DIAMOND HILL

INVESTED IN THE LONG RUN

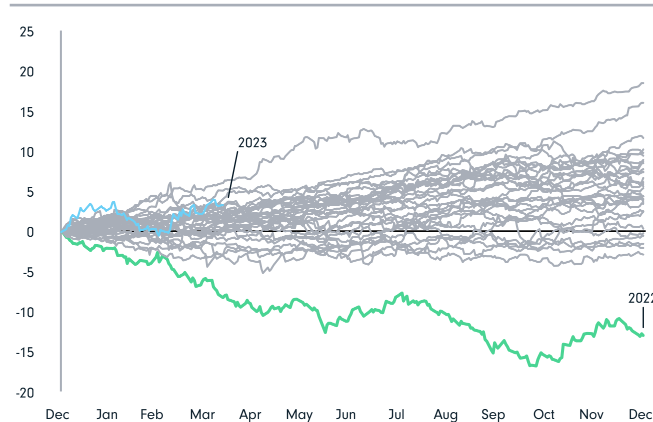
Core Bond Strategy

As of 31 Mar 2023

Market Commentary

Fixed income markets moved on from what was likely the most difficult year ever for the asset class by delivering an up and down quarter that, thankfully, was more up than down. The Bloomberg US Aggregate Bond Index was up +2.96% in Q1, which is the best quarterly performance since Q1 2020 (+3.15%). Exhibit 1 is an update to a chart we shared last quarter, illustrating the historic calendar year returns since the turn of the century as well as the first quarter progression for comparison purposes.

Exhibit 1 – Bloomberg Aggregate Total Return, Year to Date (%)



Source: Bloomberg.

The year started on a positive note with strong employment news (+517k jobs added), rising consumer confidence, China reopening and continued disinflation (decrease in the level of inflation). Despite the solid economic news, which would entail further Fed tightening, the markets continued to disagree with the Fed and projected a lower terminal rate and eventual cuts. This divergence between the Fed and markets slowly broke down as continued strong employment news in February (+311k jobs added) coupled with slower disinflation brought the markets nearly in line with the Federal Reserve's tightening schedule. And then we reached March 9, and the markets were upended as Signature Bank and Silicon Valley Bank failed, and Credit Suisse was rescued by the Swiss government and UBS. The subsequent dislocation in the market and upheaval abruptly shifted market expectations for Fed action.

How shaky did things get in the fixed income markets during the final month of the quarter? The MOVE Index, which measures Treasury rate volatility through options pricing, experienced its wildest daily shifts and highest level since the 2008 global financial crisis. As shown in Exhibit 2, the index peaked the Monday following the collapse of Signature Bank and Silicon Valley Bank, surpassing the level reached during the 1998 Long Term Capital Management crisis and ranks as the highest level reached second only to the levels seen during the 2008 crisis. As the market moved past the unrest associated with regional banks, and concerns ebbed on widespread contagion, the MOVE index settled back into familiar territory, ending the month at 135.93.

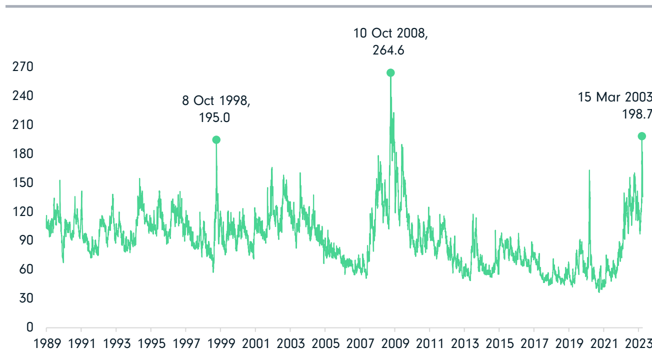
Team

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

Douglas Gimple
Senior Portfolio Specialist

Exhibit 2 – MOVE Index (1989-2023)



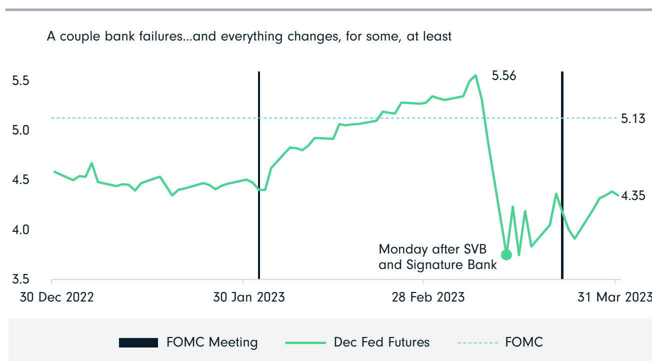
Source: Bloomberg.

