LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
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Glass Half Full or Half Empty?

For many, 2022 will be a year they will happily put in the rearview mirror. A tough environment to navigate for most markets to say the least. Largely, we saw geopolitical conflicts in the Ukraine and occasional monetary policy conflicts amongst many global central banks as they focus on fighting strong inflation numbers while avoiding too much economic damage. A generally volatile thematic rang true for most of the calendar year, though it eased a bit in the fourth quarter as investors were less likely to trade in size and put on big positions ahead of economic data or policy decisions.

Looking ahead, its hard to recall a time where we saw such a wide and large variety of economic and market projections for the new year. In the end, it all depends on if you see the glass as half full or half empty – as it could be fairly easy for one to make strong arguments for both outcomes. Since the economic data throughout the year continued to show pockets of strength and pockets of weakness, how you extrapolate the interaction between them over the next twelve months ultimately defines where one thinks we end up.

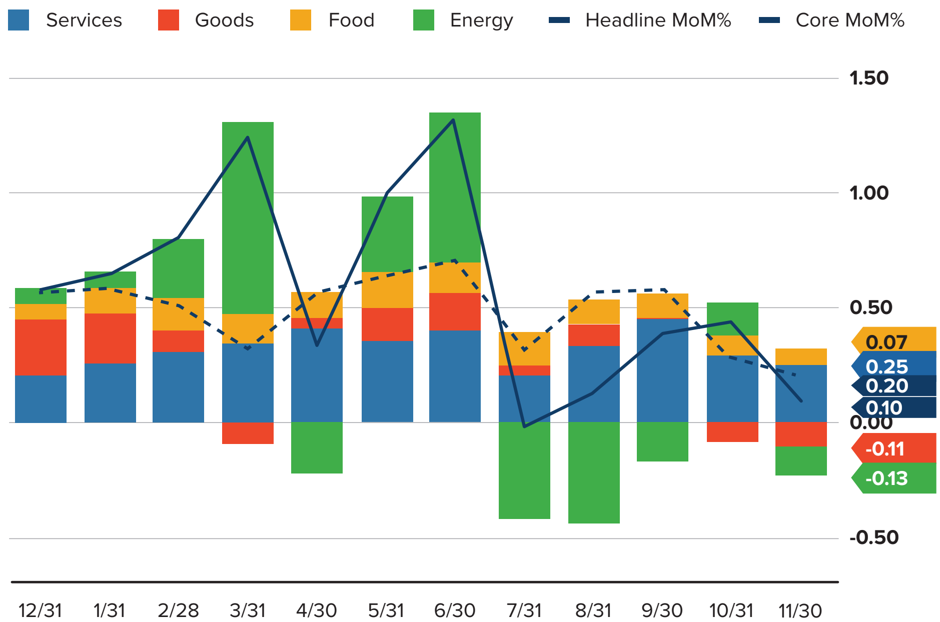
Predicting human psychology and how different socioeconomic partitions of the economy will react to this fast-changing landscape is one of the reasons the forecasts are wide and numerous. While we have talked plenty about the importance of getting inflation under control, determining whether the recent softening has come from Fed hikes, weakness in consumer demand, or a combination of both, we believe will be the key element in forecasting where the economy goes from here. Other geopolitical and overseas market action aside, our economy can withstand outside influence to the extent that its much less of a concern today. Recession fears at home still remain high though, with our view centering around a shallow recession beginning next year that ought to be somewhat short lived.

Quarter in Review

Economic data in the fourth quarter showcased an economy that continues to pose more questions than answers for investors, as CPI data began to show signs of softer increases in prices, labor market indications remained strong, but retail sales and housing market statistics continued to trend weaker. Accompanied by some recent dire guidance and earnings expectations from some large multinational corporations, an undertone of caution became ever more present across all markets as we end the year.

While the quarter posted positive returns for all fixed income sectors, the dichotomy present amongst investor outlook and positioning remains large. Additionally, it appears that even as the quarter presented a less volatile environment than the previous three quarters of the year, it's clear that it will not disappear anytime soon until clarification on the direction of the consumer and the economy is better understood. Flows remained somewhat muted across the sectors and liquidity continued to pose some issues for certain subsectors and names in the credit markets. Some investors are even claiming to see occasional liquidity constraints in the Treasury market though that is not something we have seen ourselves.

