INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

JUNE 2022

Faster Rate Hikes Hike Recession Risk

The Federal Reserve (Fed) hiked rates again this month up 75 basis points—the biggest rate hike in 28 years, which continues the shift toward a more aggressive stance against elevated inflation. The hike was larger than the Fed had indicated as likely before the start of the blackout period leading into the meeting due to two troubling data points that came right before the meeting. First, May's Core Consumer Price Index (CPI) printed unfavorable readings, with rent and owner's equivalent rent (OER) staying stubbornly high and, since they have a large weighting in core CPI, they applied upward pressure on the overall index. Given that rent inflation tends to be sticky, with overlapping contracts resetting infrequently month to month, this may signal the upward pressures from this source are likely to continue. Second, 5-10 year inflation expectations in the University of Michigan consumer sentiment survey, a measure closely watched by the Fed, jumped to 3.3% after hovering around 3% for six months—a meaningful deterioration.

"An inflexible tree breaks in a storm."

– Matshona Dhliwayo

The Fed had previously signaled that they thought a smaller increase in the target range of 50 bps would likely be appropriate at this meeting. So why the shift? As we've noted in the past in this space, the Fed is no longer in the business of giving hard commitments. Those commitments were needed at the effective lower bound as it was a way in which they could affect market expectations, and hence overall financial conditions. That is no longer the case. Instead, if they want to change financial conditions, the Fed can simply act, just as they did with the 75 bps hike. Indeed, the Fed's language over the last several months reflects that, with any guidance being very soft and conditional. Discussions of their future actions are phrased in terms of what they "expect" or are "likely" to do, quite different than the much less conditional language they previously used back in the early 2010s. In other words, if the data changes the Fed will change course, and relatively quickly. That's not to say that the Fed's thoughts on the future of policy should be given no weight, but rather that if there is a conflict between what they previously indicated as likely and the incoming data, the incoming data matters more.

The Fed now has a challenge ahead of it as it tries to thread the needle. They hope to restore price stability by cooling the economy, lowering growth to a below-potential rate without tightening so much that the slowdown goes too far. Fed estimates from the Summary of Economic Projections (SEP) show the median estimate of longer-run potential growth rate is around 1¾%, so their goal is growth below that. Figure 1 (below) shows schematically what the Fed is trying to achieve. Through the end of their forecast horizon, the end of 2024, potential would grow by about 4.8%. If we assume the economy starts from a position where it's overheated by about 1½ pp, then through the end of 2024 they would like total growth to be about 1½ percentage points below potential, or about 3.4%—average quarterly growth rates of 1.22% rather than 1¾%. Note that this doesn't precisely correspond to the SEP, where they have faster growth in each quarter, apparently allowing for somewhat more rapid near-term potential GDP growth. That likely reflects that potential can grow faster in the short run as the economy recovers from COVID, but the basic point remains the same.

