DIAMOND HILL

INVESTED IN THE LONG RUN

Core Bond Fund

As of 31 Mar 2024

Resilient Labor Market, Stubborn Inflation Test Fed's Rate Cut Path

2023 finished on a powerful note, fueled by near-historic performance in November and December, pushing the Bloomberg US Aggregate Bond Index into positive territory and potentially setting the tone for an ongoing recovery from 2022's challenges. Alas, this was not to be the case.

Team

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

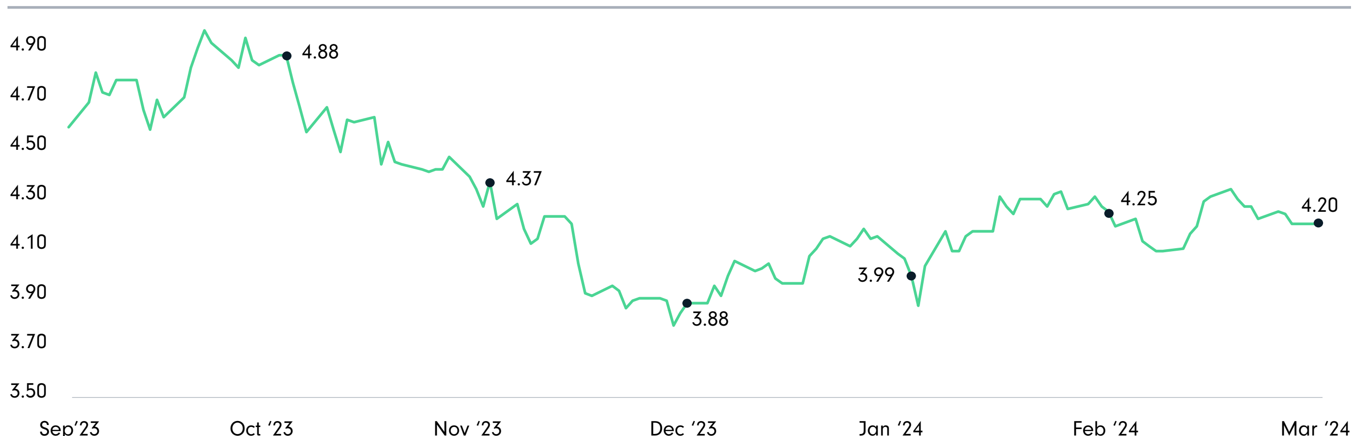
Douglas Gimple
Senior Portfolio Specialist

Stronger-than-expected economic reports about the labor market and inflation spurred interest rates higher, generating negative returns for the overall fixed income markets in Q1 2024. The first quarter was almost a replica of 2023 — starting slow with negative returns in January and February, with a strong recovery in March. But March's return of +0.92% was not enough to offset the loss of -1.68% in January and February.

The index's performance reflected interest rate movements as the 10-year Treasury climbed from 3.88% at the end of 2023 to finish February at 4.25% before maintaining some stability in March to finish the quarter at 4.20%. The shift higher in the curve reflected the market's expectations coming in line with the Federal Reserve's projected path of interest rates for 2024.

At the end of 2023, market expectations were still pricing more than six 25-basis point (bps) rate cuts by year-end 2024, despite the Fed repeatedly communicating plans for three 25-bps rate cuts. By the end of the quarter, market expectations had shifted to match the Fed's outlook, with roughly three 25-bps cuts priced into the futures market. Consistently better-than-expected labor market news and stubborn inflation numbers supported the Fed's agenda of "higher for longer."

Exhibit 1 — 10-Year Treasury Yield (%)



