LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

Michael Chalker

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A Banking Crisis or A Bank in Crisis?

We continue to see a wide and large variety of economic and market projections for the remainder of the calendar year. Traders are still pricing in a series of rate cuts beginning this summer and yields appear to be pricing in some kind of serious recession, while equities continue to hover around the same levels we saw a year ago. At some point a new trend will take place for both markets - which direction that is seems to be anyone's guess.

We certainly did not see any volatility subside this quarter, especially during the month of March. Even though much of the economic data this quarter demonstrated some strength, other aspects of manufacturing and price impacts to producers and consumers highlighted more concerns that weakness may be stirring underneath the economy. US economic data published since the beginning of the year suggests that the largest economy in the world continued to grow slightly in the first quarter. The labor market remains fairly resilient as February non-farm payrolls grew by a stronger-than expected 311,000 and average hourly earnings showed that wage pressures are gradually decelerating.

The February consumer price index report showed that headline inflation fell to 6.0% year on year, down considerably from its 8.9% peak in June. As we've pointed out before, inflation continues to be dominated by shelter costs, now accounting for over 70% of the increase in prices, but changes in rents and house prices tend to feed through with a lag so we may see those numbers decrease in coming reports.

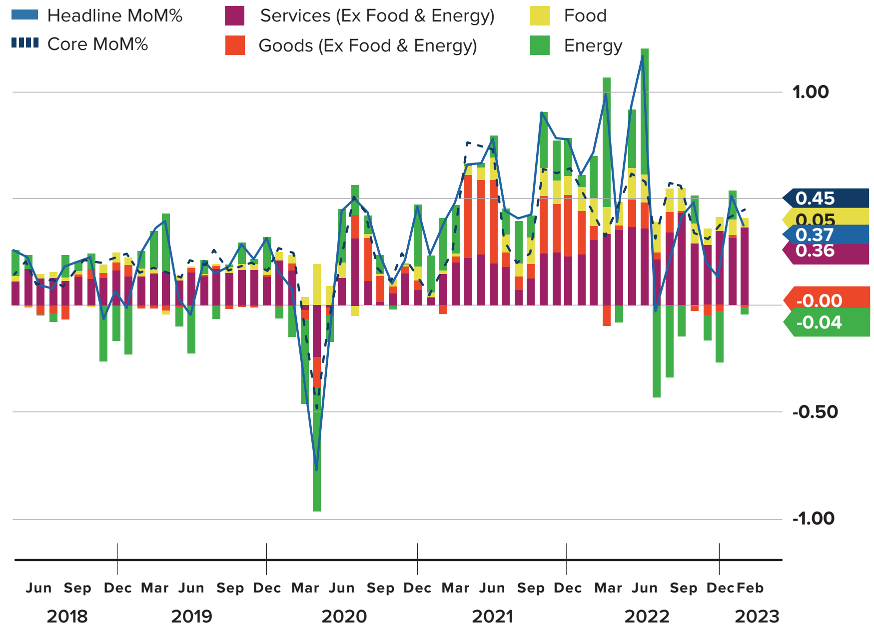
Quarter in Review

The highlight of the quarter were the events that unfolded within the banking system in March, some at home and some abroad. The failure of two regional banks within a 48hr period and the ongoing issues with Credit Suisse overseas, scared investors into a slight panic, thinking the worst – that another systemic banking crisis was staring us in the face. Regulators were quick to step in and do what they could to stem any further worry over the first weekend while many market participants and pundits were quick to point out that the issues at hand were most likely localized to poor risk management by both respective banks and should not be representative of a larger systemic concern. It took some time for calm to re-emerge but not before the market quickly slashed its outlook on financials in general, blowing out credit spreads on Senior and Subordinated bank paper during the month.

Coupled with these events, the FOMC meeting occurred about two weeks later where the market had originally priced a large possibility of a 50bps hike. Those odds went to zero almost overnight and shifted to a 25bps hike, then to no hike occurring at all. The committee ultimately decided on a 25bps hike, acknowledged some of the risks to the aforementioned events and reminded markets they continue to focus on their dual mandate.

