INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

NOVEMBER 2022

U.S. Inflation: This Time, Some Good News

Stubbornly high inflation has been the focal point for global markets this year and steered central banks to restrictive monetary policy. As a result, we have seen large sequential interest rate increases across developed and emerging markets alike, with the U.S. Federal Reserve (Fed) delivering a fourth consecutive rate hike of 75 basis points (bps) earlier this month. The Fed's latest rate decision brings the benchmark lending rate to a new target range of 3.75% to 4%—the highest level for the fed funds rate since 2008. The Fed is clearly willing to risk a recession, maintaining the position that persistent inflation causes more severe economic harm. However, the latest U.S. inflation data tilt in a somewhat more positive direction and could potentially be the start of a turning point the Fed has been aiming for. We break apart the inflation report, noting both reasons for cautious optimism as well as lingering risks, as the path of inflation will be critical in determining the pace of rate increases going into 2023.

The economic impact of restrictive policy has taken quite a long time to materialize and has certainly taken longer than our baseline assumption coming into this year. While inflation remains unquestionably too high, we are finally starting to see some signs of inflation moderation. With the slowdown in core inflation to 0.27% month-on-month in October—a rate that seems almost normal compared to readings from earlier this year—it appears the latest set of data has cooperated enough for the Fed to likely slow the pace of future rate hikes. On the broader inflation outlook, however, we think some remaining concern is still warranted, given that there have been false hopes of easing inflation over the past year, and as we are reminded that a short run of figures does not make a trend. Nevertheless, the latest contours of inflation dynamics suggest room for some very cautious optimism looking into 2023.

"The more difficult the victory, the greater the happiness in winning."

– Pele, Brazilian former professional soccer player

In order to gain a more clear understanding of the better-than-expected inflation data, we find it useful to separate the core inflation data into three buckets and identify the key areas of improvement, as well as determine how much the improvements really matter. To that end, we examine separately 1) core goods inflation, 2) rental inflation, and 3) core services outside of rent.

But first, it is important to recognize that there are a lot of moving parts in the inflation report, not all of which point in the same direction. For instance, used cars subtracted meaningfully from the overall report. But, given how volatile they are, and how they are driven by idiosyncratic factors, we mostly look through that decline when thinking about the broader inflation picture, just as we advocated mostly looking through their increase in the not-too-distant past.

Outside of used cars, however, there has been a broader easing of goods price inflation. October saw core goods prices decline from annualized rates over 20% to around zero at a three-month annualized rate (see figure 1). A significant portion of this improvement likely reflects the ongoing post-Covid normalization of supply chains. According to The New York Fed's measure of aggregate supply chain disruption, the overall supply chain is not quite back to normal, but it is getting pretty close (see figure 2). Also helping, import prices are falling as a result of both supply chain improvement and the strength of the U.S. dollar. Our baseline expectation is we see modest core goods deflation over coming months.

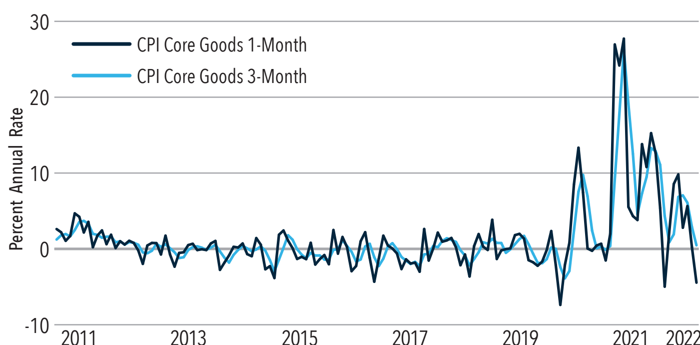
The services side also showed improvement in October. We think it is helpful to look at core services excluding shelter and the rent and owners' equivalent rent (OER) driven part of core shelter. On the rental side, the short-term news remains grim, though somewhat

less grim than September, as annualized rates remain in the very high single digits. Rental inflation had been a big factor pushing overall core inflation higher over the last six months. But, looking ahead, the latest measures of newly signed leases—different from the BLS data, which looks at the average of all leases—are no longer showing big increases. Indeed, the incoming data suggest there is likely to be some moderation in 2023. One example is Zillow data, which has moved lower over the last several months. CPI measures lag because they aim to capture average rental prices (see figures 3). Although the timing is hard to pinpoint, the overall move to a lower run rate is likely, in our view but it probably will not start to really show up in the BLS data until late in the first quarter of 2023, with quite a bit of uncertainty around the precise timing.

