July 2021

Stone Harbor
INVESTMENT PARTNERS

Investment Policy Statement

A monthly review of the markets

Inflation "Driven" Upwards

"It's not time to worry yet"

–Harper Lee, to Kill a Mockingbird

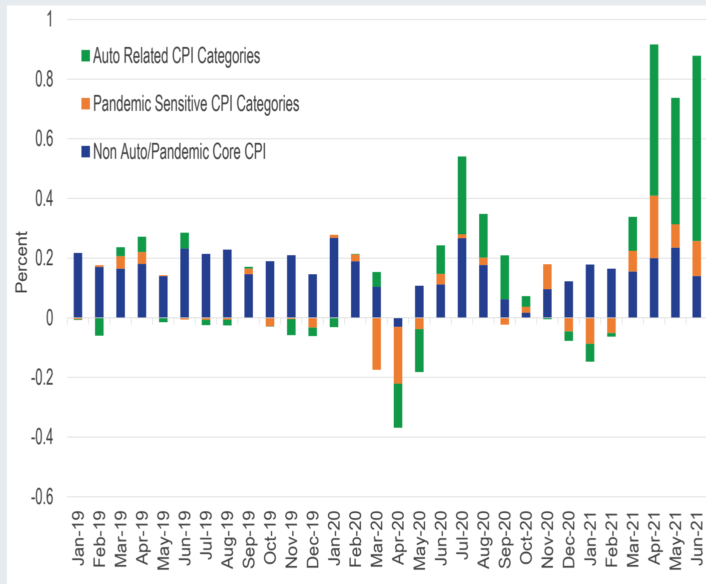
Since we last wrote on US inflation, it has surprised significantly to the upside. While we expected a notable increase in year-over-year rates this spring due to base effects as we lapped the very low readings from last year, what we have seen this year is well beyond what we expected. Indeed, over just the last three months, core CPI is up by more than it has increased in a full year many times over during the past decade: a gain of 2.55%.

We can ascribe the high sequential inflation rates mainly to two buckets: 1) the rebound in the pandemic-affected areas that are returning quite rapidly to normal and 2) vehicle-related price increases (surges, really). Figure 1 breaks core CPI inflation down into these two categories and everything else. The sharp acceleration in these categories—and lack of acceleration elsewhere—is clear in the chart.

A substantial portion of the upside continues to be in pandemic-related categories, which are reverting higher. Several areas were hit especially hard by the behavioral changes that Covid induced: airfares, other intercity transport, hotels and motels, and event admissions. In these segments of the economy, prices dropped sharply in response to the Covid-induced demand shock, as shown in Figure 2. The last several months have seen these prices revert back up, though to differing degrees. For instance, prices at hotels and motels have essentially returned to their late 2019 levels, while airfares remain somewhat lower.

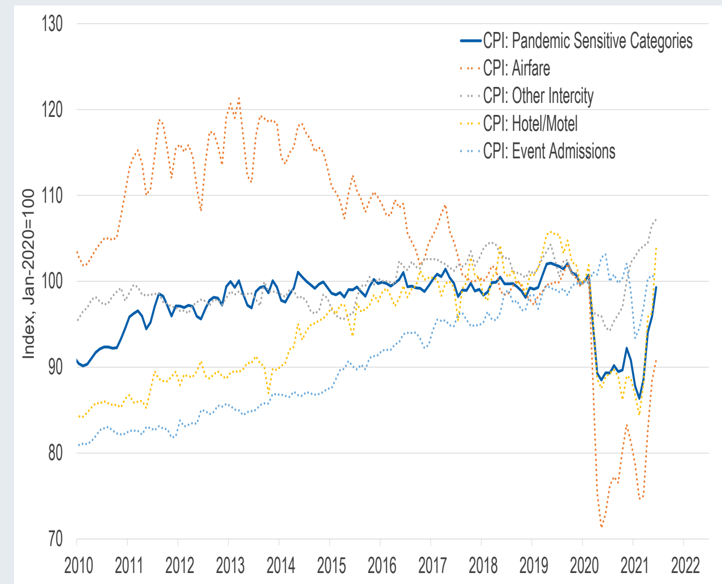
The other—and largest—reason for high sequential inflation is the broad automotive complex. Essentially all auto-related areas are up significantly. New car prices have increased significantly, partly due to supply chain issues related to chip shortages but also from very robust demand. Along with them, prices for auto parts and car insurance have also increased much faster than during more normal times. The true standouts though are rental car prices, and especially used car prices. Indeed, used car prices have increased about 45% relative to pre-Covid pricing; that's 30 percentage points higher than the next fastest increase over the last 40 years. What has pushed up used car prices so rapidly? The combination of

