Investment Policy Statement

A monthly review of the markets

What History Tells Us about Market Recoveries

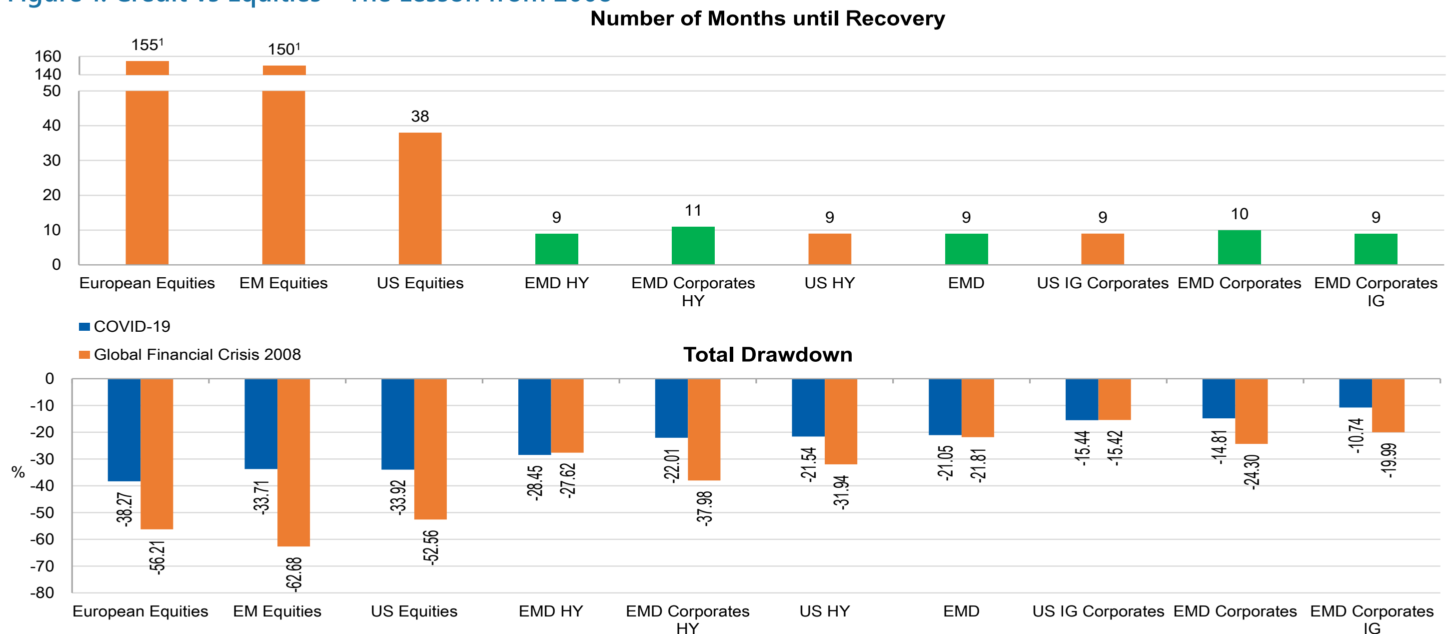
"Losing your head in a crisis is a good way to become the crisis."
-C.J. Redwine

The past several months have been marked by massive disruptions in the financial markets and, more importantly, loss of lives on a global scale. The devastating spread of the novel coronavirus (COVID-19), a dramatic drop in oil prices, and the tumultuous civil unrest in the US shined a bright light on the vulnerability of people and systemic shortfalls of nations. By all measures, this was a challenging period of extreme market volatility, where the VIX volatility soared from 14% at the end of 2019 to a high of 87% in mid-March 2020. The S&P index fell over 30% and credit spreads widened across all fixed income sectors.

The spread of the pandemic and the resulting collapse in economic activity that carried the threat of financial contagion necessitated a rapid and comprehensive government and central bank intervention to help mitigate some of the economic damage. The US Federal Reserve (Fed) implemented aggressive quantitative easing, including corporate bond purchases, and set in motion various crisis era liquidity facilities; and the European Central Bank (ECB) accelerated the purchase of government bonds. In other advanced economies, central banks that had policy rates above zero moved to cut them; and the Bank of Japan increased the amount of asset purchases. Across emerging markets (EMs), policy makers – many having limited room for fiscal expansions – focused on interest rate cuts, and some countries took additional steps to support proper market functioning and liquidity in key financial markets, especially in the foreign exchange (FX) markets.

