October 2021

Investment Policy Statement

A monthly review of the markets

China at a Critical Juncture as Growth Slows

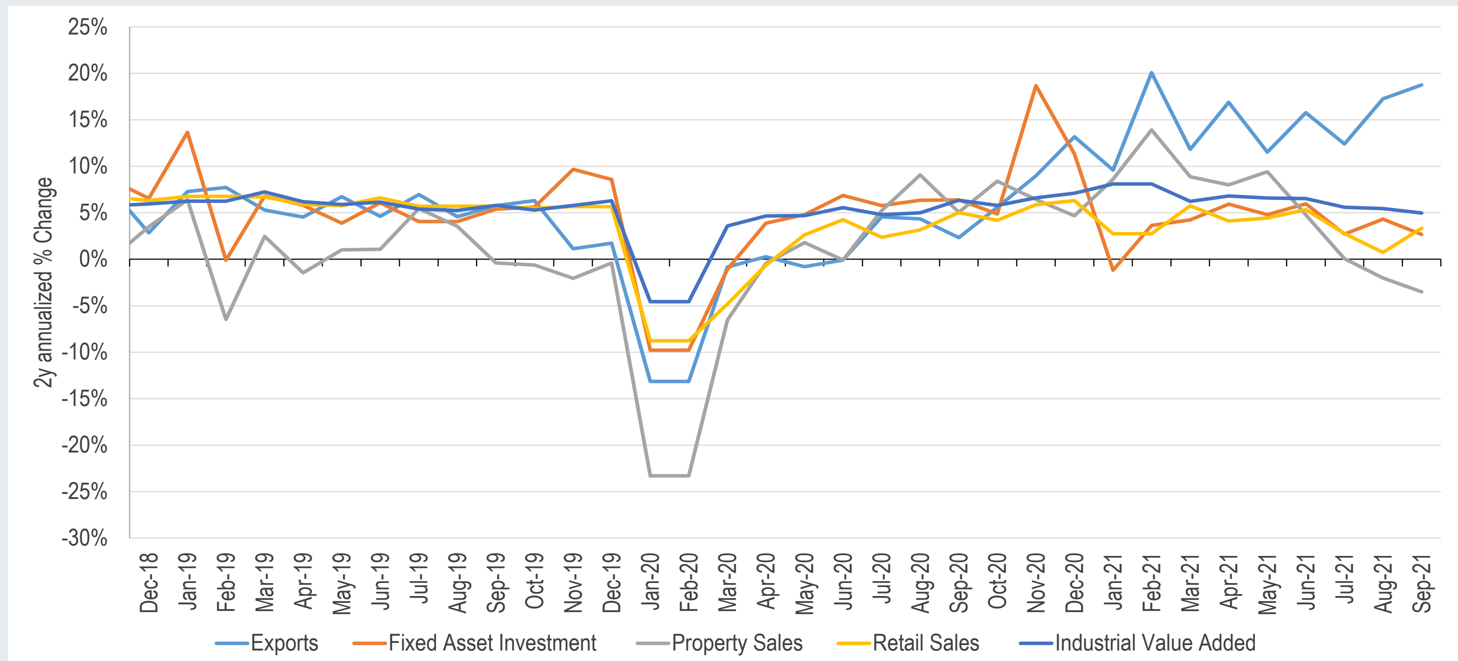
"We cannot solve problems by using the same kind of thinking we used when we created them."

– Albert Einstein, Physicist

Global vaccination rates are continuing to improve, while at the same time the spread of Covid-19 virus is subsiding globally, with a few exceptions. Emerging markets (EMs) are catching up quickly to developed markets (DMs), with vaccination rates in some countries -- e.g., Argentina, Brazil, and Chile -- now surpassing those of the US. Although many low-income countries, particularly in Sub-Saharan Africa, are still lagging on this front, the overall vaccine progress has been and should continue to provide a significant support for global growth. However, economic data across DMs and EMs over the recent months have disappointed, including a weaker-than-expected US labor market, evidence of supply disruptions impacting business activity, and softer PMI surveys, which are indicative of some pressure on global economic and business conditions. While we ultimately expect the global recovery to continue, the recent slowing in growth momentum does introduce risks in select regions and countries that carry important implications and require close monitoring.