The 10yr began the quarter at 3.87% and spent the quarter in a similar range and shape as last quarters, almost breaking out to the upside until the events with Silicon Valley Bank and Signature Bank brewed a flight to safety, sending the benchmark Treasury down to finish at 3.47%. The US Dollar finished slightly lower by just -0.98% this quarter, following a quarter where the currency saw significantly lower returns. Within the credit subsectors, industrials and utilities outperformed financials as the curve bear-flattened and the banking issues that arose early in March, scared investors out of the sector. The US Treasury (+3.01%), High Yield (+3.57%), Non-Dollar (+3.06%) and Corporate (+3.50%) sectors outperformed the broader Barclays US Aggregate Index's return of +2.96% on the quarter. The Mortgage-Backed Securities (+2.53%), Government Agency Securities (+2.09%) and Emerging Market Debt (+2.15%) sectors underperformed the broader index's return.

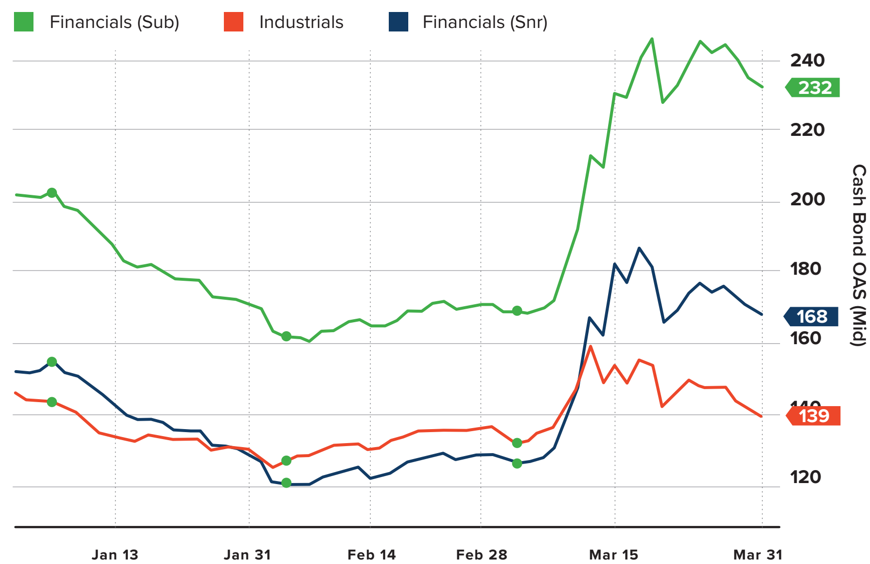
Consumer Price Index



Source: Bloomberg

USD Investment Grade Option Adjusted Spread

12/31/22 - 03/31/23



Source: Bloomberg

Market Outlook

The forward-looking sentiment has now changed as prospects for a recession and Fed easing have increased significantly. Nonetheless, inflation data remains stubbornly high and employment data, however suspect, signals a strong labor market with inflationary wage pressures.

Taking a deep breath, we remind ourselves that the Fed's primary objective is price stability and full employment, except when they're distracted by bank failures and a depositor run on several banks. This places the Fed in a reactive mode, data dependent on the inflation and employment front while subjectively viewing and measuring consumer and depositor sentiment towards the banking system as a whole, hoping that another shoe doesn't fall to the floor.

In this situation, post- a very strong Treasury rally in March, we remain slightly short duration versus our benchmark indices. More importantly, we become more risk averse with the credit sectors, especially US high yield and emerging market debt. The US Dollar appears to have peaked and we see no opportunities in the non-Dollar bond market. Although the investment grade corporate index performed well in March due to its longer duration, the volatility associated with that sector causes us to be more cautious as corporate spreads fluctuated across a 45 basis point range. Despite the creditworthiness associated with the MBS sector, that sector's performance was somewhat disappointing in March and year to date due to spread widening. Hence, our positioning favors the Treasury/Agency sectors as we maintain a more defensive position in the MBS and credit sectors. Finally, we assume a trading range in rates during this quarter as the market sorts out the Fed's dilemma of addressing inflation versus financial stability concerns.

Frank Hacklander CFA

Senior Credit Analyst

Easter Baskets

With Easter in the offing, it seems important to remind everyone that it is not wise to keep all one's eggs in one basket, an admonition that the management teams at Signature Bank and Silicon Valley Bank (SVB) seem to have forgotten or willfully ignored. Unfortunately, it was not the only asset liability management (ALM) tenet that the managements of these firms ignored. ALM risk mitigation has four cornerstones:

i) Liquidity risk management;
ii) Interest rate risk management;
iii) Currency risk management; and
iv) Capital markets risk management.

