LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

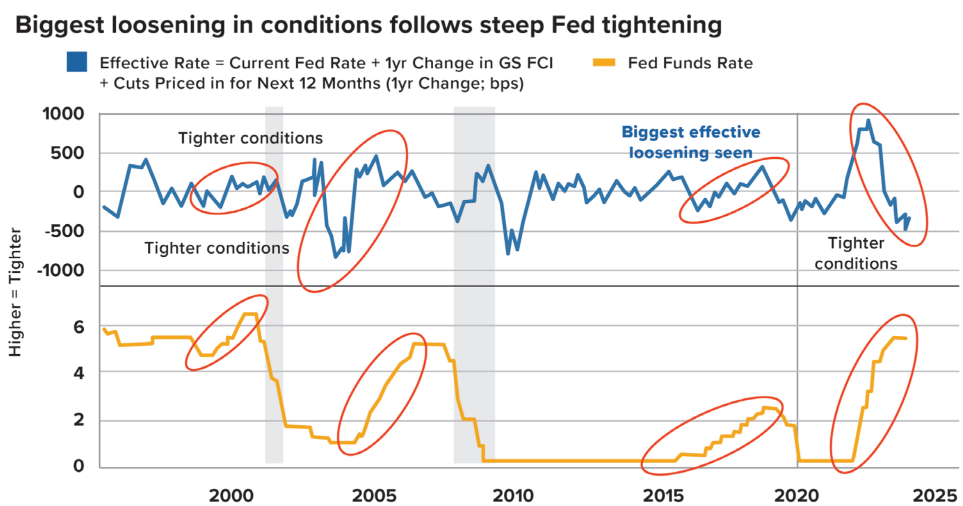
# LM Capital Group Perspectives
Investment Insights
1Q 2024


**Michael Chalker**

Senior Portfolio Manager, Senior Analyst


## Here No More - The Dovish Pivot that Came and Went

Resilient economic data helped investors get into the Spring spirit during the first quarter of 2024. The US economy grew more than expected during Q4 2023 and survey data from the composite Purchasing Managers' Index (PMI) remained firmly in expansionary territory, boosting investor sentiment. The labor market remains historically tight as evidenced by strong wage growth, however some data can be interpreted to signal that the labor market is weakening slightly. Inflationary pressures appear contained despite a disrupted global supply chain with choke points in the Red Sea, the Panama Canal and Baltimore Harbor. Macroeconomic data elsewhere around the world also showed encouraging signs, further supporting the prospect of a soft landing. In the EU and the UK, we continue to expect that recessionary pressures will force their rates lower before the FOMC begins cutting rates in the US.



