# Investment Policy Statement

## *A monthly review of the markets*

### Safe Harbor on the Horizon, But a Storm May Be Rolling In

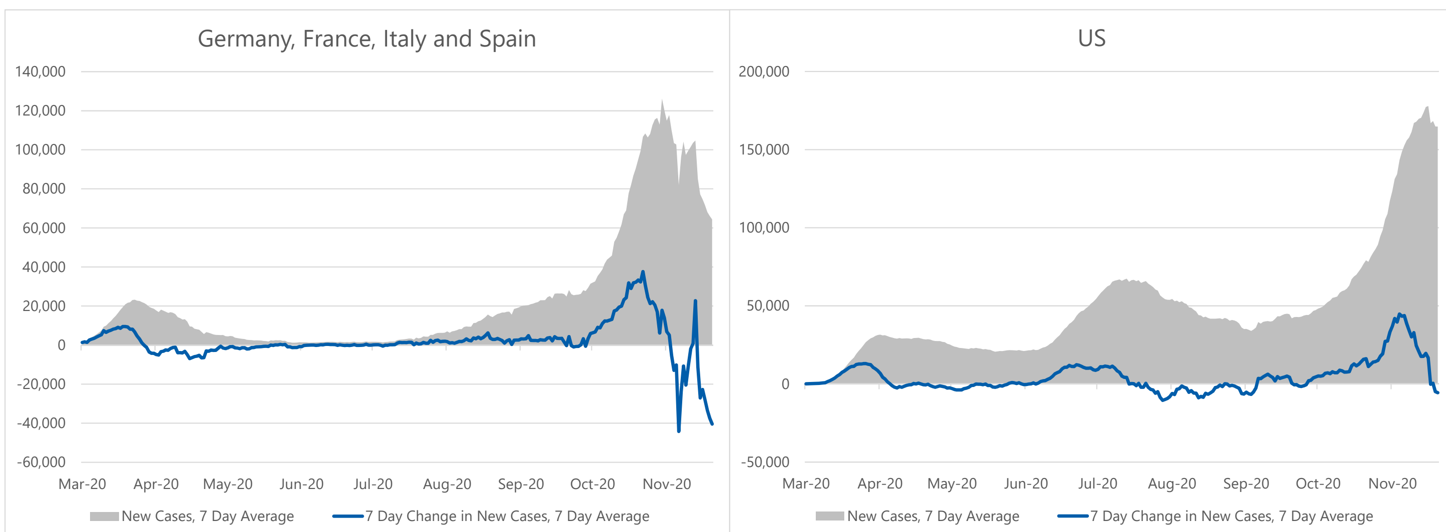
*"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails"*
*– William Arthur Ward*

We noted in our last month's issue that substantial uncertainty would be resolved by new information, particularly as it relates to the outcome of the US presidential election and progress with the coronavirus vaccine. Since then, we have gained clarity around these key risks, and arguably, positive developments concerning a vaccine have exceeded expectations. We are mindful that significant risks remain: on the political front, the smoothness of the Trump-Biden transition in the US and the existence and size of the still-to-come stimulus package; and on the vaccine side, the timeline for availability and broad distribution of the vaccine. Though the path forward is clearer, the positive impact will take some time to filter through the global economy. Given the significant amount of new information we now have, but acknowledging that there are growing virus risks that need to be properly managed, we are cautious in our short-term economic outlook, but optimistic over the next year.

Virus cases have spiked in Europe and the US, while case numbers in Latin America, Asia, and Africa are generally trending down or at least holding stable. To some extent, this highlights the seasonal factor in the virus spread, but wide dispersion of Covid dynamics across emerging markets, for example, suggests that containing the surge will require behavioral changes and endogenous responses in concert with government mandates.

In Europe, there are tentative signs that these behavioral changes are having a positive effect in slowing the infection rate. However, the cost is a clear short-term drag on economic activity, albeit a smaller one compared to what we saw in Q2.

## Figure 1: Case Growth is Very Elevated, But There are Tentative Signs of Growth Slowing




As of November 29, 2020
Source: Bloomberg and Stone Harbor Calculations. (Confirmed coronavirus (2019-nCov) case counts compiled by Bloomberg Newsroom. Counts are subject to change as governments survey and confirm cases. Data are based on reported values as of Midnight EST. Sources include Johns Hopkins University, World Health Organization, DXY, NHC, BNO News, China CDC, European CDC, US CDC, Italy Ministry.)

For example, declining private consumption data and mobility point in the direction of slowing activity. We are also seeing deterioration in European Purchasing Managers' Indexes for services across the continent, but again, the level is not near that of March/April of this year. We expect more fiscal support out of individual European countries, which will continue to help buffer the near-term economic pain, in our view.

