INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

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The U.S. Economy: A Roadmap to "Soft Enough" Landing

Over the last several months, U.S. economic data has been surprisingly resilient. The core personal consumption expenditures (PCE) price index reaccelerated in September with an increase of 0.3%, following the move higher in consumer price index. At the same time, gross domestic product (GDP) has also picked up at an annualized rate of 4.9%—a growth rate that remains too strong. As the debate continues around whether the Federal Reserve will exercise patience or tighten the policy rate further, we sat down with our developed markets economist, Seamus Smyth, to get his thoughts on some of the most pressing questions on both inflation and growth, and the factors that might impact the path to a "soft enough" landing over the next several months.

We have seen interest rates move sharply higher over the last several months. Given this backdrop, has the base case changed in a significant way?

Our base case continues to reflect a relatively good outcome—one in which the economy continues to revert toward a 2% inflation. Growth does move quite a bit lower, but that's likely necessary to help the inflation moderation process. Data we have seen since the spring are broadly consistent with that outlook, in our view.

That is not to say there have been no changes. Within our base case, we have marked up growth going forward a bit and incorporated some of the move up in longer-term rates. But the broad contours of the outlook remain the same.

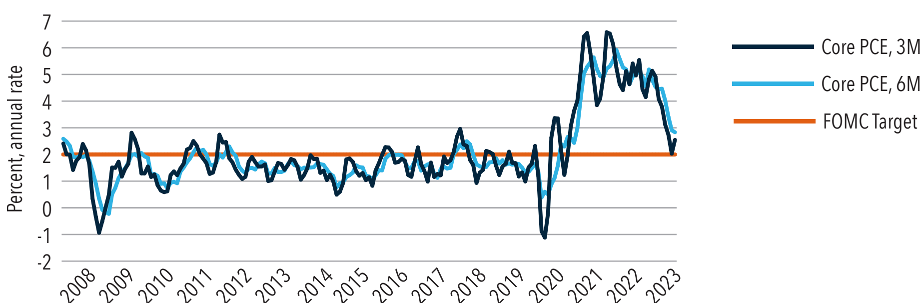
What data would you say has been most important in that assessment?

The most revealing data has been on the inflation side, which has shown substantial moderation over the summer. On a 3-month annualized basis, core PCE inflation has dropped to 2.5% in September from 3.1% in April, a fairly substantial decline (see figure 1). We expect some temporary giveback through the fall—giveback that has already started with the September data. Two more technical factors will help push up inflation. First, seasonal factors impute some of the covid-related swings in prices to changes in seasonality, which pushed down reported seasonally adjusted inflation during the summer, but likely push it up the inflation level through year-end. Second, for the Consumer Price Index (CPI) but not PCE, the treatment of health insurance will push measured inflation higher.

"For fast-acting relief, try slowing down."

– Lily Tomlin, Actress

FIGURE 1: CORE PCE HAS DROPPED CONSIDERABLY SINCE APRIL

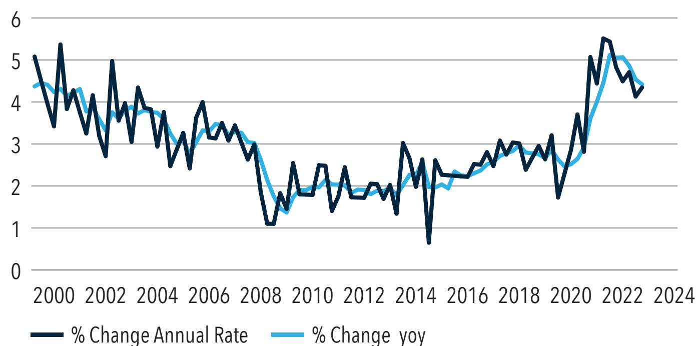


As of September 30, 2023. Sources: Haver Analytics, Stone Harbor Investment Partners.

Looking across various expenditure categories, we have seen declining goods prices, as well as lower inflation in the housing components of price indices; forward looking indicators point at more housing moderation. Services excluding rent appears more mixed; here we've seen some signs of improvement, but the most recent data has shown some reversion.

