Investment Policy Statement

A monthly review of the markets

China: Can Its Long-term Strategic Goals Withstand Turbulence?

"You measure the size of the accomplishment by the obstacles you have to overcome to reach your goals."

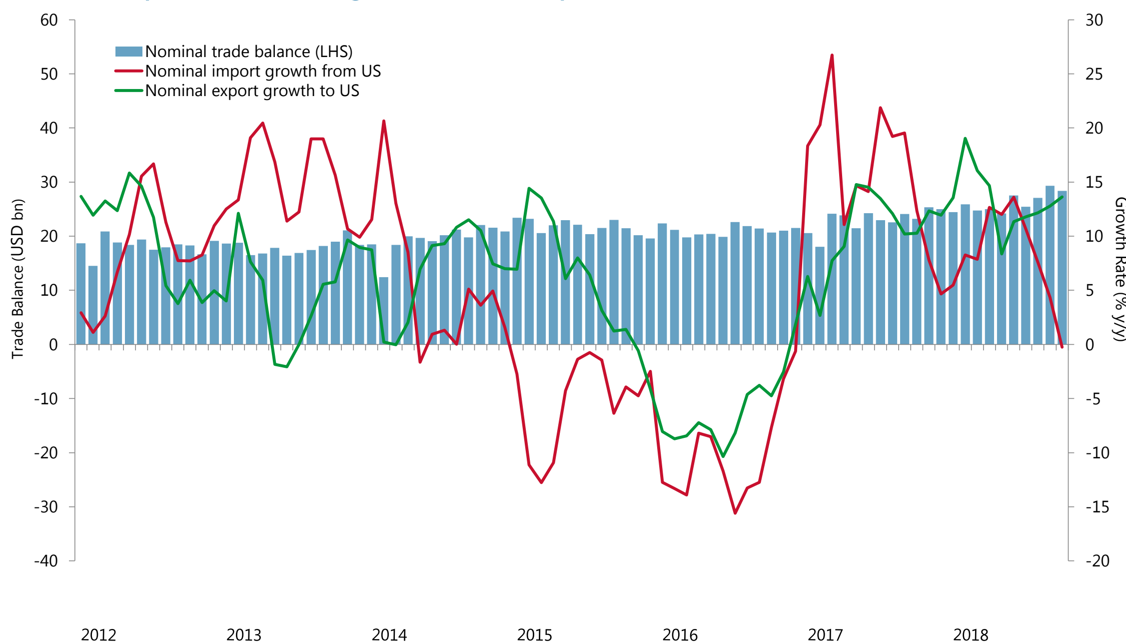
– Booker T. Washington

Four decades of reform have transformed China from one of the most under-developed countries to the second largest economy in the world. It is transitioning from an export-based to a service-based model – the success of which carries huge implications for the world, in general, and for emerging markets ("EM"), in particular. Over the next five years, we expect Chinese financial markets to be fully open, as China aims to deepen its integration into the global economy and financial markets. The large scale "Belt and Road" initiative – infrastructure and economic network connecting Asia, Europe, and Africa – demonstrates China's determination to play a larger global role. A key incentive for opening capital markets is the goal to "internationalize" their currency and achieve international reserve currency status. China's efforts in this respect would also help attract foreign investment, which has become more important as the current account surplus has all but disappeared.

With China's successes comes the ongoing debate on the extent and timing of its eventual economic growth slowdown. While growth has stabilized at about 6.5%-7% since 2015, the debate about a potential further slowdown continues, mainly driven by concerns around high leverage in the economy, continued imbalances with very high investment and low consumption rates, and more recently, heightened concerns about the impact of US trade measures.

As of yet, there does not appear to be evidence of significant impact from US tariffs on China's exports. Latest data does not show weakness in China exports to US and to rest of the world. This could be attributed to front-loading of products that will get hit with the 25% tariff in January 2019 and may explain China's better-than-expected export performance since the US implemented the first round of tariffs on Chinese imports in early July. There is also no sign of China slowing in imports.

China's Trade Balance: Exports to US strengthened while imports from US slid



As of 31 October 2018. Source: Haver Analytics

Although, similar to the front-loading concept, this could also be a timing issue where the weakness appears at a later stage. But where we are seeing change is imports from the US to China, which has slowed. In other words, exports to US has strengthened, while imports from US has slid, leading to a record high China-US trade surplus (see chart above). One possible driver of this outcome may be a deliberate reluctance by China to buy US products and not necessarily a result of tariff implementation thus far.

On the flip side, however, some high frequency, forward looking data suggests slowdown ahead. China's Purchasing Managers Index (PMI) export orders have slowed and this data suggests weakness ahead. Retail trade is also showing some slowdown. In other measures, e.g., industrial and electrical production and fixed asset investment growth, although volatile, there is no sign of a slowdown. However, it is worth mentioning that any weakness would likely trigger further policy stimulus, some of which are already underway. This would at least partially offset trade-related weakness.