The management teams at both Signature and SVB seem to have ignored the first two of these to the detriment of the stakeholders of both firms while proving a burden to the FDIC and the Federal Reserve. While each of the two had a variety of non-bank entities, the core holding of each was the bank. Indeed, Signature was not organized as a bank holding company which allowed Signature to escape regulatory scrutiny that SVB, which was a bank holding company, did not avoid. The issue of supervision aside, both entities had certain similarities, the first of which was a focus on a very narrow customer base.

	SVB	Signature
Customer focus	Technology	Healthcare
	Healthcare	Private equity
	Private equity	Non-public companies
	Venture capital	Digital asset banking clients

The products offered to these customer groups included products applicable to individuals and organizations.

Both institutions had relatively limited histories. Silicon Valley Bank commenced operations in 1983 while Signature commenced operations in 2001. From the date of founding, both institutions grew very quickly. In fact, in his Senate testimony, the vice chair for supervision for the Federal Reserve, Michael S. Barr, pointed out that SVB tripled in asset size between 2019 and 2022. By contrast, the national deposit growth rate during the Covid crisis was 35% according to the Federal Reserve, a growth rate that was still well above historical norms.

SVB's deposits, for example, increased 152% since 2020 and, of this amount, 93.9% exceeded FDIC deposit insurance limits. Before the run began, it was estimated that SVB had $161.5 billion in domestic deposits. This is even though both SVB and Signature indicated that each had suffered from significant asset shrinkage during the second half of 2022. For Signature the decline in assets was driven by cryptocurrency fears. Signature indicated that its core deposits declined $17.5 billion to $88.6 billion. This decline was divided between $12.4 billion in so-called digital assets (i.e., cryptocurrency-related assets) and $5.2 billion in other assets. At the same time, brokered and time deposits ("fast money" in some respects) increased to $6.5 billion from $2.8 billion. For Signature, 89.7% of its domestic deposits of $88.6 billion fell into the uninsured category.

So, each bank had significant levels of uninsured deposits. Each had a very narrow customer focus. Arguably, there was also a lack of geographic diversification as well. Signature focused on the NYC Metropolitan area. SVB, as reflected in its name, primarily focused on Silicon Valley (although it also had a side business supporting premium wine producers which, in some respects, was an extension of its Silicon Valley focus).

With all these eggs in one basket, the similar responses to rising rates accentuated these issues. Each institution had significant assets accounted for as "available for sale securities," or AFS, which are marked to market, and "held to maturity securities," or HTM, which are not marked to market on a periodic basis unless an expectation of loss arises. At 12/31/22, SVB had $26.1 billion in AFS and $91.3 billion in HTM. At 12/31/222, the fair value of SVB's HTM portfolio was $76.2 billion. Signature had a total securities portfolio of $26.4 billion of which $18.6 billion were AFS and $7.8 billion were HTM. Unrealized losses on this portfolio increased to $1.8 billion at 12/31/22 from $174.7 million at 12/31/21. The fair value of Signature's HTM portfolio at 12/31/22 was $7.0 billion. Each institution had unrealized losses on its HTM portfolio that would have eliminated almost 23% of Signature's book equity and almost 93% of SVB's book equity.

Once these vulnerabilities were exposed, runs on the deposits of each institution began. These runs were compounded by the ability of related depositors to instantly communicate their concerns to one another which exacerbated the situation. For example, by 3/9/23, luminaries such as Peter Thiel had begun encouraging client firms to pull their funds from the bank. What is troubling is that the management of each institution was seemingly unaware of the potential for chaos in the wake of their respective disclosures. Signature had declared the payment of a dividend in February, which boggles the imagination, while SVB had never declared the payment of a dividend. Regardless, due to the movement in these uninsured deposit accounts, each institution failed and was taken over by the FDIC.

What is interesting to note in this regard is that each institution's management team modeled the impact of interest rate increases and liquidity movements and constraints. Indeed, each company's financial documents are filled with tables depicting the impact of such movements. What this modeling appeared not to recognize are the correlations/concentrations among the respective customer bases and the resulting lack of diversity. This modeling also did not account for the speed of response by holders of these uninsured accounts. In addition, while some have pointed to the mismatch between interest paid on accounts versus interest received on assets, the management teams involved did not flag any significant disparities in actual or prospective net interest income. This seems to highlight the fact that what really affected both institutions was the lack of customer and funding diversification, a clear example of putting too many of the same eggs in one basket.

