DIAMOND HILL

INVESTED IN THE LONG RUN

Fighting Inflation and Identifying Recessions

July 2022

The Bloomberg US Aggregate Bond Index returned 2.44% in July. That's right, positive performance, for only the third time in the past 12 months. But it's the second time in the last three months that fixed income markets have stayed out of the red. July's performance is the best monthly return since August 2019 and provided some much-needed solace after a brutal start to the year.

Investment grade markets were led by the corporate sector (as measured by the Bloomberg US Corporate Bond Index), which generated a return of 3.24% in July after losing nearly -15% in the 1H 2022. Treasuries returned 1.59% (Bloomberg Treasury Bond Index) and the securitized sector returned 3.09% (Bloomberg US Securitized Index) in July but are still mired in some of the worst historical returns since the beginning of the year (down -7.69% and -5.87%, respectively). The one-month reversal has been broad-based and fueled by the prospect of a not-as-hawkish-as-originally-expected-but-still-relatively-hawkish Federal Reserve and a shift in the terminal rate for this rate hiking cycle. Have financial markets turned a corner? Unlikely. But it is a nice reprieve from a challenging start to the year.

Federal reserve

The Fed once again brandished its inflation fighting prowess, following up June's 75 basis points (bps) increase with an additional 75 bps at its late July meeting. The central bank has now delivered 225 bps of rate increases over the first four meetings of 2022 — a tightening pace not seen in more than 40 years. Expectations are for an additional 100 bps of rate hikes by year end to reach the terminal rate of 3.25% to 3.50%, making this one of the fastest hiking cycles in history. Exhibit 1 illustrates the timing of the four previous tightening cycles.

Exhibit 1 — Timing of Tightening Cycles

	FOMC Rate Increases	Time Period	# Of Meetings	Remaining Increase to Terminal Rate
1994–1995	250 bps	10 months	6	50 bps
1999–2000	175 bps	12 months	6	N/A
2004–2006	225 bps	12 months	9	200 bps
2015–2018	225 bps	36 months	9	N/A
2022 (YTD)	**225 bps**	**5 months**	**4**	**100 bps ***

Source: Federal Reserve Economic Data (FRED). *Estimate based on 2023 fed funds futures contract.

The Fed's July statement was little changed though there was a shift to acknowledge that economic activity is slowing, "Recent indicators of spending and production have softened," but continued to emphasize that the job market remains strong, "…job gains have been robust in recent months, and the unemployment rate has remained low." The vote was unanimous from Fed members, including newest members Susan M. Collins and Michael S. Barr. During the press conference following the announcement, Chairman Jerome Powell kept the door open for an additional "unusually large increase" (i.e., 75 bps) in September but reinforced that the next move would depend on forthcoming data. The futures market continues to price in roughly 100 additional basis points of rate increases through the end of 2022, more heavily weighted to the upcoming meetings in lieu of the latter part of the year. One of the biggest takeaways from the press conference was Powell's comment that the committee is moving to a "meeting by meeting" basis in making decisions, effectively ending discrete forward guidance, and following in the footsteps of the European Central Bank.

We have now entered the longest period between FOMC meetings this calendar year (56 days), during which the market will digest additional data on inflation (twice), the labor market (twice) and the second revision of Q2 GDP (August 25). The GDP revision announcement coincides with the first day of the annual Jackson Hole Symposium, an event that has been used in the past to adjust the Fed's message around rates and economic outlook.

The determination of a recession

Media and various pundits continually refer to the common definition of a recession as a period when the economy experiences at least two consecutive quarters of negative gross domestic product (GDP) growth. The US economy just experienced its second consecutive quarter of negative GDP growth (-1.6% in Q1 and -0.9% in Q2). But keep in mind this is the advance report on Q2 GDP; we will get the second print on August 25 and the final print on September 29. Recall that the first publicly available release on GDP data from the Bureau of Economic Analysis relies on incomplete reports and utilizes sophisticated statistical methods to fill in missing information. This isn't to say that we're expecting a revision from negative to positive growth in Q2, just that GDP advanced estimates in times of economic stress should be considered very preliminary.

The actual arbiter of a recession, the National Bureau of Economic Research (NBER), uses a much more nebulous approach than two consecutive quarters of negative GDP: "…a significant decline in economic activity that is spread across the economy and lasts more than a few months." This leaves quite a bit of wiggle room in the determination of a recession. The NBER focuses on avoiding political entanglements and being as subjective and cautious as possible, which at times results in identifying a recession after it has already passed. This begs the question, do the two methodologies for determining a recession match up with one another throughout history? For the most part, yes, but not always.

