LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

# LM Capital Group Perspectives

## Investment Insights
## 2Q 2023

**Michael Chalker**

Senior Portfolio Manager, Senior Analyst

# Is There Any Good Value Out There?

It has been a few quarters since we have been able to remark that volatility has subsided across global markets. This quarter we finally saw a bit more tranquil and optimistic actions reflected in the US markets as the recessionary fears were replaced with more talk centered around the potential for a successful soft landing. Many investors and pundits continue to believe a recession is coming – with their argument lying deep within the layers of each economic data point, they claim their argument is a valid one. Those constructive on the path of the economy claim they need only to highlight the labor market to make their point. The simple fact is that projecting the direction of the economy remains as tough as ever with each potential negative being offset by a positive.

The Fed remains in a reactive mode, data dependent on the inflation and employment front while monitoring for possible bank weakness due to potential non-performing loans on commercial real estate (CRE). Thus far, the impact from non-performing CRE loans has been minimal though concerns in the marketplace are becoming more of a forethought in today's conversations. It is yet to be seen if they'll play a large role in preventing the economy from achieving a successful recovery and therefore make it tough for equity markets to continue marching upward, ignoring the ever-changing fundamentals from the past twelve months.

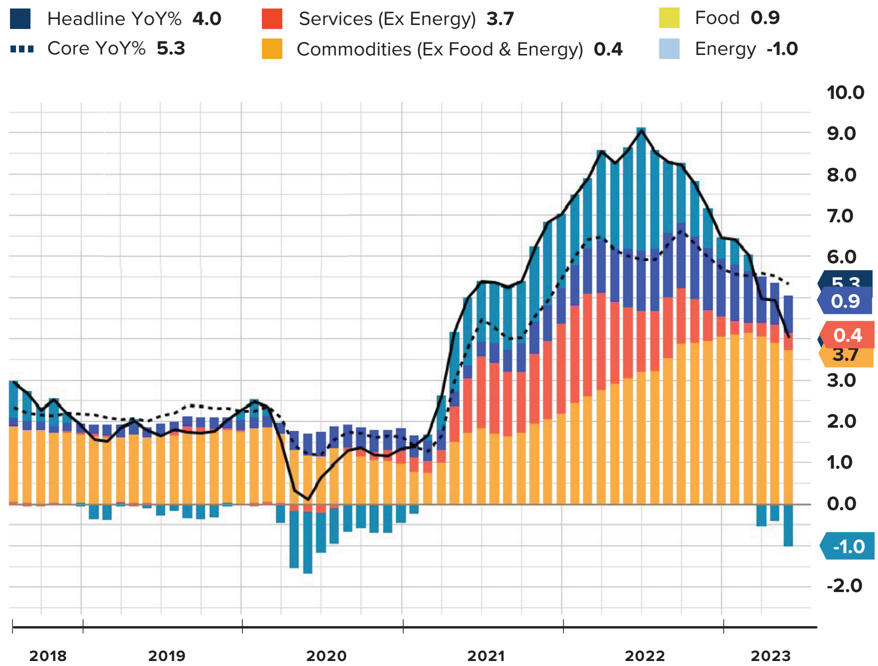
## Quarter in Review

Inflation numbers fell sharply from last year's peak of 9% down to 4% this quarter, largely due to favorable base effects from oil prices, which peaked last June and have come down significantly since. Core inflation remained stickier at 5.3% but may also be helped by a moderation in shelter inflation ahead, as the material slowdown in housing prices and rent growth starts to be reflected in the official core inflation numbers. That said, the Atlanta Fed's median wage growth tracker continued to show wages growing around 6%. This is not surprising given the low unemployment rate but is clearly not consistent with inflation falling sustainably to the Fed's long-term target of 2-2.5%. Retail sales growth remained in positive territory, but the decline in business investment intentions and weak corporate loan demand pose risks to the economy going forward. Risks to small bank lending, particularly linked to potential losses on commercial real estate loans – to which small banks are disproportionately exposed – are also worth monitoring closely as mentioned above.

The 10yr began the quarter at 3.47% and spent the period continuing to bounce between 3.30% and 3.60% until it broke up and out of that range in the middle of May, marching higher to finish at 3.84%. The US Dollar finished slightly higher by just +0.40% this quarter, following another quarter where the currency saw continued significantly lower returns. Within the credit subsectors, industrials and utilities underperformed financials as the many bank and financial names had strong recoveries after the fiasco in March. Longer maturity securities underperformed shorter maturities generally speaking this quarter, especially in the US Treasury markets.

