INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

MAY 2023

The U.S. Fed Crossing Their Fingers to Be Done

In keeping with prior messaging and as widely anticipated, the Federal Open Market Committee (FOMC) hiked policy rate by 25 basis points earlier this month, bringing the target range to 5.00%-5.25%. While the Federal Reserve (Fed) suggested a potential for a pause in the next meeting, they remain in a commitment-free and data-dependent mode, and the actual evolution of the incoming data will determine whether or not rates end up still higher. The debate, therefore, over whether the Fed is done hiking or not remains live, with the market assessing the uncertainties around incoming data, evolving financial conditions, and the delayed impact of previous rate increases. We think it most likely that the data will cooperate enough for the Fed to pause, and that the pause will stretch into them being done.

"The right word may be effective, but no word was ever as effective as a rightly timed pause."

– Mark Twain

Earlier this month, the Fed opened the door to a pause in the rate hiking cycle, while raising the policy rate for the tenth consecutive time. Fed Chairman Jerome Powell pointed to signs that supply and demand in the labor market are potentially coming into "better balance," and that effects of policy tightening on demand are becoming evident, particularly in housing and business investment. The potential of a pause continued to be accompanied by language emphasizing the importance of inflation and the risk that the Fed may need to increase rates further if necessary. According to a Fed statement, "The Committee will closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." Importantly, the statement, "some additional firming may be appropriate" was removed.

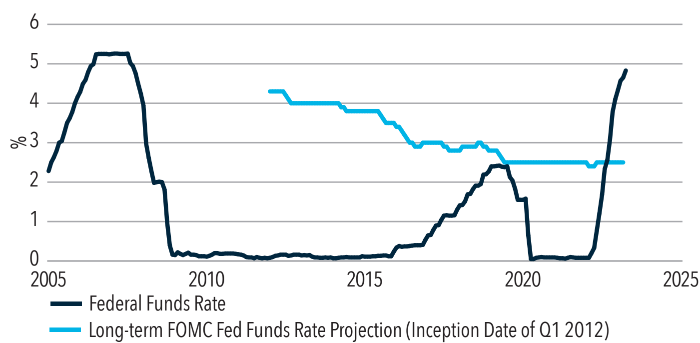
These statements highlight the debate around what the Fed will do next. Would the Fed like to be done? Yes. Is the most likely outcome of the next meeting a pause? We believe, yes. Are they done for sure? No, they could still hike either at the next meeting or a future one, even if it is not the most likely outcome, in our view.

The Fed steadfastly remains in what we have called a commitment-free zone. Indeed, the Fed has not given hard commitments in quite some time: all guidance for the past 18 months has been in the form of something they can walk away from. That has come both through various caveats or expressing future moves as potentialities, but the key is that they were not firm commitments. Firm commitments were needed at the effective lower bound to mold market expectations and, through those, overall financial conditions. That is no longer the case—if the Fed wants to change financial conditions, they can simply act. The Fed's discussions of their future actions continue to be phrased around what they "expect" or are "likely" to do. In other words, if the data changes, the Fed will change course. As we pointed out in the past, this does not mean that the Fed's thoughts on the future of policy should be given no weight, but rather that if there is incongruence between what they previously indicated as likely and the incoming data, the incoming data wins.

That said, let's start with where the Fed thinks they are. The FOMC, as a whole, thinks they have raised rates to the point of being restrictive. As Figure 1 shows, with policy rates up over 5%, the median FOMC member from the Summary of Economic Projections thinks they are currently well above their estimate longer-run neutral rate, which is 2 ½%. Indeed, over the course of this inflationary episode, the FOMC has not shifted their view on

neutral rates; these have been almost entirely flat since 2019. That is not to say the median can't shift going forward. From the inception of the projections through 2019, the estimate of the neutral rate fell from over 4% to 2 ½%, as participants responded to the persistently depressed economy by reassessing the neutral funds rate. But, so far, there has not been the same sort of reassessment despite the marked increase in inflation. It's certainly something to watch very closely as a move higher in the assessment of neutral rates could feed into the longer end of the curve and push rates higher. There has recently been a creep higher in the upper end of the range of participants' views on the neutral rate, which potentially foretells the median shifting.