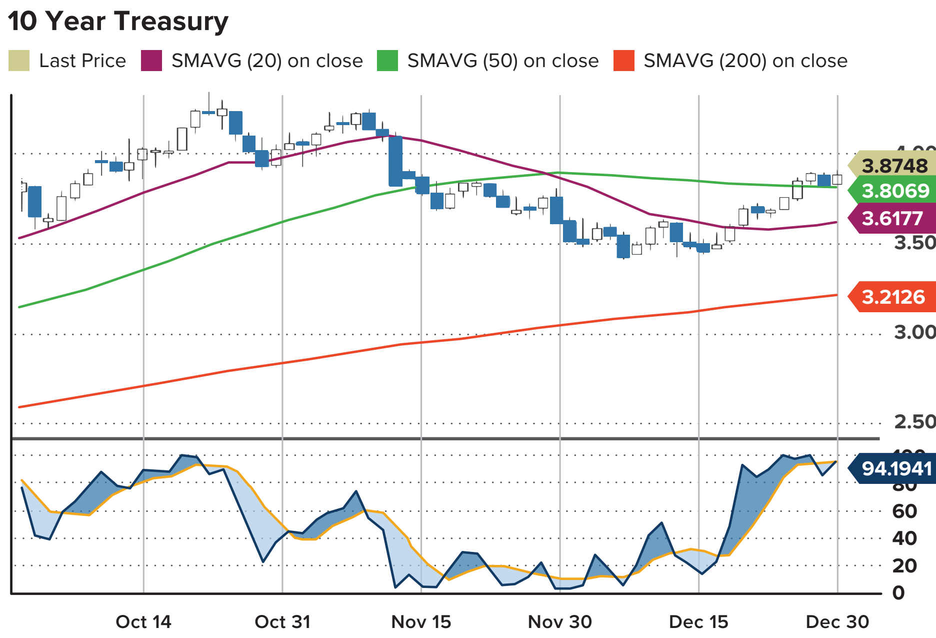
CPI MoM 1yr



Source: Bloomberg

Tenor	US Treasury Actives Curve 12/30/22	US Treasury Actives Curve 09/30/22	(Change) 12/30/22-09/30/22
1M	3.99	4.679	132.1
2M	4.357	3.041	131.6
3M	4.374	3.270	110.4
6M	4.761	3.934	82.7
1Y	4.710	3.989	72.1
2Y	4.429	4.281	14.8
3Y	4.226	4.290	-6.4
5Y	4.005	4.092	-8.7
7Y	3.969	3.985	-1.6
10Y	3.877	3.832	4.5
20Y	4.147	4.091	5.6
30Y	3.966	3.779	18.6

Source: Bloomberg, JP Morgan Indices



Source: Bloomberg

We continue to see a very oddly shaped yield curve and this quarter only further extended that condition. With the very short end of the curve rising considerably as investors read through the tea leaves that a higher terminal rate, held for longer, will be needed to bring inflation down to the Fed's long-term goal. Not much action was seen at the belly of the curve. Aside from some intra-quarter swings, most maturities were anchored around where they had finished Q3. The 10yr began at 3.83% and spent the quarter mimicking the sine-wave pattern to ultimately finish almost where it started, at 3.87%. The US Dollar finished significantly lower by -7.67% this quarter, after more than a full year of ripping higher, possibly ending a cyclical run up for the currency. Amongst the credit subsectors, industrials and utilities outperformed financials as the curve bear-flattened with short end rates moving significantly higher. The US Treasury (+0.72%) and Government Agency Securities (+0.70%) sectors underperformed the broader Barclays US Aggregate Index's return of +1.87% on the quarter. The Non-Dollar (+6.81%), Corporate (+3.63%), Mortgage-Backed Securities (+2.14%), High Yield (+4.17%) and Emerging Market Debt (+6.59%) sectors outperformed the broader index's return.

Market Outlook

The significant rise in interest rates in 2022 brought about by Fed policy has been slow to impact the economy and reduce inflation as evidenced by the continued strength in the labor market, where wage growth continues and layoff announcements remain low. The largest fiscal stimulus in history during the past two years created a financial windfall for many consumers who now appear unwilling to return to work whether it be at home or at the office. And while some parts of the economy have clearly slowed, such as housing, the overall economy continues to grow at a reasonable rate. While the inverted yield curve and negative leading economic indicators predict a recession in 2023, the timing of such an event and the Federal Reserve's response remain uncertain, especially if consumer inflation levels off at a 4-5% level.

