DIAMOND HILL

INVESTED IN THE LONG RUN

Bond Market Insights — First Half of 2022 Review

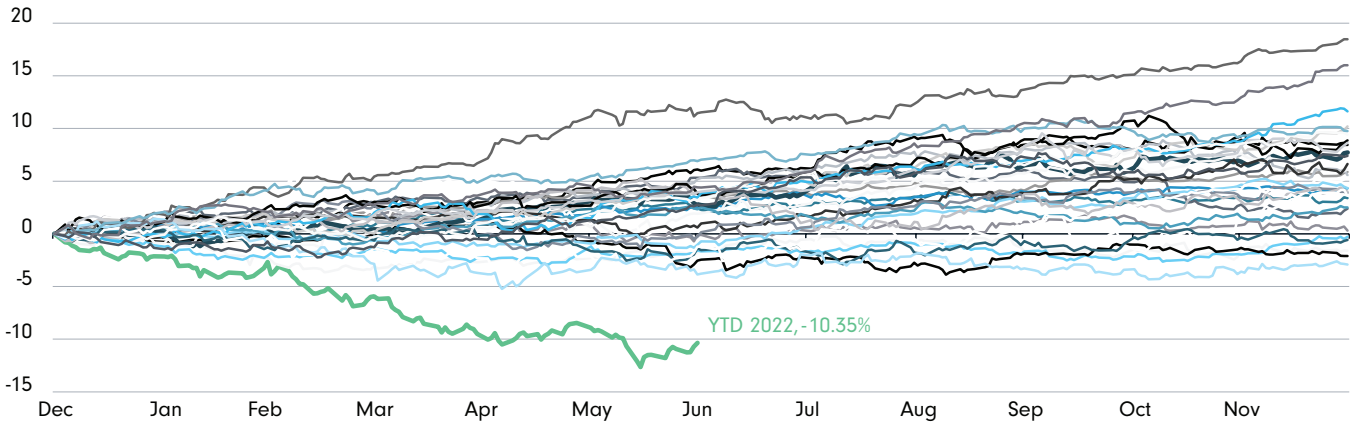
July 2022

After a painful first quarter, fixed income markets were mostly down in Q2, with a brief respite in May. The first six months of the year produced the worst back-to-back quarterly returns for the Bloomberg US Aggregate Index since its inception (down -5.93% in Q1 and -4.69% in Q2) and only the tenth occurrence of consecutive negative quarters since the index's inception. Prior to these past two quarters, the first and second quarter of 2018 were the most recent back-to-back negative quarters for the index.

Within the economy, inflation continued to run at a sizzling pace while the employment situation continued to strengthen, defying the odds with roughly two job openings per applicant. The Federal Open Market Committee (FOMC) met twice during the quarter in what can only be deemed as very different meetings, with the second meeting delivering the largest rate hike since November 1994.

The first half of 2022 has been difficult for all asset classes, not just fixed income. To put the performance of the Bloomberg US Aggregate Bond Index into perspective, Exhibit 1 shows calendar year performance from 1991 to 2021 along with the year-to-date performance through Q2 2022. While there are calendar years that delivered negative returns (1994, 1999, 2013, 2021), there has been nothing to match the magnitude of the year-to-date decline in 2022. Besides the first two quarters of 2022, the only quarters that delivered worse performance were in the early 1980s, when interest rates were multiples of their current level and headed higher. Concerns around the battle against inflation, the impact of geopolitical uncertainty and ongoing supply chain issues, and expectations for Fed actions through the rest of the year all played a part in market performance this past quarter.