We think that wages remain important to understanding the path of inflation. Here the data has been mixed, but on net a bit more encouraging than not. Average hourly earnings (AHE) have recently been somewhat softer, reversing some strength in the summer. The Employment Cost Index (ECI), which remains the best overall measure, was slightly higher in Q3 than Q2 at a 4.35% annualized rate, but the path still appears downward as the year-over-year rate dropped to 4.4%, and a measure that excludes incentive compensation was softer sequentially (see figure 2). Still, overall, the ECI remains higher than we think consistent with 2% inflation, so we will need to see it fall further going forward. Some labor market metrics have shown moderation consistent with the move down in wages. For instance, quits and openings from the Job Openings and Labor Turnover Survey (JOLTS) are generally lower than in the spring.

FIGURE 2: ECI CAME IN SLIGHTLY HIGHER IN Q3 COMPARED TO Q2 BUT PATH CONTINUES TO TREND DOWN



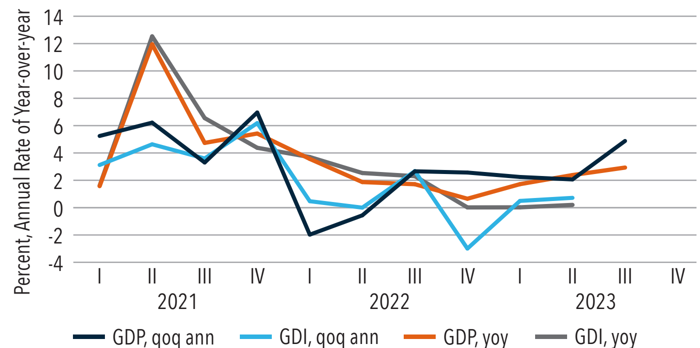
As of September 30, 2023. Sources: Haver Analytics, Stone Harbor Investment Partners.

You've talked about inflation so far, what about the growth side of the economy?

Growth remains very much the sticking point. Simply put, the economy is growing at a pace that is still too rapid for the inflationary backdrop.

According to the latest release, Q3 GDP increased by 4.9%, which is far above even the most optimistic views of potential GDP growth. We know that any given quarter can be noisy, but the year-over-year rate has increased to 2.9%, which is also well above potential GDP growth. Gross Domestic Income (GDI)—a parallel measure that should equal GDP in theory but differs as it is built up from different sources—has been softer. GDI is reported with a lag to GDP, so we only have Q2 data, which estimates growth at 0.2% in year-over-year terms for Q2 compared to 2.4% for GDP on the same basis (see figure 3).

FIGURE 3: GDI SHOWS LESS ROBUST GROWTH THAN GDP



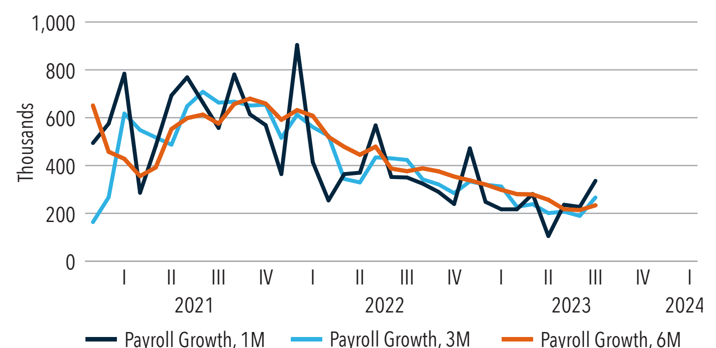
As of September 30, 2023. Sources: Bureau of Economic Analysis, Haver Analytics, Stone Harbor Investment Partners.

In broad terms, what would we need to see on growth, inflation, and labor market for the base case of a "soft enough" landing to hold?

Perhaps most importantly, we need to see slower growth. Unless we get a substantial and persistent upside surprise on productivity, growth substantially above 2% is simply too fast as it would likely keep upward pressure on inflation. Our focus is on growth because inflation data, despite recent uptick, is currently not too alarming and we see signs of underlying improvement.