In the US, virus cases have also increased significantly since early September and are still rising. However, there are some signs that case growth is slowing as behavioral changes — both mandated by various levels of government and taken individually — are starting to take effect. As the chart above illustrates, the 7-day change in the 7-day average of new cases, though still high, is lower than in mid-November (though the most recent several days may be distorted by Thanksgiving). Mobility data has just started to move down but the response looks to be somewhat slower than in Europe. The potential lack of a fiscal support package, or an undersized one, may exacerbate risks through winter as personal income levels are coming back down from an earlier boost. Our baseline view is that what we have learned about safely keeping parts of the economy open and hence better targeting of stringency measures will allow the US to contain virus spread with a substantially less severe hit to economic activity than in the spring. However, risks around this clearly remain high over the next several months.

Beyond the next several months, our outlook is meaningfully more positive, driven primarily by medical progress on vaccines and, to a lesser degree, on monoclonal antibodies, and even if controlling the near-term spread requires more stringent measures, So far, vaccine results from Pfizer and Moderna — both producing high efficacy rates of ~95% — are unambiguously positive. News on the Oxford/AstraZeneca collaboration, while showing lower efficacy, is also an important positive as their vaccine is logistically simpler to distribute and could be rolled out in greater size. With eight other vaccines currently in phase 3 testing as of this writing, the likelihood of further good news is high. Progress with therapeutic antibodies is also encouraging.

For this progress to translate into real economic impact, the vaccines and antibodies need to be produced in size and distributed broadly and quickly. Here, the apparent success of multiple vaccines, with potentially more to come, is important as more approved vaccines allow for faster distribution. A plan from the National Academy of Medicine places those at highest risk of contracting the virus at the top of the list to receive the vaccine, which potentially means that 15% of the US population could be vaccinated by January or February 2021. With a multi-phase process of vaccinating segments of the population, we could see activity levels reach something close to "normal" by summer, in our view. Our current outlook takes into account a potentially choppy path to recovery in the short-term if virus containment disruptions drag on growth through the winter. However, if near-term downside risk is realized, we envisage more rapid post-vaccine growth in 2021 that compensates for the previous drag. The biggest risk to our medium-term optimism is that lingering scars from the shutdowns — e.g., closed businesses, permanent unemployment, high debt etc. — impede the recovery. A substantial and well targeted stimulus package would alleviate some of these downside risks and help to assuage our concerns.

We continue to expect monetary policy to remain very supportive; the Federal Reserve and European Central Bank are both likely to ease further in December, even if the exact form of that easing is still unclear. In our baseline, we anticipate that Congress will eventually pass a further fiscal package, though one that is moderately undersized. Other countries are also likely to continue to provide further fiscal support, in our view. That support should provide impetus to growth that aligns with a vaccine-led rebound in developed markets, but near-term growth is likely to remain soft.

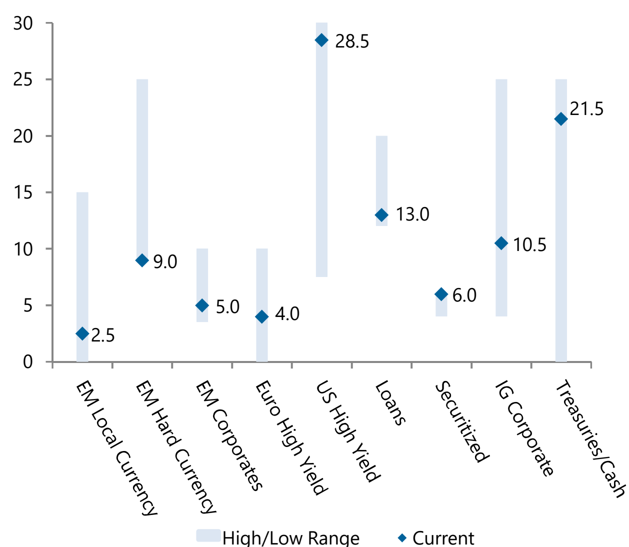
## US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