Figure 1:Auto-Related Categories Drive Core CPI Higher



As of June 2021
Source: Bureau of Labor Statistics, Stone Harbor Investment Partners LP Calculations

Figure 2: Pandemic-Sensitive CPI Categories Reversion Almost Complete



As of June 2021
Source: Bureau of Labor Statistics, Stone Harbor Investment Partners LP Calculations

constrained robust demand, fewer new cars, and issues in the rental car market are driving factors. Taken together these auto-related components comprise 155 basis points of the 253 basis points increase that core CPI is up over the past three months.

Outside of these areas, inflation data has been mixed, but not accelerating overall. Rent and OER have increased from very low levels over the course of 2021. Other important areas in the services side have also been relatively restrained. Medical care has actually seen falling prices over the last several months, while prices in education and communication have also been quiescent. Taken together, the non-auto and non-pandemic related parts of CPI are up by 57 basis points over the last three months—about 2¼% at an annual rate—a much less concerning increase.

To be clear, the pandemic and auto related price jumps are real price increases that have happened more rapidly than we expected. However, in assessing the outlook for policy and the economy going forward, what matters more is if these are likely to be sustained and more broadly based, or if they are reversions and relative price adjustments.

It is likely, in our view, that we get a moderation in inflation over the rest of 2021. In the pandemic-sensitive areas, most of the upward price reversion has already taken place. Referring back to Figure 2, the thick line shows that, overall, current levels are almost back up to pre-Covid levels. There might still be some areas where there is a bit more reversion to come—airfares are still somewhat below their late-2019 levels—but most of the reversion has already happened. On the autos side, we don't expect price increases for used cars to be as rapid as they have been. The price increases have been so large they will start to put a damper on demand, and there are already signs that is happening. The Manheim index, which measures the prices of used cars at auction, tends to lead the CPI used cars index, which measures the prices that consumers pay, by a couple months. That index declined slightly in June and then further in the mid-month July update. As we noted, auction prices usually take a couple of months to flow through to used car prices, and there could easily be another increase in July as the last of the lagged increases feed through. However, it looks like most of the upward adjustment has already taken place. Our central expectation is that prices remain around current levels over the next several months, but even stability, rather than ongoing massive increases, does a lot to dampen core inflation. Moreover, a bit further out, there is potential for some downward pressure if used car prices revert back down, though that should be look through just as the upside was.

Does this mean that looking forward we should be expecting low inflation? Probably not. Though very high rates likely do not persist, there is an important developing factor that will support core inflation measures: the housing market, especially in core CPI where housing's weight is higher. Rental increases have been quite low over the past year, but they have recently turned higher. The National Multi Housing Council's "Apartment Market Tightness Index", as well as other anecdotes, point at further rental price increases ahead.

More broadly, it is difficult to get sustained inflation without wages also increasing. The Employment Cost Index (ECI) is the best overall measure of wages in our view, as it compares wages for similar occupational categories. In Q2, it increased at a 2.8% annual rate, almost exactly the same as the year-over-year rate. Though it has moved up after a dip down during 2020, the 2.8% pace is about the same as late-2019. As of now, there are not any signs of a rapid, broad-based and inflationary wage acceleration, though there do appear to be localized pockets.

All that said, we will continue to watch incoming inflation data extremely closely. The economy has not seen this combination of pandemic, recovery and fiscal stimulus before, so we have to put some non-trivial weight on the actual observed high core inflation readings. Whether or not the auto-related and pandemic-related categories moderate over the coming months will provide much additional information about how persistent the inflation acceleration really is.

