June 2021

Stone Harbor
INVESTMENT PARTNERS

Investment Policy Statement

A monthly review of the markets

A Holding Pattern Until Incoming Data Helps Us Answer Some Big Questions

"It is a capital mistake to theorize before one has data."

–Sherlock Holmes

As we move into the heat of summer, we find ourselves in a bit of a holding pattern on the overall direction of the economy. A number of meaningful economics questions loom, and hence we will be watching incoming data closely to assess how things will develop. While many of the most important questions are US-centric, we are as always looking globally, and to the emerging markets (EMs) in particular.

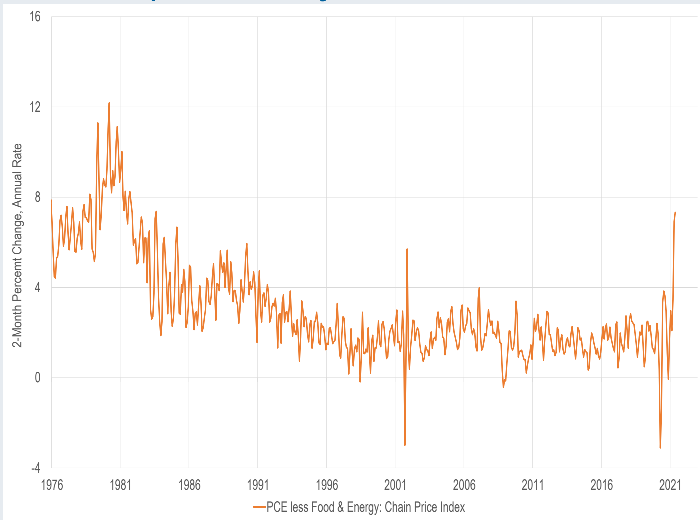
Perhaps the most important question is not economic but medical and social. Vaccinations have proven to be very effective, and the rotation of rapid dosing from the US to other developed markets now appears to be well underway. Unfortunately, that comes with the important caveat "when they are taken." Vaccine hesitancy is an issue in the US, but has yet to show up in cases – something we'll be watching.

With what has been a recurring theme over the past year – the current situation doesn't offer much precedent upon which to base our understanding, and certainly not our thoughts about the future. As a consequence, around our broadly constructive baseline, we think the most prudent approach as economists and investors may be to discover our humility, reserve judgement, and await the data to tell us what is coming.

As the virus takes less of a role as an economic driver, we look toward how reopening activity flows through to the economy and important questions about interconnected impacts on inflation, labor, wages, and growth.

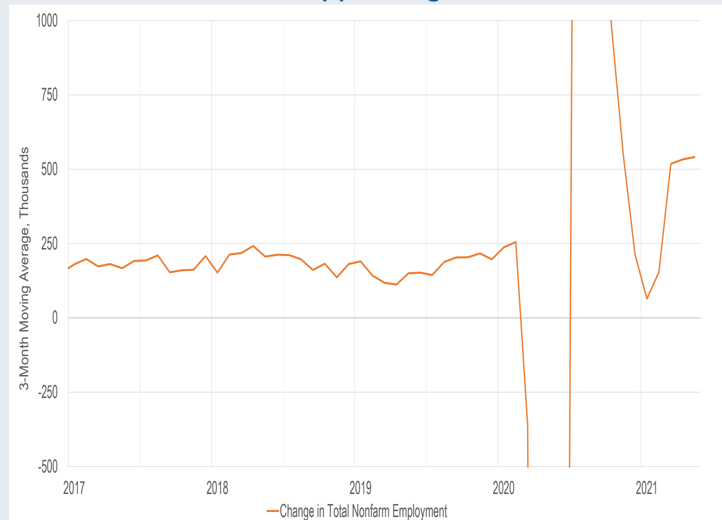
Is the current inflation rebound transitory or not? Core Personal Consumption Expenditures (PCE) increased by over 1.2% in just the last two months—by far the most rapid two-month increase in over 30 years. It's unclear exactly how much of that is transitory and just where we are right now, as reopening price reversions continue to be large contributors and concentrated in pandemic-related categories such as airlines, used cars, lodging at hotels, rental cars, and car insurance. An important factor in the persistence of inflation will be if the higher inflation readings spill over into inflation expectations. Broadly, inflation expectations have moved higher, but only back to the level they were at during the first half of the last decade, when inflation was too low rather than too high. There are signs of the