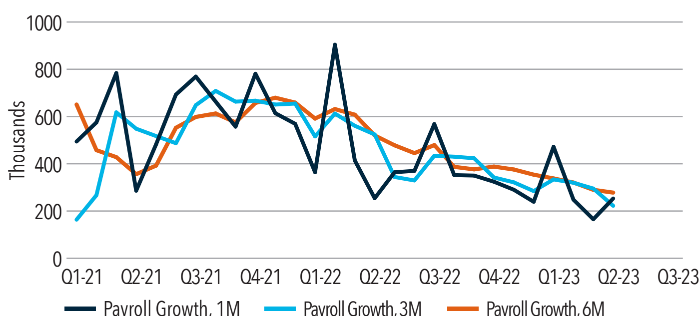
FIGURE 1:
RATES HAVE MOVED TO THE POINT WHERE THE FED THINKS THEY ARE CLEARLY RESTRICTIVE



As of 30 April 2023. Sources: Federal Reserve Board, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

Evidence across a range of data suggests that rates have indeed moved above neutral. In broadest terms, the economy has clearly slowed and most incoming data suggests a continuation of that slowdown. As an example, for a broad and important measure, the 6-month average payroll growth has dropped from nearly 500k in the middle of 2022 to just under 300k (see Figure 2). 300k is still too rapid, on balance, as over time the pace that would stabilize the unemployment rate is below 200k, and probably even closer to 100k. The economy could be moving closer to that—as the 3-month average is lower and two of the last three months are lower still.

FIGURE 2:
PAYROLL GROWTH CONTINUES TO TREND DOWNWARD

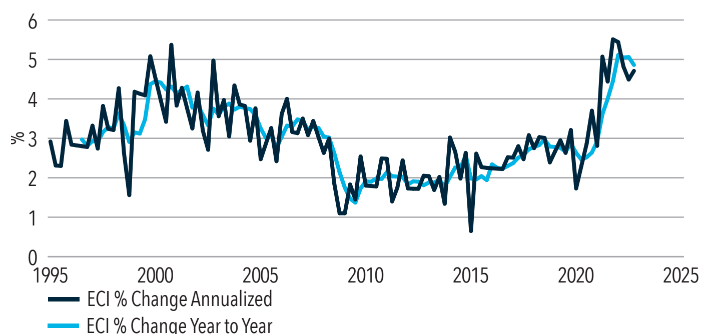


As of 30 April 2023. Sources: BLS, Haver, Stone Harbor Investment Partners. For illustrative purposes only.

Evidence from other data mostly, though not uniformly, points to the gradual slowing of overall growth continuing into the late spring. Weekly jobless claims, though with some noise induced by problems with fraud in Massachusetts, sit somewhat higher than the early spring. Regional Purchasing Managers' Index (PMIs)—both manufacturing and services—have been mixed, but broadly remain in contractionary territory. The mixed data theme is also apparent within the retail sales report, as headline sales were relatively disappointing, but the control group—ex autos, building materials, and gasoline—was stronger. One notable area that has shown signs of stabilization after a substantial move down is housing, where single family permits, and new home sales, moved higher from second half of 2022.

Turning to inflation and wages, most data has been somewhat lower, but one key data point has come in clearly too high. The Employment Cost Index (ECI) for Q1 was around 4¾% and Q4 was revised upward to nearly 5% (see Figure 3). This disappointment was an important one. That pace of wage growth looks too rapid to be consistent with 2% inflation, in our view. Other secondary signals of wage growth do show more ongoing slowing: wage indexes out of regional Fed PMIs, measures from the National Federation of Independent Business (NFIB) and average hourly earnings all show a bit more of a downward trend. But the ECI is the highest quality, so the high readings remain a concern, in our view. April's Core CPI services ex housing inflation was under 4% at an annual rate, better for the second month in a row, but also still elevated. Where does that leave us on the overall inflation picture? Taken together, we think there has been some moderate underlying improvement.