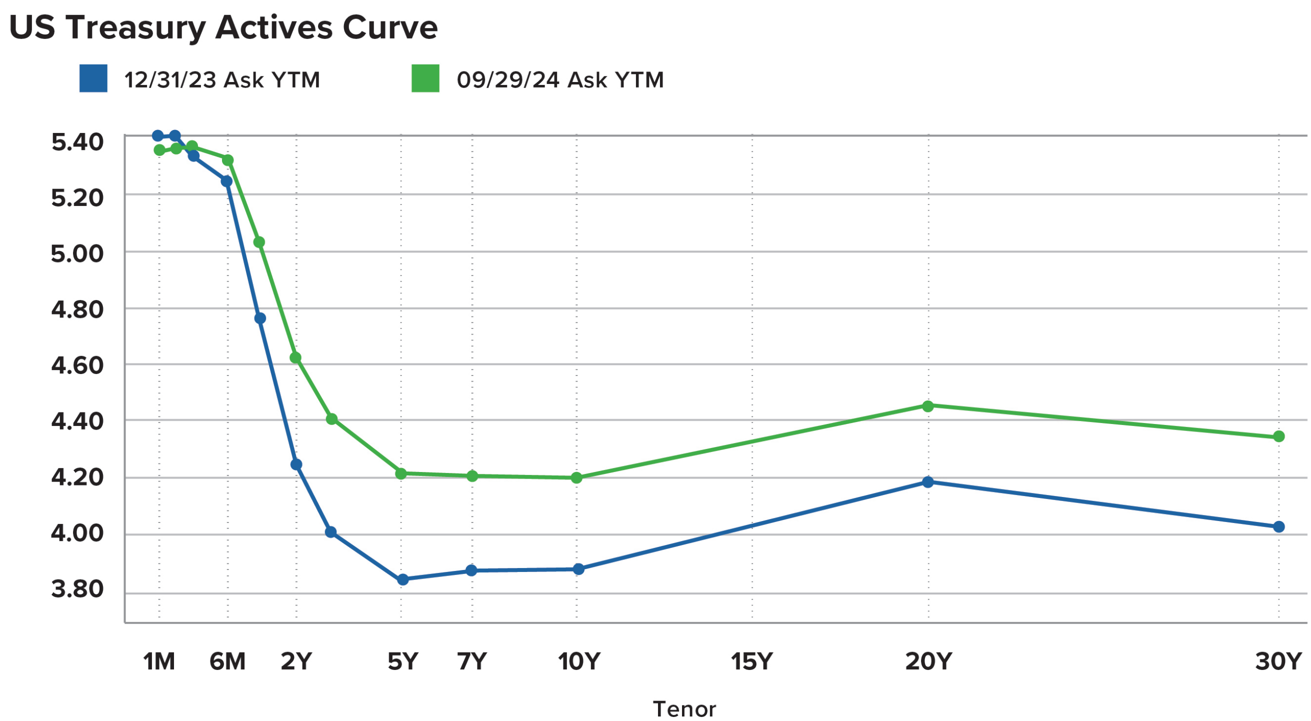

Source: Bloomberg: Macrobond

So what was that Dovish pivot excitement all about last quarter? The market getting too far ahead of itself? Wishful thinking? Regardless, I think many of us are glad this quarter brought back a sense of reality to the inflation battle the FOMC continues to fight. If we look at the chart to the right it shows the Effective Fed Rate: the policy rate, plus its expected change over the next year, plus the one-year change in Goldman Sachs' Financial Conditions Index, which is calibrated to convert the move in stocks, equity volatility, credit spreads and so on to an equivalent change in the Fed's rate. As we can see, in the three prior rate-hiking cycles the Effective Rate tightened - this time the rate has loosened by more than any other time in at least 30 years. It is against this backdrop the Fed's pivot in December is even more inexplicable. By then it had become clear that a US recession was not imminent, yet Powell did not push back on the over six cuts that were priced in for 2024. Those six cuts disappeared quickly this past quarter.

## Quarter in Review

A sense of proper rationale returned to the markets this quarter, after frustrating a good number of fixed income investors at the end of last year. Stickier inflation prints, resilient economic activity, and the FOMC backpedaling on its dovish December tone, combined to drive negative returns for bonds this quarter. The shift in the macro backdrop was also reflected in market expectations for interest rate cuts, where the implied number of US rate cuts for 2024 reduced from cuts to no more than three rate cuts in total, starting in the summer. Today's market pricing is now broadly in line with the Fed's latest dot plot as published in March. All in all, fixed income markets are more fairly priced today than at the end of 2023 and appear well positioned to help cushion portfolio performance in the case of an adverse growth shock. As was written in last quarters commentary, we believe it's still possible to have a type of "Goldilocks" scenario where the economy continues to grow, the job market doesn't soften significantly, and inflation subsides – though the inflation factor has proved to be "stickier" in recent months prints and will likely require the FOMC to hold rates higher for longer, as we've predicted for almost a year now.

The 10yr Treasury began the quarter at 3.88% and started off heading higher but encountered a few reversal periods as it searched for an overall trend. It ended up finishing higher at 4.20%, right within an area we feel appropriate as we see the range of 4% to 4.50% to be respected in the near term. Within credit, high yield outperformed investment grade thanks to its lower interest rate sensitivity and easier financial conditions. The US Dollar finished much higher this quarter on the backs as last quarter's pivot to supposed looser policies was erased and reality returned to strengthen the currency. Spreads continue their relentless grind tighter, even as the quarter set a record for the amount of new corporate issuance. Spreads on all sectors within the corporate landscape finished the quarter significantly tighter. Within the credit subsectors, industrials and utilities underperformed financials this quarter as the financial sectors higher yields were in favor as the curve moved higher. Longer securities in both the Treasury and corporate space outperformed shorter ones significantly from a total return standpoint.




