

# L M CAPITAL GROUP, LLC

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Investment process:  
**Global macroeconomic /  
Fundamental**

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Total firm assets:  
**\$1.50 billion**

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**4TH QUARTER, 2003**

## ***EXPECTED ECONOMIC RECOVERY FUELS INFLATION FEARS; BONDS BREAKDOWN***

**BY JOHN CHALKER, MANAGING DIRECTOR**

Since the end of World War II, bond managers have equated economic strength with a resurgence of inflation. That scenario usually led to higher interest rates as portfolio managers anticipated a rise in interest rates by the Federal Reserve as a means to subdue the inflation 'bogey man'. Today, the Federal Reserve is attempting to convince bond managers that stronger economic growth will not bring inflation roaring back from its decade long hibernation. That's a big pill for most of us to swallow given our habit patterns of the past 25 years.

Seated in our trading turrets, we listen to the Fed's calming words and observe, or feed, the market reaction to increasingly stronger economic data. It could only make sense to a true bond vigilante. The trigger was pulled in June as the economic data started to give a clear indication of a strong recovery. The bond market declined despite reassurances from the Fed that rates would remain low for a considerable time period; the situation was further aggravated by an FOMC rate cut of only 25 basis points at the June 25th meeting versus the market's expectation of a 50 basis point cut. With that surprising disappointment behind the market, consistently strong selling and price volatility has gripped the market through October.

Investors are now concerned with the sustainability of the economic recovery and any related inflationary impact. This stronger

economic data and subsequent uncertainty has pushed our Trend Identification Score into a neutral/defensive indication. We have reduced the average duration and maturity of our portfolios to closely match the assigned benchmark for domestic portfolios. We expect that the near future will be difficult for US Treasury and agency securities, while comparatively more favorable for MBS securities and corporates, and especially lower grade corporate issues.

The Opportunistic Core strategy has performed admirably in this environment, providing excellent defense against the recent domestic market decline while reaping the benefit of a stronger economy impacting the US high yield asset class. Additionally, the non-dollar sector of the portfolio has added significant positive relative performance as the US Dollar continues to trend lower against the Euro and commodity based currencies such as the Canadian and Australian Dollars. Finally, the higher yielding Emerging Market Debt sector, denominated in US Dollars, continues to outperform almost all other domestic fixed income sectors. Going forward, we plan to review our weightings in these sectors. We are especially interested in the global fundamentals that are fueling the trends in the non-dollar and US high yield asset classes which may offer the opportunity for continued gains in 2004.

## **EMERGING MARKETS ECONOMIC COMMENTARY**

**LUIS MAIZEL, SENIOR MANAGING DIRECTOR**

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US Treasuries weakened and the string of monthly inflows to Emerging Market Debt funds came to a halt in October. High coupon paper outperformed the better credits, which are no longer a capital appreciation play as their prices have skyrocketed.

Argentina is still a major concern for the markets as the proposed restructuring, offering 25 cents on the dollar, was much lower than the expected proposal and was violently rejected by the markets. As the country reports a strong economic recovery, the incentive to give Argentina concessions diminishes as its ability to repay increases.

EMD issuance was about \$13 billion during October, with almost \$5 billion of new money. Market absorption was very good with a minimal widening of 5 bps in the spread.

Issuance in other currencies outside of the dollar is growing as the greenback continues to lose its appeal and buyers look for alternatives. A major supply of Eastern Europe infrastructure bonds is expected to reach the market, especially if the Euro reaches the US\$ 1.10 level.

Mexico and Brazil continue to move in divergent directions as industrial production in Mexico contracts and jobs are lost while Brazil expands its role as a significant producer/exporter of iron ore, steel, chemicals and other high-volume products. Unless the proposed structural reforms in Mexico are implemented, there is growing concern about the country's ability to maintain its competitiveness and to remain the third largest supplier to the US. Mexico just relinquished its second place position to China.

As of the end of October, EMD is still the best performing asset class over a 5-year period against every major asset class with a very low correlation. I recommend concentrating in better quality EMD issues with a strong focus on coupon return as the markets remain volatile in these difficult times.