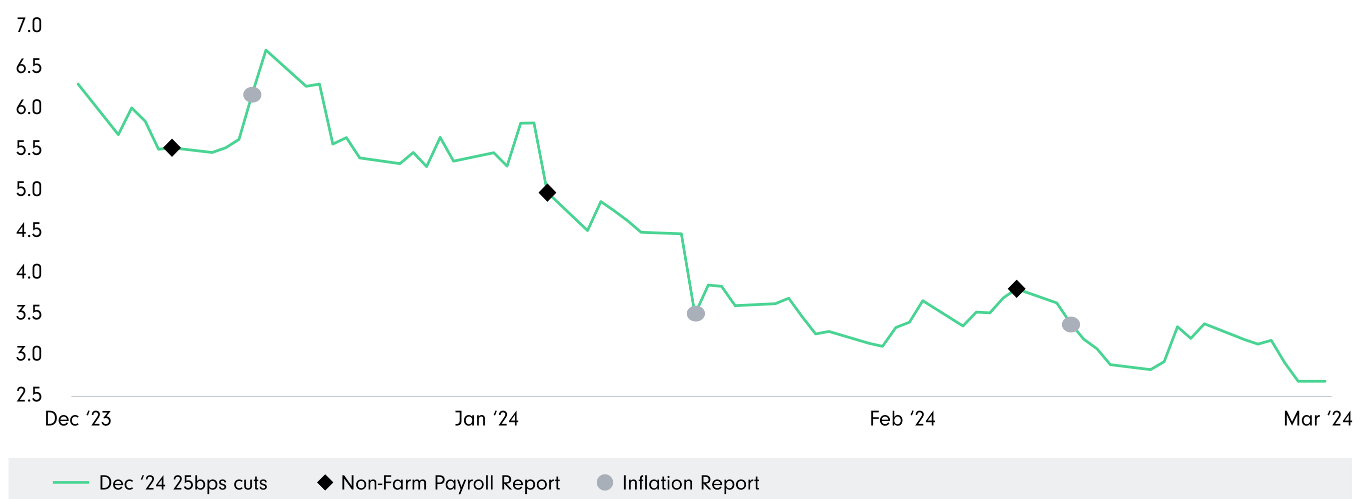
Source: Federal Reserve Economic Data (FRED).

The labor market continued to defy expectations, outpacing economists' estimates. January was the biggest outlier, as the economy reportedly added 256,000 jobs (revised) against expectations of 185,000. February saw 270,000 jobs (revised) created (expectations of 200,000), and March eclipsed the 300,000 level with 303,000 jobs added (expectations of 185,000). This labor market production resulted in a quarterly average of 276,000 jobs added monthly, the best three-month average since March 2023.

Inflation remained stubborn, dropping slightly from January's year-over-year number of 3.9% to 3.8% in February and March. The inflation data has remained stubborn in recent months. The core CPI increased at a 4.5% annualized rate in Q1, the fastest pace since May 2023. And Federal Reserve officials appear to be using public speeches and interviews to imply that "higher for longer" isn't going away anytime soon.

Governor Christopher Waller delivered his speech titled, "There's Still No Rush," on March 27 of this year, encapsulating the Fed's viewpoint that the future path of rates remains uncertain. In perhaps the strongest comment to date, Federal Reserve Governor Michelle Bowman said it's not time for the US central bank to consider cutting its interest rate target and noted that more hikes could be on the table if progress on lowering inflation stalls.

Exhibit 2 — Rate Cut Expectations Fall with Economic News (%)



Source: Bloomberg.

With the stronger economic news and expectations for a hold on rates for the foreseeable future, the Fed heads into dangerous territory. Suppose we assume the Fed is in a holding pattern until more economic data becomes available. In that case, we must consider the potential political implications of an initial rate cut occurring in September, seven weeks ahead of the 2024 Presidential election.

The Fed strives to avoid the perception that politics motivates actions. However, the stubbornness of first-quarter inflation indicates it would be challenging to make the first cut without additional information. Recent economic data appears to have removed May and June from the mix for a rate cut, and even July seems unlikely without a dramatic shift in the economic trajectory.

All things equal, a rate cut in September fueled by pertinent economic data might make the most sense but would face the scrutiny of attempting to influence the election despite the Fed's true intentions. The updated dot plot after the June meeting could provide a lifeline to the Fed, allowing it to communicate expectations for the remainder of the year well ahead of September.

Portfolio Performance & Positioning

The surge in interest rates in Q1 was the main driver of performance for fixed income markets as yields climbed along the curve, reflecting the market's capitulation to the Fed's expected path of interest rates. Most of the damage occurred in January and February as the yield on the 10-year Treasury climbed from 3.88% to 4.20%, and the yield on the 2-year Treasury climbed from 4.25% to 4.62%.

The curve shift in March was much more subdued, with the 10-year and 2-year Treasury yields tightening roughly five basis points from the end of February to the end of the quarter. The move higher for yields in Q1 resulted in the Treasury market (as measured by the Bloomberg US Treasury Index) losing nearly -1%. The long-term impact of the move higher in yields is indicated in Exhibit 3, with the near doubling of the coupon return when compared to the same period last year.