Given this situation, we focus on the first half of 2023 and expect the Federal Reserve to continue raising rates, albeit at a much slower pace than in 2022, until inflation drops closer to the two percent target zone or the unemployment rate moves well above the four percent level. In the near term, this scenario calls for a defensive portfolio position which is further supported by our proprietary Trend Identification Score. Yield curve positioning in this scenario also assumes greater importance than in normal market conditions, and we would look for the Treasury curve to flatten further in 2023. Our sector allocation currently favors cash and the MBS sector and we have reduced the allocation to all credit sectors. One area that may appear attractive in 2023 would be emerging market debt (USD denominated) should commodity inflation persist, and this would also focus our attention on some foreign currencies as the US Dollar could potentially continue to weaken especially if spreads tighten versus other countries.

Patrick Faul
CFA, FRM

Director of Research

The Shopping Mall

One fascinating aspect of the global bond market is that each large component closely resembles a shopping mall. Different shoppers looking for different bond characteristics. Some want short bonds, some want long bonds. There are always a lot of overseas buyers at the US Treasury Mall, you'll see the Cayman Islands hedge fund folks wandering around in their shorts and sandals. You can always count on the best clearance sales to be at the High Yield Mall and at the Emerging Market Debt Mall.

Given the different shoppers and the different times that they show up, at any given time there are some bonds that are too cheap and others that are too expensive. And this relative value may have little to do with fundamental analysis. It's just a function of who's buying what right now.

Come with us and take a stroll through the Bloomberg US Corporate Credit Bond Mall. The Mall currently has almost $6 trillion in goods on the shelves.

A word of warning before you enter the mall: on some days, fleets of buses full of ETF and index shoppers show up in the parking lot. These "passive" shoppers run frantically through the mall, stopping quickly at almost every store. They do skip a lot of the smaller stores though and just buy a larger amount from the bigger stores. Just keep an eye out for them and stay out of their way.

There are 1,077 stores here at our mall. First, let's stop at the biggest anchor store, the Bank of America store. Known as BAC to frequent shoppers, the store takes up 2.77% of the US Corporate Credit Bond Mall space. BAC sells Financial Institution bonds, which overall account for 34% of the mall space. Many of the shoppers at BAC think that they can get higher-quality bonds at the same yield that can be found at some of the smaller Industrial stores selling lower-quality goods. I tend to agree with them. On the other hand, many shoppers don't want 2.77% of their bonds to have BAC logos. They like to spread things around a bit more.

Bonds five years and less in maturity account for 52% of BAC's space, let's call those short bonds. In the mall, Financial Institutions stores sell 54% of their product as short bonds. For the mall as a total, the number is only 39%.

It is said that many of the shoppers for short bonds are corporations looking for something with more yield than what they can get at the Money Market Mall that is a few miles down the highway. Those corporation buyers are said to rarely buy long bonds unless they're looking for something to fill up their pension funds.

One problem for people who buy only short bonds is that Bank of America accounts for almost 4% of all the short bonds sold at the mall. If you're trying to build a diversified portfolio of only short corporate bonds, you may find it tough to stomach a 4% position from one issuer. That dynamic should make BAC bonds cheaper for those who can shop for anything.

Bloomberg US Corporate Index	**100.00**
Corporate	**100.00**
Industrial	57.76
0-1yr	0.19
1-3yr	9.49
3-5yr	8.85
5-7yr	6.31
7-10yr	8.95
10+yr	23.97
Utility	8.20
0-1yr	0.02
1-3yr	1.02
3-5yr	0.94
5-7yr	0.73
7-10yr	1.35
10+yr	4.15
Financial Institutions	34.04
0-1yr	0.21
1-3yr	9.62
3-5yr	8.48
5-7yr	3.67
7-10yr	6.34
10+yr	5.72

Source: Bloomberg, As of December 31, 2022

Let's take a quick stroll over to the largest store that sells Industrial bonds. That's Apple, with 1.29% of the mall's space. As a shopper myself, what I like about Apple is that their bonds are big in size and liquid. The average issue size is more than $1.8 billion, so I don't have to worry about trying to sell part of a $400 million issue from an issuer that nobody knows. I'm not naming names, but I am looking over at the Aptar Group kiosk that only sells 2032 maturity bonds that have a $400 million issue size. I've heard that Aptar has more of a presence at the Non-Index Eligible Mall, but here they only sell those 2032 bonds.

