LM Capital Group Perspectives

Investment Insights
2Q 2026

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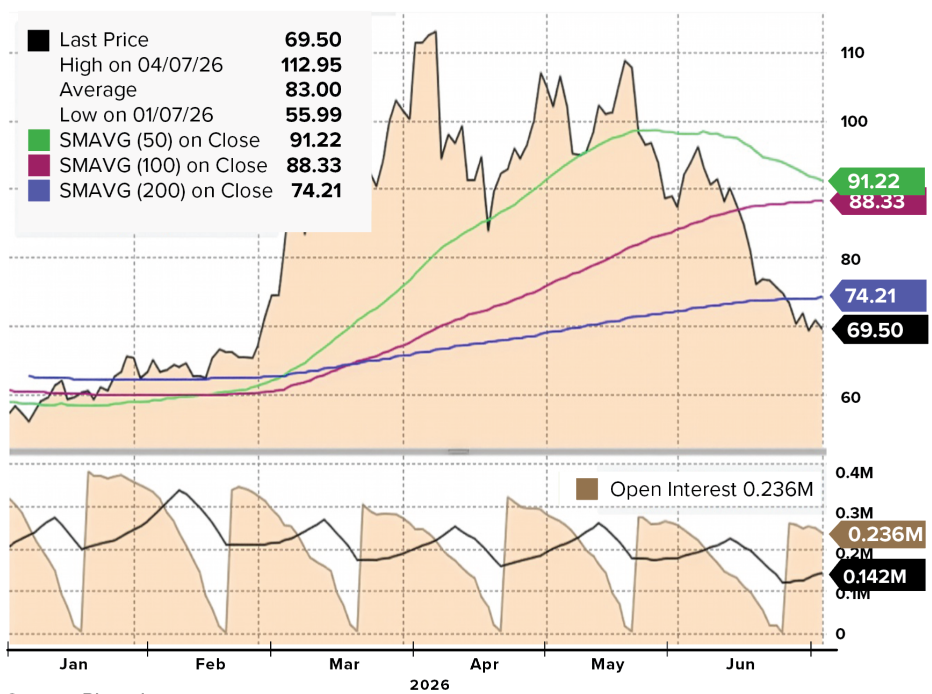
Energy Market Volatility – Here to Stay?

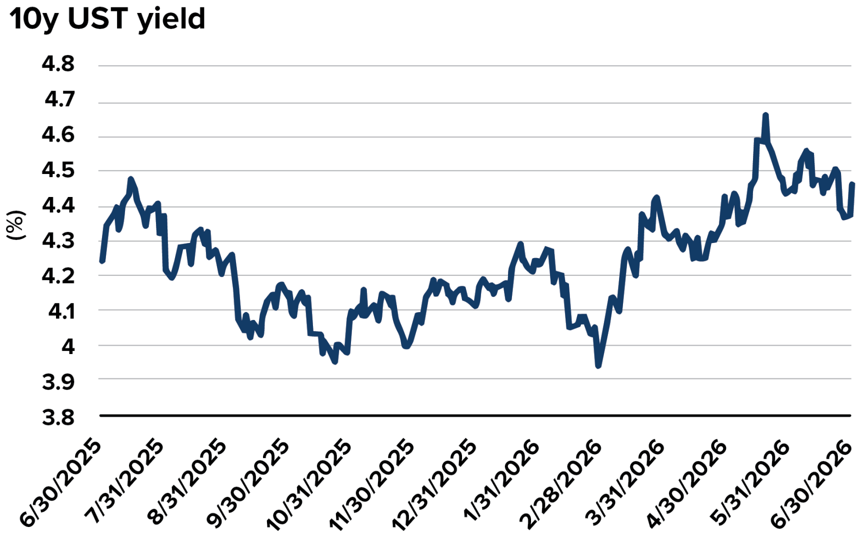
In the second quarter, geopolitics and technology continued to dominate market movements. Risk sentiment turned decisively positive as the war in Iran began to de-escalate and crude prices started to fall after peaking at $120 per barrel in April. Most commodities faced a strong headwind over the last three months until a memorandum of understanding was signed between the US and Iran - initially helping to significantly ease pricing pressures - but with both sides wavering on their commitment's, energy markets remained volatile for the entire month of May. As talks around the reopening of the Strait of Hormuz continued, hopes of easing the supply disruption in energy markets helped oil fall almost 40% from the highs and continued to subside throughout the month of June. Gold and precious metals also fell significantly as the currency debasement trade lost further momentum.



