



# Investment Policy Statement

*A monthly review of the markets*

## Three Questions Whose Answers Will Determine the Course of Fed Policy

*"A prudent question is one-half of wisdom."*

*– Francis Bacon, English statesman*

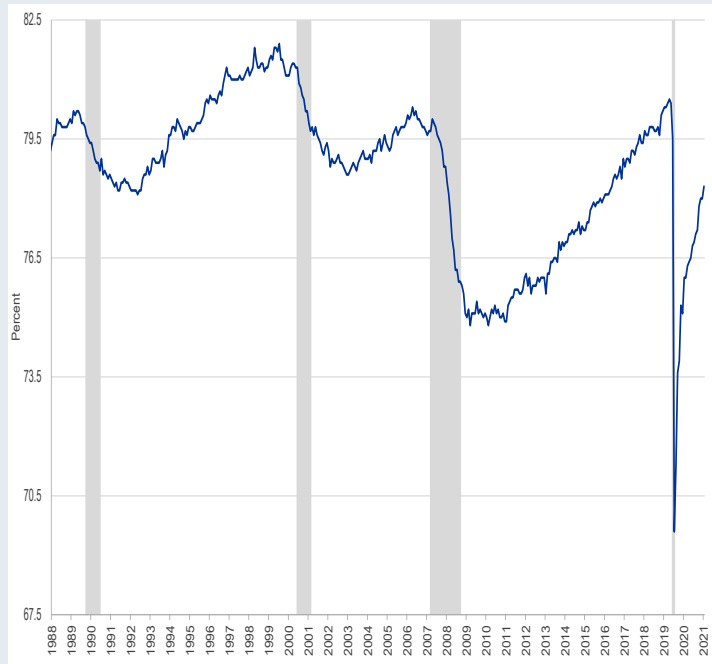
A newly re-nominated US Federal Reserve (Fed) Chair Jerome Powell and now nominated as vice-chair for monetary policy, Lael Brainard, face an economic landscape markedly different than one seen over the past several decades. Instead of a slow grind after a recession, the bounce-back from the coronavirus pandemic has been relatively rapid and accompanied by upward price pressure. In setting policy, there are a multitude of questions for which they would like answers, but there are three that we think most important.

The first question surrounding the labor market is *can the economy return to the 2019 pre-pandemic labor market?* The Fed had previously expressed that the return to pre-pandemic level was the desired outcome, but Chairman Powell loosened this goal at the last press conference and noted the potential for structural change. The pre-pandemic labor market contemplated by the Fed would be one that showed the prime age employment population ratio of 80%. This measure has rebounded substantially from the pandemic lows and has continued to increase over the last several months, but the pace of improvement has slowed. Other measures, such as the unemployment rate have retracted more of the lost ground. The depressed employment-population ratio for prime age workers most likely suggests more room for rebound, in our view, but whether or not the pre-pandemic level can be achieved is an extremely important unknown.

The second question on the labor market is *how tight is the labor market right now and for how long will it remain that way?* The employment to population ratio implies plenty of remaining labor market slack; however, by other measures, such as the unemployment rate and the number of unfilled jobs openings, the labor market appears much tighter. The most important recent data point indicating a tighter labor market was the substantial acceleration in the Employment Cost Index (ECI) for Q3. The ECI, which in comparison to average hourly earnings, is a higher quality measure of wages that aims to keep the workforce composition constant and is less impacted by employment shifts across

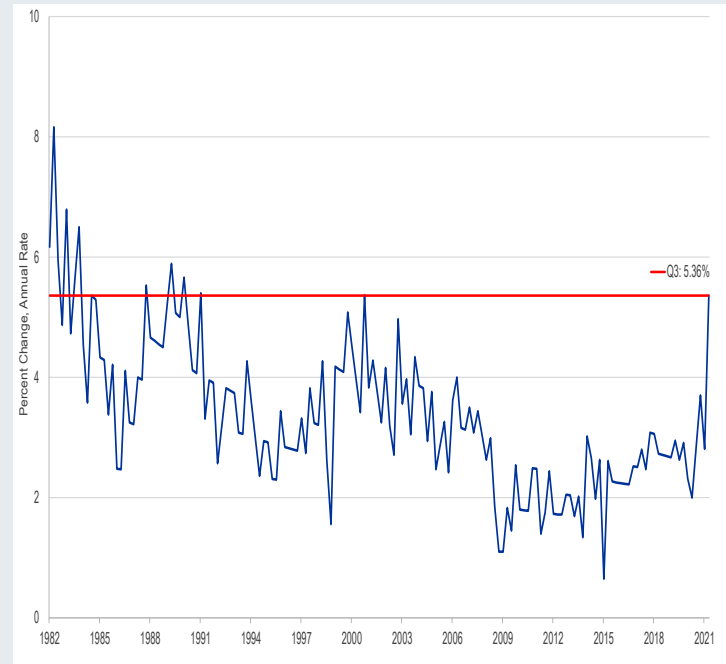


**Figure 1: Prime-Age Employment-Population Ratio Remains 2pp Below Pre-COVID Level**



As of 31 October 2021  
Sources: Bureau of Labor Statistics, Haver Analytics, Stone Harbor Investment Partners LP  
Dec-05 = 100