That slower pace would also need to extend to the labor market. After mostly moderating over the course of the year—the 3-month average gain slowed from nearly 350k in January to under 200k in September—October saw a month-over-month increase of 336k (see figure 4).

FIGURE 4: PAYROLL GROWTH NEEDS TO SLOW AGAIN AFTER LATEST SIGN OF PICK UP



As of September 30, 2023. Sources: Bureau of Labor Statistics, Stone Harbor Investment Partners.

Let's be a bit more concrete. What will you be looking at over November and December to assess whether the data is compatible with your base case?

In the near term, we are looking for a slowdown in the growth data, perhaps most importantly moderation in currently robust consumption growth, along with a further slowdown in business investment, most likely to show up first in the durable goods report. Signs of renewed housing drag, or at least no sign of a boost from housing, would also be consistent with our base case.

On the employment side, we would like to see a resumption of the drift down in the pace of employment growth: toward 100k, with initial claims drifting up modestly to roughly toward 225k.

On inflation, as we discussed above, we think the next couple CPI prints are higher rather than lower due to healthcare and residual seasonality. So, we are not looking for near-term further improvement, but we will be watching to see if there is deterioration beyond what those imply. Along with that, we'll be examining the composition to see how prices, but especially services prices and rents, are behaving. We'd also anticipate PCE to be somewhat better than CPI, potentially causing a bit of whiplash within the month.

How about as we enter 2024?

Most importantly, once we're past the issues on CPI, we need to see a resumption of lower readings. So, early next year we would need to see core CPI between 0.25-0.30% month-over-month with core PCE in the 0.20-0.25% range. After the move down in the pace of growth in late 2023—to something below 2%—we envisage signs of stabilization around 1.5% or so. Also early in the year, we would see continued evidence of labor market loosening in JOLTS while initial jobless claims stabilize around 250K. We'll also be watching the U.S. government's fiscal position to see if there is an uptick in revenues as share of GDP.

And, what would be the key factors to monitor further out?

Basically, we would be looking for more of the same: inflation not too far from target and growth below potential, with the labor market stabilizing with modestly less slack than we currently see. If we get into the summer with the economy tracking roughly along those expectations, we would expect the Fed to start to emphasize that policy rates are restrictive and probably don't need to remain so, potentially setting up for rate cuts toward the end of 2024.

What are the current risks around the base case scenario?

When thinking about positioning our portfolio, we are currently looking at three key risk scenarios. Although recent strength in the U.S. economy lowers the probability of a global recession, that risk still very much remains. In this scenario, the Fed is spooked by still-rapid growth data and the upward reversion in inflation. They resume rate hikes in the fall, and the lagged effects of tighter fiscal and monetary policies, combined with banking issues and associated credit contraction, tip global economies into recession.

Another risk is a significant economic slowdown in China, led by further deterioration in the housing crisis. In this scenario, measures introduced by the government to promote Chinese housing demand fail to gain traction, real estate sales volumes drop further as a result, triggering more outright price declines. The government refrains from large-scale bailouts and debt swaps on concerns of exacerbating moral hazard. This scenario would have more limited effects on developed markets economies, particularly on the U.S. due to ongoing efforts to decouple from the Chinese economy.

Finally, we see risk around U.S. growth that remains too strong. This scenario would keep an upward pressure on inflation rates that stay well above the FOMC's target and also move up market reassessment of where neutral rates are. In response, the Fed raises policy rate further to over 6% in an effort to put downward pressure on growth and inflation.

We removed a scenario of seeing substantially better inflation but incorporated some of the better inflationary news into our base case scenario.

