Investment Policy Statement

A monthly review of the markets

Progress is in Motion, Sideways Until Better Growth in 2021

"Markets trend only about 15% of the time; the rest of the time they move sideways."

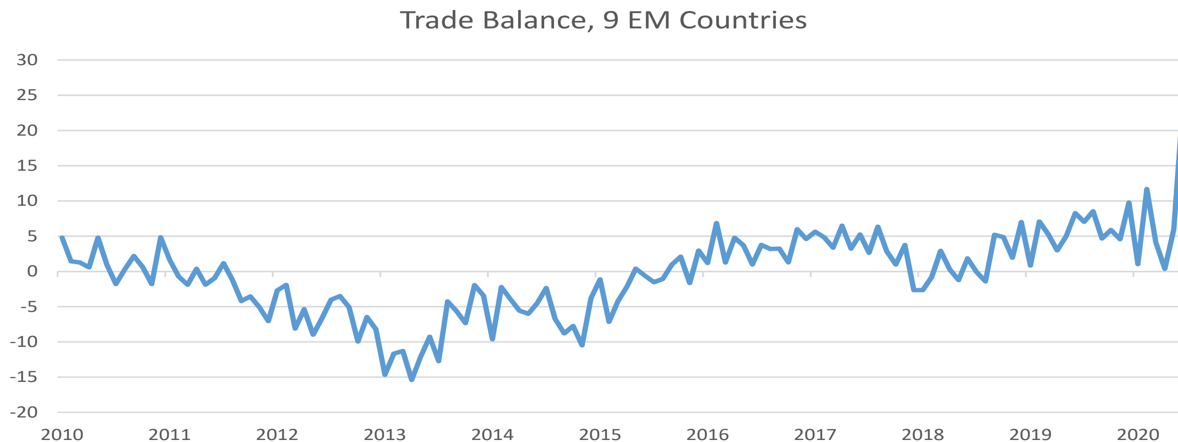
– Paul Tudor Jones, American billionaire hedge fund manager, conservationist and philanthropist

At our last writing in July, U.S. coronavirus cases were at their peak. Actions taken globally including government-forced lockdowns and endogenous behaviors like social distancing and increased masking have begun to reduce the pace of infections. As such, the second round of spread is now moderating, as concerning hotspots recede in Arizona, Texas, and Florida, with death rates at high numbers, but coming down a bit. As the spread of cases ebbs and flows between earlier infections and emerging spreads, we continue to watch for significant increases in other states. Improved virus treatments such as remdesivir, steroids, and monoclonal antibodies, coupled with broadly positive vaccine development lead us to cautious optimism for a Q1 2021 vaccine, and significant 2021 economic growth.

After a considerable boost upon emergence from lockdown conditions, the U.S. economy has started to move firmly… sideways. At least relative to the bounceback from more stringent measures, the pace of improvement has slowed and likely will remain substantially below the rebound earlier in the summer. Some high frequency indicators, such as Chase's measure of consumer credit card activity, are moving resolutely sideways year-over-year. A more traditional high frequency indicator, jobless claims, continues to drop, albeit more slowly. The Fed's recent Senior Loan Officers survey helps underscore this caution, as banks have become about as likely to be tightening lending standards as in the aftermath of the financial crisis. With the notable exception of housing that is, where lending is helping to support the one sector that appears to be undergoing a fully V-shaped recovery.

Fiscal stimulus has provided substantial support for both developed and emerging markets (EM) economies, offsetting some of the severe drag of forced lockdowns and subsequent consumer pullback. Stimulus tools, most significantly the U.S.

Figure 1: Sharp Improvement in EM Country's Trade Balances



As of June 2020
Aggregate Trade Balance for Brazil, Chile, Mexico, Poland, Turkey, South Africa, Indonesia, Malaysia, and Thailand (USD bn)
Source: Haver Analytics

government's CARES Act, more than offset the decline in earned income, and contributed to a jump in personal income and rebound in consumption. This jump began to reverse in June, as payments ceased; we will watch carefully how the attempts to provide an extension, both from the administration's executive action and Congress, play out. The risk of fiscal support receding appears particularly pronounced in the U.S. so we are watching developments closely. U.S. monetary policy, in contrast, continues to be extremely supportive. At Jackson Hole, Fed Chairman Powell announced that the Fed was shifting to average inflation targeting, essentially aiming for above 2% inflation in the latter stages of a recovery. Accompanying that was an important change in emphasis on unemployment: instead of worrying about "deviations" the FOMC will now worry about "shortfalls". That change telegraphs the Fed is now much less concerned about negative repercussions from low unemployment for inflation than they used to be. Together these changes underscore that monetary policy will remain accommodative well into any recovery.

We also note the considerable divergence that is developing between markets and the economy: many, though not all, markets have rebounded fully or almost so, but the economy has not yet. That is partly due to how some industries are much more important for markets than the economy. Information technology, for example, comprising roughly 23% of the S&P 500 market cap, is only 5% of GDP. Housing, which we noted above is recovering particularly well, is much more represented in GDP than markets. In their industry analysis, our researchers will keep in mind that the market isn't the economy, and the importance of this distinction.

