LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

Michael Chalker

Senior Portfolio Manager, Senior Analyst

Did We Just Witness THE Reality Check?

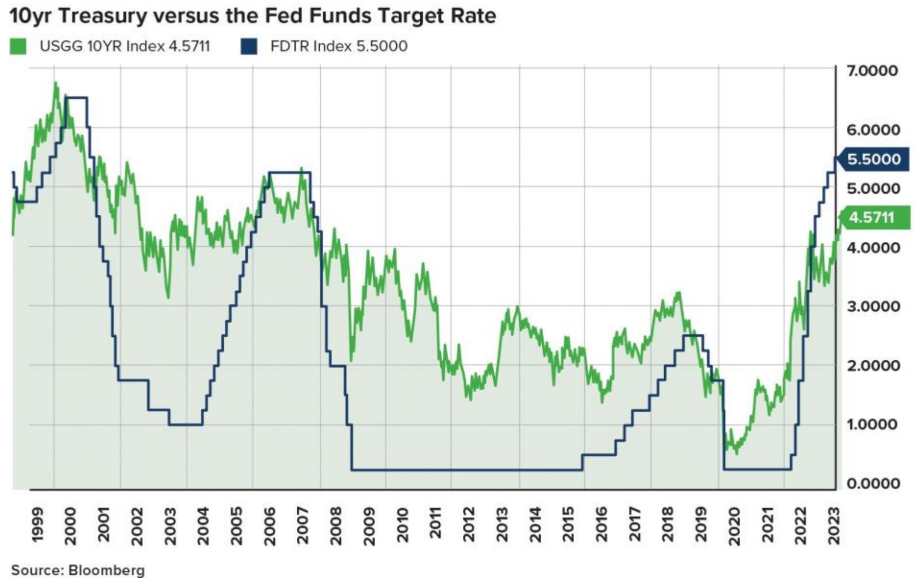
Higher for longer. Higher for longer. Higher for longer.

This quarter we finally witnessed markets adjust to the reality of this phrase, which has been stated clearly by numerous Federal Reserve committee members for almost a year now. Why it took so long for markets to react is a topic for another time but the effect certainly led many markets to negative returns this quarter, creating another period of time where it was tough to find a safe place to hide. The fundamental economic picture did not change during the quarter but a new, significantly higher rate environment has implications that have the potential to significantly rattle consumers and companies alike.

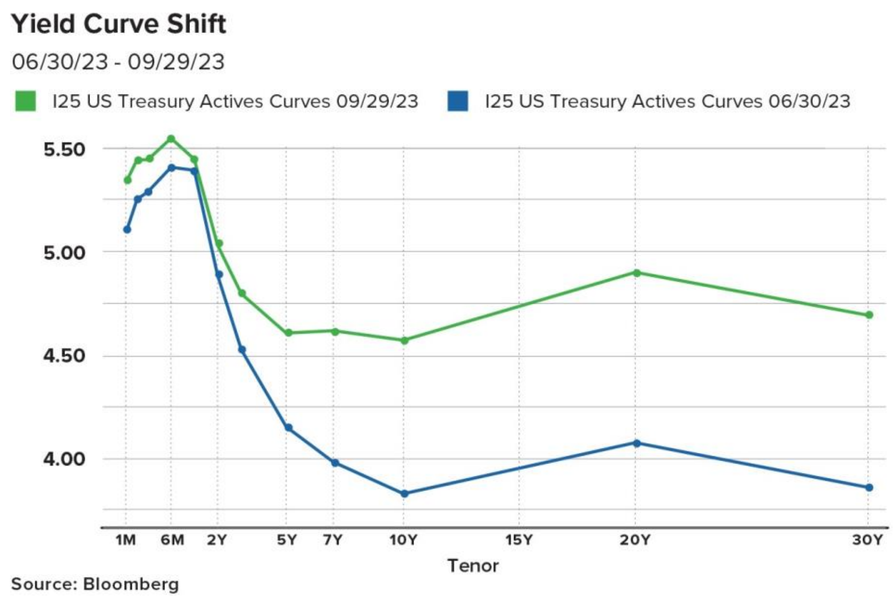
The Fed continues to be data dependent on the inflation and employment front with the fixed income market consensus unsure of future interest rate moves. Lately, we have seen that inflationary pressures have waned but continued upward pressure on food, energy and housing prices remain high as the economy continues to push out this long predicted recessionary cycle. Following no increase in the Fed Funds rate at the September FOMC meeting, we believe that another rate hike is possible in the future, though it would be almost strictly for perception as another 25bps at this point is less than significant in terms of its effects on the inflation fight. The chart below gives some context to the current dichotomy between the level of the 10yr Treasury versus the Fed Funds Target Rate (FFTR). At some point the two lines will reconverge. The biggest question that continues to divide markets is whether the 10yr Treasury will rise to catch up with the FFTR or the FFTR falls to meet the lower rates of the 10yr Treasury? The next six months could be key to solving that divide.

