February 2021

Investment Policy Statement

A monthly review of the markets

Economies Have Room to Grow, Perhaps More Than Some Think

"Growth is never by mere chance; it is the result of forces working together"
– James Cash Penney

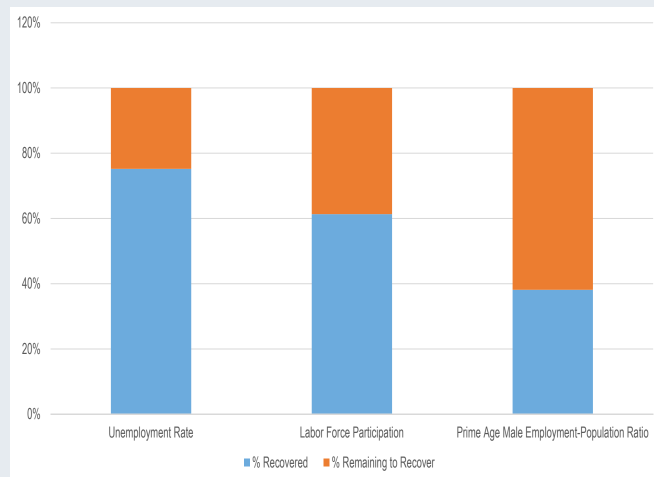
Recent US economic data shows initial signs of increased economic activity, with the outlook further supported by the improving pace of vaccinations and the likelihood of substantial stimulus. Along with these positive developments, however, concerns are being raised about the possible outcome of the economy ultimately overheating and creating an environment of higher interest rate and inflation. We believe these concerns are misplaced. In our view, output gaps[1] still yawn wide and suggest economies have significant room to grow.

The concern of economic overheating is partly driven by excessive pessimism about the productive capacity of developed market economies. For instance, the Congressional Budget Office (CBO) currently estimates that the US output gap is approximately 3%. Indeed, we would be worried about overheating if this were correct as we have penciled in 6% real GDP growth over 2021 in our base case. Especially so as data moving into 2021 has firmed in a manner consistent with the economy starting to accelerate. The February US Markit Purchasing Managers Index (PMIs) confirm that activity remains solid, with the services version incrementally improving to roughly the post-Covid high, while its manufacturing counterpart also points at solid growth. Housing continues to trend toward boom territory, as permits point at robust residential investment into the spring. Even more importantly, retail sales increased sharply in January, rebounding from depressed levels in late 2020. Not only does this data put the overall economy on a firmer path, in our view but it potentially shows the ability of fiscal policy to boost growth since $600 stimulus payments were delivered in early January.

However, we believe a 3% output gap seriously underestimates the upside growth potential. Why this optimism? Let's start by looking back to 2018 and 2019, when the CBO labelled the economy as well above potential, by about one percent each year. We believe CBO's outlook was then and is now misguided. Though the 2019 unemployment rate averaged 3.7%, the lowest since 1969, there were few signs of an overheated economy. Overall inflation remained very low with core personal consumption expenditures (PCE) running at 1.6% year-over-year in December 2019. That was 0.4 percentage points below the target of the Federal Open

[1] The difference between GDP and the CBO's estimate of potential GDP.

Figure 1: Broader Labor Market Metrics Point out More Slack



As of January 2021
Source: Bureau of Labor Statistics, Stone Harbor Investment Partners LP

Figure 2: Prime Age Male Employment-Population Ratio Has Not Recovered

As of January 2021
Source: Bureau of Labor Statistics, Haver Analytics, Stone Harbor Investment Partners LP

Market Committee (FOMC). Wages were only just starting to accelerate as the Employment Cost Index (ECI) had moved up to 2¾% from a 2009 low of 1½%, but in the early-2000s it was closer to 4% without any meaningful inflationary issues. In other words, the pre-COVID economy showed no sign of overheating in our view. Since we think the CBO was incorrect about the economy being one percent above potential back in 2019, we would add that percentage point back into the current output gap.

We are optimistic about the ability of the economy to rebound given the current market landscape. Though the labor market has improved substantially on some metrics, we think a fuller look at the overall state of labor market shows an underlying weakness, and hence room for more recovery. The US unemployment rate has dropped from 14.8% to 6.3%, a rapid recovery relative to history. Taken by itself, the unemployment rate points at relatively limited remaining slack; it has recovered about 75% of the ground lost. However, a large portion of that improvement is due to shifts in labor force participation. Due to the effects of the pandemic—temporary closures, business slack, childcare issues and so on—a substantial number of workers have left the labor force entirely. Labor force participation dropped sharply in the spring of 2020 and, though it recovered in the summer, it has again tailed off over the fall and winter, contributing to the depressed unemployment rate. Overall, unemployment has recovered only about 60% from the spring lows.

Comparisons of labor force particpation across time are imperfect due to shifts in labor force composition (e.g., portion of women and aging population in the labor force). However, prime-age male labor force participation is a useful metric because though there is a downtrend over time, the decline is fairly slow and steady, therefore, it provides a less skewed comparison over shorter time periods. Prime-age male employment to population is still deeply depressed, and only slightly better than the lows during the global financial crisis (GFC). Here, the rebound has recovered only about 40% of the ground lost, which implies that there is much more to go.

