LM CAPITAL GROUP
GLOBAL BOND MANAGEMENT

LM Capital Group Perspectives

Investment Insights
3Q 2024

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The Beginning of a New Era

The third quarter ended with healthy returns across most major asset classes, despite several bouts of market volatility. Most markedly, fourteen months after its last interest rate hike, the Federal Reserve kickstarted its cutting cycle with a 50 basis point cut at the September FOMC meeting. With the unemployment rate having drifted up from a low of 3.4% in April of last year to 4.2% today, it seems FOMC officials have now made it clear that they do not welcome any further weakening in the economy and are keen to quickly move interest rates back to less restrictive levels.

With inflation cooling and activity relatively muted, other western central banks also deemed it appropriate to cut rates. The European Central Bank delivered its second rate cut in September taking interest rates to 3.5%, while the Bank of England embarked on its own easing cycle with a 25 bp cut at its August meeting.

For multi-asset investors, perhaps the most significant takeaway from this summer is the shift in the outlook for stock/bond correlations. With inflation having returned to tolerable levels, central banks once again stand ready to support the economy via lower interest rates in the event of a growth shock – as was evident in the midsummer swoon to equity markets, where a sharp fall in bond yields helped to offset those losses. There will likely be more volatility ahead, with November's Presidential election and continued unrest in the Middle East being just a few of several potential future catalysts.

Quarter in Review

The 10yr Treasury began the quarter at 4.40% and fell all quarter long, with a large waterfall seen the first few days in August that ultimately left the benchmark Treasury at quarter end at 3.78%. The US Dollar finished with its first negative quarter of the year, practically erasing the gains seen year to date, finishing at -4.81%. Investment grade spreads finished the quarter slightly wider. Within the credit subsectors, Utilities were the best performers overall this quarter. Additionally, higher rated credits outperformed lower rated ones and longer securities in both the Treasury and Corporate space outperformed shorter ones significantly from a total return standpoint this quarter.

USGG 10yr Index

Source: Bloomberg

The High Yield (+5.28%), Emerging Market Debt (+5.82%), Corporate (+5.85%) and Mortgage-Backed Securities (+5.53%) and Non-Dollar (+8.51%) sectors outperformed the broader Barclays US Aggregate Index's return of +5.20% on the quarter. The US Treasury (+4.74%) and Government Agency Securities (+3.40%) sectors underperformed the broader index's return.

Market Outlook

The size and number of rate cuts to occur in 2024 and 2025 remains uncertain and Chairman Powell has provided no specific guidance on this issue. We expect at least another 50 basis points of cuts during the remainder of 2024, with some further amount of reduction in 2025 dependent on future economic data. We note that the volatile geopolitical situation in the Middle East and the length of the ILA dockworkers strike may meaningfully impact future economic data.

Although positioned for a stable rate environment, our duration and sector allocation positions have allowed us to closely track our benchmark indices this quarter. We remain cautious regarding the historically tight spreads in all credit sectors, especially in the longer maturity paper, and this has proven wise given the recent spread volatility.

Portfolios remain underweight in US Treasuries and slightly overweight in investment grade corporates while avoiding the longer maturities. Although our EMD allocations remain low, we believe that both US Dollar denominated and local currency EMD offer investment opportunities on a selective basis. Therefore, we anticipate adjusting portfolio positioning in the coming months, both in duration and sector allocation.

Our Investment Strategy Group maintains our portfolio duration positioning closer to the index, assigning 5% short as a target position. We continue to expect more positive returns for fixed income for the remainder of the year and early 2025 as well. While the upcoming US election remains too close to call, we expect the policies of either party to further increase the budget deficit and total US debt. Therefore, we expect the yield curve to continue to normalize over the coming months until the fiscal and regulatory policy of the new administration becomes clear.

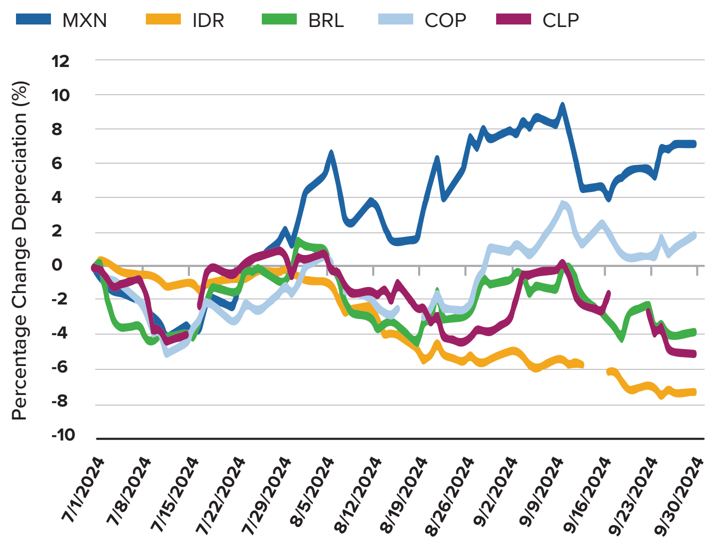
Pablo Barrientos

Senior Credit Analyst

Emerging Markets 3Q 2024 Review

The anticipated Fed easing cycle has created favorable conditions for emerging market (EM) currencies, particularly in countries with high real interest rates, such as Indonesia. However, some currencies have faced headwinds due to unique domestic factors. One example is the Mexican peso, which weakened from 18.31 per USD on July 1st to 19.69 by September 30th.