The Mortgage-Backed Securities (-0.64%), Government Agency Securities (-0.44%), High Yield (+1.75%), Emerging Market Debt (+1.12%) and Corporate (-0.29%) sectors outperformed the broader Barclays US Aggregate Index's return of -0.84% on the quarter. The US Treasury (-1.38%) and Non-Dollar (-2.16%) sectors underperformed the broader index's return.

**Consumer Price Index**




Source: Bloomberg

**USGG 10yr Index**


Source: Bloomberg

# Market Outlook

We agree with the consensus call for a 25-basis point rate hike in July with the possibility of another rate hike in the future dependent on inflation and employment data. The 1Q GDP revision, which indicated stronger economic growth than anticipated, could give the marketplace more room to run – particularly if followed by a stronger than anticipated 2Q print. Given the continued strong labor market, upward pressure on food and housing prices and an economy that refuses to enter a long predicted recessionary cycle, we expect that interest rates will be higher for longer and that inflation will remain stubbornly high through year end. In this situation, our portfolios' slightly short duration position provided for good relative performance versus our benchmark indices in June as rates rose slightly across the Treasury curve in response to comments by the FOMC members and Chairman Powell.

We continue to remain risk averse within the credit sectors despite seeing positive returns for June in the Corporate (IG), US High Yield (HY) and Emerging Market Debt (EMD) Indices. The US Dollar remained in a trading range versus most currencies and we continue to see no opportunities in the non-Dollar bond market at this time. Selective new issues coming to market, both in IG and HY, provided some attractive opportunities to take advantage of new offering concessions while slightly extending maturities.

Neither Treasury nor agency securities offer good relative value in our view. Hence, our positioning favors inefficiently priced corporate credits that offer attractive yields on a relative basis. The market has broken our previous assumption of a trading range in the 10-year Treasury, and we now wait to see if that range will simply expand or post a new direction higher or lower based upon the labor and inflation data.

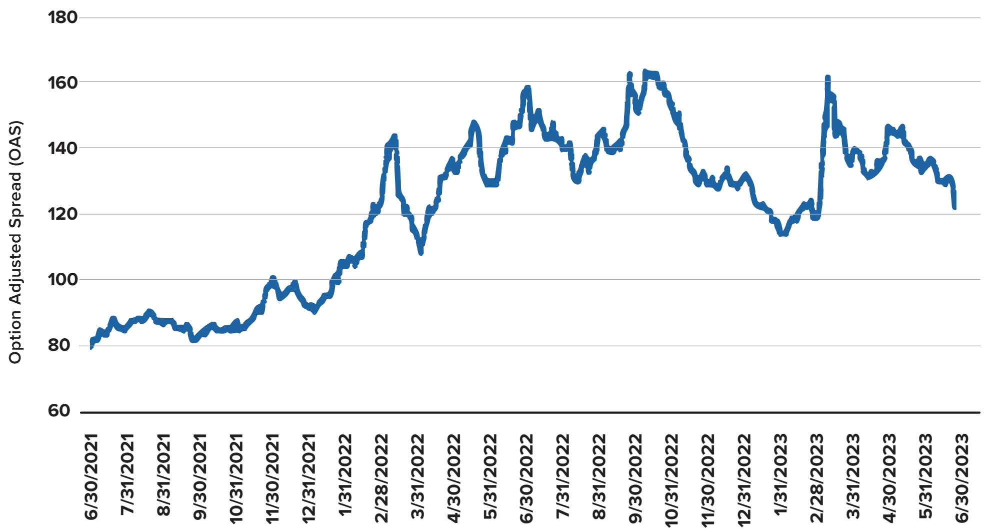
# Higher Rates. Inverted Yield Curve. Tighter Credit Spreads: What do investors do?


**Vikrant "Vik" Khadilkar CFA, FRM**

Portfolio Manager, Senior Analyst


**US IG Cash Spread (bp)**

6/30/2021 - 6/30/2023




Source: Bloomberg

Over the past 15 months, the Federal Reserve has tightened monetary policy by raising the Fed Funds rate to 5.25% and by continuing the balance sheet reduction of $90 billion each month. During this period, credit spreads, although volatile, have remained range bound and currently are close to being at the tightest level since the Federal Reserve embarked on its policy normalization.

