

It was a quarter with enough drama and shifting landscape at the Federal Reserve and in Washington, D.C., to make most reality shows jealous. There was finally talk about tapering after previously only thinking about talking about tapering. The third quarter contained not only two meetings of the Federal Open Market Committee (FOMC) but the annual Jackson Hole Policy Symposium, as well as a variety of FOMC members clamoring for press appearances to share their notions of taper timing and logistics.

As if the machinations of the most important central bank in the world weren't enough, we were given a solid dose of scandal, resignations and a prominent U.S. Senator referring to the Federal Reserve Chairman as a "dangerous man" while making it clear she would not support his re-appointment. To top it off, the U.S. government is heading toward financial abyss as another game of chicken is underway regarding the debt ceiling and future government spending.

Dots and more dots

What we learned from the most recent dot plot (Exhibit 1) is that 9 out of the 18 members of the FOMC expect no rate increases in 2022, 6 expect a single rate increase and 3 members expect 2 rate increases. It's a much broader set of results for 2023:

- 1 member keeping rates steady at the current level from now until the end of 2023
- 4 members at one 25 bps increase
- 3 members at 2 increases
- 1 member expecting 3 increases
- 6 members expecting 4 increases
- 3 members expecting 6 increases

Nothing exciting with regards to movement on rates as Powell has continually pointed out that the test for lift-off on rates is more stringent than the test for tapering. Remember, the rates test is focused on inflation (transitory) and employment (4.8% unemployment as of 9/30) while the tapering test is the nebulous "substantial further progress." If we assume that rate expectations are fairly accurate (with a major caveat that dots can't predict the future and much can change), it's a fair expectation that we'll see a lift-off at the end of 2022 (similar to the 2015 rates process: one increase per year for two years before a gradual climb higher).



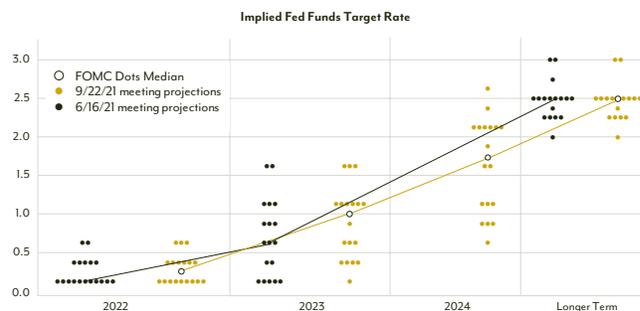
TEAM

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

Douglas Gimple
Senior Portfolio Specialist

EXHIBIT 1: DOT PLOT



Source: Bloomberg.

The tapering talk is here but brings more questions

If we assume the taper is officially announced in November and begins in December with expectations (per Powell) to be wrapped up by mid-2022, we're looking at a much faster taper than what the market experienced in 2014. That taper started at a time when the Fed was buying \$85 billion combined in Treasury and agency mortgages each month, with a reduction beginning in December 2013 and wrapping up almost a year later in October 2014. This time, the Fed will be reducing a higher level of monthly purchases (\$120 billion per month) in a much tighter period (six months), so we can't use the "original taper" as a road map for how the market will absorb this tapering iteration.

Tapering is coming, but this time will be different based on what we've learned from the Fed, and new questions will need to be asked:

- Once tapering has concluded, will the Fed follow the same plan as it did in 2014?
- Will the Fed roll maturities to hold the balance sheet steady?
- When/will the Fed begin any kind of quantitative tightening?

Back in 2014, once tapering wrapped up, the Fed continued to re-invest maturing securities back into the market, keeping the balance sheet steady through October 2017. The Fed didn't begin reducing the balance sheet (known as quantitative tightening) until late 2017, allowing \$6 billion in Treasury and \$4 billion in mortgages to roll off the balance sheet, ramping those levels higher until the Fed was rolling off \$30 billion in Treasuries and \$20 billion in mortgages each month.

Scandal shifting the Fed landscape?

“No one on the FOMC is happy to be in this situation, to be having these questions raised. It’s something we take very, very seriously.”

