Stone Harbor
Investment Partners

Letter from the CIO:

Our Outlook for the Remainder of 2016

It seems only a short while ago that I was last writing to update you on our outlook. Six months later, and we have held another investment offsite at which we sought again to challenge our thinking and refine our outlook. By coincidence this particular offsite came soon after our tenth anniversary. We founded Stone Harbor in April 2006 and looking back I have to confess that I did not foresee all that the past ten years would throw at us. In hindsight, a recession was predictable and to some extent so was the financial crisis but certainly not in depth and breadth. More pertinently we did not envision annual GDP growth rates of only 1.4% in the US, 0.7% in the Eurozone and 0.4% in Japan over our first ten years. Even less would we have predicted the introduction of QE and its accompanying negative interest rates. And from the perspective of ten years ago, the idea that 70% of the developed world's government bond markets would be offering negative yields seems preposterous. In the face of these challenges, I am delighted with how Stone Harbor and our people have responded. No doubt the next ten years will throw up yet more unforeseen challenges but, as our deliberations highlight, there are plenty of recognizable challenges directly ahead.

Secular Issues – Demographics and Productivity

Let me start with demographics. Potential GDP growth is simply the sum of working age population growth and productivity growth. Over the past 25 years, the working age population has grown at an annual rate of 1% in the US, 0.1% in Europe and has declined by 0.4% in Japan. Demographic studies point to a depressing outlook. US working age population growth is estimated at 0.3% per annum over the next 35 years, a rate similar to that forecast for France, the UK and Brazil. In contrast, China, Germany, Italy, Japan and Russia are all forecast to see declines of between 0.6% and 1% per annum. Faced with this headwind, it will take extraordinary productivity gains to return growth to the levels that we formerly considered trend growth. Unfortunately, the reality is that productivity gains have been declining for some years now.

Post the financial crisis, productivity growth rates have averaged less than 1% per annum in China, Brazil and India and are somewhat lower in all of the G7 countries. Why didn't significant investments and rapid technological change generate stronger productivity growth? The answer perhaps lies in two observations. First, the highest levels of physical investment have been in those emerging countries with a lower level of social investment stock. I'm referring to the societal structures, including education, health, legal and political, that allow a high degree of physical investment to be efficiently absorbed and utilized. The result is that the efficiency of productivity gains lags that generally observed in developed markets. The notion that we can throw investment at these economies and that they will somehow morph towards western levels of productivity may be just plain wrong. For evidence of this, look at the poor return on assets of China's state-owned enterprises or the level of corruption in Brazil. Secondly, many recent changes in technology have focused on how transactions occur, rather than the development of new products. Take Uber as an example; it has transformed how we book taxis but the production of a taxi ride still requires one driver and one car. The output per worker has not fundamentally changed.

So how do we overcome these demographic and productivity constraints? It is by answering this question that we can try to identify winners and losers. Fertility policies may ultimately deliver more workers but in

the meantime we could do with some quicker fixes and these lie at the national level. Immigration and later retirement are two obvious solutions but both carry political baggage. Those countries that combine substantial wealth advantages and an openness to immigration will be likely winners - think developed market economies such as the US, UK and Germany, but watch policy closely. A number of countries have taken steps towards a later retirement age but those countries most able to do so will have the lowest levels of state retirement savings relative to working age income where the imperative to earn will force later retirement and so increase the working population. Productivity is a more challenging problem and will require a combination of improved education, better directed investment and social, legal and political reform. Education will require cash-strapped governments to re-prioritize their spending.

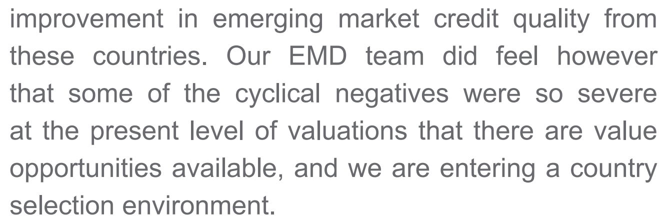
Nothing is easy but the differentiation between those who address these problems and those who don't may be stark. Those countries with more room for reform can arguably move the productivity dial fastest but the political hurdles are obvious. Our EMD team pointed to Argentina as an example of improved productivity where structural reform has boosted output. Brazil was highlighted as a country where the ability to turn the corner exists should a strong reform agenda take place. The key takeaway is that we think opportunities for structural reform are greatest in emerging markets but evidence of political will to move forward is still needed in those locations.

