Stone Harbor
INVESTMENT PARTNERS

27th January 2021

Stone Harbor 2021 Global Credit Seminar

Summary

Outlook for Global Credit Markets

Despite a turbulent 2020, we begin 2021 at the same portfolio yield levels of about 4.2% in our flagship Multi Asset Credit strategy as we did at the start of 2020. Whilst similar on the surface, the portfolio constituents generating this yield have changed materially. At the beginning of 2020 around 35% of the yield or about 150 bps was contributed by exposure to underlying government bond curves. Today, this contributes only contribute 10% or 50 bps, towards total portfolio yield, with the rest contributed by credit spreads.

This augurs for a change for the **sources of fixed income return** going forward. Traditionally, there have been 3 main sources: 1) duration, 2) asset allocation / credit beta, and 3) security selection. Given current yields for developed market government bonds, we do not expect duration to be a major source of returns going forward. Instead we expect asset allocation and security selection to be key drivers going forward, a significant change from what we have experienced over the past 3 years.

In terms of **risk** levels, while we entered 2020 with a cautious view on the back of low spreads and volatility levels, 2021 presents a different picture. With the exception of investment grade corporates, credit spreads are higher today than they were in 2020, despite retracement from the highs of the crisis in March/ April. The VIX Index, our preferred volatility measure, also currently stands in the mid-20s as compared to the low 10s this time last year. The combination of tight spreads and low volatility that we saw at the end of 2019 tend not to be great for credit spreads. Today, with volatility higher and spreads wider we encounter a different environment. Hence we believe solid returns from fixed income are achievable without much more additional risk, although the composition of returns will be different, more from credit risk and less from duration risk.

On the **macro** front, the recent rise in government bond yields suggest that markets have been concerned about potential inflation risks presenting. We disagree and view this as a tactical opportunity in duration positioning. Whilst we expect to see a big increase in Year-on-Year core inflation largely due to base effect, a deeper look into the current economic situation shows what we see as a significant output gap, with wage inflation misleadingly high due to a significant proportion of the lower wage earners being out of employment. With regard to growth, despite recent headwinds, the rollout of effective vaccines in combination with substantial additional fiscal stimulus following the Democrat wins in US elections point to the possibility of what might be some of the fastest growth in decades, nonetheless tempered by persistent output gaps and labor market slack. If the US, for example, was able to generate double the highest rate of job creation seen during the post GFC recovery it would still take until 2023 before we would only see the unemployment rate reaching pre-COVID levels. Our expectation is that the recovery in growth as it emerges will be broad based with emerging markets performing well. Any risk of divergence in growth between emerging markets (EM) and developed markets (DM) appears limited with Emerging Market countries potentially benefiting from younger less vulnerable populations and a broad array of vaccines.

Turning to central bank policy, we expect DM central banks, led by the Fed, to keep policy accommodative in a bid to aid employment and support growth. Importantly, structural changes such as the Fed's move to average inflation targeting, suggests to us a long runway for the central banks allowing them to keep rates low for the foreseeable future. In summary, despite strong growth and expansionary fiscal policies, we expect yields to remain low supported by large output gaps and little likelihood of any monetary tightening.

Asset class valuations look attractive. Current spreads for High Yield, EMD and Loans are higher than they were this time last year. In a longer context spreads remain high relative to their historical modal levels. With volatility elevated but growth likely to turn positive we believe there is room for spread compression and positive returns. Overall risk positioning should reflect this in our opinion.

From a cross asset class perspective, within the higher yielding asset classes, Emerging Markets Debt (EMD) Hard Currency valuations appear attractive to us, particularly relative to US High Yield spreads. It has to be acknowledged that most of this value is to be found in the high yield segment of the EMD market. Indeed investment grade EMD spreads are at 2019 levels. Flows are now turning supportive of this view with signs that these are no longer lagging those into other asset classes. In terms of portfolio positioning we currently maintain an elevated exposure to EMD Hard Currency but have chosen to hedge some of the risk via CDX where spreads are typically tighter and reflect the largely investment grade nature of the constituents.

We have increased EM Local Currency allocations. Real yields are high on a relative basis and positive yield curves suggest to us that bonds offer a level of carry not seen for a long time. Combine that with what appear to be cheap currency valuations against a strong US dollar valuation and a substantial positive turn in current account deficits and it can be seen that relative valuations look more attractive than they have for many years in our opinion.

