Investment Process:
Global Macroeconomic / Fundamental

Total Firm Assets: $5.0 Billion

LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

Luis Maizel, Co-Founder & Senior Managing Director
John Chalker, Co-Founder & Managing Director
Todd Crescenzo, CFA, Director – Research

2016: A Quick Recap

Negative returns across the high yield space dominated headlines in the beginning of 2016 as oil prices collapsed and recessionary concerns were fanned. Financial markets were subject to fears of deflation and investors were uneasy over the Federal Reserve's previous December rate hike and the Chinese yuan deflation. A sense of disorder resulted in a swift flight to quality as fixed income markets rallied, led by Treasuries and highly rated government bonds. Then seemingly overnight, credit markets, namely high yield and EMD, rebounded with strength that continued well into the second quarter as value based investors stepped in.

Moving into the second half of the year, dovish global central bank policies, improving liquidity and a stronger labor market boosted economic growth modestly. The yield on the 10-year U.S. Treasury bottomed at 1.37% in July and has since climbed more than 100 basis points. Political surprises and unanticipated market reactions, first seen during Brexit, had investors feeling uncertain as the focus remained firmly on a contentious US Presidential race that led to another market head fake. Our expectation of a Fed interest rate hike in December played out accordingly and Chair Yellen indicated additional increases would follow in 2017. Therefore, fiscal and monetary policy initiatives within the context of a rising rate environment will form a large part of our theme during the coming year.

Fourth Quarter Review

The fourth quarter saw negative absolute performance across the fixed income space as Treasury yields rose sharply (10yr Treasury rose 85bps) during the period. Specifically, the bearish 10/30s flattening of the curve was most affected during the surge in rates which largely occurred during the latter half of the quarter. As a result, the Emerging Market Debt (-2.61%), Corporate (-2.83%), US Government Agency Securities (-1.96%), Agency Mortgage Backed Securities (-1.98%) and High Yield (+1.75%) sectors outperformed the broader Barclay's US Aggregate Bond index return of -2.98% during the quarter. The Non-Dollar (-10.26%) sector was the largest underperformer, followed by the Treasury (-3.84%) sector which also lagged the broader index's return.

Our active portfolio management style allowed us to remain nimble, adjusting duration and sector weightings

Fourth Quarter Review (con't)

throughout the quarter leading to relative outperformance versus the benchmark across all strategies respectively. During the quarter we moved our overall neutral-to-mild underweight duration portfolio position to a more modestly underweight duration position with continued exposure to the plus sectors. The investment strategy group reconfirmed our continued slightly defensive positioning with the addition of Treasury Inflation Protected Securities into the Core and Core+ portfolios to help mitigate any possible volatility, future inflationary pressures and any impact from rising interest rates moving forward. Our continued underweight Treasury sector allocation and duration across the Core and Core+ strategies led to negative relative sector performance in both strategies however, as securities held in the 7-10yr part of the curve were hit hardest. Our selective plus sector allocations provided a strong hedge to performance as both the high yield and EMD sectors outperformed their respective benchmarks on a relative basis, further strengthening overall portfolio performance. We also exited our non-dollar positions during the first week in December, avoiding the sell-off that followed and protecting our gains in the sector.

Fixed Income Outlook

Looking forward, we think macroeconomic and policy conditions will continue to offer support for the coming rate-hike cycle, favoring our underweight portfolio duration and the attractive return potential offered by the spread sectors. In the high-yield bond market, which has enjoyed particularly robust returns over the last twelve months, we expect the sector to continue to generate attractive yields in an environment of below-average defaults. While we expect near term volatility in markets as investors react to the new Presidential administration, our continued long-term approach calls for patience and observation. With these factors in mind, we continue to favor our current allocations to EMD and high yield securities while tactically rotating our Treasury and Mortgage Back Securities to maintain the desired duration effect. Careful security selection and market timing will also remain critical to performance over the foreseeable future. Finally, we continue to closely monitor the depth and breadth of liquidity within the fixed income markets. Should any of the situations deviate from our baseline scenarios, action in the portfolio may be taken.

Emerging Market Debt Update

There is no doubt that the unexpected win of Donald Trump put the emerging markets in a state of flux as a sudden uncertainty related to exports, immigration, and general bilateral negotiations between the US, China, Mexico and

Emerging Market Debt Update (con't)

other countries arose. The economic stability of countries that depend on the US as a market for their goods and/or services (outsourcing, maquiladoras, etc) was abruptly called into question.

Up until November 8, the EMD asset class was doing well with oil having recovered from the mid $20's to around $50/barrel as a broad-based commodity rally ensued. The widening of spreads without any corresponding increase in default rates has made the asset class even more attractive, particularly in the case of corporations that have a mix of domestic market dominance and active participation in the hard currency markets. Examples of this would be JBS, the Brazilian meat company that has grown immensely in the US market or Mexican companies BIMBO and CEMEX, which generate over 50% of their sales in first world markets.

Brazil finally seems to be closing the dramatic corruption chapter that forced President Rousseff out of office and landed prominent businessmen, like the CEO's of Pactual and Odebrecht, in jail. Very heavy fines and other sanctions were a setback for many issuers but now they are able to move forward. Areas of the world like Turkey are still unstable, keeping some of the "miracle" countries out of the markets but the turmoil seems to be subsiding.

The December rate increase by the FED was a headwind for EMD debtors but the market response was much more subdued than in previously similar situations. We continue to reiterate our position of liking the asset class overall and exercising the need to be disciplined in security selection as this is *not* a case where a rising tide will lift all boats.

What to Watch

As we look ahead we believe many opportunities exist in the current environment but effective security selection will be crucial and will continue to drive returns moving forward. Some of the same challenges from 2016 continue to be present - political uncertainty, fiscal policy changes, rising rates, U.S. dollar strength and global economic slowdown. We believe the Fed will stay the course, letting economic data drive monetary policy for the foreseeable future as a gradual rise in rates becomes par for the course.

We believe President elect Trump's proposed policies have the potential to increase the pace of US economic activity toward 3-4% real GDP growth, up from the recent 1.5-2.5% pace. Talk of the economy overheating can be put on

LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

What to Watch (con't)

hold for the immediate future until we gain more clarity on what will and won't be implemented by Congress. The consumption (consumer, final sales) trend should remain stable as job growth continues to expand at a reasonably steady pace. As we evaluate Trump's policy changes, investors should keep a close eye on areas involving financial and environmental regulation, capital spending and the tax code, infrastructure spending, biotech/pharmaceuticals and the IT/telecom sectors.