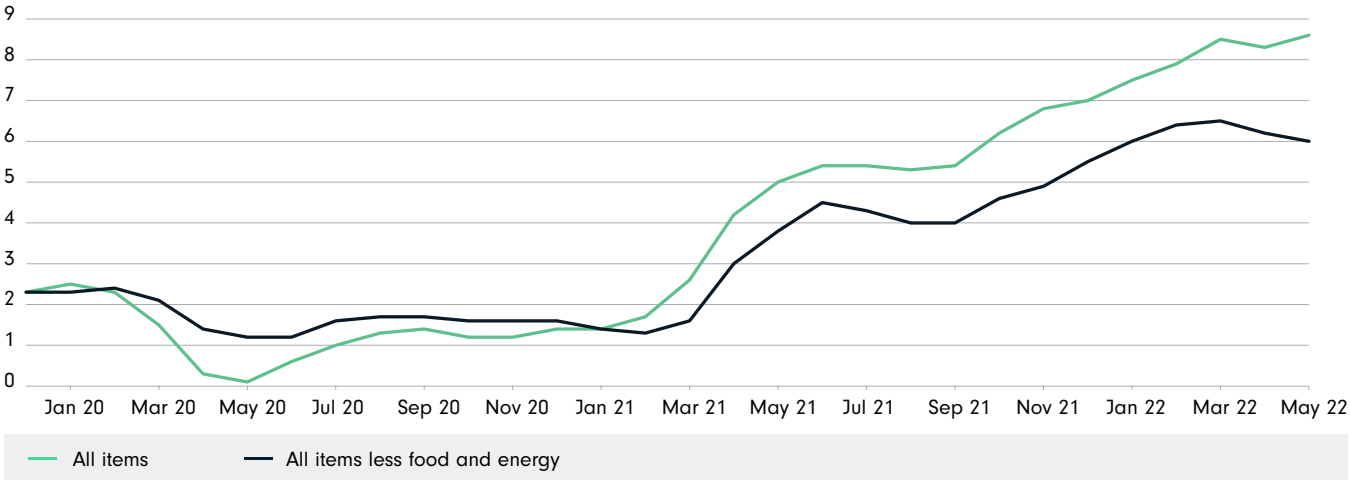
Exhibit 1 — Bloomberg US Aggregate Bond Index, Calendar Year Total Returns (%)



Source: Bloomberg.

Coming into Q2, inflation was running red hot, reaching decade-level highs before cooling slightly in April (reported in May), down from the preceding 8.5% to 8.3% year over year (yoy). But core inflation once more ramped up with the May number (delivered in June), showing inflation pushed higher to 8.6%. As shown in Exhibit 2, significant inflation within food (+10.1% yoy) and energy (+34.6% yoy) were the main culprits for the increasing levels while Core CPI (less food and energy) continued to drop from March to May (6.5% yoy to 6.0% yoy, respectively). But consumers still need food and fuel, so they've continued to feel the impact of rising inflation despite some stabilization in other areas of the economy. Rising prices have been the focus of the Federal Reserve as it continues to receive criticism for its transitory approach. As concerns about rampant inflation and the potential for an economic recession in the US continued to grow, all eyes have been focused on the Fed and other central banks around the world.

Exhibit 2 — Year-Over-Year Inflation (%)



Source: Bureau of Labor Statistics. Dec 2019 - May 2022.

With that focus, the FOMC conducted two very different meetings in Q2. The first meeting was rather benign, with the Fed raising interest rates by a highly anticipated 50 bps to a range of 0.75% - 1.00%. The market's reaction on the longer end of the curve was somewhat muted, with the 10-year Treasury pushing above 3% before settling back down to finish the month of May at 2.84%. The 2-year Treasury pulled back from an early-month high of 2.78% to spend the rest of May in a range from 2.73% to 2.48%, before ending at 2.56%.

The second meeting, which occurred on June 15, was more dynamic. With the red-hot inflation report (+8.6%) hitting the newswires on Friday, June 10, the Fed only had two business days to digest the data and what it could mean for the upcoming rate decision. Sequestered in its quiet period pre-FOMC meeting, Fed members were unable to provide any insight to the markets as to what may have changed their viewpoints on rates and inflation. Thus, we were exposed to the kind of Fed meeting that rarely occurs, a meeting with the potential for a surprise, with street talk ranging from 50 bps to 75 bps to 100 bps with no clear consensus. Not since the global financial crisis has there been a meeting with such uncertainty as to how things were going to progress. And the Fed didn't disappoint, delivering the largest rate hike since November 1994 (75 bps) with a clear message that another 75 bps rate hike in July is a distinct possibility. The Fed was also clear that a more restrictive stance would be possible if elevated inflation pressures were to persist. "*In discussing potential policy actions at upcoming meetings, participants continued to anticipate that ongoing increases in the target range for the federal funds rate would be appropriate to achieve the Committee's objectives*," the most recently published minutes said. "*In particular, participants judged that an increase of 50 or 75 basis points would likely be appropriate at the next meeting*."