

DIAMOND HILL

INVESTED IN THE LONG RUN

Intermediate Bond Strategy

As of 31 Dec 2023

Strong finish to a puzzling year

As Q3 wound down, fixed income markets were staring into the abyss, faced with the prospect of an unprecedented third consecutive year of negative returns. The Bloomberg US Aggregate Bond Index had lost -1.21% through September's month-end, and market participants were anxious about the final quarter of the year, especially after the pain of 2022, when the index lost more than 13%.

A shaky October, during which the index lost -1.58%, reinforced the angst felt around the halls of fixed income managers around the country. The 10-year Treasury breached the 5% level, if only on an intraday basis, in the middle of October after climbing steadily higher since the beginning of Q4, fueled by expectations of rates remaining "higher for longer" as well as geopolitical tensions. However, declining inflation in the year's final months fueled the outlook for a soft landing and pushed rates lower as the market ramped up expectations for an aggressive easing cycle in 2024.

The final impetus for lower rates came from the Fed itself as the dot plot (released after each quarterly FOMC meeting) signaled an additional 25 basis point (bps) rate cut expected for 2024. Nevertheless, a substantial disconnect remains between market expectations and those of the FOMC, which we discuss later. Amazingly, the 10-year Treasury yield finished 2023 at nearly the same level as it began the year, 3.88%.

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Exhibit 1 - 10Y Yield Treasury Rollercoaster Ride in 2023 (%)



Source: Federal Reserve Economic Data (FRED).

While October's performance was a setback for the overall fixed income market (as measured by the Bloomberg US Aggregate Bond Index), November and December delivered some of the best returns in decades. November generated the best monthly performance for the index (+4.53%) since May 1985 (+5.23%), and December's +3.83% return was the best since February 1986 (+3.94%). The combined performance for November and December was the best two-month return for the Bloomberg US Aggregate Bond Index since October 1982 (+9.56%, during which the 10-year Treasury dropped from 12.81% to 10.71%).

Q4 2023 delivered the best quarterly performance for the index since Q2 1989 (+7.97%), generating a return of +6.82%. Coming into the final two months of the year, the index was down -2.77% but finished 2023 with a return of +5.53%, the best calendar year return since 2020 (+7.51%).

Federal Reserve vs the Markets

The most significant change at the final FOMC meeting of 2023 was the shift in the dot plot, which is a chart used to illustrate where each FOMC member believes interest rates will be by the end of the current year, two or three (depending on the time of year) consecutive years after, and the more ambiguous "longer run." Each dot represents a member's individual view and is updated quarterly.

After the September meeting, the Fed estimate was for two 25 basis point cuts per the dot plot by the end of 2024. The December dot plot reading revealed the Fed is now expecting three 25 basis point cuts in 2024 and an additional 100 basis points in cuts in 2025 (no change from September), indicating that it believes it is most likely at the end of this rate hiking cycle.

But this meeting's shift was a close call. There are 19 participants that make up the dot plot, each providing their expectations for future rate movements. Two dots were the difference between an estimate of 75 bps of cuts versus 50 bps in 2024. Even with the inclusion of an additional 25 basis point rate hike sometime in 2024, the FOMC's outlook differs quite a bit from how the market is pricing in the future path of interest rates.

Fed fund futures contracts are the best method for understanding how the market is viewing the future path of interest rates. The prices of fed funds futures expiring after upcoming FOMC meetings reflect the market's expectations for the outcome of those meetings in terms of federal funds rate targets. Those market prices can be expressed as probabilities of rate hikes (or cuts) of a given size at those meetings, usually broken down in 25 basis point increments. These contracts are not meant to predict the future but rather communicate current market expectations for Fed action in upcoming meetings.

As expectations for a potential soft landing grew and inflation slowed in the final months of 2023, the fed funds futures market shifted to reflect an aggressive easing posture from the Fed. This shift occurred despite ongoing hawkish comments from various FOMC members and their own dot plot expectations. At the beginning of Q4, the futures market was pricing in roughly 62.5 basis points of interest rate cuts by year-end 2024, only slightly ahead of the FOMC's projection of 50 basis points of cuts.

By the end of the quarter, the December 2024 contract indicated market expectations of 157 basis points in cuts, which is more than double the adjusted FOMC outlook of 75 basis points by year-end 2024. The shift in market expectations helps explain the massive rally across both Treasury and risk markets as an accommodating Fed and lower rates lift all boats.

"Don't fight the Fed" is a long-standing mantra in the markets that has never been more appropriate than heading into 2024. Despite the most recent dot plot indicating 75 basis points of interest rate cuts by the end of 2024, the Federal Reserve kept interest rates steady at its December 13 meeting and stated it is not likely to raise rates further this cycle. However, Chairman Jerome Powell did say that the Fed is prepared to tighten further if needed. So, while the chances for one last rate hike have diminished substantially, the possibility cannot be discounted entirely.