Elsewhere in developed markets, coronavirus cases in Europe are still relatively low, despite creeping slightly higher in August. While we don't expect this to derail the otherwise solid European recovery, we continue to watch closely. Surprise indexes for Europe are making new highs, and unemployment has risen only modestly, supported by government policy. Bank lending in Europe has not tightened as in the U.S., another positive sign for the Eurozone.

In the EM, coronavirus cases have moved sideways overall over the past two weeks, rising slightly, with the earliest hotspots easing but cases still rising in others. We see the highest levels in the western hemisphere, particularly in Latam, as well as the Middle East, the Balkans and South Africa. A slight downward revision of 2020 GDP forecast was due to weaker second quarter GDP results. Substantial data improvements in June partially offset poor April/May results including global manufacturing indicators, and production data. Notable exceptions prevail for each of these indicators. In Latam, steep virus cases have limited the economic rebound, with the exception of Brazil, due to its significant fiscal stimulus. Asia ex-China lags other EMs in global manufacturing PMI. In EMEA, Turkey stands out with a faster recovery though driven by unsustainable monetary and credit policies. Across EM economies, we presume gains in activity will continue but slow meaningfully going forward.

Somewhat in contrast to the economic activity side, we noticed significant upside surprises in EM external indicators. In particular, trade balances have improved sharply in June across many EMs and this trend appears to be continuing as some countries are reporting July data. For many countries, recent trade balances have reached new multi-year highs. While the recession clearly plays a role, we believe this is supporting a broader structural adjustment following many years of exchange rate weakness that is starting to be reflected in stronger external balances and ultimately a very positive development for EM as it implies lower external funding needs. Meanwhile, we are also seeing moderate upticks in inflation indicating that the large disinflation has run its course for now, though observed inflation rates are still very close to historic lows.

Our base case scenario assumes continued virus transmission in the U.S., but without renewed spikes, as endogenous social distancing and localized government measures proved sufficient to avoid another nationwide lockdown. Given positive development thus far, we estimate a vaccine to be available in Q1 2021. We expect continued fiscal support from governments globally, including U.S. Congress reaching agreement on a 4th support package. We also expect continued wide-ranging credit support from the U.S. Fed of roughly $1.5 trillion, coupled with ongoing direct purchases of Treasuries and mortgage-backed securities (MBS). Tensions between the U.S. and China remain high with rhetoric elevated, but avoiding a full trade war thus far. Despite optimism that global stimulus continues to offset the pandemic's negative economic implications, we are keeping a watchful eye on the risks that would emerge should fiscal stimulus not be extended.