Select EM Currencies Performance 3Q24

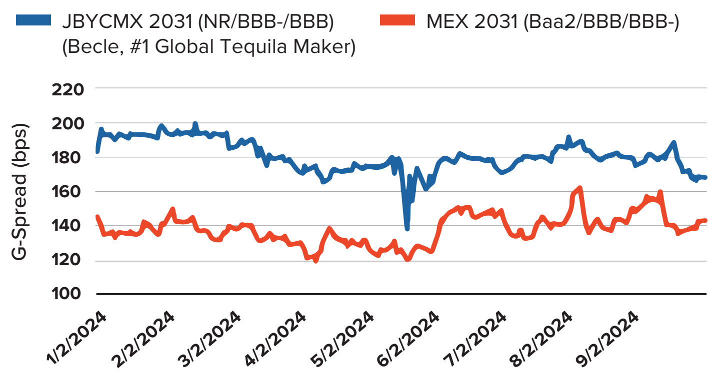


Source: Bloomberg

As highlighted in our August 30th commentary, "[What is Really Happening in Mexico with the Judicial Reform,]" Former president AMLO's proposed judicial reform has sparked significant controversy. This reform mandates the removal of all sitting judges, including those in the Supreme Court, with new judges to be selected via popular vote from a government-approved list—effectively granting the Executive branch control over the judiciary. Despite widespread concern, the reform passed through Congress in September. Mexico's newly elected president, Claudia Sheinbaum, has since countered criticisms that the reform undermines judicial independence, insisting that it is intended to enhance the judiciary's autonomy and uphold the rule of law.

We anticipate continued volatility in Mexican assets over the coming months, but remain optimistic about well-diversified global corporations.

Similarly Rated Corporate vs. Sovereign

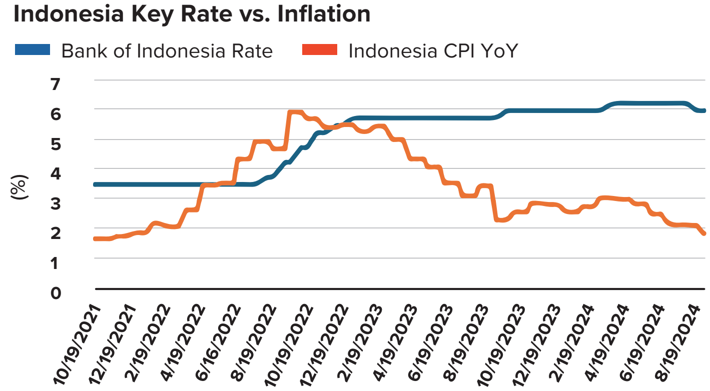


Source: Bloomberg

Meanwhile, Indonesian assets have experienced robust demand, particularly for government bonds, which contributed to the Indonesian Rupiah (IDR) appreciating from 16,322 per USD on July 1st to 15,140 on September 30th. Strong investor interest persists despite a recent rate cut from 6.25% to 6.00%, thanks in part to Indonesia's Q2 GDP growth of 5.05% year-on-year and its success in bringing inflation below 2.0% year-on-year.

Global markets are closely monitoring China's stimulus measures aimed at reviving its slowing economy. These measures include interest rate cuts, lower reserve requirements for banks, increased infrastructure spending, and tax incentives for businesses, particularly in real estate and technology. The government has also introduced programs to boost consumption, like subsidies for electric vehicles and housing incentives. However, investor skepticism remains due to concerns over China's rising debt, the slow recovery of its real estate sector, and weakened consumer confidence. This uncertainty, especially for commodity-exporting economies reliant on China, continues to affect market sentiment.

Indonesia Key Rate vs. Inflation



Source: Bloomberg

At the same time, local factors in emerging markets—such as fiscal balance concerns in Brazil and political instability in Colombia—continue to dominate the EM landscape, adding another layer of complexity for investors.

As we look ahead to the remainder of the year, alongside closely monitoring the impact of the U.S. elections on global markets, we anticipate ongoing volatility in U.S. interest rates driven by conflicting economic data. Survey data and labor statistics have been sending mixed signals, reflecting both resilience and underlying weaknesses in the economy, complicating the Federal Reserve's policy outlook.

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