US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Vaccine Led Rebound Continues, But Slows over Second Half of 2021 (40%)

- Vaccine take-up continues but doesn't reaccelerate. Vaccines continue to provide solid 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 starts to fade over H2 as most disbursements are in the past and enhanced UI stops in September. Q2 is the local peak for US growth; H2 growth above trend, but notably slower.
- Other DMs continue to provide fiscal support. Their most rapid growth generally 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 core inflation increase. Core PCE—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.
- ECB, having completed their framework reviews, underscores it by enhancing guidance.
- More EM central banks start gradual rate hikes.
- Oil moderates to ~$65/barrel WTI, Brent ~$70.
- 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 remains robust. Payrolls growth reaccelerates to over 1mn/ month and overall growth remains rapid in H2.
- Europe follows the same path as their vaccinations continue at the current rapid pace. Rapid activity rebound through the summer; H2 growth higher than the US as more ground to be made up.
- DM Asia increases vaccines rapidly through Q3. EM countries ramp up vaccines by late summer.
- Passage of meaningful infrastructure bill, which starts providing support to output by early 2022.
- Supportive monetary policies gain traction and inflation moderates.
- Fed tapering as above. Discussion of rate increases moves to late 2022 in the context of more rapid labor market gains.
- Improvement is global.
- Oil: WTI at ~$75/barrel; Brent ~$80/barrel.

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, CBs 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 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 $80/barrel, Brent $85/barrel.

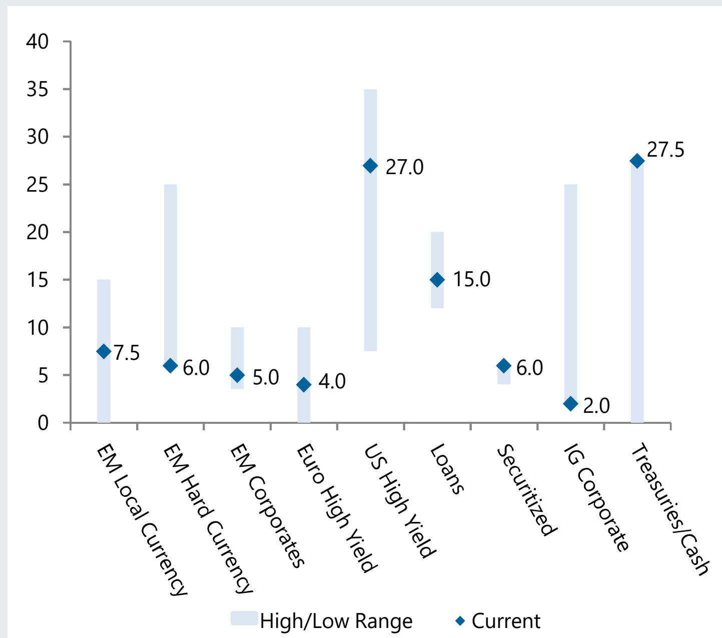
Growth Lags Expectations (15%)

- Long-standing growth issues return to the fore.
- Localized outbreaks of the delta variant continue to drag on COVID-sensitive industries.
- US growth fades more sharply with the withdrawal of fiscal stimulus. Employer-employee matching takes longer-than-expected restraining growth; LFP withdrawal among older workers continues. Only an undersized infrastructure package passes. Additional gov't spending does not materialize.
- Combo of above leads to sluggish investment.
- Inflation moves down notably as growth fades.
- Malaise not limited to the US: other DMs and most EMs substantially underperform expectations through 2021 and into 2022.
- Tapering pushed out to mid-2022. No discussion of 2023 rate increases anymore. ECB also extends guidance that rates will remain fixed.
- Trade tensions persist, as in the base case. Dollar sees modest upward pressure from renewed flight to safety.
- Oil prices hit by lower growth: ~$50/barrel for WTI; Brent ~$55.

	Vaccine Led Rebound Continues, But Slows over Second Half of 2021 (40%)	Stimulus & Vaccines Power Rapid Growth into 2022 (25%)	Inflation Accelerates (20%)	Growth Lags Expectations (15%)
US Real 4Q GDP (%)	5.50	7.00	5.50	4.00
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.80	2.10	2.75	1.60
2yr Treasury (%)	0.55	0.80	1.10	0.13
10yr Treasury (%)	1.75	2.35	2.75	1.00
10yr Bund (%)	-0.20	0.10	0.85	-0.75
China 4Q GDP (%)	5.50	6.00	5.50	4.50
EM 4Q GDP (%)	5.00	6.00	4.50	3.50

[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 30 June 2021. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

JUNE CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	1.36	0.73	0.37	-1.21	0.84	0.63	1.15
Duration (Returns from Interest Rates %)	0.17	0.98	-0.11	0.44	0.23	0.05	0.75
Credit Beta (Returns from Spreads %)	1.19	-0.25	0.48	-1.65	0.61	0.58	0.40

Month Ended 30 June 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.

Important Disclosures

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