Diamond Hill Core Bond Strategy

As of September 30, 2021

It was a quarter with enough drama and shifting landscape at the Federal Reserve and in Washington, D.C., to make most reality shows jealous. There was finally talk about tapering after previously only thinking about talking about tapering. The third quarter contained not only two meetings of the Federal Open Market Committee (FOMC) but the annual Jackson Hole Policy Symposium, as well as a variety of FOMC members clamoring for press appearances to share their notions of taper timing and logistics.

As if the machinations of the most important central bank in the world weren't enough, we were given a solid dose of scandal, resignations and a prominent U.S. Senator referring to the Federal Reserve Chairman as a "dangerous man" while making it clear she would not support his re-appointment. To top it off, the U.S. government is heading toward financial abyss as another game of chicken is underway regarding the debt ceiling and future government spending.

Dots and more dots

What we learned from the most recent dot plot (Exhibit 1) is that 9 out of the 18 members of the FOMC expect no rate increases in 2022, 6 expect a single rate increase and 3 members expect 2 rate increases. It's a much broader set of results for 2023:

- 1 member keeping rates steady at the current level from now until the end of 2023
- 4 members at one 25 bps increase
- 3 members at 2 increases
- 1 member expecting 3 increases
- 6 members expecting 4 increases
- 3 members expecting 6 increases

Nothing exciting with regards to movement on rates as Powell has continually pointed out that the test for lift-off on rates is more stringent than the test for tapering. Remember, the rates test is focused on inflation (transitory) and employment (4.8% unemployment as of 9/30) while the tapering test is the nebulous "substantial further progress." If we assume that rate expectations are fairly accurate (with a major caveat that dots can't predict the future and much can change), it's a fair expectation that we'll see a lift-off at the end of 2022 (similar to the 2015 rates process: one increase per year for two years before a gradual climb higher).

TEAM

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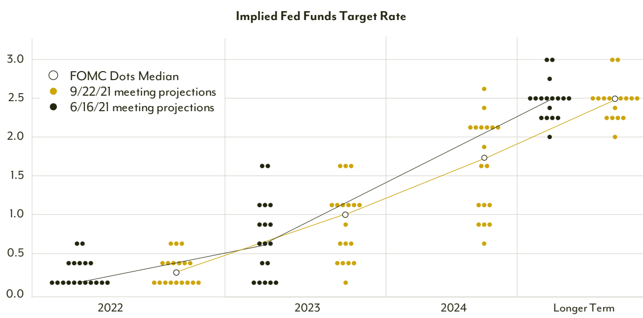
EXHIBIT 1: DOT PLOT



Source: Bloomberg.

The tapering talk is here but brings more questions

If we assume the taper is officially announced in November and begins in December with expectations (per Powell) to be wrapped up by mid-2022, we're looking at a much faster taper than what the market experienced in 2014. That taper started at a time when the Fed was buying $85 billion combined in Treasury and agency mortgages each month, with a reduction beginning in December 2013 and wrapping up almost a year later in October 2014. This time, the Fed will be reducing a higher level of monthly purchases ($120 billion per month) in a much tighter period (six months), so we can't use the "original taper" as a road map for how the market will absorb this tapering iteration.

Tapering is coming, but this time will be different based on what we've learned from the Fed, and new questions will need to be asked:

- Once tapering has concluded, will the Fed follow the same plan as it did in 2014?
- Will the Fed roll maturities to hold the balance sheet steady?
- When/will the Fed begin any kind of quantitative tightening?

Back in 2014, once tapering wrapped up, the Fed continued to re-invest maturing securities back into the market, keeping the balance sheet steady through October 2017. The Fed didn't begin reducing the balance sheet (known as quantitative tightening) until late 2017, allowing $6 billion in Treasury and $4 billion in mortgages to roll off the balance sheet, ramping those levels higher until the Fed was rolling off $30 billion in Treasuries and $20 billion in mortgages each month.

