



JANUARY 2023

China Changes Direction

Over the last several months, China has announced two significant policy changes that will likely accelerate the country's economic growth prospects. In contrast to the message of policy continuity emphasized at the Chinese Communist Party Congress last October, the government is now pivoting to fully reopen the local economy and provide more support to the housing sector. The substantial shift in policy direction has been preceded by large-scale popular protests that carried the underlying message of prioritizing tangible and positive economic results for the public. Overall, if these policy shifts are sustained, we believe they will positively impact the global economy in general, and other emerging markets economies in particular.

Since the Chinese Communist Party Congress in October last year, in which Xi Jinping further solidified and demonstrated his political power, we have seen two very important policy shifts. Both have clearly improved our outlook for Chinese growth in 2023. The most important and surprising change has been the abrupt abandoning of the Zero-COVID policy, firmly in place since the beginning of the pandemic. As the colder weather triggered new COVID waves across the country, popular protests against lockdowns emerged across China and instead of cracking down on the protests, the government quickly abandoned the Zero-COVID policy in December. We had expected the Zero-COVID policy to end sometime in 2023, but this move came much earlier and much faster than anticipated, and thus, alters China's economic prospects for the year ahead.

The immediate impact of the change in COVID policy was a broad wave of infections that spread rapidly across the country. Mobility and select activity indicators dropped, this time driven mainly by sick people remaining at home and voluntary behavioral changes rather than strict government-imposed measures. However, the economic impact was milder than anticipated. China's 4Q GDP registered 2.9% growth compared to the same quarter of the previous year, lower than the 3.9% in Q3 but well ahead of expectations of only 1.6%. While the Q4 data has been encouraging, the more important development has been the relatively rapid decline of this COVID wave which now allows a faster and more robust resumption of normal activity (see Figure 1).

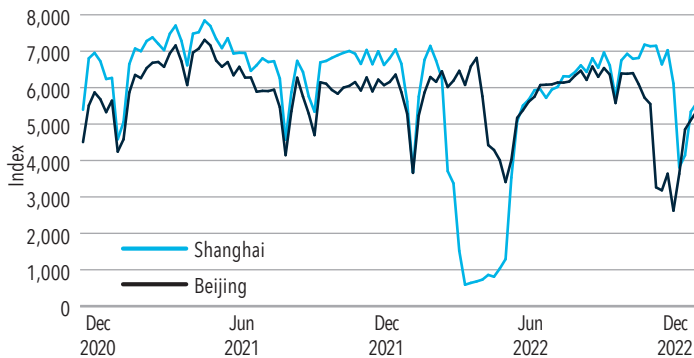
We expect the upswing to be driven by consumption, which has been depressed since the beginning of the pandemic. In contrast to U.S. consumers that expanded goods demand very sharply during the pandemic, China's consumers remained cautious and increased savings instead. As a result, household personal bank deposits have expanded rapidly, by 18 trillion CNY during 2022 and averaging 13 trillion per year since end 2019, compared to about 7 trillion annually before the pandemic (see Figure 2). This puts Chinese consumers in a good position to increase spending again as pandemic-related uncertainty declines and the local economy fully reopens.

The second key policy change applies to the housing market, which has been in crisis since about mid-2021. After failing to signal any meaningful policy change during the party congress in October, a broad set of measures was then announced in November, aimed at promoting the "stable and healthy development" of the industry. The most important and consequential changes were credit and financial support for housing developers with a particular focus on facilitating completion and delivery of projects. We believe this was the beginning of a very important policy shift for this critical sector. The main policy focus clearly shifted from shrinking and consolidating the industry to stabilizing the market by alleviating the funding squeeze of private developers.

"Only the wisest and stupidest of men never change."