**Figure 2: Employment Cost Index Accelerated Significantly in Q3**



As of 30 September 2021  
Sources: Bureau of Labor Statistics, Haver Analytics, Stone Harbor Investment Partners LP

industries and occupations. During the recovery through Q2, the ECI had not accelerated much, but then increased sharply in Q3 to a 5.36% annual rate—the highest quarterly reading since the early 2000s and, if sustained at this level for a couple of more quarters, since the early 1990s. We will be watching to see if the tightness continues as the pandemic retreats further—our base case into 2022.

The amount of labor market tightness question leads into the last, and arguably the most important, question: *will inflation ultimately prove to be transitory in nature?* The Fed's post-FOMC statement revealed that while price increases, driven mainly by supply chain disruptions, have been larger and longer-lasting than they had anticipated, these increases are still viewed as mostly pandemic-related. Their baseline expectation is that supply bottlenecks persist "well into next year," but that inflation will start to decline by the second or third quarter of 2022. The risk—one that has commanded market attentions—is that the wage acceleration persists and translates into broader and more permanent price increases. The inflation acceleration from the early summer has not retreated as rapidly as we expected as pressure remained in the auto-related categories and broadened out to other areas of prices. Most notably, in October the rent and owners' equivalent rent components increased at an annual pace of over 5% for the second month in a row. This is important for the future path of inflation for two reasons. First, the housing components are a large portion of the overall basket of goods and services that goes into inflation. For total CPI, they comprise just over 30% of the basket, and for core inflation about 40%. The weighting is a bit smaller for PCE, but still a very substantial chunk. Second, these components tend to be more persistent, with less month-to-month variation, and secondary data indicates the pressures persisting here.

Ideally, the Fed would be able to wait for substantial additional clarity about the answers to these questions. The data over the next two to three quarters will likely go a long way toward providing

those answers, though it is unlikely that we get full and final resolution in that timeframe. Indeed, we think the Fed's original plan with the announcement on tapering of asset purchases at a pace of US\$15 billion per month, which would end purchases in mid-2022, was to allow themselves some time for that data to come in. However, the reacceleration in core CPI since the meeting we noted above has complicated matters. Political and market pressure on the Fed to act more quickly has increased. Two board members—Governor Waller and outgoing vice-chair Clarida—raised the possibility of reexamining the pace of taper at the December meeting. Then at Congressional testimony, Chair Powell threw his weight behind the reexamination.

Given the latest round of employment and inflation data, we have increased our assessment of the probability of a stubborn inflation scenario from 20% to 25%. While this is not our base case, we do think that the data indicate greater risks of a more durable inflation acceleration that warrant this adjustment, as we highlighted above. Our base case, however, is that a vaccine-led rebound continues, but remains slower into 2022, and several key inflation measures revert lower. Following the latest set of communication from the Fed, we now think the Fed adjusts the pace of asset purchases at the December meeting and completes purchases by end of Q1-2022 in both scenarios. In the base case we have also drawn forward our expectations of the first rate increase to September 2022 from our previous expectation of late 2022 or early 2023, and risks are now skewed earlier. Recent news on the coronavirus front—the identification of the Omicron variant—also calls for inclusion in our scenarios. We have hence introduced a scenario where Omicron causes meaningful downside to growth, and to a lesser degree inflation, though we think the negative effects on growth are far smaller than the original coronavirus introduction in 2020.



## MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK<sup>1</sup>

### Vaccine Led Rebound Continues, But Remains Slower into 2022 (55%)

- Vaccine take-up continues in the US but pace remains suboptimal; vaccines continue to provide solid protection, including against Omicron variant. Delta circulation continues, but at a lower level than the late summer.
- Travel, restaurants, conventions and large gatherings continue slow improvement.
- In EM, Asian and LatAm vaccinations progress further. Africa's pace starts to pick in early-22.
- Q2 was the local peak for US growth; H2 growth above trend, but notably slower. Other DMs follow the US, with a lag; their most rapid growth happens in Q3 and Q4.
- US/China tensions remain cooler, but do not return to pre-Trump status quo.
- China growth somewhat softer than consensus.
- Core PCE remains elevated through end-21 but starts to decline in sequential terms into 22.
- Fed accelerates taper at the December meeting and asset purchases end in late Q1-2022. Better inflation outturns allow them some space, and first rate increase comes in September 2022. ECB holds off for somewhat longer.
- Other DM central banks broadly maintain simulative policies.
- Rate hikes continue across EM.
- Oil gradually returns to ~\$65/barrel WTI, Brent ~\$70.
- Dollar broadly weakens over 1-year horizon, partly due to closing of interest rate differentials.

