Investment Policy Statement

A monthly review of the markets

Setting the Pace: A Proactive Fed Helps Keep the Economy on Track

"The crashes people remember, but the drivers remember the near misses."

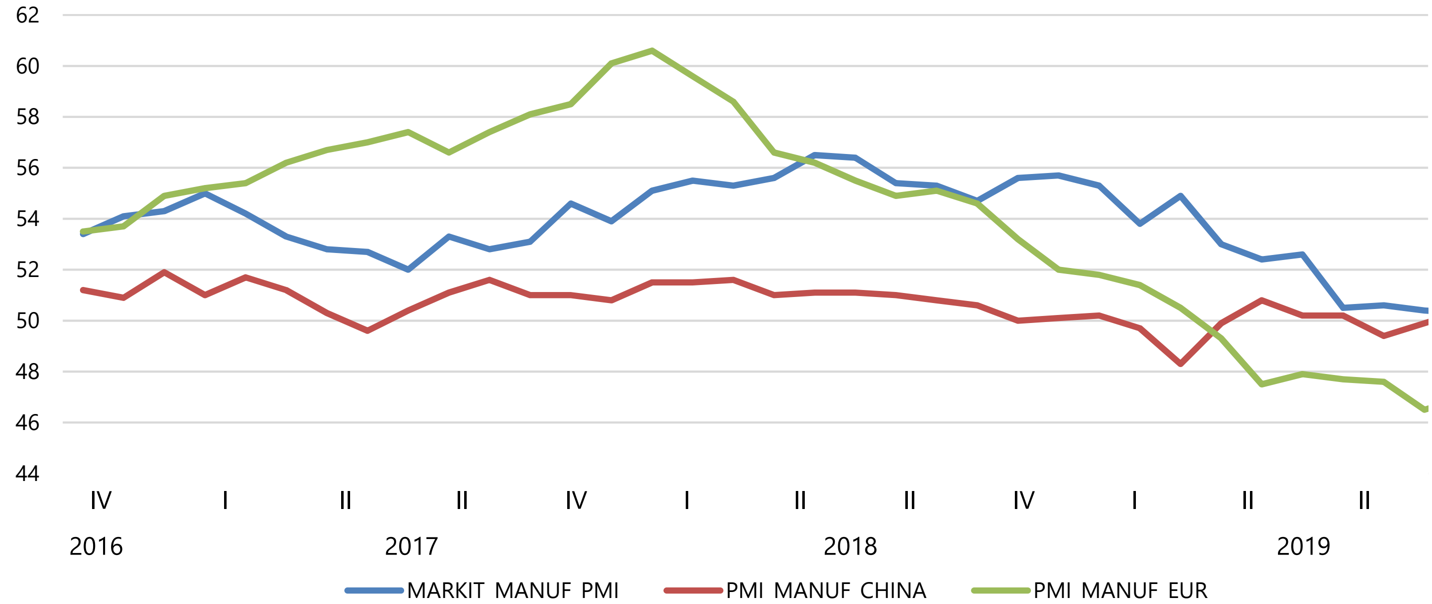
– Mario Andretti

After strong market returns so far in 2019, it's easy to forget where we were at this point last year. In late 2018, a combination of rate hikes by the US Federal Reserve ("Fed"), an escalating trade war and slowing global growth pushed global equity and credit markets down sharply. There was real fear that a recession was imminent. That sentiment started to shift in January 2019 when Fed Chairman Jay Powell announced that the Fed would be patient, patience that eventually transformed into the ongoing policy easing. Since the "Powell Pivot," risk assets—including equities and global credit—have risen dramatically, while interest rates have plummeted. The resulting easier financial conditions have helped to buffer the US economy, as growth has gradually slowed though unemployment remains low. Europe, China and the rest of the world have likewise slowed to varying degrees, but have not slipped into recession.

The Fed's actions highlight the continued role of central banks in helping markets navigate changing conditions. We think it's helpful to view the Fed and other central banks as pace cars—also called "safety cars"—which set the pace and position of drivers during a car race. More importantly, pace cars can intervene mid-race if the course becomes treacherous. Much like a pace car, the Fed in particular has shown a willingness to take proactive actions when necessary—leading to generally favorable conditions for risk assets.

Looking at the US, we believe the risk of a recession remains just a risk—a higher risk than in most of the past decade, but still just a risk for now. The Fed's actions this year seem to have steadied the US economy, partially offsetting the drag from trade tensions and fading fiscal stimulus. Lower mortgage rates appear to be hitting the accelerator for housing, offsetting weaker areas of the economy. Consumer spending remains decent, as low unemployment and modestly firmer wage gains provide support. Those two boosts balance out the ongoing drag from manufacturing. Driven by a global manufacturing slowdown and the trade war, the ISM Manufacturing Index declined to 47.8 in September. We'll continue to closely monitor incoming data, especially jobless claims, as a deterioration in the labor market would increase our concern of a tire blowout for the US economy.

