DIAMOND HILL

INVESTED IN THE LONG RUN

Don't Fight the Fed, Round II

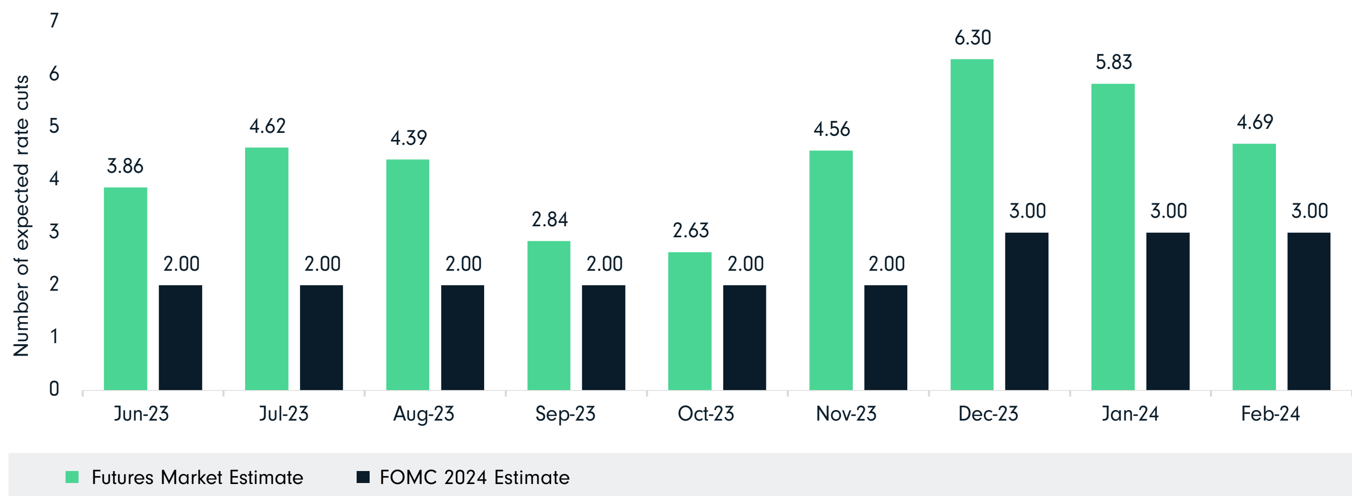
Jan 2024

Over the past several months, our commentaries have examined the ongoing disconnect in interest rate expectations between the markets (as measured by fed fund futures) and the Federal Reserve. The chasm between the two reached its widest in December 2023, but we've seen some market capitulation as we've moved into 2024. Assuming the FOMC has reached the end of this tightening cycle, it is now about when the easing begins and with what type of velocity.

At the September 2023 meeting, the FOMC projected an additional 25 basis points (bps) rate hike before the end of 2023 and 50 bps of rate cuts by year-end 2024 to reach a level of 4.625% based on the Summary of Economic Projections (SEP). At the final FOMC meeting in December, the Fed held rates steady at the 5.25% to 5.50% range, opting not to follow through on the projected September rate hike due to incoming economic data.

In the December SEP, the FOMC projected 75 bps of rate cuts in 2024 from the current 5.25% to 5.50% level. While the Fed was projecting three 25 bps rate cuts in 2024 — with no indication as to the timing of those cuts — the futures market was indicating more than six 25 bps cuts in 2024 (Exhibit 1), with the earliest rate reduction occurring in March 2024 (Exhibit 2).

Exhibit 1 — Cumulative 25-bps rate cuts estimated at the December 2024 FOMC meeting



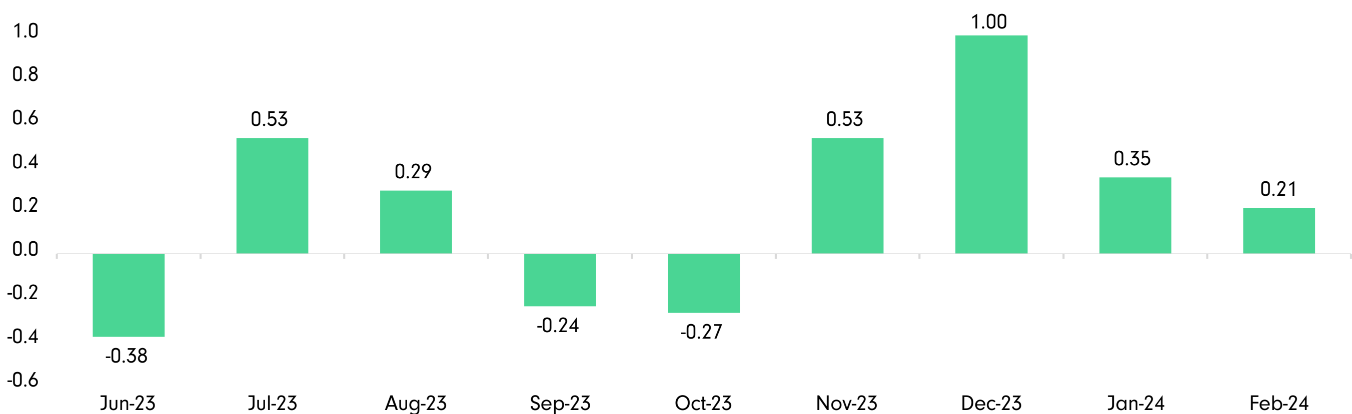
Source: Bloomberg.