| Scenario | Assumptions |
|---|---|
| Base Case: Slow Grind Followed by Vaccine-Led Rebound (70%) | • Coronavirus transmission continues in the US. Increases in endogenous social distancing and localized measures prove sufficient to keep spread at levels the public finds acceptable. Vaccine starts to become broadly available in late Q1-21.<br>• US avoids another nationwide lockdown.<br>• Travel, restaurants, sports, conventions and large gatherings remain depressed until vaccine distribution.<br>• Potential for choppy path to recovery in the short-term if virus-containment disruptions drag on growth through the winter: a realistic near-term downside. In the case of a soggier winter, however, in this scenario faster post-vaccine 2021 growth makes up the lost ground and leaves the level of GDP one year ahead the same.<br>• Increased European virus spread leads to some growth-retarding measures, but not full lockdowns. As in US, recovery continues but at a slower pace and near-term shortfalls are made up by more rapid future growth.<br>• Congress eventually passes a moderately undersized fiscal package. That package provides impetus to growth that aligns with vaccine-led rebound, but an air-pocket remains in place until then. Other countries also continue to provide further fiscal support.<br>• US/China tensions cool somewhat with Biden administration, but do not return to pre-Trump status quo.<br>• Central banks provide modest additional stimulus. For the Fed, the amended average inflation targeting framework leads to enhanced forward guidance tied to outcomes and some enhancements to QE. The ECB provides more accommodation through tweaks to PEPP and TLTROs.<br>• Oil remains stable: ~$40/barrel WTI, Brent ~$45.<br>• Dollar broadly weakens, partly due to closing of interest rate differentials and partly from lower US real rates associated with Fed policy shift. |
| Medical-Led Acceleration (15%) | • Pharmaceutical progress continues to exceed expectations. Additional vaccines show positive results. With more vaccines approved, vaccinations get to the populace more quickly. At the same time, the rollout of monoclonal antibodies helps push death rates down further.<br>• In the US and Europe containment measures restrain virus spread with substantially lower economic cost than in Q2-2020. Asia remains in relatively good shape.<br>• With better-than-expected outturns on containment, treatment and vaccination, activity improves substantially.<br>• Supportive monetary policies gain traction.<br>• Improvement is global as better treatments spread.<br>• By early 2021, output looks on track to return quickly to pre-virus levels. Fiscal policies remain supportive; US passes another package.<br>• Fed puts into place duration extension at December meeting but otherwise focuses on maintaining accommodative policy, but doesn't feel need to push further. Similarly ECB only modestly extends PEPP.<br>• Oil: WTI at ~$50/barrel; Brent ~$55/barrel. |
| 2nd Wave Leads to Lasting Scars (15%) | • The virus leaves lasting scars on the economy. As a result the expected recovery in 2021 does not materialize.<br>• The scars come from a variety of lingering effects: 1/ business bankruptcies increase as official support fades; 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.<br>• Malaise not limited to the US: other DMs and most EMs underperform expectations through 2021.<br>• 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.<br>• Trade tensions persist, as in the base case.<br>• Dollar sees renewed flight to safety support.<br>• Oil prices hit by lower growth: ~$35-30/barrel for WTI; Brent ~$30-35. |

| | Base Case: Slow Grind Followed by Vaccine-Led Rebound (70%) | Medical-Led Acceleration (15%) | 2nd Wave Leads to Lasting Scars (15%) |
|---|---|---|---|
| **US Real 4Q GDP (%)** | 5.50 | 6.00 | 3.00 |
| **Fed Funds (%)** | 0.13 | 0.13 | 0.13 |
| **US Core PCE (%)** | 1.50 | 1.70 | 1.00 |
| **2yr Treasury (%)** | 0.13 | 0.40 | 0.13 |
| **10yr Treasury (%)** | 0.75 | 1.10 | 0.25 |
| **10yr Bund (%)** | -0.45 | -0.30 | -0.75 |
| **China 4Q GDP (%)** | 5.00 | 5.25 | 4.50 |
| **EM 4Q GDP (%)** | 5.00 | 6.00 | 3.50 |

[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** | Aug-Sept 2020 | +2.5 |
| **Loans** | Feb-Mar 2020 | +1.0 |
| **Securitized** | Mar-April 2019 | +1.0 |
| **IG Corporate** | Aug-Sept 2019 | +3.0 |
| **Treasuries/Cash** | Aug-Sept 2020 | -2.5 |

[3]Latest allocation change

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

## OCTOBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

| | US High Yield | EM Hard | Loans | EM Local | EM Corp | Euro High Yield | IG Corporate |
|---|---|---|---|---|---|---|---|
| Total Return | 0.45 | -0.03 | 0.20 | 0.43 | 0.26 | 0.42 | 0.11 |
| Duration (Returns from Interest Rates %) | -0.40 | -1.17 | -0.04 | -0.71 | -0.53 | 0.25 | -0.70 |
| Credit Beta (Returns from Spreads %) | 0.85 | 1.14 | 0.24 | 1.14 | 0.79 | 0.17 | 0.81 |

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

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- 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.


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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 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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