DIAMOND HILL

INVESTED IN THE LONG RUN

Core Bond Strategy

As of 30 Jun 2022

Market Commentary

After a painful first quarter, fixed income markets were mostly down in Q2, with a brief respite in May. The first six months of the year produced the worst back-to-back quarterly returns for the Bloomberg US Aggregate Bond Index since its inception (down -5.93% in Q1 and -4.69% in Q2) and only the tenth occurrence of consecutive negative quarters since the index's inception. Prior to these past two quarters, the first and second quarter of 2018 were the most recent back-to-back negative quarters for the index.

Within the economy, inflation continued to run at a sizzling pace while the employment situation continued to strengthen, defying the odds with roughly two job openings per applicant. The Federal Open Market Committee (FOMC) met twice during the quarter in what can only be deemed as very different meetings, with the second meeting delivering the largest rate hike since November 1994.

The first half of 2022 has been difficult for all asset classes, not just fixed income. To put the performance of the Bloomberg US Aggregate Bond Index into perspective, Exhibit 1 shows calendar year performance from 1991 to 2021 along with the year-to-date performance through Q2 2022. While there are calendar years that delivered negative returns (1994, 1999, 2013, 2021), there has been nothing to match the magnitude of the year-to-date decline in 2022. Besides the first two quarters of 2022, the only quarters that delivered worse performance were in the early 1980s, when interest rates were multiples of their current level and headed higher. Concerns around the battle against inflation, the impact of geopolitical uncertainty and ongoing supply chain issues, and expectations for Fed actions through the rest of the year all played a part in market performance this past quarter.

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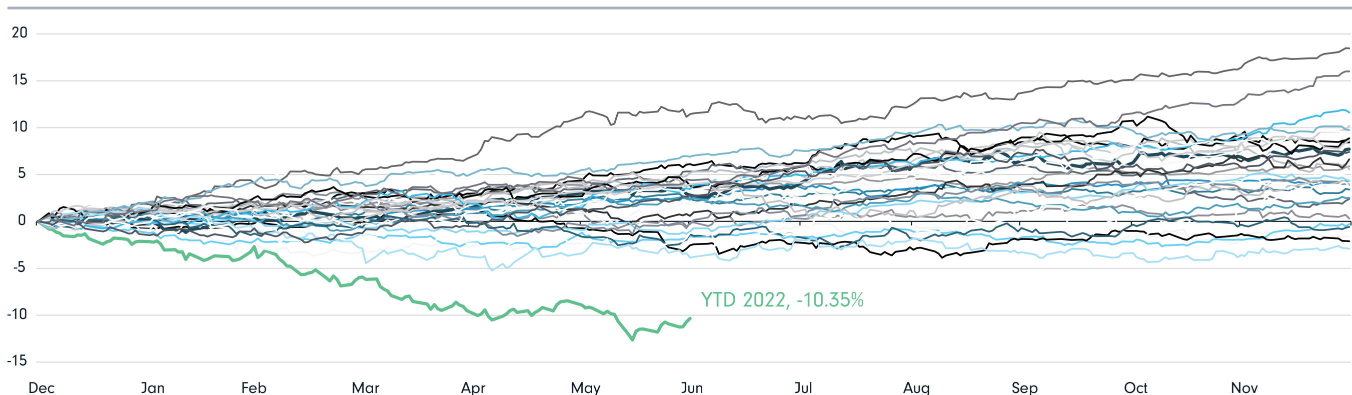
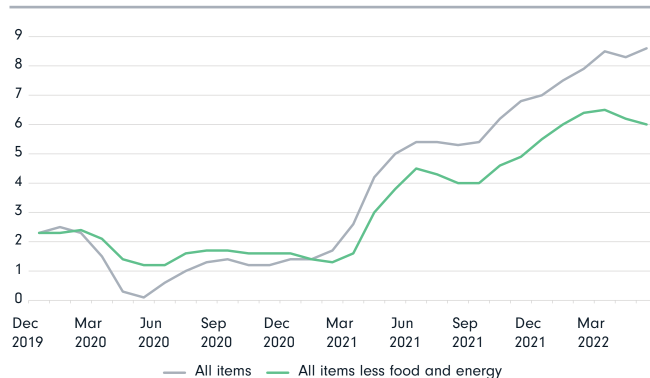
Exhibit 1 – Bloomberg US Aggregate Bond Index, Calendar Year Total Returns (%)



Source: Bloomberg.

Coming into Q2, inflation was running red hot, reaching decade-level highs before cooling slightly in April (reported in May), down from the preceding 8.5% to 8.3% year over year (yoy). But core inflation once more ramped up with the May number (delivered in June), showing inflation pushed higher to 8.6%. As shown in Exhibit 2, significant inflation within food (+10.1% yoy) and energy (+34.6% yoy) were the main culprits for the increasing levels while Core CPI (less food and energy) continued to drop from March to May (6.5% yoy to 6.0% yoy, respectively). But consumers still need food and fuel, so they've continued to feel the impact of rising inflation despite some stabilization in other areas of the economy. Rising prices have been the focus of the Federal Reserve as it continues to receive criticism for its transitory approach. As concerns about rampant inflation and the potential for an economic recession in the US continued to grow, all eyes have been focused on the Fed and other central banks around the world.

Exhibit 2 – Year-Over-Year Inflation (%)



Source: Bureau of Labor Statistics. Dec 2019 - May 2022.

With that focus, the FOMC conducted two very different meetings in Q2. The first meeting was rather benign, with the Fed raising interest rates by a highly anticipated 50 bps to a range of 0.75% - 1.00%. The market's reaction on the longer end of the curve was somewhat muted, with the 10-year Treasury pushing above 3% before settling back down to finish the month of May at 2.84%. The 2-year Treasury pulled back from an early-month high of 2.78% to spend the rest of May in a range from 2.73% to 2.48%, before ending at 2.56%.

The second meeting, which occurred on June 15, was more dynamic. With the red-hot inflation report (+8.6%) hitting the newswires on Friday, June 10, the Fed only had two business days to digest the data and what it could mean for the upcoming rate decision. Sequestered in its quiet period pre-FOMC meeting, Fed members were unable to provide any insight to the markets as to what may have changed their viewpoints on rates and inflation. Thus, we were exposed to the kind of Fed meeting that rarely occurs, a meeting with the potential for a surprise, with street talk ranging from 50 bps to 75 bps to 100 bps with no clear consensus. Not since the global financial crisis has there been a meeting with such uncertainty as to how things were going to progress. And the Fed didn't disappoint, delivering the largest rate hike since November 1994 (75 bps) with a clear message that another 75 bps rate hike in July is a distinct possibility. The Fed was also clear that a more restrictive stance would be possible if elevated inflation pressures were to persist. *"In discussing potential policy actions at upcoming meetings, participants continued to anticipate that ongoing increases in the target range for the federal funds rate would be appropriate to achieve the Committee's objectives,"* the most recently published minutes said. *"In particular, participants judged that an increase of 50 or 75 basis points would likely be appropriate at the next meeting."*

Portfolio Performance & Positioning

The rise in Treasury yields in Q1 continued into Q2 with the shorter end once more taking on the brunt of the increase as markets reconciled the impact of a more aggressive Fed compared to earlier expectations. With the relatively stronger increase in yield in shorter maturities, the curve continued to flatten as the 6-month T-bill and 1-year Treasury were the biggest movers. The result was a challenging month in the Treasury market. No segment of the curve went untouched, with the shorter end of the curve delivering negative performance while the longer end of the curve delivered its worst quarterly performance since Q1 2021. The dreaded curve inversion between the 2-year Treasury and the 10-year Treasury occurred during the first days of the quarter but reversed by the end of the first week of April. In fact, the spread between the two bellwether securities held at an average of roughly 21 bps during the quarter, though the spread level was down to 6 bps by the end of the quarter. The portfolio held an underweight in Treasury securities relative to the benchmark, but the portfolio's allocation is longer in duration so the net impact of the position on a relative basis was negative.

The portfolio's duration has been maintained at the low end of the targeted range of +/- 10% of the benchmark's duration, which limited the impact from interest rate movements. The portfolio finished Q2 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.86 years compared to 6.44 years. The portfolio's duration positioning relative to the benchmark contributed positively to relative performance in the quarter.

The Bloomberg US Corporate Bond Index lost -7.26% in Q2, nearly matching the loss of -7.69% that occurred in Q1. Relative to comparable duration Treasuries, the corporate index lost 224 bps as longer duration and spread widening compounded to hurt the index on a relative basis. Longer duration had a greater negative impact than spread widening as the AAA component of the corporate index lost -8.22% during the quarter, the most of any of the credit quality segments. Single-A corporates held up the best, only losing -6.56% over the past three months. The portfolio's combination of an underweight position to the corporate market relative to the benchmark, shorter relative duration and security selection with the corporate allocation contributed positively to relative performance during the quarter.

The Bloomberg US Securitized Index lost -3.90% in Q2, which is the second worst quarter since the launch of the sub-index in 1997 (Q1 2022 was the worst), but still the best for the quarter relative to other sectors. Shorter duration asset-backed securities (ABS) held up the best, with the sector down only 91 bps during the quarter, fueled by the resiliency of the auto ABS sector (down 72 bps). While delinquencies have been trending higher in various areas of consumer related debt instruments, levels continue to hold at or near pre-COVID levels. Within the mortgage segment of the market, commercial mortgage-backed securities (CMBS) held up slightly better than residential mortgage-backed securities (RMBS) as the market continued to adjust to the fact that the Federal Reserve is in run-off mode for its agency RMBS holdings, though we are just at the beginning of the process.

The healthy start to the year in issuance for the ABS markets finally cooled off in the final month of Q2. After averaging roughly $29.0 billion per month for the first five months of the year, issuance dropped off to $18.3 billion as ongoing concerns around the future path of rates as well as the impact of inflation slowed issuance. The new issue market was just over $163 billion for the first six months of the year, which puts the market on pace to nearly match last year's record issuance.

On a relative basis, the portfolio's securitized allocation delivered the best performance during the quarter, led by ABS and non-agency commercial and residential mortgage-backed securities. Specific to ABS, consumer unsecured and small business held up the best during the quarter while the auto allocation trailed the benchmark slightly. The portfolio's allocation to agency CMBS trailed the benchmark allocation while the 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 contributed positively to performance during the quarter.

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

Period and Annualized Total Returns (%)

	Since Inception (31 Jul 2016)	5Y	3Y	1Y	YTD	2Q22
Gross of Fees	1.84	2.05	0.23	-8.39	-8.61	-3.90
Net of Fees	1.57	1.79	0.00	-8.63	-8.73	-3.96
Bloomberg US Aggregate Bond Index	0.58	0.88	-0.93	-10.29	-10.35	-4.69

Calendar Year Returns (%)

	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021
Gross of Fees	-2.45	4.64	2.06	8.56	8.34	-0.55
Net of Fees	-2.56	4.33	1.76	8.28	8.13	-0.79
Bloomberg US Aggregate Bond Index	-3.14	3.54	0.01	8.72	7.51	-1.54

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