Despite the unique circumstances surrounding the market dislocation, we believe it is important to reflect on market behavior during prior external shocks. The Global Financial Crisis (GFC) of 2008 provides a proximate, albeit imperfect,

Figure 1: Credit vs Equities - The Lesson from 2008



Data as of 31 May 2020.

[1]MSCI EM and Euro Stoxx still has not recovered since 10/31/2007 and 5/31/2007 high.

Benchmarks: European Equities: Euro Stoxx, EM Equities: MSCI Emerging Markets Index, EMD HY: JPM EMBI GD HY, EMD: JPM EMBI GD, US HY: ICE BofAML US HY Constrained, US IG Corporates: Bloomberg Barclays US Corporate Index, EMCR: JPM CEMBI BD

Please refer to endnotes for benchmark definitions. Past performance is not a guarantee of future results. For illustrative purposes only.

point of reference. During the GFC, the magnitude and duration of drawdowns were larger and longer for major equity benchmarks than for credit indices (see figure above). We believe one reason for this reaction is the pull to par in fixed income assets; that is, as long as obligors pay, investors in credit fixed income, unlike in equities, are paid to wait. Looking back at the past 25 years, we note in particular that significant drawdowns for the JP Morgan EMBI Global Diversified, the market tracking index for US dollar-denominated emerging markets sovereign debt, have been followed by significant returns, with 12-month returns averaging over 21% following the 15 worst monthly return periods.

Based on historical record of large drawdowns and our analysis of credit market dynamics, we believe that the COVID-19-related volatility offers investment opportunities in credit markets, EMD in particular. The unprecedented policy support in developed markets (DM) are likely to have broad global impact. What we typically anticipate and have seen in past episodes of significant market dislocation is that as DM economies recover, global demand improves with direct spillovers to EMs. At the same time, global financial conditions ease, which lends significant growth implications for EMs. Apart from benefitting from DM developments, emerging markets are also being supported by IMF lending programs, as well as by other multilateral lenders and liquidity provision from the Fed. While some EMs will use the additional support offered, others have tools to manage by themselves. In contrast to previous crises, many EM central banks are now in a position to cut policy interest rates, and so far have avoided the vicious cycle of tightening domestic liquidity to defend exchange rates that are under pressure from a slowing growth outlook.

We believe current spread and price levels in EM credit markets already reflect dire economic scenarios over the next 12 months and that EM credit markets will eventually recover. We acknowledge risks to our view: the spread of the coronavirus could accelerate further and trigger sharp lockdown measures, and many EM country healthcare systems remain ill-equipped for a surge in transmission. Oil prices are likely to remain under pressure due to reduced global energy demand.

Our base case macroeconomic scenario assumes that developing and advanced economies will broadly continue to gradually ease lockdown restrictions and economic activity will return, though not to pre-virus levels. Although some regions may see spikes – as is happening now in several US states – our baseline assumption remains that most economies avoid a global lockdown of the scale instituted in the spring. Across the globe, further fiscal support will buttress economies and consumers under stress. Central banks will mainly focus on implementing existing policies. We expect that the US Fed will further extend its balance sheet through asset purchases under the panoply of programs they have instituted, as well as ongoing purchases of Treasuries and mortgage-backed securities. We also expect enhanced forward guidance – aimed at keeping rates low – to come at one of the next several meetings and be explicitly tied to economic conditions. In EM, we expect central banks to continue easing monetary policies alongside government support and borrowing from multilateral and bilateral lenders. While EM GDP growth will drop this year, we expect a sharp recovery to 6.5% GDP growth in 2021 as countries reduce restrictions on mobility and commerce. In this scenario, we expect continued spread tightening in EM external sovereign debt. We will be closely monitoring the incidence of testing rates, hospitalizations and deaths from the virus in the coming months as EM governments grapple to find a balance between economic activity and health risks.