We at LM Capital understand that each security has its risks. When analyzing a particular issuer's securities for inclusion in one of our portfolios, one of the first questions we attempt to answer is whether we are adequately compensated for the assumed risk. We are especially wary of high-cost, low-probability event risks. An over-dependence on an undiversified customer base compounded by a lack of focus on ALM risk mitigation cornerstones has always proven to be a red flag for us and a flag of which we are keenly aware.

Vikrant "Vik" Khadilkar CFA, FRM

Portfolio Manager, Senior Analyst

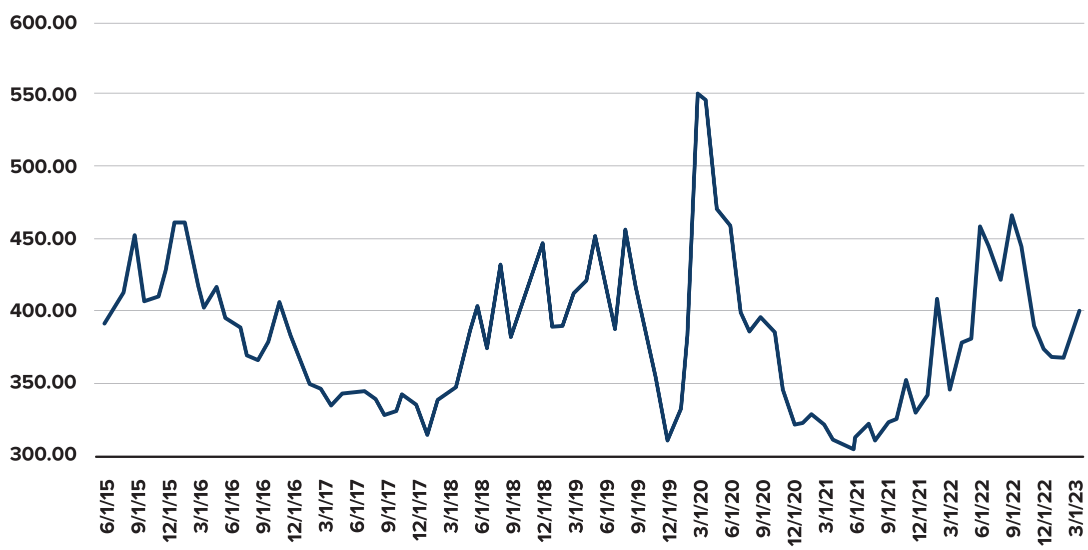
EMD Update

Emerging Market Debt stands to benefit as higher carry attracts investors

Demand for carry is driving asset flows into emerging markets as higher yields show potential to better protect EM creditors from adverse moves in currencies, credit spreads and bond yields. Asset flows into hard currency and local currency Emerging market debt while strong during January and February 2023, had a dramatic reversal in March 2023 as banking sector volatility picked up. We believe asset flows will provide a tailwind in support of EM spreads as investor demand for higher carry remains strong.

EM Sovereign Credit Spreads vs US Treasury

6/1/15 - 3/1/23



Source: Bloomberg

Emerging Market Spreads Converge on China Reopening

Since the China reopening plan was announced in October 2022, Emerging Market credit spreads have grown more sensitive to China and have had a great run till the banking sector volatility of March 2023. Strong beat in March PMIs for China showed that the Chinese reopening trade has legs beyond pent up demand.

At LM Capital, we continue to avoid investing in China and countries that lack prudent rule of law. We maintain a significant overweight to commodity exporters that have strong fundamentals and continue to benefit from the sustained demand for commodities.

Latin America's second 'Pink Tide' gets a reality check

During the pink tide of mid 2000s, Latin American leaders enjoyed a commodity boom and, by the end of the decade, a significant U.S. interest rate reduction, which created an ideal macroeconomic environment for the region. These leaders were popular thanks to their increased public spending, and generally won reelection or succeeded in picking their successors.

By contrast, today's leaders face a perfect storm of rising U.S. interest rates, geopolitical instability and limited fiscal budgets as the devastating pandemic that hit Latin America particularly hard. As the bearers of bad news, the leaders today generally suffer lower approval ratings as they stumble to implement their progressive agenda.

