INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor INVESTMENT PARTNERS
A Virtus Investment Partner

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Assessing Underlying Growth When Good News Is (Potentially) Bad News

Recent data reinforces that the course of U.S. monetary policy remains squarely dependent on incoming data. The latest Consumer Price Index (CPI) was almost exactly in line with expectations; however, expectations had anticipated an uptick, thus the result attenuates the disinflationary trend from the end of 2022. Although data on economic activity and growth always appears unclear in real time, the current data mix is even more unclear than usual. Underlying growth in select areas, e.g., payrolls and retail sales, seemed to accelerate into 2023, though there are caveats about seasonality and the weather, while the manufacturing sector appears to be contracting. The apparent robust growth is problematic in the current environment, where "good news is bad news" on growth. Why would robust growth be bad news? In the current environment, strong growth raises the chances of the U.S. Federal Reserve (Fed) increasing interest rates too far and tipping the economy into recession.

"There are years that ask questions and years that answer."

– Zora Neale Hurston, American author

Through January, burgeoning signs of slowing inflation appeared encouraging and markets reacted to the prospect of the Fed pausing interest rate increases. Data through February, however, has tempered those expectations due to somewhat disappointing inflation data and conflicting incoming growth data. On net, growth data has been too strong, though with a great deal of uncertainty. In this note, we sort through the conflicting growth data, as it remains key to asset markets.

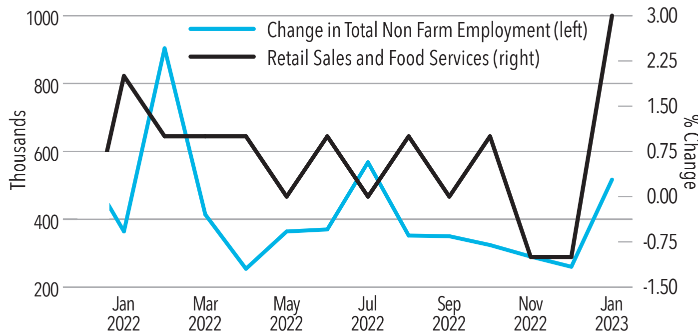
When it comes to growth, we are in the part of the economic cycle where "good news is bad news." Growth that is too firm elevates economic risks due to the current inflation situation. The Fed wants below potential growth—that is less than about 1¾%—to open up a bit of space in both labor markets and overall output. This implies that above potential growth would lead the Fed to tighten policy to pull growth below that level. However, since changes in policy show up in the economy with lags, the effects will take a while to be actually observed, making it hard to appropriately calibrate the correct amount of tightness. That is especially true as, in our view, recessions are probably non-linear beasts—there is a tipping point beyond which recessionary dynamics, which are distinct from normal economic dynamics, take over. So, the firmer growth data increases the risk that the Fed unintentionally hits that tipping point and pushes the economy into recession.

Real-time growth data is always murky, but the recent growth data has been even more so than usual, with some indicators showing too much strength, others not enough, and some in between.

In the clearly too strong category are the payroll and retail sales figures for January, though there are meaningful caveats that apply to both of those. Payrolls employment increased by 517k—well above the pace consistent with stabilizing the unemployment rate, given population growth, while retail sales jumped nearly 3%. Both of those, on their face, point at substantially faster growth into early 2023 than through late 2022, as shown in Figure 1.