Figure 1: Last Two Months of Core PCE Inflation Most Rapid Since Early 80s



As of May 2021
Source: Bureau of Economic Analysis, Haver Analytics

Figure 2: Average Payroll Growth Good in Normal Times, But Disappointing Now



As of May 2021
Source: Bureau of Labor Statistics, Haver Analytics
Please note Y-Axis is truncated

increase stabilizing: last week's reading on expectations 5-10 years out from the University of Michigan survey dropped back down to 2.8% from 3.0%.

Does the pace of job gains pick up as we move toward fall? While job gains over the last several months would be very good in normal times, at roughly 500,000 per month over the last three months, they disappoint; the current pace would take several years to achieve the pre-Covid labor market. We will be watching to see if that picks up through the summer, though will likely need to wait for a cleaner read as, by then, (a) Covid will be less salient, (b) in-person school will likely be back in session reducing child-care issues, and (c) most expanded unemployment benefits will fade.

The more concerning prospect is that the easy gains were already made as firms recalled temporarily laid off workers, and forming new employer-employee matches will take longer, perhaps limiting the pace at which jobs can be added economy-wide. A possible positive sign is that companies have increased HR hiring, assumedly in hopes to hire more workers, which may help increase the pace of job gains.

Will wages pick up meaningfully across the economy? Wage growth has recently increased in pandemic-related sectors. Leisure & hospitality—where we've seen the most anecdotal reports of shortages—has led with annualized gains in Average Hourly Earnings (AHE) of around 17% over the last three months. Retail trade and trade transportation and warehousing have also seen rapid gains, though not as stratospheric as leisure & hospitality. Thus far though, the more rapid wage gains have not spread to higher compensation sectors, and have in fact decelerated in fields like IT and education/health. The Atlanta Fed's wage growth analysis, which tracks continuously employed workers, has not accelerated, so for now the pickup appears mostly contained to the newly hired.

How much will US growth slow? In the US, the vaccine-fuelled reopening has ramped up growth; Q2 looks to be well above 10%. We expect that pace to slow into H2 as many of the pandemic-restricted activities resumed in Q2 and as the substantial fiscal stimulus from earlier this year is fading, and turns to a drag on growth. Early indicators are mostly consistent with a slowing pace: retail sales slipped slightly and overall consumption was essentially flat, though regional services Purchase Managers Indexes (PMIs) have been strong.

What about other developed markets? While Europe's total vaccinations delivered still lags the US, the current pace of roughly 3.5 million vaccinations daily is well above the US's current pace—they are and will continue to catch up. We expect that to translate into activity with Q3 looking to be the equivalent of Q2 in the US with growth of over 10%. Turning to Japan, after an even slower start the vaccination pace has surged over the past month. That should also flow into growth numbers, though with fewer intense shutdowns there may be a bit less ground to be recovered.

How quickly can EM vaccine activity catch up to the developed world? Growth is still being hampered in many EM countries by persistent Covid spread. While economies are coping much better through the most recent waves, the full resumption of activity in important sectors, like tourism, will depend on vaccination progress. The vaccination pace is already up noticeably and we expect further acceleration in Q3 but uncertainty remains as to the effectiveness of various vaccines used in EMs against the more aggressive new Covid variants.

In EMs, will the recent commodity price-driven pickup in inflation rates develop into broader price pressures? We have already seen some pass-through to core inflation indices in EMs, in line with usual patterns, but the development of broader inflation pressures would hinge on continued accommodative policies as growth accelerated further. Monetary policy is already being tightened across various EM economies and fiscal policy has played a much smaller role than in developed markets. Thus, policy stimulus is unlikely to be a key driver of inflation acceleration in EMs.

