INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

JULY 2022

Details of Slowing Growth Still Data Dependent

More aggressive global monetary policy induced by sustained high inflation and the potential impact of larger rate increases on the economy continue to feed market volatility. At the same time, concerns around geopolitical events, supply chain disruptions, and spread of COVID-19 variants weigh on market sentiment. In this context, we examine the latest set of available data and outline our economic scenarios, which broadly reflect an elevated level of uncertainty in the global growth outlook.

Incoming data often helps to narrow the range of plausible outcomes. That has not been the case over the past month. Instead, incoming information across different areas of the economy, markets and geopolitics has, in effect, broadened the scope of highly plausible outcomes.

> *"Errors using inadequate data are much less than those using no data at all."*
>
> *– Charles Babbage, Mathematician*

In the U.S., incoming data across various sectors suggests a clear slowing in economic activity and growth. Perhaps the most obvious weakness is in the housing sector, where the homebuilders index dropped a sharp 12 points, down to 55 from 67, representing a significant sequential deterioration. Other housing market data also shows a retrenchment; mortgage purchase applications, some of the most timely data for the housing sector, continue to drop sharply and existing home sales, which lag a bit, are still following them down. S&P flash July PMIs for both manufacturing and services also continue to move significantly lower, albeit still broadly consistent with modest growth (see Figure 1); and manufacturing industrial production fell in both May and June, down over 1%. Even the previously strong consumer sector is showing some moderation in real terms.

The notable exception to these signs of slowing growth has been the still robust employment data. The establishment survey, which is the most prominent metric, still shows rapid pace of job gains. In the June payroll survey, employment increased by 372k month-on-month, which is well above the pace that helps to maintain the unemployment rate stable over time. However, the parallel household survey is significantly weaker and shows virtually no gain in employment over the last several months, though it can be noisy month-to-month. One potential explanation is that the establishment survey is subject to revisions which can, especially around turning points, meaningfully change the picture; the household survey mostly avoids revisions. Also less subject to revisions are the jobless claims data. Initial jobless claims have turned higher by approximately 50k from their low late in the first quarter, an increase that is starting to look meaningful and more consistent with the softer household survey data.

The inflation picture also remains complicated. In the face of slowing growth, the latest U.S. CPI data offered an unambiguously high inflation reading that underscores the problem that rapidly increasing prices pose for the broader U.S. economy. The worse incremental news was the core Consumer Price Index—excluding food and energy reading —that increased by 0.7% month-on-month. In particular, the increase in core services was the most concerning part; as we have highlighted in the past, we consider core services the most important part of the report, so the deterioration over the last several months is particularly concerning. Rent and owners' equivalent rent (OER) were, again, notable contributors to the core services increase. These had already picked up sharply over the last several months and accelerated further in June. Both of these tend to be "sticky"—an increase one month tends to not revert the next—due to the overlapping nature of many rental contracts. Rental contracts are often for a year, so moves higher in the rent for newly signed leases take a while to filter into this series, which measures what renters are actually paying now. Core goods prices, after a couple better months, also moved back up.

On the other hand, there are some potential signs that wage growth might be slowing, which would make the sort of wage-price spiral that took place in the 1970s less likely. Average hourly earnings (AHE) measured at a 3-month annualized rate have declined to about 4% from a pace of around 6% late in 2021 and earlier this year. Though the decline is clearly good news, we also treat it with a great degree of caution—AHE is a very noisy series, which can be swung around by the mix of the newly employed. The Employment Cost Index is a higher quality measure, one which holds the composition of the work force constant, though it is much less timely only being released quarterly. We—and the Fed, as Chair Powell has indicated—will be watching the late July release of this indicator very closely.

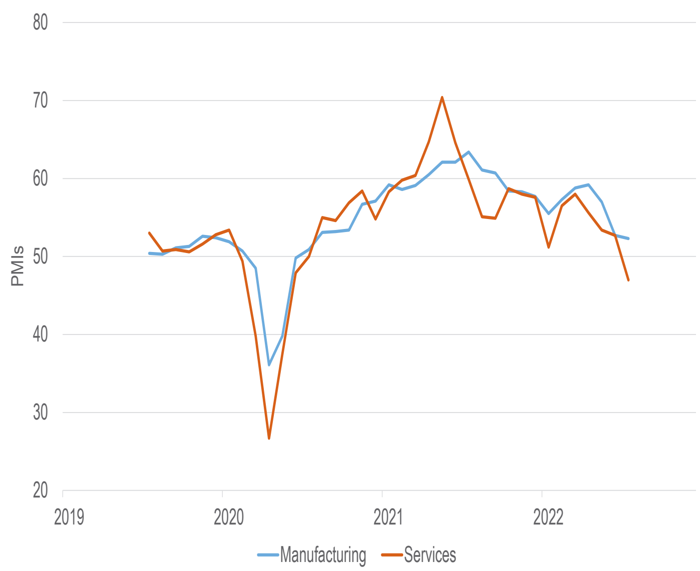
Further adding to the complexity of the current inflation picture are some recent commodity price moves and signals on supply chains. For instance, oil prices have come down roughly ~20% off the June highs while wheat and corn have reversed much of the price appreciation that was precipitated by the Russian invasion of Ukraine. Also positive are some signs that supply chains continue to ease. For example, shipping rates are generally lower and measures of supply chain pressures, such as supplier deliveries indexes, look a bit better (see Figure 2).