Quarter in Review

Following a robust rally for stocks in the first half of 2023, the third quarter offered something of a reality check. A sell-off in global bond markets was partly to blame for the pressure on most risk assets, with the global aggregate bond benchmark falling by -3.6% in the third quarter. US markets were not spared any of this volatility as we saw action reminiscent of 2022 with notable negative returns for both fixed income and equity markets. As bonds and stocks fell simultaneously, commodities were the notable outperformer, returning 4.7% over the quarter, echoing the same market dynamics of previous year. The only sector with positive returns for the quarter was high yield as it continued to prove to be a strong outperformer on the year as well – mostly due to its shorter duration profile overall.



The shape of the curve shifted significantly during the quarter as the long bond rose 84bps in a very bearish steepening fashion which left investors with any long duration securities extremely exposed. The short end of the curve, using the 2yr Treasury for representation, only rose 15bps during the quarter. Historically, we have typically seen curve steepening act as a bit of a precursor to future recessions. It is possible that were seeing that occur here as well as it further tightens financial conditions.



The 10yr began the quarter at 3.84% and spent the quarter marching higher in a very direct but stair step fashion, to finish at 4.57%. The US Dollar finished much higher this quarter (+3.17%) as it acted as safe-haven against unstable market movements elsewhere. Within the credit subsectors, industrials and utilities underperformed financials again this quarter as the financial sector has a much shorter duration than the other two. Longer securities in both the Treasury and corporate space suffered significantly versus shorter dated maturities as the curve bearishly steepened all quarter long.

The US Treasury (-3.06%), Government Agency Securities (-0.24%), High Yield (+0.46%), Emerging Market Debt (-2.31%) and Corporate (-3.09%) sectors outperformed the broader Barclays US Aggregate Index's return of -3.23% on the quarter. The Non-Dollar (-3.90%) and Mortgage-Backed Securities (-4.05%) sectors underperformed the broader index's return.

Market Outlook

Our outlook for awhile now has been that we are of the belief of "high for longer", implying that we are very close to the end of the Fed's rate hiking cycle but no where near the start of a decline in interest rates. We expect that inflation will be more difficult to push toward the Fed's 2.0% target as we approach year end and we are concerned about the large wage gains that unions are winning at the bargaining table. In this situation, we continue to maintain our portfolios' short duration position which has provided for good relative performance versus our benchmark indices as rates trend higher in the intermediate and long maturities.

We continue to remain risk averse within the credit sectors with negative returns for September in the MBS, Corporate (IG), High Yield (HY) and Emerging Market Debt (EMD) Indices. The US Dollar displayed continued strength versus most currencies and we continue to see no opportunities in the non-Dollar bond market at this time. Our positioning favors inefficiently priced but still highly liquid corporate credits that offer attractive yields on a relative basis. Selective new issues coming to market, both in IG and HY, provide some attractive opportunities to take advantage of new offering concessions, though many are ultimately coming to market at tighter and tighter levels as issuance is beginning to wane. We have been very heavily weighted toward shorter duration securities for the better part of the past year but may begin to look at some longer duration, high quality names as the steepness of the curve is beginning to provide some attractiveness that bears watching more closely.