Source: Bloomberg

The High Yield (+1.50%), Emerging Market Debt (+1.55%), Corporate (-0.40%), US Treasury (-0.96%), Government Agency Securities (+0.08%) sectors outperformed the broader Barclays US Aggregate Index's return of -0.78% on the quarter. The Non-Dollar (-3.21%) and Mortgage-Backed Securities (-1.04%) sectors underperformed the broader index's return.

# Market Outlook

The major change in the market outlook since February is the uncertainty surrounding the timing of the FOMC's first rate cut. The FOMC had signaled that the next move in rates would most likely be a rate cut but they would not commit to a specific timeline, thus providing uncertainty to a disappointed fixed income market expecting a March rate cut. The possibility of no rate cut in 2024 has been mentioned in recent Fed speak. 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 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 decline in the Fed Funds rate. In February we saw the market reverse course as both the timing and size of any rate cuts were pushed further into the future and reduced in size; this behavior reversed in March as all fixed income sectors rallied strongly.

The US Dollar remained strong versus most currencies in February, reversing the earlier weakness, but 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 while avoiding the 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. We continue to believe that short term interest rates have peaked. We revisited our duration and sector allocation positioning based upon our recent Trend Score and made no meaningful changes to our portfolio positioning in March. We continue to expect 2024 to be a year where fixed income returns will be positive despite a negative return year to date, and markets will be less volatile following two years of very volatile results. Finally, we must closely watch the activity in Washington D.C. and the electoral process which may be the source of unforeseen tail risk in this election year.


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

Portfolio Manager, Senior Analyst



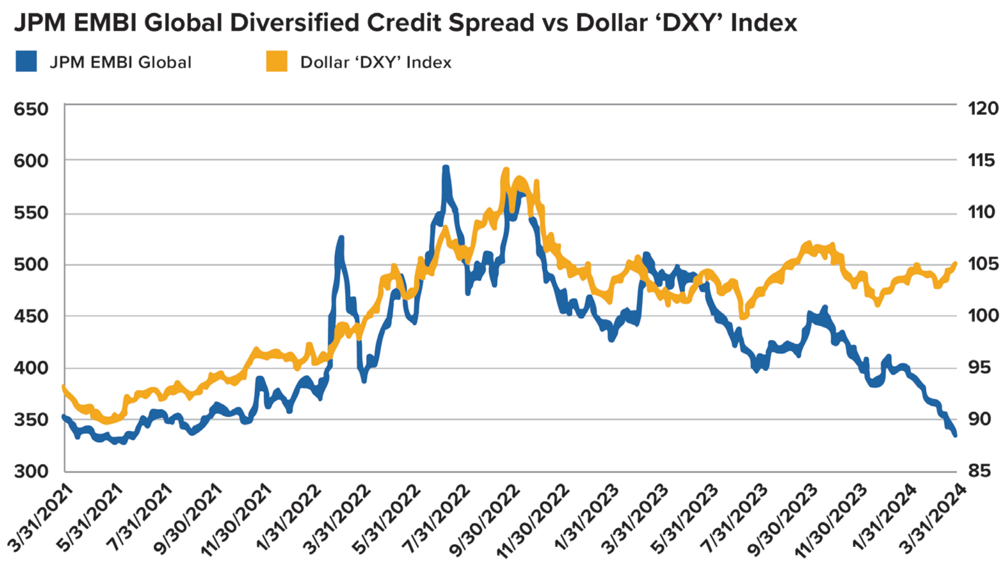
**Pablo Barrientos**

Senior Credit Analyst


# Emerging Markets 1Q 2024 Review

Emerging Market credit spreads have been very expensive in anticipation of the US economy achieving a soft landing aided by a synchronous global rate cutting campaign.  Over the last 12 months this soft-landing narrative has gathered steam (outside of hiccups around March 2023 and September-October 2023) and thus increased the appetite for higher yielding Emerging Market debt paper.

Our view is that US growth will continue to demonstrate more resilience when compared to its global peers.



Source: Bloomberg

EM countries experiencing slowdown in domestic growth have already begun easing monetary policy through their rate-cutting campaigns.  In addition, the lack of impact from continued stimulus efforts in China will continue to put downward pressure on EM growth.  Slowing global growth coupled with elevated US interest rates create conditions for a strong US dollar which will be what breaks the back of EM debt. Over the last three years, EM credit spreads have closely followed the strength in US dollar (as proxied by DXY Dollar Index). A recent break in this trend might serve as an early warning indicator for the potential normalization of EM credit spreads.