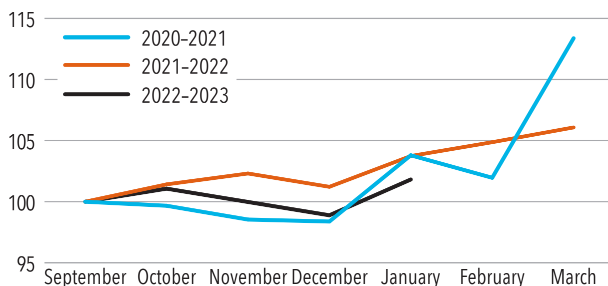
However, we are somewhat cautious on fully taking on board the sharp January increases, for several reasons. First, we have some concerns about residual seasonality, especially in the retail sales numbers, and to a lesser degree in the payroll gains. What could be happening? Anecdotal reports over the past couple years have referenced changes in the shopping habits of consumers around Christmas, with the supply chain issues that led to availability issues, causing consumers to move their shopping away from the period directly leading into the holiday. If seasonal adjustment doesn't correctly pick that up, and it takes time to pick up this sort of change in seasonal patterns, reported data would show softer retail sales growth in December, followed by a rebound in January. And that is exactly what we are now

FIGURE 1:
EMPLOYMENT AND RETAIL SALES



As of 31 January 2023. Sources: BLS, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

FIGURE 2:
RETAIL SALES AND FOOD SERVICES (INDEX, SEPT=100)



As of 31 January 2023. Sources: BLS, Haver, Stone Harbor Investment Partners For illustrative purposes only.

seeing as November and December registered meaningful declines in retail sales, over 1% in both months. Further, if we examine the previous two years, as shown in Figure 2, we detect the same pattern of weakness in November and December and then a January bounce. Compared to the two prior years, the current growth from September to January is weaker. We are also concerned that some of this might be reflected in payrolls, though the evidence there is less robust. Second, there was probably some boost from an unseasonably warm January that will fade over coming months. Figure 3 plots the heating degree day deviation for the U.S.; a negative number means a downward deviation in heating degree days—warmer weather. January 2023

FIGURE 3:
U.S. POPULATION-WEIGHTED HEATING DEGREE DAYS—DEVIATION FROM NORMAL

As of 31 January 2023. Sources: BLS, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

was a very warm month, and weather has a decisive effect on many economic data series, though obviously not the only factor.

Other data has been more mixed, though generally not showing the sort of sharp acceleration displayed by retail sales and payrolls, with manufacturing being an area of notable weakness. The ISM remains below 50 and dropped another point in January, while the regional manufacturing PMIs for February have generally been soggy. Manufacturing IP continues to sit around 2% lower than in the fall. Housing likewise appears to be a drag on overall growth. Housing starts continued to broadly decline; of particular note is recent weakness in multifamily starts, which had generally held up better. Existing home sales continued to decline into 2023, as well. There are some signs that the pace of decline in housing might be slowing. For instance, the homebuilder's index is showing a modest uptick, but the overall sector remains soft as higher rates drag on activity.

Jobless claims data—particularly valuable because of their timeliness—straddle the middle. After declining through January, initial claims have leveled off right around 200k. Continuing jobless claims have been roughly flat since late Q4. Taken together, claims show some support for a firming of the labor market in January, but a more modest firming than indicated by payrolls and not one that continued into February.

Where does that leave us? Looking across the broad swathe of incoming data over February, it does look like there has been some pickup in early 2023 growth, though probably a more modest pickup than the eye-popping headline numbers suggest. What is very clear from the reaction of the market, and to a lesser degree from Fed rhetoric, is that the incoming economic data remains central. With uncertainty high, data that pushes in one way (or the other) is going to be key. What are we watching in the data going forward? The inflation data remains the most important, but data points that help sort out underlying growth momentum are also very important. Given the potential issues we noted above on retail sales and payrolls, we are going to be watching the February numbers extremely closely for any potential giveback. As they come at a higher frequency, claims data remain useful, as well.

Our base case scenario of a "softish" landing remains in place, as we still expect enough reversion in the growth data in the near-term to calm worries that the Fed will need to be more aggressive with tightening. However, that process is not likely to come quickly enough to allow a very near-term pause. Therefore, we've added in several more hikes to our baseline, and as a result, lowered our growth expectations over the coming four quarters by 25 basis points. Globally, there is an offset from accelerating growth in China as their reopening proceeds apace. We assign a probability of 45% to this base case. We've also increased our probability on a harder landing since, as detailed above, the risks of overtightening now look higher. The disappointing inflation news leads us to take some probability from the more quickly receding inflation scenario. This adjustment reflects our judgement that if economic data is above trend, the Fed will likely not accept it, but instead act to restrain the economy even at the cost of a recession.

