LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
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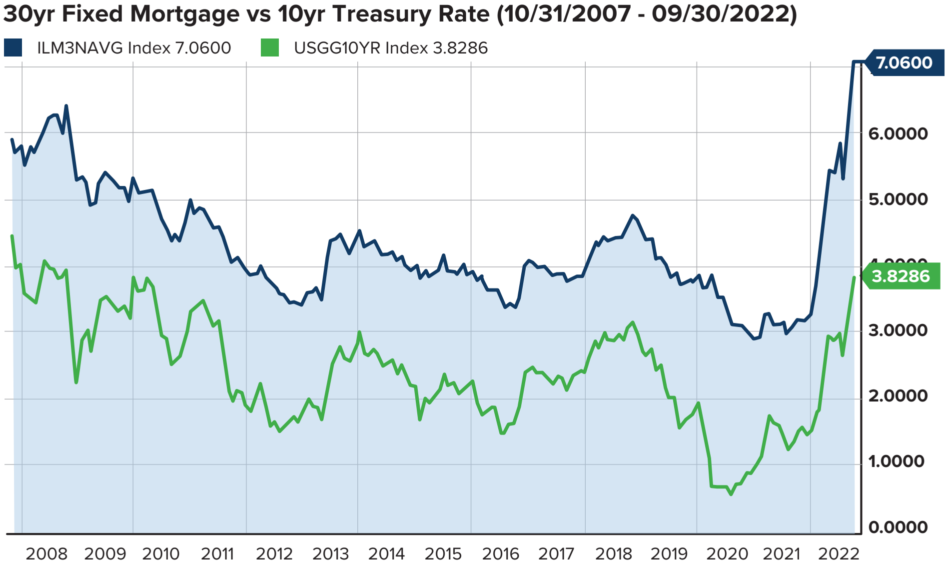
An Uncertain Future

A less than exciting title, I know. But it's true. It's been a long time coming since such a degree of uncertainty in the markets has existed. How the economy will handle the surge higher in rates we see across the board today and the path forward for economic growth, and markets as a whole, is really anybody's best guess. The variance of outcomes is wide and the opinions voiced by the "best" investors on the street are similarly at odds. For fixed income investors though, there's some light to shine on today's reality though it can truly only exist in its best form if the infamous "soft landing", or something similar, can be achieved. So … will it?

Even with recent global economic slowing, rising inflationary pressures have forced global central banks to remain hawkish and it kept market volatility around once more this quarter. At home, a tight labor market with substantial household wage gains provided ample excuse for the FOMC to remain on path to continue their aggressive rate hike schedule. A total of 125bps in additional hikes is expected through year end between the remaining two meetings, with the terminal rate recently estimated to be 4.6% at the latest September meeting. Whether directly related or not, areas of the economy, like the housing market, are already feeling the pain of higher rates and are cooling quickly as 30-year fixed mortgage rates topped 6% for the first time since October, 2008 (as I write this, they continue to soar, touching 7%). Historically, we know it can take six to nine months for the economy to feel the full impact of a significant hiking cycle, so much of the realized "pain" is yet to come. How well the consumer, and the economy as a whole handles those effects will determine our growth path forward and the path of markets.

30yr Fixed Mortgage vs 10yr Treasury Rate (10/31/2007 - 09/30/2022)

