DIAMOND HILL

INVESTED IN THE LONG RUN

Déjà Vu All Over Again?

Feb 2024

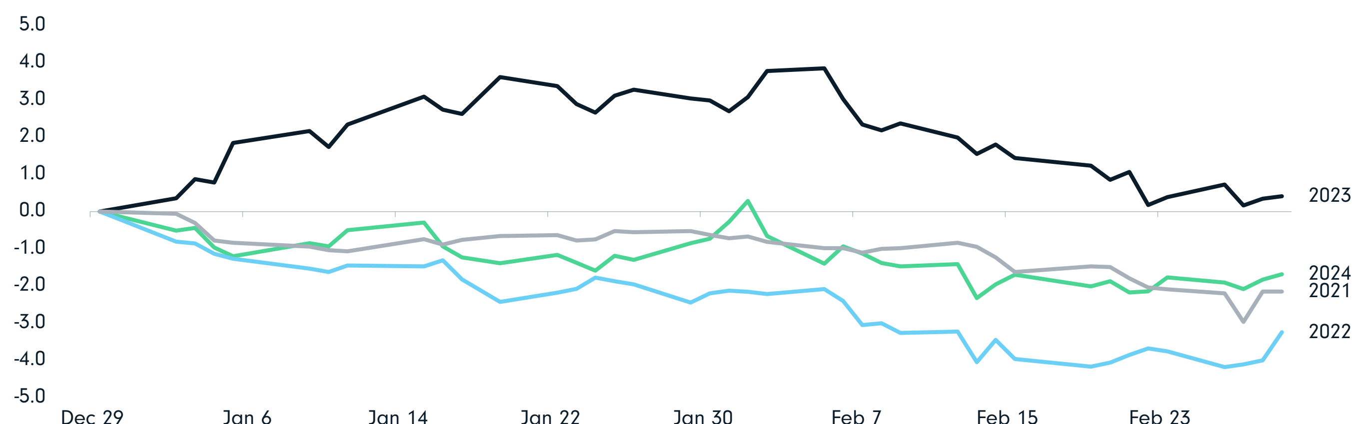
It's an annual rite of spring; pitchers and catchers report for spring training in Florida and Arizona to begin the new baseball season. With each new season, hope springs eternal for all teams, whether the high-powered Los Angeles Dodgers with the newly acquired superstar Shohei Ohtani or the lowly Pittsburgh Pirates hoping to catch lightning in a bottle for a magical season. Financial markets are pretty similar: the calendar turns over, and the slate is wiped clean; we start over again and track performance from the start of the year, though longer-term performance is vital to success.

In reviewing the performance since the start of the year, I was reminded of a quote from Yogi Berra, who was known as much for his Yogi-isms as he was for his prowess behind the plate as one of the best catchers of his time (18-time All-star, 13-time World Series champion, 3-time American League MVP, member of Major League Baseball's All-Century Team). Oh yeah, he also served his country as a gunner on a landing craft on D-Day — an amazing man.

Some of his Yogi-isms are somewhat silly — "When you come to a fork in the road, take it," "A nickel ain't worth a dime anymore" and "If you can't imitate him, don't copy him" — but others have become cultural wisdom. Upon witnessing Mickey Mantle and Roger Maris repeatedly hitting back-to-back home runs in the early 1960s, Berra said, "It's déjà vu all over again." Berra had front-row seats in the 1961 battle between Maris and Mantle as they assaulted Babe Ruth's single-season home run record.

What does any of this have to do with fixed income markets? While it hasn't been nearly as painful as 2021 and 2022, the start of 2024 feels eerily like what we experienced during those challenging years for fixed income. Recall that 2021 and 2022 delivered the first-ever back-to-back negative years for the Bloomberg US Aggregate Bond Index, which has never occurred since the index's inception (1986, data backfilled to 1976). Before 2021, the index had only printed a negative number since its inception in 1994 (-2.92%), 1999 (-0.82%) and 2013 (-2.02%). While it has been a rough start to the year, there are many reasons to believe that we can avoid a similar fate to what occurred in 2021 and 2022.

Exhibit 1 — Bloomberg US Aggregate Bond Index Total Return through February (%)



Source: Bloomberg.

"The future ain't what it used to be."

One of the biggest issues in the fixed income markets over the past several months has been the market's unwillingness to buy into the outlook from the Fed regarding the future path of interest rates. As discussed in previous commentary, the Federal Reserve has been adamant in holding the line, first with regards to the tightening cycle that began in 2022 and, second, to the prospect of "higher for longer" while the market had been pricing in a rather aggressive, rate reducing Federal Reserve.