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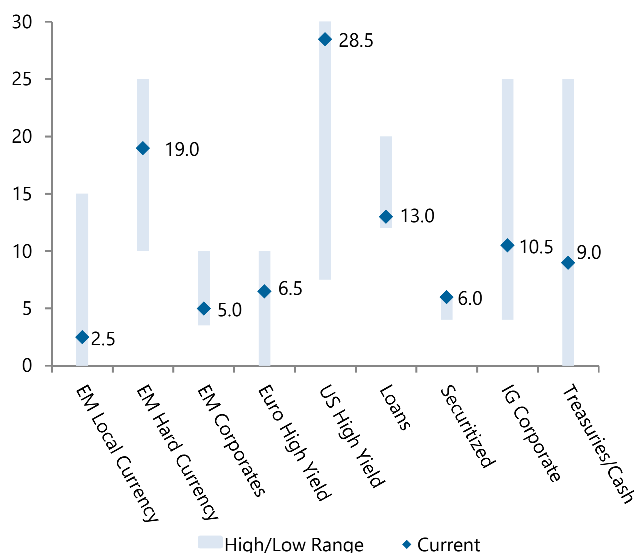
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Scenario	Assumptions
Base Case: Economies Reopen to 90+%, Slow Grind Higher (45%)	• Lockdowns continue to be eased. Coronavirus transmission continues, with local spikes. Most countries and states avoid returning to broad lockdowns. • Some government restrictions remain in place; people continue to social distance. Travel, restaurants, sports, conventions and large gatherings deeply depressed. • Measures are enough to keep spread to a manageable level, and severe measures not reinstituted. Vaccine available around late Q1-2021. • Across the globe, further fiscal support put into place to buttress economies and consumers that remain under stress. • Central banks mainly focus on implementing existing policies. For the Fed, that means the wide-ranging extension of credit worth about $2tr along with ongoing direct purchases of Treasuries and MBS. However, with the shock looking lasting they strengthen forward guidance. • Financing from Fed and Treasury successful in bridging over the demand shortfall for most companies. Defaults and bankruptcies increase but remain limited. • European work-sharing programs support employment. EU-wide coordination improves, but remains somewhat disjointed. • Oil rebounds: $35-40/barrel WTI, Brent $40-45/barrel. • Dollar broadly remains strong—flight to safety.
China/US "Phase 1" Deal Unravels: Base Case on Coronavirus (15%)	• Base case mostly holds on virus front, but tensions resurface in the US-China relationship. The "Phase 1" deal unravels. • As a result, the US significantly increases tariffs on Chinese goods. Non-tariff relationships—virus cooperation, vaccines, intellectual property, cyber-spying, etc.—prove very contentions. • Financial market dislocations return as the US-China conflict escalation causes concern. Various Fed facilities see increase in take-up as market financing harder and more expensive to attain. • Further drag on US growth, though relatively modest: about 50bp. • Oil prices hit: ~$30-35/barrel for WTI; Brent ~$35-40. • Non-China-related DM policies largely as in base case.
V-Shaped Recovery (25%)	• Lockdowns eased over coming months. Initially substantial government restrictions remain. • Virus spread/virulence less than feared, from some combination of effective anti-transmission mechanisms, substantially higher asymptomatic, an early-than-expected vaccine or better pharmaceutical treatment reducing fatalities. • With better-than-expected outturns the remaining restrictions are eased and supportive fiscal and monetary policies gain traction, boosting growth. • By the end of Q3 the economy is operating at a slightly depressed level. Unemployment rise restrained by additional labor necessary to maintain containment. • Fiscal policies start to be dialed back. • Fed maintains accommodative policy, but doesn't feel need to push further. Similarly for ECB. • Oil: WTI at $45-50/barrel; Brent $50-55/barrel.
Major Second Wave of Coronavirus Spread Reactivates Lockdowns (15%)	• Lockdowns eased over coming months. Meaningful government restrictions remain in place and people continue to voluntarily social distance. Travel, restaurants, sports, conventions and large gatherings deeply depressed. • Coronavirus spread reaccelerates—either from ending containment measures too early or pronounced seasonality in virus transmission. • Asian (China, South Korea etc.) countries are not immune as second wave pops up there as well. • Restrictive lockdowns reinstituted as a result. Those remain quite restrictive until a vaccine starts to be broadly available around Q1-2021. • The hit to economic activity is severe and many temporary layoffs turn permanent. • Fiscal measures are ramped up. Government intervention/support in the economy increases notably (e.g. production coordination for virus-related equipment). • Fed institutes yield curve control (YCC) and pegs 10y at 0.25%. Numerous additional financing facilities put in place, and Fed pushes further out risk spectrum. • Defaults and bankruptcies increase meaningfully. • EU forced to issue Eurobonds. ECB substantially expands asset purchases. • Oil returns to $20/barrel for WTI & $25 for Brent.