"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 that are already lagging, such as housing, 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, though anemic. Eurozone growth close to zero.
- China growth accelerates driven by reopening. The continuing housing slump and weak global growth prevent a more dynamic rebound, but the drag from housing wanes as policy has turned more supportive.
- Growth in other EMs also recovering as impact of China offsets drag from DMs, while monetary conditions starting to ease in H2. 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.
- Fed continues to increase rates by 25bp per meeting through 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 hikes ending in EMs in Q1. China remains a key exception with continued accommodative monetary policy.
- Oil prices little changed: ~$85/barrel WTI, Brent ~$90.

Central Bank-Led Global Recession

(40%)

- 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.
- China recovery stalls as global growth headwind and initially tighter financial conditions offset otherwise positive dynamics.
- Broadly, sanctions against Russia remain in place.
- Fed continues to hike rates topping around 6%. It then pauses as payrolls turn negative. As recession dynamics take hold, they reverse course and start to cut the funds rate. By Q1 2024, rates are back to around 2½% 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.
- EM economies shifting policy stance with more decisive cuts than in base case scenario.
- Oil: WTI at ~$55/barrel; Brent ~$60/barrel.

Inflation Reverses Course, Leading the Fed to Also Reverse Course

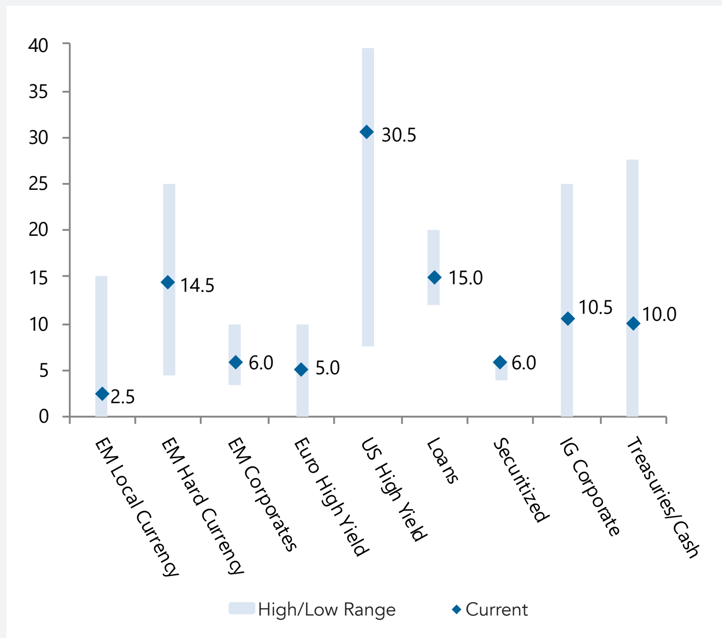
(15%)

- Fed continues to raise rates and fed funds rate peaks just under 5%.
- 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 ~$85/barrel; Brent ~$90/barrel.

	"Softish" Landing (45%)	Global Recession (40%)	Inflation Reverses Course (15%)
U.S. Real 4Q GDP (%)	0.50	-1.25	1.25
Fed Funds (%)	5.13	2.63	3.88
U.S. Core PCE (%)	3.40	2.75	2.60
2yr Treasury (%)	3.90	1.75	2.75
10yr Treasury (%)	3.50	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

[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	-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

[2]Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 31 January 2023. 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	3.91	3.17	2.73	4.29	3.04	3.57	3.48
Duration (Returns from Interest Rates %)	1.62	2.48	0.42	1.93	1.62	0.98	2.19
Credit Beta (Returns from Spreads %)	2.29	0.69	2.31	2.36	1.42	2.59	1.29

Month Ended 31 January 2023. 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.

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 **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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