LM Capital Group Perspectives

Investment Insights
4Q 2024

Michael Chalker

Senior Portfolio Manager, Senior Analyst

The Pendulum Swings WAY Right

Investors can reflect on 2024 being a good year overall. Strong risk asset performance carried over into fixed income markets with positive returns seen across all sectors for the year, though it was not without a handful of binary, market-moving events. The first half of 2024 saw broad based disinflation and throughout the summer, many central banks felt confident they could start normalizing policy. However, the last mile proved harder than markets anticipated and outside of Europe, investors are paring back their hopes for more aggressive rate cuts.

The back half of the year was largely marked by the US Presidential and Congressional elections - in which the Republicans swept all chambers with meaningful surprise – and the results signaled a significant shift in upcoming governmental policy that investors are still trying to digest. Much of the market action post-election was due to this repricing and understanding the impacts of the cabinet chosen by President-elect Trump. The potential for more inflationary and stimulative policy action is high and that was reflected via the rise in volatility seen in some asset classes.

In addition, the FOMC meetings in September, November and December demonstrated the committee's adherence to returning policy to a more "normal" level by lowering the overnight rate by a total of -100bps thus far (50/25/25bps respectively), as they continue to be cognizant of any labor weakness and signs of inflationary pressures returning. No imminent concerns about the strength of the economy appeared from investors nor FOMC members and while the recent Atlanta Fed GDPNow number was revised down slightly, the economy is forecast to maintain a slow but steady growth pace.

Looking ahead to 2025, investors should question whether the same drivers of performance will remain in play. Our view is that US rates will likely continue to remain elevated for longer than many pundits assumed. However, US equity markets are at lofty valuations and credit spreads are near record tights, which could drive flows into safe havens like US Treasuries, even without a distinctive cause. Given this, investors will continue to look for ways to safely diversify portfolios without giving up meaningful yield or returns.

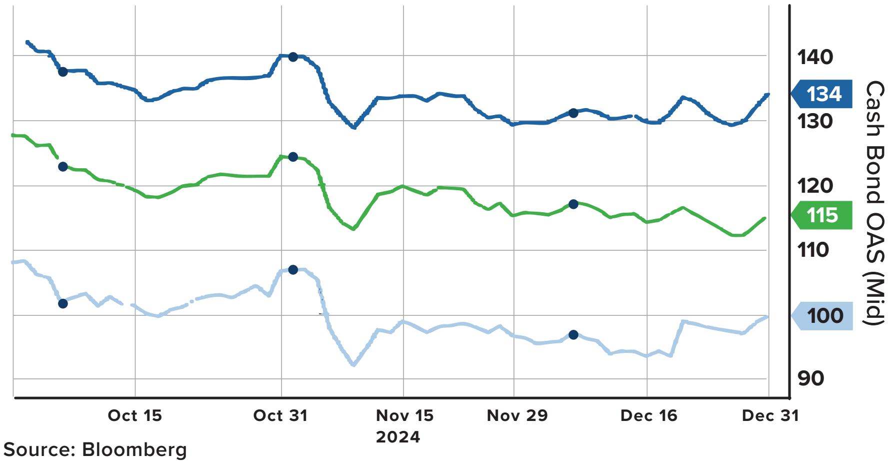
USGG 10yr Index

Source: Bloomberg

Quarter in Review

The 10yr Treasury began the quarter at 3.78% and rose all quarter long, with a slight dip in late November before rising in an almost straight line to finish 4.57%. The US Dollar finished the year with a very strong quarter, up +7.65%, making for a very strong year-to-date return of +7.06%. High yield bonds were the top performing sector for the fourth year in the row as a combination of high all-in yields and tightening spreads boosted returns by +8.19%. Spreads across all sectors within the corporate landscape finished the quarter significantly tighter as the demand for credit, particularly in the new issue landscape, continues unabated. Within the credit subsectors, Financials were the best performers overall this quarter. Additionally, lower rated credits outperformed higher rated ones and shorter securities in both the Treasury and Corporate space outperformed longer ones significantly from a total return standpoint this quarter as the curve continued to steepen bearishly.

