L M Capital Group, LLC

Investment process:
Global macroeconomic / Fundamental

Total firm assets:
$2.06 billion

THE STUBBORN CONUNDRUM

By Mario Modiano, Portfolio Manager

It is June 30, 2005 and the Fed raises rates another quarter point in both the Federal Funds rate to 3.25% and the Discount rate to 4.25%, yet the ten year Note remains under 4.00%. The Fed signals further rate increases, but the long term Note resiliently remains under 4.00%. It seems that this intuitive conflict is just another one of the improbable situations that have converged on the economic world.

There are rising oil prices but subdued inflation; money growth in the European countries at a significant pace but their bond yields at historical lows. The severe US Trade and Current Account deficits are still in a rising trend, but the dollar and long term bonds are both strengthening. Economists have tried to explain these situations, even going back to the Nineteenth Century when the first real globalization phase was recorded and similarities were found in the conflicting trends. Even Mr. Greenspan, in various instances since his "conundrum" comments of last February, has dismissed as inadequate some of the prevailing reasons for this situation, i.e. the significant increase in the purchase of ten year Treasury Notes by foreign central banks, the effect of hedge funds making a play in bonds, and even the interest of pension funds to reduce their presence in the equity markets and reinvest in the fixed income arena.

It is important to justify this yield curve flattening because if this tendency continues, there is the possibility of the curve inverting with short term yields higher than long term yields. Studies have shown that whenever an inverted yield curve presents itself, a recessionary period has followed. It has been argued that this time it might be different because in the previous instances both short and long term rates were rising, with the short term rates rising faster and thus the inversion. In the present situation, short term rates are rising while long term rates are actually falling, a significant difference in how inflation is being perceived by the marketplace.

In my view, the behavior of the yield curve is first the result of supply and demand. It is evident that the liquidity in the US and the recycling of the trade and petrodollar deficits are keeping pace with the demand from the Government and the strong housing market. With supply and demand level, the main factor that will make interest rates fluctuate is the expected inflation. It appears that the market has decided that the Fed is focused on keeping inflation under control for the short term. The economy will continue to grow at a moderate pace and inflation is not an issue in the longer term.

If this is so, Mr. Greenspan's conundrum has been caused by his strategy and tactics, and thus should not be as perplexing as he has communicated.

Emerging Markets Economic Commentary

Luis Maizel, Senior Managing Director

The spread against US Treasuries has moved to the lowest level in the past 10 years. As an asset class, it has been the best performing of all fixed income classes for the last 13 years and has now come of age demonstrating that it no longer performs as a block but each country lives and dies by its own results.

As rates have tumbled in the mature economies and investors look for higher yielding alternatives, EMD becomes more attractive since most issuing countries base their economies on commodity exports which have increased in price and governments of the emerging countries seem to be more stable and much less militant.

In South America, Brazil continues to do very well with budget surpluses now the norm and not the exception. If not for various corruption incidents the bonds would be even higher as the currency has strengthened and exports keep booming.

Venezuela is flying high on increased oil prices but it is still a very speculative investment as President Chavez continuously shows he is an unstable leader and has already warned of the possibility of postponing debt repayment.

Mexico is still a second tier country where the economy is doing extremely well in terms of stability but there is little growth and the political climate is getting more complicated everyday with the rise in the polls of the populist Mayor of Mexico City. The election in July of 2006 will be very hard fought and the possibility of a leftist becoming President doesn't bode well for the country.

Argentina is finally approaching a conclusion of its debt restructuring process which is a “rip off” of foreign investors but will probably result in a much stronger borrower for the future.

Eastern Europe and Asia have had little issuance in dollars and at the very narrow spreads offered by the strong borrowers these countries don't offer a very viable alternative.

We think that this investment class will continue its good performance, not so much in terms of capital appreciation but offering a considerable yield pick up.

Domestic Portfolio Commentary

John Chalker, Portfolio Manager

The Treasury yield curve has produced higher volatility and directional change during the past three months than is normal when judged from a historical perspective. With the Federal Reserve continuing to raise short-term interest rates at a measured pace, many investors did not expect a rally in the long end of the curve during April. The result has been a bearish curve-flattening situation during the first quarter followed by April's strong rally with a bull-flattening situation. Trend following systems based upon fundamental analysis were negatively impacted by these movements.

Despite benign inflation reports and steady economic growth in the 3.0 to 3.5% range, the Fed has continued to raise interest rates.

We approached this period with the same defensive outlook as previous quarters, and our domestic portfolios were positioned with average maturity and duration characteristics that were approximately five to ten percent below the assigned benchmarks. However, our portfolios remained significantly overweight in the government agency and investment grade corporate sectors, while being underweight in mortgage-backed and Treasury securities. As a result, portfolio performance was poor relative to our assigned benchmarks as the corporate sector under performed by a significant margin due to several credit related events. We slightly reduced the allocation to corporate securities and increased the weighting in US Treasury and MBS securities. Additionally, we are slightly adjusting our duration target in response to changes in our Trend Identification Score, moving duration closer to the benchmark duration.

Going forward, we must question the ability of long maturity interest rates to move lower in the face of further Fed interest rate hikes before year end. We would look for an opportunity to extend the average duration of the portfolios on any significant backup in interest rates. Technical and credit worthiness factors have played a big role in the current market environment as foreign capital flows continue to support Treasury purchases and a slight flight to quality trade pervades the market based upon the GM and Ford credit downgrades and the rumors of significant hedge fund losses.

As usual, a key factor will be the Fed's desire to adjust monetary policy to a more neutral stance from the current Fed Funds rate of 3.25%. Clearly, the Fed should take its cue from inflation and economic data, yet it appears that the Fed will lean towards higher rates despite tame inflation data with steady economic growth. The tough question to answer is defining the neutral zone for monetary policy; does that call for 50 or 150 basis points of additional tightening? We also must question why the long end of the curve doesn't respond to those higher interest rates; is there a real supply-demand imbalance at work in the 10-30 year maturity sector?

LM CAPITAL ADDS TWO MARKETING ASSOCIATES

LM Capital is pleased to announce that Jeannie Lacaeyse and Sheré Martinez have joined the marketing and client service team-

Jeannie Lacaeyse, Assistant Vice President, Marketing & Client Service. Jeannie joined LM Capital Group in February of 2005. Her previous experience includes Marketing Manager for Pacific Corporate Group, LLC where she was responsible for all marketing efforts for potential and existing clients. She received her Bachelor of Arts degree from Denison University with an emphasis in Communications.

Sheré Martinez, Assistant Vice President, Marketing & Client Service. Sheré joined the firm in February of 2005. Her previous experience includes four years of Brokerage and Advisory Compliance at LPL Financial Services. She volunteers in the non-profit organization, Rebuilding Together San Diego. She is currently completing her Bachelor of Arts degree.

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

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