Investment Policy Statement

A monthly review of the markets

Can the ECB Keep Steady in Their Balancing Act?

"Step with care and great tact, and remember that Life's a Great Balancing Act."

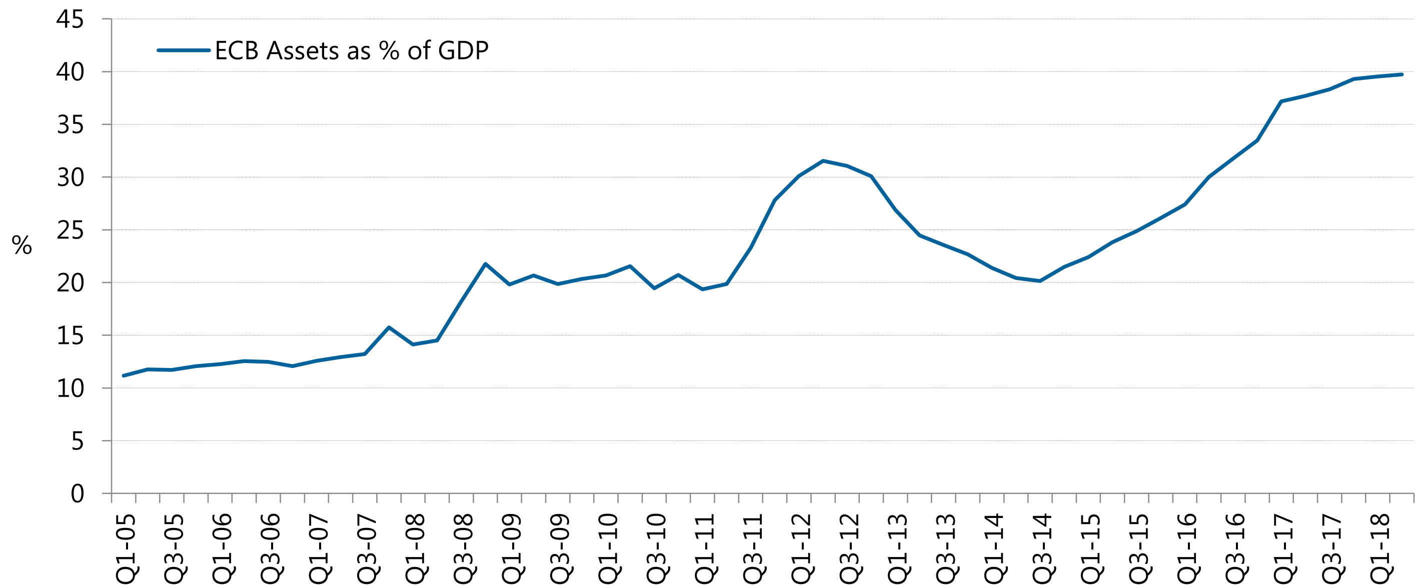
– Dr. Seuss

After four years of a stimulus program that was designed to boost the health of the European economy and induce growth, the European Central Bank ("ECB") met on December 13th and decided it will stay on course to formally end the EUR2.6 trillion bond buying program, raising the possibility of rate increases in late 2019. At the same time, the US Federal Reserve ("Fed") is marking year two of its balance-sheet unwind and announced a fourth rate hike of the year, setting the Fed Funds target rate at 2.5%. In both cases, the policy moves that control the world's key interest rates are closely being scrutinized given the current backdrop of global growth slowdown, market volatility, and rising trade tensions.

The ECB has been positioning for an end to quantitative easing ("QE") in recent months, pointing to the growth in the 19-nation euro zone economy, which has outpaced trend growth for much of the past two years. While recent economic data have been weaker than expected, the ECB president, Mario Draghi, has characterized the weakness as a natural slowdown and normalization of the growth process on the heels of robust growth since 2014. In fact, the weakness has been compounded by stops in auto production as manufacturers adjust to new emissions standards. The ECB has further suggested that inflation in the euro area should pick up and their forecast is for the core inflation to rise to 1.5% next year.

We would be inclined to see a downward bias to the ECB's inflation forecast. Firstly, the current slowdown, which has been most notable in Germany, has been more impacted by the slowdown in global trade, and in particular, by softness in China. The IFO

ECB Balance Sheet vs. Eurozone GDP: Support From QE is Set to Diminish



As of 30 June 2018. Source: Haver Analytics

survey of business expectations in Germany continues to decline and suggests growth may not rebound as rapidly as some expect. Secondly, while labor markets are tight in Germany, there remains significant slack in the rest of the euro area and this may potentially dampen any upward pressure on inflation, in our view.

Furthermore, the ECB needs to be cognizant of a series of asymmetric risks to European growth. While a new budget deal has been reached and disciplinary actions against Italy seem to have been averted, concerns remain around the mechanics of the spending plan, and ultimately the sustainability of Italy's budgetary policies. In the near term, the risk of further widening of Italian bonds spreads and increased difficulty for Italian Banks in financing markets remain. As the euro zone's third biggest economy, significant instability here risks contagion. Another risk is the UK's ongoing Brexit discussions that retain the risk of a hard break from the EU. While a hard break scenario would likely be extremely challenging for the UK, it could also potentially create broad disruption for the Eurozone. External to Europe, the slowdown in China and its impact on global growth is evident in declining exporter confidence readings. At the same time, the threat of US auto tariffs remains. With uncertainty readings high, we expect that the ECB will bias towards caution in its future guidance.