Manufacturing Purchasing Managers Index (PMI): US, China & Eurozone



Source: Bloomberg, Markit, Caixin.

Overall, while the data remains mixed, the Fed's intervention during a period of potential hazard appears to have set the US economy on a more stable course.

Europe, however, has slowed to an even more anemic pace: below 1% for the Euro area as a whole, though the slowdown has not been equally distributed across sectors or countries. The same trade tensions hurting the US manufacturing sector have hit the European manufacturing sector, particularly in Germany, where manufacturing comprises a larger share of the economy. Germany's PMI reading has declined sharply, while France and Spain have fallen more modestly. Eurozone core inflation remains stuck at just over 1%, well below the European Cental Bank's (ECB) target of just below 2%. As a result, the ECB has taken new actions, including a package with even lower policy rates, more quantitative easing (QE), tiering of reserves and renewed targeted longer-term refinancing operations (TLTROs). We expect these actions will support growth; however, with rates already this low, there has been substantial pushback. In our view, the room to apply more monetary stimulus looks limited, at least in the absence of a more severe downturn. In other words, the policy nudge from the ECB looks a bit weaker than that from the Fed.

China's economy has also slowed, though more gradually than many had feared given higher US tariffs enacted over the past two years. Determined to control the pace of the economic slowdown, Chinese policymakers implemented various policy easing measures earlier in 2019, and we see evidence these measures are having an impact. As a result, recent data has been mixed. Exports to the US have been down sharply, but Chinese exports to other countries have increased. Housing in China appears stable, though new starts have declined. We're also seeing signs that Chinese policymakers are calibrating their stimulus to recent economic performance. As the situation seems to have stabilized, China has taken its foot off the gas pedal and slowed down some of its stimulus measures, in particular in the monetary/financial area with a noticeable decline in the credit impulse in recent months.

One common theme is that we believe central banks and other policymakers still have the ability to stimulate their economies, though as we've discussed previously, the amount of policy space varies. We expect the Fed to act swiftly if they detect recessionary dynamics. For instance, in the case of meaningful labor market deterioration—an increase in the unemployment rate of more than one or two tenths of a percentage point—we believe the Fed would rapidly move the fed funds rate back to zero. How rapidly? Perhaps over the course of two meetings, with a potential intermeeting cut. We believe the Fed would also return to offering forward guidance, and the re-initiation of explicit QE is a real possibility. Unlike in Europe, the Fed appears quite reluctant to take rates negative, for reasons both practical and political.

Europe has less monetary policy space, but potentially more usable fiscal policy space. As in the US, we think it would take labor market deterioration for Germany to take decisive action, but the Germans appear more willing to take such steps than in the past. China has clearly shown its ability and willingness to react aggressively to deteriorating economic conditions, though high leverage has reduced the pace of policy intervention, and policymakers are acting more cautiously than during past slowdowns. Overall, while the track will not always be smooth, our base case remains that the policy pace cars will be successful in keeping the major economy racecars on track.

STONE HARBOR INVESTMENT STRATEGY OUTLOOK

Economic Analysis

- Economic data ex-US soft, US softening
- Fed pivoting to ease
- ECB/PBOC more accomodating

Valuation

- U.S. yield curve prices 100 basis points (bps) of easing over next 12 months
- Bund yields at all time lows
- Volatility low
- Credit spreads have rallied to slightly cheap "through the cycle" value but do not capture "late cycle" environment
- EMD sovereigns can be cheap versus Loans/High Yield with potentially less fail risk

Sector Specialist Review

- Some concern over nature of Loan issuance
- Within Emerging Markets Debt, bifurcation of spreads masks full extent of some opportunities
- More generally, markets responding aggressively to event risk

