Investment Policy Statement

A monthly review of the markets

Zone of No Action: The Federal Reserve's Move to Create Policy Space

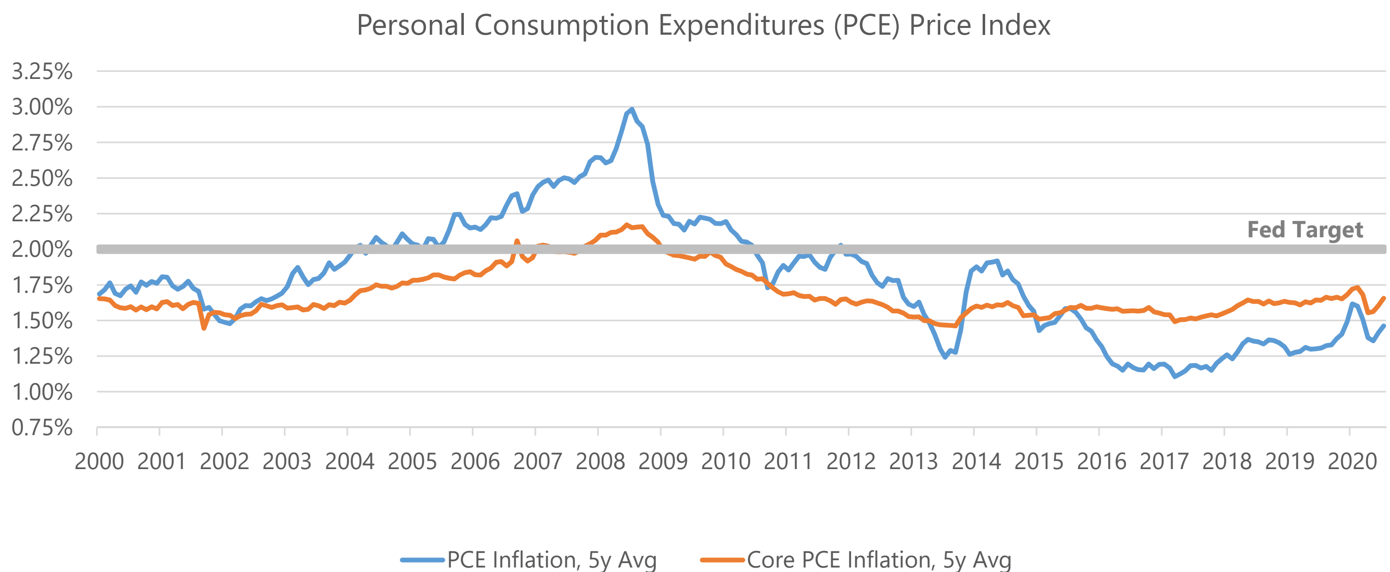
"Patience is also a Form of Action" – Auguste Rodin

For the past two decades, the US Federal Reserve (Fed) has consistently missed its inflation goal of 2% per year. In fact, over that period, the 5-year average inflation as measured by the Personal Consumption Expenditures (PCE) price index has mostly been well below 2%, with the exception of a couple years in the late 2000s. On the same 5-year basis, core PCE inflation – the Fed's preferred inflation gauge that excludes volatile food & energy prices – which the Fed arguably has more control over, has been above 2% in only one year, between 2008 and 2009 (see figure 1). Even at the end of 2019, when the economy was considered to be on solid footing, the 5-year average was just 1.6%.

Concurrently, unemployment has spent far too much time above levels the economy can sustain without triggering inflation; unemployment has been too high over the past two decades. It is difficult to gauge the best achievable unemployment rate in real-time, but in hindsight, it is clear that the Fed was consistently wrong and always in the direction of underestimating how low unemployment could fall. The Fed not achieving their interpretation of the congressionally mandated goals is a policy failure, and combined with concerns about inflation expectations de-anchoring to the downside necessitated a review and change in the Fed's policy framework.

At Jackson Hole, the Chair of the Federal Reserve, Jerome Powell laid out how the Fed is adjusting their goals following the conclusion of their policy review. The dual mandate—maximum employment and stable prices, set forth in legislation from Congress—remains the Fed's stated goal, but how the Fed interprets that goal has changed in a meaningful manner with significant implications for policy.

