Investment Policy Statement

A monthly review of the markets

Policy Space:
Room to Respond Matters, and the Fed Might Like a Little More

"There is no harm in hoping for the best, as long as you're prepared for the worst."

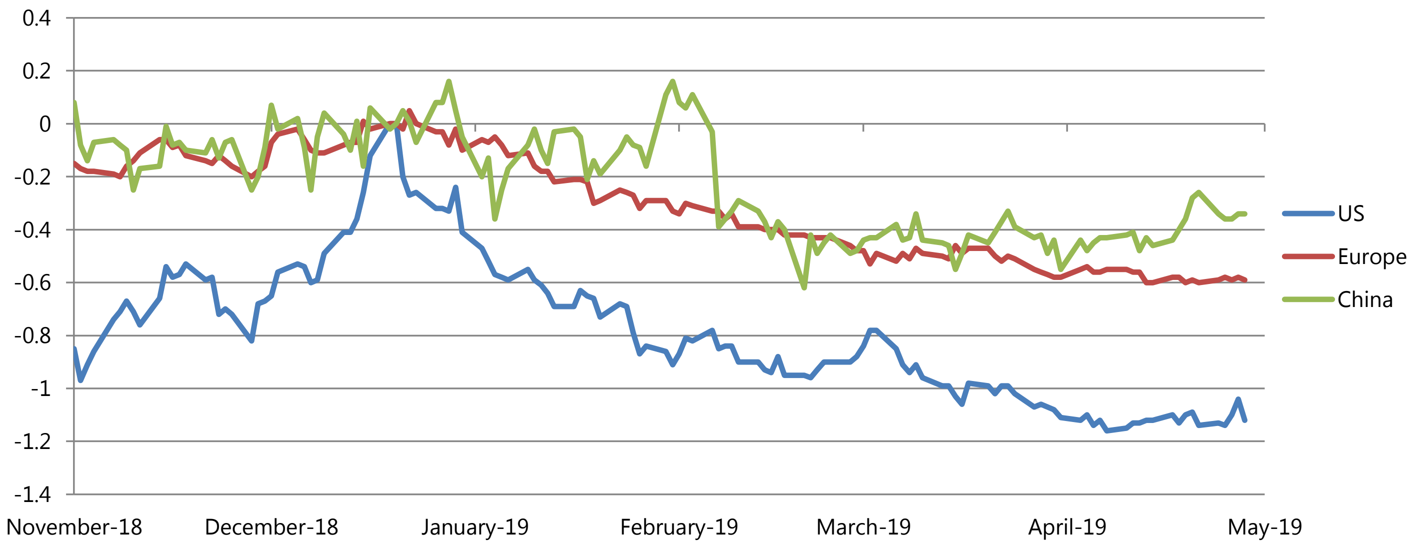
– Stephen King

The idea of policy space – the extent to which monetary and fiscal authorities have room to provide stimulus to the real economy – has been a useful framework for understanding the rationale for and market reaction to actions taken by policy makers over the last six months. Many economies currently have limited policy space. This constraint has led policy makers to be extremely sensitive to signs of an economic slowdown and tightening financial conditions. With lower bounds limiting their ability to stimulate the economy by cutting interest rates, many policy makers acted more preemptively than they might have in the past.

The world's largest markets – the US, Europe, and China – exhibit a wide range of policy space. The US falls in the middle: it has room to ease, but the zero lower bound on rates presents a real limit. Europe has very little room to ease: it is already at what appears to be its effective lower bound on rates. Then there is China, which has the most policy space, albeit using a broader concept of space that is less tied to monetary policy than in the US and Europe.

The shift in the US monetary policy stance since the end of 2018 sheds light on how having adequate policy space can playout to achieve real economic impact. At the end of 2018, US interest rates were well above zero, and markets were pricing in further rate increases. By ceasing rate increases and inserting the word "patient" into their policy description, the US Federal Reserve ("Fed") induced the market to price out future rate increases and loosened overall financial conditions, without actually lowering short-term interest rates. The limits on policy space, however, likely played a role in pushing the Fed toward easing. In the past, the Fed might have been more willing to allow data to accumulate before changing course, but the knowledge that they had only limited room to respond likely pushed them

Changes in Goldman Sachs Financial Conditions Index Relative to December 2018



Source: Goldman Sachs

to act earlier than they might have otherwise. That said, the US is far from unconstrained as the zero lower bound ("ZLB") would be binding in a pronounced downturn.