FIGURE 3:
EMPLOYMENT COST INDEX REMAINS TOO HIGH TO BE CONSISTENT WITH 2% INFLATION



As of 31 March 2023. Sources: Federal Reserve and Bloomberg. For illustrative purposes only.

The above discussion leads to what we think is perhaps the most important economic question right now: just how long are the lags in monetary policy, both for activity and inflation? In other words, are the effects of tightening still filtering through as we move from the spring into the summer? Despite the fact that much has been written about the topic with no shortage of estimates, there is still no consensus on the timing associated with lags of monetary

policy. Our best read of the literature and our own work estimates that it takes between 4-6 quarters for the economy to feel the full impact of rate increases. Since rates have continued to increase through Q2 2023, this implies to us that plenty of tightening has not yet been fully worked through the economy.

Taking all of the above into consideration, we think the most likely outcome of the June meeting is a pause. That is subject to change if the data on growth shows more pronounced reacceleration, but at this point, we think the Fed would like to see more data on whether the substantial tightening already done will be enough to sufficiently slow the economy. After all, while the Fed is willing to risk a recession, they would prefer to avoid it.

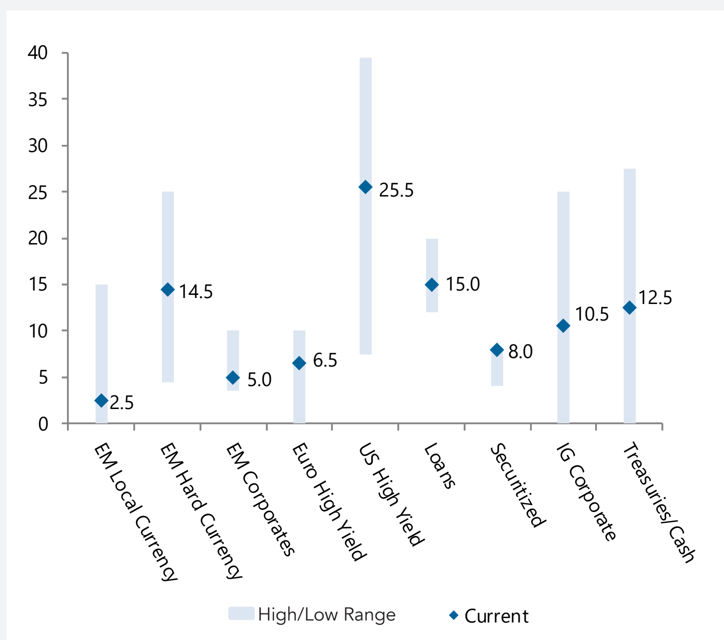
Our base case, at a 40% probability, remains a "softish landing" in which the Fed will avoid tipping the U.S. economy into recession, maintaining positive, though very slow, growth. Global recession risks, however, remain elevated. Tighter fiscal and monetary policies exacerbated by a credit contraction from persistent banking issues could eventually tip the global economy into a recession. We continue to assign a substantial probability to a global recession in the next 12 months at 40%. We assign a 10% probability to a scenario in which inflation remains sticky and the Federal Reserve has to raise rates over 6% to reduce growth and inflation. This scenario projects higher interest rates over the next 12 months and elevated recession risk thereafter. We also assign a 10% probability to inflation cooling more rapidly while growth remains below trend, causing the Fed to reverse course in late Q3 2023.

