LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
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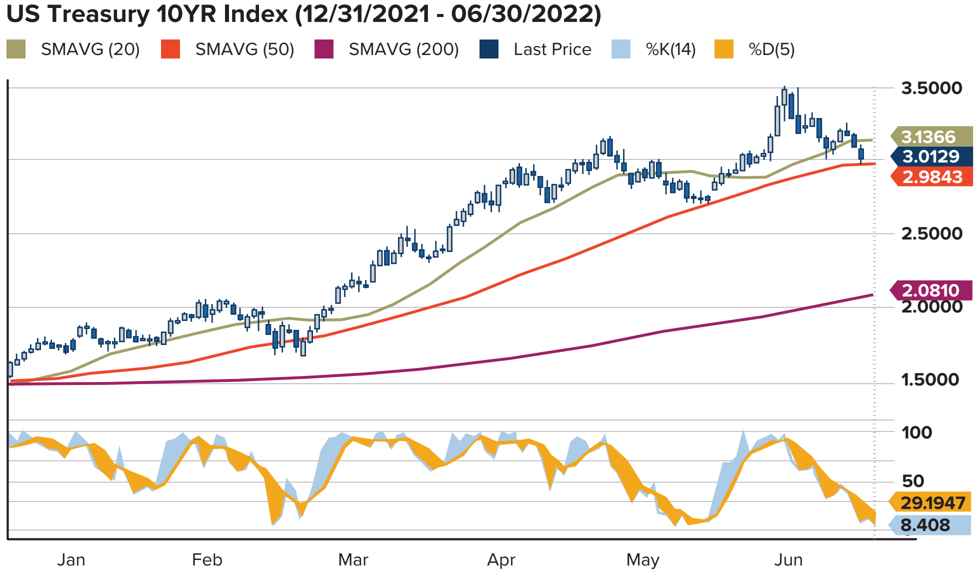
Rough Start... Tough Finish?

It has been another difficult quarter for markets after what had already been a tough start to the year. This is now the worst first half of the year for developed markets in over 50 years as government bonds have also been hit hard, failing to provide the protection that investors are accustomed to. While unemployment remains low and wage growth strong, consumer sentiment has fallen sharply. Additionally, the Federal Reserve's indication that it is determined to get inflation under control, with the median Fed member now expecting to raise the overnight rate to 3.8% by next year, have the markets worried that task could require unemployment to rise much higher than the projected 4%, as has historically been the case. Therefore, recession fears have risen significantly as the squeeze on consumers from higher prices and higher borrowing costs, have consumer spending data in focus.

US Treasury 10YR Index (12/31/2021 - 06/30/2022)



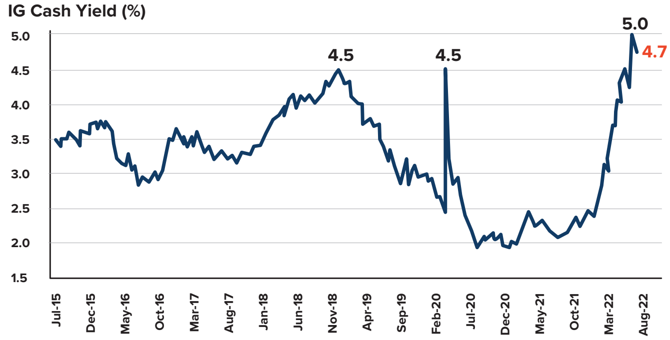
Source: Bloomberg

The 10yr began the quarter at 2.34%, and after a rapid rise in the first quarter, it continued flying higher non-stop into mid-June where it struck a high of 3.50% - a number not seen for more than a decade, back in May 2011 – but was immediately rejected and fell steadily for the remainder of the month to ultimately finish the quarter at 3.01%. The US Dollar finished much higher this quarter once again, advancing +6.48% as the continued strong flight to safety trade remained all quarter.

Much of what we saw in the first quarter continued through to the second quarter narrative. While selling across all sectors occurred throughout the quarter, it was noted that duration risk was again quick to be removed from investors' portfolios as longer duration credits and Treasuries both significantly underperformed versus shorter dated issues from a total return perspective. Amongst the credit subsectors, Financials were the best performers, relatively speaking, as higher rates tend to benefit the sector incrementally. High yield bonds were the worst overall performers this quarter partially due to some idiosyncratic stories from some consumer discretionary retail issuers that pummeled prices.