Soft-Enough Landing

(55%)

- Higher rate environment keeps U.S. growth somewhat below potential. Growth slowdown rotates from the most interest rate sensitive sectors—e.g., housing—to the consumer and business investment. Eurozone growth somewhat slower.
- Weakness in global economic activity and a continuing housing slump constrain China's growth.
- Growth in other emerging markets (EMs) is supported by rate cuts in the second half of 2023 and solid domestic demand in some EMs, offsetting the drag from low DM growth. Commodity exporters still benefit from supportive terms of trade.
- U.S. core PCE holds onto most of moderation through the fall, and then dips slightly more into the new year.
- Fed keeps rates flat into 2024 and balance sheet runoff continues at sustained US$95 billion/month pace. With inflation continuing to moderate through the first half of 24, Fed cuts are on the horizon, but Fed is relatively slow to implement. European Central Bank (ECB) dynamics similar.
- Rate cuts across many EMs following lower inflation pressures.
- China continues gradual monetary easing. Some incremental stimulus measures slowly roll out, but high debt levels restrain the aggressive use of credit policies. Large-scale bailouts or debt restructurings are avoided due to moral hazard concerns.

Global Recession

(25%)

- Fed resumes rate hikes in the fall and fed funds tops out ~6%. Lagged effects of tighter fiscal and monetary policies combine with renewed banking issues and associated credit contraction to tip global economies into recession.
- Worries about commercial real estate losses exacerbate credit crunch.
- U.S. growth fades through fall. Interest rate sensitive sectors—housing, business investment, and durables—sink. Recessionary dynamics take hold in the labor market and weakness spreads.
- Inflation moderates rapidly with slow consumer and demand contracting activity.
- European growth follows U.S. growth downward. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./EZ.
- China also stalls amid global growth headwind and initially tighter financial conditions. Policy stimulus limits downside.
- As recession dynamics take hold, the FOMC reverses course and starts to cut the funds rate. By Q3 2024 rates are back to around 2½% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. Eurozone growth also stalls and then contracts; ECB likewise begin reversing hikes.
- EM economies policy stance also shifts, with more decisive cuts than in base case scenario.

High Growth, High Rates, and Inflation Still-Too-High

(10%)

- U.S. growth remains solid, notably over current estimates of the potential growth rate (~1¾%).
- The ongoing firm growth outlook, despite substantial rate increases, does two things. First, it keeps upward pressure on inflation rates, which remain well above the FOMC's target. Second, it pushes further on market reassessments of where neutral interest rates are.
- In response, the Fed pushes up policy rates further—to over 6%—so as to put downward pressure on growth and inflation. Longer-term rates also move higher with the higher expected neutral rates.
- Solid U.S. growth provides some support to other DMs. Eurozone growth firms from the current dip, but as in the U.S., inflation remains stubbornly high.
- Effect on EMs varies. Positive impact from solid U.S. and better EZ growth dominates, but some countries feel the effects of the higher rate environment.
- Oil broadly supported by the robust growth.

Housing Slowdown Pulls Down Chinese Economy

(10%)

- Measures to promote Chinese housing demand fail to gain traction. Real estate sales volumes drop further, triggering more outright price declines.
- Defaults spread among real estate, local government financing vehicles, wealth management products. Policy makers incrementally add more stimulus measures. However, cautious on adding more leverage and concerned about exacerbating moral hazard, they shy away from large-scale bailouts and debt swaps.
- China GDP growth declines ~2pp vs. base case
- Non-China EM GDP growth declines around 1pp; more for commodity exporters, less for manufacturing exporters.
- More limited effects on DM economies. Drag on U.S. economy attenuated by ongoing decoupling. Eurozone sees somewhat larger effects.
- Commodity prices decline and risk premia rise.

	Soft-Enough Landing (55%)	Global Recession (25%)	High Growth, High Rates, and Inflation Still-Too-High (10%)	Housing Slowdown Pulls Down Chinese Economy (10%)
U.S. Real 4Q GDP (%)	1.25	-1.50	2.5	1.00
Fed Funds (%)	5.38	2.88	6.38	5.13
U.S. Core PCE (%)	2.75	2.00	3.50	2.60
2yr Treasury (%)	4.65	2.00	6.00	4.50
10yr Treasury (%)	3.75	1.75	5.50	2.75
10yr Bund (%)	2.75	1.00	3.50	2.25
China 4Q GDP (%)	4.00	3.00	5.25	2.00
EM 4Q GDP (%)	3.50	1.75	4.25	2.00
Oil (WTI/Brent)	$80/85	$55/60	$90/95	$65/70

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