Overhangs and Burst Bubbles

In the short term, it is possible for growth to exceed the constraints of longer term productivity and demographic trends if demand runs at sufficiently high levels to reduce output gaps. Unfortunately we have scant evidence over the past few years that economies can generate self-sustaining, above-trend demand cycles. Our team believes that high levels of leverage remain a constraint on both consumption and investment and will likely continue to do so. This is compounded by a subdued nominal growth outlook which discourages investment and constrains growth. This suggests that concerns about low levels of inflation and the risk of a move to a protracted period of deflation are likely to remain with us for some time. Spare capacity, in the form of unemployment, underemployment or disengagement from the workforce remains evident globally.

None of the above denies cyclicality. Full employment and the Phillips curve are not merely concepts but recognition of human behavior. Tight labor markets will beget inflation, but in the absence of nearer term consumption growth we do not believe we will see true full employment anytime soon in most countries. It is for this reason that we may see increasing calls for renewed fiscal expansion which, let's face it, is cheap when rates are negative.

Talking of output gaps, our team received a presentation from our Metals and Mining credit analyst. He had just returned from a trip to China and his sense was very much that those industries which are heavy commodity users remain mired in slow growth. Further, he argues that there is little evidence that they are responding to credit expansion. This likely leads to Chinese fiscal policy that follows a start-stop pattern as the authorities seek to focus on reform but want to coordinate the growth cycle with the political cycle. He argues that future low cost capacity which is due to come on stream will keep commodity prices low. Asked what level of Chinese growth he felt that commodity producers were factoring in to their outlook, he suggested something in the order of 5-6% per annum. Given a declining working age population and limited productivity growth there was concern that Chinese growth could ultimately fall below these expectations and that commodity prices could suffer further price declines. At the very least it seems difficult to make the case for further investment in commodity extraction. This in turn led to some members of our Core strategy team to question whether we may be at the end of secular tailwinds in emerging market credit quality for the more commodity-sensitive countries. With limited working age population growth, limited ability to absorb new investment and an overhang from excessive commodity investment it is hard for us to see a continuation in the secular



improvement in emerging market credit quality from these countries. Our EMD team did feel however that some of the cyclical negatives were so severe at the present level of valuations that there are value opportunities available, and we are entering a country selection environment.

We have seen and continue to see rising defaults in the high yield market, reflecting problems in the Energy, Metals and Mining sectors. We believe this risk will likely continue. Our High Yield team pointed to the evolving structure of the high yield market as poor companies default and fall out of the index, improving average credit quality across the market. This is further compounded by the large number of fallen angels arriving in the high yield market via ratings downgrades. This has allowed distress ratios to fall and coverage ratios to improve. Our bottom up analysis continues to highlight individual corporate risk but growth remains sufficiently firm to suggest to us that opportunities exist on a company by company basis.

One longer term concern that we continue to focus on is the impact of low nominal growth with high levels of debt. This is perhaps better described as a concern that economic downturns will likely lead to negative real and nominal growth for potentially protracted periods and that this will be in conflict with the need to service nominal debt. A couple of counterpoints to this concern were raised; first, the example of Japan where deflation has led to de-leveraging and improvements in credit quality, essentially the only way to survive is to improve one's balance sheet. Second, rates will need to stay low to encourage refinancing. Despite these considerations it seems likely to us that the fear of debt default in a low or negative nominal growth environment will remain high for some time and that this will result in periodic bouts of spread widening. This volatility is likely to be compounded by structural market issues, in particular the post-financial crisis reduction in the size and flexibility of bank balance sheets. Members of the team pointed out that the increased role of high yield ETFs together with QE serves to further compound volatility. It was judged likely that these bouts may be more frequent but that they would also represent greater opportunities to benefit from asset allocation. One of my colleagues put it rather nicely when he said that the days of "coupon clipping" may be over, at least for a while.