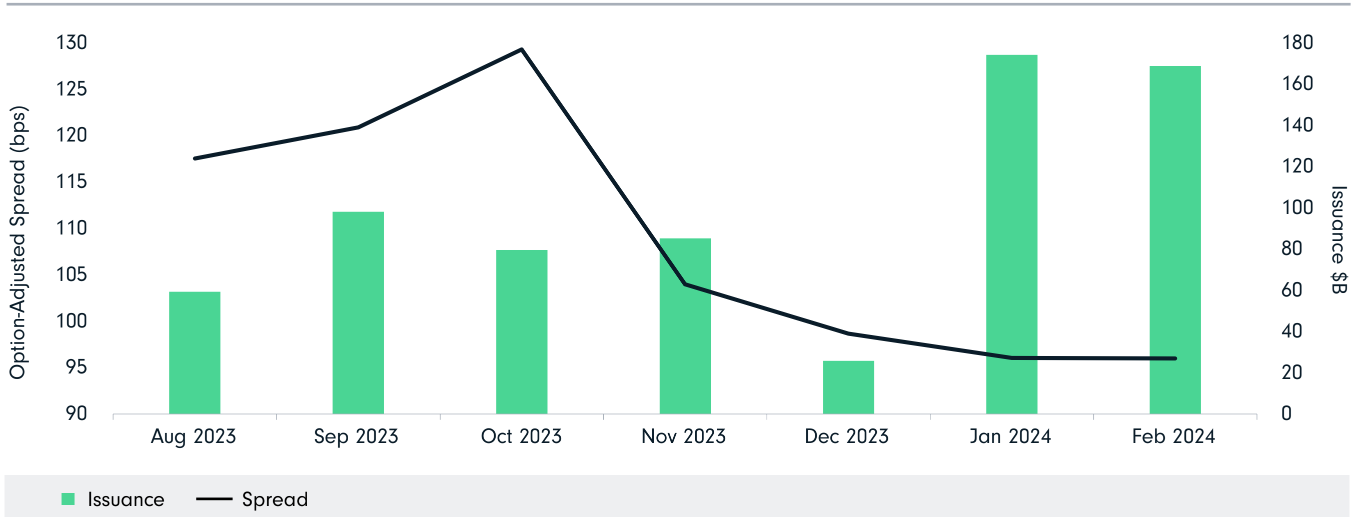
The market's expectations for the future have changed, and the readjustment of those expectations led to a rather challenging February in the fixed income markets. At the start of the year, fed fund futures were pricing in a 25-basis point (bps) rate cut in March, two 25-bps cuts in June and six cuts by year-end. Continued commentary from the Fed holding the line on rate expectations, as well as stronger economic data, finally sunk in, and the market shifted expectations for the future to finally get in line with the Fed's plan. By month-end February, expectations were for zero rate cuts in both March and May and slightly more than three by year-end, directly in line with the Fed.

"Nobody goes there anymore. It's too crowded."

This Yogi-ism refers to Ruggeri's restaurant, a hot spot in Yogi's old neighborhood in St. Louis, and can apply to the corporate market over the past couple of months. After a blistering final two months of 2023, during which the Bloomberg US Corporate Bond Index returned 10.57% and its option-adjusted spread compressed from 129.3 bps to 98.7 bps, the corporate market has held the line with regards to spread.

But while spreads have held relatively level since the start of 2024, the new issue market has been scorchingly hot, with more than $389 billion in new issues coming to the market, an increase of 31% compared to the same period last year. February's issuance of $196 billion represents the fifth largest issuance month on record and is an increase of 77% compared to the prior 4-year average (ex-2020). The new corporate issues have been fiercely gobbled up by a hungry market searching for additional yield. Through the first two months of 2024, investment-grade corporate mutual funds have experienced $15 billion in net new flows.

Exhibit 2 — Spreads Compress Despite Massive Issuance to Start the Year



Source: Bloomberg.

"We were overwhelming underdogs."

Speaking with legendary pitcher Nolan Ryan, Yogi fondly recalled his experience as the first base coach for the Miracle Mets of 1969. It was the eighth season for the Mets, and before 1969, the team had never had a winning season nor finished higher than ninth place in the ten-team National League East. But the team shocked the world and captured their first World Series championship, beating the Baltimore Orioles four games to one.

The commercial mortgage-backed securities (CMBS) market has been considered the black sheep of the fixed income family, suffering from rising delinquencies and vacancies as the world adjusted to a hybrid work environment. But the sector has been painted with a broad brush, punishing areas of the market that are well-structured and not as exposed to problem children like office and retail. Even with office, there is a bifurcation between truly challenging properties and properties that are holding up well and delivering near-full occupancy and performance.

Outside of shorter duration asset-backed securities, the non-agency CMBS market, as measured by the Bloomberg US Non-Agency CMBS Investment Grade Index, has generated the best sector performance since the calendar turned over to 2024.

"It ain't over 'til it's over."