Exhibit 3 — Bloomberg US Treasury Index, Impact of Higher Yields

	Price Return	Coupon Return	Total Return
January '22	-2.02	0.13	-1.89
February '22	-0.78	0.12	-0.66
March '22	-3.25	0.14	-3.11
January '24	-0.51	0.23	-0.28
February '24	-1.54	0.22	-1.31
March '24	0.40	0.25	0.64

Source: Bloomberg.

The portfolio's duration began the year at roughly 96% of the benchmark's duration and held steady for most of Q1. With the move higher in rates during the quarter, the portfolio's duration positioning contributed to relative performance, though the absolute impact for the portfolio was negative. The portfolio remains underweight Treasuries relative to the benchmark while maintaining a longer duration posture in Treasuries, and this positioning detracted from performance over the first three months of the year. The portfolio finished Q1 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.80 years compared to 6.21 years, respectively.

The Bloomberg US Corporate Bond Index lost -1.67% during the first two months of the year, and March's return of +1.29% helped offset some of that damage, but it wasn't enough to bring the quarterly return into positive territory. The corporate index was down -0.40% during the quarter, and duration played a key role in the breakdown by quality. Longer duration AAA-rated corporates felt the most pain during the quarter, losing -1.64%, followed by AA-rated (down -0.98%), A-rated (down -0.55%) and BBB-rated (down a mere -0.14%).

Financials were the lone bright spot in the corporate sector, advancing +0.35% during the quarter, while industrials and utilities were both down -0.77%. Issuance in the corporate space continued to show strength, with the investment-grade corporate sector bringing a record $530 billion to market in Q1. Despite this, corporate spreads tightened during the quarter, from 98.7 bps to 90.0 bps, indicating more than adequate demand from investors. The portfolio's underweight to the corporate sector, as well as strong security selection, contributed positively to relative performance in the first quarter.

Since the beginning of the year, the story in the securitized market has been the strength in the non-agency or private label commercial mortgage-backed securities market. This sector, which has received quite a bit of negative press, rebounded with a nearly +2% return in Q1 (as measured by the Bloomberg US Non-Agency CMBS Index) as investors migrated to this beaten-down sector due to attractive spread levels in anticipation of later-in-the-year rate cuts from the Federal Reserve.

Returns in the sector were differentiated by credit quality, with the A-rated portion of the index returning +7.3% during the quarter, followed closely by the BBB-rated segment (+6.7%). While positive, the higher quality segments of the index trailed the lower-rated segments, with AAA-rated returning +0.7% and AA-rated returning +0.6% during the quarter.

Residential mortgages felt the pain from the fluctuation in interest rates during the quarter, with benchmark-eligible passthrough mortgages losing more than -1.0% and CMOS (as measured by the ICE BofA CMO Index) only slightly better, losing -0.2%.

Shorter-duration ABS delivered positive returns in January and March, helping generate a +0.7% return for the quarter. Auto ABS continued to lead the way, advancing +0.8% in a challenging quarter for the overall fixed income markets.

Strength in security selection, as well as the allocation to non-benchmark securities, were a benefit to our portfolio. Specific to CMBS, only conduit CMBS are included in the benchmark, and the portfolio's allocation to Single-Asset Single Borrower instead of conduit deals significantly benefited performance, with those sectors returning more than +3.5% combined during the quarter. The portfolio's ABS allocation was also a positive contributor to relative performance as non-benchmark segments of this market far outpaced the index-eligible segments of the market.

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 (5 Jul 2016)	5Y	3Y	1Y	YTD	1Q24	Expense Ratio (%)
Class I (DHRIX)	1.51	1.10	-1.40	3.24	0.03	0.03	0.47
Bloomberg US Aggregate Bond Index	0.64	0.36	-2.46	1.70	-0.78	-0.78	–

Risk disclosure: In general, when interest rates rise, fixed income values fall. Mortgage- and asset-backed securities are influenced by factors affecting the housing market and the assets underlying such securities. The securities may decline in value, face valuation difficulties and become more volatile and/or illiquid. They are also subject to prepayment risk, which occurs when mortgage holders refinance or repay loans sooner than expected, creating an early return of principal to loan holders.
The views expressed are those of Diamond Hill as of 31 March 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.
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