INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

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Focus on Growth Grows as Inflation Moves Closer to Target

Over the past several months, the markets have focused—correctly—on the downward path of inflation, which has led to a reassessment of when the interest rate easing cycle might start. While inflation levels have been of paramount importance, the incoming news on economic growth has also mattered for the path of rates in recent months, with signs that Q3's torrid pace was an exception and an important secondary factor in market moves. Going forward, we think that the path of growth will matter a lot. What constitutes good news for growth will be counterintuitive: growth that is too robust would be problematic as it would likely lead to delays in rate cuts by the U.S. Federal Reserve (Fed). In this issue, we examine some of the details of near-term growth factors, as well as interactions with longer-term underlying growth, and how those could impact the Fed's economic outlook.

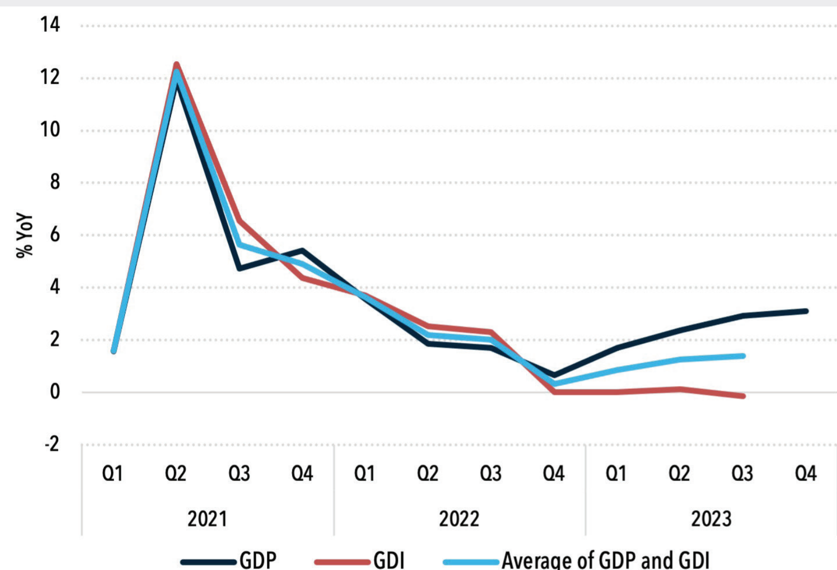
"Not too slow, not too fast. Kind of like half-fast."

– Louis Armstrong, American Vocalist

Alongside moderating inflation, data has mostly pointed at slower growth in Q4, following the torrid pace in Q3. While the substantial moderation in core PCE inflation has been the primary driver of lower yields, slowing growth has also played a role. The headline GDP numbers show some slowing of growth, as real Q4 growth was 3.3%, nearly 2 percentage points lower than Q3. That is the currently reported numbers for GDP, as we note that if we compare the two measures of national output produced by the Bureau of Economic Analysis (BEA)—gross domestic product (GDP) and gross domestic income (GDI)—GDI continues to show a substantial divergence with GDP through Q3, rising much more slowly in year-over-year terms (see Figure 1). These two measures should be equal in theory, but they are built up from different data and sources and can vary, as we are seeing now. But we think both contain some real information, and we would not be surprised to see GDP growth revised down over time.

While Q4 GDP growth was slower, it was still quite rapid and we continue to watch incoming growth data, especially as there are some tentative signs of reacceleration that we think would be unwelcome. For example, regional Fed services Purchasing Managers' Index (PMIs) have firmed slightly, as have the preliminary national PMIs for both services and manufacturing from S&P, while real consumption in November and December was strong—all potentially hinting at further growth momentum. Claims data has also potentially shown some labor market firming, with the 4-week moving average dropping to below 210K. Continuing claims have also moved down slightly, though some lingering seasonality issues make interpreting continuing claims tricky.

FIGURE 1: GDP and GDI Have Diverged Substantially Over the Past Year



Analysis as of 26 January 2024, using latest data available. Sources: Haver Analytics, Stone Harbor Investment Partners.

