LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
2Q 2024

Michael Chalker

Senior Portfolio Manager, Senior Analyst

The Race to Cut Rates

The economic momentum of the first quarter continued through the second as the last three months brought another generally positive period for markets. Initially, investors had dialed back expectations for rate cuts as the quarter began with some strong economic data. After the initial pick-up in April, US economic data softened over the quarter and has generally been coming in below consensus since early May. As this data returned to a more balanced profile - no immediate signs of overheating, no immediate signs of recession - soft-landing hopes returned with the market pricing in a high chance of at least one cut before year end. Despite all this, the FOMC struck a hawkish tone at its June conference with all but one cut being removed from the 2024 dot plot projections. That said, soft US consumer data meant that investors continued to be slightly more hopeful for policy easing.

The European Central Bank (ECB) became the latest developed market central bank to cut interest rates in early June. This move was heavily signaled prior to the meeting but stickier-than expected services inflation meant that the ECB was keen to stress that the path to any further policy normalization is heavily data dependent. Despite the lowering of policy rates, the fallout from both the European parliamentary elections and the announcement of snap French elections meant that European sovereign yields rose, delivering negative returns over the quarter.

Similarly, sticky services inflation dashed hopes of a June rate cut in the UK, despite the Bank of England (BoE) signaling it could have been an option. Supportive base effects meant UK headline inflation returned temporarily to target in June but the drop in inflation was widely expected. A series of strong wage prints plus a forecast reacceleration in inflation meant the BoE felt unable to cut rates, though they did leave open the possibility of a move in August.

Quarter in Review

The 10yr Treasury began the quarter at 4.20% and wavered between the respected general range of 4.20% to 4.70% all quarter long depending on data and Fed activity and ultimately finished at 4.40%. It was a fairly quiet quarter in terms of volume and volatility, especially during the back half of the quarter. The US Dollar finished another quarter with a positive return at +1.32%. Spreads on all sectors within the corporate landscape finished the quarter generally wider though they were tighter through the first two months before widening in June. Within the credit subsectors, industrials and utilities underperformed financials this quarter significantly once again as the financial

sectors lower duration benefited. Additionally, lower rated credits outperformed higher rated ones and longer securities in both the Treasury and corporate space underperformed shorter ones significantly from a total return standpoint once again this quarter.

The High Yield (+1.09%), Emerging Market Debt (+0.68%), US Treasury (+0.10%), Government Agency Securities (+0.76%) and Non-Dollar (+0.11%) sectors outperformed the broader Barclays US Aggregate Index's return of +0.07% on the quarter. The Corporate (-0.09%) and Mortgage-Backed Securities (+0.06%) sectors underperformed the broader index's return.

USGG 10yr Index

USGG10YR Index **4.3961** | SMAVG (200) on close **4.3539** | LBB (2) **4.1539**
SMAVG (20) on close **4.3186** | UBB (2) **4.4832**
SMAVG (50) on close **4.4445** | BollMA (20) on close **4.3186**

Source: Bloomberg

Market Outlook

Our view remains unchanged that inflation will be more difficult to push toward the Fed's 2.00% target in 2024. Our proprietary Trend Identification Score remains slightly bearish, calling for slightly short duration and defensive positioning. Our outlook remains "higher for longer", implying that we are at the end of the Fed's rate hiking cycle but nowhere near the start of a continuous decline in the Fed Funds rate.

The US Dollar remained strong versus most currencies this quarter, reversing the earlier weakness though select opportunities are beginning to appear in the non-Dollar bond market. Our positioning favors a stabilizing move in rates in the near term and no rate cut by the FOMC in the immediate future. We are also cautious regarding the historically tight spreads in investment grade corporates, especially in the longer maturity paper. We remain underweight in US Treasuries and slightly overweight in investment grade corporates, avoiding longer maturities. Our MBS positioning favors higher coupon securities and is slightly overweight the index. In the Core Plus strategies, we have slightly increased our position in select EMD securities and placed a few quick trades in multiple currencies that all produced favorable returns.

We continue to believe that interest rates have peaked for this cycle. We revisited our duration and sector allocation positioning based upon our recent Trend Score and made no meaningful changes to our portfolio positioning. We expect 2024 to be a year where fixed income returns will be positive and while markets may have a very quiet summer, the expected return of more volatility ahead of the upcoming Presidential elections is sure to be around the bend.

