LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

Luis Maizel, Co-Founder & Senior Managing Director
John Chalker, Co-Founder & Managing Director
Michael Chalker, Senior Analyst

The Gears Are In Motion, But Are We Going Anywhere?

Second quarter economic data continues to suggest that the US economy is still on track even as the labor market continues to provide no discernable increase in wage inflation. Economic data wavered slightly during the quarter but continues to demonstrate a stable overall environment amidst a perceived slowing in labor market trends and some downwardly revised GDP forecasts. The Fed gave the market the expected rate hike of 0.25% and released plans for rolling off its Mortgage Backed Securities and Treasury assets. Markets kept a close eye toward lower fundamental economic expectations during the quarter due to less efficient policy discussions and the potential for exogenous shocks. April's consumer spending report provided a more compelling argument for continued growth, though some are revising their yearly GDP figures downward closer to the 2-2.5% range. While we continue to view the current administration's policy stance likely to enhance growth, the timeline for realizing these improvements may be stretching further into 2018 and less likely to be seen, if at all, in the next six months.

Second Quarter Review

During the quarter, US Treasury markets produced positive total returns with the 10yr Treasury yield finishing 9bps lower at 2.30%. All major sectors produced positive returns with Investment Grade and High Yield gaining the most as investors continued to flock to higher coupon paper. While producing positive absolute returns, the Agency Mortgage Backed Securities (+0.88%), Treasury (+1.19 %) and US Government Agency Securities (+0.90%) sectors underperformed the broader Barclays US Aggregate Index's return of +1.45%. The Corporate (+2.54%), High Yield (+2.17%) and Emerging Market Debt (+1.77%) sectors outperformed the broader index's return on the quarter.

Our active portfolio management style allowed us to remain nimble, adjusting duration and sector weightings throughout the quarter leading to relative outperformance versus the benchmark across all strategies, with the exception of Core whose short duration positioning was a detractor during the month of June. The Core+ portfolios benefited most from their overweight allocations to credit, particularly Investment Grade credit issuers in the banking and finance sector or securities with maturities in the belly to longer end of the curve.

In addition, our overall plus sector allocations to High Yield, EMD and Non-Dollar provided strong alpha in the Core+ strategies. We also took advantage of the recent rally in the New Zealand Kiwi and exited our non-dollar position at a profit.

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2017 Outlook

Looking forward, we think improving macroeconomic and policy conditions will continue to offer support for the continuing rate-hike cycle, favoring our short portfolio duration relative to the index and the attractive return potential offered by the spread sectors. While we expect near term volatility in markets as investors react to the ups and downs of President Trump's administration, our continued long-term approach calls for patience and observation. With these factors in mind, we plan to maintain a lower duration position versus the corresponding indices and will be monitoring economic data and fiscal policy to perhaps reduce the duration differential in the coming quarter. We continue to support our overweight Investment Grade Credit position, monitoring those sectors that may be affected by domestic or global economic forces like energy, materials, and defense. We will also be focusing on the Fed's balance sheet program and plans to roll off assets that may affect valuations in the Mortgage-Backed Sector.

We continue to view both the EMD and High Yield sectors as attractive areas through the third quarter as the higher coupon return from those securities provides a cushion against the gradual FOMC rate hikes and QE tapering expected in late 2017. We are closely monitoring the US High Yield sector for further weakness due to possible contagion from declining energy prices. Finally, we continue to monitor legislative developments in Congress regarding possible tax reform and other policy or regulatory changes that may impact inflation and economic growth forecasts. Careful security selection and market timing will also remain critical to performance over the foreseeable future. Should any of the situations deviate from our baseline scenarios, action in the portfolio may be taken.

Emerging Market Debt Update

US Dollar denominated Emerging Market Debt (JP Morgan CEMBI Broad) outperformed the Bloomberg Barclay's US Aggregate by 21bps for the quarter and by a whopping 259bps for the first half of the year. President Trump toned down the aggressive rhetoric against Mexico and other emerging countries so emerging currencies recovered against the Dollar, fortifying the economies and allowing for more domestic issuance by the private sector.

In spite of the crisis in North Korea, the continuing corruption scandal in Brazil that reached all the way to the presidential palace, and the public and violent protests in Venezuela against the dictatorial and bankrupt government of Nicolas Maduro, the sector again repeated as the best performer of the fixed income asset subclasses with positive inflows both into funds and ETF's. Argentina issued a 100-year bond with a coupon of 7.9%, about 1% above their 30-year bond and the issue was oversubscribed by more than threefold. It is amazing how short investors memories are, as defaulting is the country's

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second favorite "sport" after soccer with six default events occurring in the last 60 years. Could it be the need for yield for some investors?

There is no longer any doubt that the lack of contagion and the improving balance sheets of EMD issuers have created the appetite for those bonds as they provide a very attractive risk adjusted return that is not that far below other asset classes that tend to have a higher volatility. Countries like Peru, Chile, Colombia and Mexico in LatAm, India and Korea in Asia, and Poland in Eastern Europe, have the stability and growth to strongly support foreign investment but obviously they are an area of the world that requires permanent monitoring and active management in many cases apart from financial reasons.

Firm Update

Over the quarter, the firm welcomed Patrick Faul, CFA, FRM, as the new Director of Research. Prior to joining the firm, Mr. Faul was Vice President, Head of Credit Research at Calvert Investments, where he led a team of credit analysts responsible for analyzing fixed income securities for prospective purchase and sale, served as portfolio manager for the firm's high yield bond fund, and was an active member of Calvert's Valuation Committee, Fixed Income Strategy Committee, and Strategic Accountability Taskforce. A CFA charter holder and Certified Financial Risk Manager, Mr. Faul is also a member of the Association for Investment Management and Research, the Washington Society for Investment Analysts, and the Global Association of Risk Professionals. He received a Bachelor of Science Degree in Economics, with a concentration in Finance, from the University of Pennsylvania, Wharton School. His personal interests include reading (particularly history), working on his family tree, and running marathons.

Mr. Faul is a leading practitioner of integrating Environmental, Social, and Governance (ESG) risk analysis into credit risk analysis and fixed income relative value decisions, believing that (ESG) factors are a source of potential risk to investment portfolios and should be prudently managed. "As a bond person, when I analyze a company's credit, I also want to get a sense of the ESG risks it faces," says Mr. Faul. "For example, a company might have underlying labor issues, a potential environmental problem coupled with lack of insurance, an ineffective board that rubber stamps company decisions, etc. I also tend to worry about smaller companies with little risk oversight and/or only one line of business and view companies with diverse service or product offerings as having lower risk." Detecting such material risks and opportunities associated with potential investments has a proven, positive affect on risk-adjusted returns, and the firm feels that assimilating ESG factors as a data tool into the research process will help us to better manage risk and generate sustainable, long-term results.

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In addition to hiring Patrick Faul as Director of Research, LM Capital established a management committee during the quarter comprised of John Chalker, the firm's Co-Founder and Managing Director; Rachel Wilson, CFA, Director of Fixed Income Trading, Portfolio Manager, and Member of the Investment Strategy Group; Jeff Frankel, Chief Compliance Officer; and Johnita Mizelle, Head of Business Development. This committee will handle all day-to-day business decisions. LM Capital further initiated searches to make two additions to the business development and client service teams. A new economist, Debra Watkins, is scheduled to join the firm in the third quarter of 2017, and the firm iMarkServ was contracted in February of 2017 to provide supplemental research.