Within higher yielding developed market corporate bonds we increasingly favour US High Yield over Bank Loans. This reflects a combination of factors; higher average credit quality in High Yield versus Loans; a use of funds pattern in High Yield that is more orientated to balance sheet improvement unlike loans issuance which is more linked to M&A and LBO activity, and flow patterns which suggest a degree of caution around loan market liquidity.

One concern that investors have raised is the prospect of an elevated number of "zombie" companies, those that need to borrow to support ongoing activity. Clearly the current low levels of economic activity have contributed to this but it was observed that this is temporary and it is better for the economy to maintain companies for the recovery phase than see them fold now. From that perspective, a positive financing environment which bridges companies to the future is both positive for credit markets near and long term. However as we move beyond the pandemic we believe it is likely that a more normal functioning of credit markets is likely to return and in that environment it will be necessary to highlight the survivors and the industries from which they are likely to come. Sector views will be particularly pertinent during this period.

Pivoting to our **sector views**, 'Stay at home' related sectors such as consumer staples did well, as did energy, basic industries, and metals and mining, in 2020. As the situation improves, we would expect travel, gaming, airlines and other hard-hit industries to rebound a little (as they have already) but would also expect tailwinds and issue selection opportunities in idiosyncratic industries such as healthcare, where consumption has been delayed, and apparel if purchases increase in line with a reduction in working from home.

In **conclusion**, we believe credit portfolios are likely to generate positive returns in 2021. We believe those returns are more likely to come from credit spread compression rather than any significant move in government bond yields which we expect to be broadly stable. Asset allocation opportunities should reflect the overall attractive valuations of markets, in our opinion, and within these the relative attractiveness of the emerging markets. Opportunities still exist within developed market corporates where some fundamental changes to market structures suggest to us that relative value assessments may favour High Yield over Loans.

Integration of ESG into Credit Portfolios

The importance of recognizing ESG risks – and identifying opportunities – is increasingly recognized by investors. While the focus for ESG investing has traditionally been on governance, the **environmental** aspect has now moved to the forefront when we evaluate corporates, both investment grade and high yield. Incidents such as pollution from oil and gas production and collapsing dams have direct impact on the financial performance of a company, and hence incorporating ESG analysis into investment decisions is key. In emerging markets (EM), whilst governance has traditionally also been the factor that people focus on, focus on environmental issues have been growing and policy changes such as a government's plan to decarbonize have direct impact on economic performance. In addition, **social issues** drive politics and hence directly influence policy changes.

Scoring companies on ESG factors remains a challenge, as such a process requires assigning quantitative values to often qualitative factors. As such, the efficacy of utilizing **ESG data providers** has also been of interest to investors. Their methodologies can vary significantly. Some are more driven by their background which

influences the weights they apply to different ESG factors, and we have seen providers which rely more heavily on databases and take a more quantitative approach to evaluating companies on ESG. We have seen a proliferation in specialized ESG data providers while traditional credit rating agencies have also started providing such services.

In terms of trends within ESG, there has been a bias for European companies to score better than American companies who in turn tend to score better than EM companies. We believe that this is natural as the ESG movement started in Europe, has migrated to the US and is now building in EM. We believe the scores reflect the stage of ESG development in each region. Another trend that has been observed is that larger companies typically score better than smaller companies, although this then begets the question of whether better ESG scores are a function of better resources. As investors, we hence believe that it is critical to have our **own process** to account for these biases. For example, should a smaller company make a proportional effort to improve, we believe that their efforts should be recognized in their ESG score.

At Stone Harbor, we believe that while such external data providers are useful, it does not substitute for our own analysis. We have hence incorporated our own ESG analysis into our investment process and this can certainly lead to different outcomes relative to data providers. We believe that the **forward looking** aspect of our analysis is critical in determining investment outcomes and we seek to capitalize on improving issuer trends. Additionally, as issuers recognize the importance of ESG we have in turn seen the data provided improving significantly. Our fundamental research driven process also leads us to engage both sovereign and corporate issuers on ESG matters. While some may believe that it is not possible to **engage** issuers at a sovereign level, our process allows us frequent contact with government officials and we believe governments increasingly recognize that markets reward improvements in ESG.

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