Chile: A year into his mandate, President Boric has yet to deliver on his reform agenda amid ongoing political gridlock. The issue that really dominated Boric's first year in office, however, was that of rewriting the constitution. With unexpectedly large margin of 62% to 38%, Chileans voted to reject the text of the new constitution to hand President Boric his first big loss. Following the result, pragmatism kicked in for President Boric as he reshuffled his cabinet to bring in experienced hands from the old center left. President Boric however received another setback recently as lawmakers refused to move forward with the proposed tax reform meant to finance key elements of the president's progressive agenda.

Colombia: Colombian President Gustavo Petro suffered his first major setback in congress after the government withdrew a proposed bill to overhaul the political system. Some of the president's allies in the ruling coalition have dissented from plans such as granting government a bigger role in health system or holding talks with cocaine trafficking and guerrilla groups in pursuit of 'Total Peace'. The coalition is increasingly at risk of fragmenting and it will force the government to give up on a lot in the reforms it has sent to congress. It is becoming increasing clear that the coalition does not operate as a bloc that could easily allow the government to push through coming reforms.

Brazil: In his return to presidency, Lula has mixed periods of welcome normalcy with a contentious and bitter tone that has alarmed many in business and financial markets. Since winning the election in October 2022, President Lula has spent valuable time and capital lashing out at Brazil's independent central bank or the judge that sentenced him to prison last decade. After much anticipation, the Brazilian government has finally unveiled the first details of its proposal for a new fiscal framework to tame public spending and prevent the public debt from ballooning. On the surface the fiscal plan seems to be a step in the right direction but seems insufficient on the matters of putting public debt on a sustained path in the short term. Although the government has shown optimism about the fiscal framework's chances of passage in Congress, risks remain as both chambers of congress have tilted even further right while being run by fickle operators who could run the risk of dooming the president's entire agenda for the next four years.

LM Capital Group Adds Two Senior Professionals

LM Capital Group is proud to announce the addition of two senior professionals, Pablo Barrientos and Gerry Dodd, to positions in the Research and Business Development teams, respectively.

Pablo Barrientos joined LM Capital as a Senior Credit Analyst on November 1, 2022. Prior to joining the firm, he had focused his professional career on capital markets origination with Citigroup in New York. He was most recently a Director in the Latin America Debt Capital Markets group and regional leader of the Global ESG Debt Capital Markets team. Pablo's experience includes advising, structuring, and executing international bond and syndicated loan transactions for Latin American sovereign and corporate borrowers. These transactions were across industries and credit ratings. Pablo graduated from the University of California, Berkeley with two degrees: a Bachelor of Arts in Applied Mathematics and a Bachelor of Arts in Economics. He is currently working towards his CFA level 2. Mr. Barrientos lives in San Diego with his wife.

“Mr. Barrientos’s addition to the research team further strengthens our comprehensive understanding of fixed income markets,” said Luis Maizel, Senior Managing Director. “His skills and experience bring another facet to our understanding of the needs and thinking of issuers and underwriters. His experience in Emerging Markets Debt origination further strengthens our team’s proven strengths.”

Gerry Dodd joined the firm on March 13, 2023 as a Senior Vice President, Business Development; he will be based in Austin, Texas and replace Brenda Alfaro who departed the firm in September, 2022. Mr. Dodd is a seasoned sales professional with over 25 years experience in the financial services industry.

Prior to joining the firm Mr. Dodd was a Financial Advisor at Prudential Advisors focusing on small businesses and family financial solutions. The majority of his career was spent building alternative sales and research businesses at a number of investment banks, including CIBC, State Street, Bank of Montreal and JP Morgan. He started his career at JP Morgan on the foreign exchange desk and then spent 12 years at State Street Corporation where he was Global Head of Relationship Management for Hedge Funds and Private Equity. Mr. Dodd received a Bachelor of Arts degree from London Metropolitan University and an MS in Business Finance from Brunel University.

“Mr. Dodd’s addition to the Business Development team further strengthens LM Capital’s ability to bring our fixed income strategies and customized solutions to the institutional marketplace. His years of experience across many asset classes provides him with a unique insight into addressing the needs of our future clients,” said John Chalker, Managing Director

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