While the Federal Reserve continues to reiterate its "Higher for Longer" policy framework, and inflation expectations have remained anchored, US Yield curve has inverted to levels last seen in 1981 with the 2 Year – 10 Year curve differential at -106bps.

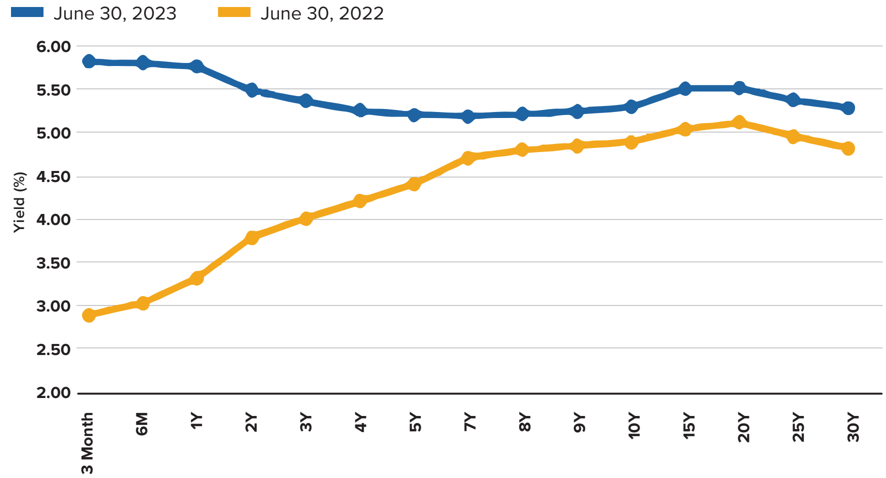
The impact of an inverted Treasury curve, coupled with tighter credit spreads across the maturity curve, have led to a US investment grade corporate credit curve that is relatively flat today compared to a year ago. Further adding to the flattening of the corporate credit curve is the "Preferred Habitat Theory" that different bond investors prefer a particular maturity length over another and only higher risk premiums can entice them to do so otherwise. As we explained in our [4Q 2022 newsletter titled "The Shopping Mall"], historical buyers of short dated bonds include corporations who can now find comparable yields in money market funds, while buyers of long dated bonds, like insurance companies, cannot find any such alternatives.

When comparing today's yield on short dated (1-5 year) US investment grade corporates with their long-dated counterparts, the differential at -14bps is much lower than the historical average over the last 30 years. This is the first time in the last few decades that the flattening of the corporate yield curve is a function of underlying inversion in the Treasury curve as compared to the flattening driven by a blowout in corporate credit spreads circa 2008.

During periods of lower interest rates, yield starved investors have satiated their demand for yield by either extending the duration or lowering the quality profile of issuers. A flat corporate credit curve as highlighted above, makes extending duration an unattractive trade that adds interest rate risk without a meaningful pickup in yields.

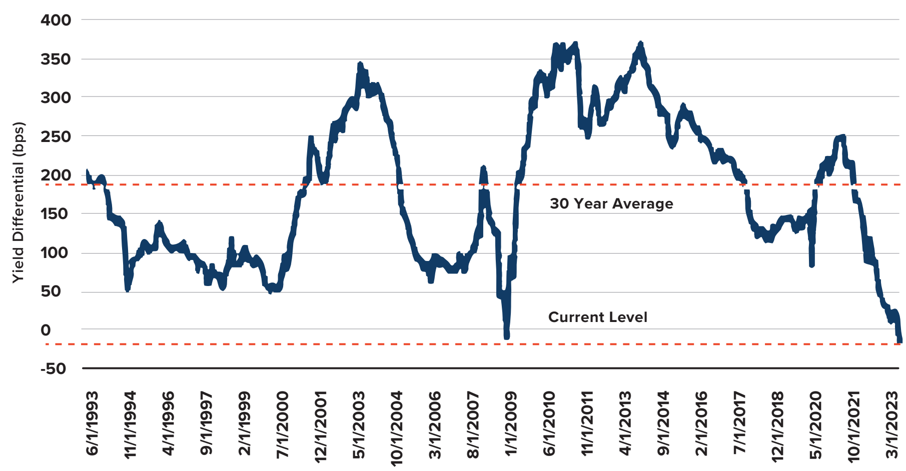
Example: Morgan Stanley Sr Unsecured bonds that mature in 2026 offer 5.3% yield while its 2050 maturity counterpart offers a risk premium of only 20 bps to yield 5.5%.

