December 2019

Investment Policy Statement

A monthly review of the markets

What's on Developed Markets' Central Banks' Holiday Wish List?

Inflation

"A wonderful gift may not be wrapped as you expect."

– Jonathan Lockwood Huie

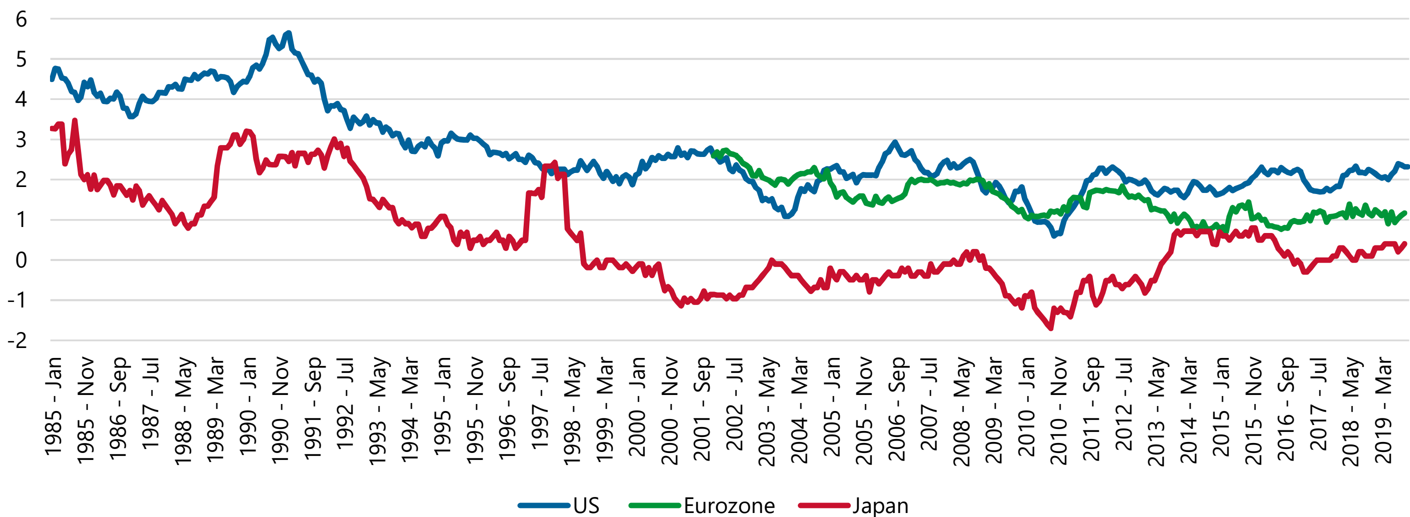
In the 1980s, Ronald Reagan colorfully stated that "inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." That vivid description reflected then-widespread fears that rampant inflation would erode consumer purchasing power, along with concerns that it could cause broader economic damage. High inflation rates in the 1970s were associated with frequent recessions, and stamping out persistently high inflation required the severe double-dip recessions of the early 1980s. During this time, developed markets central bankers saw fighting the specter of high inflation as their number one priority.

Following the Global Financial Crisis in 2008–2009, fears of runaway inflation emerged again as central banks embarked on unprecedented monetary and fiscal stimulus to attempt to jumpstart the global economy. However, despite a 10-year bull market and continued low rates over this time period, the developed world is now following Japan in finding out that *too little* inflation can also have negative side effects, as the Japanese experienced during the two "lost" decades of the 1990s and 2000s.

Today across the globe, the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan are all confronting inflation rates running below their targets. Indeed, as we approach the holiday season, if developed markets central bankers were to draw up their wish lists, higher inflation would probably be the top-most item.

In the US, Fed Chairman Jerome Powell explicitly addressed the consequences of too low inflation in a press conference following the December Federal Open Market Committee (FOMC) meeting. Powell stated that "while low and stable inflation is certainly a good thing, inflation that runs persistently below our objective can lead to an unhealthy dynamic in which longer-term inflation expectations drift

Inflation Rates for the US, Japan and Eurozone
Year-over-year (%)



Japan inflation rate does not include effects of the Value-Added Tax (VAT). Source: Haver Analytics, Bureau of Labor Statistics, Ministry of Internal Affairs and Communications, Statistical Offce of the European Communities

down, pulling actual inflation even lower….As a result, the scope for interest rate reductions to support the economy in a future downturn would be diminished, resulting in worse economic outcomes for American families and businesses." Powell acknowledged that while low inflation may appear beneficial, persistently lower inflation rates makes the Fed's policy tools less effective, as we discuss further below.

The Eurozone is in even worse shape than the Fed in terms of battling low inflation, as the ECB has consistently missed its inflation target. The new ECB president, Christine Lagarde, emphasized the bank's focus on increasing the Eurozone's inflation rate, which on a core basis stood at about 1¼% in early December versus its goal of close to but below 2%. In her first ECB statement, Lagarde reaffirmed "the need for monetary policy to remain highly accommodative for a prolonged period of time to support underlying inflation pressures and headline inflation developments over the medium term" and stated that the ECB will "closely monitor inflation developments and the impact of the unfolding monetary policy measures on the economy." Of note, Lagarde explicitly sees the goal of the ECB's monetary policy actions as to *increase* inflation rates. Compared with central banks' focus on crushing inflation in the 1970s and 1980s, these comments are truly remarkable.

