DIAMOND HILL

INVESTED IN THE LONG RUN

What a Strange (and Painful) Ride, But May Provided a Respite

May 2022

After a historically painful first four months for fixed income markets, we may be starting to see some stability in the investment grade fixed income universe. Our commentary last month examined how the increase of the 2-year Treasury yield reflected most of the work that the Federal Reserve communicated before its second meeting of the year on March 16. There is still slightly more than 30 basis points (bps) of difference between the yield on the 2-year Treasury (2.56% as of month end) and the expected terminal fed funds rate (2.875% as of month end), but May provided a certain level of stability, especially relative to the volatility of the first four months of the year.

As illustrated in Exhibit 1, the first four months of 2022 witnessed significant negative performance for bellwethers, as measured by Bloomberg. The 2-year Treasury lost 3.05% while its yield climbed from 0.73% at the beginning of the year to finish at 2.72% by April month-end, an increase in yield of 270.9%. The 10-year Treasury lost 11.29% during the first four months of 2022 as its yield climbed from 1.51% to 2.93% over the same period, an increase of 94.3%. There were many factors that combined to deliver this "perfect storm" for fixed income markets, including but not limited to the Russian invasion of Ukraine, ongoing pandemic concerns, supply chain issues, red hot inflation and an aggressive Federal Reserve. But the month of May brought some stability and calm after a tumultuous and difficult start to the calendar year. Are we in the quiet that is found in the eye of a hurricane, with more thunderous winds and disruption to follow, or have we reached a time of longer-term stability plagued by short-term disruptions driven by headlines?

Exhibit 1 — Some Calm After a Four-month Storm (%)

Source: Bloomberg.

A welcome breather

After a seemingly constant barrage of bad news, negative performance and rising yields, the fixed income universe took a breather in May and delivered some welcome news (Exhibit 2). While the positive returns in May were nowhere near the historic levels of what came in the preceding four months, investors were relieved to see some positive numbers alongside their fixed income investments.

Exhibit 2 — Fixed Income Markets Total Returns (%)

	Aggregate	Treasury	Investment Grade Corporate	Securitized	High Yield
January	(2.15)	(1.89)	(3.37)	(1.48)	(2.73)
February	(1.12)	(0.66)	(2.00)	(0.98)	(1.03)
March	(2.78)	(3.11)	(2.52)	(2.61)	(1.15)
April	(3.79)	(3.10)	(5.47)	(3.40)	(3.56)
May	**0.64**	**0.18**	**0.93**	**1.04**	**0.25**
May YTD	(8.92)	(8.33)	(11.92)	(7.27)	(8.00)

Source: Bloomberg.

It was no April Fool's Day joke when the 2-year Treasury yield exceeded the 10-year Treasury yield for a couple of days, beginning on April 1 (Exhibit 3). This inversion of the relationship — called the 2-10s spread — between the two bellwether securities has sometimes, but not always, occurred prior to the economy entering a recession. The dreaded 2-10s inversion was short-lived as the difference between the two held at a negative level on Friday (April 1) and the following Monday (April 4) but resumed a positive posture on Tuesday (April 5).

Exhibit 3 — A Brief Flirtation With Inversion

Source: Bloomberg.

When inversion occurs, the financial press ramps up the recession talk by demonstrating previous periods of inversion with subsequent recessions. Almost in anticipation of an inversion of the 2-10s spread, the Fed published a follow-up to its 2018 paper, "(Don't Fear) The Yield Curve," on March 28 of this year, which demonstrated that the 2-10s spread was less than helpful in predicting future economic conditions. The Fed's analysis in "(Don't Fear) The Yield Curve, Reprise" illustrated that the near-term forward spread, based on yields of Treasury bonds shorter than two years, was much more substantial in predicting chances for a recession and the pace of GDP growth. The most important aspect of the inversion was that it only held for two days and by the end of May, the relationship between the 2-year and 10-year Treasury was back in positive territory (29.6 bps) though still below the historical average since the turn of the century (125.6 bps).

The yield on the 2-year Treasury increased, on average, 49.6 bps over each of the first four months of 2022 before falling 16.7 bps in May. Similarly, the yield on the 10-year Treasury increased an average of 35.6 bps over the same period before dropping 9.0 bps in May. The rebound in demand for US Treasuries helped fuel the rally in May, with the 2-year Treasury delivering positive performance (0.59%) for the first time since August 2021 and the 10-year Treasury generating 0.58% of performance, its first positive performance since November 2021. In fact, the only segment of the Treasury market that failed to deliver positive performance was the 30-year Treasury, which was down -2.29%, unable to capture the same type of yield movement that the rest of the curve experienced.

After a disastrous start to the year, the investment grade corporate sector finally saw a ray of light, delivering 0.93% return after losing nearly -13% through April. A slowdown in issuance during the latter part of May helped push investment grade credit spreads tighter through month end, after having climbed substantially higher from lows reached in early April. In fact, May 2022 ($90 billion) delivered the slowest May issuance in the investment grade corporate space since 2012 and was well below the four-year average of $150 billion. It's been a period of significant volatility for the investment grade corporate space as illustrated in Exhibit 4, which shows the option-adjusted spread for the Bloomberg US Corporate Bond Index since the beginning of the year. The significant uptick in March coincided with the lead up to the second Federal Open Market Committee (FOMC) meeting of 2022 and was followed by a short-term rally before concerns around inflation, geopolitical issues and an economic slowdown pushed yields higher. The final week of the month witnessed the quietest week since February 2020 for issuance as issuers held back during the worst of the equity market upheaval, pushing spreads tighter to finish out the month.