Our final grouping, non-rental related core services, dropped down to around a 3% annual rate in October—a meaningful step down from the over 10% peak (see figure 4). But, this represents only one month. On the same three-month annualized basis used for core goods inflation above, non-rental related core services is running around 6%, still very significantly above most of the 2010s and, more importantly, still clearly too high. Some idiosyncratic segments are better and are likely to remain so over the next several months—health insurance, for example—but whether we get further moderation in core services outside rent is the big swing factor looking ahead and, unlike rents, there are no alternative data that clearly lead. One thing we are watching closely is wage data, which we view as an important link to core services as employee compensation is a significant part of services costs.

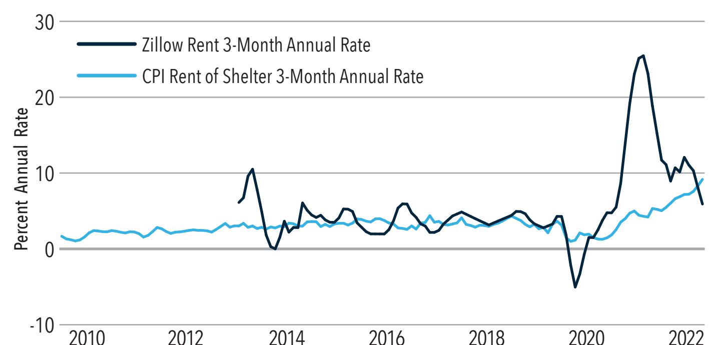
With the latest round of better inflation data, our cautiously optimistic base case remains broadly unchanged, although with a slightly higher probability of 40%, marked up from 35%. We anticipate that the U.S. core Personal Consumption Expenditure (PCE) inflation will remain elevated through 2022 as services inflation remains elevated, albeit some relief from goods prices will become more evident. By spring 2023, we are likely to see inflation moderate further—though remaining above target. Slower goods price inflation in turn would allow the Fed to moderate the rate increase to a 50 bps hike in December, followed by 25 bps in early 2023. With growth meaningfully slower and rates above neutral, the Fed pauses to assess. Outside of the U.S., our base case envisages the ECB maintaining pace at 75 bps for next meeting before dropping back to 50 bps. And in emerging markets, rate hikes continue, but rate begin to peak on average in the first quarter 2023. China remains a key exception with continued very gradual easing.

FIGURE 1:
CORE GOODS SAW MILD DEFLATION IN THE OCTOBER PRINT



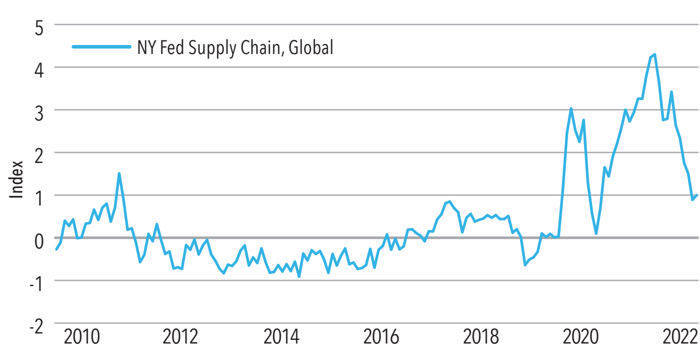
As of 31 October 2022. Sources: Bureau of Labor Statistics, Haver Analytics, and author's calculations.

FIGURE 3:
RENTAL INFLATION LIKELY TO MODERATE



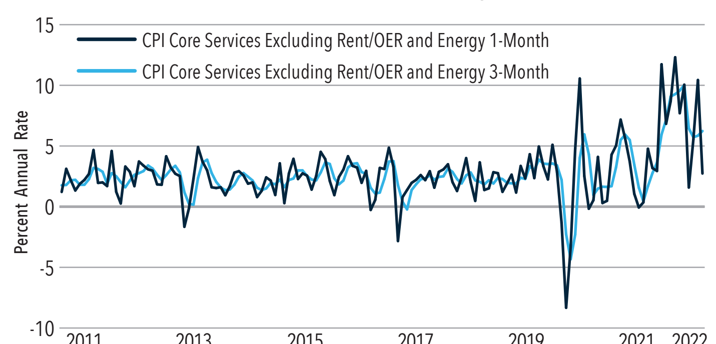
As of 31 October 2022. Sources: Zillow and Bloomberg.

