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China's Shifting Priorities Under President Xi's Third Term

The 20th National Congress of the Chinese Communist Party confirmed China's orientation away from a growth-focused policy based on international integration and towards a more security-focused policy, aimed at a more independent China. While China will likely continue to take advantage of global integration, the long-term goal is to become less reliant on other countries, particularly in areas of security and technology. China's increased focus on economic independence, coupled with growing efforts by the West to diversify supply chains away from China present a challenge for the global economy but some emerging markets (EM) countries could potentially benefit from these changing dynamics.

"You don't lead by hitting people over the head—that's assault, not leadership."

– Dwight Eisenhower, 34th president of the United States

The National Congress of the Chinese Communist Party, a week-long event held every five years, establishes the broad policy framework and direction in addition to major reassignment of leadership positions. The 20th Congress, which concluded on October 22nd, revealed no major policy changes but instead confirmed China's path of moving away from a growth-focused policy based on international integration and towards a more security-focused policy, aimed at a more independent China.

The most symbolic event during the session was the public removal of Xi Jinping's predecessor Hu Jintao from the stage on the day before the confirmation of Xi's third term as party leader. While the reason for Hu's removal is not known, the event appeared in line with Xi's break from the collective, consensus-based, leadership model, which characterized Hu's tenure as party leader. Xi's efforts to further concentrate power was displayed through a reshuffling of the top ruling body this week. Xi has now filled 24 spots of the Politburo and seven top leadership positions of the Politburo Standing Committee with his own loyalists. He personally retains the primary leadership positions of General Secretary of the Communist Party of China and Chairman of the Central Military Commission in addition to the more ceremonial position of President.

From an economic perspective, Xi's hold on power suggests the recent trend of de-emphasizing growth will not be reversed any time soon. Chinese growth has already slowed down sharply under Xi's tenure, with average annual GDP growth more than 4 percentage points below the levels observed during Hu's leadership (see figure 1). While some of that slowdown was likely inevitable given the different starting point and global economic backdrop, we see a very clear change in the policy response to economic shocks.

Hu's response to the global financial crisis in 2008/2009, for example, included very large stimulus combined with a drive to further open and integrate China in the global economy. Under Xi's regime, the growth-oriented policy has fundamentally changed. Heavy-handed policies triggered the current housing crisis and Xi has shown an unwillingness to resolve it quickly for the sake of higher growth. Similarly, the zero-Covid policy has been a severe impediment to growth. Yet, it remains in place with no signs of meaningful change. Meanwhile, longer-term projects of opening and integrating China financially have suffered from Xi's move against private enterprise as a cornerstone of economic development in China. While Chinese financial markets have gradually opened for foreign investors, other policy changes have made such investments less attractive.

