LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
3Q 2025

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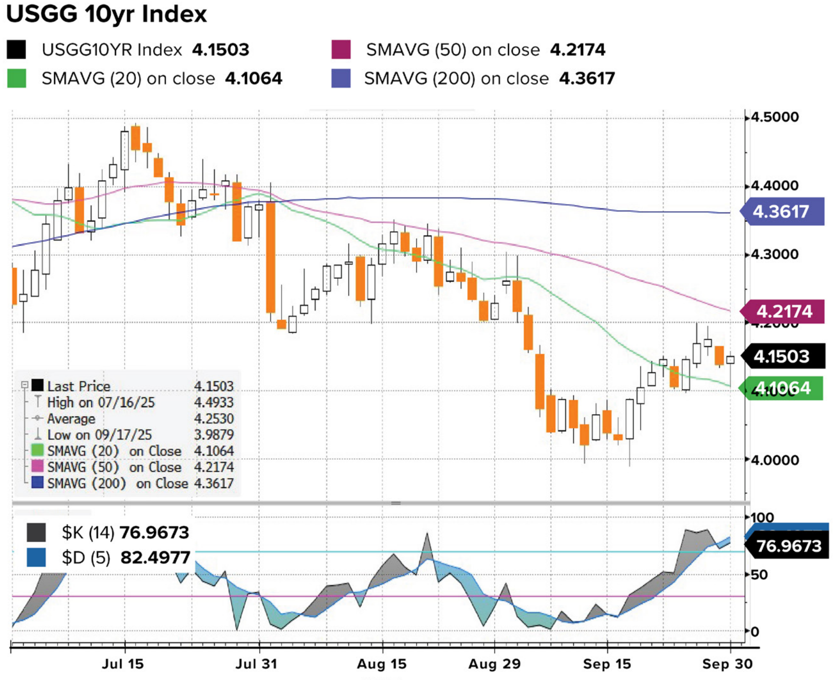
Shock, Slack & Scarcity: Tariff Uncertainty Meets Labor Supply Stress

As immigration enforcement tightens and net foreign labor inflows dwindle, the U.S. labor supply is coming under structural pressure—especially in lower-skill sectors where immigrant labor has historically filled critical gaps. That squeeze is colliding with tariff uncertainty, which is sowing hesitation in hiring and capital investment, thereby signaling potential downstream slack in wages, productivity, and output. In the Treasury markets, we're seeing the tug-of-war play out: front-end yields are pricing in rate cuts in response to weakening labor momentum, while the long end remains elevated, factoring in inflation risk and policy ambiguity. The yield curve is oscillating as markets grapple with the conflict between faltering real growth and sticky inflation pressures. Heightened fiscal and trade uncertainty has further injected a policy term premium, with investors demanding incremental compensation for the risks baked into forward expectations.

Quarter in Review

The 10-year Treasury began the quarter at ~4.28 % and pushed higher, cresting near ~4.49 % on July 16, 2025. As the "Liberation Day" tariffs reverberated through the economy, incoming data confirmed cracks in the labor market's resilience. Within the Fed, divisions widened: some officials argued for preemptive rate cuts to prevent labor deterioration, others cautioned that loosening too soon risks reigniting inflation. The market ultimately leaned dovish, triggering a pronounced bull steepening rally in Treasury yields. That rally ran into resistance at the most recent FOMC meeting, where hawkish comments from Chair Powell sent front-end rates spiking, ultimately leaving the 10-year yield at ~4.15 % to close out the quarter.

USGG 10yr Index



Source: Bloomberg

Meanwhile, the U.S. dollar—after a rough Q2—held mostly steady, trapped within a ~1 % trading band. Credit markets continued their narrowing march: both investment grade and high yield spreads edged toward all-time tights. Mortgage spreads tightened in Q3 as volatility receded, risk premia compressed, and investor demand for MBS strengthened, dragging mortgage spreads tighter. Sector returns were strong: High Yield (+2.54 %), Emerging Market Debt (+3.40 %), U.S. IG (+2.60 %), and MBS (+2.43 %) all outpaced the broader Barclays U.S. Aggregate Index (+2.03 %). Treasuries lagged at +1.51 %, and the Non-Dollar index posted –0.59 %.