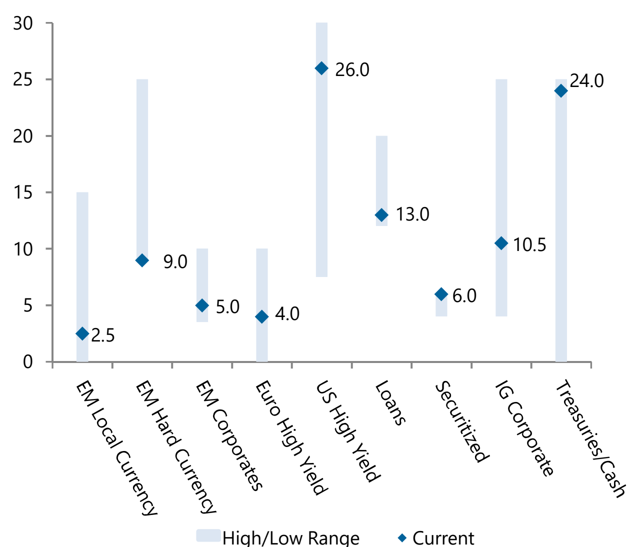
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Scenario	Assumptions
Base Case: Slow Grind Higher (50%)	• Coronavirus transmission continues in the US, but does not spike again; endogenous social distancing & localized government measures prove sufficient. • US avoids another severe nationwide lockdown. • Travel, restaurants, sports, conventions and large gatherings remain deeply depressed until a vaccine is available around late Q1-21. • Congress reaches an agreement on 4th package of fiscal support. Other countries also continue to provide further fiscal support. • Tensions between the US and China remain high. Rhetoric elevated between the two countries; this is partly for electoral reasons in the US and comes from both parties. Some further retaliatory trade & tech actions put into place, but both sides pull back from initiating full trade war. • Central banks mainly focus on implementing existing policies. For the Fed, that means the wide-ranging extension of credit worth about $1.5tr along with ongoing direct purchases of Treasuries and MBS. Framework reviews leads to enhanced forward guidance and average inflation targeting. • Defaults and bankruptcies—both individual and corporate—increase but remain under control. • European work-sharing programs support employment. Solid EU-wide coordination. • Oil remains stable: ~$40/barrel WTI, Brent ~$45. • Dollar flat to slightly weaker, partly due to closing of interest rate differentials.
Medical-Led Acceleration Starts in Q4 (15%)	• US spike controlled while Europe and Asia remain in relatively good shape. • Treatment improvements are substantial as pharmaceutical progress exceeds expectations; death rates move down substantially. Vaccine comes early—late 2020 rather than early 2021. • With better-than-expected outturns on treatment, activity improves substantially. Larger gatherings—including restaurants, sports and conventions—are able to resume at a higher rate. Supportive fiscal and monetary policies gain traction. • Improvement is global as better treatments spread. • By early 2021, output looks on track to return quickly to pre-virus levels. Though fiscal policies start to be dialed back, they remain supportive. • Fed maintains accommodative policy, but doesn't feel need to push further. Similarly for ECB. • Oil: WTI at ~$50/barrel; Brent ~$55/barrel.
US Exceptionalism... But Not in a Good Way (25%)	• Virus spread continues in the US, with ongoing disjointed policy response. Virus spread and deaths remain markedly higher in the US than other DMs; Europe and Asia continue to contain spread significantly better. • Congress does not pass additional fiscal support. Without the unemployment insurance supplement, the unemployed pull back on consumption. Delinquencies and personal bankruptcies increase. • Europe makes solid progress on coordinated fiscal support programs. • US growth lags significantly due to ongoing virus issues. Dollar weakens significantly due to wide growth differential and narrower interest rate differential. • Vaccine progress continues. As in the base case, vaccinations start in late Q1-21. Activity picks up substantially as a result globally. US does not pick up more than other countries. • Though US growth is softer, it is not soft enough to push the Fed into substantial further action. • EM virus control, and hence economic impact, mixed—some countries follow the European path and some the US. LatAm continues to do poorly. • Oil prices hit by lower growth: ~$30-35/barrel for WTI; Brent ~$35-40.
Lasting Global Scars (10%)	• 2020 proceeds largely inline with base case path. • The pickup in 2021 does not materialize. This could either be the result of failure/delays in the vaccine, or that the lingering scars of business bankruptcy, layoffs and changed behavior are substantial. • Malaise not limited to the US: other DMs and most EMs underperform expectations through 2021. • The hit to economic activity is pronounced; many temporary layoffs turn permanent. • Fiscal measures are ramped up further, but transmission to the real economy falters. • Fed institutes yield curve control (YCC) and pegs 10y at 0.25%. Numerous additional financing facilities put in place, and Fed pushes further out risk spectrum. • Defaults and bankruptcies increase meaningfully. • EU issues Eurobonds. ECB substantially expands asset purchases. • Oil: WTI drops to ~30/barrel; Brent ~$35.

	Base Case: Slow Grind Higher (50%)	Medical-Led Acceleration Starts in Q4 (15%)	US Exceptionalism...But Not in a Good Way (25%)	Lasting Global Scars (10%)
US Real 20 GDP (%)	-5.00	-4.50	-6.50	-5.00
US Real 21 GDP (%)	5.00	7.00	5.50	3.00
US Core PCE (%)	1.25	1.75	1.10	1.00
Fed Funds (%)	0.13	0.13	0.13	0.13
2yr Treasury (%)	0.13	0.50	0.13	0.13
10yr Treasury (%)	0.60	1.15	0.40	0.25
10yr Bund (%)	-0.45	-0.30	-0.15	-0.75
China 20 GDP (%)	2.00	2.50	2.00	2.00
China 21 GDP (%)	9.00	10.00	9.00	7.50
EM 20 GDP (%)	-1.50	-1.00	-2.00	-1.50
EM 21 GDP (%)	6.50	8.00	6.50	4.00

[1]Forecast Period: Next 12 months. Source: Stone Harbor.

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION AND RECENT ALLOCATION CHANGES[2]



Allocation Changes[3]		
	Month	Change (%)
EM Local Currency	April-May 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	May-June 2020	-2.5
Loans	Feb-Mar 2020	+1.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Aug-Sept 2019	+3.0
Treasuries/Cash	June-July 2020	+10.0

[3]Latest allocation change

[2]Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 31 July 2020. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

JULY CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	4.75	3.71	1.96	3.02	2.32	1.84	2.62
Duration (Returns from Interest Rates %)	0.37	1.22	0.11	0.70	0.55	0.17	0.97
Credit Beta (Returns from Spreads %)	4.38	2.49	1.85	2.32	1.77	1.67	1.65

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 25-year performance history
- Offices in New York, Chicago, 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.

New York	Chicago	London	Singapore
31 W. 52nd Street	10 S. Riverside Plaza	48 Dover Street	3 Killiney Road
16th Floor	Suite 875	5th Floor	Winsland House I
New York, NY 10019	Chicago, IL	London, W1S 4FF	Singapore 239579
+1 212 548 1200	+1 312 492 4251	+44 20 3205 4100	+65 6671 9711
Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets

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.