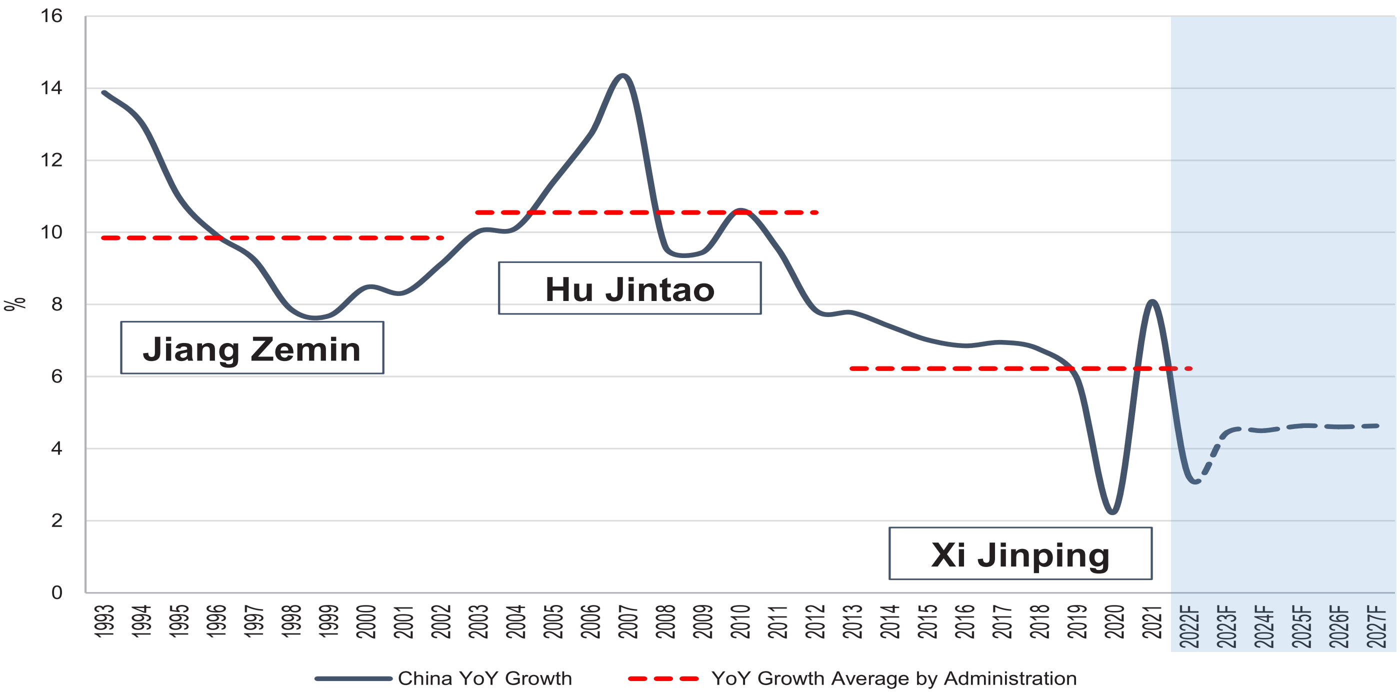
One of Xi's most important foreign economic policy initiatives, the Belt and Road Initiative, has clearly put China's geopolitical influence and control over critical foreign infrastructure ahead of economic concerns. The current wave of debt restructurings demonstrates this point. Many of China's debtors that received large Chinese infrastructure investments are now struggling to service the debt because the projects often failed to improve the payment capacity of the debtor, ultimately forcing China to restructure the loans (e.g., in Zambia and Sri Lanka).

In terms of China's relation to Western countries, we also see a substantial shift away from focus on the economy to focus on security. To a large extent, key events in recent years—ranging from the "trade war" with the U.S., to Western sanctions on Russia, tensions over Taiwan, and U.S. technology export controls—have reinforced China's perceived need to become more independent. This theme of security is also evident in Xi's Party Congress report, the key document that set the policy direction for the National Party Congress. Compared to previous reports, the word "security" has become more prevalent than "economy" and "reform." Specifically, the report emphasized security of supply chains, food, energy, technology, and innovation. Developing domestic substitutes for critical imports now appears to be a key element of the Xi's strategy. While Xi's China still has very important economic objectives, it appears that Xi views economic development important primarily because it enables a strong state and improved security and independence, not because it allows a more comfortable standard of living for the general population.

Going forward, efforts to de-integrate will continue from both China and the West. China will work towards increased security and technological independence while continuing to secure critical commodity inputs abroad. Meanwhile, Western countries will work towards diversifying supply chains. Against that backdrop, Chinese growth is likely to remain moderate, in our view, as any big initiatives to return to previous growth rates are unlikely given the continuation of Xi's policy framework.

Adapting to this paradigm presents a challenge for the global economy. However, various EM countries have the potential to benefit from this de-integration process by aiming to gain a larger share of the new supply chains while continuing to seek Chinese investment in infrastructure and commodities. For example, last month, the U.S. administration invited Mexico to participate in the expansion of North American semiconductor production capacity, for which US$50 billion have already been authorized under the CHIPS act. We expect to see similar examples from select European countries, as well as countries in South-East Asia, where the technology sector could benefit from supply chain rotation away from China.