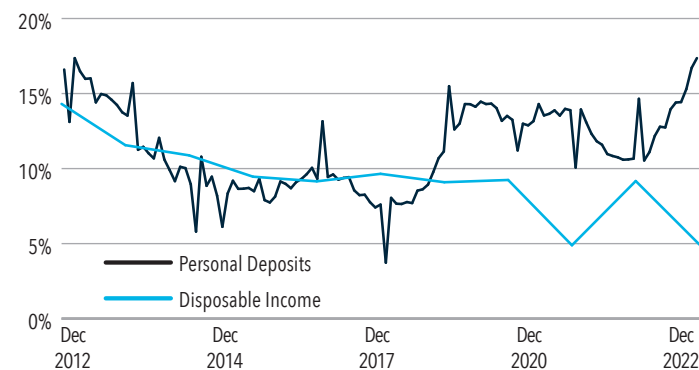
– Confucius

FIGURE 1:
CHINA MIGRATION NETWORK TRAFFIC INDEX



As of 9 January 2023. Sources: UBS, Stone Harbor Investment Partners. For illustrative purposes only.

FIGURE 2:
CHINESE CONSUMER FINANCIALS, YOY % CHANGE



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

While these measures are critical for the market to reset, they don't ensure a fast rebound. Any broader and lasting recovery will require housing demand to pick up again, and this will require confidence that units will get completed and delivered and that prices will stop falling. We believe the end of Zero-COVID helps home buyers gain confidence, and the rise in liquid savings could support buyers. This broader recovery will likely take more time to gain footing but it carries the potential of further supporting Chinese growth later this year.

These key policy changes, taken together, paint a clearly better growth prospect for 2023. We currently forecast 5.1% in 2023, up from 4.0% forecast in October, following the party congress. Whether this improved near-term outlook driven by the lifting of Zero-COVID policy gets sustained depends to a large extent on the housing market. We believe there is upside potential. Watching Chinese credit data will be key to assess the strength of the recovery. Faster credit expansion will be needed to sustain the recovery in economic activity and will likely also be needed

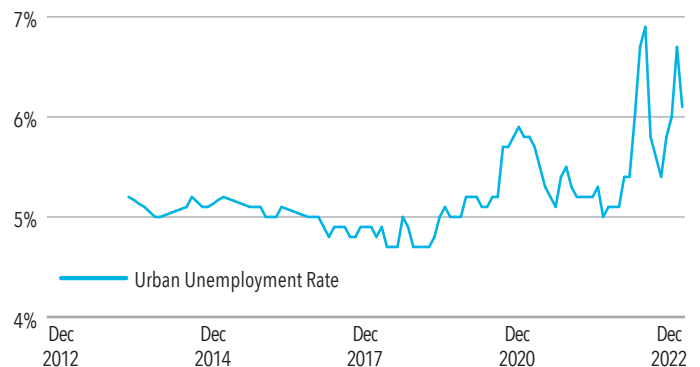
for the housing market to recover. On the other hand, the weakening global economic conditions are limiting demand for Chinese exports, and this will likely prevent a sharper growth acceleration in China.

The developments in China stand to benefit the rest of the world, especially many developing countries. The most important channel will likely be higher Chinese demand for imports. The resumption of mobility as a result of China's COVID policy shift will raise energy demand. And higher growth will require more commodity imports, especially if housing activity is recovering. Consequently, EM commodity exporters are expected to be the main beneficiaries, but we suspect benefits could also extend to manufacturing-based economies. In addition, a return of Chinese tourists to international destinations would significantly benefit several countries, especially in South-East Asia.

But, the developments in China also carry risks. Concerns have been raised regarding the impact of higher Chinese growth on global inflation. Here too, we believe commodity prices would be the main driver. This could become an important driver but we also see limiting factors. With unemployment significantly above pre-pandemic levels in China (see Figure 3), we do not see the same labor market pressures emerging that we have seen in major developed market economies during the recovery from the pandemic. A softer external economic backdrop also helps in this regard by easing demand pressures of Chinese exports. Supply chain disruptions have already declined, removing a key driver of the global inflation surge last year.

Overall, the policy changes outlined above have improved our outlook for global for 2023, with Emerging Markets likely benefiting disproportionately. While higher commodity prices would slow the disinflation already underway, the current soft global growth backdrop helps limit second round inflation effects.

FIGURE 3:
CHINA UNEMPLOYMENT RATE



As of 31 December 2022. Sources: Haver, Stone Harbor Investment Partners. Urban unemployment rate for 31 major Chinese cities. For illustrative purposes only.