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Senior investors and consultants will remember an old Broadway play entitled, "Stop the World, I Want to Get Off". It was a crazy musical comedy that entertained you with lots of surprises. Unfortunately, that description fit the US domestic bond market as we navigated through the record setting price volatility of the third quarter. Outside forces such as MBS hedging and highly leveraged bond positions greatly exaggerated the market response to positive economic data despite reassurances by the Fed that short-term rates would remain unchanged for a considerable time period.

In July and August, our domestic portfolios were positioned for a continuation of a lower or stable interest rate trend. The portfolios performed poorly in the wake of the rapid rise in market rates, although much ground was recovered by the September rally and our adjustment to the portfolios' average duration characteristics. As the economic data in August and September signaled a stronger economy, our Trend Identification Score became more neutral/defensive and we reduced our portfolios' average duration in October and November. The lag in our indicator system, coupled with the rapidly moving market, produced poor third quarter results for most of the domestic portfolios.

Going forward, the portfolios are positioned with above average cash positions and average duration and maturity characteristics more closely aligned with their respective benchmark indices. We continue to overweight the corporate sector and underweight both US Treasuries and MBS securities. Our duration adjustments are being made in the cash and Treasury sectors. As longer-term investors with a 12 month time horizon, we are uncertain regarding the sustainability of the current recovery and its inflationary impact. This is an issue that cannot become clearer until we enter the new year. With good performance year to date, our process is guiding us towards a defensive position as the economic fundamentals confirm their strengthening trend while global political and social events have their day-to-day impacts. Market sentiment is extremely volatile, switching almost weekly between inflation fears fueled by the recovery versus no inflation and no rate hike through 2004 despite a good economy. Stay tuned for Act 2.

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## CLIENTS REWARD LM CAPITAL WITH ADDITIONAL ASSETS

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Although 2003 has been a tumultuous year in the fixed income marketplace, LM Capital has continued to provide strong results for our clients. We are pleased to announce the addition of new assets from three existing clients: the San Diego Metropolitan Transit Development Board, Coca-Cola Enterprises and Shell Oil Company.

MTDB allocated an additional \$30 million to LM Capital Group for their short term portfolio. Coca-Cola Enterprises awarded LM Capital an additional \$24 for their Opportunistic Core portfolio, and Shell Oil awarded LM Capital an additional \$5 million via Progress Investments for their Core Portfolio.

“Any time a client chooses to award you additional assets, it is tremendously rewarding. It represents their continued support and confidence in our capabilities, our process and our people.” said John Chalker, Managing Director.

### NEW TELEPHONE NUMBER EFFECTIVE IMMEDIATELY

The telephone number for LM Capital Group has changed. **The new number is 619-814-1401.**

All other contact information for the firm remains the same. Please update your records so that we can keep in touch!

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### PORTFOLIO CHARACTERISTICS (AS OF SEPTEMBER 30, 2003)

	LM Short Term	LM Intermediate	LM Core	LM Opp. Core	LM Emerging Market
Duration	1.85 yrs	3.37 yrs	4.34 yrs	3.58 yrs	2.25 yrs
Yield to maturity	1.81%	2.92%	3.67%	4.09%	9.96%
Average coupon	3.24%	4.94%	5.31%	5.91%	9.35%
Average maturity	2.05 yrs	3.92 yrs	5.60 yrs	4.57 yrs	3.43 yrs
Average quality	AA1	AA3	AA2	A3	BB3

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For more information on LM Capital Group, LLC,  
contact a member of our marketing team:

Mack Christian  
email: [mchristian@lmcapital.com](mailto:mchristian@lmcapital.com)

Richard T. Deary  
email: [rdeary@lmcapital.com](mailto:rdeary@lmcapital.com)

401 B Street, Suite 920  
San Diego, CA 92101-7650  
Tel: 619.814.1401  
Fax: 619.814.1404  
website: [www.lmcapital.com](http://www.lmcapital.com)