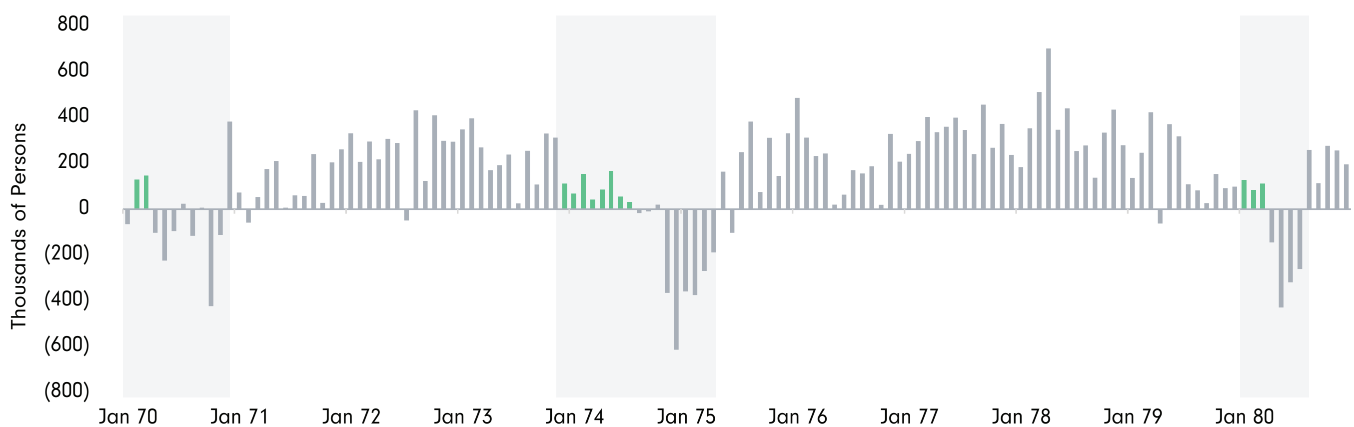
- **Recessions without consecutive negative quarterly GDP?** In 2001, the NBER-designated recession did not include two consecutive quarters of decline in real GDP though it did include two out of three quarters reporting negative GDP as Q1 and Q3 printed negative growth (-1.3% and -1.6%, respectively) that year with Q2 growth of 2.5%. In late 2007 and early 2008, the NBER noted that the global financial crisis-fueled recession began in Q4 2007, despite positive GDP (2.5%) in that quarter, negative GDP in Q1 2008 (-1.6%) and positive GDP in Q2 2008 (2.3%).
- **Are there times when two consecutive quarters of negative GDP have not been declared a recession by NBER?** Once, in 1947. GDP was down in Q2 and Q3 of that year (-1.10% and -0.80%, respectively), but the NBER didn't declare a recession had occurred, most likely due to technical issues regarding inventory adjustment and post-war runaway inflation (peaked at 19% in April 1947) as a shortage in production capacity led to a surge in inflation (sound familiar?). *Historical note: The NBER declared a recession beginning in Q4 1948 and lasting until Q3 1949*. Every other instance of consecutive negative GDP quarters has been deemed a recession, usually later by the NBER.

NBER's Business Cycle Dating Committee is tasked with determining whether the economy has slipped into recession, and the committee is made up of eight economists selected by the NBER president. The committee is run by a private non-profit group (not the federal government and thus, hopefully, not susceptible to political manipulation) and meets on an irregular, non-publicized basis. In fact, the committee can spend long stretches of time without meeting if there is nothing pertinent to address. The Business Cycle Dating Committee looks at some key economic variables, none of which is GDP. Specifically, non-farm payrolls, real personal income less payments to governments, donations or fees/fines, real personal consumption, real

manufacturing and trade sales, household employment (captures in-home employees) and the Index of Industrial Production, all statistics that are readily available at the Federal Reserve Economic Data (FRED) website, an invaluable tool. It should be noted that the committee stresses on its website that "there is no fixed rule about what measures contribute information to the process or how they are weighted in our decisions."

