DIAMOND HILL

INVESTED IN THE LONG RUN

New Year. New Markets?

Jan 2023

Overview

The story of fixed income markets in 2021 was driven by a challenging Q1, which was witness to the January 6 insurrection as well as a euphoric mix of accelerated vaccine distribution, expectations for an end to quarantines, two stimulus packages and a re-opening of the US economy. Little did we know what the re-opening of a long-dormant economy would do to inflation, but hey, we were just happy to be going out to dinner and being amongst family and friends again.

2022 was all about the resulting runaway inflation and the Federal Reserve's stoic assault to rein in inflation. The assault — fueled by the most aggressive tightening cycle since the late 1970s and early 1980s — wreaked havoc on fixed income (Bloomberg US Aggregate Bond Index) and equity markets (S&P 500) as both delivered double digit losses in the same calendar year for the first time ever.

But was 2022 all bad for fixed income markets? The first nine months were a disaster as the index lost -14.61%, driven by the largest increase over that period for the 10-year US Treasury yield in history, 2.32% or an increase of more than 150%. But the fourth quarter provided a reprieve — as the Aggregate index returned +1.87% and rates held steady quarter over quarter despite some intraday volatility — possibly signaling a long-awaited turnaround for a market that had been under heavy pressure since the pandemic began. And, as we discussed in our October commentary, The Not-So-Great Rate Reset, Q4 positioned fixed income investors for something they haven't had for quite some time...actual income.

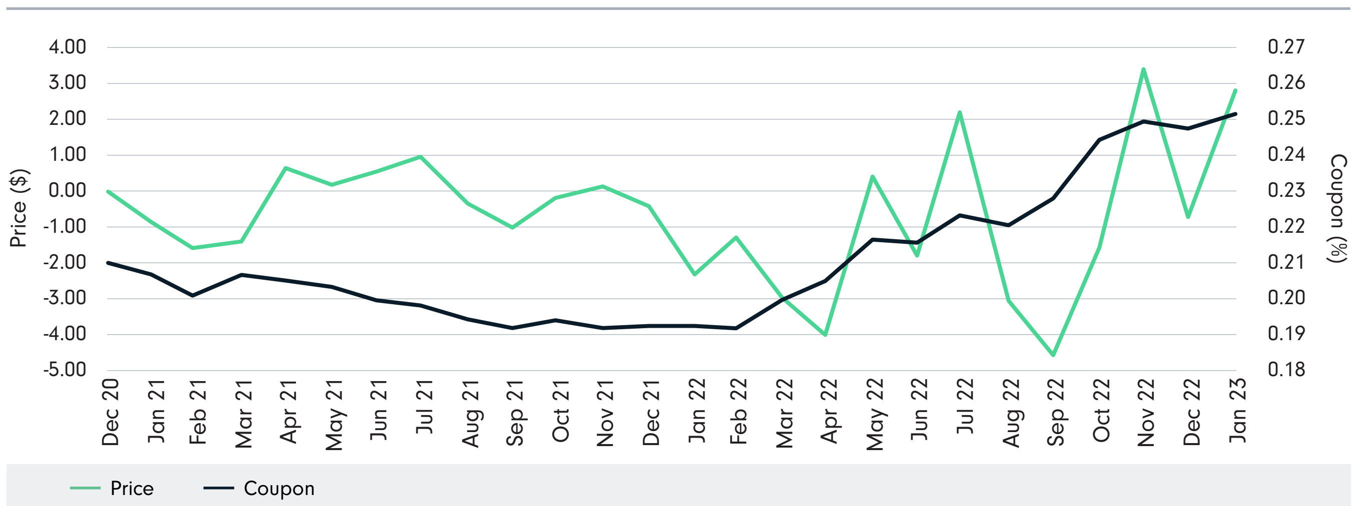
After the trauma of last year, fixed income investors are happily opening their January statements to positive returns, building on the momentum of Q4 2022. In fact, the 3.08% return of the Bloomberg US Aggregate Bond Index was the third-best single month behind December 2008, when the index advanced 3.73%, and November 2022 when the index returned 3.68%. The Fed continues to reinforce its planned rate hikes, projecting a terminal rate for 2023 in the 5.00% to 5.25% range, but the pace is slowing, and it feels as if we're nearing the end (or at least a pause) of a very painful tightening cycle. There remains a disconnect between market expectations — terminal rate between 4.75% and 5.00% reached in June followed by one to two 25 basis point (bps) cuts by year end — and the Federal Reserve's current path, but a repeat of 2022's or even 2021's marginally negative performance seems unlikely.