## Rising tide lifts all boats.. even the broken ones

Since 2021 when inflation fears pushed US rates higher, it coincided with a widening of credit spreads for the riskiest segment of EM $ debt (coming off the goldilocks period with low spreads/ low rates of 2021). The fear around the impact of rising global rates on lower rated issuers led to significant selloff in 2022. In 2023, as inflation started coming down and most global central banks started hinting at ending their rate hiking campaign, it unleashed animal spirits and demand for risky assets led to significant tightening of credit spreads while interest rates remained elevated. This can be seen through the comparison below of JPM EMBI Global Diversified High Yield Index credit spreads and 10 year US Treasury rates.

National election outcomes (e.g., Argentina) as well as progress in sovereign debt restructurings, particularly in Africa, have also played an important role in attracting demand from yield seeking investors despite some of these economies still experiencing weak growth coupled with double and even triple-digit inflation rates. Comparing Credit Spreads for the JPM EMBI Global Diversified HY Index with the S&P 500 Index helps illustrate the similarities in risk taking behavior across risk assets. We have seen the extremes of risk appetite in the high yield segment of EM dollar denominated debt.

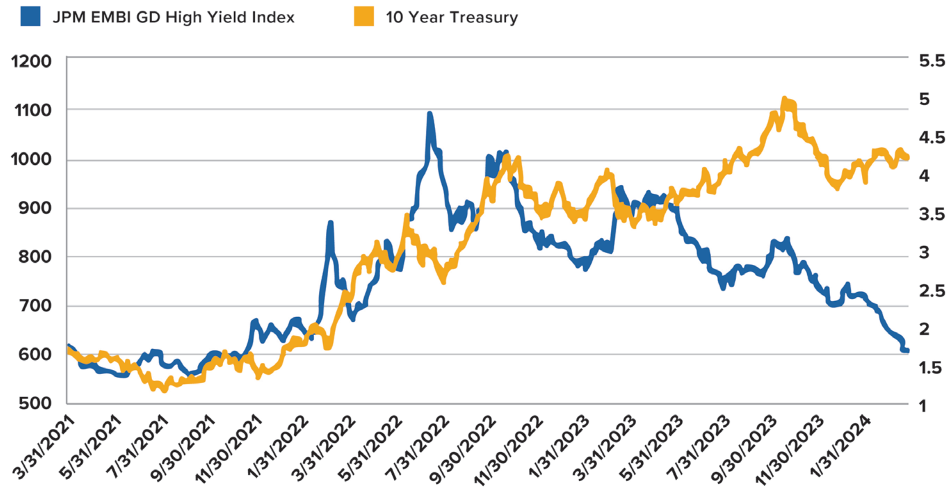
### Returns as of March 31, 2024

| EMBI GD Index | 1Q 2024 | 12 Month |
|---|---|---|
| AA | -1.16% | 1.74% |
| A | -0.6% | 2.47% |
| BBB | -0.8% | 4.29% |
| BB | -0.4% | 8.26% |
| B | 4.6% | 19.14% |
| CCC & below | 22.0% | 70.30% |
| | | |
| IG | -0.77% | 3.36% |
| HY | 4.92% | 20.01% |

Source: Bloomberg, Ratings breakdown using Bloomberg using Bloomberg Composite Rating