**“Softish” Landing
(45%)**

- Tighter financial conditions, induced by higher Fed policy rates, and fading rebound from COVID continue meaningfully slowing 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 resulting 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. Eurozone growth close to zero.
- China growth remains subdued despite easing COVID policies and more policy support. The continuing housing slump and weak global growth 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, dragged up by services inflation, though with some relief from good 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 Fed enough room to moderate further to 25bp increase 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 remains at 50bp for several meetings, before dropping down to 25bp.
- Rate hiking cycle ending in Q1 in most EMs. Cuts starting early in Q3.
- Oil prices rebound somewhat: ~\$85/barrel WTI, Brent ~\$90.

**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 continues to fade in early 2023 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, which spreads weakness across economy.
- With contracting 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 continues to hike rates at 50bp clip several more times in 2023: two more 50bp increases and one 25bp. It then pauses as payrolls turn negative. As recession dynamics take hold, they reverse course and start to cut the funds rate. By Q4 2023, rates are back to around 2%, with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart.
- ECB continues to lift rates by 50bp for next several meetings, but then pauses as the combination of rate increases and the drag from high energy prices induce a recessionary contraction. They then likewise begin reversing hikes.
- Rate hiking cycle ending in Q1. Earlier and more decisive rate cuts than in baseline, starting already in Q2.
- Oil: WTI at ~\$55/barrel; Brent ~\$60/barrel.

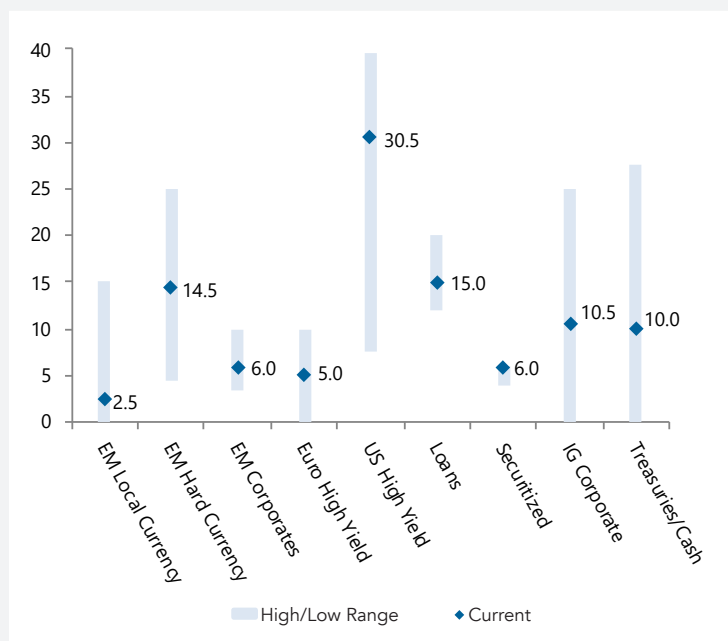
**Inflation Reverses
Course, Leading
the Fed to Also
Reverse Course
(20%)**

- 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 outside 2022 gains.
- Oil: WTI at ~\$85/barrel; Brent ~\$90/barrel.

	“Softish” Landing (45%)	Global Recession (35%)	Inflation Reverses Course (20%)
U.S. Real 4Q GDP (%)	0.75	-1.00	1.25
Fed Funds (%)	4.63	2.13	3.88
U.S. Core PCE (%)	3.40	2.75	2.65
2yr Treasury (%)	3.70	1.75	2.75
10yr Treasury (%)	3.40	1.75	2.75
10yr Bund (%)	2.50	0.25	0.75
China 4Q GDP (%)	5.50	3.50	6.00
EM 4Q GDP (%)	4.25	2.00	4.75

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

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION & RECENT ALLOCATION CHANGES²



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	-2.5
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	+2.5

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

DECEMBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-0.75	0.33	0.44	2.16	1.54	-0.63	-0.65
Duration (Returns from Interest Rates %)	-0.15	-0.39	0.40	-0.21	-0.11	-1.70	-1.04
Credit Beta (Returns from Spreads %)	-0.60	0.72	0.04	2.37	1.65	1.07	0.39

Month Ended 31 December 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: Morningstar LSTA U.S. Leveraged Loan Index. **Past performance is not a guarantee of future results.** Returns are shown gross of fees. For illustrative purposes only.

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- 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 Morningstar LSTA U.S. Leveraged Loan Index is a daily total return index that uses LSTA/LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current

outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated 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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