FIGURE 1:
FED AIMS TO BRING REAL GDP BACK TOWARD POTENTIAL…

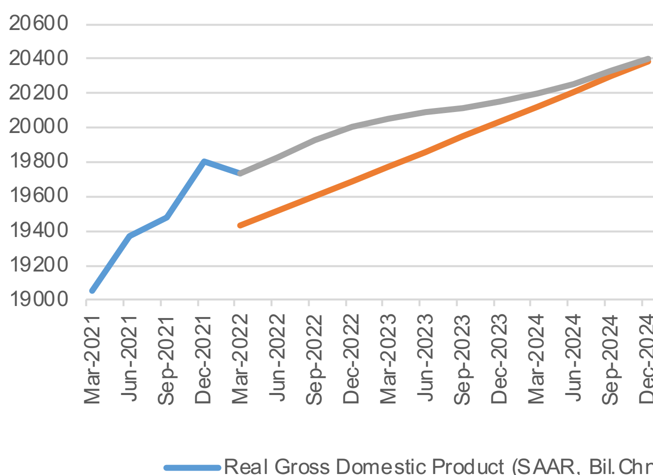
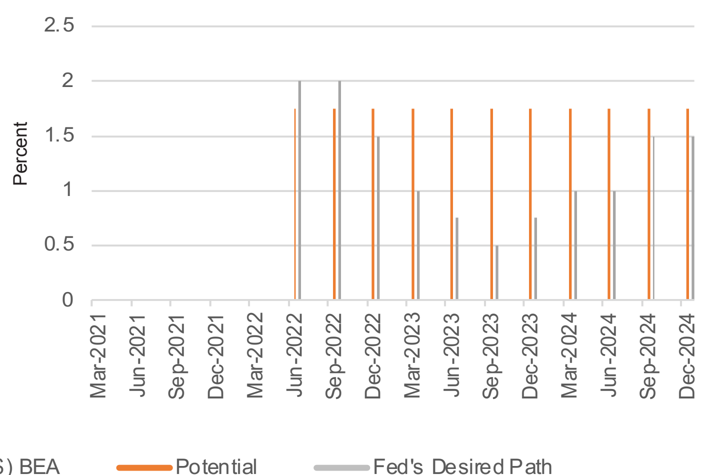


FIGURE 2:
…WITH BELOW TREND, BUT POSITIVE, GROWTH

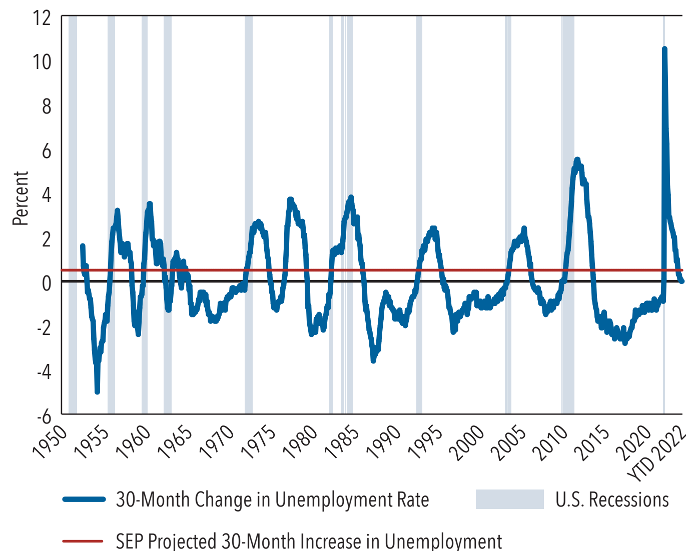


Real Gross Domestic Product (SAAR, Bil.Chn.2012$) BEA — Potential — Fed's Desired Path

Data as of 31 March 2022. Sources: Summary of Economic Projections, Stone Harbor Investment Partners Calculations.

Achieving this will be difficult since the Fed's goal of a soft landing is historically rare. The exhibit below illustrates the obstacle: The SEP forecasts the unemployment rate will increase by 0.5 pp between now and the end of 2024 as labor supply and demand come into better balance, up from 3.6% to 4.1%. However, unemployment data going back to the 1950s shows only one 30-month rate increase falling within that range and then coming back down or stabilizing. Instead, once the unemployment rate starts to increase, it's far more typical for the rate to keep increasing until it has jumped by around 2 pp rather than 0.5 pp. As the economy gets worse, it tends to trigger a self-perpetuating cycle in which layoffs lead to cuts in consumer spending, leading to more layoffs. In other words, pushing the economy to a certain threshold of weakness leads recessionary dynamics, which are non-linear, to take over.

FIGURE 3:
THE FED'S PROJECTED 30-MONTH CHANGE IN UNEMPLOYMENT IS UNUSUAL



Data as of 1 May 2022. Source: Federal Reserve Bank of St. Louis.