Fed vs Market Expectations, Part Deux

It appeared as though the Fed's stalwart reinforcement of its much-publicized terminal rate (5.125% in both the December and March Statement of Economic Projections or SEP) had finally convinced the markets of its commitment to its tightening plan. The markets, as measured by fed funds futures, had stubbornly refused to accept both the aforementioned terminal rate and the well communicated pause through year-end 2023, instead pricing in a lower terminal rate and subsequent cuts by year end.

Stronger economic news and a slowdown in the pace of disinflation prompted the market to finally get on board with the Fed's plan of a terminal rate north of 5% and holding the line until at least the end of the year. Exhibit 3 illustrates market expectations for the fed funds rate in December 2023, which by mid-February had finally fallen in line with the Fed — even exceeding the FOMC estimate for the terminal rate (5.62% priced on March 7) though still projecting a potential cut by year end.

Exhibit 3 – Fed Funds Rate Futures (%)



Source: Bloomberg.

All of that changed on the Monday following the Signature Bank and Silicon Valley Bank failures. Expectations for Fed action plunged on March 13 as concerns around potential contagion and a redux of the 2008 global financial crisis reverberated throughout the economy. The volatility that plagued the equity and fixed income markets came to a head with the most anticipated and uncertain FOMC meeting since the 2008 crisis.

Given the stronger economic data and stubbornly resilient labor market, pre-regional bank crisis expectations had been growing for a 50 basis-point (bps) hike at the March 22 meeting, but on the heels of the mid-March events, uncertainty loomed. Fed Chairman Jerome Powell announced the 25-bps hike and, despite the SEP showing a terminal rate for 2023 holding fast at 5.125%, the market continued to show a lower terminal rate as well as rate cuts before year end.

We've returned to a period similar to earlier this year, with the Fed holding the line and the markets expecting something different. Economic data is beginning to show the impact of the Fed's tightening cycle and the regional bank crisis has served to slow aspects of the economy, so we could be near the end of this tightening cycle. But if we've learned nothing else from Q1 of this year, it's that the best laid plans are also susceptible to the unknown.

Portfolio Performance & Positioning

It was another quarter of rollercoaster returns in the Treasury market with alternative months of positive and negative performance. But whereas Q4 2022 included one month of positive performance offset by two months of negative performance, Q1 2023 was the opposite. Strong performance in January (+2.51%) and March (+2.89%) offset the downside of February (-2.34%) to deliver the best non-COVID influenced quarterly performance (+3.00%) since Q2 2019 (+3.01%).

The disconnect between the Federal Reserve and markets reached a fever pitch in January as Treasury yields rallied throughout the first month of the year amid market expectations that the Fed was nearing the end of the tightening cycle. Ongoing stronger economic data combined with slowing disinflation and various members of the FOMC pushing their agenda of a higher terminal rate finally brought markets in line with FOMC expectations for the terminal rate.

The largest bank failures and first Global Systemically Important Bank (G-SIB) to be taken over since 2008 drove investors to the perceived safety of US Treasuries, pushing yields to their low points of the quarter.

To provide context on the volatility in March, consider this: The largest single-day move (up or down) in the 2-year Treasury yield since the turn of the century was March 13, the Monday after SVB/Signature failed. The 2-year Treasury rallied 60.9 bps on the 13th, followed by a back-up of 27.4 bps, rally of 36.4 bps, increase of 27.1 bps and a decrease of 32.0 bps during the days following the 13th to finish one of the most tumultuous weeks in the security's history.