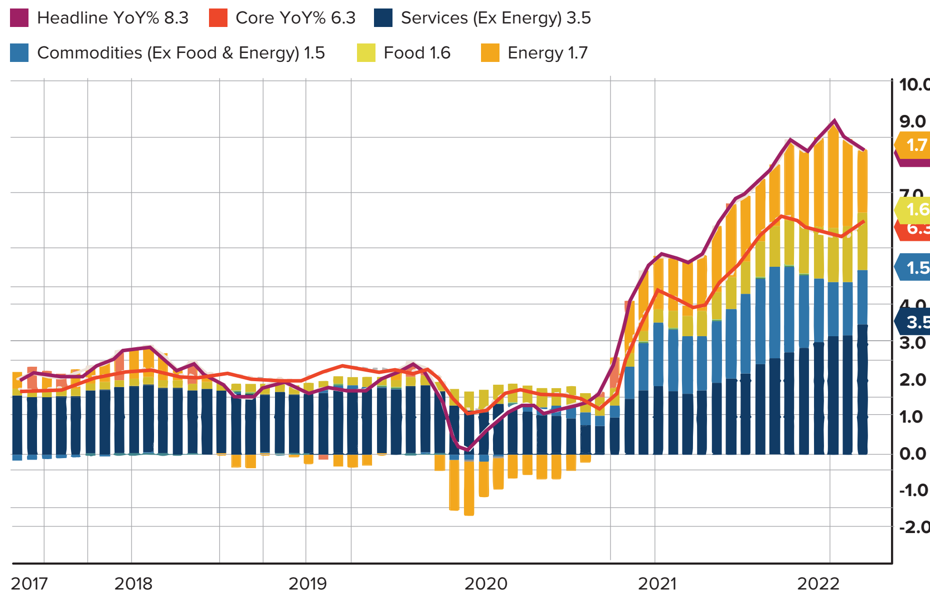


Source: Bloomberg

While the US economy had already recorded two consecutive quarters of negative economic growth this year and the University of Michigan's consumer confidence survey dropped close to its lowest levels in 50 years, most economic data published in the third quarter continued to highlight the resilience of the US economy. Recession fears remain high though, albeit most talk centered around a shallow recession – which is our house view as well - as the squeeze on consumers remained from higher prices and higher borrowing costs. Price pressure intensified once again this quarter with recent year-over-year inflation data printing 8.3%, much of which was driven by stickier core inflation and increased shelter/rent costs - a reflection of the current high levels of unaffordability in the housing market.

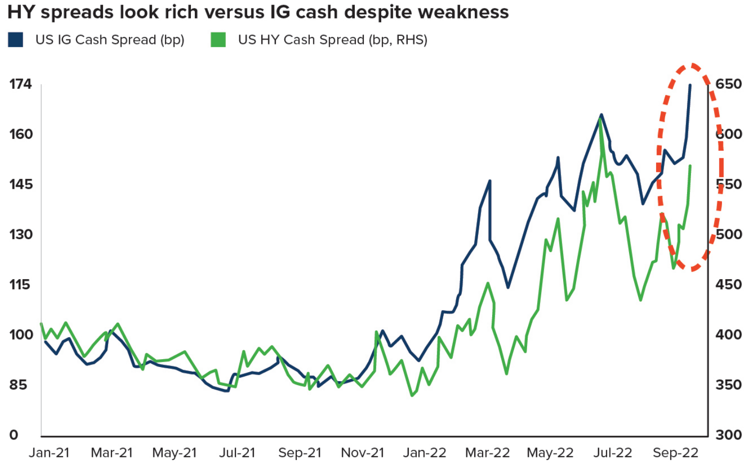
Much of what we saw in the second quarter continued through to the third quarter narrative. The 10yr began the quarter at 3.01% and was fairly range bound for the beginning of the quarter until it began its rapid ascent higher, briefly breaking above the closely watched 4% "ceiling" toward the end of September, before retracing to ultimately finish at 3.83%. The US Dollar finished higher for the third quarter in a row, advancing +7.10% as the continued strong flight to safety and a more aggressive hiking schedule kept investors focus all quarter. While selling across all sectors occurred throughout the quarter, particularly in retail, 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 again, relatively speaking, as higher rates tend to benefit the sector incrementally. High yield bonds were the best overall performers this quarter and continue to outperform investment grade year-to-date, as a combination of spreads and the Treasury moves have taken a larger toll on the investment grade sector. Additionally, high yield issuance remains very low and is expected to remain low as many issuers front loaded much of their fundraising needs at much lower interest rate levels during the past two years.