Scenario	Assumptions
"Softish" Landing (40%)	• 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, continue. • U.S. growth remains positive, though anemic. Eurozone growth slows from current solid pace. • China growth accelerates, driven by reopening. The continuing housing slump and weak global growth prevent a more dynamic rebound; housing drag wanes as policy has turned more supportive. • Growth in other emerging markets (EMs) also recovering as impact of China offsets drag from developed markets (DMs). Monetary conditions start 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 goods prices. By late Q2, labor market space starts to open, so inflation starts to moderate further, though run-rate is still above target • With short-term rates well above their estimate neutral, the Fed pauses to assess. Balance sheet runoff at sustained $95bn/month pace. • ECB pace remains at 50bp for the next meeting before dropping down to 25bp. • Rate hikes peter out in EMs. China remains a key exception with continued accommodative monetary policy. • Oil prices little changed: ~$8o/barrel WTI, Brent ~$85.
Global Recession (40%)	• Tighter fiscal and monetary policies combine with persistent banking issues and associated credit contraction tip global economies into recession. • Worries about commercial real estate losses and ongoing deposit flight drive credit crunch. • Growth fades further through the spring 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 and weakness spreads. • With contracting activity and sluggish consumer demand, inflation moderates rapidly. • European growth follows U.S. growth downward. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./Eurozone. • China recovery stalls, as global growth headwind and initially tighter financial conditions offset otherwise positive dynamics. • Broadly, sanctions against Russia remain in place. • Fed rate hikes continue in near term, taking rates up to nearly 6%. These finally stop as payrolls turn negative. As recession dynamics take hold, they reverse course and start to cut the funds rate. By Q2 2024, rates are back to around 2½%, with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. • ECB lifts rates by 25bp/meeting into the fall as inflation remains sticky, then pauses. Eurozone growth also stalls and then contracts. ECB likewise begins reversing hikes. EM economies shifting policy stance, with more decisive cuts than in base case scenario. • Oil: WTI at ~$55/barrel; Brent ~$60/barrel.
Stubbornly Sticky Inflation (10%)	• Growth and labor markets remain relatively solid through 2023, despite Fed hikes. • Inflation fails to moderate, stubbornly remaining around 5%. As a result, the Fed continues to push rates higher, and they sit above 6% by early 2024. • Market participants and the Fed broadly conclude that neutral real rates have moved substantially higher and some extended period of high policy rates is necessary. • Dollar is broadly quite strong. • European inflation also remains stubbornly high and induces a similar ECB response, as rates continue to push substantially higher. • EM benefits from stronger global growth. Global trade holds up better and commodity prices remain buoyant. • China's reopening-driven rebound extends in 2023. • Oil prices: ~$90/barrel WTI, Brent ~$95.
Inflation Reverses Course, Leading the Fed to Also Reverse Course (10%)	• Inflation proves more sensitive to slower growth than expected; core inflation rates drop quickly. Goods prices don't just stop increasing, but reverse some of the post-COVID run-up, while, with lower wage growth, services prices moderate. • With inflation cooling rapidly and growth below trend, the Fed starts to reverse course in late Q3 of 2023. Market prices in further cuts ahead and a rebound of growth back toward potential • Other DMs and EMs also see meaningful inflation and wage pressure moderation. As a result, there are similar policy rate pullbacks. • Dollar broadly gives back some of the outsize 2022 gains. • Oil: WTI at ~$80/barrel; Brent ~$85/barrel.

	"Softish" Landing (40%)	Global Recession (40%)	Stubbornly Sticky Inflation (10%)	Inflation Reverses Course (10%)
U.S. Real 4Q GDP (%)	0.50	-1.50	1.50	1.00
Fed Funds (%)	5.13	2.63	6.38	3.88
U.S. Core PCE (%)	3.25	2.75	5.00	2.60
2yr Treasury (%)	4.75	1.75	6.15	3.00
10yr Treasury (%)	3.50	1.75	6.00	2.75
10yr Bund (%)	2.50	0.25	4.75	0.75
China 4Q GDP (%)	5.75	3.75	6.25	6.00
EM 4Q GDP (%)	4.50	2.25	5.00	4.75

[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 April 2023. 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 2023	-1.0
Euro High Yield	Feb-Mar 2023	+6.5
U.S. High Yield	Jan-Feb 2023	-5.0
Loans	Jan-Feb 2021	+1.5
Securitized	Feb-Mar 2023	+2.0
IG Corporate	Oct-Nov 2022	+0.5
Treasuries/Cash	Feb-Mar 2023	-7.5

APRIL CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.97	0.53	0.95	0.86	0.88	0.50	0.81
Duration (Returns from Interest Rates %)	0.53	0.59	0.41	0.55	0.50	0.12	0.40
Credit Beta (Returns from Spreads %)	0.44	-0.06	0.54	0.31	0.38	0.38	0.41

Month Ended 30 April 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

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 **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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