Are the recent rate hikes in EMs harbingers of more to come? Several EM central banks have already started hiking cycles with additional rate hikes priced in, as the fear of broader global inflation pressures emerging while the recovery continues is keeping EM yield curves steep. This makes it easier for central banks to deliver hikes as needed and so far EM central banks have been surprising on the hawkish side this year.

An array of varied data will be filtering in and we expect it will take at least through the summer and into the fall to make substantial progress on answering these questions. That said, data will be noisy and spread across multiple indicators. Assessment will require digging into the details, and even then, clarity isn't going to come quickly.

US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Vaccine Led Rebound Continues, But Slows Modestly into Late21-Early22 (50%)

- Vaccine take-up continues but doesn't reaccelerate. Vaccines continue to provide decent protection against variants but COVID circulates at a low level.
- Travel, restaurants, sports, conventions and large gatherings improve further over the summer.
- Vaccines become broadly available across EM countries by late-21/early-22. Some EMs ramp up vaccination by late summer.
- US stimulus continues to support growth over next several quarters. Q2 is the local growth peak for the US; H2 growth is above trend, but notably slower.
- Other DMs continue to provide fiscal support. Their most rapid growth occurs in Q3.
- US/China tensions remain cooler, but do not return to pre-Trump status quo.
- The Fed and other DM central banks look through the current increase in core inflation. Core inflation—in yoy terms—drops back to around 2¾% over 2021.
- DM central banks maintain stimulatory policies. Fed continues to discuss tapering and provides more detail in late summer /early fall. After the FOMC penciled in two 2023 hikes at the June meeting, discussion continues about timing of rate hikes in 2023, but growth isn't fast enough to pull them meaningfully forward.
- More EM central banks start gradual rate hikes.
- Oil moderates slightly: ~$60/barrel WTI, Brent ~$65.
- Dollar broadly weakens over 1-year horizon, partly due to closing of interest rate differentials and partly from lower US real rates associated with Fed policy shift.

Stimulus & Vaccines Power Rapid Growth into 2022 (25%)

- Economic activity accelerates as stimulus and vaccination turn into a full-on boom for the US. Payrolls growth reaccelerates to a pace near 1mn per month and growth remains rapid in H2.
- Europe follows the same path, with a lag, as their vaccinations continue at the current rapid pace. European activity rebounds rapidly in the summer; H2 growth proves even higher than the US as more ground to be made up.
- DM Asia remains in relatively good shape with vaccinations increasing through Q3. EM countries start ramping up vaccines by late summer.
- The Democratic Senate moves on to infrastructure and passes a meaningful bill; the infrastructure spending starts to boost GDP by early 2022.
- Supportive monetary policies gain traction and inflation remains contained.
- Fed tapering as above. Discussion of rate increases earlier in 2023, with late 2022 also mooted, comes in the context of more rapid labor market gains.
- Improvement is global.
- Oil: WTI at ~$70/barrel; Brent ~$75/barrel.

Variants Derail Vaccine-Led Recovery (5%)

- Coronavirus variants prove resistant to current vaccines; the new strains spread rapidly. As a result the recovery dips back down as governments reinstate social distancing and other restrictions.
- With activity falling back down, economic scars turn lasting.
- The scars come from a variety of lingering effects: 1/ business bankruptcies increase; 2/ risk taking sentiment is depressed leading to less investment and fewer new business formations; 3/ layoffs turn permanent and unemployment rates increase in many countries and 4/ elevated sovereign balance sheets lead to payment stress in some countries.
- Malaise not limited to the US: other DMs and most EMs substantially underperform expectations through 2021 and into 2022.
- Fed institutes yield curve control (YCC) and pegs 10y at 0.25%. Additional financing facilities put in place; Fed pushes further out risk spectrum.
- Trade tensions persist, as in the base case.
- Dollar sees renewed flight to safety support.
- Oil prices hit by lower growth: ~$35-30/barrel for WTI; Brent ~$30-35.