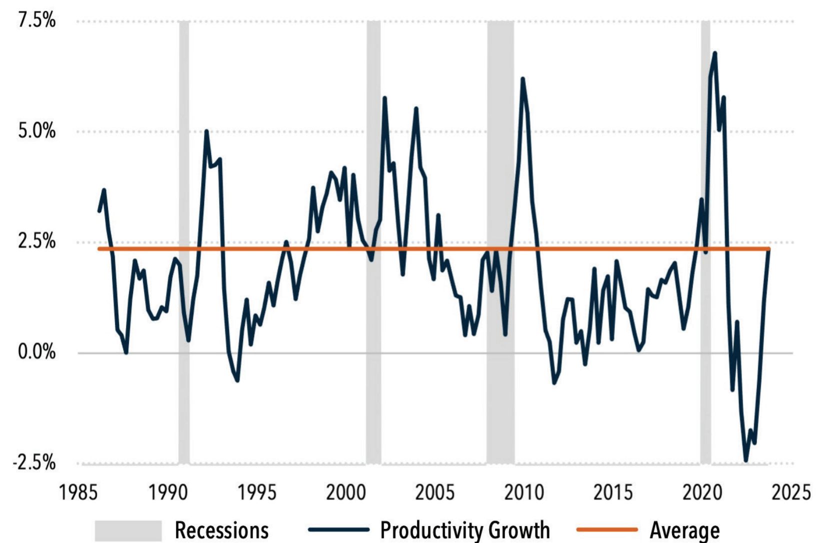
The concern that growth could be too fast stands in contrast to most of the past 15 years. Over that time, the economy was continuously operating below potential, and inflation was low, which is not the current situation. This implies that near-term growth matters a lot in shaping how the Fed thinks about setting policy. We assess that the Fed views the economy as currently operating at about its potential.

Saying growth above or below potential seems easy, but that elides the more challenging question of determining exactly where potential growth is in real time. To that end, we are monitoring several factors that we view as important inputs into potential growth and that may have shifted: productivity and labor force participation (LFP).

Through Q3, productivity grew at 2.4% annual rate, the fastest rate outside of periods immediately surrounding a recession or pandemic since the late 1990s (see figure 2). That rapid pace could be the ongoing aftereffects of COVID, as productivity has been even more volatile than normal over the past couple of years (see figure 3). But there are also potential fundamental factors that could have accelerated productivity. One is that the period of tight labor markets and the jump in wages have incentivized firms to minimize labor. New technologies—such as artificial intelligence, better robotics, and medical advances—are another potential factor that could push up productivity growth, though based on historical experience it seems early for them to be showing up in the numbers. One important potential effect of faster productivity growth would be that it would allow more rapid wage growth without inflationary pressures.

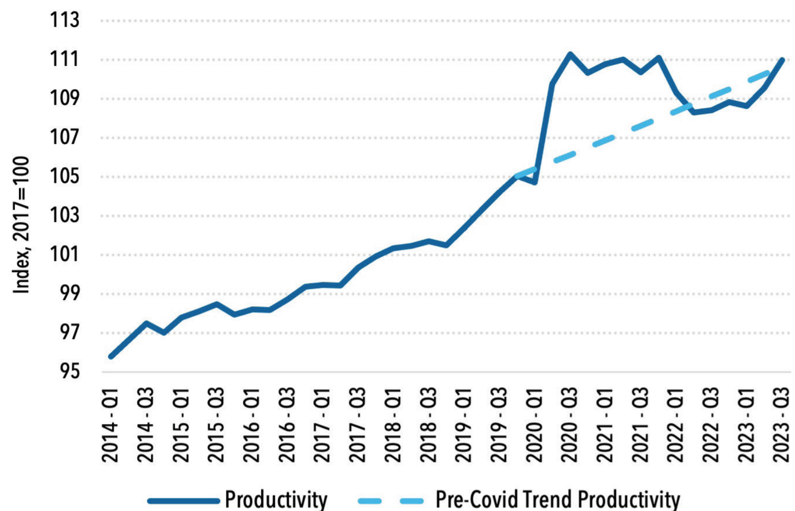
The second factor we are watching for impacts on potential growth is labor force participation (LFP). LFP has generally been strong post-pandemic, with prime age (25-54) participation rate finally recovering to the pre-financial crisis levels of 2005/2006 (see figure 4). Young females represented a significant portion of this improvement. Female LPF in age groups 25-34 and 35-44 has moved much higher and provided an important supply boost to the economy (see figure 5). However, we have seen some recent backsliding as prime-age LFP has moved down over the past several months This data can be noisy, especially for smaller age ranges and over shorter time periods, so we'll be watching LFP data, and particularly female LFP data, closely over the next few months.

FIGURE 2: Productivity Growth Best Since Late 1990s / Early 2000s, Except For Right Around Recessions



Analysis as of 26 January 2024, using latest data available. Sources: Bureau of Labor Statistics, Haver Analytics, and Stone Harbor calculations.