The NBER would be hard-pressed to announce a recession this early when the economy has been delivering an average of 475,000 jobs since the start of the year, despite the back-to-back negative prints for GDP. The job market continues to recover from a pandemic that cost the economy 22 million jobs in a two-month time frame with only half a million jobs needed to offset in 26 months what was lost in two. It is not unprecedented to have positive growth in non-farm payrolls in the early months of a recession. The 1970s and early 1980s saw the US economy experience three different recessions (Jan to Nov 1970, Dec 1973 to Mar 1975, Feb to Jul 1980) and in each of those recessions, job growth was positive in the early months (green bars in the Exhibit 2).

Exhibit 2 — Non-Farm Payroll Growth During 1970s and Early 1980s Recessions



Source: Federal Reserve Economic Data (FRED).

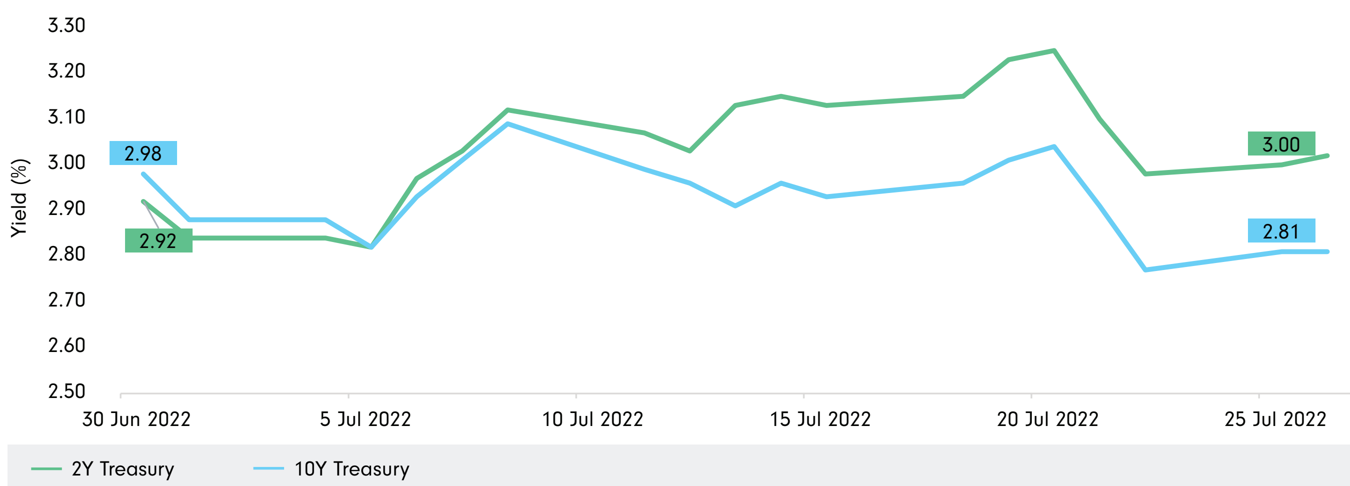
Yes, the highest inflation rate in over 40 years is putting pressure on the consumer and businesses but the unemployment rate has been anchored at 3.6% over the past four months and has not been north of 5% since August 2021. While other areas of focus for NBER have cooled slightly (real manufacturing sales, real personal income and consumption, and industrial production) and are positioned similarly to the months preceding the 2008 recession, there is nothing that indicates that we are in a recession, though we could most definitely be headed into one. One must also consider that since the start of the pandemic in March 2020, the US economy has confounded modeling and deviated from historic cycle norms. Is it possible the US slips into recession in the coming months or is already within the early stages of one? Without a doubt. But it is not a forgone conclusion by any stretch.

What's next?

With rates somewhat stable in July (at least relative to the preceding six months), the question for investors is…what's next? Is it time to look at longer duration assets and add some risk to your fixed income allocation?

Based on the futures market, the terminal rate has dropped from 3.50% to roughly 3.25% following the most recent FOMC meeting. This means the Fed has an additional 75-100 bps of tightening before year end, which could be split a variety of ways among the remaining three meetings based upon incoming economic news. Option-adjusted spreads, or the spread between a fixed income security yield and the risk-free rate (adjusted for any optionality), have retreated from recent highs but remain elevated relative to the past several years. It is almost certain that the market will experience bouts of volatility from now until year end, but hopefully nothing along the lines of what we have seen to start the year.

Exhibit 3 — Trading Range for Treasuries?