Europe also faces some idiosyncratic geopolitical risks. The war between Russia and Ukraine looks unlikely to resolve in the near term and Europe remains dependent on Russian gas shipment. This month, gas shipments from Russia through the Nordstream 1 pipeline stopped, with maintenance issues pointed to as the explanation. Regardless of the cause, this interruption underscores that there persists a risk of a full shutoff into the winter, which would severely impair European growth.

This month, we introduce two new economic scenarios that try to account for some of the risks brought forward by recent data. The first one highlights risk of a European, but not global, recession precipitated by a gas supply shock. However, this scenario, in which Russia shuts off gas flows to Europe, overlaps with the recession scenario, as it is entirely possible to get both the shock to Europe and an overtightening that tips the U.S. into recession. The second new scenario contemplates a more substantial improvement in inflation scenario, where lower commodity prices and dropping growth, along with lower wages, lead to better-than-expected inflation outturns. This scenario would allow the Fed to, without a full-on recession, pull back on the amount of policy tightening by next summer.

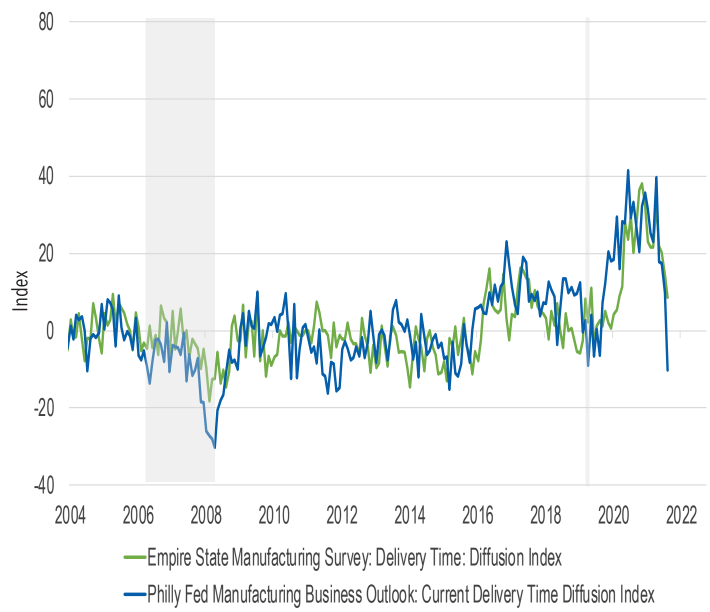
In addition to our main scenarios, we continue to watch others that, though they have become less likely, have not really gone to zero probabilities. For example, China's zero-COVID policy remains an issue with significant implications. The other key risk is that the U.S. inflation situation could deteriorate further. As we noted above with respect to intertwined gas shutoff and recession risks, our scenarios are never exhaustive—we did not present a 1% scenario with the advent of the pandemic in 2019 after all—but are intended to try to capture what we see as the biggest risks to our portfolios.

FIGURE 1: S&P MANUFACTURING AND SERVICES PMIS CONTINUE TO MOVE LOWER



Data as of 26 July 2022. Source: Bloomberg.

FIGURE 2: SUPPLIER DELIVERY INDEXES HAVE IMPROVED RECENTLY



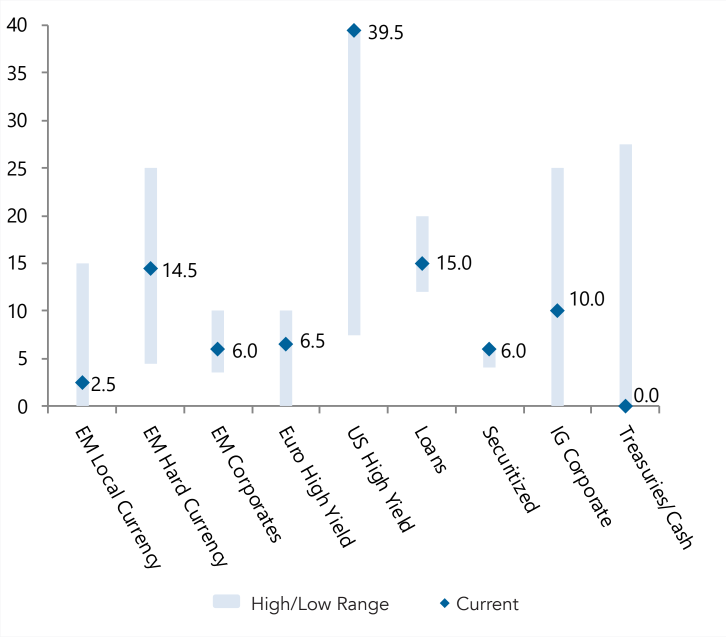
Data as of 26 July 2022. Sources: FRBPHI, FRBNY, Haver Analytics.

Slower, But Still Resilient, Global Growth **(35%)**	• Higher energy and commodity prices are 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. In U.S., fiscal tightening also slows growth. • China rebounds from Shanghai lockdowns helped by more policy support in H2, but overall activity remains moderate as the housing slump and continued zero-Covid policy prevent a more dynamic rebound. Growth in other EMs also modestly slower due to drag from DMs, but remains overall resilient. Commodity exporters benefit from strong terms of trade. • Russia-Ukraine continues as grinding near-stalemate. Western sanctions against Russia remain in place. Resulting disruption, and reduction of supply, keeps commodity prices elevated, though below peaks. • U.S./China tensions remain cooler, but do not return to pre-Trump status quo. • Core PCE remains elevated through 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. • Starting in the fall, the pace of rate hikes decreases. With growth meaningfully slower and rates close to neutral, they pause to assess into 2023. Balance sheet runoff at sustained $95bn/month pace. • ECB rate hikes continue into fall, but after the initial 50bp hike move down to 25bp. • Rate hikes continue across EM, with the exception of China. • Oil prices remain elevated, though premium declines somewhat ~$95/barrel WTI, Brent ~$100.
Central Bank-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. • 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, but purchases do not restart. • 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.
Inflation Reverses Course, Leading the Fed to Also Reverse Course (15%)	• Fed continues to raise rates relatively quickly over the course of 2022; fed funds rate peaks ~3¼%. • However, inflation proves more sensitive to slower growth and core inflation rates drop quite quickly; easing of supply chain snarls amplifies drop. • With inflation coming off and growth quite slow, the Fed starts to reverse course in late Q1 of 2023. With inflation moderating, market prices in further cuts ahead and a rebound of growth back toward potential. • Other DMs and EMs also see some moderation of inflation pressures, which leads to similar central bank pullbacks. • Dollar broadly gives back some of the outsize 2022 gains. • Oil: WTI at ~$90/barrel; Brent ~$95/barrel.
European Recession Precipitated By Russian Gas Shutoff (15%)	• Summer gas flows into Europe not sufficient to fully rebuild storage as rolling temporary restrictions continue. • Into the winter, natural gas flow from Russia into Europe severely reduced. The level is low enough that, even with household conservation measures, industrial rationing put into place. • Eurozone output shrinks notably as a result and enters a meaningful recession. • ECB eventually reverses rate cuts in the face of substantially higher employment, but is slow to do so, as core inflation is high entering the shutdowns. • European contraction a mild drag on U.S. growth, but boost to inflation from higher energy and commodity prices, which include a risk premium. • Effects vary widely across EM, with Eastern European countries hit hart, but some energy exporters buoyed. • Oil: WTI at ~$110/barrel; Brent ~$115/barrel.

	Resilient Global Growth (35%)	Global Recession (35%)	Inflation Reverse Course (15%)	European Recession (15%)
U.S. Real 4Q GDP (%)	1.25	-0.50	1.25	1.00
Fed Funds (%)	3.13	0.63	2.63	2.88
U.S. Core PCE (%)	3.40	2.50	2.65	3.45
2yr Treasury (%)	2.90	0.75	2.10	3.10
10yr Treasury (%)	2.70	1.50	2.25	3.00
10yr Bund (%)	0.90	-0.50	0.50	0.00
China 4Q GDP (%)	4.50	2.50	4.50	4.00
EM 4Q GDP (%)	4.00	1.50	4.00	3.25

[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 30 June 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	May-Jun 2022	-2.5
EM Hard Currency	May-Jun 2022	+2.5
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

JUNE CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-6.81	-6.21	-2.16	-4.45	-3.06	-6.97	-2.74
Duration (Returns from Interest Rates %)	-0.64	-0.75	0.16	-0.61	-0.65	-0.83	-0.93
Credit Beta (Returns from Spreads %)	-6.17	-5.46	-2.32	-3.84	-2.41	-6.14	-1.81

Month Ended 30 June 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 **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

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