FIGURE 3: Recent Growth Returns Productivity to the Pre-COVID Trend



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Both of these inputs—productivity growth and LFP—have the potential to shift around the timing of what the Fed does over the coming months. In the near term, with inflation near target, slower growth would provide the space for the Fed to cut the policy rate sooner, in our view.

Though the Fed is watching all these factors, and we very much think the path of growth matters in assessing the Fed in the short-term, what will matter most over longer time horizon is the behavior of inflation. That is because the Fed is trying to avoid the experience of 1970s' high inflation. The Fed believes the policy error in the late 60s and early 70s that allowed inflation to become entrenched was easing too soon; errors they very much don't want to repeat. Therefore, inflation readings remaining around 2% for core Personal Consumption Expenditures (PCE) remains by far the most important data. But alongside that, the economy's growth path can affect the timing of the Fed's actions. And if growth turns from somewhere around trend to recessionary, then the Fed will quickly turn as well.

Our base case (35% probability) assumes that inflation continues falling globally, growth slows, and the Fed keeps rates flat through early 2024 and starts cutting rates in the summer. If we are wrong, we believe the two most likely scenarios will lead the Fed to cut policy rates more aggressively, either to contain an economic downturn (25% probability), or to keep up with falling inflation while growth in the U.S. converges toward trend (30% probability). These point to lower U.S. policy rates by mid year. Another scenario leads the Fed to hike policy rates as inflation turns back higher. We only assign a 10% probability to this outcome.

FIGURE 4: Strong LFP Growth in Recovery, Though Some Recent Backsliding

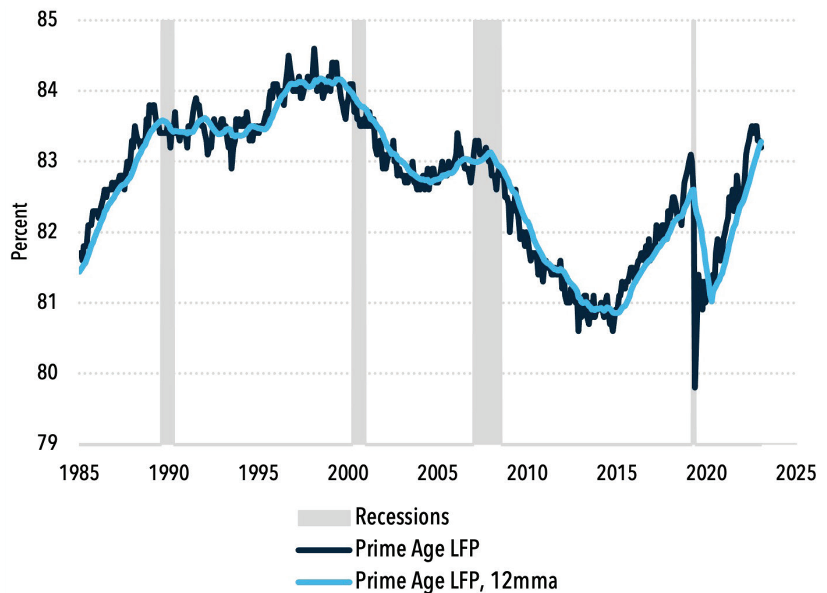

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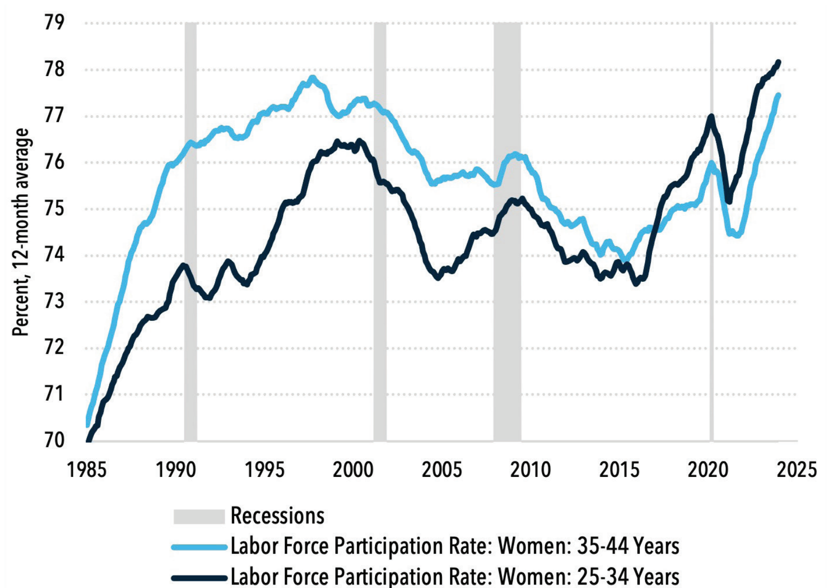
FIGURE 5: LFP for Younger Women Has Meaningfully Surpassed Late 90s Highs