One country where we are more concerned about the slowdown giving rise to deeper economic scars is China, which is already experiencing reduced economic momentum. China's growth decelerated in Q3 with GDP growth dropping to only 0.2% quarter-on-quarter, bringing the annual growth rate to 4.9% year-on-year from 7.9% in Q2. Though exports and retail sales improved, industrial production and fixed-asset investment slowed, in part due to power shortages and production curbs. Of particular concern is the troubled property sector that is grappling with government-imposed de-leveraging rules aimed at reversing the effects of excessive borrowing over the years. Based on the latest available data, property sales volume dropped 3.5% after declining 2.0% in August, and construction starts also declined 7.9% after falling 7.7% in the prior month. These developments raise the question, can China's growth slowdown become a trigger for a broader global

Figure 1: China's Domestic Slowdown Continued in September



As of 30 September 2021
Sources: General Administration of Customs, China National Bureau of Statistics, Haver Analytics, Stone Harbor Investment Partners LP Calculations

slowdown. Our base case remains that Chinese authorities avoid major policy mistakes and will be able to restructure distressed real estate developers without triggering a broader real estate crisis. But given the importance of construction and real estate for the Chinese economy, the downside risks are significant.

A real estate crisis in China could be prompted by forced asset sales from distressed real estate companies that in turn put further pressure on housing prices, leading to broad price declines. A spiraling effect could cause end-buyers to delay purchases, out of fear of falling prices and reluctance to pre-fund future apartment purchases. Banks would also be less willing to extend credit to real estate developers and end-buyers in that environment. Once established, such a broad loss of confidence could be difficult to reverse by Chinese policy makers. And given the substantial size of the real estate sector in the Chinese economy -- measures ranging from 8% of GDP (in value added terms) to around 25% (counting all activity related to construction and real estate) – prolonged slowdown would yield global consequences.

For one, Chinese demand for imports would drop. This would have knock-on effects on investment goods and commodities. Commodity prices would be affected with negative implications for investment. Growth in commodity-producing countries would slow. Then the broader loss of confidence and risk-off reaction across markets would slow demand globally.

Ultimately, this scenario also includes a substantial policy reaction by the Chinese authorities that stabilizes growth, though at a lower level (we currently expect Chinese growth about two percentage points lower in this adverse scenario compared to baseline). The impact in DMs would be smaller (we estimate one percentage point lower for the US), but we think the impact on EMs more broadly could exceed the slowdown in China because policy space is much more limited in many EMs.

Given this possible scenario, China's real estate sector is at a critical juncture, in our view. At this time, funding access to developers needs to be restored in order to avoid either 1) substantial asset sales—which would lead to price drops and could destabilize the market along with confidence of households—and/or 2) a sharp decline in construction activity. In the absence of funding support, the combination of forced asset sales and depressed construction activity could trigger a serious deceleration of China's economy.

It appears that Chinese policy makers have understood the seriousness of the issue and have now asked the banks to accelerate mortgage approval and keep credit to the real estate sector stable and orderly. Moreover, there are indications that policy makers are working with local governments to safeguard stable housing markets. Monitoring loan flows to developers will be key over the next months. Historically, Chinese policy makers have been mostly successful in directing bank lending. But financial incentives suggest that banks might be slow to follow the policy guidance.

In short, liquidity pressure on China's property developers will likely continue for some time and exert downward pressure on growth. However, we believe support from policy makers are forthcoming as evidenced by recent comments on the urgency to stabilize the property sector.