	Base Case: Economies Reopen to 90+%, Slow Grind Higher (45%)	China/US "Phase 1" Deal Unravels: Base Case on Coronavirus (15%)	V-Shaped Recovery (25%)	Major Second Wave of Coronavirus Spread Reactivates Lockdowns (15%)
US Real 20 GDP (%)	-7.50	-8.00	-5.00	-9.00
US Real 21 GDP (%)	8.00	8.00	8.50	4.00
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.25	1.15	1.75	1.00
2yr Treasury (%)	0.13	0.13	0.50	0.13
10yr Treasury (%)	0.60	0.45	1.25	0.25
10yr Bund (%)	-0.45	-0.55	-0.30	-0.75
China 20 GDP (%)	1.00	0.50	3.00	-0.50
China 21 GDP (%)	9.50	9.00	8.00	10.50
EM 20 GDP (%)	-1.50	-2.00	1.50	-3.50
EM 21 GDP (%)	6.50	6.00	5.00	8.00

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

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION AND RECENT ALLOCATION CHANGES[2]



Allocation Changes[3]		
	Month	Change (%)
EM Local Currency	April-May 2020	-2.5
EM Hard Currency	April-May 2020	+2.5
EM Corporates	May-June 2018	+1.5
Euro High Yield	Feb-May 2020	+3.5
US High Yield	Jan-Feb 2020	+18.0
Loans	Feb-Mar 2020	+1.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Aug-Sept 2019	+3.0
Treasuries/Cash	Feb-Mar 2020	-3.5

[3]Latest allocation change

[2]Since Inception: September 2013. Multi-Asset Credit Representative Target Allocation as of 31 May 2020. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

MAY CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	4.54	6.07	3.80	5.18	3.91	2.93	1.19
Duration (Returns from Interest Rates %)	0.11	-0.17	0.11	0.03	0.06	-0.33	-0.26
Credit Beta (Returns from Spreads %)	4.43	6.24	3.69	5.15	3.85	3.26	1.45

Performance reflects representative asset class benchmarks. HY: ICE BofAML US 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 Barclays Global Agg Corporate Index; Loans: S&P/LSTA Leveraged Loan Index; Past performance is not a guarantee of future results. For illustrative purposes only.

Stone Harbor Investment Partners

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation.
- 100% employee-owned
- Over 25-year performance history
- Offices in New York, Chicago, London, and Singapore.
- Total assets under management: USD 16.1 billion as of 31 March 2020

Stone Harbor Investment Partners LP manages institutional clients' assets across a range of investment products including multi-sector credit, emerging markets debt, core fixed income, securitized, high yield, and bank loan strategies. Across all strategies, we seek to generate attractive risk-adjusted returns through a disciplined process of fundamental credit analysis complemented by solid portfolio management skills and sound risk management. Experience, teamwork and dedicated client service - the cornerstones of our success - help us achieve sustainable results.

New York	Chicago	London	Singapore
31 W. 52nd Street	10 S. Riverside Plaza	48 Dover Street	9 Temasek Boulevard
16th Floor	Suite 875	5th Floor	#09-03A Suntec Tower Two
New York, NY 10019	Chicago, IL	London, W1S 4FF	Singapore 038989
+1 212 548 1200	+1 312 492 4251	+44 20 3205 4100	+65 6671 9711

Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets

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 **MSCI World Index** is a broad global equity index that represents large and mid-cap equity performance across all 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of January 2009 the MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The **S&P 500 Index** is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

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 **STOXX Europe 600** Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 17 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

The **Bloomberg Barclays US 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 Barclays 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.

Important Disclosures

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