DIAMOND HILL

INVESTED IN THE LONG RUN

Recovery to Inflation to Uncertainty

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We recently sat down with portfolio manager Henry Song, CFA, to discuss the fixed income market environment and how rising rates are impacting investment opportunities.

Q1 2021 saw the longer end of the curve climb significantly higher while the shorter end remained anchored thanks to the Fed. This year, interest rates have moved higher, and the shift has been much broader based occurring across the entirety of the yield curve. How has the start of 2022 compared to the start of last year?

Henry Song, CFA: First, the yield curve is drastically different. At the beginning of 2021, the 2-year Treasury was at roughly 12 basis points (bps) and the 10-year was around 92 bps. Fast forward to the end of 2021 and the 2-year had risen to 72 bps and the 10-year had gone up to 150 bps. So, it took an entire year to see a 60 bps rise in the 2-year Treasury. At the start of 2022, the 2-year went from 72 bps to nearly 234 bps — that was a 160 bps rise in just three months. And the 10-year, which went up about 60 bps in 2021 rose 83 bps (from 1.51% to 2.34%) in Q1 2022. That's how quickly rates have gone up.

From a spread environment perspective, we were still coming out of the COVID pandemic in early 2021 and there were still sectors lagging in terms of recovery, but we were seeing the return to "normal" or pre-COVID levels at the start of that year. Fast forward to 2022, and we entered the year with a high level of uncertainty in terms of when and how the Federal Reserve was going to start raising rates. We saw spreads widening out and investors were skittish to put money to work. Even though spreads have reversed, investors have stayed on the sidelines out of the fear of uncertainty, especially after Russia invaded Ukraine.

Henry Song, CFA
Portfolio Manager

Ultimately, the biggest difference between the start of 2021 and the start of 2022 was the type of concern investors had — recovery concerns in 2021 and uncertainty in 2022.

With rates rising, have you seen issuers — corporate or in the securitized market — speeding up plans to get into the market to lock in cheaper financing before rates continue to climb higher?

Henry Song, CFA: Yes and no. There are opportunistic issuers interested in taking advantage of the lower rate environment. However, some have been deterred by the higher spreads that investors are currently demanding. We've seen some issuers take deals to the market, shop around and then decide that it's not worth it in the current environment.

On the other side of the coin, you have programmatic issuers who are not able to time when they go to market. For example, commercial mortgage lenders and auto issuers are constantly underwriting loans, programmatically issuing three, four or five times a year. These types of issuers have to hedge interest rates. From a commercial lender's perspective, it's not a huge concern because they are able to pass along higher costs to borrowers.

Another aspect of today's environment is that there is still a lot of uncertainty out there. It's not perfectly clear how fast and long this tightening cycle might be. The Fed has intentionally left its plans open ended, so there are still a lot of outstanding questions. One of my biggest questions is when will the supply chain issues we've seen start to dissipate. The Fed can only impact the demand side of the equation, not the supply side. So, what happens to the supply chain from here could materially impact the trajectory of the overall economy.

One of the impacts of rising rates for the fixed income market is the accompanying extension risk or interest rate sensitivity for mortgage-backed securities. Specifically, as rates climb, homeowners are less and less incented to refinance mortgages, which leads to existing mortgages having longer duration, making them even more sensitive to interest rate movements. What are some ways to mitigate the risk of duration extension for investors who hold an allocation to mortgage-backed securities?

Henry Song, CFA: That really comes down to security selection. When you talk about extension risk, you're really talking about the 30-year, 2.0% to 2.5% mortgages that were issued during the pandemic when rates hit all-time lows. Even if you owned bonds backed by these collaterals, it doesn't mean that you're going to have the same sort of extension because investors can buy collateralized mortgage obligations (CMOs) that have a structure in place to protect against extension risk. So, one of the best ways to protect against extension risk is to invest in securities that have those protections in place.

The other way is through portfolio construction. Having a well-diversified portfolio is key so that you're not invested in a bunch of securities that all have the same interest rate biases. If you have a well-balanced portfolio with good structure, that can really buffer against extension risk.

If you already own a portfolio of securities with high extension risk, over time that risk declines as more issuance in higher-rated mortgages become a bigger part of the index. If you look at the percentage of Treasuries versus mortgages in the index, we have seen mortgages dwindle in comparison over the past couple of years. However, because these 30-year, 2.0% to 2.5% mortgages are going to be in the index for a while, the percent of mortgages in the index should continue to increase for the foreseeable future.