The European Central Bank ("ECB") also attempted to ease policy by firming up forward guidance and discussing further targeted long-term refinancing operations ("TLTROs"). But given that the interest rates were already below zero and the market was not pricing in any near-term increases, there was less policy space in which to act. Fiscal space, particularly in the countries that needed it most, was also limited due to low growth rates and higher debt/GDP ratios. The countries with more policy space, e.g., Germany, were also those doing better economically and, therefore, policy space offered limited value. As a result, and in contrast to the market reaction to policy easing actions in the US, the easing of European financial conditions was more muted, reflecting the perceived limits on further policy.

Lastly, China had the most policy space of the three markets, but the policy space for China was dissimilar to those in the US or Europe due to different political systems and goals. Instead of acting through standard monetary policy, they used policy space along fiscal and macroprudential dimensions to provide support to the economy. In particular, their ability to influence credit expansion of major state-owned banks proved to be a useful tool in early 2019 to quickly generate significant economic stimulus, although at the price of accepting higher leverage.

In terms of financial conditions, we have observed movements that are broadly in line with the amount and nature of policy space available. The US has seen a substantial easing in financial conditions. Europe has also seen financial conditions ease, but by less, reflecting the lower margin of policy space. China has only seen financial conditions ease modestly, but driven by the difference in the nature of the policy space, in our view. China's easing was not as focused on financial markets but reflected their ability to pull fiscal and macroprudential levers.

Looking forward, the understanding that more policy space allows the central bank to better achieve their goals is useful in thinking about the future path of US monetary policy. The Fed, led by Vice-Chair Richard Clarida, is assessing changes to their policy framework. In the context of the above discussion, this exercise can be viewed, at least partially, as an attempt to build in more policy space going forward. An upcoming conference at the Chicago Fed in June will provide a platform for different views within the system to be aired, but the thrust seems to us to be toward opening up more policy space. There are a number of forms this could take, for instance by allowing inflation to run above the 2% target during expansions. In any case, the potential implications of this attempt to expand policy space are large, and we will be watching it closely.

INVESTMENT STRATEGY OUTLOOK

Economic Analysis

- Fed approaching neutral
- ECB potentially less accommodating
- Economic sentiment data more cautious
- China easing

Valuation

- Broad long term valuations approaching fair value, in our view, but with disparity across asset classes
- Emerging Market Sovereigns look very cheap versus High Yield Corporates to us

Sector Specialist Review

- Within High Yield most industries look expensive to us
- Within Emerging Markets Debt, real yields and Local Currency look relatively attractive, in our view
- Markets appear to have priced in idiosyncratic risk