Stone Harbor Investment Partners

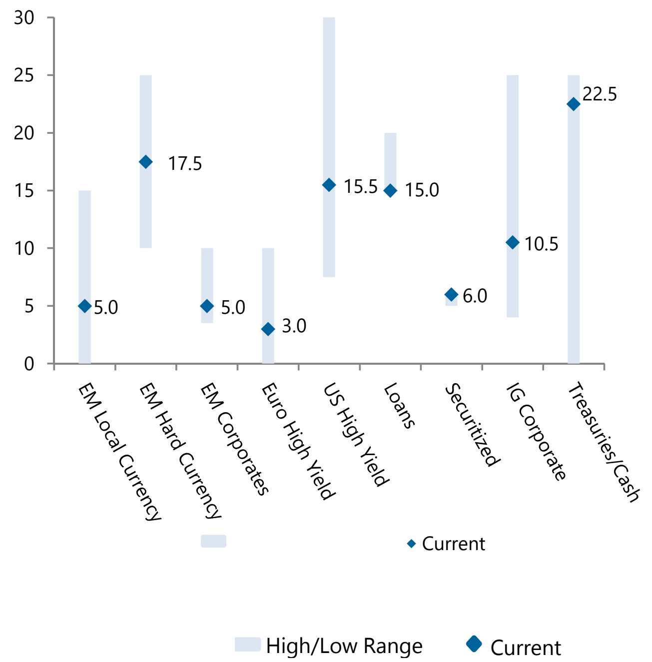
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Scenario	Assumptions
Current Trade Status Quo; Growth Slows (45%)	• Trade issues remain central but escalation pauses. The currently scheduled tariffs are implemented, but no more. Mexico and Europe escape further tariffs. • Trade uncertainty and fading of fiscal stimulus pull GDP growth down to a 1¾% run rate. • Labor market remains decent (~150k); the unemployment rate broadly stabilizes. • Core PCE continues the partial rebound of the last few months, with an extra boost from tariff-induced price increases. • The Fed cuts rates another 25 bps. Growth data firms enough for them to not cut further. • Growth in Europe remains sluggish, though improves relative to US. • ECB implements current plan on tiering and asset purchases, with additional 10bps cut. • Japan growth hit near-term by VAT hike. • EM growth little changed, but growth differential to US widens. • EM FX roughly flat against dollar. • Corporate profitability growth comes under modest downward pressure.
Growth Better than Expected; Mini-Deal on Trade (15%)	• Growth surprises to the upside. Productivity starts to push higher as the tighter labor market incentives labor-saving investment. • China and US reach a mini-deal that delays implementation of next round of tariffs. • Firmer growth supports inflation. • Fed cuts another 25 bps in October. Following that cut, there is a combo of better news on trade and improving data that short-circuits the easing cycle. • ECB leaves rates unchanged; asset purchases remain at current pace. • EM growth firms, as EM exporters of both manufactured goods and commodities benefit from rollback of trade tension. • EM FX modestly strengthens as growth improves in EM relative to the US. • Corporate profitability growth comes under modest downward pressure.
Trade Conflict Intensifies (20%)	• 10% tranche of tariffs pushed up to 25%. The administration finds Mexico deficient at the border and Mexican imports are tariffed at 10%. European auto tariffs implemented. Various retaliations. USMCA is dead in Congress. • With higher tariffs looking more permanent, pass-through into inflation increases in US and other DM. • Slow US/China growth drags on global growth. • The Fed cuts rates a further 50 bps, both as insurance against a more pronounced downturn but also in response to poor incoming data. Policymakers look through tariff-driven inflation as a one-time increase in the price level: growth effects dominate policy. • Rate cuts are effective: the US avoids outright recession, though growth clearly slows. • ECB cuts another 10 bps, and substantially increases the size of assets purchases. • The dollar is broadly stronger as flight to quality predominates. CNY depreciates to ~8. • Corporate profitability hurt by tariff-led higher input costs and slower growth.
Shallow Recession (20%)	• Non-linear dynamics take over and slowing growth from the combination of fiscal drag, trade tensions and lagged policy tightening tip the US into recession. • Unemployment rises notably (~2.50pp). • The Fed cuts rapidly and deeply in response; rates are quickly taken back to the ZLB and forward guidance reinstated. QE restarted. • The recession is mild: the 2001 shallow slump rather than the 2009 once-in-a-generation crash. • With little policy space to respond, Europe and Japan also enter mild recessions. ECB cuts a further 10 bps and substantially increases the size of assets purchases. There are ongoing discussions on buying equities in size. • EM growth decelerates; some countries see output contract. • Flight to quality boosts dollar against EM. • Corporate profitability takes a substantial hit.

	Current Trade Staus Quo; Growth Slows	Growth Better Than Expected; Mini-Deal on Trade	Trade Conflict Intensifies	Shallow Recession
US Real GDP (%)	1.75	2.5	1.4	0
US Core PCE (%)	2.1	2.1	2.3	1.25
Fed Funds (%)	1.625	1.625	1.375	0
2yr Treasury (%)	1.7	2.1	1.4	0.1
10yr Treasury (%)	1.8	2.5	1.45	0.85
EM Growth (%)	4.5	5.0	4.0	3.4
China Growth (%)	5.7	6.1	5.1	4.7

[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	May-June 2019	-5.0
EM Hard Currency	Dec-Jan 2019	-5.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	Aug-Sept 2019	-3.5
US High Yield	July-Aug 2019	+3.0
Loans	Nov-Dec 2018	-5.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Aug-Sept 2019	+3.0
Treasuries/Cash	Aug-Sept 2019	+0.5

[3]Latest allocation change

[2]Since Inception: September 2013. Multi-Asset Credit Representative Target Allocation as of 30 September 2019. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

SEPTEMBER 2019 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	0.32	-0.46	0.47	0.96	0.63	-0.01	-0.51
Duration (Returns from Interest Rates %)	-0.32	-1.00	0.16	-0.73	-0.56	-0.41	-0.88
Credit Beta (Returns from Spreads %)	0.64	0.54	0.31	1.69	1.19	0.40	0.37

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. 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 21.9 billion as of 30 September 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 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.

Important Disclosures

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