Investment Policy Statement

A monthly review of the markets

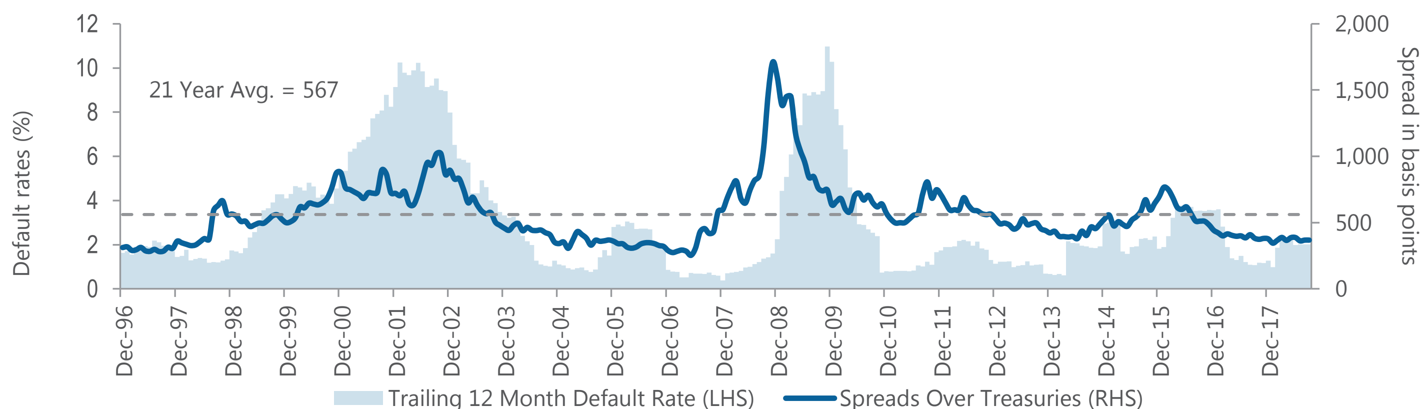
Inflation Target: What is Neutral?

Following a protracted period of low growth and low inflation, the Federal Open Market Committee ("FOMC") has taken the position that the current level of inflation, at modestly above 2%, is consistent with the Committee's inflation objective. While there has been debate around what the optimal inflation target might be moving forward, in the context of a 10-year expansion, the current level represents balanced inflation, in our view, and perhaps even suggests an alternate to the proverbial 2% target in an economic environment that has gone through deep changes in the last decade.

Whether inflation remains at the current level or is adjusted back to 2%, the catalyst has been and remains solid economic conditions that seem poised to continue for at least through the end of this year. In this late-cycle expansion phase, we continue to see a strong labor market, federal tax cut benefits with few signs of cyclical stress in the financial sector, and high level of consumer confidence. Under these conditions, it would take a large shock to risk a significant growth downturn, in our view. As noted in our August Investment Policy Statement, the US trade policy poses a risk to global growth and could very well be the shock that disrupts the growth trajectory and heightens market volatility. For now, the economic consequences do not seem dire because the aggregate value of goods affected is relatively minor (although as of this writing, further US tariffs on China goods have been announced). And there is still the possibility of de-escalation or resolution.

While the second quarter's 4.2% growth pace – the strongest quarter since 2014 – is unlikely to be sustained, the economy,

High Yield Historical Spreads and Default Rates



As of 30 September 2018. Source: London Stock Exchange Group, J.P. Morgan, Moody's. J.P. Morgan's domestic trailing 12-month default rate calculation: JP Morgan corporate default rate is easily interpreted as a measure of default risk on a par basis. The default rates calculated are fractions in which the numerator represents the par amount of long-term debt issuers in the index at the start of a given 12-month period that defaulted during that period. The denominator represents the par amount that could have defaulted during that period. The index uses Moody's data as a basis for defaults.

in the near-term, looks to be growing around 3%. For the full year 2018, we expect growth of 2.9%, equal to 2015 and up substantially from 2.2% last year. Much of this growth has been driven by the federal tax cut, which has had meaningful impact on investment spending and consumption. Granted, corporate profits have been strong for several years now, but the dramatic cut in federal corporate taxes earlier this year has provided a further boost. Business fixed investment has also been very strong, growing at a 10% pace over the first six months of the year (triple the pace of the rest of the economy). Unfortunately, the tax-cut windfall is a one-off event and the tailwinds due to the tax cut should fade later this year and early in 2019, making the business outlook for 2019 less robust.

Consumer fundamentals are also stable. In response to the tax stimulus, consumer spending grew 3.8% in Q2, up from only 0.5% in Q1. Some of the increase is seasonal, but a good part of the upswing appears to be due to the effects of the tax cut on consumer cash flow and spending. We believe the momentum in the consumer sector is likely to continue through 2018 before fading next year.