CPI YOY Index



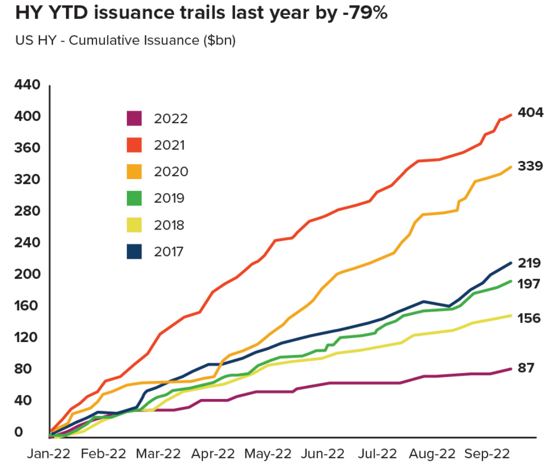
Source: Bloomberg

HY spreads look rich versus IG cash despite weakness



Source: Credit Suisse

HY YTD issuance trails last year by -79%



The Corporate (-5.06%) and Mortgage-Backed Securities (-5.35%) sectors underperformed the broader Barclays US Aggregate Index's return of -4.75% on the quarter. The US Treasury (-4.35%), Government Agency Securities (-2.69%), High Yield (-0.65%) and Emerging Market Debt (-4.06%) sectors outperformed the broader index's return.

Market Outlook

High inflation appears to be persisting for longer than anticipate. The situation is further amplified by the loose fiscal policy evidenced by recent Congressional legislation. The FOMC's tighter monetary policy of higher rates and quantitative tightening continues to not only raise fears of a recession in 2023 but concerns also exist regarding financial instability - as evidenced by the recent volatile Gilts market in Great Britain, with some fixed income investors concerned about the pace of global central bank rate hikes. Currently, we continue to take the Fed at its word and do not expect a 'dovish pivot' unless the unemployment rate rises meaningfully. Therefore, guided by our proprietary Trend Identification Score, we continue to maintain a defensive portfolio position. We note that the market has reversed the recent July bond market rally to again post sharply negative returns for August and September.

Our defensive position holds a portfolio duration targeted at 8-10% short versus the benchmark index, with an underweight allocation to the Treasury sector. Our Corporate sector holds a market overweight allocation as we closely monitor credit spreads, which have widened to attractive levels, although we have not yet initiated any purchases in the credit space. The MBS sector is also close to an index weighting. Our Core Plus and Enhanced Return strategies may further reduce positions in the EMD sector, as we remain focused on evaluating the risk-reward equation regarding individual security selection.