I can't move on without mentioning our outlook for global monetary policy. Given the limitations on longer term growth, it seems likely that trend-normalized rates are perhaps only modestly higher than where we are today, perhaps a couple of percent or so in the US, for example. Add to that the deflation pressures from the overhangs discussed above and it seems clear to us that there will be no rush to raise rates collectively. It is still likely that the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PBoC) will all lean towards more monetary easing. While the US Federal Reserve (Fed) may look to raise rates given an opportunity on the back of firmer jobs growth and global stability, it is likely that such moves will be small and very deliberate in nature. The Fed's deliberate path of rate increases they laid out just six months ago is likely an opportunity missed. The team did feel that the flatness of yield curves suggested that there was some lack of supply of risk free assets in periods of slower growth as a consequence of QE. This suggests to us that longer dated yields may have fallen precipitately in the recent past and risk to the upside exists but fears of a significant move higher are unwarranted. Indeed the team judged it unlikely that the direction of yields would be a driving force for asset allocation decisions for some time to come.

Impact of Political Surprises

Of course politics can serve up a nasty dose of market volatility. The British vote to leave the EU was a surprise to markets, the latest in a long series of EU related event risks. The near term risks lie predominantly with the UK where uncertainty about the UK's relationship with Europe will likely result in a drop in FDI and domestic investment which will outweigh any likely benefit from a weaker Sterling. For Europe the risk is more existential in nature with concerns that Brexit will spark a push for referendums in other countries, with perhaps the Netherlands and Austria being high on the list of candidate countries. EU politicians, having witnessed

the hasty end of David Cameron's term as Prime Minister, will likely try to avoid calls for referendums. We expect a two pronged approach from the European Union – internal reforms targeted at discouraging dissent in conjunction with a tough negotiating stance towards the UK. In parallel with this the ECB is likely to stand ready to provide further monetary accommodation to support growth. The credit risks arising in Europe as a result of Brexit appear limited in our view and even more so the further we move away from the epicenter of events.

We should not, however, assume that the Brexit vote was merely a judgement on the European Union mandate. My UK colleagues argue that the pattern of voting strongly suggests that this was a vote from many who feel economically and politically disenfranchised. These are the votes of those left behind by globalization and western economies around the world face this same problem. It is, arguably, the root of the popularity of the Front National in France, the Five Star Movement in Italy and Donald Trump and Bernie Sanders in the US. This line of argument, combined with our concerns about trend growth, point toward periodic political concern and potential pressure on the profit share of GDP.

So What Does a Credit Investor Do?

Valuations remain OK on a relative basis in our view. Much of that valuation support in credit assets is driven by extraordinary levels of government interest rates, and many credit expansions seem to be getting later in the cycle. Nevertheless, these valuation supports are likely to stay around for a while. Currencies are at levels where current accounts are improving and this will soften credit concerns. Distressed markets are in many cases priced at or similar to levels where the IMF has stood ready to provide support. Our Investment Grade team raises concerns that Treasury curves globally suggests that there is a shortage of risk free assets. They judge this not from the level of rates but from the flatness of the yield curve. This again suggests that there is an abnormally high level of fear in the markets. Against this, our economists argue for a cyclical pick-up in growth in China and the US and a continuation of modestly above- trend growth in Europe. This should all bode well for credit markets in the near term as we see it. Arguably, as the recent post-Brexit volatility suggests, market valuations are at levels where a degree of uncertainty can be absorbed relatively smoothly.

At the beginning of the year, I wrote that valuations were attractive and that we expected opportunities to exploit them to arise as the year progressed. By mid-February we were adding risk in high yield markets where valuation levels seemed excessive to us at a time when the ECB, the BoJ and the PBoC were providing support. These entities continue to provide support and we believe this should allow markets to absorb uncertainty that arises post-Brexit. But risks will remain and with growing political pressures globally, the continuing debt overhang from the financial crisis and subsequent commodity bubble, and a fundamental low trend trajectory for growth we should expect bouts of volatility to be more frequent. As I mentioned earlier, the need to be nimble when making asset allocation decisions has never been more apparent and I continue to emphasize to our team that they need to remain very responsive to an ever changing landscape.

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