**US Investment Grade Corporate Yield Curve: June 2023 vs June 2022**




Source: Bloomberg

**Yield Differential: 1-5 Year US IG Corporates vs Long (10+ Year) US IG Corporate**




Source: Bloomberg

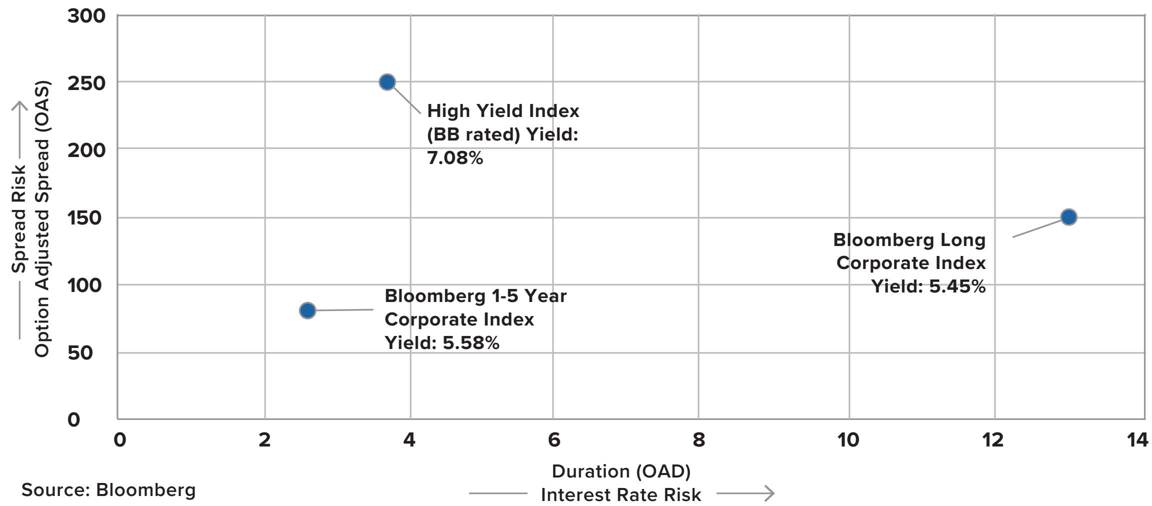
**Yield Differential: 1-5 Year US IG Corporates vs US High Yield Credit**


Source: Bloomberg

Comparing the yields on short dated IG corporates vs High Yield Corporates (BB and B rated) highlights the diminishing risk premium associated with the credit profile of junk rated issuers. At 150bps, the differential in yield for BB rated High Yield Index vs a Short-dated IG Corporate index is among the lowest it has been over the past three decades. Only in periods preceding stressed market conditions (1997, 2000 and 2007) did we see a similar lack of risk premium associated with junk rated issuers.

Example: Ford Motor Credit, a BB rated issuer maturating in 2032, is offering a risk premium of only 140bps to yield 6.7% compared to the 5.3% yield associated with Morgan Stanley bonds maturity in 2026.

**Risk Matrix: Interest Rates vs Credit Spreads**




Source: Bloomberg

Attractive yields associated with short maturity IG corporates offer a perfect hiding place for investors as impacts from the Federal Reserve's monetary tightening continues to permeate through the economy. Short dated corporates, while offering attractive yields, do so without increasing exposure to the risk associated with rising rates and widening credit spreads.


**Pablo Barrientos**

Senior Credit Analyst


# Emerging Markets 2Q 2023 Review

Although several economies continue to experience elevated inflation, the rate of price increases in many emerging market countries started to fall toward target ranges during the second quarter. These trends have prompted central banks to delay rate hikes and even cut the reference benchmark rate in some jurisdictions (e.g., Uruguay and Costa Rica).