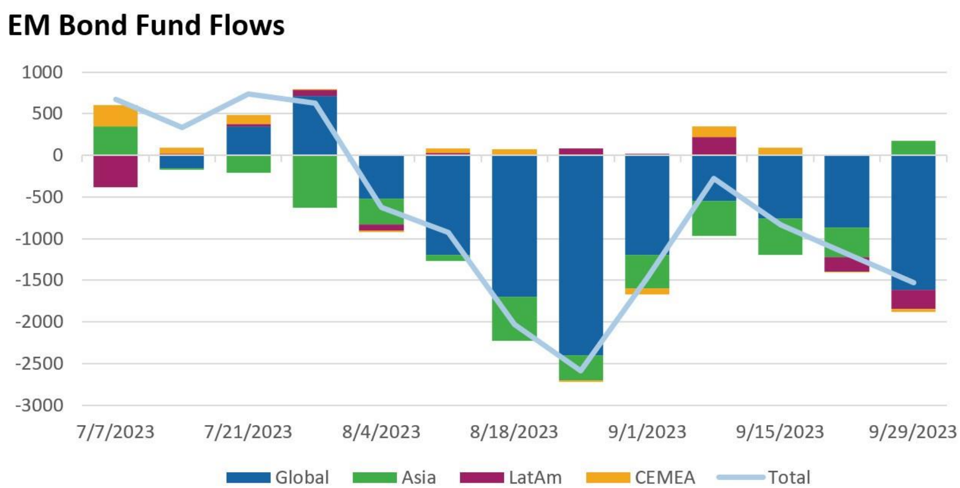
As longer maturity Treasury securities are approaching attractive yield levels in our view, the 10-year Treasury yield has now surpassed the 200-month historical average of 4.50% and the 30yr long bond nears 5%. In our opinion, short term interest rates will peak sometime in 2024, although that does not necessarily signal the start of a decline in rates. Therefore, we expect 2024 to be a year where fixed income returns are very positive following two years of disappointing results.