Source: Bloomberg

Treasury yields stayed relatively flat during the quarter as consumer prices rose by 0.5% in May, resulting in a year-over-year increase of 4.2% - still nowhere close to the FOMCs 2% goal. Most of this gain was due to a 7% jump in gasoline prices but the expectation is that falling oil prices should lower price pressures in the coming months. Currently, there is little evidence that higher inflation is feeding through to higher wages, despite a relatively tight labor market with an unemployment rate of 4.3% and healthy private payroll growth reported during the quarter, with average hourly earnings for all workers rose just 3.5% in May.

On the monetary policy front, we got our first glimpse of the new Federal Reserve regime as Chair Warsh held his first meeting and press conference. The March 18th meeting held a few surprises though, as a number of the FOMC members were decisively more hawkish, expecting two hikes before the year is over while the Committee held interest rates at 3.50%–3.75% at the meeting. Markets have since continued to attempt to reprice expectations but it is clear that rate market volatility is going to be a persistent thematic under his leadership. The sudden removal of any forward guidance on policy decisions introduces more future unknowns to the market and leaves investors in a bit in the dark.



Source: Bloomberg

The US dollar gained 1.23% this quarter, its fourth straight positive quarter as the market reprices inflation expectations and pulling rate hikes forward. The U.S. Treasury (+0.32%), Mortgage-Backed Securities (+0.58%) and Government Agency (+0.39%) sectors lagged the benchmarks total return of +0.67% this quarter. The US Corporate (+1.40%), Emerging Market Debt (+3.42%), High Yield (+2.47%) and Non-Dollar (+0.99%) all beat the benchmarks return.

Market Outlook

The focus of the fixed-income market has shifted from the Middle East back to the US economy. It is too soon to see if there will be any long-lasting inflationary effects from the war. Restocking effects may keep prices elevated. Residual inflation may take a while to work its way out of the economy. For example, oil prices are a bit below the levels from the last business day in February, but gasoline prices nationally are about 29% higher than they were on that day.

The tug of war between jobs and inflation has resumed. Some officials and pundits have declared victory in the war against inflation, but the market consensus is for one rate hike in 2026.

In the long-term, we remain concerned about weaker demand for the US dollar from international investors. Several months ago, this was practically the consensus opinion, but dollar strength has greatly diminished the ranks of believers. The seemingly unlimited appetite of investors for US Treasuries will be tested if international equity investors start to question the AI/data center US growth story.

The US economy appears to be strong, but not too strong. Spending on data centers and the reshoring of manufacturing facilities should support US growth. We worry about possible changes in tariffs and the inflation-fighting commitment of the new Federal Reserve Chair, Kevin Warsh. Mr. Warsh has made it clear that there will be less forward guidance from the Fed. On balance, we think this will cause more uncertainty and volatility in the US bond market.

For June, we are maintaining our cautious stance, with portfolio durations close to those of the benchmark indices. Durations are generally 1-3% shorter than 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 yield curve steepening, despite the recent curve flattening. As inflation appears to be a continuing concern, we maintain exposure to Treasury Inflation-Protected Securities (TIPS). We maintain non-dollar-denominated debt in accounts that include that sector in their mandates, despite temporary headwinds facing many international currencies.

We continue to expect positive fixed-income returns for 2026, dominated by coupon clipping. 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. We believe that the risk of a sudden change in market sentiment is relatively high. We are biased towards adding credit on significant spread widening and changing our key rate duration weightings as the US Treasury market moves.

Emerging Markets 2Q 2026 Review

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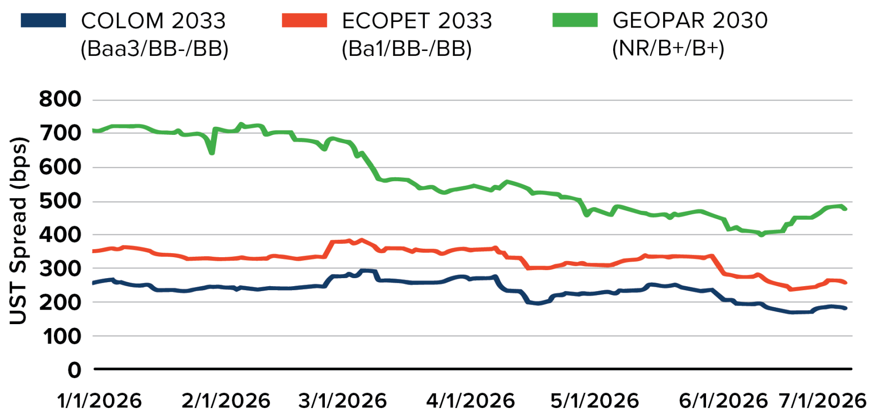
Senior Credit Analyst