Patrick Faul
CFA, FRM

Director of
Research

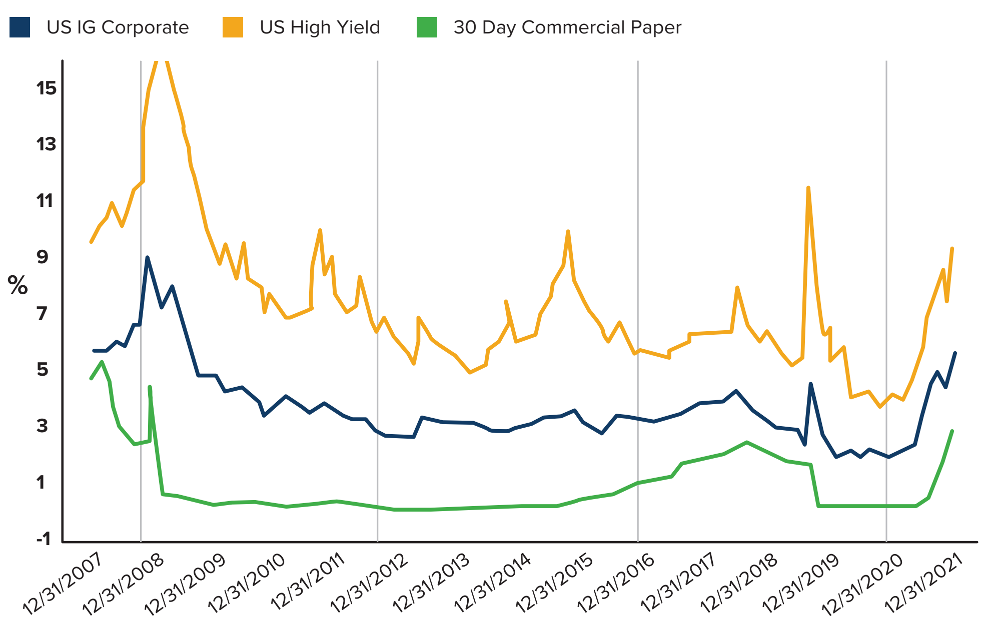
The Yield Famine is Over

For years, yield-starved investors have had to make do with paltry offerings. The safety of money market funds came at near-zero yields, and the certainty of losing the race with inflation. Longer US Treasury bonds offered a bit more yield, or a lot more yield, depending on your perspective. Is 1.00% a lot more than 0.03%, or a little bit more? US corporate bonds led investors to ask, is 2.00% twice as much as 1.00%, or only 1.00% more? Am I willing to take on that extra risk of worrying about the business cycle? Can you say "high yield is at 5%", without making "air quotes" with your hands when you say "high"?

We live in a very different world now. The uncertainty we face now is completely different from the uncertainty of March 2020. In March 2020, the economy had come to a screeching halt in unique circumstances that were, on many levels, terrifying. The uncertainty we face now is much less terrifying. It's the difference between being lost in a dark forest and trying to find the best path to come down from a sunny mountain top. In both cases, looking at past US economic history to predict the future does not seem particularly helpful.

Investment flows based on the new reality will percolate through the market slowly. As the days pass by, millions of investors around the globe will each make decisions based on the new levels of interest rates, the constant balance of supply and demand should make markets very interesting.

The End of the Yield Famine

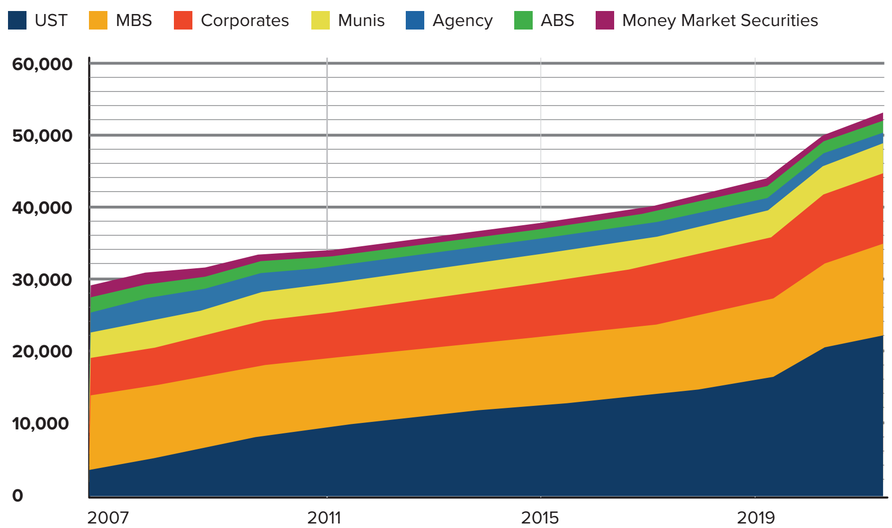


Source: Bloomberg

Money market yields have skyrocketed, up about 10,000%! Or up about 3.00%, depending on your perspective. If the Fed can get inflation down to 3% in the next few months, 3% on a money market fund might look pretty attractive. But, that might not last. Maybe you should lock in these attractive yields. US corporate bonds are at yields last seen in 2009, 5.50% plus! You can buy senior unsecured bonds from JP Morgan, maturing in 2029, at 5.75%. If the Fed can get inflation down to 3% in the near future, you can lock in a very nice real return for the next seven years. You can now say "high yield" without making hand gestures, almost 10%! Junk bond yields have been this high a few times since 2008, but those times were scary and short-lived. Now, we have these yields in a strong economy, so strong that the Fed feels the need to cool it down. The main driver of one's outlook for rates is driven by an outlook for a possible recession.

