January 2021

Investment Policy Statement

A monthly review of the markets

Inflation Outlook: Reading through Noise for the Signal

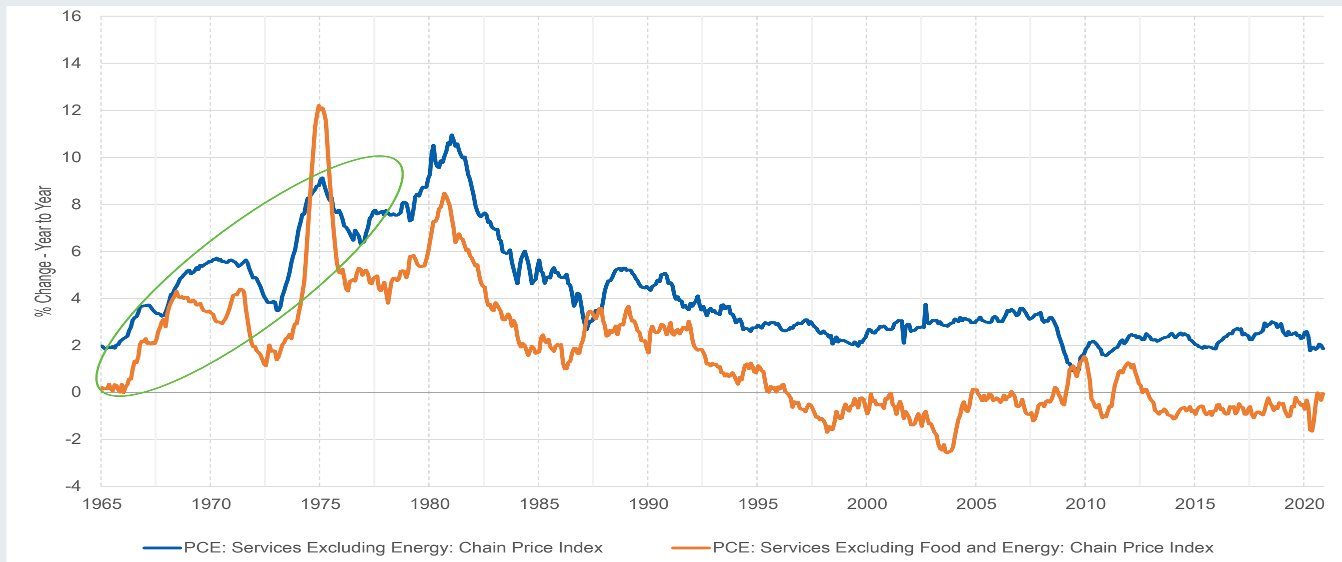
"The Signal is the truth. The noise is what distracts us from the truth"

– Nate Silver

Despite having been well behaved for the last three decades, the combination of easy central bank monetary policy and the likely injection of a substantial further fiscal stimulus by the new US administration have raised concerns among some market participants about the return of inflation. The concern is a scenario in which consumer demand, restrained by pandemic-related restrictions, rebounds and bumps into supply constraints that have been exacerbated by business closures. From our vantage point, we remain quite sanguine on the prospects of sustained inflation as we think there remains substantial excess capacity, especially in the labor market. Note that while we focus on the US below, most of our comments translate into other developed markets.

First, it is important to note that there is likely to be a significant spike in year-on-year (yoy) inflation over the next several months. We currently expect core inflation measures, which exclude transitory price volatility of food and energy products, to move up to ~2¾ by April—a large and rapid move up from recent levels. For context, core price measures saw an unprecedented move down during the spring of 2020 due to the freezing of economic activity before rebounding into the summer; during March and April, the core CPI price level dropped at a 3.3% annual rate, only the third decline in the last 55 years and the steepest by about 1½ percentage points. When compared against those depressed readings from a year-ago, inflation looks firm to us, but we would characterize this jump as being purely mechanical in nature rather than a sign of underlying inflation. By mid-summer, we think inflation will likely drop back to 2%.

Figure 1: 1970s High Inflation Was Preceded by Steady Rise in Core Services Prices



As of November 2020
Source: Bureau of Economic Analysis, Haver Analytics, Stone Harbor Investment Partners LP

What we will be monitoring over the near-term are 3-month and 6-month annualized averages—which we currently do not expect to move meaningfully. Absent a notable move, we would be inclined to fully look past the inflation upswing. The Federal Reserve will likely do the same, in our view.