US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Vaccine Led Rebound Continues, But Remains Slower into 2022 (45%)

- Vaccine take-up continues in the US but pace is suboptimal; vaccines continue to provide solid protection against variants. Delta circulation continues, but at a lower level than the late summer.
- Travel, restaurants, conventions and large gatherings slowly improve.
- Vaccines become broadly available across EM countries by late-21/early-22. Recent good vaccinations outturns in some EMs continue.
- US stimulus effects continue to fade over H2 as large disbursements are in the past and enhanced unemployment insurance has expired. 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 and Q4.
- 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% at end-2021 and continues to decline into 2022.
- DM central banks maintain stimulatory policies.
- Fed initiates tapering in late 2021. Discussion continues on timing of rate hikes but growth isn't fast enough to pull expectations further forward.
- More EM central banks start gradual rate hikes.
- Oil returns 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.

Weaker Growth Triggered by China Real Estate Bust (20%)

- Asset sales by distressed Chinese developers trigger price declines.
- Buyers lose confidence and fail to step in, triggering deeper liquidity problems for developers, deeper price cuts, and sharp drop in construction activity
- As a result, China's economy slows sharply.
- US fails to pass reconciliation bill, so fiscal policy tightens more than expected into 2021.
- Growth slump spreads globally as China troubles coincide with the withdrawal of fiscal stimulus in DMs and some EMs.
- Inflation moves down notably as growth fades, and supply pressures ease.
- Commodity prices fall.
- Discussion of 2023 rate increases disappears. ECB also extends guidance that rates will remain fixed.
- Trade tensions persist, as in the base case.
- Dollar sees upward pressure from renewed flight to safety.
- Oil prices hit by lower growth: ~$50/barrel for WTI; Brent ~$55.

Inflation Acceleration Proves Durable (20%)

- Stimulus induced demand crashes into still constrained supply, and firms respond by raising prices. Facing tight labor supply, firms continue to bid up wages attempting to pull workers off the sidelines.
- Recent inflation surprises prove durable: there is no reversion to below 3%. Wage inflation flows into price inflation through rental measures.
- Core inflation remains elevated and is well over 3% heading into the end of 2021 for the US. Inflation also drifts higher in other DMs.
- Relatively steep taper implemented in late 2021.
- 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 $95/barrel, Brent $100/barrel.

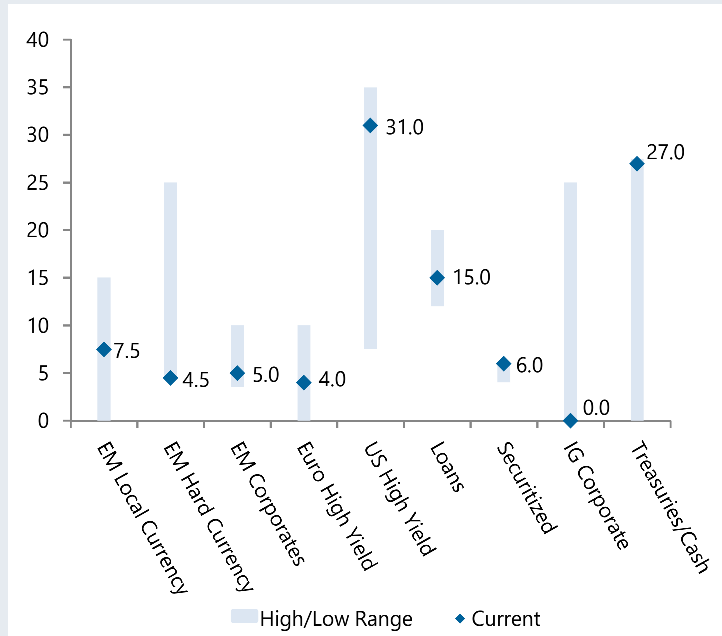
Stimulus & Vaccines Power Rapid Growth into 2022 (15%)