Good luck to market prognosticators predicting how the demand dynamics for fixed income and equity will change. The 25-year-old who was making decisions on where to put their 401k money in 2007 is a very different person now, and has a very different perspective on risk. The usefulness of backward-looking statistics from 2009 is probably minimal. As is an investor's confidence level based on a five-year risk and return history.

Composition of US Fixed Income Market (in Billions)



Source: SIFMA

Oh, and by the way, Europe might run out of natural gas in March. And about that diesel fuel that all the trucks in Europe (and everywhere else) use, don't forget that that same oil is often the best alternative to burning natural gas for power generation. And inflation might still be running at 8% with no end in sight. The usefulness of backward-looking statistics is probably minimal. Good luck predicting the earnings of mega-cap multinationals with all of that happening.

That's just the demand side of fixed income. The market structure of fixed income is very different then it was in 2009. The fiction that money market funds were completely safe was exposed. New regulations since 2008 make money market funds safer, but less lucrative, for lack of a better phrase. Government bonds are a much bigger part of the fixed income market. With huge ongoing budget deficits predicted, that trend is expected to continue. It used to be that the "crowding out theory" was very important in Finance 1A. As a refresher, that is when government spending crowds out private spending.

So let's see. All we have to do is figure out: the new demand dynamics for previously yield-starved investors, whether or not the Fed will be able to rein in inflation, what will happen in Ukraine, how high natural gas, coal and oil prices will go, what will happen with China's zero covid policy, and the 2022 US mid-term elections. And all the second-degree effects of those. Oh, and also, we need to figure out the appropriate valuation for the stock market with all of that happening.

At LM Capital, we are very certain of our market outlook: the uncertainty will continue.

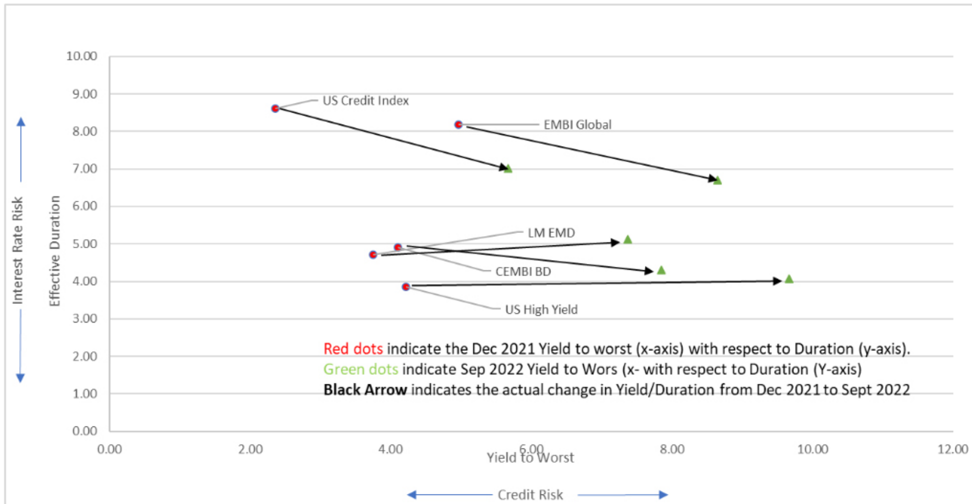
Vikrant "Vik" Khadilkar CFA, FRM

Senior Research/ Risk Analyst

Hard Currency EM Debt

(Un)expected Victim of Rising Interest Rates

Over the last few newsletters, we have continued to highlight the vulnerability of hard currency EM debt to rising interest rates so the selloff in hard currency EM debt in 2022 doesn't come as a surprise to us.



Source: Bloomberg, JP Morgan Indices. LM Capital's EMD strategy represents characteristics for our representative account

As can be seen from the chart, 2022 has seen a significant increase in the yields associated with dollar denominated credit. Contrary to recent history, the rise in yield has come from the outsized increases in underlying treasury yields as compared to widening credit spreads. As of September 2022, yields on the JPM EMBI Global Index has risen by 370bps (YTD change) with credit spreads widening by 120bps.

Over a 25-year history for JP Morgan EMBI Global Index, the only other instance of a greater change in yield over the year (396bps) happened in 1998 where credit spreads rose by 635bps.