### Omicron Variant Notably Slows Recovery (10%)

- Omicron variant proves to be a significant drag on global growth, though very far short of the original coronavirus impact. Growth does not turn negative, but the recovery clearly slows.
- High social contact activity bears the brunt of the effect. Combination of re-imposed government restrictions and endogenous social distancing.
- Current vaccines continue to provide some protection, but that protection is attenuated. Work on reconfigured mRNA vaccines proceeds relatively quickly; new treatment options get approval and help improve outcomes.
- Growth starts to improve into H2-2022.
- Congress lacks appetite to do another substantial fiscal package.
- With slower activity and sluggish consumer demand inflation moderates.
- Combination of slower growth and uncertainty about outlook keeps Fed on current tapering path. Rate hikes no longer look likely by end-2022.
- Oil: WTI at ~\$50/barrel; Brent ~\$55/barrel.

### Weaker Growth Triggered by China Real Estate Bust (10%)

- 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. Move away from using regulatory policy in stabilization makes adjustment of the economy harder.
- 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: ~\$55/barrel for WTI; Brent ~\$60.

### Inflation Acceleration Proves Durable (25%)

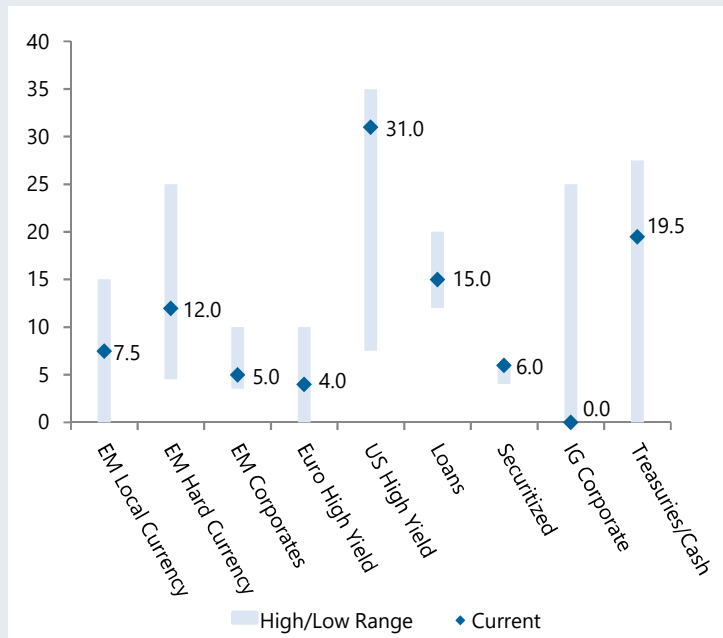
- Demand remains robust and supply constrained. Supply chain issues do not resolve and price increases remain elevated.
- Facing tight labor supply, firms continue to bid up wages attempting to pull workers off the sidelines.
- Recent inflation surprises prove durable: there is no reversion downward in sequential rates. Wage inflation flows into price inflation through housing as CPI rent and OER are high.
- Core inflation remains elevated into mid-2022. Inflation also drifts higher in other DMs.
- Tapering pace accelerated and purchases end in late Q1-2022.
- Fed immediately transitions to rate hikes and indicates a steeper path ahead. Other central banks also indicate sooner and more rapid rate increases.
- 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 further with growth and inflation fears: WTI to \$95/barrel, Brent \$100/barrel.

	Vaccine Led Rebound Continues, But Remains Slower into 2022 (55%)	Omicron Variant Notably Slows Recovery (10%)	Weaker Growth Triggered by China Real Estate Bust (10%)	Inflation Acceleration Proves Durable (25%)
US Real 4Q GDP (%)	3.75	1.50	2.50	3.25
Fed Funds (%)	0.38	0.13	0.13	0.88
US Core PCE (%)	2.10	1.75	1.80	3.25
2yr Treasury (%)	0.80	0.25	0.13	1.35
10yr Treasury (%)	1.90	1.25	1.60	2.75
10yr Bund (%)	-0.20	-0.50	-0.75	0.90
China 4Q GDP (%)	5.25	4.00	3.00	5.00
EM 4Q GDP (%)	4.75	2.00	2.50	4.00

<sup>1</sup>Forecast Period: Next 12 months. Source: Stone Harbor.



## MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION & RECENT ALLOCATION CHANGES<sup>2</sup>



Latest Allocation Changes		
	Month	Change (%)
EM Local Currency	Dec-Jan 2021	+2.5
EM Hard Currency	Sep-Oct 2021	+7.5
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	Sep-Oct 2021	-7.5

<sup>2</sup>Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 31 October 2021. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

## OCTOBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
<b>Total Return</b>	-0.19	0.02	0.27	-1.33	-0.46	-0.56	-0.08
<b>Duration</b> (Returns from Interest Rates %)	-0.38	0.02	-0.14	-0.25	-0.33	-0.57	-0.17
<b>Credit Beta</b> (Returns from Spreads %)	0.19	0.00	0.41	-1.08	-0.13	0.01	0.09

Month Ended 31 October 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.



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- 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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