Overall, long Industrials account for 24% of the mall's sales. The mall currently has 444 stores that sell long, Industrial bonds. There are only 114 stores that sell long Financial Institution bonds and there are 116 stores that sell long Utility bonds. About 51% of the Utility bonds at the mall are long bonds, 41% of the Industrial bonds are long bonds, but only 17% of the Financial Institution bonds. It is said that many long bond shoppers tend to be insurance companies and pension funds. You can often find the long bond shoppers picking over the small issue size bonds available at the Utility stores. Shoppers that don't plan on selling their bonds before maturity, don't really care about whether or not anybody else would want to buy their bonds on the secondary market.

You can always spot a Utility store in the mall, they're always brightly lit. Once you step inside, you'll notice that they always have the heat or air-conditioning on full blast, depending on the season.

Personally, I try to stay away from Utility stores. There's an awful lot of turmoil in utility regulation and in fossil fuel prices. One of the advantages of being a buy-and-hold investor, like an insurance company, is that you can ride out the bumps of news events and price volatility. It makes more sense for them to buy illiquid bonds.

As we walk around the mall, at many of the smaller stores you'll see the staff getting grilled by anxious-looking people taking careful notes of what the staff says. Those are fundamental analysts, they tend to stay away from the bigger stores and are always looking for bargains.

At LM Capital, our fundamental analysts tend to spend their time at the Emerging Markets Debt Mall and the High Yield Mall, rather than the US Corporate Credit Bond Mall. Generally, we believe that the mispriced bonds are at those malls. We generally stick to the larger stores at the US Corporate Credit Bond Mall.

In our experience, gained painfully through experience, a cheap US corporate bond with a small issue size is often an illiquid bond that becomes even cheaper in times of moderate market stress. We generally look for cheap US corporate bonds from big issuers. In times of moderate market stress, those bonds remain liquid.

Emerging Markets 2022 Review

Vikrant "Vik" Khadilkar CFA, FRM

Portfolio Manager, Senior Analyst

Central banks begin to pause restrictive policies as economic activity decelerates...

Following central banks quick and aggressive response to combat global inflationary pressures (with some exceptions such as Turkey), most EM countries' official rates have nearly reached or surpassed the pace of domestic inflation in 2022.

Among these group of countries, some central banks have started to reduce the size of rate hikes (e.g., India) while others have already opted to pause entirely (e.g., Chile) as the effects of restrictive monetary policy become more visible.

...however, rate cuts still not in sight as inflation generally remains above target levels.

While signs begun to appear in 4Q 2022 that inflation pressures start to peak, EM countries will also need to consider currency outflows if global recession expectations materialize, i.e., EM central banks will need to keep rates high to protect import costs.

Political events continued to play an important role in shaping the EM investing environment...

From presidential elections in Brazil and Colombia to China's continuation of its authoritarian rule extending Xi's rule to a third term, the rule of law (or lack thereof) was tested once more across the emerging world.

Separation of powers was also highlighted across EM, from Peru's successful ousting by congress of former president Castillo after a failed coup d'état attempt to Erdogan's influence on Turkey's central bank that has fueled inflation beyond triple digits.

...including increasing geopolitical tensions across the globe.

India's growing ties with the United States while maintaining trading relationship with Russia despite western sanctions emphasize the increasing economic influence that the now 5th largest economy (passing the UK in 2022) has in global markets.

US-China tensions were heightened by Xi's visit to the middle east in December, testing the US influence in the region as China left with multi-billion private and public sector investment agreements.

The fragile economic backdrop has started to push some highly indebted EM sovereigns as well as corporates into restructuring...