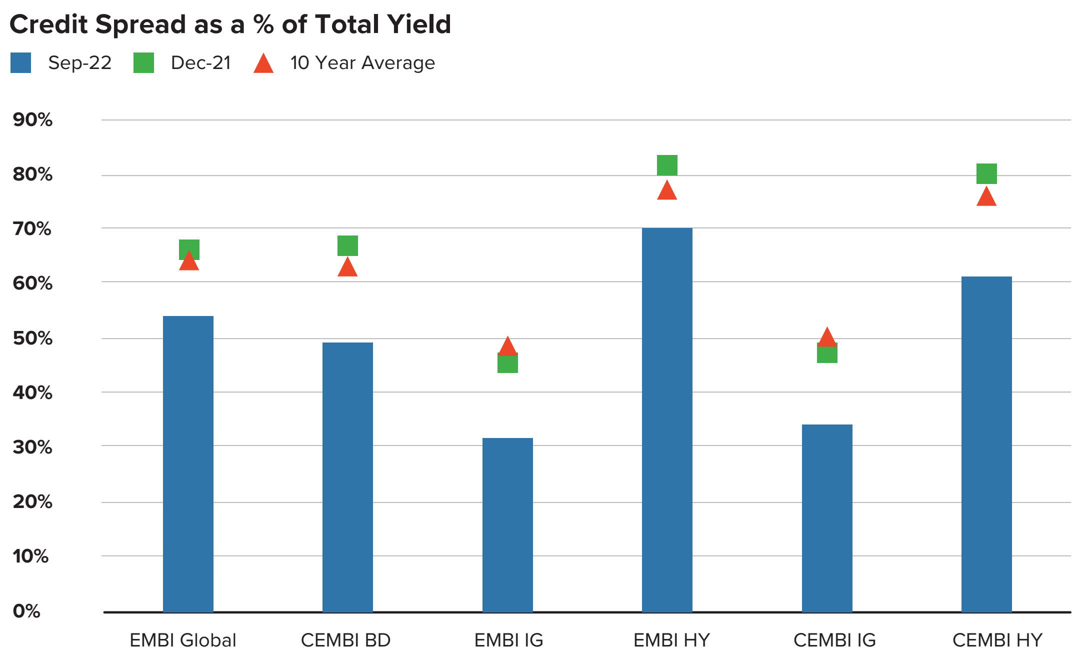
Below table shows five instances in the 25-year history where Yields increased by more than 100bps over a calendar year.

	Yield Change (bps)	Credit Spread Change (bps)
12/31/1998	396.20	634.00
9/30/2022 (YTD)	371.30	120.00
12/31/2008	261.80	470.00
12/31/2013	160.20	61.40
12/31/2018	152.40	123.60

Source: Bloomberg, JP Morgan Indices

Forthcoming Bumpy Ride for Emerging Market Debt:

As interest rate volatility remains extremely high by historical standards, emerging markets with questionable fundamentals (lack of fiscal adjustment, widening external deficits, political noise) will continue to find themselves under extreme pressure in this environment. Credit spreads across the EM universe (exception of frontier markets and Russia) have held in quite well in 2022. As of September 2022, Credit spreads as a percent of total yield for dollar denominated EM (Sovereigns and Corporates) has fallen significantly below the 10-year average as show in the chart below.



As the impact of globally synchronized monetary tightening continues to transmit through the world economy, we expect credit spreads as a percent of yield for dollar denominated EM to trade in line with their historical average. With a global recession in sight, we continue to maintain a bias to high quality EM corporates with strong fundamentals and sovereigns that are net exporters of energy.

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Disclosure: LM Capital specializes in active fixed income management using a top-down, macroeconomic approach supported by in-depth, bottom-up research in an effort to provide attractive risk-adjusted returns.

LM Capital Group, LLC, is an SEC registered, employee-owned minority business founded in 1989. Fixed income assets under management totaled $4.7 billion as of September 30, 2022 for public funds, corporations, foundations, financial advisors, and individual investors. SEC registration does not imply a certain level of skill or training.