- Economic activity reaccelerates into Q4. Payroll growth rebounds to ~1mn/month.
- High vaccinations rates in Europe allow their activity rebound to extend into the fall; H2 growth higher than the US as more ground to be made up.
- DM Asia continues to vaccinate at a rapid pace, which spills into activity.
- EM vaccination also proceeds relatively rapidly, with commensurate economic activity benefits.
- US fiscal—both infrastructure and reconciliation bills—pass over the fall and start providing support to output by early 2022.
- Inflation moderates, which allows supportive monetary policies to remain in place.
- Fed tapering as above. Discussion of rate increases moves to Q3 2022 in the context of more rapid labor market gains.
- Activity improvement is global.
- Oil: WTI at ~$75/barrel; Brent ~$80/barrel.

	Vaccine Led Rebound Continues, But Remains Slower into 2022 (45%)	Weaker Growth Triggered by China Real Estate Bust (20%)	Inflation Acceleration Proves Durable (20%)	Stimulus & Vaccines Power Rapid Growth into 2022 (15%)
US Real 4Q GDP (%)	3.00	2.00	3.00	5.00
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.90	1.70	2.75	2.20
2yr Treasury (%)	0.60	0.13	1.10	0.80
10yr Treasury (%)	1.85	1.50	2.75	2.35
10yr Bund (%)	-0.20	-0.75	0.85	0.10
China 4Q GDP (%)	5.50	3.50	5.50	6.00
EM 4Q GDP (%)	5.00	2.50	4.50	6.00

[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 September 2021. 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	Dec-Jan 2021	+2.5
EM Hard Currency	June-July 2021	-1.5
EM Corporates	May-June 2018	+1.5
Euro High Yield	May-June 2020	-2.5
US High Yield	June-July 2021	+4.0
Loans	Jan-Feb 2021	+1.5
Securitized	Mar-April 2019	+1.0
IG Corporate	June-July 2021	-2.0
Treasuries/Cash	June-July 2021	-0.5

SEPTEMBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.04	-2.07	0.64	-3.43	-0.67	-0.03	-0.94
Duration (Returns from Interest Rates %)	-0.67	-1.29	-0.09	-0.86	-0.72	-0.43	-1.24
Credit Beta (Returns from Spreads %)	0.71	-0.78	0.73	-2.57	0.05	0.40	0.30

Month Ended 30 September 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

This material is solely for informational purposes and should not be viewed as a current or past recommendation or an offer to sell or the solicitation to buy securities or to adopt any investment strategy. The opinions expressed herein represent the current, good faith views of the author(s) at the time of publication and are provided for limited purposes, are not definitive investment advice, and should not be relied on as such. The information presented in this material has been developed internally and/or obtained from sources believed to be reliable; however, Stone Harbor Investment Partners LP ("Stone Harbor") does not guarantee the accuracy, adequacy or completeness of such information. This material includes statements that constitute "forward-looking statements". Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to market, geopolitical, regulatory or other developments. Any forward-looking statements speak only as of the date they are made, and Stone Harbor assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, and are based on current market trends, all of which change over time. The views expressed herein are not guarantees of future performance or economic results and involve certain risks, uncertainties and assumptions that could cause actual outcomes and results to differ materially from the views expressed herein. The views contained in this material are subject to change continually and without notice of any kind and may no longer be true after the date indicated. All investments involve risk including possible loss of principal. There may be additional risks associated with international investments involving foreign economic, political, monetary and/or legal factors. These risks may be heightened in emerging markets. Past performance is not a guarantee of future results. This material is directed exclusively at investment professionals.

Stone Harbor
INVESTMENT PARTNERS

CONTACT

Main Office - New York

31 W. 52 Street
16th Floor
New York, NY 10019
+ 1 212 548 1200

London Office

48 Dover Street
5th Floor London,
W1S 4FF
+ 44 20 3205 4100

Singapore Office

3 Killiney Road
Winsland House 1
Singapore 239519
+ 65 6671 9711

www.shiplp.com