A more rapid pace of rate hikes makes it harder to calibrate policy around these non-linear effects. There is plenty of uncertainty around the transmission of rate increases to the economy, both around the size and the lags. Slower rate increases allow the Fed to, at least partially, observe the effects on the economy of their previous policy moves. Very rapid ones increase the risk of bad real economy outcomes, though they decrease the risks of bad inflation outcomes such as inflation expectations becoming de-anchored. In our view though, on net the faster pace increases the risk of recession substantially.

Though the Fed is now willing to run a greater risk of recession, it's important to remember that their goal is still to avoid one. As noted above, the Fed isn't giving any firm guidance on rates, but on instead laying out a path conditional on the economy's evolution. So far this has worked in the direction of more rapid tightening, but it could work in the other direction as well: if inflation improves and growth looks to be slowing too much, the Fed retains the option to adjust their policy in a more accommodative direction. There is even recent precedent for such a shift. In 2019, the Fed, with much the same leadership in place, reversed tightening when the economy was slowing more than they desired. If we see data that, instead of surprising in the direction of higher inflation, surprises in the direction of lower inflation or too low growth, we expect the Fed to exercise the same flexibility in judgment again.

Combo of Factors—Energy Prices, Tighter Fiscal and Financial Conditions—Materially Slows, But Doesn't Derail, Global Growth

(45%)

- COVID drag continues to fade as global economies mostly operate along pre-pandemic norms.
- Russia-Ukraine continues as grinding near-stalemate. Western sanctions against Russia remain in place.
- Disruption, and reduction of supply from Russia, keeps commodity prices elevated.
- Higher energy and commodity prices a modest drag on U.S. growth and a meaningful drag on European growth. Interest rate sensitive sectors, e.g. housing, start to lag with the move higher in rates.
- Policy of local lockdowns remains in place for China, and continues to impact economic behavior. China growth somewhat softer than consensus.
- U.S./China tensions remain cooler, but do not return to pre-Trump status quo.
- Aggregate EM growth lower due to drag from Russia. Growth in other EMs decent.
- Core PCE remains elevated through H1-2022. Some of the increase comes from still-snarled supply chains, which start to normalize in the summer combined with rotation of demand back to services. But the underlying inflation run-rate has moved higher.
- Fed hikes rates to their estimate of neutral by year-end '22. One more 75bp increase followed by a transition back to 25bp as growth slows. With growth meaningfully slower and rates close to neutral they pause to assess into 2023. Balance sheet runoff moves to $95bn/month pace.
- ECB winds down asset purchases by middle of 2022; rate hikes commence in late 2022.
- Rate hikes continue across EM, with the exception of China.
- Oil prices remain elevated, though premium declines somewhat ~$95/barrel WTI, Brent ~$100.

Fed-Led Global Recession

(35%)

- Combination of tighter fiscal and monetary policies, sharply elevated energy prices, hit to sentiment from Russia-Ukraine War, and associated trade disruption tips global economies into recession.
- Growth fades rapidly over H2 for the U.S. Interest rate sensitive sectors—housing, business investment, and durables—lead the downshift, but typical recessionary dynamics take hold in the labor market spreading the weakness across economy.
- With slower activity and sluggish consumer demand inflation moderates rapidly, dipping toward target by early '23.
- European growth even slower than U.S. growth. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./EZ.
- Broadly, sanctions against Russia remain in place.
- Fed hikes rates by 75bp four times, then pauses in the face of negative payrolls. As recession dynamics take hold they reverse course, and cut the funds rate back to the lower bound. Balance sheet shrinkage pauses.
- ECB lifts rates twice before recessionary dynamics become clear, but then likewise reverses cuts.
- EM economies reverse some of the recent rate hikes.
- Oil: WTI at ~$55/barrel; Brent ~$60/barrel.