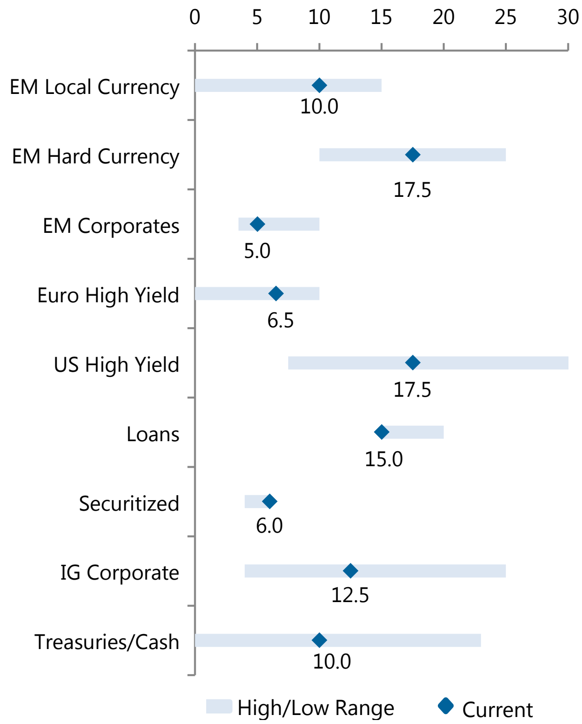
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Gradual Growth Slowdown (55%)	• The ongoing roll off of US fiscal stimulus pulls GDP growth down to 2%. • Labor market remains healthy as the unemployment rate broadly stabilizes. • Trade issues remain, but do not significantly intensify. • Questions about below target inflation remain pertinent as inflation measured by the core personal consumption expenditures ("PCE") deflator only partially rebounds. • Growth in Europe and Japan remains sluggish, though improves relative to the US. • Emerging Markets ("EM") growth is little changed, but growth differential to the US widens. • Soft growth and sluggish inflation leads to Fed inaction. A rate cut is a realistic possibility, but is dependent on the realization of continued below target inflation. • EM FX shows moderate strength against US dollar as US rates remain restrained. • Corporate profitability growth comes under modest downward pressure.
Mild US Recession (15%)	• The combination of fiscal drag, lagged rate increases, overleveraging, trade wars, and drag from weak foreign growth tilt the economy into recession. • The Fed cuts rates rapidly and deeply in response; rates are quickly taken back to the zero lower bound ("ZLB") and forward guidance is reinstated. Balance sheet reduction is paused and there are ongoing discussions about restarting quantitative easing ("QE"). • The recession is mild and resembles the 2001 shallow slump not the 2009 once-in-a-generation crash. • Growth in Europe and Japan slows, but they manage to avoid recession. • EM growth decelerates, but generally avoids recession. Flight to quality boosts US dollar against EM currencies, on average. • Corporate profitability declines moderately.
Substantial Trade Conflict (22.5%)	• No progress is made in resolving the China-US impasse. The US ends up imposing tariffs on European autos, Europe then retaliates. USMCA appears unlikely to move through Congress, leading to renewed negative NAFTA rhetoric. • With higher tariffs likely more permanent, pass-through into inflation increases both in the US and other developed markets ("DM"). • Trade reversal results in a moderate drag on growth in both DM and EM. • Higher inflation roughly offsets weaker growth; policy rates remain unchanged. • Corporate profitability is hurt by tariff-led higher input costs.
Global Growth Acceleration (7.5%)	• The recent US productivity acceleration proves durable. Some combination of tax reform and tighter labor markets prove sufficient to boost productivity growth to ~2% from past half decade's ~1% rate. • With rapidly expanding potential output, there is little inflationary pressure. • More robust growth spills over internationally; Europe and Japan both accelerate. • GDP growth also picks up for EM exporters of both manufactured goods and commodities. • EM FX comes under modest pressure. Firmer US growth and higher real rates help push the dollar stronger, but are mostly offset by the better growth results in EM. • Improved productivity boosts corporate profitability.

	Gradual Growth Slowdown	Mild US Recession	Substantial Trade Conflict	Global Growth Acceleration
US Real GDP (%)	2.0	0	1.5	2.75
US Core PCE (%)	1.75	1.25	2.25	2.1
Fed Funds (%)	2.375	0.125	2.375	2.875
2yr Treasury (%)	2.5	0.1	2.4	3.25
10yr Treasury (%)	2.75	1.25	2.5	3.5
EM Growth (%)	5.1	4.0	3.2	5.7
China Growth (%)	6.2	5.0	4.5	6.7

[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 2018	+2.5
EM Hard Currency	Dec-Jan 2019	-5.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	Mar-April 2019	+2.5
US High Yield	Jan-Feb 2019	-3.0
Loans	Nov-Dec 2018	-5.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Mar-April 2019	+1.5
Treasuries/Cash	Mar-April 2019	-5.0

[3]Latest allocation change

[2]Since Inception: September 2013. Multi-Asset Credit Representative Account Target Allocation as of 30 April 2019.

April 2019 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	1.40	0.24	1.65	-0.18	0.78	1.68	0.62
Duration (Returns from Interest Rates %)	0.04	-0.35	0.21	-0.17	-0.05	-0.19	-0.38
Credit Beta (Returns from Spreads %)	1.36	0.59	1.44	-0.01	0.83	1.87	1.00

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. Actual allocations within any account may be significantly different from the target allocations shown here. 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, Singapore and Melbourne.
- Total assets under management: USD 26.99 billion as of 31 March 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 U.S. Corporate Investment Grade Index** is a sub-index of the U.S. Aggregate Index. It measures the investment grade, fixed rate, taxable corporate bond market and includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.