At the first FOMC meeting of 2024 on January 31, Chair Powell reiterated the FOMC's focus on data dependency and flexibility to react to incoming economic data. The SEP is published quarterly, so there was no published report reflecting the FOMC's rate expectations, but Powell (and subsequent meetings/interviews with other FOMC members) reiterated expectations for three 25-bps rate cuts by year-end, most likely beginning later in the year. After that meeting, the market shifted slightly with December 2024 fed funds futures projecting just under six 25-bps rate cuts by year-end 2024.

It wasn't until the strong January non-farm payroll (NFP) report on February 2 that we saw some true capitulation from the market. Estimates for the January NFP report ranged from 120,000 to 300,000, with the median estimate coming in at 185,000 — but the actual number for January was an astounding 353,000 jobs added.

Compounding the impact of January's strong employment news was the revision to the December NFP report, which was revised higher by 117,000. By the end of the first full week of February, fed fund futures had adjusted expectations for an initial rate hike in March to an 18% chance from a 100% chance at year-end 2023 (Exhibit 2). Regarding the timing of the first cut, with March no longer the expectation, futures were pricing the initial cut to possibly occur in May (54%) but much more likely in June (81%), reflecting recent Fed members' comments about early to mid-summer as the most likely possibility.

Exhibit 2 — Fed fund futures expectations for a 25-bps rate cut at the March 2024 FOMC meeting



Source: FRED.

The ongoing disparity between the markets and the Federal Reserve continues to reinforce our belief that you can't fight the Fed. The markets and various talking heads can publish and discuss opinions and expectations with the possible hope of influencing the Federal Reserve, but as we've seen over the past 18-24 months, the FOMC is holding the line on implementing its plan for rates. The second round of the battle between the Fed and the markets was a decisive win for the Fed and helped strengthen the institute's credentials as an independent entity, free from market influences. We're firmly in the camp of following the Fed, not fighting them.

Commercial Mortgage-Backed Securities Led the Market in January

Like other fixed income sectors, the commercial mortgage-backed securities (CMBS) sector bounced back in the final two months of 2023. Despite the year-end rally, CMBS spread levels remained elevated compared to other market sectors. Other spread sectors saw that late-2023 rally fizzle out in January as the fixed income markets mainly delivered negative returns to start the year. Non-agency or private-label CMBS bucked the trend and continued the rally well into January, providing the best sector performance for the month.

Utilizing the ICE Bank of America CMBS indices, we can see the significant rally in spreads in January when examining comparable duration CMBS and corporate allocations, broken out by credit quality (Exhibit 3).

Exhibit 3 — Spread Changes

	Duration	31 Dec 2023 OAS	31 Jan 2024 OAS	Change
7-10 Y AAA CMBS	6.89	99	88	-11
7-10 Y AAA Corporate	7.42	54	74	20
7-10 Y BBB CMBS	6.47	855	637	-218
7-10 Y BBB Corporate	6.68	147	148	1

Source: Bloomberg and ICE BofA.

The spread tightening was reflected in the performance of the sectors as well, with CMBS delivering strong January returns (Exhibit 4). Given the ongoing concerns about commercial real estate and the almost daily headlines surrounding various market segments (e.g., New York Community Bancorp's earnings report in late January), why the massive rally in a month when the rest of the market pulled back?

Fundamentals are still weak, with delinquencies increasing during the month, and there's still downgrade risk in certain market areas (e.g., S&P downgraded four tranches, while DRBS placed numerous deals on negative watch). But the sector has benefitted from the FOMC's shift in tone — potentially done with tightening, easing on the horizon — and the prospect for more favorable refinancing opportunities.

Exhibit 4 — Total Returns (%)

As of 31 January 2024	1M return	3M return	1Y return
7-10 Y AAA CMBS	0.93	11.12	2.02
7-10 Y AAA Corporate	-0.89	9.35	1.98
7-10 Y BBB CMBS	15.34	26.02	7.97
7-10 Y BBB Corporate	0.12	11.70	5.69
CMBS	1.49	6.88	3.81
Corporate	0.15	10.08	4.50

Source: Bloomberg and ICE BofA.

Just as 2023 saw the entire segment painted with a broad (and punishing) brush, so have the positive aspects of January been felt industrywide. Both instances provide opportunity for relative value investors: strong securities attractively priced due to the spread widening across the sector last year or weaker but well-structured securities carried along by broad spread tightening in January. The movements over the past several months reflect the importance of security selection and strong due diligence when selecting securities for a well-diversified portfolio.

Bonds rated AAA, AA, A and BBB are considered investment grade.

ICE BofA AAA and BBB CMBS indexes measure the performance of US dollar denominated investment grade rated commercial mortgage-backed securities publicly issued in the US domestic market. These subsets include all securities with a given investment grade rating AAA and BBB, respectively. **ICE BofA AAA and BBB Corporate indexes** measure the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. These subsets include all securities with a given investment grade rating AAA and BBB, respectively. 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.

The views expressed are those of Diamond Hill as of February 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.