Commodity Price Spike Accelerates Further With Sticky Core Inflation

(5%)

- Western economies broadly prove resilient to the higher commodity prices and growth remains strong. Output moves clearly above the pre-pandemic trend.
- Europe cuts off Russian oil and gas exports. Diversion to China and other countries ongoing, but is a messy process.
- Firm growth bumps up against ongoing sanctions and removal of substantial amount of Russian supply to elevate commodity prices even further.
- Supply chain issues do not resolve and price increases remain elevated. Facing tight labor supply, firms continue to bid up wages attempting to pull workers off the sidelines. Higher energy prices spill into core.
- With U.S. inflation continuing to run well above target, the Fed continues increasing rates at a 50bp clip and rates move above neutral.
- Rates move sharply higher along the curve.
- Oil prices rise further with growth and inflation: WTI to $140/barrel, Brent $145/barrel.

COVID-Zero Led China-Centric Weakness

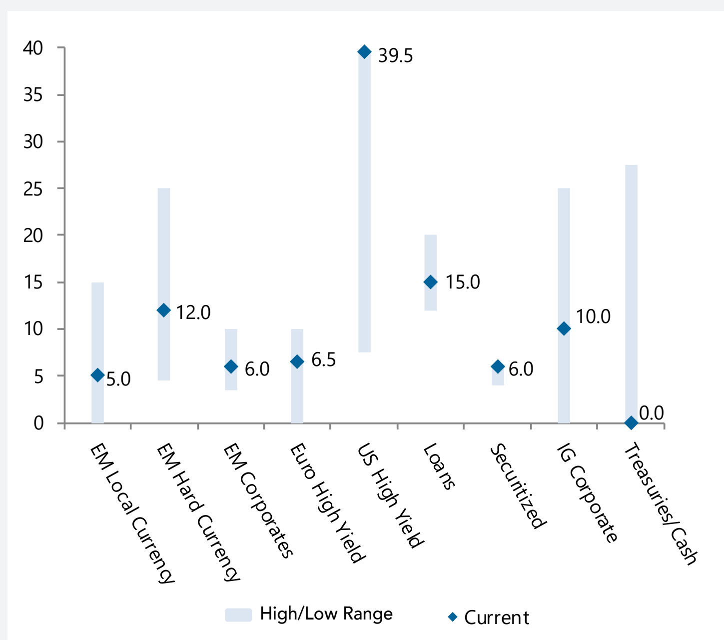
(15%)

- China continues to have recurrent COVID outbreaks across the country. The government response remains very restrictive containment measures.
- Chinese growth meaningfully softer due to the rolling lockdowns across cities.
- Global supply chain woes persist with ongoing China-led disruptions.
- China's weaker growth has limited impacts on U.S. growth, though somewhat larger impacts on European growth.
- EM impacts varied, with commodity exports to China and those tied into the Chinese value chain hit harder.
- Fed proceeds along a very similar policy normalization route as in baseline over 2022, but the China weakness allows enough commodity price weakness to hike one less time.
- Weaker Chinese demand restrains down oil prices: ~$75/barrel for WTI; Brent ~$80.

	Combo of Factors (45%)	Global Recession (35%)	Commodity Price Spike (5%)	China-Centric Weakness (15%)
U.S. Real 4Q GDP (%)	1.75	0.00	3.50	1.75
Fed Funds (%)	2.88	0.13	3.38	2.88
U.S. Core PCE (%)	2.80	2.25	3.75	2.80
2yr Treasury (%)	2.75	0.50	3.90	2.75
10yr Treasury (%)	2.65	1.50	4.00	2.65
10yr Bund (%)	0.90	-0.50	2.00	0.80
China 4Q GDP (%)	3.75	2.25	4.50	1.00
EM 4Q GDP (%)	2.50	0.50	3.00	1.50

[1]Forecast Period: Next 12 months. Source: Stone Harbor.