Figure 1: For the Past Two Decades, the Fed has Consistently Missed its Inflation Goal



As of July 2020
Source: Bureau of Economic Analysis, Haver Analytics

Though there were many changes in the statement, two words drive the new policy: "averages" and "shortfalls." The implications of these two words are significant. On the inflation side, the FOMC amplifies that "[It] seeks to achieve inflation that "**averages"** 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." That means that inflation at the tail end of the business cycle will likely be 2¼% to 2½% rather than 2%, or less. On the employment side, the directive states "it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the "**shortfalls"** of employment from its maximum level," replacing "deviations" with "shortfalls." In other words, the Fed would not be concerned about unemployment below their estimate of the sustainable level. They would still, however, try to drive down unemployment if it were above their estimate.

These changes mean that the current zero policy rates are unlikely going anywhere for a long time. In late 2015, the Fed started to increase rates—slowly, but still increasing—despite the fact that inflation remained well below 2%. The Fed has now effectively pledged not to raise rates for years. In allowing the possibility for inflation to overshoot after periods of weakness and only acting when there is an employment shortfall, the Fed's actions imply preemptive tightening is no longer part of the current policy mix, in our view.

With the Fed's implied rates pegged at zero for an extended period, the question becomes when will this new policy matter? In our view, this question needs to be considered in the context of the stark reality that unemployment has increased sharply on the heels of the coronavirus pandemic. It has dropped back down rapidly over the last several months as firms recalled temporarily furloughed workers; unfortunately, we think most of the easy gains are behind us and further progress will be slower. Under the previous regime, with full recognition that events will intervene, the Fed would probably have been considering rate increases sometime in 2024. We think the policy shift keeps rates at zero for another 12-18 months beyond that. The practical outcome of this is that real rates are likely to be extremely low for quite a long time.

In terms of near-term Fed action, we see an upside potential for the Fed to aggressively push further quantitative easing: they need to back up their words with action. We currently expect an increase in the pace of US Treasury and mortgage-backed securities purchases either later this year or early next year. We believe the increase could amount to US$175 billion per month (from US$120 billion), or US$2 trillion a year.

The fact that the Fed has a dual mandate, and so has been told explicitly by law to care about employment makes it easier for them to shift policy. Many foreign central banks have mandates that direct them to either exclusively or primarily focus on inflation, making a similar shift more complicated. As a result, inflation in the US could run persistently above other developed market economics. This outturn, combined with narrowed interest rate differentials and lower US real rates from Fed policy shift, we believe has the potential to put persistent downward pressure on the US dollar.

More broadly, our targets had already assumed that developed market central banks would maintain very accommodative policies for a long time, and the Fed's policy shift only amplifies that prospect. In this environment, we believe the yield advantage may lie outside developed markets.

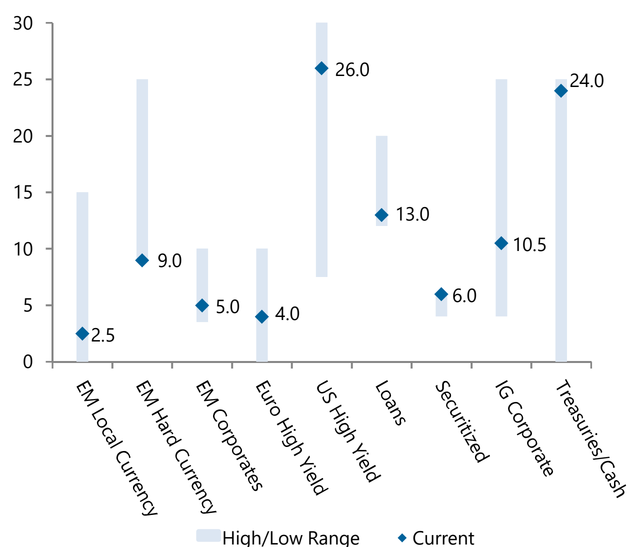
US MACRO RISK SCENARIO ASSUMPTIONS AND MARKET OUTLOOK[1]