Pablo Barrientos

Senior Credit Analyst

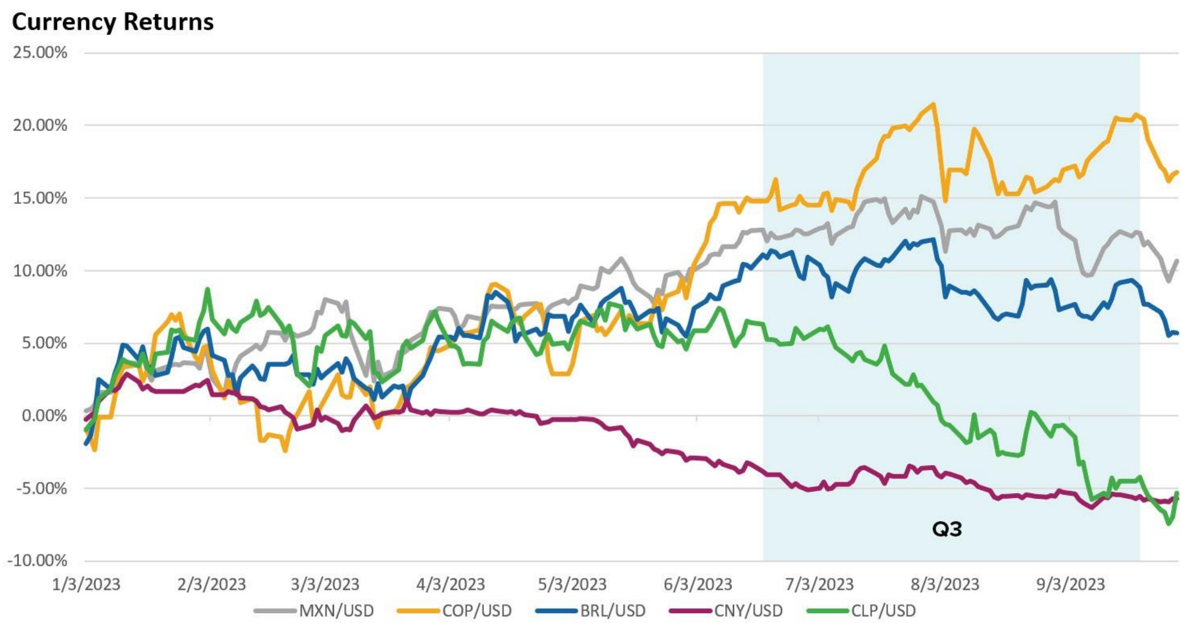
Emerging Markets 3Q 2023 Review

Flows into EM debt-dedicated funds were negative during the third quarter, mainly due to outflows from Asia-focused funds as investors continue to be wary of China's attempts to stimulate its economy. In terms of new issue supply, most volume came from investment grade issuers as all-in yields kept junk-rated borrowers in the sidelines.



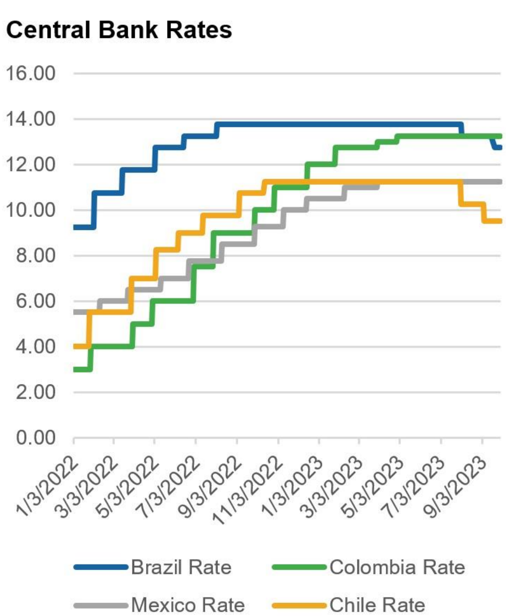
Source: Morgan Stanley. Includes Hard, Local and Blended Currency funds.

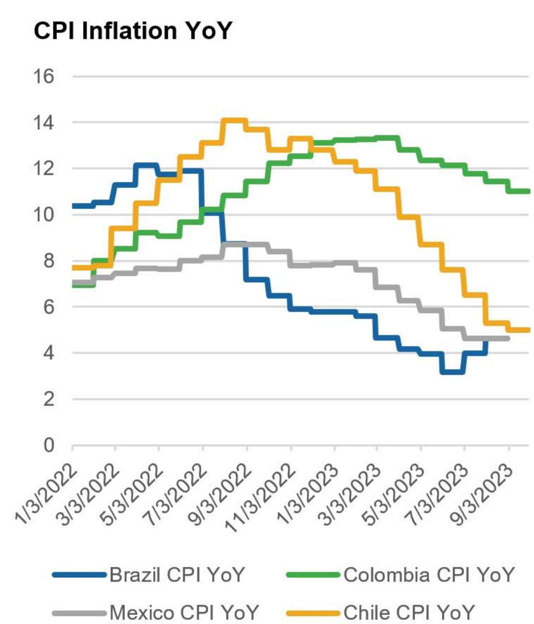
As the Chinese renminbi continued to weaken in the third quarter, additional EM currencies joined the downward trend, particularly Latin America's which had been top performers in previous months. While idiosyncratic factors impact each market, China's disappointing economic data has put incremental pressure on commodity exporting regions when at the same time the US Fed continued to signal higher- for-longer USD rates.



Source: Bloomberg

The softening economic environment along with the decreasing inflationary pressures have allowed central banks, particularly those in Latin America that were early to adopt tight policies in 2021, to announce and/or start to shift to lose monetary policies.

