DIAMOND HILL

INVESTED IN THE LONG RUN

Q4: A Brief Respite for Bond Markets After a Turbulent Year

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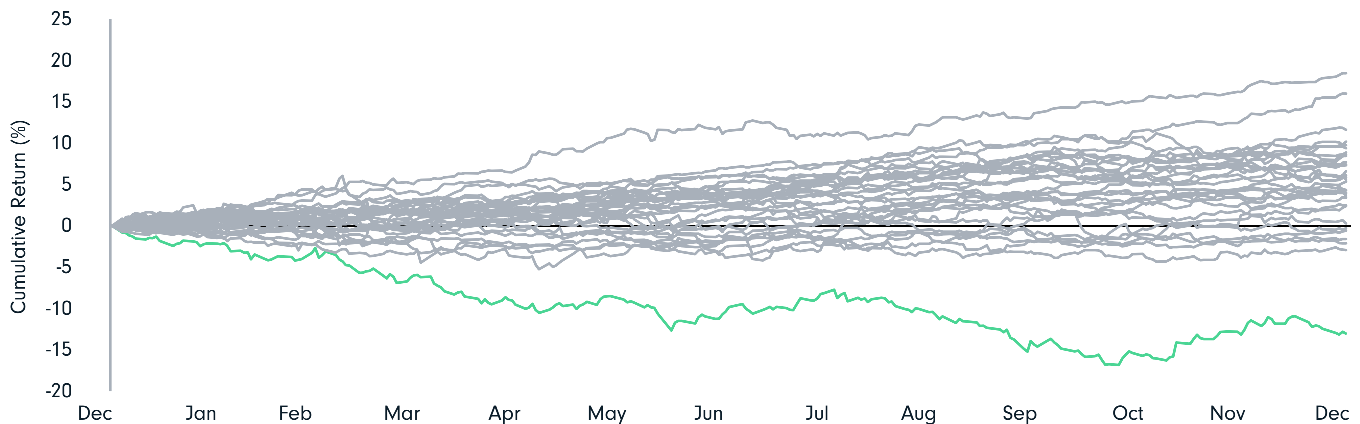
The most difficult year in the history of fixed income markets has ended — thankfully, with the markets closing out the year with some strength in Q4, the only quarter of positive returns in 2022. This brief period of relief in a turbulent year could not keep the fixed income markets from posting the worst annual performance (-13.01% for the Bloomberg US Aggregate Bond Index) since the index's inception in the early 1970s. Prior to this year, the worst calendar year performance was a loss of -2.92% in 1994.

Exhibit 1 illustrates the divergence in calendar year performance in 2022 compared to the prior 30 years. The continued pressure on interest rates and spreads brought to light the stark reality that many may have forgotten: Bonds contain an inherent sensitivity to interest rate fluctuation, and the dramatic and consistent move higher in rates throughout the year brought unprecedented volatility.

Exhibit 1 — Full Year Performance, Bloomberg US Aggregate Bond Index (%)



Source: Bloomberg.

But from the destruction of wealth that occurred in 2022 comes the opportunity to bring back some stability to the markets. If, as the Federal Reserve has indicated, we are much closer to the end of this rate hiking cycle, then fixed income should be well positioned to return to its place within an overall asset allocation as the ballast that provides an offset to the historic volatility of the overall markets. This isn't to say that 2023 is going to be roses and unicorns, simply that the higher yield derived from investment grade fixed income is in its best position in years to mitigate any continued interest rate volatility going forward.

Since the beginning of quantitative easing (2008) through the beginning of the current rate hiking cycle (March 2022), the average yield on the Bloomberg US Aggregate Bond Index was 2.63%, which trended higher as we approached the FOMC's point of rate liftoff. Over the same period, the duration (bond/index sensitivity to interest rate movements) of the index continued to extend, from 4.33 years at the end of 2007 to 6.53 years on the day of the first FOMC rate hike (16 March 2022). This meant that investment grade fixed income was set for a perfect storm — low yields and peak duration levels — and what a storm it was. But now we are (hopefully) emerging from the worst of it, with higher interest rates and expectations for the Fed to slowly apply the brakes on this rate hiking cycle, which we saw in December as the FOMC dropped from a 75 basis points (bps) pace in the prior meetings to 50 bps.

Federal Reserve vs Market Expectations

Despite the Fed's efforts at transparency, it appears that the market is not buying what the various members are selling. In December, the FOMC released its quarterly Statement of Economic Projections (SEP), including the dot plot, which illustrates expectations for the future path of interest rates.

The FOMC is expecting 2023 to finish with a targeted fed funds rate of 5.125%, indicating an additional two to three rate hikes in 2023 before holding the line at the terminal rate. The dot plot doesn't age well, as it serves as a snapshot in time and expectations will shift as the market moves and economic data is released. But it does provide some insight into the various FOMC members' expectations. The most important aspect of the December dot plot, as well as comments from various FOMC members, is the shift in longer term expectations. In September, the dot plot showed FOMC members expecting a median level of 4.625% for 2023, with only two members expecting a terminal rate higher than 5%. The December report showed a terminal rate of 5.125% for 2023, which is a significant move higher. With this massive shift in expectations, 17 of the 19 voting members had the terminal rate or the rate at the end of 2023 above 5%. And 7 members had the terminal rate above 5.375%. So, while one could theoretically consider dropping from a 75-bps rate hike in November to a 50-bps rate hike as relatively dovish, because the Fed was slowing the pace of increases, it was very hawkish if you look out over the long term.

The markets, as represented by fed funds futures, are showing fed funds year-end 2023 rates at 4.51%, with an increase to 5.0% by mid-year before a pullback of 50 bps by the end of the year. Maybe the Fed is being overly optimistic in thinking it can deliver a soft landing while the markets are being more pragmatic, but only time will tell. The Fed does have the advantage of being able to pivot at any time and adjust to incoming economic data and market movements. "Data dependent" is going to become a frequently used phrase in the coming months and quarters to help the Fed navigate and temper expectations.

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). The index is unmanaged, market capitalization weighted, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is 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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