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION & RECENT ALLOCATION CHANGES[2]



[2]Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 31 May 2022. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

LATEST ALLOCATION CHANGES

	Month	Change (%)
EM Local Currency	Jan-Feb 2022	-2.5
EM Hard Currency	Jan-Feb 2022	-5.0
EM Corporates	Feb-Mar 2022	+0.5
Euro High Yield	Dec-Jan 2022	+2.5
U.S. High Yield	Jan-Feb 2022	+8.5
Loans	Jan-Feb 2021	+1.5
Securitized	Mar-April 2019	+1.0
IG Corporate	Mar-April 2022	+10.0
Treasuries/Cash	Mar-April 2022	-10.0

MAY CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.24	0.03	-2.56	1.76	-0.59	-1.32	0.20
Duration (Returns from Interest Rates %)	0.64	0.11	0.13	0.38	0.45	-0.44	-0.18
Credit Beta (Returns from Spreads %)	-0.40	-0.80	-2.69	1.38	-1.04	-0.88	0.38

Month Ended 31 May 2022. Performance reflects representative asset class benchmarks. HY: ICE BofAML U.S. High Yield Constrained Index; EMD: J.P. Morgan EMBI Global Diversified; EMDLC: J.P. Morgan GBI-EM Global Diversified; EMDCR: J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified; EUR HY: ICE BofAML European Currency High Yield 2% Constrained Ex Financial; IG Corp: Bloomberg Global Agg Corporate Index; Loans: S&P/LSTA Leveraged Loan Index. **Past performance is not a guarantee of future results.** Returns are shown gross of fees. For illustrative purposes only.

STONE HARBOR INVESTMENT PARTNERS

Stone Harbor 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. We manage credit portfolios for clients globally.

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation
- Over 30-year performance history
- Offices in New York, London, and Singapore
- Effective January 1, 2022, Stone Harbor Investment Partners is an affiliate of Virtus Investment Partners

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 **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The **J.P. Morgan CEMBI Broad Diversified (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 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 (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 **ICE BofAML European Currency Non-Financial High Yield 2% Constrained Index** contains all non-Financial securities in the ICE BofAML European Currency 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.

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

The **S&P/LSTA Leveraged Loan Index** is a partnership between Standard & Poor's and the Loan Syndications and Trading Association, tracking returns in the leveraged loan market and capturing a broad cross-section of the U.S. leveraged loan market—including dollar-denominated, U.S.-syndicated loans to overseas issuers.

The **Bloomberg U.S. Aggregate Index** is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

The **Bloomberg Global Aggregate Bond Index** provides a broad-based measure of the global investment grade fixed-rate debt markets. It is comprised of the U.S. Aggregate, PanEuropean Aggregate, and the Asian-Pacific Aggregate Indexes. It also includes a wide range of standard and customized subindices by liquidity constraint, sector, quality, and maturity.

Important Disclosures

This material is solely for informational purposes and should not be viewed as a current or past recommendation or an offer to sell or the solicitation to buy securities or to adopt any investment strategy. The opinions expressed herein represent the current, good faith views of the author(s) at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this material has been developed internally and/or obtained from sources believed to be reliable; however, Stone Harbor Investment Partners ("Stone Harbor") does not guarantee the accuracy, adequacy or completeness of such information. This material includes statements that constitute "forward-looking statements". Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to market, geopolitical, regulatory, or other developments. Any forward-looking statements speak only as of the date they are made, and Stone Harbor assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and are based on current market trends, all of which change over time. The views expressed herein are not guarantees of future performance or economic results and involve certain risks, uncertainties, and assumptions that could cause actual outcomes and results to differ materially from the views expressed herein. The views contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated. All investments involve risk including possible loss of principal. There may be additional risks associated with international investments involving foreign economic, political, monetary, and/or legal factors. These risks may be heightened in emerging markets. Past performance is not a guarantee of future results. This material is directed exclusively at investment professionals.

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

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

Singapore Office
3 Killiney Road
Winsland House 1
Singapore 239519
+ 65 6671 9711

shipemd.com

Stone Harbor Investment Partners is a division of Virtus Fixed Income Advisers, LLC ("VFIA"), an SEC registered investment adviser.
9076 7-22 © 2022 Stone Harbor Investment Partners.