FIGURE 1: CHINA YOY GROWTH



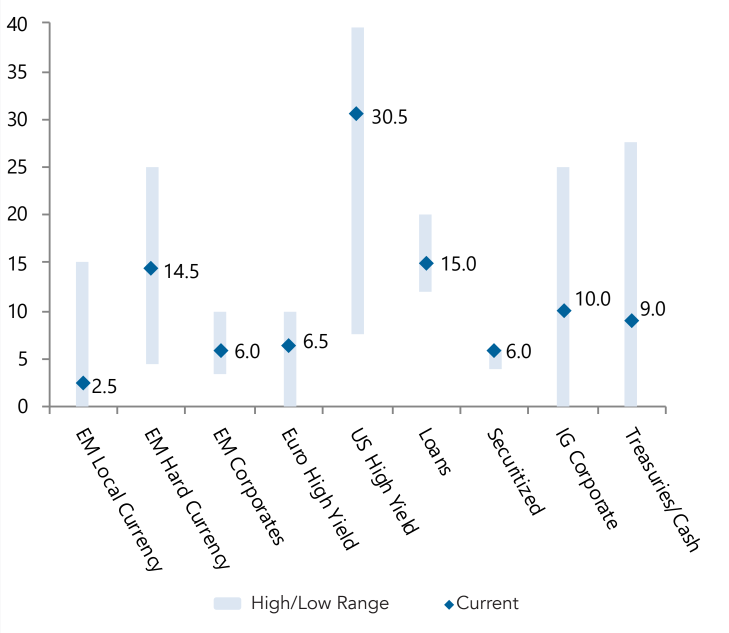
As of 31 July 2022. Sources: IMF WEO, Stone Harbor Investment Partners. For illustrative purposes only.

"Softish" Landing (35%)	• Tighter financial conditions, induced by higher Fed policy rates, along with tighter fiscal policy and fading rebound from Covid, meaningfully slow growth. • Slower growth spreads out beyond interest rate sensitive sectors that are already lagging, such as housing, to the consumer and investment. • Russia-Ukraine War and sanctions both continue. Natural gas supplies to Europe continue to be erratic at best. The resulting higher prices for both natural gas and electricity substantially drag down European growth through the winter. • U.S. growth remains positive, though Eurozone is modestly negative. • China growth remains subdued despite more policy support in H2. The continuing housing slump and continued zero-Covid policy prevent a more dynamic rebound. Growth in other EMs also slower due to drag from DMs and tighter monetary conditions. Commodity exporters still benefit from strong terms of trade. • U.S. core PCE remains elevated through 2022 as services inflation remains elevated, though some relief from goods prices. By spring 2023, enough labor market space has been opened up that inflation starts to moderate further, though run-rate is still above target. • Fed hikes by 75bp in November, but slower goods price inflation gives enough room to moderate to 50 in December and 25bp in early '23. With growth meaningfully slower and rates above neutral to neutral, they pause to assess. Balance sheet runoff at sustained $95bn/month pace. • ECB pace accelerates to 75bp for two meetings and then drops back to 50bp. • Rate hikes continue in many EMs, but are peaking, on average, in Q1. China remains a key exception with continued very gradual easing. • Oil prices remain elevated, though premium declines somewhat ~$90/barrel WTI, Brent ~$95.
Central Bank-Led Global Recession (35%)	• Combination of tighter fiscal and monetary policies, sharply elevated energy prices, hit to sentiment from Russia-Ukraine War, and associated trade disruption tips global economies into recession. • Growth fades rapidly over Q4 for the U.S. Interest rate sensitive sectors—housing, business investment, and durables—lead the downshift, but typical recessionary dynamics take hold in the labor market, spreading the weakness across economy. • With slower activity and sluggish consumer demand, inflation moderates rapidly. • European growth even slower than U.S. growth. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./EZ. • Broadly, sanctions against Russia remain in place. • Fed hikes rates by 75bp in both November and December and continues to hike in the face of slowing growth, with two 50bp increases in 2023. It then pauses as payrolls turn negative. As recession dynamics take hold, they reverse course, and start to cut the funds rate. By Q3 2023, rates are back to around 2% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. • ECB lifts rates by 75bp at the next three meetings, slows to 50, and then pauses as the combination of rate increases and the drag from high energy prices induce contraction. They then likewise begin reversing hikes. • EM economies still raising rates in 2022, but shifting policy stance by Q2 2023. More decisive cuts than in base case scenario. • Oil: WTI at ~$55/barrel; Brent ~$60/barrel.
Resilient Inflation in Face of Slow Growth (20%)	• Despite ongoing tightening—and slower growth—inflation proves resilient. Core continues to run over 4% despite substantially slower growth. • Similar inflation dynamics across DM economies. • Faced with the higher ongoing inflation, central banks broadly continue to push up rates at the expense of growth. Economies stagnate, though don't tip into outright recession. • Markets mark up estimates of the neutral interest rate and expect the higher rate environment to be persistent. The 10y trades a bit under 6%. • EM inflation fails to fall meaningfully. Weaker growth in EMs as central banks keep tighter monetary conditions. Especially weaker EMs are struggling with tight funding conditions. • Oil: WTI at ~$105/barrel; Brent ~$110/barrel.
Inflation Reverses Course, Leading the Fed to Also Reverse Course (10%)	• Fed continues to raise rates and fed funds rate peaks just over 4¼%. • However, inflation proves more sensitive to slower growth and core inflation rates drop quite quickly; easing of supply chain snarls amplifies drop. • With inflation cooling rapidly and growth below trend, the Fed starts to reverse course in early Q3 of 2023. Market prices in further cuts ahead and a rebound of growth back toward potential • Other DMs and EMs also see some moderation of inflation pressures, which leads to similar central bank pullbacks. • Dollar broadly gives back some of the outsize 2022 gains. • Oil: WTI at ~$90/barrel; Brent ~$95/barrel.