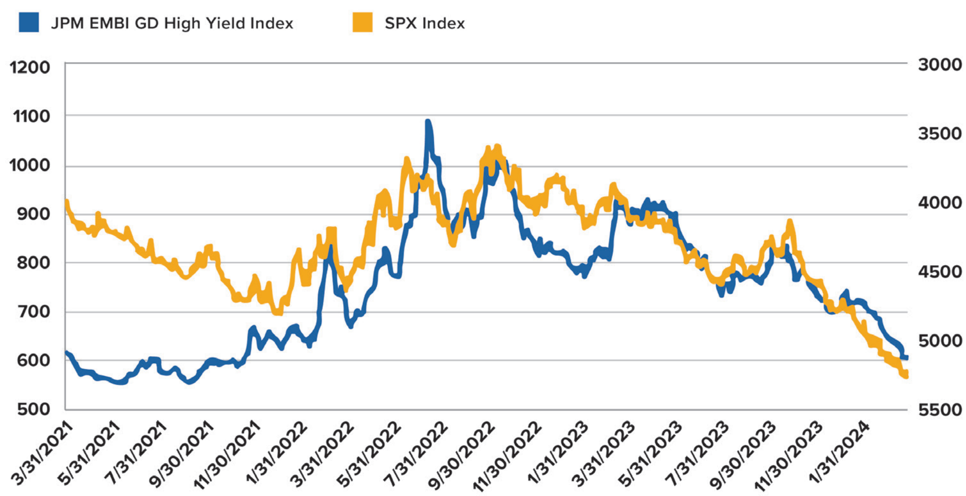
Looking at recent performance of EMBI Global Diversified Index broken down by rating categories helps highlight the extreme nature of the rally in lower rated Emerging Market issuers. Recency bias can lead to underpricing potential risks associated with lower rated issuers in Emerging Markets. By taking a longer time horizon, we can better highlight the volatility associated with the riskiest segment of Emerging Markets. Over the last 10 years ending March 2024, 'BB' rated group of issuers in the JPM EMBI GD Index have significantly outperformed their counterparts with CCC and below rated issuers having the worst total return.

### JPM EMBI GD High Yield Index vs 10 Year Treasury




Source: Bloomberg

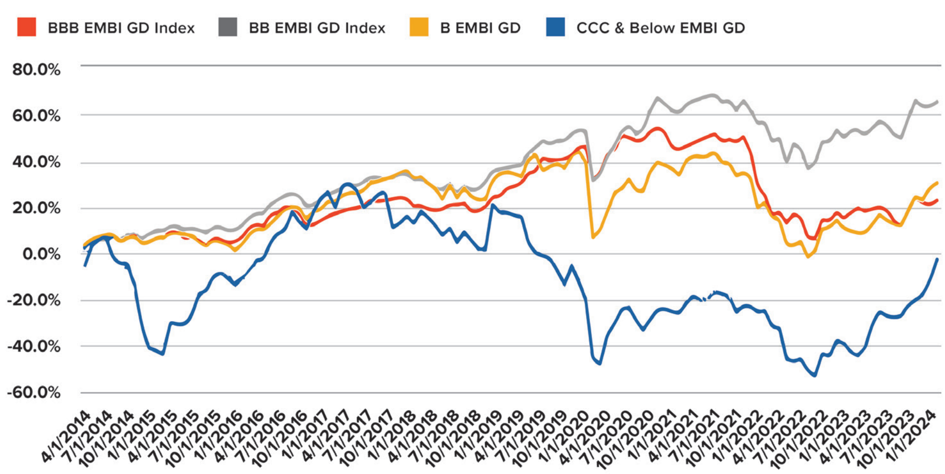
### JPM EMBI GD High Yield Index vs SPX Index




Source: Bloomberg

### Cumulative Returns EMBI Global Diversified Index - By Rating Categories

March 2014 - March 2024




Source: Bloomberg, Rating category breakdown for JPM EMBI Global Diversified Index

Over the ten-year period, significant drawdowns have been associated with the riskiest segment (CCC rated and below) of Emerging Markets, leading to additional volatility without a corresponding increase in returns as shown in the table of 10 year and 5 year Risk/Return statistics.

| | | A | BBB | BB | B | CCC & Below |
|---|---|---|---|---|---|---|
| 10 Year ending March 2024 | Annualized Return | 2.5% | 2.0% | 5.1% | 2.6% | -0.4% |
| | Annualized Risk | 6.0% | 9.0% | 8.9% | 12.8% | 26.8% |
| | Return/Risk | 0.43 | 0.23 | 0.57 | 0.21 | -0.01 |
| | | | | | | |
| 5 Year ending March 2024 | Annualized Return | 1.2% | -0.9% | 3.8% | -0.7% | -3.7% |
| | Annualized Risk | 7.6% | 11.4% | 11.6% | 16.5% | 29.4% |
| | Return/Risk | 0.15 | -0.08 | 0.33 | -0.04 | -0.13 |

Source: Bloomberg, Ratings Category breakdown for JPM EMBI Global Diversified Index.