This move was bigger than the day markets opened following the September 11 attacks in 2001 (down 53.3 bps) and beyond any of the peak Lehman days during the 2008 global financial crisis (Monday 9/15 down 49.7bps, 9/19 up 47.3 bps, 9/29 down 43.9 bps).

Exhibit 4 – 10-Year Treasury Yield and MOVE Index

Source: 10-Year Treasury, FRED. MOVE Index, Bloomberg.

The portfolio's duration has been maintained at the low end of the targeted range of +/- 10% of the benchmark's duration, which has worked both for and against the portfolio. The shorter positioning relative to the benchmark detracted from performance in Q1. The portfolio finished the quarter at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.59 years compared to 6.33 years, respectively.

The Bloomberg US Corporate Index has now delivered strong back-to-back quarters after suffering from three consecutive quarterly losses. Investment grade corporates followed a similar pattern as Treasuries in Q1 with strong January (+4.01%) and March (+2.78%) returns serving as the bookends for February's results (-3.18%). It was the best first quarter performance for the index since 2019's +5.14% return and ended the streak of negative first quarter performances (2020, 2021, 2022). Relative to comparable duration Treasuries, the corporate index gained +0.20% — the best relative performance across the various investment grade fixed income sectors outside of non-corporate credit (+0.23%). Higher quality and longer duration were the winning combination in Q1 with the AAA-rated segment of the corporate index returning +5.03%, followed by AA-rated (+3.95%), BBB-rated (+3.57%) and A-rated (+3.31%). The portfolio's combination of an underweight position to the corporate market relative to the benchmark and shorter relative duration detracted from relative performance in Q1.

The Bloomberg US Securitized Index outpaced the previous quarter's strong performance, returning +2.47% in Q1, which was the best quarterly performance since Q2 2010 (excluding Q1 2020's return of +2.65%).

Mortgage-backed securities, both residential and commercial, led the way for the sector with lower duration asset-backed securities (+1.86%) delivering the lowest performance amongst all the major sectors. Index-eligible residential mortgages had a strong Q1, generating a return of +2.53% but trailed collateralized mortgage obligations, as measured by the ICE Bank of America Collateralized Mortgage Obligation (CMO) Index, which delivered +3.08%. In the commercial mortgage-backed securities (CMBS) sector, high-quality agency CMBS outpaced their non-agency counterparts, +2.47% compared to +1.24%, respectively. Concerns continue to grow around the office segment of the CMBS market, and we believe investors should exercise caution when considering this part of the market.

Index-eligible asset-backed securities were rather pedestrian during the quarter (+1.86%) but non-index areas of the market delivered compelling returns, fueled by strong performance from mortgage servicing rights (MSR), private student loans and unsecured consumer debt.

Relative to comparable duration Treasuries, all segments of the securitized market trailed during the quarter. While concerns remain regarding the strength of the consumer, volatility associated with uncertainty has provided significant opportunities if investors are diligent in their underwriting and selective in their allocations. In total, the portfolio's securitized allocation was additive to relative performance with the best relative value coming from the portfolio's favoring of CMOs in lieu of pass-through RMBS (residential mortgage-backed securities).

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

ICE BAML MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries. **ICE BofA US Agency Collateralized Mortgage Obligation (CMO) Index** measures the performance of US dollar-denominated, fixed-rate Agency CMOs publicly issued in the US domestic market.

Period and Annualized Total Returns (%)

	Since Inception (31 Jul 2016)	5Y	3Y	1Y	YTD	1Q23
Gross of Fees	1.65	1.92	-1.15	-3.77	3.37	3.37
Net of Fees	1.35	1.62	-1.44	-4.05	3.29	3.29
Bloomberg US Aggregate Bond Index	0.50	0.91	-2.77	-4.78	2.96	2.96

Calendar Year Returns (%)

	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021	2022
Gross of Fees	-2.44	4.64	2.06	8.56	8.34	-0.55	-11.47
Net of Fees	-2.56	4.33	1.77	8.24	8.03	-0.84	-11.73
Bloomberg US Aggregate Bond Index	-3.14	3.54	0.01	8.72	7.51	-1.54	-13.01

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