	"Softish" Landing (40%)	Global Recession (35%)	Resilient Inflation (15%)	Inflation Reverses Course (10%)
U.S. Real 4Q GDP (%)	0.75	-1.00	0.00	1.25
Fed Funds (%)	4.63	2.13	5.38	3.63
U.S. Core PCE (%)	3.60	2.75	4.75	2.65
2yr Treasury (%)	3.70	1.75	5.50	2.10
10yr Treasury (%)	3.40	1.75	5.75	2.75
10yr Bund (%)	2.25	0.25	4.00	0.75
China 4Q GDP (%)	3.50	2.50	3.00	4.00
EM 4Q GDP (%)	3.00	1.50	2.00	4.00

[1]Forecast Period: Next 12 months. Source: Stone Harbor.

MULTI-ASSET CREDIT TARGET ALLOCATIONS (%) SINCE INCEPTION & RECENT ALLOCATION CHANGES[2]



LATEST ALLOCATION CHANGES

	Month	Change (%)
EM Local Currency	May-Jun 2022	-2.5
EM Hard Currency	May-Jun 2022	+2.5
EM Corporates	Feb-Mar 2022	+0.5
Euro High Yield	Dec-Jan 2022	+2.5
U.S. High Yield	Aug-Sep 2022	-9.0
Loans	Jan-Feb 2021	+1.5
Securitized	Mar-April 2019	+1.0
IG Corporate	Mar-April 2022	+10.0
Treasuries/Cash	Aug-Sep 2022	+9.0

[2]Since Inception: September 2013. Stone Harbor Multi-Asset Credit Representative Target Allocation as of 30 September 2022. Actual allocations within any account may be significantly different from the target allocations shown here. For illustrative purposes only.

SEPTEMBER CREDIT MARKET TOTAL RETURNS & ATTRIBUTION

	U.S. High Yield	EM Hard	Loans	EM Local	EM Corp	Euro High Yield	IG Corporate
Total Return	-4.02	-6.36	-2.27	-4.87	-3.83	-4.17	-4.49
Duration (Returns from Interest Rates %)	-2.87	-3.89	0.28	-3.01	-2.68	-2.13	-3.67
Credit Beta (Returns from Spreads %)	-1.15	-2.47	-2.55	-1.86	-1.15	-2.04	-0.82

Month Ended 30 September 2022. Performance reflects representative asset class benchmarks. HY: ICE BofAML U.S. 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 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

Stone Harbor is a global credit specialist with expertise in emerging and developed markets debt, with three decades of informed experience allocating risk in complex areas of the fixed income markets. We manage credit portfolios for clients globally.

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation
- Over 30-year performance history
- Offices in New York, London, and Singapore
- Effective January 1, 2022, Stone Harbor Investment Partners is an affiliate of Virtus Investment Partners

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 U.S. 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 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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