Generally, we think this metric does the best job of proxying for overall slack. Given this view, we remain quite sanguine on the prospects of sustained inflation as we think there remains substantial excess capacity, especially in the labor market.

Underscoring the importance of the labor market in assessing slack and hence monetary policy, Chairman Powell recently described what the US Fed is looking to recover: the labor market that existed in December 2019, before the coronavirus shock. He noted that "despite the surprising speed of recovery early on, we are still very far from a strong labor market whose benefits are broadly shared. Employment in January of this year was nearly 10 million below its February 2020 level, a greater shortfall than the worst of the Great Recession's aftermath. … Correcting this misclassification and counting those who have left the labor force since last February as unemployed would boost the unemployment rate to close to 10 percent in January." We believe this assessment, combined with a "flexible average inflation target," leaves the Fed poised to not overreact to the likely rapid growth in 2021. Instead, they will view it as the first steps toward closing the output gap and let the economy grow.

In Europe, the output gaps could be even larger than in the US in our view, given the lack of full recovery from the twin crises of the GFC and the Eurozone crisis. Europe has exhibited persistent and very low inflation over the past decade, which points to an extended period with an output gap. Indeed, if we look at the same prime-age male labor force participation rate, a number of European countries, especially Southern European countries, have levels that remain far below pre-GFC levels. To our mind, this implies that there is untapped labor in Europe that continues to exert downward pressure on inflation. On the fiscal side, though Europe has provided substantial support and the pan-European package being rolled out should help, there is nothing comparable in terms of size to the Biden plans. Unfortunately, this is coupled with what looks to be a slower rollout of vaccinations in Europe, which will likely keep activity, especially services activity, subdued in the near future. We expect that vaccinations will pick up over time and remain optimistic about European activity over the course of 2021. Nevertheless, we think that sizeable output gaps in Europe, much like in the US, make economic overheating a highly unlikely scenario.

US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Base Case: Slow Grind Transitions to Sharp Vaccine-Led Rebound (70%)

- Vaccine distribution acceleration continues; vaccines provide at least partial protection against variants.
- Travel, restaurants, sports, conventions and large gatherings improve with wider vaccination.
- European countries keep containment measures in place over short-term hurting activity. Near-term shortfalls made up for by more rapid future growth.
- Substantial stimulus passes through reconciliation, 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 and core inflation drops back below 2% by mid-summer.
- Central banks maintain extremely stimulatory policies.
- Oil remains roughly stable: ~$55/barrel WTI, Brent ~$60.
- 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 (10%)

- Pharmaceutical progress exceeds expectations. Additional vaccines approved and get to the populace 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 and moves on to infrastructure. The combination 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 ~$70/barrel; Brent ~$75/barrel.

Variants Derail Vaccine-Led Recovery (10%)

- Coronavirus variants prove resistant to current vaccines; the new strains spread rapidly. As a result the recovery lags as social distancing and government restrictions remain in place. The 2021 recovery disappoints meaningfully and economic scars turn lasting.
- 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.

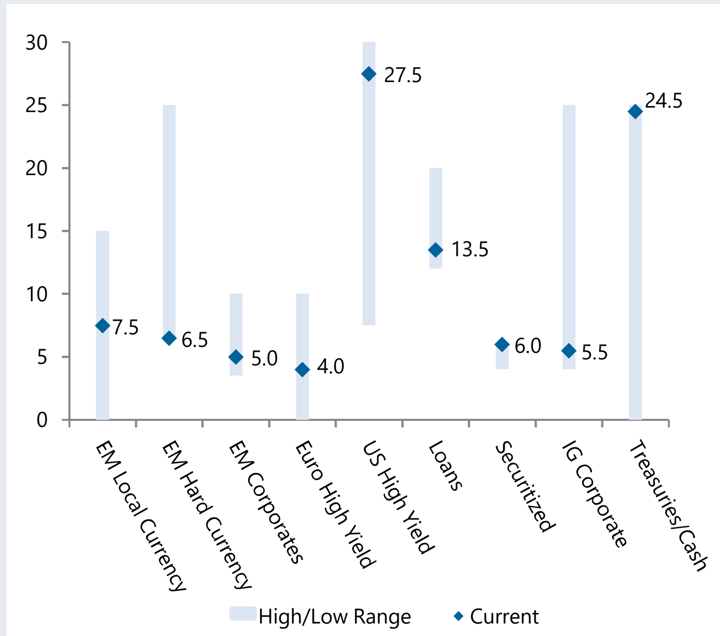
Inflation Accelerates (10%)

- 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 (70%)	Medical & Stimulus Led Acceleration (10%)	Variants Derail Vaccine-Led Recovery (10%)	Inflation Accelerates (10%)
US Real 4Q GDP (%)	6.00	6.75	3.00	6.00
Fed Funds (%)	0.13	0.13	0.13	0.13
US Core PCE (%)	1.70	1.90	1.10	2.60
2yr Treasury (%)	0.35	0.50	0.13	1.00
10yr Treasury (%)	1.40	1.90	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]



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

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

JANUARY CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.39	-1.09	1.19	-1.07	-0.07	0.57	-0.79
Duration (Returns from Interest Rates %)	-0.34	-1.27	0.00	-0.68	-0.52	-0.11	-0.96
Credit Beta (Returns from Spreads %)	0.73	0.18	1.19	-0.39	0.45	0.68	0.17

Month Ended 31 January 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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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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