FIGURE 2:
SUPPLY CHAIN NORMALIZING



As of 31 October 2022. Source: New York Federal Reserve.

FIGURE 4:
CORE SERVICES EXCLUDING RENT STILL HIGH, BUT BETTER



As of 31 October 2022. Sources: Bureau of Labor Statistics, Haver Analytics, and author's calculations.

"Softish" Landing (40%)

- Tighter financial conditions, induced by higher Fed policy rates, along with tighter fiscal policy and fading rebound from Covid, meaningfully slow growth.
- Slower growth spreads out beyond interest rate sensitive sectors that are already lagging, such as housing, to the consumer and investment.
- 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 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 goods prices. By spring 2023, enough labor market space has been opened up that inflation starts to moderate further, though run-rate is still above target.
- Slower goods price inflation gives enough room to moderate to a 50bp hike in December and 25bp in early 2023. 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 next meeting and before dropping 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 rebound 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 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 2023, 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 two 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 2023. More decisive cuts than in base case scenario.
- Oil: WTI at ~$55/barrel; Brent ~$60/barrel.

Resilient Inflation in Face of Slow Growth (10%)

- 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.

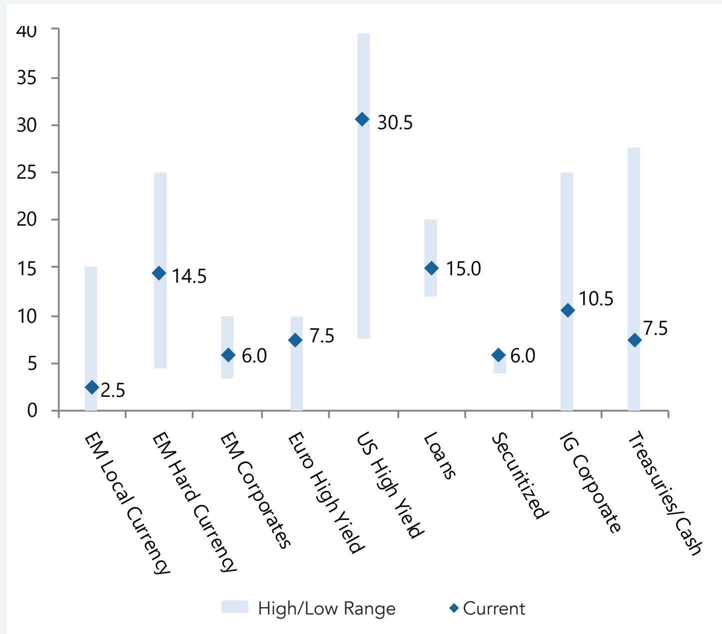
Inflation Reverses Course, Leading the Fed to Also Reverse Course (15%)

- Fed continues to raise rates and fed funds rate peaks just over 4½%.
- 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 (10%)	Inflation Reverses Course (15%)
U.S. Real 4Q GDP (%)	0.75	-1.00	0.00	1.25
Fed Funds (%)	4.63	2.13	5.38	3.88
U.S. Core PCE (%)	3.60	2.75	4.75	2.65
2yr Treasury (%)	3.70	1.75	5.50	2.75
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]



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	Oct-Nov 2022	+1.0
U.S. High Yield	Aug-Sep 2022	-9.0
Loans	Jan-Feb 2021	+1.5
Securitized	Mar-April 2019	+1.0
IG Corporate	Oct-Nov 2022	+0.5
Treasuries/Cash	Oct-Nov 2022	-1.5

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

SEPTEMBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	2.85	0.15	1.03	-0.88	-2.05	2.11	-0.58
Duration (Returns from Interest Rates %)	-0.72	-1.74	0.36	-1.06	-0.80	0.17	-1.16
Credit Beta (Returns from Spreads %)	3.57	1.89	0.67	0.18	-1.25	1.94	0.58

Month Ended 31 October 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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