield was in Turkey, where yields increased by 314 bps as the central bank remains committed to a restoration of orthodox monetary policy. South Africa's yields increased by 83 bps.

Corporate Debt

The J.P. Morgan CEMBI Broad Diversified posted a total return 2.3%, consisting of positive returns from high yield bonds (+4.2%) and positive returns from investment grade bonds (+1.0%). High yield bond spreads declined by 87 bps, and investment grade bond spreads declined by 24 bps, on average.

At the industry level, all industries had positive total return with the real estate and transport sectors the largest outperformers. Within the real estate sector, Chinese homebuilders were a top contributor with an average total return of 6.5%. The pulp & paper and oil & gas sectors were the largest underperformers with total returns of 1.1% and 1.6%, respectively.

At the regional level, Africa and Europe were the top performers posting total returns of 4.1% and 3.2%. In Europe, Ukrainian bonds were the largest contributor to total return as Metinvest released positive operational results. Corporate bonds from the Middle East underperformed the benchmark with a total return of 1.1% for the quarter.

OUTLOOK

Our base Case (40% probability) assumes a soft-enough landing that will enable the U.S. Fed to cut interest rates as the economy and inflation slow in response to higher interest rates. We currently expect between two to three reduction in the Fed funds rate over the balance of the year. The ECB is also likely to cut rates in response to a sluggish domestic economy and lower inflation rates. China is likely to continue its gradual easing policy to sustain growth, although large-scale bailouts are unlikely due to moral hazard issues. The three main risks that we have identified include a sharper-than-expected fall in inflation, a sharper-than-expected fall in global growth, and also a more resilient U.S. economy leaving the Fed on hold for an extended period of time.

For external markets, in our base case, we see spreads as being more or less fairly priced at current levels, but lower core interest rates supporting overall total return gains. The major downside for EM risk premia is posed by the global recession scenario—when core rates would likely fall significantly. Total return expectations would also be lower than the Base Case in a scenario where the Fed remains on-hold, as core rates would likely continue their recent move higher.

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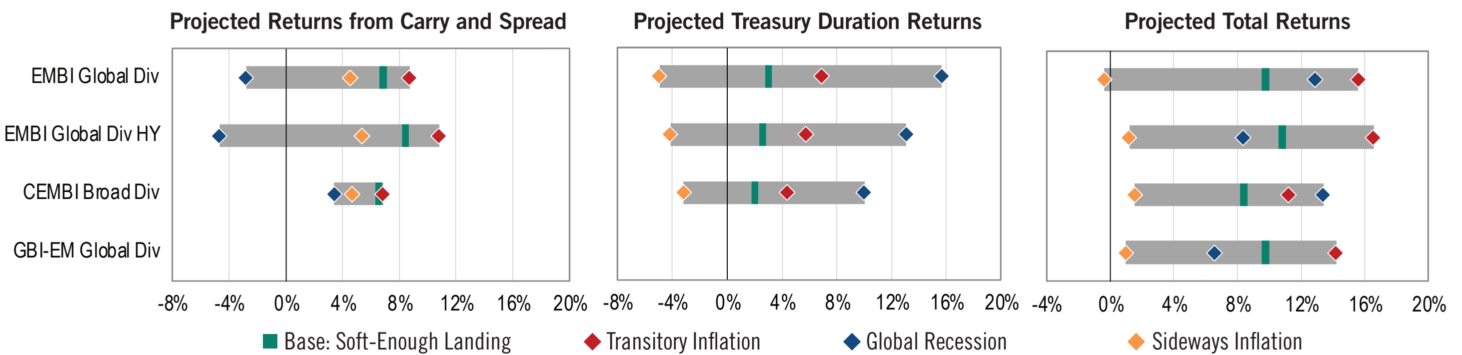
Within the local currency space, we continue to see scope for local interest rates to fall as easing cycles are maintained. There may also be scope for some weakening of the U.S. dollar once the Fed starts to ease interest rates.

Again, the global recession scenario and the Fed on-hold scenario would likely see renewed dollar strength, potentially damaging returns.

FIGURE 6: MACROECONOMIC SCENARIO ASSUMPTIONS AND PROJECTED RETURNS (12 MONTH) AS OF MARCH 22, 2024

	Base Case	Alternative Scenarios		
	Soft-Enough Landing	Transitory Inflation	Global Recession	Extended Hold as Inflation Turns Sideways
Probabilities	40%	20%	20%	20%
Macroeconomic Assumptions				
U.S. Real 4Q GDP (%)	1.25	2.25	-1.00	2.50
EM 4Q GDP (%)	3.75	4.25	1.75	4.50
China 4Q GDP (%)	4.75	5.25	3.25	5.50
Brent	$80 bbl	$80 bbl	$60 bbl	$95 bbl
U.S. Core PCE (%)	2.60	2.00	1.75	3.00
Fed Funds (%)	4.38	3.63	2.63	5.38
2yr U.S. Treasury (%)	3.80	3.25	2.00	5.38
10yr U.S. Treasury (%)	3.75	3.15	1.75	5.00
10yr Bund (%)	2.25	1.75	1.00	3.50
SHIP Return Forecasts fro Carry + Spread (%)				
EMBI GD	9.7	15.6	12.9	-0.4
EMBI GD HY	10.7	16.6	8.4	1.2
CEMBI Broad Div	6.4	6.8	3.4	4.7
GBI-EM GD Local Rates	8.2	9.9	11.8	3.3
GBI-EM GD FX	1.5	4.3	-5.2	-2.4



Source: Stone Harbor Investment Partners. 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

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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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