Market Outlook

The central question for markets this year has been whether the Federal Reserve will be more worried about inflation or about the jobs outlook. Recent data suggests that the Fed will focus on jobs. At the moment, the market is expecting two more cuts in the Fed Funds rate this year. Although discussion regarding inflationary pressures, including any tariff-driven inflation, will continue, we believe that inflation fears will take a backseat to jobs data in moving the market.

As this is being written, the federal government is largely shut down. The timely release of the monthly economic data that comes from the federal government will be delayed until the shutdown is over. The market does not care at the moment, but we expect that to change if the shutdown continues for several weeks.

For October, we are maintaining our cautious stance, with portfolio durations close to those of the benchmark indices. Durations are generally 2-5% short of the benchmark indices, and, where appropriate, we remain underweight in long-duration credit exposure by favoring U.S. Agency MBS sector exposure instead. We are positioned for a steepening of the US Treasury yield curve, with the difference between short-term and long-term rates becoming greater.

In accounts that have a benchmark that includes 30-year US Treasuries, we remain significantly underweight in the 30-year bucket of the benchmark. We have long seen that there is something special about the 30-year bond that allows its yield to be lower than expected by a rational long-term investor. We are now adding non-dollar-denominated debt in accounts that include that sector in their mandates.

We remain positioned for a range-bound market but think that the market is too complacent. The market seems to focus on any sign of economic weakness and downplays any sign of economic strength. Despite the recent focus on job creation, few market participants seem worried about a recession. The bottomless market appetite to buy corporate credit and capture 5% or 7% yields is being mistaken for a sign from the heavens that there is nothing to worry about in this asset class. With the expectation of lower Fed Funds rates, and therefore lower money market rates in the future, it makes partial sense that this is happening. What does not make sense about this is that the prices being paid for corporate bonds seem to ignore the risk inherent in corporate bonds.

We expect positive fixed income returns over the next several months. October will provide greater insight into the economy's reaction to the new fiscal policy, tariffs, federal budget deficits, and tax cuts. What could go wrong? If there is a whiff of fear in credit markets, we expect it to be largely offset by lower rates in the US Treasury market.

Absent an unforeseen catalyst, we do not expect to make significant changes to our portfolio positioning. However, what appears to be market complacency is worrying and remains one of our chief concerns. We continue to expect a clearer picture of the economy and interest rates to emerge later in the year.

Emerging Markets 3Q 2025 Review

Pablo Barrientos

Senior Credit Analyst

EM debt bond spreads continued to tighten throughout the third quarter of 2025, driven by reduced tariff uncertainty amid ongoing U.S. trade negotiations. However, outcomes remain fluid for key economies like India and Brazil, where discussions on tariffs and trade policies are still evolving. Beyond U.S.-related developments, positive momentum emerged from South America's Mercosur bloc and the European Union, which advanced talks on a new trade agreement aimed at boosting cross-regional flows.

Investor inflows into EM debt funds—covering both hard-currency and local-currency denominations—remained positive in Q3, though the pace moderated compared to Q2's record growth in local-currency funds. This slowdown reflects a more cautious global sentiment amid shifting interest rate expectations.

JPM EMBI

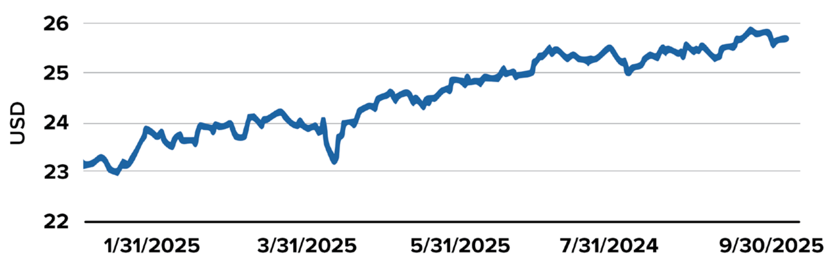
Source: Bloomberg

	9/25	8/25	7/25	6/25	5/25	4/25	3/25	2/25	1/25
EM Sovereign Credit	2,104.7	361.0	-1,460.7	1,257.6	-39.4	-1,771.9	-855.6	614.0	-784.3
EM Local Government	-159.3	262.5	456.5	1,468.8	392.0	-301.6	446.6	-80.2	-27.9
EM Corporate	16.6	17.5	20.6	28.3	-13.7	-39.8	-1.2	46.1	8.5
EM Credit	35.4	45.9	35.4	-85.4	29.7	-43.8	-128.0	48.6	-26.9