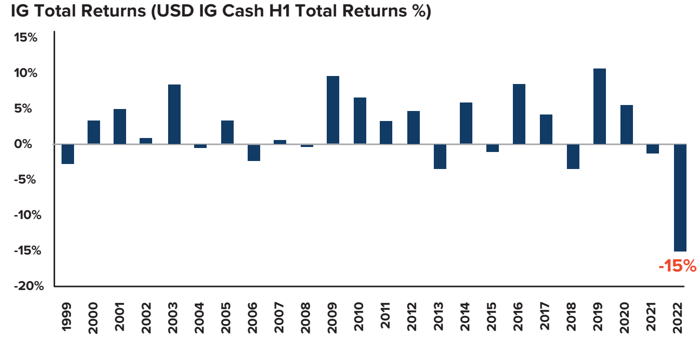
The US Treasury (-3.78%), Government Agency Securities (-1.86%) and Mortgage-Backed Securities (-4.01%) sectors outperformed the broader Barclays US Aggregate Index's return of -4.69% on the quarter. The US Corporate (-7.26%), High Yield (-9.83%) and Emerging Market Debt (-8.72%) sectors underperformed the broader index's return.

IG Cash Yield (%)



Source: Credit Suisse

IG Total Returns (USD IG Cash H1 Total Returns %)



Source: Credit Suisse

Market Outlook

As the EU imposed new sanctions on Russian oil imports, fears arose of a severe reduction in Russian natural gas supplies which would negatively impact the EU economy. Despite this, the ECB is signaling higher rates in the near future. In China, shifting policies on lock-downs to contain COVID are making economic forecasts very uncertain. Although the FOMC continues to signal its desire to raise rates in an attempt to cool inflation, and the consensus is for a minimum 50 basis point rate hike in July, the market expects this anti-inflation stance to cause a recession in the next 12 months. The result would then be a halt to further rate hikes by the Fed around year end 2022. All of these events are disruptive and create an environment unseen in many decades. Given the Fed's mandate to achieve price stability and full employment, and observing a very strong labor market with stubbornly high inflation, our outlook calls for continued interest rate hikes by the Fed despite the risks of a Fed induced recession.

Therefore, we continue to maintain a defensive portfolio position as we have outlined in previous commentary. This defensive position includes a duration position now targeted at 8-10% short versus the benchmark index with a slightly increased Treasury allocation coming at the expense of the corporate sector. The MBS sector remains close to an index weighting with a focus on higher coupon MBS securities. Our Core Plus and Enhanced Return strategies reduced positions in the High Yield and EMD sectors, and we remain bullish on the US Dollar for the near term.

Luis Maizel

Co-Founder & Sr.
Managing Director

Emerging Market Debt Update

The second quarter was very tough for emerging market debt as all fixed income products struggled with the fear of inflation and the reaction of the FED.

In general, the emerging economies are doing well as they are mostly commodity-based and prices are up, but the fear of a recession and the increase in value of the US dollar against most currencies works against the asset class.

Elections in Chile and Colombia moved the balance of power more to the left and all countries in LatAm, with the exception of Brazil which will hold elections soon, are now led by populists.

The lockup of China in their fight against Covid is making economists revise their GDP growth estimates and many see that country growing by less than 4% in 2022, the lowest figure in 15 years. The crisis of the real estate developers, many of which have defaulted on their foreign debt, is also a headwind in their expected recovery.

As spreads widen, the EMD asset class is more attractive every day as some very solid credits of global companies, that generate hard currencies through operations, are currently paying more than far riskier high yield bonds issued by US companies.

Today, more than ever, security selection has become the biggest driver of alpha in a very complex fixed income landscape.

LM Capital Adds Senior Research Professional

LM Capital is pleased to announce the addition of Frank Hacklander, CFA on July 1, 2022 as a Senior Credit Analyst; he will be based in the firm's San Diego office and will replace Bryan Campbell who recently departed the firm for an opportunity in the private credit arena. Mr. Hacklander has over 25 years experience as a seasoned high yield and distressed credit professional.

Prior to joining the firm, he was an independent credit research analyst at FEH Analytics and he held senior research roles at Calvert Investments, Guggenheim Securities, Society Generale and served as an analyst at Fleet Securities and Bank of America Securities LLC. Mr. Hacklander earned a Bachelor of Arts in Economics and Philosophy from Harvard College. Following graduation, he served as an officer in the U.S. Navy for five years before completing his Masters of Business Administration in Finance and Accounting at the Wharton School, University of Pennsylvania. He is a CFA Charterholder and a member of the CFA Institute.

"Mr Hacklander's addition to the research team further strengthens our commitment to comprehensive research at the individual security level," said John Chalker, Managing Director. "And we plan to further expand our research team in the coming months with an additional analyst."

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