IG Subsector Spreads



Source: Bloomberg

The High Yield (+0.17%), Government Agency Securities (-1.06%), Emerging Market Debt (-1.47%) and Corporate (-3.04%) sectors outperformed the broader Barclays US Aggregate Index's return of -3.06% during the quarter. The US Treasury (-3.14%), Mortgage-Backed Securities (-3.16%) and Non-Dollar (-6.84%) sectors underperformed the broader index's return.

Market Outlook

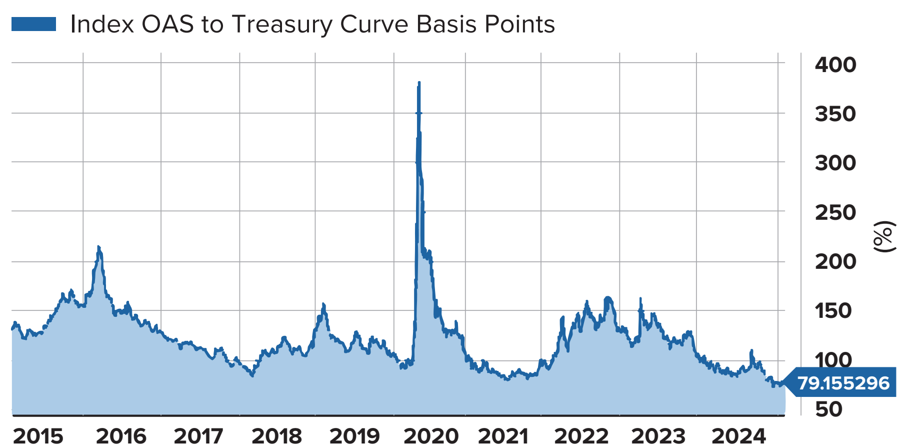
We expect continued evidence of a mildly strong economy and few signs of a strong labor market. Our proprietary economic matrix is close to neutral but indicates a greater likelihood of higher rates than lower rates. Even though economic data has continued to push our proprietary economic matrix towards a more neutral position, our Trend Identification Score remains unchanged.

Patrick Faul
CFA, FRM

Director of Research

As we noted in last month's outlook, we remain positioned for a range-bound rate environment. Our duration and sector allocation positions have allowed us to closely track our benchmark indices in the current uncertain market. Portfolios remain underweight US Treasuries, with the balancing overweight in shorter investment grade credit and Agency MBS securities. Depending on the day, we vacillate between seeing ourselves as being coiled and ready to spring on any market opportunity and seeing ourselves as facing a looming freight train.

IG Corp Spreads History



Source: Bloomberg

The looming freight train is tight spreads in the credit markets. The extra amount paid to bondholders to take on credit risk is at multi-year lows. Our active imaginations conjure many possible events that can lead to a horrific rout in credit markets. We cannot see them, but we are quite sure that there are scary monsters hidden in the dark basement where the bond market stores their long corporate bonds. If the economy remains mildly strong, these tight spreads can continue for an extended period, with the monsters biding their time. We remain vigilant for strange noises and other signs of danger.

There is one corner of the fixed-income market where we see opportunity. The Agency MBS market offers attractive yields compared to the very tight credit markets. The trade-off for the attractive yields is an unknown timing of cash flows from home mortgage monthly payments and refinancings. The risk that this opportunity adds is reinvestment risk. If home mortgage rates drop to 3.0%, there will be a rush to refinance and we will have to reinvest the cash flows at the new, much lower rates. We think it is unlikely that we will see those low mortgage rates again. The relatively flat shape of the US Treasury curve, with the two-year at 4.28%, and the 10 year at 4.60%, as of January 3, 2025, leaves us relatively sanguine about possible smaller moves in US mortgage rates that slightly quicken prepayments.

We note the continued strength of the US dollar and the weakness of currencies that rely on selling commodities to China. We see signs of opportunities in the currency market but are generally waiting to see if there are unexpected dangers in new US trade policies.