Corporate credit and the prospective financing environment

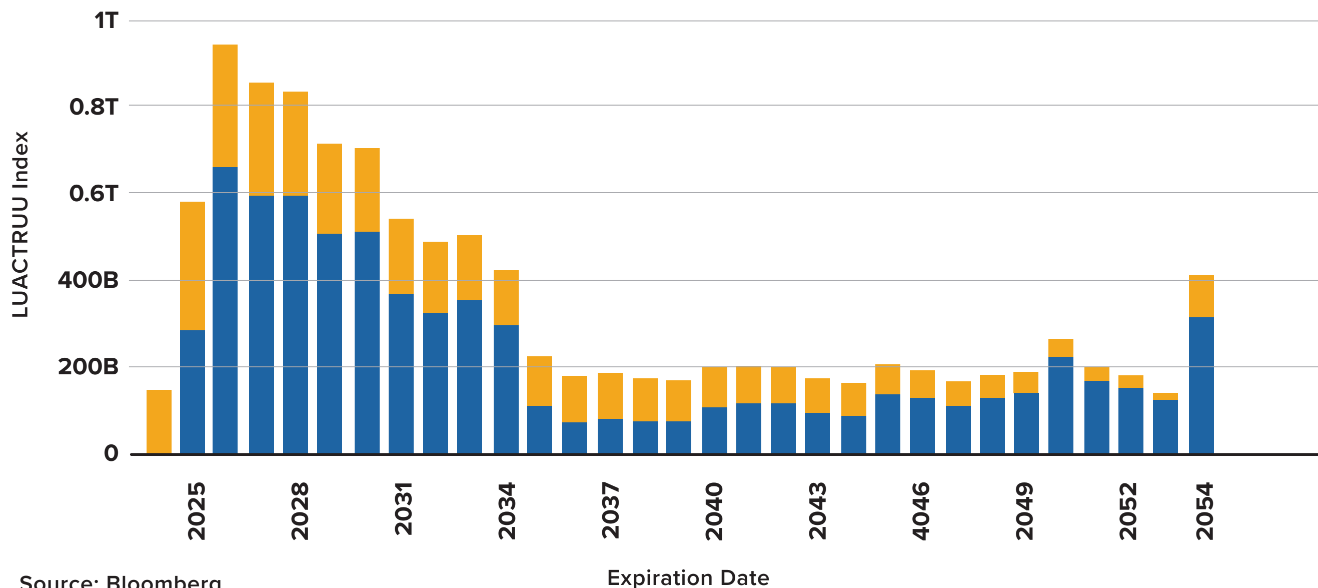
Frank Hacklander, CFA

Senior Credit Analyst

The current corporate financing environment has seen sustained new issuance as both high yield and investment grade issuers have accessed the marketplace. Year-to-date, high yield issuers have priced $223.6 billion in debt with an average coupon of 7.67% while investment grade issuers priced $1,075.1 billion in debt with an average coupon of 5.35%. These rates are significantly greater than found in the two of the indices we use to gauge our performance, namely, the Bloomberg US Corporate High Yield Index and the Bloomberg US Corporate Investment Grade Index. An interesting function available in each shows the distribution of forthcoming maturities.

Maturities are important because they provide a gauge of future capital markets activity and are generally referred to as the financing wall. Why is this financing wall important? The usual assumption is that capital markets will function normally and that capital will be readily available albeit at a price. On those occasions when the debt markets have closed and access was limited, most notably in the high yield market, would-be issuers had to "pay up" or find alternative sources of capital. Year-to-date borrowing costs clearly have increased and prospects for increased rates are clearly in the offing. The prospect of larger federal deficits (the crowding out hypothesis) may also exacerbate future corporate borrowing costs. The burden imposed by the increasing cost of funds could result in a worsening of corporate credit.