If we look at the real estate segment of the Chinese economy, we see that the housing cycle remains supportive of growth, as well. Real estate development remains strong, property prices continue to rise, particularly outside of Tier 1 cities, and vacant floor space in residential real estate is down. Importantly, policies remain in place that have aimed at reducing demand in top cities, while encouraging inventory reduction in lower tier cities (albeit these policies could easily be relaxed in case of market weakness).

With these measures aside, the headline focus is on global trade tensions scenarios. According to the IMF, direct impact of tariffs on US (incorporating the 25% tariff on $267 billion going into effect in January) is estimated to be around 0.3%, which would take a few years to materialize; impact on China is estimated to be a little over 1%. Conversely, IMF analysis shows a positive impact on USMCA (formerly NAFTA) trading partners due to trade diversions. They have also noted a slight positive impact on Japan and Euro area. The most striking point of the analysis is that the biggest impact is seen when you include loss of confidence effect.

At this time, our base case foresees a resumption of the gradual slow-down in growth towards 5.5-6.0% over the next few years, a rate that we view as sustainable given China's characteristics (in particular, its level of development, investment rate, and pace of productivity growth), or, in other words, a rate that will not require unsustainable policy stimulus. We believe the slower expected growth rate will be compensated by China's rising share of global GDP, due to its above-average growth rate and already large size. We see little data to support a hard landing or a material slowdown as sensational headlines periodically suggest. In our view, this scenario is a continuation of the status quo of gradual rebalancing and assumes that the trade dispute with the US will only escalate moderately from here on.

INVESTMENT STRATEGY OUTLOOK

Economic Analysis

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

Valuation

- Broad long term valuations appear moderately attractive, in our view, but with disparity
- 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 (31 October 2018; Forecast Period: Next 12 months)

	Rapid Growth	Moderate Growth	Slow Growth	Recession
ECONOMY				
Real GDP	3.2	2.4	1.5	0.5
Inflation	3.0	2.3	1.9	1.4
MARKETS				
Fed Funds	3.2	2.6	2.1	1.7
2yr Treasury	3.6	3.0	2.3	1.7
10yr Treasury	4.0	3.4	2.7	2.0
PROBABILITY (%)[1]	15	50	20	15

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

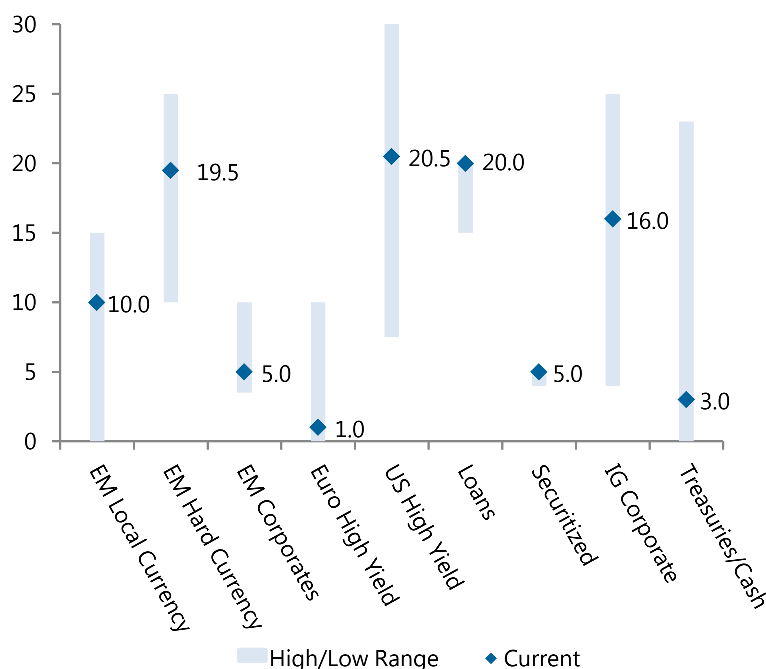
GDP Growth (%)					
	2017	Q1 18	Q2 18	Q3 18 (f)[2]	Q4 18 (f)
US	2.3	2.2	4.2	3.5	3.1
Euro	2.6	1.6	1.5	1.6	1.7
EM	5.3	5.4	5.4	5.0	5.1

[2](f) - forecasted

Interest Rates (%)[3]			
	Fed Funds	2yr TBill	10yr TBill
Low	1.07	1.60	2.31
High	2.20	2.91	3.23
Current	2.20	2.87	3.14

[3]Current as of 31 October 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	Sept-Oct 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	Sept-Oct 2018	-5.0

[5]Latest allocation change

[4]Since Inception: September 2013. Multi-Asset Credit Representative Account Target Allocation as of 31 October 2018.

OCTOBER 2018 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-1.64	-2.16	-0.03	-1.96	-0.60	-0.63	-0.82
Duration (Returns from Interest Rates %)	-0.02	-0.53	0.21	-0.28	-0.13	0.36	-0.26
Credit Beta (Returns from Spreads %)	-1.62	-1.63	-0.24	-1.68	-0.47	-0.99	-0.56

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 than 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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