– Federal Reserve Chairman Jerome Powell

The situation? A reputational crisis at the central bank fueled by several large financial transactions by Dallas Fed President Robert Kaplan and Boston Fed President Eric Rosengren during the calamitous days of the pandemic in 2020. While their actions complied with the Federal Reserve’s ethics rules, their trading activity created the appearance of a conflict of interest as illustrated by Rosengren’s purchase and sale of REITS while he was publicly warning of contagion in real estate markets. These revelations have led to a review of the ethics rules around financial holdings and activities by senior Fed officials as well as the resignations of Kaplan (effective October 8) and Rosengren (effective September 30).

At the end of Q3, First Vice President Kenneth Montgomery stepped in as interim president until a committee of Boston Fed board directors selects a permanent replacement, to be approved by the Federal Reserve Board. With additional concerns being raised regarding Fed Vice Chair Richard Clarida and his trading history as well as potentially dwindling support for Powell to be re-appointed in early 2022, there could be a very different looking Fed in 2022. Kaplan has been viewed historically as more hawkish while Rosengren has been considered only slightly hawkish, so their replacements could shift the overall sentiment of the FOMC. Powell has provided stability over his six years in office, overseeing the lift-off in rates post-Global Financial Crisis, reducing some of the financial regulations put forth during that time and guiding the U.S. economy through the recent pandemic.

Debt ceiling debate and horse trading

Based on the ongoing angst in Washington, there’s the possibility that the U.S. government shuts down for the third time in the last eight years and twice in the past three years. Previous shutdowns in 2013 and 2018 cost the U.S. economy in the range of \$2 billion to \$6 billion and \$11 billion, respectively, according to the Office of Management and Budget and Congressional Budget Office.

Treasury Secretary Janet Yellen has informed Congress that if it does not act to raise or suspend the debt limit by October 18 (also known as the “X” date), the Treasury would be left with limited resources that would be depleted quickly, potentially forcing a default on U.S. government debt.

“It is imperative that Congress swiftly addresses the debt limit. If it does not, America would default for the first time in history,” Yellen said in her remarks to the Senate Banking Committee. “The full faith and credit of the United States would be impaired, and our country would likely face a financial crisis and economic recession.”

While the U.S. has technically defaulted in the past¹, the potential for this unprecedented event forces economists to essentially guess how the global economy and financial markets would react, but the consensus is it would be a financial calamity that could trigger a broad financial market selloff as well as an economic downturn and an interest rate spike. Even if one side blinks and the issue is resolved once more by kicking the can down the road, one of the major rating agencies could follow in the footsteps of S&P in 2011 and downgrade U.S. debt—the ramifications of which would be significant.

Investors that utilize the three major nationally recognized statistical ratings organizations (NRSROs) as the measuring stick for credit quality would then be faced with an unheard-of dilemma: two of the three rating agencies would no longer hold U.S. government debt at a AAA equivalent. Depending on specifics of investment guidelines, some investors would have to drop the U.S. to a AA+ equivalent.

Portfolio performance and positioning

The Treasury curve was relatively unchanged from the beginning to the end of the quarter but experienced quite a bit of fluctuation over the past three months. The 10-year Treasury began Q3 at 1.47% and finished at 1.49% but reached a low of 1.17% on August 3 and a high of 1.54% near the end of September. This movement resulted in a pedestrian return for the quarter for the U.S. Treasury Index of 0.09% and brought the year-to-date performance for the index to -2.50%.

Our portfolio’s duration has been maintained at the low end of our targeted range of +/- 10% of the benchmark’s duration, which limited the impact from the Treasury market. While the portfolio has an underweight to the Treasury market, a longer duration contribution from the portfolio’s allocation helps to mitigate the impact from the underweight. The portfolio finished Q3 at a shorter duration posture than the benchmark, 5.76 years compared to 6.71 years. The portfolio’s duration positioning relative to the benchmark had a minimal impact on relative performance in the quarter.

¹ In 1979, investors in T-bills maturing on April 26, 1979, were told that the U.S. Treasury could not make its payments on maturing securities to individual investors. The Treasury was also late in redeeming T-bills that were due on May 3 and May 10, 1979. The Treasury blamed this delay on an unprecedented volume of participation by small investors, on failure of Congress to act in a timely fashion on the debt ceiling legislation in April, and on an unanticipated failure of word processing equipment used to prepare check schedules.