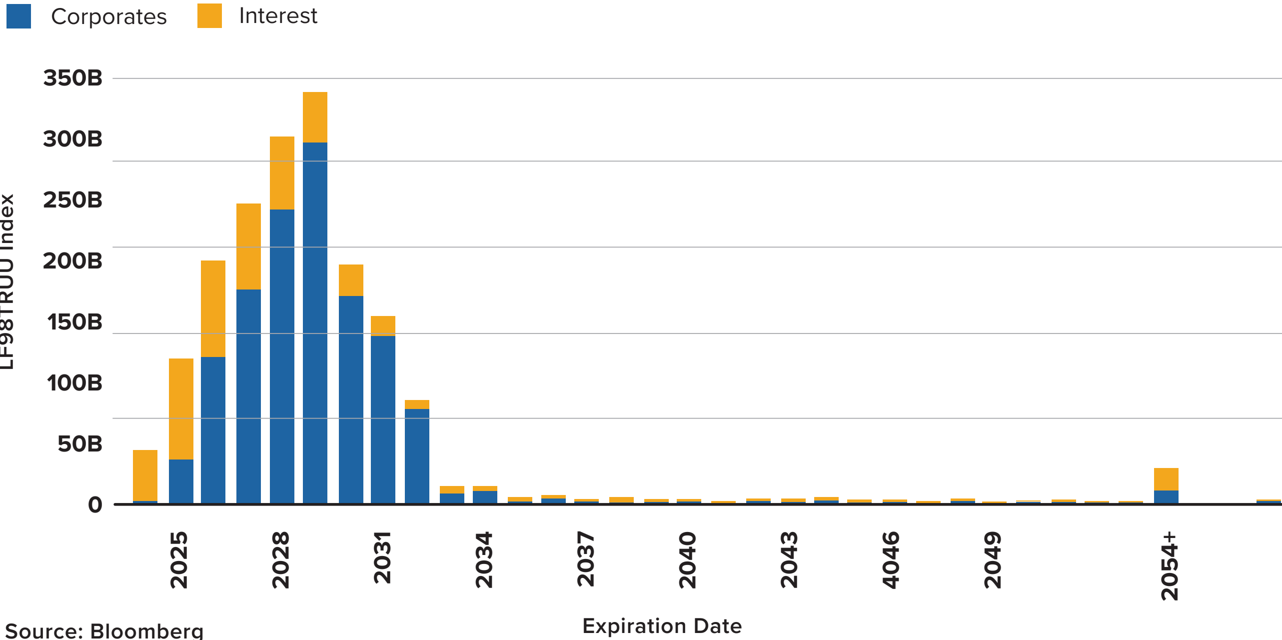
With respect to investment grade securities, prospective maturities are reflected in the Bloomberg chart below:



Source: Bloomberg

Note that the weighted average fixed coupon for this index was 4.2%, or more than 1.1% less than the average fixed coupon for bonds issued this year. Through 2027, some 22% of total outstanding investment grade debt will need to be refinanced at what will likely be much higher rates. Including the rump amount still outstanding that will need to be refinanced in what remains of 2024, over $1.5 trillion will need to be refinanced through 2027. This prospective issuance suggests that the investment grade market will remain vibrant. The question that this analysis does not answer is at what will be the cost of this debt. Arguably, the trend this year suggests that the price of debt for investment grade companies will remain elevated compared to years past even if spreads remain as tight as they have been recently.

In the high yield market, the following Bloomberg chart provides an indication of forthcoming maturities:



From the above, it appears that the peak refinancing year for high yield will be 2029. That said, on a cumulative basis, through 2027, some 25% of outstanding high yield debt will have to be refinanced which amounts to approximately $335.1 billion. With the new issue market this year having a weighted average coupon of 7.67% as compared to the average weighted average coupon of 6.3% for the existing outstanding debt, it appears that high yield issuers should also anticipate significant increases in their financing costs. Despite such expected increases in financing costs, we do not expect that issuers will choose to refinance their high yield debt with bank debt given the typically stricter covenants and security requirements of such debt.

Our key takeaways are as follows:

- Financing costs have increased this year. The potential for future increases exists.
- While costs have increased, we do not expect significant deterioration in credit quality.
- There are significant investment grade maturities through 2027 that must be addressed while the peak for high yield maturities is in 2029.
- At this juncture, credit markets remain constructive.

Emerging Markets 2Q 2024 Review

Pablo Barrientos

Senior Credit Analyst

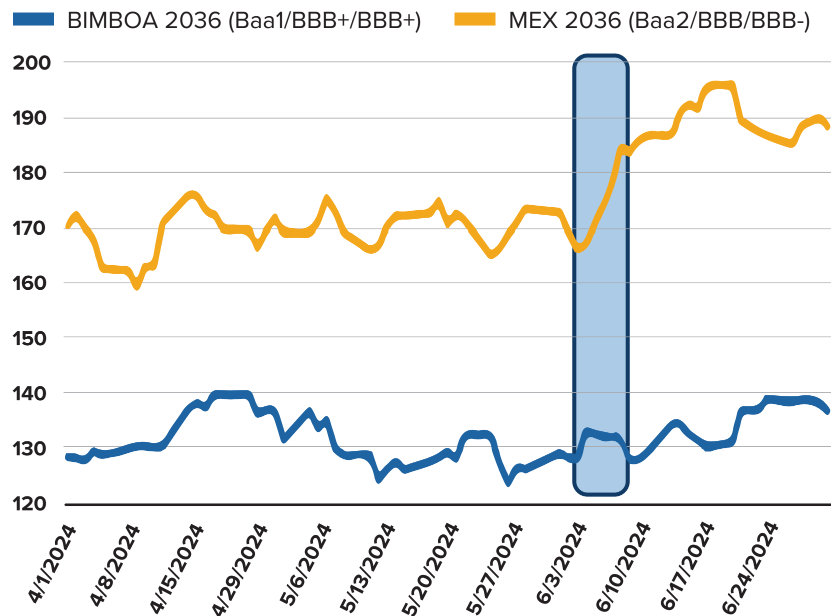
Presidential/parliamentary elections in Emerging Markets affected the macroeconomic landscape in 2Q 2024, particularly in Panama, Mexico and India.