What Has Driven 2023's Turnaround?

Duration/Treasury

Duration, the bane of fixed income investors in 2022, was a source of strength in January, with price return accounting for 2.80% and coupon return accounting for 0.25% as yields across the curve compressed due to expectations of a slowdown in the tightening cycle. The curve remains inverted as the short end pushed higher with the 1-month and 3-month T-bills climbing by 53.0 bps and 29.9 bps, respectively. The Treasury sector returned 2.51% during the month, its fourth month of positive returns since the start of 2022 but the second over the past three months. As illustrated in Exhibit 1, the income component of the index's return continues to climb, as one would expect given the shift in rates we've seen, while price return has experienced positive performance in two of the last three months. While the Fed has dialed back on rate increases once more (25 bps on February 1), the yield advantage in investment grade fixed income markets should continue.

Exhibit 1 — Bloomberg US Aggregate Bond Index, Monthly Performance



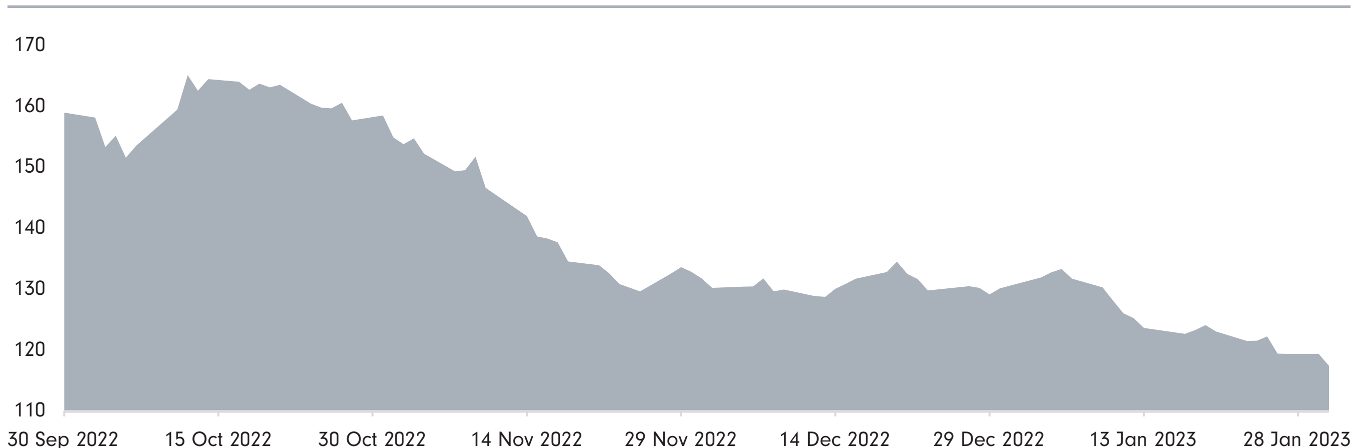
Source: Bloomberg.

Treasury auctions in January across the yield curve were well received, as every auction witnessed "stopping through" initial yield levels. Stopping through indicates that the final yield at auction is below the when-issued or initial yield level, an indication that there was more interest in the auction which forced investors to pay more, thus a lower yield. A tail is the opposite. A wide, or long, tail means that there was diminished interest in the bond at the initial level, forcing the yield higher (price lower) to generate enough interest.