The Bloomberg U.S. Corporate Bond Index was flat in Q3, with the final two months of Q3 (-1.35%) offsetting the gains in the month of July (1.37%). Lower credit quality held up best during the quarter with the corporate market BBB segment returning 0.11%, while the AAA component lost -0.34%, A lost -0.12% and AA was down -0.09%. Security selection was the main driver of relative performance in the corporate sector as this sector's performance was slightly more additive to performance than the benchmark's allocation.

The Bloomberg U.S. Securitized Index gained 9 basis points (bps) in Q3, relying on a strong month of July (+0.64%) to offset the downturn experienced in August (-0.16%) and September (-0.39%). All sectors within the securitized market followed the same pattern of the overall securitized market with strong performance in July offset by August and September downturns. Residential mortgage-backed securities, the securitized market's largest component, led the way with a 0.10% return, followed by asset-backed securities up 0.05% and commercial mortgage-backed securities, which lost -0.03% in the quarter.

New issuance in the ABS market in Q3 totaled more than \$86 billion. Both Q2 and Q3 delivered more than \$159 billion in new issuance, pushing year-to-date issuance to more than \$302 billion, already close to 2020's full year issuance of \$304 billion.

Our portfolio's allocation to areas of the ABS market outside of the index contributed positively to performance as most of these subsectors delivered significantly higher returns relative to benchmark eligible securities. The portfolio's 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, detracted from performance during the quarter but have contributed on a year-to-date basis.

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 (%) AS OF SEPTEMBER 30, 2021

	SINCE INCEPTION (7/5/16)	5-YR	3-YR	1-YR	YTD	3Q21	EXPENSE RATIO
CORE BOND FUND							
Class I	3.46%	3.47%	5.64%	-0.72%	-0.95%	0.04%	0.47%
BENCHMARK							
Bloomberg U.S. Aggregate Index	2.76	2.94	5.36	-0.90	-1.55	0.05	—

Risk Disclosure: The value of fixed-income securities varies inversely with interest rates; as interest rates rise, the market value of fixed-income securities will decline. Lower quality debt (ie: "High Yield") securities involve greater risk of default or price changes due to potential changes in the issuer's credit quality. The value of investments in mortgage-related and asset-backed securities will be influenced by the factors affecting the housing market and the assets underlying such securities. The securities may decline in value, face valuation difficulties, become more volatile and/or become illiquid. They are also subject to prepayment risk, which occurs when mortgage holders refinance or otherwise repay their loans sooner than expected, creating an early return of principal to holders of the loans.

The views expressed are those of the portfolio managers as of September 30, 2021, are subject to change and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of results, or investment advice.

The performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's current performance may be lower or higher than the performance data quoted. Investors may obtain performance information current to the most recent month-end, within 7 business days, at diamond-hill.com.

Performance returns assume reinvestment of all distributions. Returns for periods less than one year are not annualized.

Fund holdings subject to change without notice.

The Bloomberg U.S. Aggregate Index is an unmanaged index representing the U.S. investment grade fixed rate bond market, with index components for government and corporate securities. This index does not incur fees and expenses (which would lower the return) and is not available for direct investment.

Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

Analytics provided by The Yield Book® Software.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund(s) can be found in the Fund's(s) prospectus or summary prospectus which can be obtained at diamond-hill.com or by calling 888.226.5595. Please read the prospectus or summary prospectus carefully before investing. The Diamond Hill Funds are distributed by Foreside Financial Services, LLC (Member FINRA). Diamond Hill Capital Management, Inc., a registered investment adviser, serves as Investment Adviser to the Diamond Hill Funds and is paid a fee for its services. Like all mutual funds, Diamond Hill Funds are not FDIC insured, may lose value, and have no bank guarantee.

The Bloomberg U.S. Corporate Bond Index is an unmanaged index representing the investment grade fixed rate taxable corporate bond market including USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers. The Bloomberg U.S. Securitized Index is an unmanaged index representing the holdings from the securitized sector of the Bloomberg U.S. Aggregate Index. The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury.