Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

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Laying Out the Path to a "Softish" Landing

For much of this year, market participants have focused on the pace and magnitude of policy tightening by the U.S. Federal Reserve (Fed), as they confront generational highs in inflation. Of particular note, the August reading for the core Consumer Price Index (CPI) increased at an annualized rate of over 7%, well above acceptable levels. While a true "soft" landing—where growth slows toward potential from above—appears unlikely at this point, we do see a potential for a "softish" landing: one that avoids a substantial economic downturn, though growth slows notably below potential. In this issue, we lay out what the path to that outcome would look like over the next couple quarters, while continuing to acknowledge that the risks of a harder landing remain significant.

"The most difficult thing is the decision to act, the rest is merely tenacity."

– Amelia Earhart, American Aviator

In thinking about the policy path going forward, framing the analysis around the question, ***"what does the path to success look like for the Fed at this point?"*** can be useful. With the current level of elevated inflation, the Fed's primary goal is to bring it down to a reasonable level. They would clearly prefer avoiding recession, but they are also willing to run a risk—a substantial risk at that—of triggering a recession to control inflation.

A true "soft" landing—where growth slows toward the underlying trend, which we put around 1¾% from above but does not dip below that pace—appears unlikely at this point, in our view. However, we do still see a path to a "softish" landing, where growth dips below 1¾% but does not turn outright recessionary, as still a realistic possibility. That said, the path to that outcome is relatively narrow, and it is clearly possible that the economy tumbles off the path into a recession.

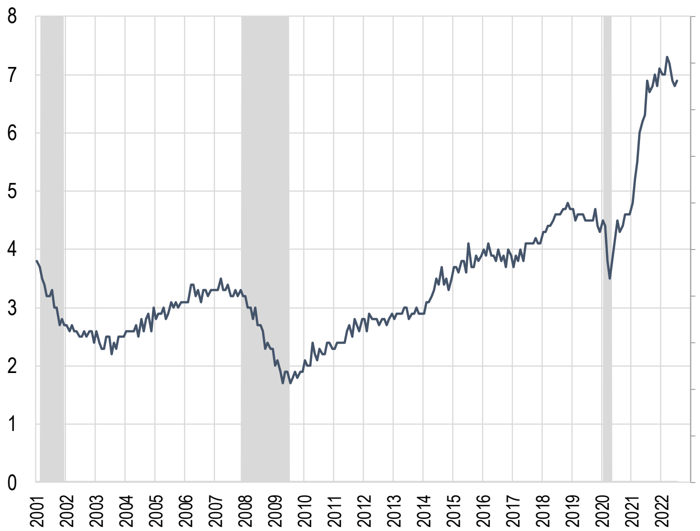
We think laying out the path to the latter outcome is useful for several reasons. First, it helps in assessing how plausible the outcome is. Second, and perhaps more important, it provides some markers along the way that can help us evaluate whether the economy is following this path or wandering off into the thickets of recession. And, put simply, the economy needs a period of below trend growth to cool off the labor market. Though there have been two consecutive quarters of negative gross domestic product (GDP) growth, that likely overstates the amount of slowdown. Gross domestic income (GDI), a parallel measure of the economy's output, has been notably stronger and GDP has swung around by noisy areas such as net exports and inventories. In looking through the weakness in first half of this year, we think that underlying GDP growth needs to dip meaningfully below 1¾% for a moderate amount of time, probably down into the ¾% range.

Along with the slowdown in growth, the labor market needs to slow, and the needed slowing looks somewhat sharper as the current pace looks elevated compared to overall output growth. Though there was some moderation, the latest employment report continues to suggest a relatively robust labor market; one with growth that is too rapid for the current inflation situation. When we look across a range of measures, the current rate of employment growth appears to be around 300k per month. That is very clearly slower than in late 2021 and early 2022, when the pace was closer to 600k, but it is still too fast in the context of where the Fed is attempting to steer the economy. The pace of employment growth that stabilizes the unemployment rate looks to be about 125k per month and to open up some slack requires dipping below that level. The path toward a "softish" landing likely requires employment growth to drop down toward about 50k per month, or even a bit lower.

We think the Fed hopes to get there through a substantial reduction in hiring, but without a big pickup in layoffs. One way to watch progress toward that is through the JOLTS data, which has information on both the openings rate and the layoffs rate. The JOLTS opening rate is about 7% now, down from a 7.3% high but still extremely elevated compared to its history (see figure 1). A rough benchmark for where it needs to go is back to where it was in the pre-pandemic labor market—about 5%. However, the most recent data from July showed a small uptick instead, following declines in the prior several months. A large part of why the Fed wants lower job openings is that they hope it will slow wage gains, which are currently above the pace consistent with the 2% inflation target. And there has been some better news here as average hourly earnings have been a little slower, and labor force participation has moved up, which could also help moderate wage gains. These positives have not yet been nearly enough though to change the direction of Fed policy.

On inflation, what is needed for a "softish" landing is pretty simple: less of it. There have been positive signs on the supply chain side, where pressures finally seem to be abating. Some of that has started to filter into actual prices. For instance, appliance prices, as shown in figure 2, have dropped substantially from their peak. Similarly, the Manheim index for used cars at auction has also dropped. But at this point, these are only tentative signs, and goods price declines need to be much broader than what we have seen so far. And importantly, we also need evidence of moderation for services prices, which has continued to experience significant upward pressures over the last several months. This will be, over time, closely tied to the labor market as labor costs, which make up a significant portion of costs in the services sector of the economy. Here, the path includes sequentially lower readings in the employment costs index, probably needing to drop to around a 3½-4% annualized rate from the current 5%.

FIGURE 1: JOLTS: JOB OPENINGS RATE (EOP, SA %)



As of 31 August 2022. Sources: Haver Analytics, Stone Harbor Investment Partners. For illustrative purposes only.

FIGURE 2: U.S. INFLATION HOUSEHOLD APPLIANCES (DEC 1997=100)

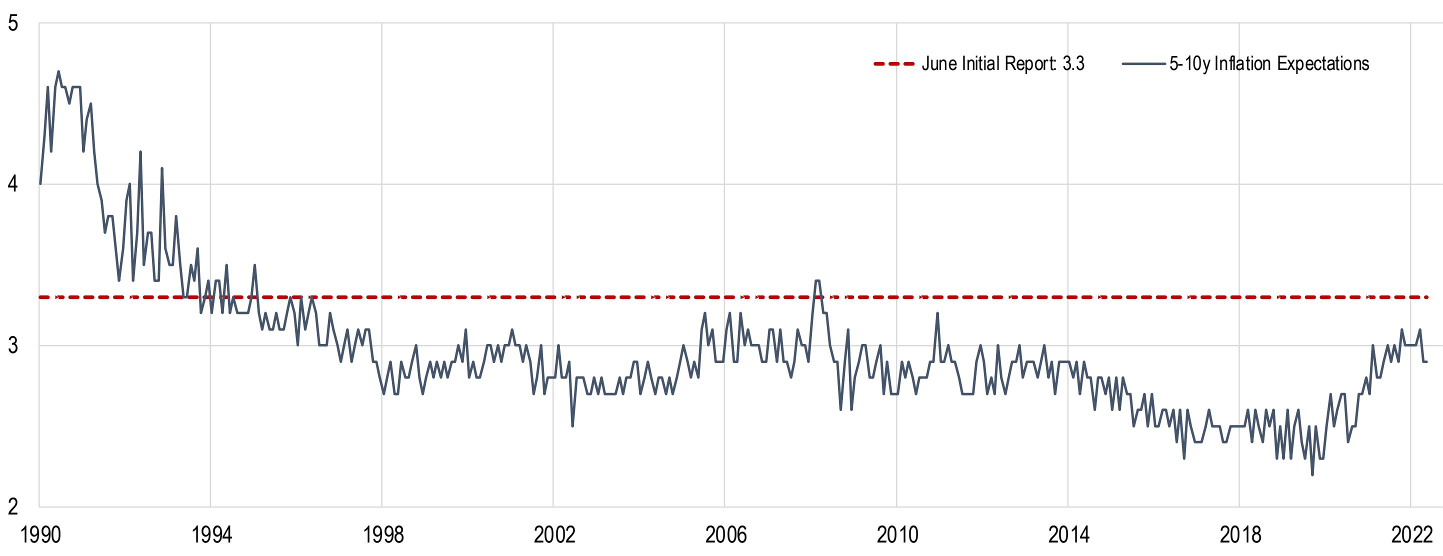
As of 31 August 2022. Sources: Haver Analytics, Stone Harbor Investment Partners. For illustrative purposes only.

At the same time, inflation expectations must remain anchored, as they have been so far. The measure from University of Michigan's consumer survey has actually been improving over the last several months (see figure 3). It has declined to 2.8% after touching 3.3% on the preliminary reading for June, an alarming jump that helped accelerate the pace of rate increases from 50 bps to 75 bps, though one that has since been partially revised away. The New York Fed's 2-3 year inflation expectations are down to 2.8% from over 4.4% in mid-2021.

The "softish" landing laid out above remains our base case macroeconomic scenario, but the risks around that are very elevated. In Europe, we have moved more drag from continued elevated energy prices into our base case. However, the more extreme downside risks we had been highlighting in a separate scenario—one where an idiosyncratic European recession is precipitated by Russian gas shutoff—look less likely to be realized and, therefore, we have eliminated that scenario. In its place, we have added one where, despite even slower growth, inflation does not drop in the face of slower activity, and both policy and longer-term rates increase further. Our expectation is that the Fed likely raises rates by another 75 bps at the next meeting. Beyond that, the path will be dependent on the evolution of the economy, but we think the Fed would like to slow down the rate hikes and, in our base case, the data cooperates enough to allow them to do so. With only 40% assigned to our base case, different outcomes are very possible. We assign a 35% probability to a scenario of a central bank-led global recession, 15% probability to resilient inflation in the face of slow growth, and 10% probability to inflation reversing course, which leads the Fed to also reverse course.

Much of emerging markets (EMs) faces a similar challenge in the sense that inflation is running too high, rate hikes have been substantial, in fact much more aggressive than the Fed, and policy makers are hoping to avoid a contraction in output. Most EMs have a similar determination to return inflation back to target relatively quickly. But for many EMs the problem is more complex as external factors usually play a larger role, i.e., the impact of exchange rates and commodity prices on inflation and the impact of the global activity cycle on output is larger. Therefore, the ability of EMs to avoid recessions in part will depend on the major developed markets, as well as China. Our base case sees many EMs succeeding and some early evidence is supportive. For example, we have seen economic activity remain resilient in several countries with very aggressive rate hikes, such as Brazil. But in most EMs, with inflation still too high, we expect to see more rate hikes and uncertainty to remain in the near term.

FIGURE 3: INFLATION EXPECTATIONS 5-10 YEARS



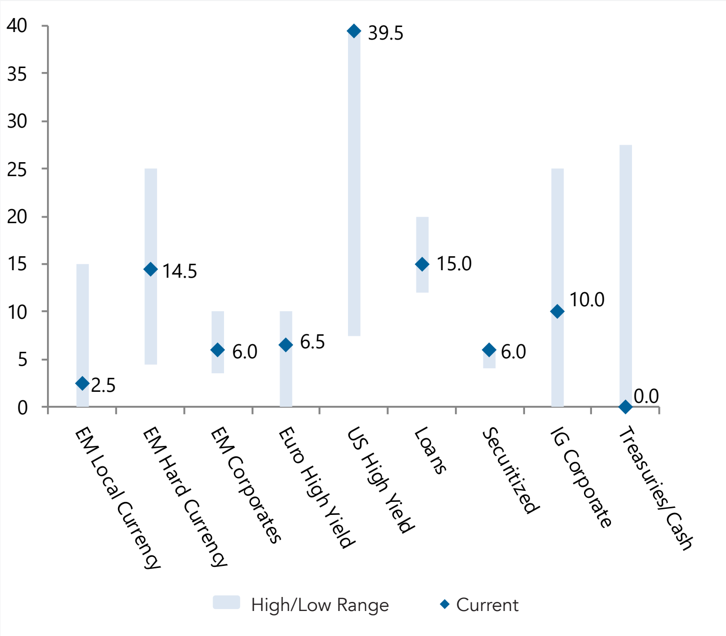
As of 31 August 2022. Sources: Bloomberg, University of Michigan, Stone Harbor Investment Partners. For illustrative purposes only.

Scenario	Assumptions
"Softish" Landing (40%)	• Tighter financial conditions, induced by higher Fed policy rates, along with tighter fiscal and fading rebound from covid meaningfully slow growth. • Slower growth spreads out beyond interest rate sensitive sectors, such as housing, that are already lagging, to the consumer and investment sectors. • Russia-Ukraine War and sanctions both continue. Natural gas supplies to Europe continue to be erratic at best. The resulting higher prices for both natural gas and electricity substantially drag down European growth through the winter. • U.S. growth remains positive, though Eurozone is modestly negative. • China growth remains subdued despite by more policy support in H2. The continuing housing slump and continued zero-Covid policy prevent a more dynamic rebound. Growth in other EMs also slower due to drag from DMs and tighter monetary conditions. Commodity exporters still benefit from strong terms of trade. • U.S. core PCE remains elevated through 2022 as services inflation remains elevated, though some relief from good prices. By spring-23 enough labor market space has been opened up that inflation starts to moderate further, though run-rate is still above target. • Fed hikes by 75bp in November, but slower goods price inflation gives enough room to moderate to 50 in December and 25bp in early 23. With growth meaningfully slower and rates above neutral to neutral, they pause to assess. Balance sheet runoff at sustained $95bn/month pace. • ECB pace accelerates to 75bp for two meetings and then drops back to 50bp. • Rate hikes continue in many EMs but are peaking on average in Q1. China remains a key exception with continued very gradual easing. • Oil prices remain elevated, though premium declines somewhat ~$90/barrel WTI, Brent ~$95.
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 Q4 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 in both November and December and continues to hike in the face of slowing growth, with two 50bp increases in 2023. It then pauses as payrolls turn negative. As recession dynamics take hold they reverse course, and start to cut the funds rate. By Q3-23 rates are back to around 2% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. • ECB lifts rates by 75bp at the next three meetings, slows to 50, and then pauses as the combination of rate increases and the drag from high energy prices induce contraction. They then likewise begin reversing hikes. • EM economies still raising rates in 2022 but shifting policy stance by Q2. More decisive cuts than in base case scenario. • Oil: WTI at ~$55/barrel; Brent ~$60/barrel.
Resilient Inflation in Face of Slow Growth (15%)	• Despite ongoing tightening—and slower growth—inflation proves resilient. Core continues to run over 4% despite substantially slower growth. • Similar inflation dynamics across DM economies. • Faced with the higher ongoing inflation, central banks broadly continue to push up rates at the expense of growth. Economies stagnate, though don't tip into outright recession. • Markets mark up estimates of the neutral interest rate and expect the higher rate environment to be persistent. The 10y trades a bit under 6%. • EM inflation fails to fall meaningfully. Weaker growth in EMs as central banks keep tighter monetary conditions. Especially weaker EMs are struggling with tight funding conditions. • Oil: WTI at ~$105/barrel; Brent ~$110/barrel.
Inflation Reverses Course, Leading the Fed to Also Reverse Course (10%)	• Fed continues to raise rates and fed funds rate peaks just over 4%. • However, inflation proves more sensitive to slower growth and core inflation rates drop quite quickly; easing of supply chain snarls amplifies drop. • With inflation cooling rapidly and growth below trend, the Fed starts to reverse course in early Q3 of 2023. 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.

	"Softish" Landing (40%)	Global Recession (35%)	Resilient Inflation (15%)	Inflation Reverses Course (10%)
U.S. Real 4Q GDP (%)	0.75	-1.00	0.00	1.25
Fed Funds (%)	4.38	2.13	5.38	3.63
U.S. Core PCE (%)	3.60	2.75	4.75	2.65
2yr Treasury (%)	3.70	1.75	5.50	2.10
10yr Treasury (%)	3.40	1.75	5.75	2.75
10yr Bund (%)	2.25	0.25	4.00	0.75
China 4Q GDP (%)	3.50	2.50	3.00	4.00
EM 4Q GDP (%)	3.00	1.50	2.00	4.00

[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 August 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

AUGUST CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-2.39	-0.95	1.54	-0.14	0.18	-1.07	-3.05
Duration (Returns from Interest Rates %)	-2.21	-2.84	0.19	-2.22	-2.04	-2.97	-3.15
Credit Beta (Returns from Spreads %)	-0.18	1.89	1.35	2.08	2.22	1.90	0.10

Month Ended 31 August 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

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- 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.

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