What led to this desire to raise inflation? Why not just take the low inflation as an unexpected gift and rejoice? One reason may be the accumulating evidence that neutral real rates—the rate that would allow central banks to meet their dual mandates of promoting stable inflation and supporting employment levels—has fallen sharply. This shift implies the effective lower bound is much more likely to constrain how much stimulus central banks can provide. Put simply, if the neutral real rate is zero and inflation is 2%, the neutral nominal rate is 2% and zero is only 200 basis points away. Sure, there are other tools, such as forward guidance and quantitative easing (QE), which can partially get around the issue. But if the neutral real rate is the same and inflation is 3%, zero is then 300 basis points away. That extra 100 basis points of rate cuts provides substantially more stimulus to the economy. Moreover, it also makes the central banks' other tools more powerful as longer-term nominal rates would also be higher and hence could be pulled down more by forward guidance and QE.

So, what do central banks need to do to receive the gift of higher inflation? Paradoxically, they have to engage in what used to be considered bad behavior and run the economy hotter than they otherwise would. Instead of raising rates in the face of low unemployment, central banks appear poised to keep rates low to support near-term growth. That should close output gaps and put upward pressure on inflation, though we believe that upward pressure is likely to be slow.

For investors, this means they should expect steeper government bond curves as policy rates stay low in the short term but markets start to build in higher inflation in future years. The "gift" of higher inflation wouldn't be felt just in the market for Treasuries though. As we noted above, the mechanism through which higher inflation would come is a high-pressure labor market, and to achieve that the economy needs to grow faster in the near term. That should boost sales growth in the short term, in our view, making it easier for borrowers to repay their nominal obligations. Then, over time as higher inflation is (hopefully!) realized, firms would have higher pricing power and, again, higher sales growth but nominally fixed obligations. This is not costless of course, as firms would also have to pay their workers more over time.

In the short term, however, some benefits would likely accrue to riskier corporate bonds and be reflected in tighter spreads. Likewise, faster growth from developed markets would partially spill over to emerging markets (EM) countries, where faster growth again makes nominal debts easier to repay. That would provide support to their hard currency debt. Overall, as we enter the holiday season and into the New Year, higher inflation could bring a range of benefits for investors and ease the minds of central bankers around the globe.

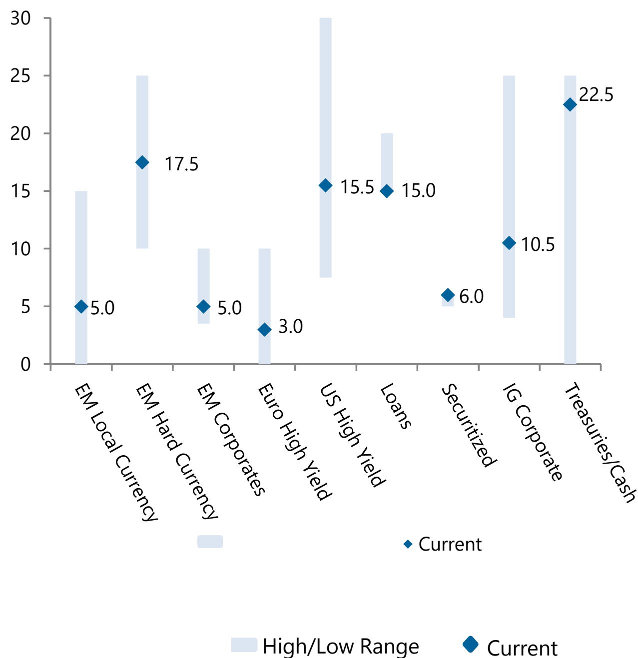
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Scenario	Assumptions
Current Trade Status Quo; Growth Reamins 1¾% (45%)	• GDP growth remains at 1¾% run rate. Growth is lower than 2018 due to lingering uncertainty and fading of fiscal stimulus. • US-China Phase 1 deal on trade sticks. Ongoing negotiations and no further increases on Chinese tariffs, but also no broader resolution. Mexico and Europe escape further tariffs, USMCA passses House and Senate. • Labor market remains decent (125k-150k); the unemployment rate broadily stabilizes. • Core PCE firms from slow late-2019 pace into 2020. • The Fed leaves policy rates in 1.5-1.75% range. • Growth in Europe remains sluggish, though improves relative to US as renewed ECB support filters through. • ECB implements curent plan but no additional monetary stimulus. Fiscal stimulus small. • Japan growth sluggish in near-term due to VAT hike but recovers somewhat into 2020. • EM growth around 4.4%; growth differential to US widens. • EM FX roughly flat against dollar. • Corporate profitability growth roughly stable.
Firmer Productivity Leads to Better-than-Expected Growth, Mini Trade Deal (25%)	• Growth surprises to the upside. Productivity starts to push higher as the tighter labor market incentivizes labor-saving investment. • China and US mini-deal builds some momentum and talks continue to go well. Further partial rollback of tariffs, and hence consequent boost to business confidence. • Firmer growth supports wages and inflation. • Fed remains on hold despite firmer growth data. Core PCE inflation firms, but not enough to concern the FOMC. • Eurozone growth moves back up to around 1½%. ECB leaves rates unchanged; asset purchases remain at current pace. • EM growth firms noticeably, as EM exporters of both manufactured goods and commodities benefit from rollback of trade tension. • EM FX modestly strengthens as growth improves in EM relative to the US. • Corporate profitability improves.
Trade Conflict Intensifies (15%)	• Trade relations deteriorate again. Tariffs originally scheduled for December 15 implemented. USMCA dies in Congress. European auto tariffs enacted along with various retaliations. • With higher tariffs looking more permanent, pass-through into inflation increases in US and other DM. • Slow US/China growth drags on global growth. • The Fed cuts rates a further 50 basis points, both as insurance against a more pronounced downturn but also in response to poor incoming data. Policymakers look through tariff-driven inflation as a one-time increase in the price level: growth effects dominate policy. • Rate cuts are effective: the US avoids outright recession, though growth clearly slows. • ECB cuts another 10 basis points, and modestly increases the size of asset purchases. • The dollar is broadly stronger as flight to quality predominates. • Corporate profitability hurt by tariff-led higher input costs and slower growth.
Shallow Recession (15%)	• Non-linear dynamics take over and slowing growth from the combination of fiscal drag, trade tensions and lagged policy tightening tip the US into recession. • Unemployment rises notably (~2.5pp). • The Fed cuts rapidly and deeply in response; rates are quickly taken back to the zero lower bound (ZLB) and forward guidance reinstated. Either QE restarted or rate caps on longer-term rates; short-term rates are not reduced below zero. • The recession is mild: the 2001 shallow slump rather than the 2009 once-in-a-generation crash. • With little policy space to respond, Europe and Japan also enter mild recessions. ECB cuts a further 10 basis points and substantially increases the size of asset purchases along with ongoing discussions on buying equities in size. • EM growth decelerates; some countries see output contract. • Flight to quality boosts dollar against EM. • Corporate profitability takes a substantial hit.