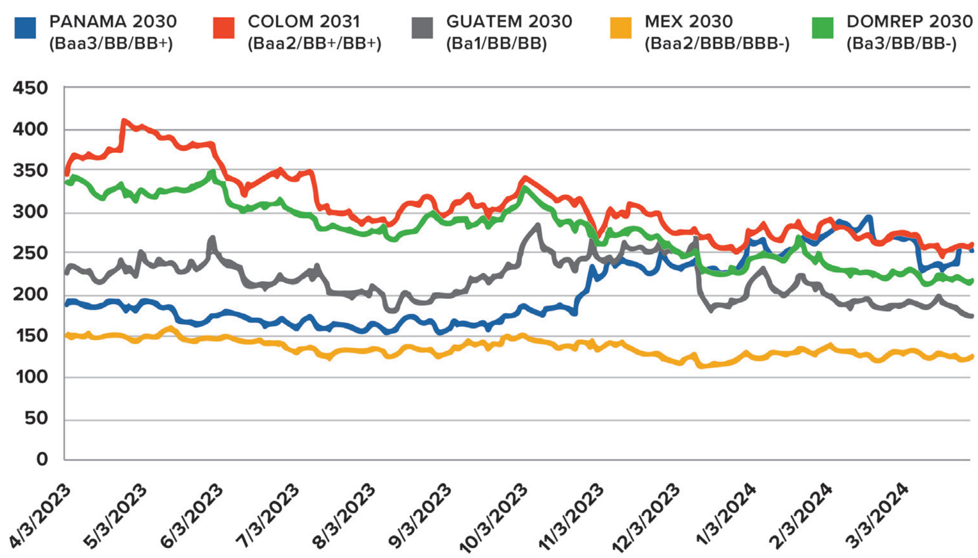
LM Capital looks at Emerging Market debt as a fixed income instrument in which liquidity and principal protection are key features. Our investment process guides us to stay away from issuers in regions without a 'Rule of Law' and to not invest in securities rated below 'B'. Our view has remained consistent where we believe the volatility associated with this segment of the market is not justified for a fixed income investor. We believe a well-diversified portfolio that maintains a higher-quality bias can offer the best risk adjusted returns over a market cycle while reducing the potential for significant drawdowns.

## What are we watching in the next quarter?

We expect central banks across EM, often encouraged by their executive, to continue to balance loosening monetary conditions with addressing recent signs of inflation stalling above target levels and, in some cases, reversing the downward trend (e.g., Chile). While food prices, caused in large part by climate events, have generally been one of the main culprits in failing to meet inflation expectations. A continued industrial recovery in China can also lead to sustained inflationary pressures from higher commodity prices.

Presidential/parliamentary elections in 2Q 2024 will continue to affect the economic outlooks of several EM countries; in particular, South Korea, India, Panama, Dominican Republic, and Mexico. Although likely outcomes in these countries are not expected to result in dramatic policy changes, we will be paying special attention to Panama given the diverging sovereign debt spread performance in the past few months. With a clearer political outlook and improving Panama Canal transit conditions, Panama is likely to focus on regaining investor confidence nonplussed by the First Quantum mine shutdown.

**Considering regional peer performance and ratings, Panama spreads appear to have reached a ceiling with attractive potential to tighten**




Source: Bloomberg as of April 2, 2024

# LM Capital Group Hires Two Operations Professionals

## LM Capital Group is pleased to welcome Ross Foster and An Phan to the firm.

Ross Foster, Director of Operations, Ross joined LM Capital Group in March 2024. Ross has over 15 years' experience in the Operations space of Financial Services. Prior to joining the firm, Ross worked at Chandler Asset Management in San Diego as the Operations Team Leader providing account reconciliation services, trade and settlements processing, training and project leadership among other tasks. Ross received his B.S degree with a concentration in Finance and a Minor in Economics from Sonoma State University and his MBA from Golden Gate University.

An Phan, Operations Analyst, An joined LM Capital Group in March 2024. Prior to joining the firm, An worked at Chandler Asset Management in San Diego as an Operations Specialist II. She provided support with daily reconciliation of accounts, processing of daily trades, portfolio reporting, and acts as a liaison between brokers and custodians. An received her bachelor's degree from the University of California, San Diego in Management Science and Public Health in 2020.


**LM CAPITAL GROUP**
GLOBAL BOND MANAGEMENT

**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