Please see GIPS report in the appendix.

Scandal shifting the Fed landscape?

"No one on the FOMC is happy to be in this situation, to be having these questions raised. It's something we take very, very seriously."
– Federal Reserve Chairman Jerome Powell

The situation? A reputational crisis at the central bank fueled by several large financial transactions by Dallas Fed President Robert Kaplan and Boston Fed President Eric Rosengren during the calamitous days of the pandemic in 2020. While their actions complied with the Federal Reserve's ethics rules, their trading activity created the appearance of a conflict of interest as illustrated by Rosengren's purchase and sale of REITS while he was publicly warning of contagion in real estate markets. These revelations have led to a review of the ethics rules around financial holdings and activities by senior Fed officials as well as the resignations of Kaplan (effective October 8) and Rosengren (effective September 30).

At the end of Q3, First Vice President Kenneth Montgomery stepped in as interim president until a committee of Boston Fed board directors selects a permanent replacement, to be approved by the Federal Reserve Board. With additional concerns being raised regarding Fed Vice Chair Richard Clarida and his trading history as well as potentially dwindling support for Powell to be re-appointed in early 2022, there could be a very different looking Fed in 2022. Kaplan has been viewed historically as more hawkish while Rosengren has been considered only slightly hawkish, so their replacements could shift the overall sentiment of the FOMC. Powell has provided stability over his six years in office, overseeing the lift-off in rates post-Global Financial Crisis, reducing some of the financial regulations put forth during that time and guiding the U.S. economy through the recent pandemic.

Debt ceiling debate and horse trading

Based on the ongoing angst in Washington, there's the possibility that the U.S. government shuts down for the third time in the last eight years and twice in the past three years. Previous shutdowns in 2013 and 2018 cost the U.S. economy in the range of $2 billion to $6 billion and $11 billion, respectively, according to the Office of Management and Budget and Congressional Budget Office.

Treasury Secretary Janet Yellen has informed Congress that if it does not act to raise or suspend the debt limit by October 18 (also known as the "X" date), the Treasury would be left with limited resources that would be depleted quickly, potentially forcing a default on U.S. government debt.

"It is imperative that Congress swiftly addresses the debt limit. If it does not, America would default for the first time in history," Yellen said in her remarks to the Senate Banking Committee. "The full faith and credit of the United States would be impaired, and our country would likely face a financial crisis and economic recession."

While the U.S. has technically defaulted in the past[1], the potential for this unprecedented event forces economists to essentially guess how the global economy and financial markets would react, but the consensus is it would be a financial calamity that could trigger a broad financial market selloff as well as an economic downturn and an interest rate spike. Even if one side blinks and the issue is resolved once more by kicking the can down the road, one of the major rating agencies could follow in the footsteps of S&P in 2011 and downgrade U.S. debt—the ramifications of which would be significant.

Investors that utilize the three major nationally recognized statistical ratings organizations (NRSROs) as the measuring stick for credit quality would then be faced with an unheard-of dilemma: two of the three rating agencies would no longer hold U.S. government debt at a AAA equivalent. Depending on specifics of investment guidelines, some investors would have to drop the U.S. to a AA+ equivalent.

Portfolio performance and positioning

The Treasury curve was relatively unchanged from the beginning to the end of the quarter but experienced quite a bit of fluctuation over the past three months. The 10-year Treasury began Q3 at 1.47% and finished at 1.49% but reached a low of 1.17% on August 3 and a high of 1.54% near the end of September. This movement resulted in a pedestrian return for the quarter for the U.S. Treasury Index of 0.09% and brought the year-to-date performance for the index to -2.50%.

Our portfolio's duration has been maintained at the low end of our targeted range of +/- 10% of the benchmark's duration, which limited the impact from the Treasury market. While the portfolio has an underweight to the Treasury market, a longer duration contribution from the portfolio's allocation helps to mitigate the impact from the underweight. The portfolio finished Q3 at a shorter duration posture than the benchmark, 5.76 years compared to 6.71 years. The portfolio's duration positioning relative to the benchmark had a minimal impact on relative performance in the quarter.