	Current Trade Staus Quo; Growth Remains 1¾%	Firmer Productivity Leads to Better-than-Expected Growth, Mini Trade Deal	Trade Conflict Intensifies	Shallow Recession
US Real GDP (%)	1.75	2.5	1.25	0
US Core PCE (%)	2.0	2.2	2.3	1.25
Fed Funds (%)	1.625	1.625	1.125	0
2yr Treasury (%)	1.7	2.2	1.3	0.1
10yr Treasury (%)	2.0	2.5	1.4	0.85
EM Growth (%)	4.5	5.0	4.0	3.4
China Growth (%)	5.8	6.2	5.2	4.8

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

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



High/Low Range ◆ Current

Allocation Changes[3]	Month	Change (%)
EM Local Currency	May-June 2019	-5.0
EM Hard Currency	Dec-Jan 2019	-5.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	Oct-Nov 2019	-3.5
US High Yield	July-Aug 2019	+3.0
Loans	Nov-Dec 2018	-5.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Aug-Sept 2019	+3.0
Treasuries/Cash	Oct-Nov 2019	+3.5

[3]Latest allocation change

[2]Since Inception: September 2013. Multi-Asset Credit Representative Target Allocation as of 30 November 2019. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

November 2019 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.27	-0.48	0.59	-1.82	0.38	1.32	0.16
Duration (Returns from Interest Rates %)	-0.15	-0.38	0.12	-0.31	-0.24	-0.18	-0.34
Credit Beta (Returns from Spreads %)	0.42	-0.10	0.47	1.51	0.62	1.50	0.50

Credit Market Total Returns reflect performance of representative asset class benchmarks. US HY: ICE BofAML US High Yield Constrained Index; EMD: J.P. Morgan EMBI Global Diversified; Loans: S&P/LSTA Leveraged Loan Index; 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. Past performance is not a guarantee of future results. Index performance is calculated on a total return basis with dividends reinvested and do not reflect the impact of management fees. Investments may not be made directly in an index. For illustrative purposes only.

STONE HARBOR INVESTMENT STRATEGY OUTLOOK

Economic Analysis

- Economic data is soft, but may be stabilizing
- Central banks have eased
- Fed expected to ease one more time

Valuation

- US yield curve prices 50 basis points of easing over next 12 months. We expect one 25 basis points cut
- Bund yields at all time lows
- Volatility is low and short positions are extreme
- Credit spreads have rallied to slightly cheap “through the cycle” value but do not capture “late cycle” environment
- EMD sovereigns can be cheap versus Loans/High Yield with potentially less fail risk

Sector Specialist Review

- Some concern over nature of loan issuance
- Within Emerging Markets Debt, bifurcation of spreads masks full extent of some opportunities
- More generally, markets responding aggressively to event risk

Stone Harbor Investment Partners

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, Singapore and Melbourne.
- Total assets under management: USD 21.9 billion as of 30 September 2019

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.

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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 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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