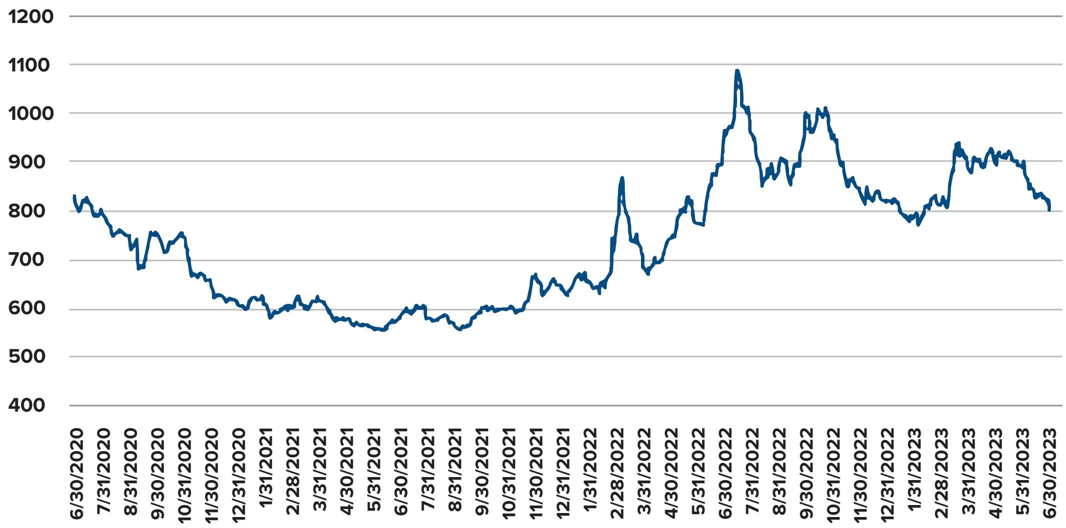
China's post-COVID-19 recovery has been disappointing on weaker than expected domestic consumption and a real estate crisis that shows no signs of abating. The Chinese government has embarked on various efforts to boost stimulus to reignite its economy and successfully achieve the Chinese Communist Party mandate of pivoting the Chinese economy from the world's factory to an economy that's driven by domestic consumption.

In addition to the overall stabilization of the macro backdrop following the U.S. regional bank turmoil, positive developments in lower-rated emerging market countries allowed for idiosyncratic factors to generate outsized returns for distressed issuers in the Emerging Market Index.

For example, Argentina's sovereign bonds have rallied significantly since early May as the government makes progress to secure emergency financing from the IMF, World Bank, and the Inter-American Development Bank. Concurrently, Argentina also posted lower-than-expected inflation data in June, albeit still in triple digits year-over-year. Other positive contributors to the high yield index benefitting from IMF debt support included Zambia and Sri Lanka.

Similarly, El Salvador bonds, another major contributor to the high yield index, generated strong returns in 2Q as the sovereign continues to stabilize its economy. The main drivers of the country's recovery continue to include significantly reducing crime, boosting the country's tourism sector, and successfully refinancing short-term debt. These efforts allowed El Salvador to come out of Selective Default in May, although still rated CCC+.

**EM Sovereign High Yield Credit Spreads**




Source: JP Morgan Indices, JPM EMBI Global Diversified High Yield Index

In terms of asset flows, emerging markets hard currency bond funds remained negative during the quarter although local currency and blended currency funds experienced a handful of weekly inflows. Performance in both categories was positive in 2Q 2023, although local currency funds outperformed in comparable USD terms.

In particular, Latin American currencies appreciated further as the region continues to offer high single-digit to low double-digit interest rates while demonstrating a clear drop in inflation. Demand for these currencies was also supported by a relatively calm political climate during the second quarter (e.g., Peru's presidential protests dissipating, Colombia's new finance minister appeasing investor concerns following Ocampo's removal, Chile's progress on its new constitution with increasing influence from the conservative opposition). Macroeconomic supply chain factors also played an important role in demand for Mexico's peso as the nearshoring effect continues to gain momentum.

Flattening of the US investment grade credit curve as highlighted earlier in the newsletter has parallels in the dollar denominated emerging market corporate universe. We continue to see attractive yields associated with short-dated high quality emerging market corporate issuers while a diminishing risk premium is associated with both longer dated and lower quality issuers.