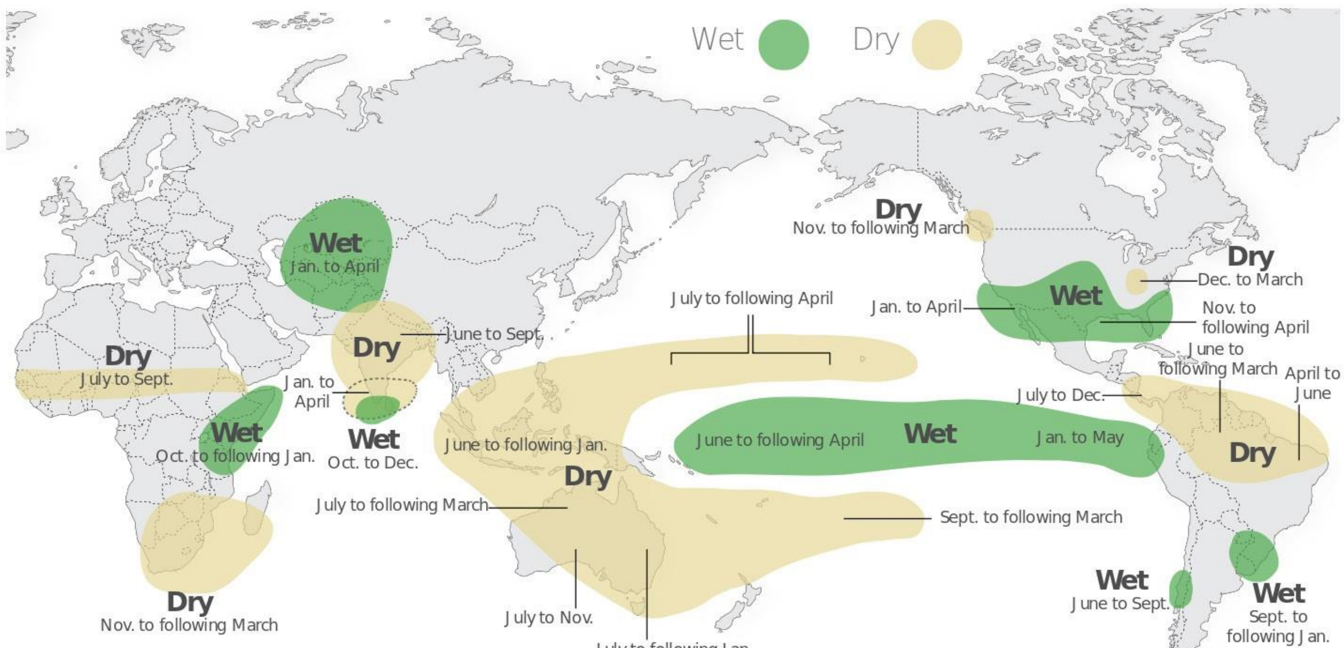




Source: Bloomberg

Nevertheless, EM central banks remain cautious on managing inflation expectations, particularly due to higher oil and food prices that can make a significant share of EM consumer price indexes. Contributing to this effect, specific attention is being placed on El Niño climate pattern as it is expected to impact agricultural activities as well as global trade corridors, among others. At LM Capital, we have been closely monitoring draught conditions and crop yields in order to identify likely beneficiaries of this natural condition.

El Niño typical rainfall impact



Source: Morgan Stanley Research, NOAA Climate.gov.

Political events were most relevant in Latin America with Guatemala overwhelmingly electing the opposition candidate, Bernardo Arevalo, who campaigned on eliminating corruption, while Argentina's primaries evidenced popular support for a right-wing candidate, Javier Milei. BRICS summit in South Africa also made headlines in August as more than 20 nations expressed interest in joining the bloc, including Saudi Arabia.

As we enter the final quarter of 2023, we continue to see attractive yields associated with short-dated high-quality emerging market corporate issuers while the market grapples with increased volatility in the long end of the U.S. Treasury curve.

LM Capital Group Hires Operations Professional

LM Capital Group is pleased to welcome Melissa Goncalves to the firm as an Operations Analyst.

Melissa Goncalves, Operations Analyst, Melissa Goncalves joined LM Capital Group in July 2023. Prior to joining the firm, Ms. Goncalves worked at Silvergate Bank in San Diego as a Lead Wire Operations Analyst, with a focus on Foreign Exchange. Ms. Goncalves has a Bachelor of Science in Economics and Finance from Manhattan College in Riverdale, NY.

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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.

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