Emerging market debt delivered positive, but mixed performance in the second quarter of 2026. Record primary issuance and tight spreads provided tailwinds, but rising U.S. rates, broad EM currency weakness, and political transitions generated volatility. A central theme was political differentiation: right-wing electoral victories in Colombia and Peru lifted sentiment and local assets, while uncertainty around Brazil's upcoming elections and the USMCA process kept markets cautious. Commodity dynamics added another layer, with the Middle East conflict pushing oil prices higher and disproportionately pressuring energy importers.

Right-wing momentum strengthened across key LatAm markets. In Colombia, Abelardo de la Espriella's presidential victory improved investor appetite for local assets and the peso, with markets anticipating a renewed focus on oil and gas exploration that should benefit issuers such as Ecopetrol. Similarly, in Peru, Keiko Fujimori's election—after finishing second in the previous three cycles—reinforced a conservative policy tilt.

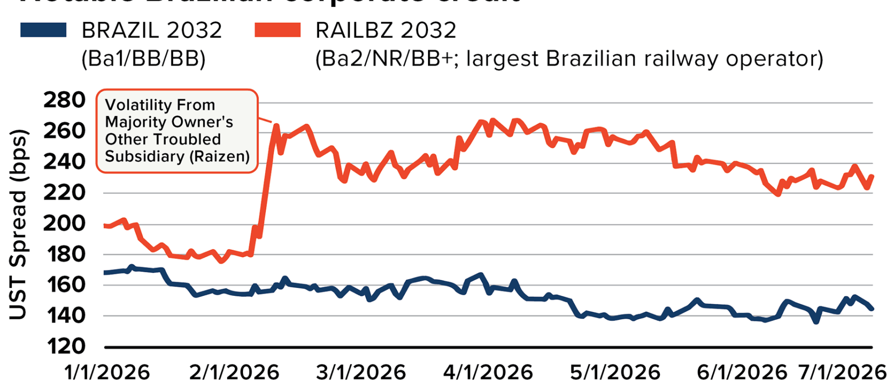
Attention now shifts to Brazil's October presidential election, where momentum appears to be building toward Flavio Bolsonaro, although Lula retains resilient support. This points to continued volatility, but we continue to see selective opportunities in Brazil—particularly in logistics, transportation, and other fundamentally attractive sectors—where market sell-offs can create compelling entry points.

Colombia spreads tighten ahead of election, energy credits still trading at attractive levels



