DIAMOND HILL

INVESTED IN THE LONG RUN

Intermediate Bond Strategy

As of 30 Sep 2023

Wake me up when September (and the third quarter) ends...

Harkening back to the turmoil of 2022, fixed income markets dealt with another challenging quarter as Treasury yields climbed and broad fixed income indices were down for the second consecutive quarter. The Bloomberg US Aggregate Bond Index lost -3.23% in Q3, its worst performance since Q3 2022, when the index lost -4.75%. The index is now in negative territory since the beginning of the year and we're looking at the possibility of three consecutive years of negative returns for the index, an unprecedented event. But there is still time to salvage performance in the final quarter of 2023, but it will be a challenge given the geopolitical climate and economic uncertainty.

Team

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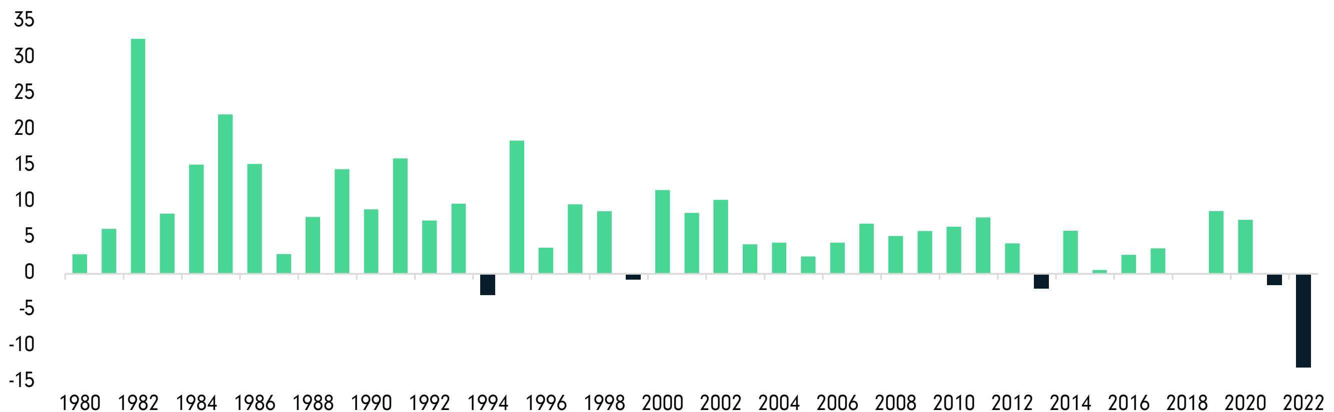
Exhibit 1 – Bloomberg US Aggregate Bond Index, Calendar Year Returns (%)



Source: Bloomberg.

The Federal Open Market Committee met twice in Q3 with both meetings serving as an opportunity for the Federal Reserve to reinforce the expectation of "higher for longer". Both meetings maintained a hawkish bias with the July 26 meeting ending with an additional 25 basis point increase in the fed funds rate while the September 20 meeting resulted in the Fed holding the line at 5.25% to 5.50%.

The hawkish aspect of the September meeting? While the committee held the fed funds rate at 22-year highs and the door open for an additional hike before year-end, the dot plot shifted the committee's outlook for 2024 rate cuts from four to two. The committee increased its forecast for 2023 GDP from 1.0% in June to 2.1% and 2024 GDP from 1.1% up to 1.5%.

The Fed has smoothly made the transition from aggressive tightening to data dependency and flexibility and heads into the final quarter of the year in control of the narrative around short-end rates. Almost quietly in the background, the Fed continues to wind down its System Open Market Account (SOMA) or balance sheet, having reduced the balance sheet by roughly 13% since the beginning of the process.

Geopolitical issues, labor gyrations and Washington gridlock

The conflict in Ukraine continues but the world's attention shifted from Europe to the Middle East as Hamas' unprecedented assault on Israeli settlements shocked the world. As we write this, Israel has marshalled its forces and appears on the verge of launching an incursion into Gaza as the world watches on with trepidation, fearing the potential for the conflict to spread into surrounding countries. Markets reacted as one would expect with a short-lived flight to quality and a backup in oil prices. With the US moving carrier fleets into the Mediterranean Sea to support the Israelis, the tension grows and concerns for a broader conflict grow with it.