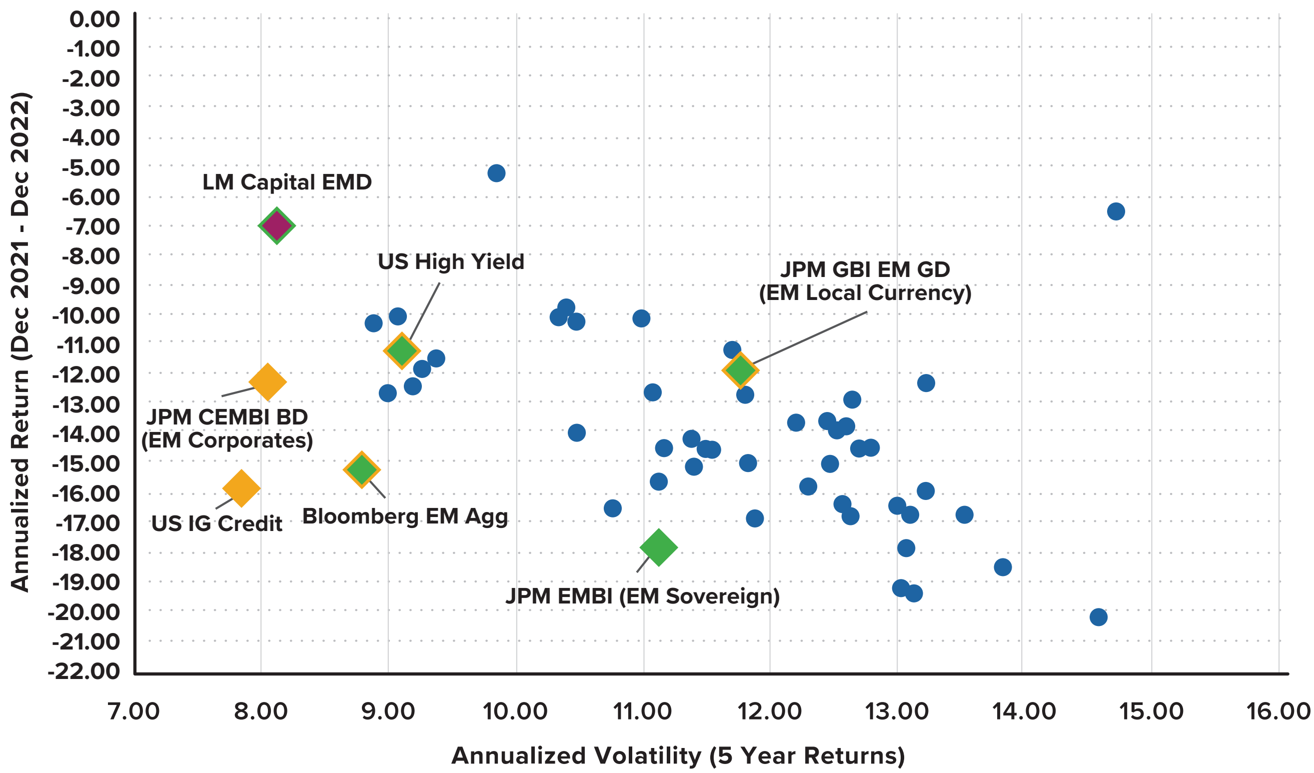
Main borrowers impacted were those with large amounts of foreign debt (e.g., Sri Lanka) and/or operating in less resilient business segments (e.g., Unifin in Mexico).

...emphasizing the importance of active and expert portfolio management.

In addition to considering rule of law implications, LM Capital's unique in-depth understanding of emerging market dynamics has once again allowed us to navigate through a volatile year. This has been a year of Low probability – High loss scenarios that has taken the market participants by surprise. It is in these times that our adherence to internal risk controls and a bias for high quality credit has allowed us to identify attractive investments with measurable risk.

As shown in the chart below, LM Capital's strategy successfully maximizes returns while minimizing volatility by employing our time-tested approach to diversify investments based on comprehensive industry and factor exposures. Diversification purely on the basis of region or country has shown to underperform in volatile periods as historical correlations begin to fade away. In this environment active management with an emphasis on risk reduction is the key to optimize for a higher risk adjusted return.

EM Peer Universe (2022 Returns vs 5 Year Annualized Volatility)



Source: EMD manager universe is calculated using gross of fees returns from Bloomberg Mutual Fund data for 53 funds with 5 years of track record; Using gross of fees returns for LM Capital's EMD Strategy. Volatility is calculated using 5 years of monthly returns

Emerging Markets 2023 Outlook

The expectations for 2023 are not very good for most emerging markets as the tightening of liquidity in the US and the expected further increases in most developed countries will probably lead to a wild global recession.

A slowdown eases pressures on the price of commodities, the main stay of emerging economies and it also lowers the appetite for manufactured goods.

The higher rates put a burden on countries with foreign debt and makes it much costlier to refinance maturing debt.

China, the largest emerging country, is still struggling with COVID-19 as the Sinovac vaccine is not very effective and they refuse to import western medicine. The restrictions on products and higher tariffs also don't help as the country is still dealing with a real estate crisis and expects a growth of 3-4%, much lower than in past years.

Russia is still involved in a war that has become very complicated and expensive for them and is now dealing with a cap of $60.00/barrel on the oil they sell to the West.

LatAm is facing a strong move to the left and to populism with new governments in Peru, Colombia, Brazil and Chile.

On the positive side, balance sheets in these emerging countries have improved and markets in local currency have made them less dependent on foreign financing.

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