Source: Bloomberg

Notable Brazilian corporate credit



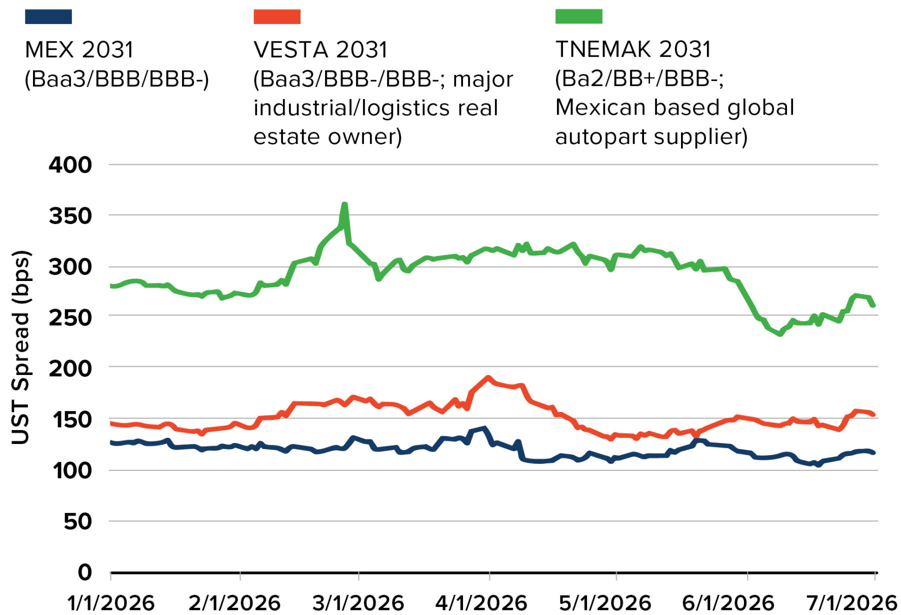
Source: Bloomberg

Trade policy uncertainty added further pressure. The U.S. opted against a full renewal of USMCA, replacing it with a 10-year annual rolling review mechanism. While the agreement remains in force for now, this introduces persistent uncertainty and an implicit threat of significantly higher tariffs on Mexico and Canada should negotiations falter by 2036. Encouragingly, U.S.-Mexico talks are progressing (with the next round scheduled for the week of July 20), covering rules of origin (beyond autos), aerospace, intellectual property, water quality, and alignment on Chinese investment.

Energy markets presented crosscurrents. Net energy exporters recorded strong trade balances, but net oil importers—including India, Romania, and Indonesia—faced rising inflationary and fiscal pressures as higher oil prices widened bond spreads. In Romania, ongoing political volatility — stemming from the prolonged difficulty in forming a stable government after the previous coalition's collapse — has intensified fiscal concerns, pushing sovereign spreads wider relative to similarly rated credits such as Panama. However, recent de-escalation with Iran and increased supply signals—highlighted by the UAE's production intentions after its withdrawal from OPEC—have helped bring energy prices lower, which should gradually improve risk appetite in these vulnerable jurisdictions.

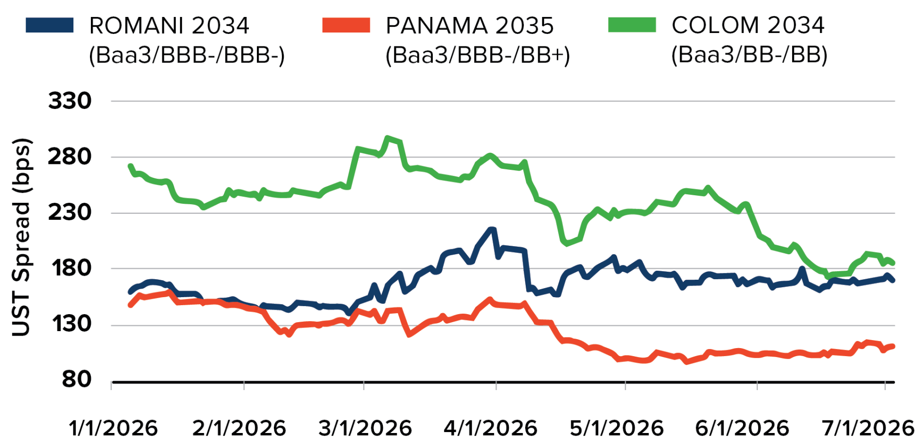
Despite still-elevated EM inflation, most EM currencies erased gains against the USD amid strong U.S. jobs data and sticky core inflation that kept U.S. rates elevated and reduced carry appeal. We remain strategically positioned in the Colombian peso (COP) following the election outcome and in the Chilean peso (CLP), though Chile's weakening economy may exert downward pressure through lower policy rates. Chilean exporters also continue to face headwinds from China's economic slowdown, marked by weak consumption, declining investment, and soft retail sales that have revived stimulus discussions. While industrial production held up better on the back of exports and technology, subdued domestic demand has weighed on sentiment and pushed Hong Kong-listed Chinese equities into bear market territory.