Our Investment Strategy Group maintains our portfolio duration positioning close to the index, assigning 0-5% short as a target position. We continue to expect positive returns for fixed income for early 2025. We believe the policies of the Trump administration could further increase the budget deficit, total US debt and inflationary pressures while also stimulating the US economy. Therefore, we expect the yield curve to continue to normalize over the next 3-6 months as the fiscal and regulatory policy of the new administration becomes clear in the presence of a mildly strong economy.

Emerging Markets 4Q 2024 Review

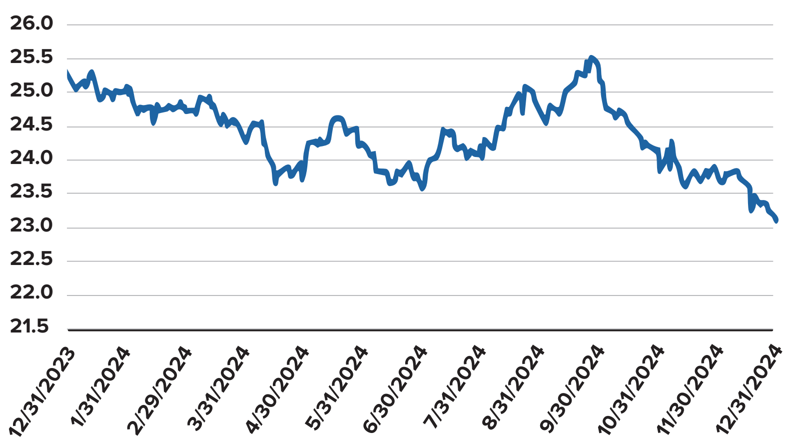
Pablo Barrientos

Senior Credit Analyst

Emerging market (EM) local currency debt reversed gains made in the previous quarter as the Federal Reserve's easing cycle failed to alleviate concerns about persistent inflation. This pushed the 10-year US Treasury yield from 3.75% to 4.57% during the fourth quarter, reducing the attractiveness of EM currencies relative to the U.S. dollar. Additionally, uncertainty over global trade following the U.S. election has adversely affected countries with large trade deficits with the U.S., particularly China and Mexico, compounding the idiosyncratic challenges these nations face.

For China, despite efforts to stimulate its economy through measures such as interest rate cuts, lower reserve requirements for banks, and increased infrastructure spending, its onshore currency weakened from 7.02 to 7.30 during the fourth quarter. This devaluation has further impacted EM countries with significant export exposure to China, notably Chile and Indonesia. In Mexico, controversial constitutional reforms have heightened volatility driven by U.S. trade threats, causing the Mexican peso to depreciate from 19.69 to 20.83 over the same period. Fiscal deficit challenges also continue to weigh on several EM currencies, particularly in nations with left-leaning governments that have struggled to convince markets of their commitment to fiscal discipline, such as Brazil and Colombia.

EM Local Currency Bond Performance (EMLC index)



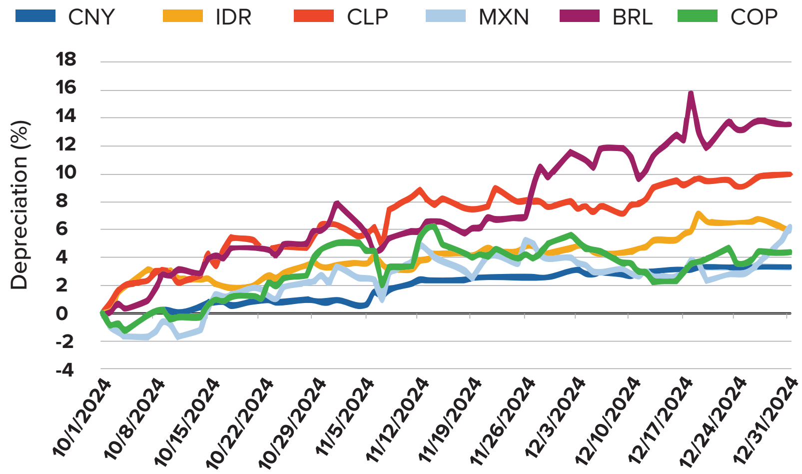
Source: Bloomberg

While most central banks globally continued easing monetary policy, volatility in foreign exchange markets and its potential inflationary consequences have prompted some economies to pause or slow the pace of rate cuts. In certain cases, like Brazil, central banks even accelerated rate hikes. Additionally, central banks in countries such as Brazil, Mexico, and Indonesia have intervened in foreign exchange markets to stabilize their currencies, albeit with limited success in reversing depreciation trends.