The end of QE in Europe means that first quarter 2019 will likely see the first year-over-year decline in central bank balance sheets since early 2015. Unlike then, this course is expected to be sustained. As balance sheets have declined and as the market has had to learn to absorb greater government bond issuance, we have seen credit spreads widen globally. At the time of writing, European credit spreads have widened approximately 180 basis points this year. Central banks will need to take into account the tightening impact when setting the future course of monetary policy. The Fed will likely moderate its pace of tightening as the fed funds rate approaches the neutral rate, recognizing that the yield curve – often a precursor to rising market volatility – is signaling a rise in recession risks. In the euro zone, we suspect that faced with moderating global growth and continued domestic risks, the ECB may well delay its first rate hike into 2020. In aggregate, we believe central bank policy actions will generally promote relative stability over the coming year.

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 very cheap versus High Yield Corporates

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

STONE HARBOR ECONOMIC AND MARKET OUTLOOK (30 November 2018; Forecast Period: Next 12 months)

	Rapid Growth	Moderate Growth	Slow Growth	Recession
ECONOMY				
Real GDP	3.1	2.3	1.5	0.0
Inflation	3.0	2.3	1.9	1.2
MARKETS				
Fed Funds	3.2	2.7	2.2	1.4
2yr Treasury	3.6	3.0	2.3	1.7
10yr Treasury	3.9	3.2	2.5	2.0
PROBABILITY (%)[1]	20	50	20	10

[1]Stone Harbor assigns probability that each scenario occurs. 12-month forecasts are 4-quarter growth ending current quarter +1 year

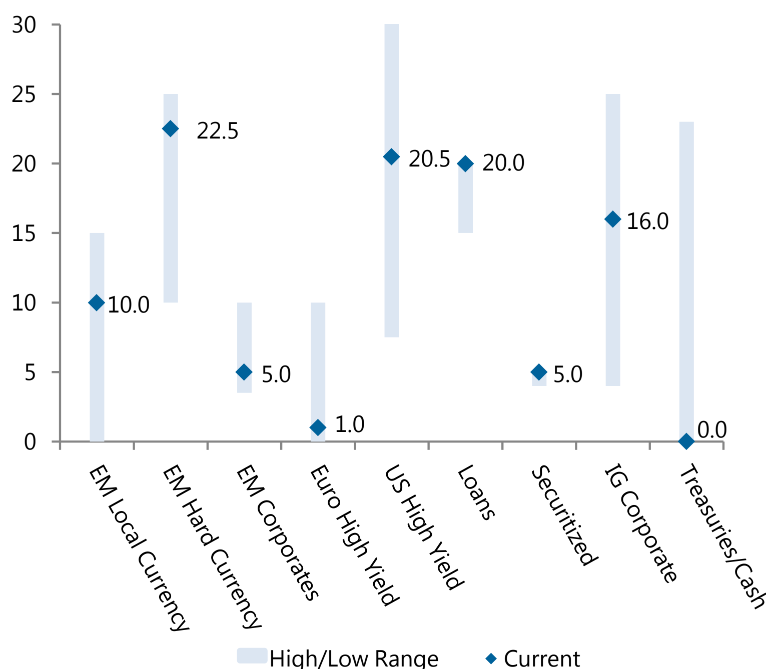
GDP Growth (%)					
	2017	Q1 18	Q2 18	Q3 18	Q4 18 (f)[2]
US	2.2	2.2	4.2	3.5	2.7
Euro	2.5	1.5	1.7	1.6	1.7
EM	5.2	5.4	5.4	4.9	4.9

[2](f) - forecasted

Interest Rates (%)[3]			
	Fed Funds	2yr TBill	10yr TBill
Low	1.25	1.77	2.33
High	2.25	2.96	3.23
Current	2.25	2.78	2.98

[3]Current as of 30 November 2018; High-Low over last 12-months

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION AND RECENT ALLOCATION CHANGES[4]



Allocation Changes[5]		
	Month	Change (%)
EM Local Currency	April-May 2018	+2.5
EM Hard Currency	Oct-Nov 2018	+3.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	Oct-Nov 2017	-2.5
US High Yield	Sept-Oct 2018	+8.0
Loans	July-Aug 2015	+3.0
Securitized	April-May 2018	+1.0
IG Corporate	Oct-Nov 2017	-0.5
Treasuries/Cash	Oct-Nov 2018	-3.0

[5]Latest allocation change

[4]Since Inception: September 2013. Multi-Asset Credit Representative Account Target Allocation as of 30 November 2018.

NOVEMBER 2018 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-0.91	-0.42	-0.90	2.81	-0.16	-1.91	-0.25
Duration (Returns from Interest Rates %)	0.74	1.01	0.21	0.88	0.77	0.23	0.78
Credit Beta (Returns from Spreads %)	-1.65	-1.43	-1.11	1.93	-0.93	-2.14	-1.03

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. Investments may not be made directly in an index. Actual allocations within any account may be significantly different from the target allocations shown here and do not reflect the impact of management 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, Singapore and Melbourne.
- Total assets under management: USD 29.35 billion as of 30 September 2018

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 FTSE High Yield Market Capped Index represents a modified version of the High Yield Market Index by delaying the entry of fallen angel issues and capping the par value of individual issuers at U.S. $5 billion par amount outstanding.

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.

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