Looking ahead, there are signs that tailwinds in 2018 could turn to headwinds in 2019 – namely, fiscal stimulus rolls off, profit growth slows or turns negative, and the trade wars escalate – and that these concerns could potentially lead to a slowdown in global growth. In our view, strong corporate profits are likely to continue most of the year, but the strength is masking deterioration in underlying profit fundamentals. Wage costs are mildly accelerating as firms are finding it more difficult to identify qualified workers late in the economic expansion and top-line revenue growth continues to be tepid. Beginning in Q1 2019, when the tax-effects roll off, profits will likely come under downward pressure. Another headwind is the uncertain trade situation, which is likely to persist for some time to come. Right now, from the perspective of global economic growth, the effect of the trade war on growth is likely to be mildly negative across developed markets, but manageable. But continued escalation would pose a more substantial threat to global growth. Endogenous cyclical risks that are associated with natural dynamics of a business cycle are low, but expected to rise modestly in 2019. Fed tightening, the maturity of the business cycle, and an aging credit cycle are likely to drive greater cyclical risks. Oil prices could also be a growing headwind as the US imposes oil sanctions on Iran at a time when global capacity is relatively tight.

Despite these developing uncertainties, in the near term, the US economy is growing modestly above-trend, nominal growth is accelerating, and fiscal tailwinds are strong. A very healthy business sector, fiscal stimulus, deregulation, all look to provide a boost to growth over the remainder of 2018. The dynamics of the business cycle now look like those seen in full-employment. Other typical imbalances that arise in the later stages of expansion — such as speculative real and financial investment, inventory over-building, over-lending, etc. — are largely absent. From our perspective, given the nature of a 10-year expansion, these imbalances would be less disruptive than what historical data may suggest, were they to arise.

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 significant 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 (30 September 2018; Forecast Period: Next 12 months)

	Rapid Growth	Moderate Growth	Slow Growth	Recession
ECONOMY				
Real GDP	3.2	2.4	1.8	1.0
Inflation	3.0	2.4	1.8	1.2
MARKETS				
Fed Funds	3.1	2.4	2.1	1.8
2yr Treasury	3.4	2.7	2.0	1.8
10yr Treasury	3.8	3.2	2.5	2.0
PROBABILITY (%)[1]	15	50	25	10

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

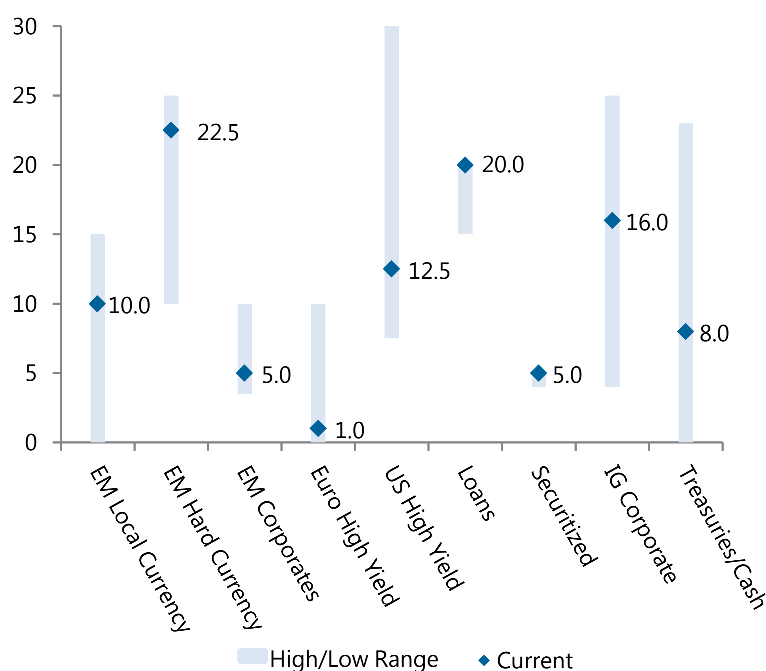
GDP Growth (%)					
	2017	Q1 18	Q2 18	Q3 18 (f)	Q4 18 (f)
US	2.2	2.2	4.2	2.9	3.0
Euro	2.5	1.6	1.5	1.6	1.7
EM	5.3	5.4	5.4	5.3	5.4

(f) - forecasted

Interest Rates (%)			
	Fed Funds	2yr TBill	10yr TBill
Low	1.06	1.42	2.22
High	1.92	2.82	3.11
Current[1]	1.92	2.81	3.07

[1]As of 21 September 2018

TARGET ALLOCATIONS (%) SINCE INCEPTION*



*Since Inception: September 2013. Multi-Asset Credit Representative Account Target Allocation as of 30 September 2018

Allocation Changes[1]		
	Month	Change (%)
EM Local Currency	April-May 2018	+2.5
EM Hard Currency	April-May 2018	+5.0
EM Corporates	May-June 2018	+1.5
Euro High Yield	Oct-Nov 2017	-2.5
US High Yield	April-May 2018	-5.0
Loans	July-Aug 2015	+3.0
Securitized	April-May 2018	+1.0
IG Corporate	Oct-Nov 2017	-0.5
Treasuries/Cash	May-June 2018	-1.5

[1]Latest allocation change made over the noted period

SEPTEMBER 2018 CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Returns	0.58	1.51	0.69	2.59	0.94	0.33	-0.32
Duration (Returns from Interest Rates %)	-0.55	-1.05	0.17	-0.77	-0.65	-0.48	-0.97
Credit Beta (Returns from Spreads %)	1.13	2.56	0.52	3.36	1.59	0.81	0.65

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: 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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