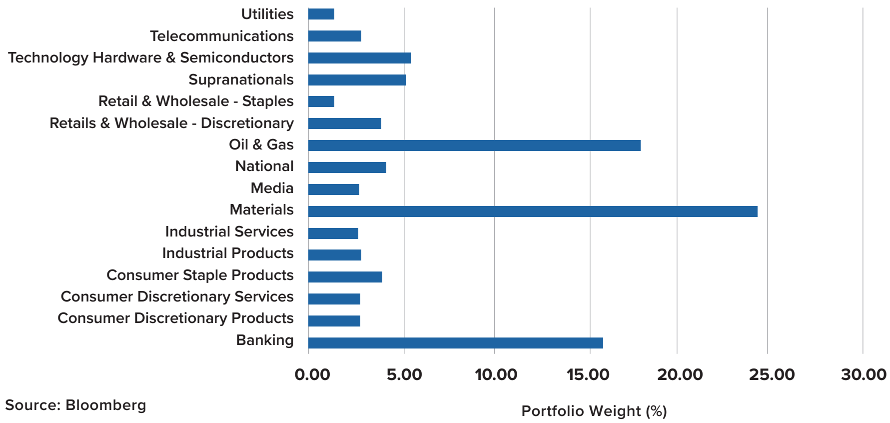
Adding LM Capital's flavor to investing in short-dated emerging market corporates, we can build a portfolio that yields 6.25% (as of June 2023), 75bps more than the US 1–5 year IG counterpart. We do so while avoiding exposure to countries without rule of law (i.e., China/Russia/Turkey and Frontier African Countries) and maintaining exposure to corporates with strong balance sheets. LM Capital aims to maximize returns while minimizing volatility by employing our time-tested approach to diversify investments based on comprehensive industry and factor exposures versus a focus on geographical diversification.

Below are the characteristics of a hypothetical short duration emerging markets corporate portfolio:

### LM Short EM Corporate

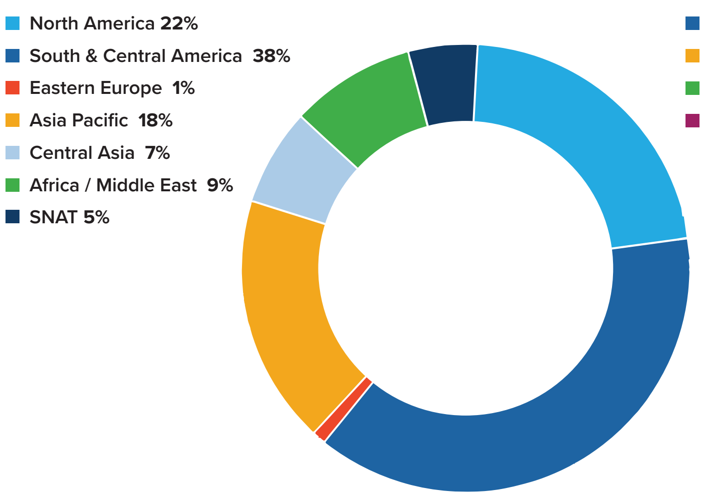
| | |
|---|---|
| Yield | 6.25 |
| Duration | 2.89 |
| Average Quality | Baa2 |
| Option Adjusted Spread | 169.02 |
| Coupon | 4.664 |

### LM Short Duration Corporate - Sector Breakdown

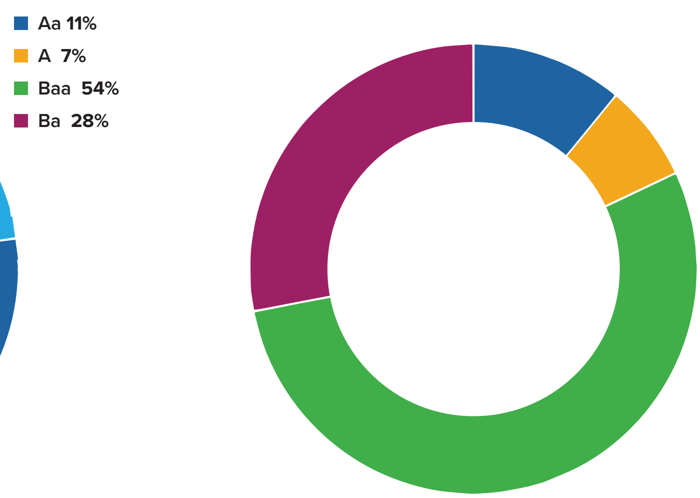



Source: Bloomberg

### LM Short EM Corporate: Region Breakdown




### LM Short EM Corporate: Quality Breakdown




Any Model performance shown for the relevant time periods is based upon hypothetical results of an LM Capital Group model portfolio. Model portfolio performance is the result of retro-active application of the LM Capital Group investment process, designed with the benefit of hindsight. It does not reflect any investor's actual experience of LM Capital Group with owning, trading or managing an actual investment account. The data used to calculate the model performance was obtained from sources deemed reliable and then organized and presented by LM Capital Group. The performance calculations have not been audited by a third party. Actual performance of client portfolios may differ materially due to the timing related to the actual deployment and investment of a client portfolio, the reinvestment of dividends, length of time various positions are held, client objectives and restrictions, and fees and expenses incurred by the individual portfolio.

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