Beyond the very near-term, we expect inflation to remain contained. This is mainly predicated on the assumption that even with rapid growth, significant excess capacity, especially in the labor market, would remain. It is difficult to envisage sustained inflation without wage increases. Average hourly earnings (AHE) have increased over the course of pandemic, but we view this as noise not signal. The composition of the workforce used in calculating AHE has changed as lower wage workers have disproportionately lost their jobs. The Employee Cost Index (ECI) readings is almost always a better gauge of wage trends in our view, and we believe that is especially true now as ECI corrects for compositional changes by bucketing wages of similarly defined jobs over time. In contrast to AHE readings, the ECI shows significant disinflation over Q2 and Q3—just 2% annualized for each of those after 3¼% in Q1.

Why do wages matter? In large part because services comprise the majority of consumption (over 60% in the CPI basket and higher in PCE), and wages are the most important cost component of most services. Further, when thinking about services, it is important to remember that rents make up another substantial portion of services. Those have already started to disinflate, and we expect that trend to continue.

Though we do not think the US is poised for inflation, we recognize that the economy has not traversed through this combination of fiscal stimulus, loose monetary policy, and rapid growth in many decades. Looking back to the only significant period of peacetime inflation in the US -- the 1970s when inflation peaked above 12% -- helps us think about what to watch for if inflation really is turning. What is relevant to note about this episode, in our view, is that 1970s inflation was a culmination of a gradual and sustained drift up, across business cycles, in both core goods and core services inflation over the 1960s, as shown in the accompanying graph. That is, the 70s inflation did not come out of the blue, but was telegraphed by persistently higher inflation rates. Of the two breakouts, core goods and core services, we view the latter as more of a potential signal than the former. One reason for this bias is that we have also seen the core goods inflation move meaningfully over the last two decades—as low as -2.5% and as high as to 1.5%—but the swings have not translated to broader inflation. Based on this key observation, we will be watching core services inflation at higher frequencies through the Q2 increase in yoy inflation rates, and at all frequencies after that, to see if we should get more concerned.

In our latest macroeconomic scenario assumptions and market outlook, we incorporate what we see as the two largest risks over the next several months: 1) a scenario in which vaccine distribution problems leave lasting economic scars, reducing the scope for economic recovery in developed markets and emerging markets; and 2) inflation accelerates as stimulus-induced demand faces constrained supply; bond yields move sharply higher. Based on current vaccine progress, as well as our current inflation outlook, we assign a 10% probability to each of these scenarios. Our base case assumes a slow growth that transitions to a sharp vaccine-led rebound bolstered by additional fiscal spending; we assign a 65% probability to this scenario. Central to this outlook is that even if activity slows more due to rising virus cases now, we expect catch up growth as vaccine rollout proceeds, ultimately leaving the level of GDP at year-end 2021 the same: up about 6% from Q4-2020 for the US, with other developed markets not quite as strong but still very firm.

As in developed markets, we expect to see a pickup in reported annual inflation rates in the spring of 2021 in emerging markets (EM), reflecting base effects, but also anticipate little reaction in monetary policy from EM central banks. Moreover, the improved trade and current account balances across EMs, combined with returning capital flows, provide a supportive backdrop.

US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Base Case: Slow Grind Transitions to Sharp Vaccine-Led Rebound (65%)

- Vaccine distribution improves after rocky start and significantly ramps up through Q1 and into Q2.
- Travel, restaurants, sports, conventions and large gatherings improve along with wider vaccination.
- Even if near-term growth remains soggy due to virus-related disruptions, faster post-vaccine 2021 growth makes up the lost ground and leaves the level of GDP at end-21 the same.
- Ongoing European virus spread leads to some growth-retarding measures. As in US, recovery continues but at a slower pace; near-term shortfalls are made up for by more rapid future growth.
- The Democratic victories in Georgia lead to another substantial stimulus package, which meaningfully boosts growth. Other countries continue to provide further fiscal support.
- US/China tensions cool with Biden administration, but do not return to pre-Trump status quo.
- Core inflation picks up sharply—to over 2½%—in Q2-2021 as year-over-year measures lap the declines from 2020. The Fed and other DM central banks look through. Core inflation drops back below 2% by mid-summer.
- Central banks maintain extremely stimulatory policies.
- Oil remains roughly stable: ~$45/barrel WTI, Brent ~$50.
- Dollar broadly weakens, partly due to closing of interest rate differentials and partly from lower US real rates associated with Fed policy shift.