Assuming the Fed is indeed finished with this tightening cycle, the next step is reconciling the difference between market expectations (extremely dovish) and the FOMC itself (holding the line and waiting for more information before acting). We'll stick with not fighting the Fed.

Portfolio Performance & Positioning

As challenging as Q3 2023 was for fixed income markets, Q4 delivered the type of performance that was more than enough to offset the damage that was done. In fact, Q4 was strong enough to turn a potentially painful year into one of the better-performing cycles in recent years.

The Treasury curve perfectly illustrates the differences between the two periods. During Q3, the 2-year, 10-year and 30-year Treasury yields rose higher by 16 bps, 78 bps and 88 bps, respectively (Exhibit 2). This massive shift led to the worst quarterly return (-3.23%) since Q1 2021 (-3.37%), excluding the carnage from 2022. This was reflected in the return for the bellwether indices of those tenors: up 0.57%, down -5.12% and down -12.72%, respectively. Compare that to Q4, in which the yield on the aforementioned tenors compressed by 80 bps, 71 bps and 70 bps, respectively. The resulting performance (+2.49%, +6.87% and +12.85%) was the best since Q1 2020.

Exhibit 2 – A Tale of Two Quarters, Treasury Yields (%)

| Calendar Quarters 2023 | 2Y | 10Y | 30Y |
|------------------------|-------|-------|-------|
| June 30 | 4.87 | 3.81 | 3.85 |
| September 30 | 5.03 | 4.59 | 4.73 |
| Change | 0.16 | 0.78 | 0.88 |
| September 30 | 5.03 | 4.59 | 4.73 |
| December 31 | 4.23 | 3.88 | 4.03 |
| Change | -0.80 | -0.71 | -0.70 |

Source: FRED.

The portfolio's duration marginally increased as the year went on, starting the year at 88% of the benchmark duration and closing out the year 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 detracted from overall performance in Q4, with the relatively longer duration posture in the Treasury sector helping to offset some of the impact from the overall positioning. The portfolio finished Q4 at a shorter duration posture than the Bloomberg US Intermediate Aggregate Bond Index, 4.09 years compared to 4.47 years.

The Bloomberg US Corporate Bond Index returned more than +4% in December to follow up its best month since December 2008, pushing 2023 calendar year performance past +8%. The two-month stretch in November and December returned +10.57% and helped push the investment-grade corporate market to the best performance of the major aggregate sectors.

The performance was back-end loaded, considering the corporate index returned +8.50% in Q4, compared to the full-year return of +8.52%. Once more, duration played a key role in total performance, with longer duration AAA-rated corporates returning +5.00% in December, followed by BBB (+4.44%), AA (+4.23%) and single-A (+4.22%) though there were significant differences in excess return relative to comparable duration Treasuries. The long corporate index returned +7.36% during the month and 10.93% for the year. AAAs trailed comparable duration Treasuries, while BBBs held up the best. Security selection within the corporate sector tracked the index allocation closely but the underweight detracted from overall performance.

November was a record-setting month for the Bloomberg US Securitized Index, as the sector generated a +5.02% return. December was close on its heels with a return of +4.20%, making the two-month return for November and December (+9.43%) the best 60-day stretch in the index's history, more than double the return of the runner-up two-month period ended December 2008 (+4.64%).

The Q4 return for the securitized sector (+7.28%) was the best since its inception in 1997. The strong push at the end of the year brought the calendar year return to +5.08%, the sector's best return since 2019 (+6.44%). Subsectors within the securitized market were strong, with the residential mortgage-backed securities (RMBS) sector delivering +7.48% during the quarter (ahead of CMOs return of +5.69%, as measured by the ICE BofA CMO Index), commercial MBS up +5.25% and asset-backed securities up +3.48%. The exuberance generated by the potential for aggressive rate cuts in 2024, as well as the overall risk-on atmosphere in the final months of 2023, pushed valuations on securitized assets higher, much like with the rest of the market.

Despite concerns about the consumer simmering in the background, a strong holiday season and continued strength in the labor market have helped calm some of the angst. In total, the portfolio's allocation to securitized sectors contributed to relative performance, helped by non-benchmark eligible positions in non-agency RMBS and security selection within ABS.

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 | 4Q23 |
|--|----------------------------------|------|------|------|
| Gross of Fees | -1.14 | 6.60 | 6.60 | 5.13 |
| Net of Fees | -1.43 | 6.29 | 6.29 | 5.06 |
| Bloomberg US Intermediate Aggregate Bond Index | -2.50 | 5.18 | 5.18 | 5.50 |

| Calendar Year Returns (%) | 31 Jul 2021 - 31 Dec 2021 | 2022 | 2023 |
|--|------------------------------|-------|------|
| Gross of Fees | -1.02 | -7.83 | 6.60 |
| Net of Fees | -1.14 | -8.09 | 6.29 |
| Bloomberg US Intermediate Aggregate Bond Index | -1.17 | -9.51 | 5.18 |

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