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Soft-Enough Landing

(35%)

- Higher rate environment keeps U.S. growth somewhat below potential. Growth slowdown rotates from the most interest rate-sensitive sectors—e.g., housing—to consumer and business investment. Eurozone growth remains quite sluggish.
- Weakness in global economic activity and a continuing housing slump constrain China's growth.
- Growth in other 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 inflation rebounds slightly from still solid services prices.
- Fed keeps rates flat through early 2024 and balance sheet runoff continues at sustained $95bn/month pace. Inflation moderation sufficient for the Fed to start cutting rates in the summer. They continue to reduce at a modest pace through the rest of the year. ECB dynamics similar.
- Rate cuts across many EMs following lower inflation pressures.
- China continues gradual monetary easing. Some fiscal stimulus measures are being rolled 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.

The Forbidden "T"-Word

(30%)

- Inflation really was "transitory"…just a (very) long version of transitory. The pandemic and its aftershocks caused a surge in prices, but it didn't translate into lasting inflation. Inflation into early 2024 essentially converges back to target in the U.S. and other DM economics.
- With 6-month core PCE staying around 2% through the end of the first quarter of 2024, the Fed looks at their policy rate, finds it too restrictive, and initiates a cutting cycle. Rates are back below 4% by December.
- Eurozone, with inflation also moderating rapidly and growth even weaker, also turns to cuts. Japan keeps short-term rates at zero, as their inflation follows other DMs down with a lag.
- Growth in the U.S. converges toward trend, though remains somewhat more sluggish in Europe.
- EMs also broadly see inflation continue to moderate. In response, EM central banks continue already-initiated cutting cycles.
- EM growth solid, both from the easier financial conditions and solid DM growth.
- Oil prices little changed as supply response helps constrain prices.

Global Recession

(25%)

- Lagged effects of tighter fiscal and monetary policies combine with renewed banking issues, commercial real estate issues, and associated credit contraction to tip global economies into recession.
- U.S. growth fades through the winter. 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 the consumer slow and demand contracting.
- Already sluggish European growth follows U.S. growth down. 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 the fourth quarter of 2024, rates are back to around 2½% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. ECB likewise has moved to substantial rate cuts.
- 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 turn back higher, returning to inflation run rates of over 3%. Second, it supports upward reassessments in markets of where neutral interest rates are.
- Inflation moves back higher into 2024 and, in response, the Fed pushes up policy rates further—to over 6%—so as to put more downward pressure on growth and inflation. Longer-term rates also move higher with the higher expected future neutral rates.
- Eurozone growth firms from the current dip, but as in the U.S., inflation remains stubbornly high. Solid U.S. growth provides some support to other DMs.
- EM effect 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. .

	Soft-Enough Landing (35%)	The Forbidden "T"-Word (30%)	Global Recession (25%)	High Growth, High Rates, and Inflation Still Too High (10%)
U.S. Real 4Q GDP (%)	1.25	1.75	-1.00	2.50
Fed Funds (%)	4.63	3.63	2.63	6.38
U.S. Core PCE (%)	2.50	2.00	1.75	3.50
2yr Treasury (%)	3.80	3.25	2.00	6.00
10yr Treasury (%)	3.75	3.15	1.75	5.50
10yr Bund (%)	2.25	1.75	1.00	3.50
China 4Q GDP (%)	4.75	5.25	3.25	5.50
EM 4Q GDP (%)	4.25	4.75	2.0	4.75
Oil (WTI/Brent)	$75/80	$75/80	$55/60	$90/95

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Main Office - New York
31 W. 52 Street
16th Floor
New York, NY 10019
+ 1 212 548 1200

London Office
48 Dover Street
5th Floor
London W1S 4FF
+ 44 20 3205 4100

Singapore Office
3 Killiney Road
Winsland House 1
Singapore 239519
+ 65 6671 9711

shipemd.com

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