In the US, a strong non-farm payroll report during the quarter contributed to the potential for a soft landing, despite the impact of the run-up in interest rates. The average gains in non-farm payroll in Q3 was 266,000 jobs, fueled by the higher-than-expected 336,000 jobs added in September. This pace is slightly ahead of the year-to-date average but trailing 2022 (399,000) and 2021 (606,000), both of which benefitted from the economy re-opening and bounce back from COVID. The strong gains were achieved despite the ongoing battle between the United Auto Workers and the Big Three auto manufacturers as well as the ongoing actors strike and recently settled writers' strike in Hollywood. Unemployment held steady in September at 3.8%, well below the historic average of roughly 5.7% and has averaged 3.6% since the beginning of the year.

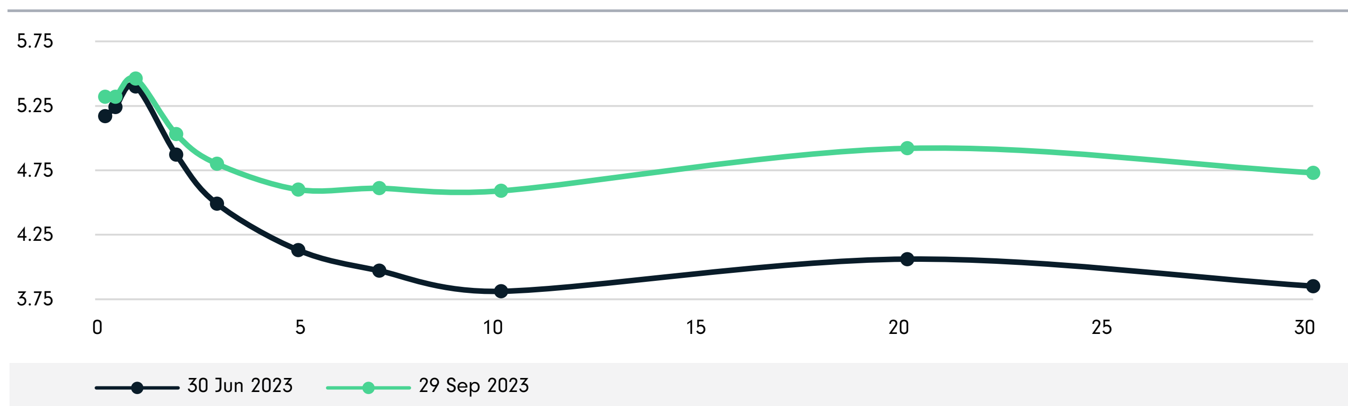
The political wrangling in Washington continues, despite the passing of a stopgap funding bill in the hours leading up to an October government shutdown. Securing a deal to keep the US government open and avoiding the third shutdown since January 2018 cost Speaker of the House Kevin McCarthy his job, as he was ousted from the position three days after the passage of the deal. It's the first time in history that the House has removed its leader and speaks volumes about the disfunction running rampant in the nation's capital. The House will now continue like a rudderless ship, absent a leader until Republicans can rally together and appoint a new Speaker. The Speaker is simultaneously the House's presiding officer, party leader and the institution's administrative head, among other duties, and ranks as second in line to succeed the President, after the Vice President. And all the stopgap funding bill accomplished was the buying of time — the government will continue operating until November 17 unless lawmakers pass another spending bill before then to avoid a shutdown. The vacancy of the Speaker's office could lead to a long, drawn-out fight for a replacement, which will delay any negotiations to resolve the ongoing issues.

Portfolio Performance & Positioning

It was a challenging quarter for investment grade fixed income as rates moved higher across the curve, with the biggest shift occurring on the longer end. Continued uncertainty around the potential government shutdown and general disfunction in Washington, DC, coupled with an assertive Federal Reserve pushed rates to their highest levels since the financial crisis.