Source: Federal Reserve Economic Data (FRED).

At Diamond Hill, we are focused on the long term and do not make decisions based on assumptions about the market or the directionality of rates. The volatility we've seen in the 1H 2022 provided opportunity in a variety of sectors based on our philosophy of bottom-up, security selection and reinforces the importance of active management as a key component of investors' overall asset allocations. We expect continued opportunity as the market digests the actions of the FOMC, inflation (both real and expected) gyrations and the shadow of a potential recession hanging over the markets.

Sector in focus — investment grade corporates

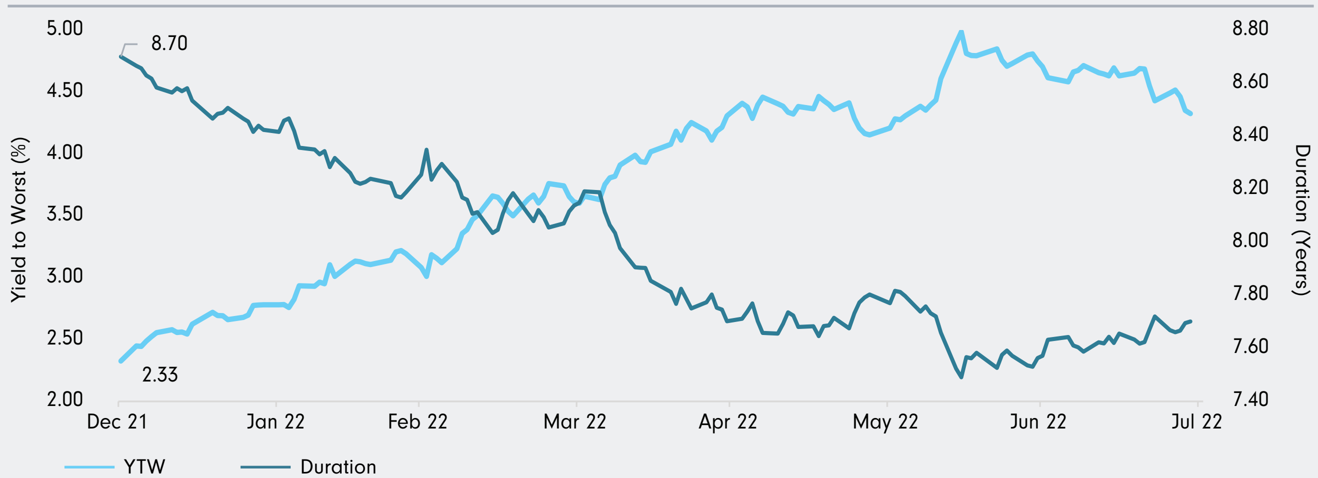
The investment grade corporate sector delivered its strongest monthly performance in nearly two years, generating 3.24% total return and 1.09% excess return (compared to comparable duration Treasuries) in July. While this performance served as welcome relief to what has been a challenging year so far (down -11.61% through July 2022), there is still quite a way to go from a recovery standpoint.

The sector was led by higher quality though a rising fixed income market lifted all vessels. AAA-rated and AA-rated corporate debt finished in a near-tie, returning 3.56% and 3.57%, respectively, while BBB-rated (3.32%) was not far behind. The laggard for the month, single-A, still generated a respectable 3.07% return. Even with the strong performance this past month, spreads in the investment grade corporate sector remain at attractive levels. Specific to the overall index, corporate spreads peaked in early July (160.1 bps) and spent the remainder of the month grinding tighter, finishing the month at 143.7 bps. Considering the sector began the year at 92.4 bps, the current level continues to offer some value despite the rally during the month, though a focus on security selection is key. Consider that the challenging first six months of 2022 led to a reduction in overall duration for the sector and an increase in the yield to worst (see chart). This shift has resulted in greater carry and less sensitivity to interest rates moving forward, though the risk is still there.

Exhibit 4 — Spread Compress in July, Still Offer Value

Source: Bloomberg.

Exhibit 5 — With Great Volatility Comes Great Opportunity



Source: Bloomberg.

Bloomberg US Aggregate Bond Index measures the performance of investment grade, fixed-rate taxable bond market and includes government and corporate bonds, agency mortgage-backed, asset-backed and commercial mortgage-backed securities (agency and non-agency). **Bloomberg US Corporate Index** measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg Treasury Bond Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **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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