Medical & Stimulus Led Acceleration (15%)

- Pharmaceutical progress exceeds expectations. Additional vaccines show positive results. With more vaccines approved, vaccinations get to the populace more quickly. At the same time, the use of monoclonal antibodies increases which helps push death rates down.
- US and European economies prove resilient to containment measures. Asia remains in relatively good shape.
- With better-than-expected outturns on containment, treatment and vaccination, activity improves substantially by the spring.
- The Democratic Senate passes a substantial stimulus package of about $1.5tr, meaningfully larger than in the base case, which further accelerates the recovery.
- Supportive monetary policies gain traction.
- Improvement is global as better treatments spread.
- Fed maintains accommodative policy, but doesn't feel need to push further. Similarly ECB only maintains PEPP.
- Oil: WTI at ~$50/barrel; Brent ~$55/barrel.

Vaccine Distribution Problems Makes Economic Scars Lasting (10%)

- Vaccine distribution issues are not solved. The new more infections virus strains spread rapidly. As a result the recovery lags and economic scars turn lasting; 2021 recovery disappoints meaningfully.
- 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 elevated 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 underperform expectations through 2021.
- 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.

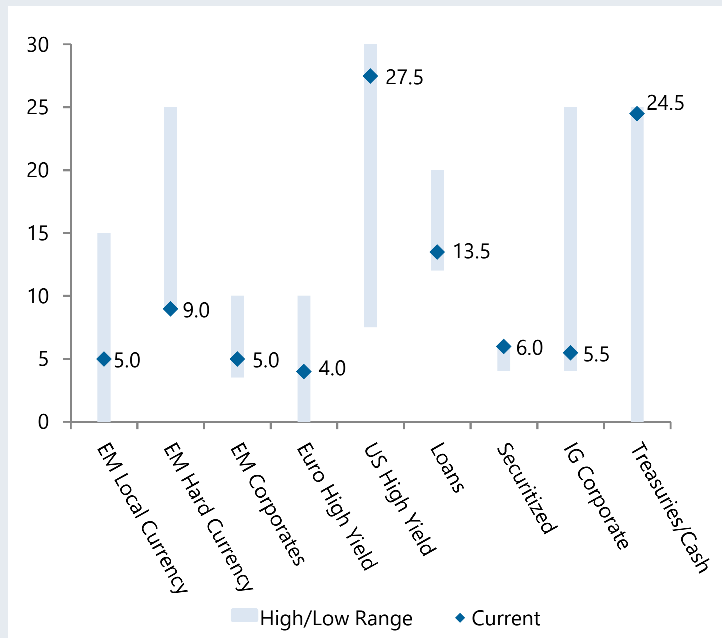
Inflation Accelerates (10%)

- Next several months proceed as in the base case, but inflation does not come back down in the summer. Stimulus induced demand crashes into still constrained supply, and firms respond by raising prices. Firms start to materially bid up wages attempting to pull workers in.
- Core inflation remains well over 2%, and is around 2½% heading into the end of 2021 for the US, and similarly higher in other DMs.
- Despite the rise in inflation, central banks initially maintain accommodative policies. Toward the end of the year they being to react pulling back on asset purchases and indicating that rates are likely to rise much sooner than 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 $70/barrel, Brent $75/barrel.

	Base Case: Slow Grind Transitions to Sharp Vaccine-Led Rebound (65%)	Medical & Stimulus Led Acceleration (15%)	Vaccine Distribution Problems Makes Economic Scars Lasting (10%)	Inflation Accelerates (10%)
US Real 4Q GDP (%)	6.00	6.50	3.00	6.00
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.60	1.90	1.10	2.50
2yr Treasury (%)	0.35	0.50	0.13	1.00
10yr Treasury (%)	1.35	1.65	0.25	2.50
10yr Bund (%)	-0.35	-0.10	-0.75	0.75
China 4Q GDP (%)	5.25	5.50	4.50	5.25
EM 4Q GDP (%)	5.50	6.50	3.50	5.00

[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 31 December 2020. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

Allocation Changes[3]

	Month	Change (%)
EM Local Currency	Nov-Dec 2020	+2.5
EM Hard Currency	June-July 2020	-10.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	May-June 2020	-2.5
US High Yield	Nov-Dec 2020	-2.5
Loans	Feb-Mar 2020	+1.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Nov-Dec 2020	-5.0
Treasuries/Cash	Nov-Dec 2020	+5.0

[3]Latest allocation change

DECEMBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	1.91	1.90	1.35	3.48	1.47	0.91	0.50
Duration (Returns from Interest Rates %)	-0.05	-0.36	0.07	-0.17	-0.09	-0.01	-0.20
Credit Beta (Returns from Spreads %)	1.96	2.26	1.28	3.65	1.56	0.92	0.70

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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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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