Panama: while markets were generally concerned on the outcome of presidential elections given the uncertainty around the legitimacy of the front-running candidate Jose Mulino, we remained positive given the similarity of economic views from the top candidates as well as an increasing recovery of Panama Canal operations due to stronger than anticipated rainfall. Panamanian courts approved Mulino's candidacy and as expected, he won the May 5th elections. The business-friendly president-elect proceeded to emphasize the importance of regaining investor confidence, particularly following the recent closure of First Quantum's copper mine, reaffirming our views that Panama will seek a resolution that is positive for domestic and international stakeholders. We continue to favor Panama sovereign bonds as well as debt from select corporate and quasi-sovereign issuers.

Mexico: while the presidential election results were no surprise to most, the overwhelming win by the ruling party Morena (winning a super majority in the lower house and almost achieving a super majority in the upper house) increased concerns regarding the current president's ability to enact certain controversial measures. For example, given that the new legislature takes office one month before the new president (Sep 1 vs Oct 1), the current executive, AMLO, is expected to address ostensible reforms rebuffed by a divided congress. The key issue is a proposed switch in how judges are selected, namely shifting from the nomination of judges by the president to popular election, including the election of justices of the supreme court. Mexican markets have reacted negatively to this and other proposals, with the fallout affecting both the Mexican peso and government bond spreads.

Despite these machinations by AMLO, we remain constructive on Mexico's macro fundamentals given that the incoming president seems to be making strong cabinet appointments designed to buoy the confidence of domestic and foreign investors. One important subject that Sheinbaum will need to address in more detail is the energy situation in Mexico. While the travails of Pemex are well-known, the country also faces challenges with respect to power generation and distribution. The scale of investment required to solve these challenges will require a resolution of the debate regarding the country's "energy sovereignty" and the role of foreign investment in this critical sector.

In terms of our portfolio positioning, we have kept our focus on corporates that have global operations/hard currency revenues and/or have an idiosyncratic credit story that we can take advantage of (e.g., Mexican multinational food company Grupo Bimbo).



India: following a month-long election process that expected to result in a landslide victory for Modi's BJP party on its own, markets were surprised that the BJP fell short of expectations and required support from allied parties in order to maintain power. While international demand for Indian assets has not been diminished, political dialogue is expected to gain a more relevant role in pushing forward with Modi's ambitious agenda that has turned India into the fastest growing economy in the world. Accordingly, we remain positive on India and have been supportive of the increasing supply of corporate debt, primarily denominated in USD from companies that have global operations and/or are protected against a rising Rupee.

Another theme across emerging markets is central banks monetary policy divergence. While many economies had started to cut rates before 2Q, central banks continue to balance loosening monetary conditions and political pressures with addressing recent signs of inflation stalling above target levels and, in some cases, reversing the downward trend (e.g., Chile).

These policy dynamics along with specific country fundamentals, mainly in Latin America where rates of the top economies reached over 10%, have presented windows to opportunistically invest in local currency debt instruments. Currently we are closely monitoring the Chilean peso as we analyze copper price fundamentals and domestic economy dynamics, the Mexican peso following the post-election sell-off, which we think can continue throughout 2H 2024, as well as the Brazilian real that keeps being impacted by concerns on the government's fiscal balance approach.

As we look toward the rest of the year, in addition to focusing on the US elections impact on global markets, we expect US interest rates to remain volatile as survey data and labor statistics show mixed results that on the margin are putting soft landing at risk.

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750 B Street, Suite 3010, San Diego, CA 92101
info@lmcapital.com | 619-814-1401

www.lmcapital.com

For more information please contact

Cheryl King
Senior Vice President -
Business Development
415-215-8882

Gerry Dodd
Senior Vice President -
Business Development
817-538-4315

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