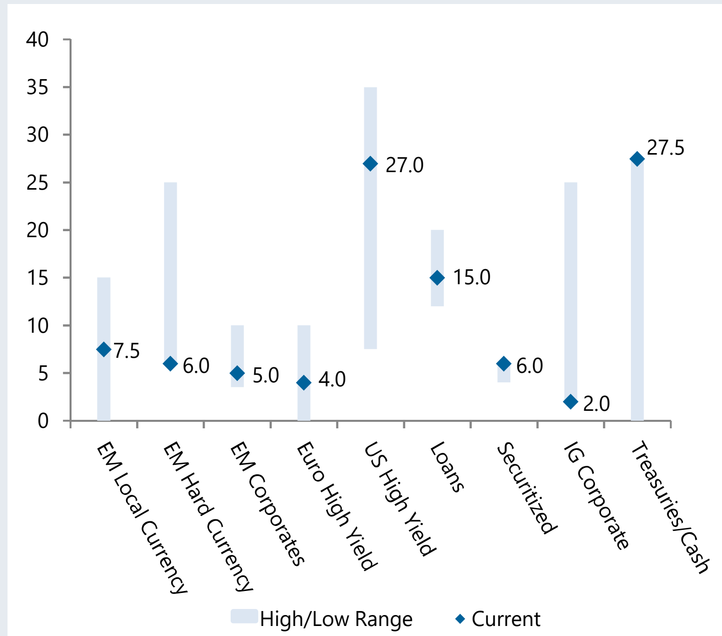
Inflation Accelerates (20%)

- Stimulus induced demand crashes into still constrained supply, and firms respond by raising prices. Facing tight labor supply, firms start to materially bid up wages attempting to pull workers off the sidelines.
- Recent inflation surprises prove durable: there is no reversion to below 3% over the summer.
- Core inflation remains elevated and is 3% heading into the end of 2021 for the US. Inflation also drifts higher in other DMs.
- Despite the rise in inflation, central banks initially maintain accommodative policies. But with inflation remaining high tapering is pulled into the end of 2021 rather than early 2022 and the taper is steeper. Along with reduced asset purchases the central banks indicate that policy rates will rise much sooner than previously anticipated.
- Rates move sharply higher along the curve.
- Interest rate sensitive sectors start to drag, but that is offset in the broader economy by growth elsewhere.
- Oil prices rise notably with growth and inflation fears: WTI to $75/barrel, Brent $80/barrel.

	Vaccine Led Rebound Continues, But Slows Modestly into Late21-Early22 (50%)	Stimulus & Vaccines Power Rapid Growth into 2022 (25%)	Variants Derail Vaccine-Led Recovery (5%)	Inflation Accelerates (20%)
US Real 4Q GDP (%)	5.50	7.00	2.00	5.50
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.80	2.00	1.10	2.75
2yr Treasury (%)	0.55	0.80	0.13	1.10
10yr Treasury (%)	1.85	2.35	0.25	2.75
10yr Bund (%)	-0.10	0.20	-0.75	0.85
China 4Q GDP (%)	5.50	6.00	4.50	5.50
EM 4Q GDP (%)	5.00	6.00	3.50	4.50

[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	Dec-Jan 2021	+2.5
EM Hard Currency	Apr-May 2021	-10.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	May-June 2020	-2.5
US High Yield	Apr-May 2021	-5.0
Loans	Jan-Feb 2021	+1.5
Securitized	Mar-April 2019	+1.0
IG Corporate	Apr-May 2021	-1.0
Treasuries/Cash	Apr-May 2021	+16.0

[2]Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 31 May 2021. 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	0.29	1.06	0.58	2.49	0.65	0.25	0.50
Duration (Returns from Interest Rates %)	0.26	0.33	0.08	0.31	0.27	-0.06	0.20
Credit Beta (Returns from Spreads %)	0.03	0.73	0.50	2.18	0.38	0.31	0.30

Month Ended 31 May 2021. 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. Returns are shown gross of fees. 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 30-year performance history
- Offices in New York, London, and Singapore.

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.

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 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 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.

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