Regarding U.S. dollar-denominated spreads, EM bonds overall tightened during the fourth quarter, though they widened somewhat after the U.S. election in line with broader fixed-income markets. A notable exception was Israel-related bonds, which continued to outperform. Among the weaker-performing jurisdictions, we see potential buying opportunities in Mexico and Romania. In Mexico, we are focused on short-term, high-yielding corporate bonds, while in Romania, ongoing political instability has significantly widened sovereign bond spreads compared to peers with similar ratings and macroeconomic fundamentals. We believe this presents a potential opportunity as clarity emerges around Romania's presidential election rerun (expected in March-April) and if the Russia-Ukraine conflict moves toward resolution.

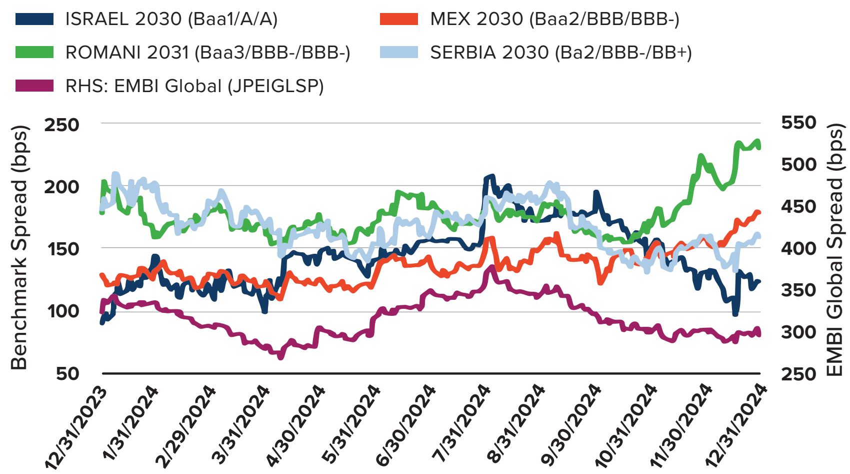
Looking ahead to 2025, we anticipate U.S. policies will have a meaningful impact on EM markets, particularly regarding trade negotiations. Nevertheless, we remain confident in our strategy of: 1) focusing on globally diversified U.S. dollar corporate debt while investing opportunistically in local currency bonds; 2) emphasizing companies with attractive industry and company-specific fundamentals; while 3) avoiding jurisdictions with weak rule of law. In terms of positioning along the yield curve, we maintain a cautious stance toward credit spread duration risk, prioritizing higher-yielding credits with short-term maturities and achieving our duration objectives through high-quality investment-grade bonds.

EM Currencies Depreciate in 4Q24



Source: Bloomberg

USD EM Sovereign Spreads



Source: Bloomberg

LM Capital Group Hires Research Analyst

LM Capital Group is pleased to welcome Owen Lingenfelder as our newest Research Analyst

Owen Lingenfelder, Research Analyst, Owen Lingenfelder joined LM Capital Group in December 2024 as a Research Analyst. Prior to joining the firm, Owen held the role of Senior Performance Analyst at Meketa Investment Group in San Diego. In this position, he was responsible for monitoring investment performance and producing detailed performance and risk reports for both general consulting and Outsourced Chief Investment Office (OCIO) clients. Owen collaborated closely with Meketa's OCIO investment committee, focusing on oversight of discretionary fixed income managers and maintaining GIPS® composites. His expertise in performance analysis and investment oversight has provided him with a strong foundation for his role at LM Capital Group. Owen graduated from the University of California, San Diego, where he majored in International Business and minored in Real Estate Development. Owen is currently a Level II candidate for the Chartered Financial Analyst (CFA) program.

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