Select Mexican corporates directly tied to USMCA



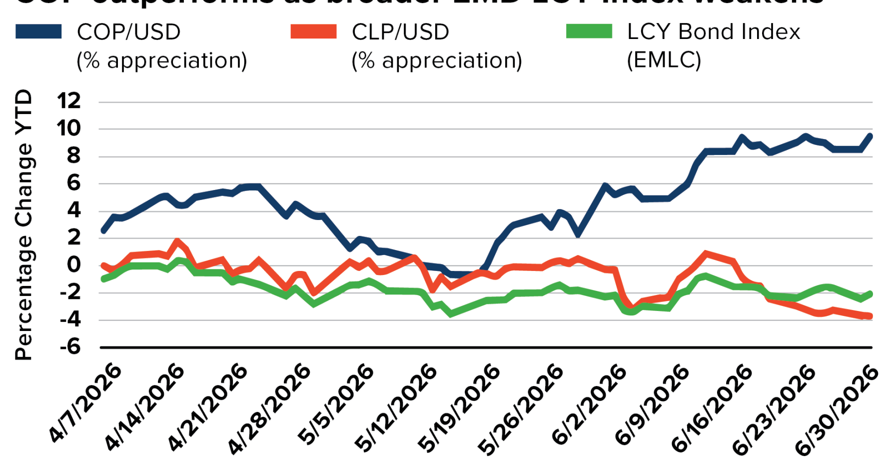
Source: Bloomberg

Romania spreads widening vs. Panama, aligning with Colombia's fiscal profile



Source: Bloomberg

COP outperforms as broader EMD LCY Index weakens

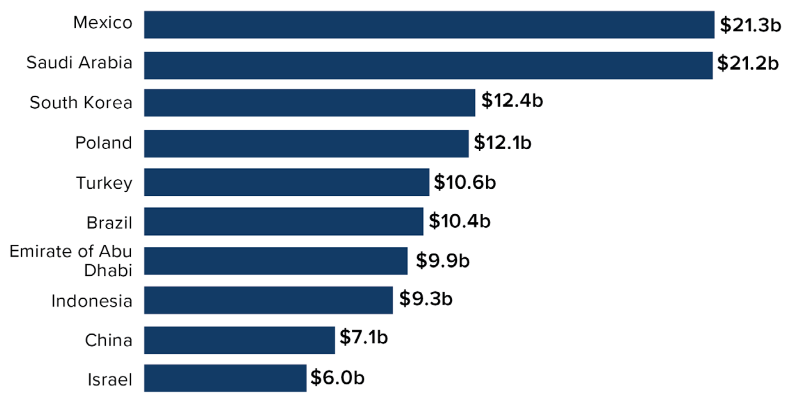


Source: Bloomberg

Issuance remained exceptionally robust. EM issuers placed a record ~$450 billion in international bonds in the first half of 2026 (up 15% YoY), taking advantage of the tightest spreads in nearly two decades. Major borrowers included Mexico, Saudi Arabia, South Korea, Poland, Turkey, and Brazil.

Record sales

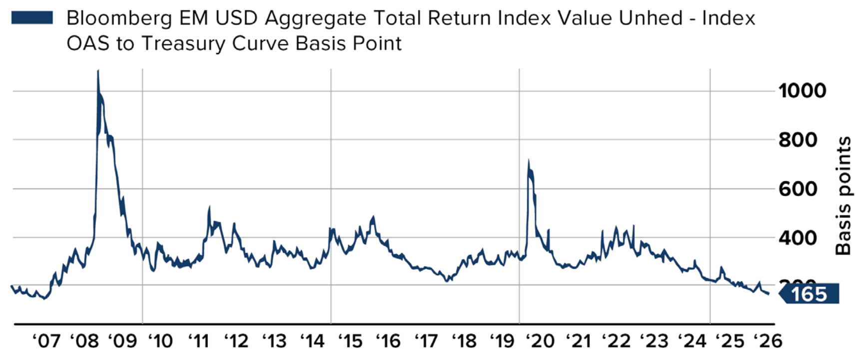
Emerging market bond sales have hit a record in first half of this year



Source: Bloomberg

Post-2007 low

Extra premium EM issuers pay is at the lowest since the global financial crisis



Source: Bloomberg

Looking ahead, several catalysts will shape the 2H outlook:

- Brazil elections (October): Expect volatility, but potential buying opportunities on weakness.
- USMCA rolling talks: Ongoing negotiations will remain a source of uncertainty and tariff risk.
- El Niño effects: Drier conditions across most EM regions, with risks to Colombia's hydroelectric generation and India's sugar cane crop.
- China policy response, oil supply dynamics (including post-OPEC UAE), and selective LatAm reform momentum.

We maintain a constructive but selective stance, favoring high-conviction credits in commodity-exposed jurisdictions showing political continuity or reform progress (e.g., post-election Colombia). We continue to monitor recently volatile markets (Mexico, Brazil, Romania, Indonesia) closely for attractive entry points. Strong liability management and primary market activity should support technicals in fundamentally sound names.

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