Scenario	Assumptions
Base Case: Slow Grind Higher (60%)	• Coronavirus transmission continues in the US, but does not spike again; endogenous social distancing & localized government measures prove sufficient to slow spread to level public finds acceptable. • US avoids another nationwide lockdown. • Travel, restaurants, sports, conventions and large gatherings remain depressed until a vaccine starts to become available in Q1-21. Pace of improvement into fall slows substantially from summer. • Increased European virus spread leads to some growth-retarding measures, but not full lockdowns. As in US, recovery continues but at a slower pace. • Congress passes another fiscal package but it is late and the size underwhelming. Other countries also continue to provide further fiscal support. • US/China tensions remain high. Rhetoric elevated, partly US electoral reasons and comes from both parties. More retaliatory trade & tech actions, but both sides pull back from initiating a full trade war. • Central banks mainly focus on implementing existing policies. For the Fed, the amended average inflation targeting framework leads to enhanced forward guidance tied to outcomes and a ramp up of Treasury and MBS purchases before year-end. • Defaults and bankruptcies—both individual and corporate—increase but remain under control. • Oil remains stable: ~$40/barrel WTI, Brent ~$45. • Dollar broadly weakens, partly due to closing of interest rate differentials and partly from lower US real rates associated with Fed policy shift.
Lasting Global Scars (10%)	• 2020 proceeds largely inline with base case path. • The expected rapid 2021 growth does not materialize. This disappointment could either be the result of failure/delays in the vaccine, or that the lingering scars of business bankruptcy, layoffs and changed behavior are substantial. • The malaise is not limited to the US: other DMs and most EMs underperform expectations through 2021. • The hit to economic activity is pronounced; many temporary layoffs turn permanent. • Fiscal measures are ramped up further, but transmission to the real economy falters. • 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. • Defaults and bankruptcies increase meaningfully. • EU issues Eurobonds. ECB substantially expands asset purchases. • Oil: WTI drops to ~30/barrel; Brent ~$35.
Medical-Led Acceleration Starts in Q4 (15%)	• US spike abates further. Asia remains in relatively good shape while European increase peters out. • Treatment improvements are substantial as pharmaceutical progress exceeds expectations; death rates move down substantially. Vaccine comes early—late 2020 rather than early 2021. • With better-than-expected outturns on treatment, activity improves substantially. Larger gatherings—including restaurants, sports and conventions—are able to resume at a higher rate. Supportive fiscal and monetary policies gain traction. • Improvement is global as better treatments spread. • By early 2021, output looks on track to return quickly to pre-virus levels. Though fiscal policies start to be dialed back, they remain supportive. • Fed maintains accommodative policy, but doesn't feel need to push further. Similarly for ECB. • Oil: WTI at ~$50/barrel; Brent ~$55/barrel.
2nd Wave as Weather Cools in North (15%)	• Virus spread and infections pick up in the fall as activity moves back indoors with colder weather. Europe struggles: the recent renewed spread picks up further with colder weather. Asia does not escape as case counts increase meaningfully there. • Government restrictions and endogenous social distancing increase with the increase in the virus. The combination arrests the ongoing recovery, though activity remains well above spring lows. • Deteriorating virus situation prods Congress into action—an additional substantial fiscal package. • Fed QE pace higher than in base case, and use of 13(3) programs substantially higher. Despite 13(3) backstops there is a drift up in corporate defaults. • Trade tensions persist, as in the base case. • Dollar sees renewed flight to safety support. • Vaccine progress continues and, as in the base case, vaccinations start in late Q1-21. Activity picks up substantially as a result globally. • Oil prices hit by lower growth: ~$35-30/barrel for WTI; Brent ~$30-35.

	Base Case: Slow Grind Higher (60%)	Lasting Global Scars (10%)	Medical-Led Acceleration Starts in Q4 (15%)	2nd Wave as Weather Cools in the North (15%)
US Real 20 GDP (%)	-4.50	-4.75	-4.00	-5.25
US Real 21 GDP (%)	5.00	3.75	7.00	4.50
US Core PCE (%)	1.35	1.00	1.75	1.10
Fed Funds (%)	0.13	0.13	0.13	0.13
2yr Treasury (%)	0.13	0.13	0.50	0.13
10yr Treasury (%)	0.65	0.25	1.15	0.40
10yr Bund (%)	-0.45	-0.75	-0.30	-0.55
China 20 GDP (%)	2.00	2.00	2.50	1.00
China 21 GDP (%)	9.00	7.50	10.00	9.00
EM 20 GDP (%)	-3.00	-3.00	-2.50	-4.50
EM 21 GDP (%)	7.00	4.50	8.50	7.50

[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	May-June 2020	-2.5
Loans	Feb-Mar 2020	+1.0
Securitized	Mar-April 2019	+1.0
IG Corporate	Aug-Sept 2019	+3.0
Treasuries/Cash	June-July 2020	+10.0

[3]Latest allocation change

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

AUGUST CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	US High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	1.00	0.51	1.49	-0.33	0.90	1.48	-0.76
Duration (Returns from Interest Rates %)	-0.27	-1.29	-0.01	-0.64	-0.48	-0.36	-1.13
Credit Beta (Returns from Spreads %)	1.27	1.80	1.50	0.31	1.38	1.84	0.37

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

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation.
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- Over 25-year performance history
- Offices in New York, Chicago, London, and Singapore.

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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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