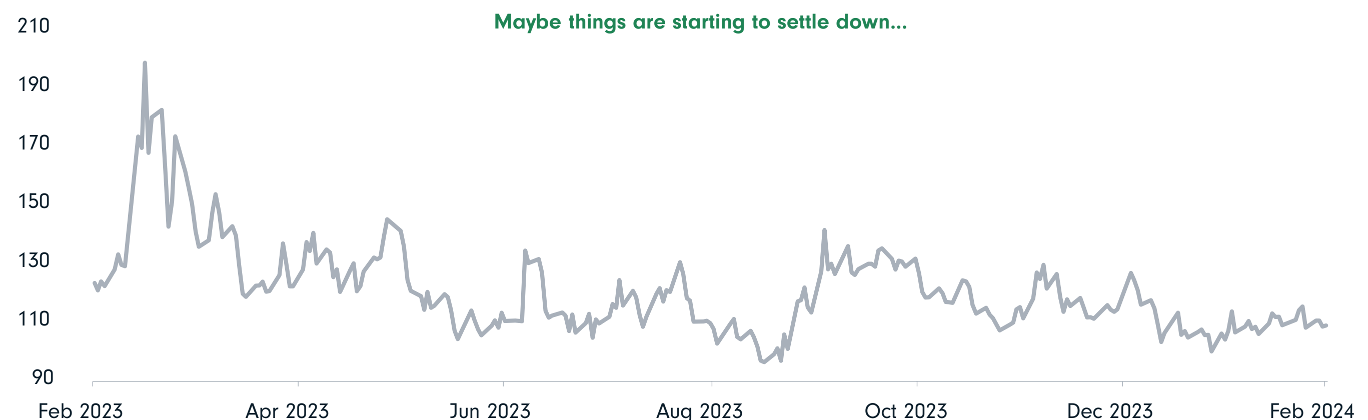
In 1973, Berra was the manager of the New York Mets, who trailed the Chicago Cubs by 9.5 games in the National League East in July, and was quoted with this classic regarding his team's chance of making the postseason. The Mets rallied to win the National League East title by amassing only 82 wins (the lowest number of wins for a team that qualified for the postseason during a regular season of 162 games), a feat matched in 2005 by the San Diego Padres. The Oakland Athletics (soon to be Las Vegas Athletics) eventually defeated Berra and the Mets in the World Series that year.

Can fixed income markets experience a surge like the '73 Mets and rebound from a challenging start to 2024? While it is a distinct possibility that fixed income markets can come back from a difficult start to the year (look at 2023; down nearly -3% through October before a solid final two months +8.53% to finish the year +5.53%), it is by no means a foregone conclusion.

The markets will gain additional clarity on the future path of rates when we hear from the Federal Reserve on March 20, even as it is assumed the Fed will hold rates steady. A quarter-end FOMC meeting means the Summary of Economic Projections (SEP) will be released, including an updated dot plot. The Fed's dot plot is a quarterly chart that records each Fed official's projection for the fed funds rate. The dots reflect what each US central banker thinks will be the appropriate federal fund rate midpoint at the end of each calendar year.

There has been significant volatility in the rates markets over the past year, but there does seem to be some stabilization as the markets have reflected the Fed expectations. The MOVE Index measures US bond market volatility by tracking US interest rate swaps across the yield curve and provides insight into relative volatility in fixed income markets. As illustrated in Exhibit 3, while there have been short periods of volatility, the past six months or so have seen some stabilization.

Exhibit 3 — MOVE Index Pricing



Source: Bloomberg.

While there will still be volatility in fixed income markets, the overall market is in a much better place than it was coming into 2022. The shift higher across the curve over the past several months has been navigated, and higher yields offer a nice buffer to the potential impacts of interest rate fluctuation.

Undoubtedly, it's been a challenging start to the year, and investors reviewing their statements in February will see negative numbers in the fixed income column and wonder, "Is this a repeat of 2022?" Recall that the 10-year Treasury yield began 2022 at 1.51% and finished that year at 3.88%, a historic run higher in rates. Bond math dictates that if a portfolio has duration (sensitivity to interest rate fluctuations), rising rates will hurt a portfolio. The impact is exacerbated when a portfolio is earning a historically low yield when rates are climbing rapidly, limiting a portfolio's ability to generate enough income to offset principal losses.

As painful as it may be to say, this time is different. The yield to worst (YTW) for the Bloomberg US Aggregate Bond Index finished February at 4.92%, which compares favorably to the 1.75% YTW of December 2021. We can't predict the future; no one can. But fixed income markets are better positioned to weather additional rate and spread volatility today than three years ago.

As we progress through the year, remember the wise words of Yogi Berra, "You can observe a lot just by watching."

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 Bond Index** measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg US Non-Agency CMBS Investment Grade Index** measures the market of US non-agency conduit and fusion CMBS deals with a minimum current deal size of $300mn and a rating of BBB/Baa or above. 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.

MOVE Index (or Merrill Lynch Option Volatility Estimate Index) is a gauge of interest rate volatility in the US Treasury market.

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