The Treasury market was hit particularly hard, losing more than -3% during the quarter, fueled by the Bloomberg 30-year Treasury bellwether losing nearly -13% and the Bloomberg 10-year bellwether down more than -5%. After a very painful second quarter for the shorter end of the Treasury curve, the Bloomberg 2-year Treasury bellwether rebounded nicely as the combination of a lesser move higher in yields was offset by a decent level of income, generating a positive return of +0.57%. Ongoing concerns around the deluge of US Treasury debt into the market to fund ongoing deficit spending has created some overall angst in the market.

Exhibit 2 – Dramatic Yield Curve Shift Q3 2023 (%)



Source: FRED.

The portfolio's duration has been marginally increased as the year has gone on, starting the year at 89% of the benchmark duration and closing out the third quarter at 91% of the benchmark duration, a position that reflects the likely end of the Fed's rate hiking cycle. The shorter positioning relative to the benchmark contributed to overall performance during Q3 and the relatively longer duration posture in the Treasury sector was offset by the underweight compared to the benchmark. The portfolio finished Q3 at a shorter duration posture than the Bloomberg US Intermediate Aggregate Bond Index, 4.18 years compared to 4.62 years.

The Bloomberg US Corporate Bond Index experienced a difficult quarter, losing more than -3%, which was fueled by duration risk as rates climbed higher over the past three months. The longer duration components of the benchmark felt the most pain with the AAA-rated segment down more than -6%, while the shorter duration BBB-rated segment lost only -2.71%. Relative to comparable duration Treasuries, the corporate index gained +0.84%, the best relative performance across the various investment grade fixed income sectors. Spreads continued to compress, following the downward trend that has been in place since mid-March and the short-lived regional banking crisis. Despite the ongoing concerns about the long-term viability of the economy's strength, investment grade corporate debt continues to hold up quite well. The portfolio's allocation to investment grade corporate debt was a slight positive, driven by security selection and a slight relative underweight.

The Bloomberg US Securitized Index was the worst performing sector of the investment grade universe, losing -3.81% during the quarter. Benchmark-eligible residential mortgage-backed securities (RMBS) were the biggest detractor as rising interest rates harshly impacted the interest rate sensitive segment of the market. The combination of surging mortgage rates (closing in on 8% for 30-year mortgages, according to Bankrate.com), the FDIC's completion of the Silicon Valley Bank and Signature Bank RMBS liquidations and the ongoing reduction of the Fed's balance sheet has resulted in a mismatch between supply and demand.

Agency collateralized mortgage obligations (CMOs), as measured by the ICE Bank of America CMO Index, held up better during the quarter (down -2.49%) as unique cash flow structures held up better during the volatility that occurred.

Relative to comparable duration Treasuries, the residential mortgage-backed securities (RMBS) market suffered while the commercial mortgage-backed securities (CMBS) sector held up well, returning +0.35% when measured against Treasuries despite negative total returns for the quarter (down -1.02%). While headline risks remain in the CMBS sector, it is a sector that has been beaten down and is positioned to offer pockets of opportunity if proper due diligence is conducted and investors are selective.

Shorter duration asset-backed securities (ABS) delivered positive returns for the quarter as the combination of less interest rate sensitivity (due to shorter duration) was buoyed by attractive yield levels. Even as concerns continue to grow regarding the state of the consumer, the ABS sector has held up well, fueled by significant levels of issuance and tightening underwriting standards. In total, the portfolio's allocation to securitized sectors contributed to relative performance strong relative return in the RMBS sector and positive returns in both the ABS and CMBS sectors.

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

Bonds rated AAA, AA, A and BBB are considered investment grade.

Period and Annualized Total Returns (%)

	Since Inception (31 Jul 2021)	1Y	YTD	3Q23
Gross of Fees	-3.53	2.48	1.40	-0.65
Net of Fees	-3.81	2.18	1.18	-0.72
Bloomberg US Intermediate Aggregate Bond Index	-5.16	1.42	-0.30	-1.89

Calendar Year Returns (%)

	31 Jul 2021 - 31 Dec 2021	2022
Gross of Fees	-1.02	-7.83
Net of Fees	-1.14	-8.09
Bloomberg US Intermediate Aggregate Bond Index	-1.17	-9.51

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