Exhibit 4 — Option-Adjusted Spread Movement, Bloomberg US Corporate Bond Index

Source: Bloomberg.

The securitized sector, as measured by the Bloomberg US Securitized Index, delivered the strongest absolute performance in May, fueled by the residential mortgage-backed securities market. This strong performance ended a nine-month losing streak and represents only the third positive month since February 2021.

While agency-backed residential (RMBS) and commercial mortgage-backed securities (CMBS) were the main drivers of the first positive monthly performance since July 2021, the non-agency commercial mortgage-backed securities market was beset by technical factors that led to significant underperformance.

The continual flow of new issuance ran into a lack of enthusiasm as financial markets dealt with equity and risk asset upheaval, pushing investors into safe-haven assets. Even better than expected remittance reports on the current level of delinquencies for non-agency CMBS (2.86%, down -0.26% from the prior month and the first sub-3% report since the peak of 8.2% in June 2020, according to Kroll Bond Rating Agency), were not enough to keep the subsector in positive territory for the month. New issuance in non-agency CMBS finished the month of May 41% higher on a year-over-year basis, though the shift in risk appetite resulted in a slowdown near the end of the month. As with other sectors, the securitized market is not immune to the actions (both real and expected) of the Federal Reserve, inflation and geopolitical concerns, and it has become evident over the past several months.

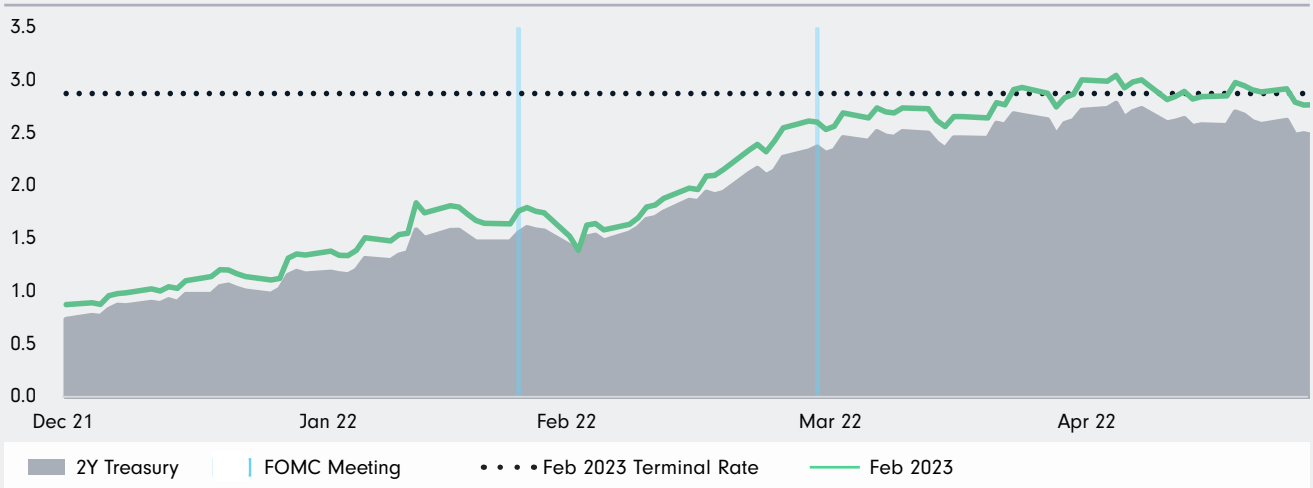
The biggest question in financial markets (outside of how the Fed will proceed after assumed back-to-back 50 bps increases in June and July) is whether or not we find ourselves in the eerie (and temporary) calmness of the eye of the storm and we should batten down the hatches once more as we head into a summer of volatility, or if we are at the beginning of the end of a strange and scary cycle of the past two years, with a moderation in economic growth and slowly cooling inflation?

At Diamond Hill, we manage our clients' money with an eye for valuation and a deep understanding of the securities in which we are investing, not by trying to predict the unpredictable. Given the recent events in May, there is hope that the Fed will be able to execute a soft landing and bring rates up while maintaining a strong employment rate and taming inflation. But there is just as much concern that inflation will continue to run hot and bring about a mild to moderate recession. Rather than picking one scenario or another, we'd much rather stay on top of the markets, look for opportunities in various sectors as they present themselves and keep our eye on the longer-term horizon.

Have we reached stabilization in Fed expectations?

Last month's commentary addressed the dramatic shift higher in the shorter end of the Treasury curve in response to the market's expectations for Fed action in the coming months. The first four months of the year brought a painful adjustment in interest rate expectations, unlike anything we've seen in the past. The market found some stability in the month of May as the 2-year Treasury as well as the February 2023 fed fund futures settled into a trading range. Prior to the May 4 FOMC meeting, expectations for the Fed's terminal rate had pushed above 3% but Powell used both prepared comments as well as responses in the subsequent press conference to bring expectations down slightly, finishing the final two weeks at an average level of 2.85%. Despite some of the noise from various FOMC members during the past month, expectations held steady for a 50 bps increase in both June and July with 100 bps of increases spread out between September, November, December and February. It remains to be seen how the Fed will deliver that 100 bps but the market agrees that the increases shall continue.

Implied Terminal Rate (Feb 2023)



Source: Bloomberg.

Investment Grade is a bond quality rating of AAA, AA, A or BBB. Option-Adjusted Spread is the difference between the portfolio yield and the risk-free rate, accounting for embedded options. Source: The Yield Book.

Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **Bloomberg US Corporate Bond Index** measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg US Securitized Index** measures the performance of the securitized sector of the Bloomberg US Aggregate Bond Index. The indexes are unmanaged, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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