Source Bloomberg ETF Fund Flows

Inflation stayed stable across most EM countries, enabling several central banks to ease monetary policy. Notable rate cuts included those by Mexico's Banxico and Indonesia's Bank Indonesia, alongside similar moves in other markets. These actions supported bond performance but led to a relatively modest outperformance by local-currency bonds, as lower yields tempered gains.

EMLC (Vaneck JPM EM LCY)



Source: Bloomberg

In particular, we maintain a positive outlook on the Chilean peso, fueled by momentum ahead of the November 16, 2025, presidential elections. Polls show right-wing candidates, including José Antonio Kast, gaining traction on issues like security and economic stability, potentially signaling a shift from the current leftist administration. Additionally, copper prices trended upward due to supply disruptions, such as the major accident at Freeport-McMoRan's Grasberg mine in Indonesia, which tightened global supply and is projected to create a 400,000-tonne copper deficit in 2025.

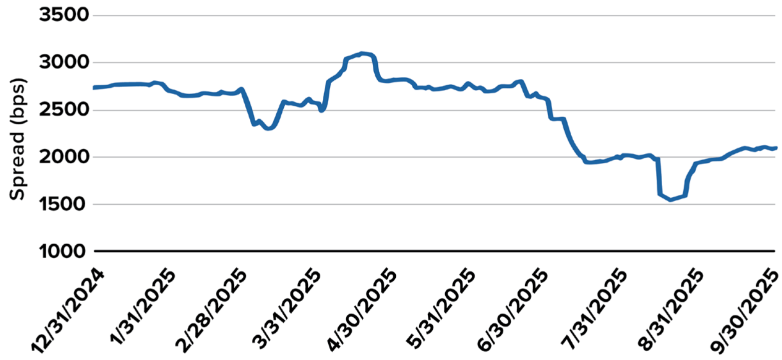
CLP/USD

Source: Bloomberg

As for other notable elections, Bolivia's August 2025 first round of presidential elections marked a pivotal shift, with voters advancing two pro-business candidates—centrist Senator Rodrigo Paz and conservative former President Jorge "Tuto" Quiroga—to an October 19 runoff. This ended over two decades of socialist dominance under the MAS party. While social unrest risks persist, an improved rule-of-law environment could open opportunities in Bolivia's sovereign external debt. We will monitor the runoff closely for potential investment signals.

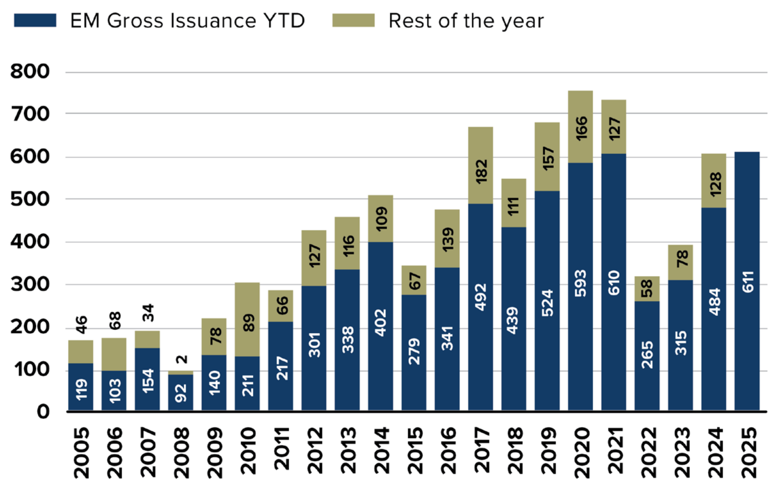
Primary markets stayed active, dominated by liability management transactions across the credit spectrum. Year-to-date issuance reached historical highs, reflecting issuer confidence and investor appetite for EM opportunities despite tightening spreads.

BOLIVI 2028



Source: Bloomberg

EM sovereign and corporate gross supply (US$bn)



Source: Bloomberg

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