[1] In 1979, investors in T-bills maturing on April 26, 1979, were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills that were due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules.

The Bloomberg U.S. Corporate Bond Index was flat in Q3, with the final two months of Q3 (-1.35%) offsetting the gains in the month of July (1.37%). Lower credit quality held up best during the quarter with the corporate market BBB segment returning 0.11%, while the AAA component lost -0.34%, A lost -0.12% and AA was down -0.09%. Security selection was the main driver of relative performance in the corporate sector as this sector's performance was slightly more additive to performance than the benchmark's allocation.

The Bloomberg U.S. Securitized Index gained 9 basis points (bps) in Q3, relying on a strong month of July (+0.64%) to offset the downturn experienced in August (-0.16%) and September (-0.39%). All sectors within the securitized market followed the same pattern of the overall securitized market with strong performance in July offset by August and September downturns. Residential mortgage-backed securities, the securitized market's largest component, led the way with a 0.10% return, followed by asset-backed securities up 0.05% and commercial mortgage-backed securities, which lost -0.03% in the quarter.

New issuance in the ABS market in Q3 totaled more than $86 billion. Both Q2 and Q3 delivered more than $159 billion in new issuance, pushing year-to-date issuance to more than $302 billion, already close to 2020's full year issuance of $304 billion.

Our portfolio's allocation to areas of the ABS market outside of the index contributed positively to performance as most of these subsectors delivered significantly higher returns relative to benchmark eligible securities. The portfolio's differentiated focus on residential mortgage-backed securities (RMBS), investing in collateralized mortgage obligations (CMOs) and specified pools in lieu of plain vanilla passthroughs held by the benchmark, detracted from performance during the quarter but have contributed on a year-to-date basis.

The portfolio continues to search for opportunities in the marketplace while maintaining a conservative risk profile relative to the index.

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PERIOD AND ANNUALIZED TOTAL RETURNS (%)

Inception Date: July 31, 2016

	SINCE INCEPTION	5-YR	3-YR	1-YR	YTD	3Q21
CORE BOND COMPOSITE						
Gross of Fees	3.88	3.93	6.13	-0.15	-0.63	0.15
Net of Fees	3.61	3.66	5.88	-0.39	-0.81	0.09
BENCHMARK						
Bloomberg U.S. Aggregate Index	2.81	2.94	5.36	-0.90	-1.55	0.05

CALENDAR YEAR RETURNS (%)

	7/31/16 - 12/31/16	2017	2018	2019	2020
CORE BOND COMPOSITE					
Gross of Fees	-2.45	4.64	2.06	8.56	8.34
Net of Fees	-2.56	4.33	1.76	8.28	8.13
BENCHMARK					
Bloomberg U.S. Aggregate Index	-3.14	3.54	0.01	8.72	7.51

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AS OF YEAR-END	DHCM	CORE BOND COMPOSITE			3-YR ANNUALIZED STANDARD DEVIATION (GROSS OF FEES)	
	Assets Under Management	Number of Accounts	Assets Under Management	Dispersion (Gross of Fees)	Core Bond Composite	Bloomberg U.S. Aggregate Index
2020	$26.4B	5 or fewer	$541.3M	NA[1]	3.71%	3.36%
2019	23.4B	5 or fewer	300.2M	NA[1]	2.78	2.87
2018	19.1B	5 or fewer	55.3M	NA[1]	NA[2]	NA[2]
2017	22.3B	5 or fewer	43.8M	NA[1]	NA[2]	NA[2]
2016	19.4B	5 or fewer	39.7M	NA[1]	NA[2]	NA[2]

[1] NA = Not Applicable

[2] Statistics are not presented because 36 monthly returns are not available.

This composite was created in July 2016.

Global Investment Performance Standards