

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Short Duration Investment Grade 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.

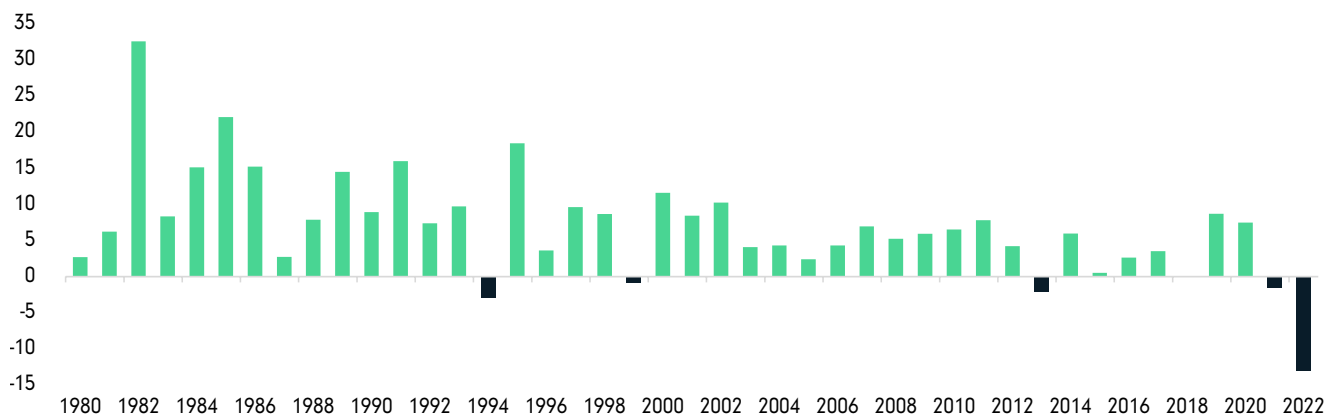
### Team

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Portfolio Manager

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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 is important to note our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured products across the investment grade quality spectrum.

As of September 30, the portfolio had a yield-to-worst (YTW) of 7.41% with an effective duration of 1.29 years, compared to a YTW of 8.46% and effective duration of 1.36 years at the end of the second quarter.

The securitized market delivered the strongest performance among the sectors held in the strategy with credit card asset-backed securities (ABS) and non-agency commercial mortgage-backed securities (CMBS) leading the way.

Within the non-agency CMBS sector, commercial real estate collateralized loan obligations (CRE CLOs) led the way while in the ABS allocation, small business and equipment were the leaders. CRE CLOs are shorter-term, floating rate CMBS that are focused on transitional properties.

While the strategy is underweight corporate debt, security selection within the sector helped mitigate the impact of that position. The significant underweight to Treasuries detracted slightly from performance during the quarter, as shorter-end Treasury securities held up well.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

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

Period and Annualized Total Returns (%)	Since Inception (30 Nov 2021)	1Y	YTD	3Q23
Gross of Fees	0.47	5.68	4.77	1.83
Net of Fees	0.12	5.31	4.49	1.74
Bloomberg US 1-3 Yr. Gov./Credit Index	-1.12	2.77	1.87	0.73

Calendar Year Returns (%)	30 Nov 2021 - 31 Dec 2021	2022
Gross of Fees	-0.09	-3.64
Net of Fees	-0.12	-3.98
Bloomberg US 1-3 Yr. Gov./Credit Index	-0.15	-3.69

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