Investment Grade Corporates

Despite a lackluster start to an earnings season that largely missed analyst expectations, credit spreads compressed throughout the month. The new issue market continued to roar in the new year with deals hitting the market an average of 3.4 times oversubscribed (level of interest relative to actual issuance) and total issuance of roughly $144 billion. Pricing on new deals have seen significant tightening as yields have narrowed an average of 28 bps from initial price talk, compared to the 2022 average of 22 bps. Investment grade trading activity on the final day of the month set a record high with $47.9 billion trading. Not only was month-end a record but the full-month average daily trading volume of $31.3 billion/day was also a new record. Investors obviously finished up the year underweight credit and have been working to reduce that underweight in January. Though the consensus from forecasters and strategists is that the US will experience a recession in the coming months, credit markets are behaving as if nothing is amiss with strong demand fueled by attractive yields in the investment grade sector. Spreads in the corporate market tightened throughout the month, following on the heels of spread compression in Q4, as investors returned to the markets in full force after the holiday break.

Exhibit 2 — Investment Grade Corporate Spread Compression Since Start of Q4 2022 (bps)



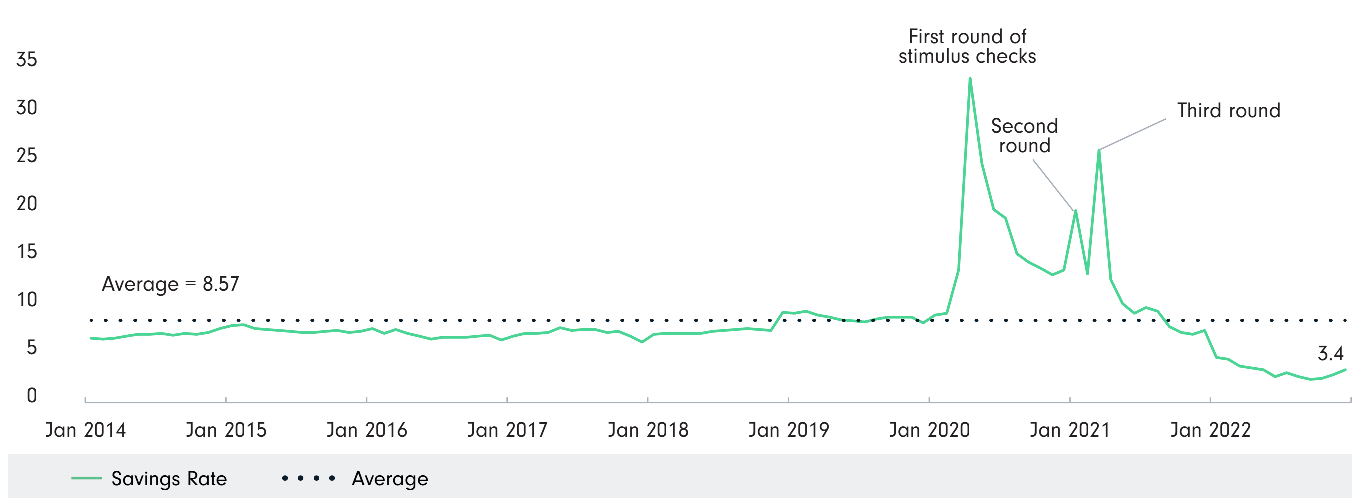
Source: Bloomberg.

Structured Product

Residential mortgage-backed securities benefitted from the shift in the yield curve, delivering its second-best monthly performance since November 2008. Just as the back-up in rates hurt interest rate sensitive fixed income, the rally contributed to January's performance. With expectations of a slowdown in the pace of increases from the Federal Reserve and the possibility of a soft landing for the economy, extension risk for the mortgage sector stabilized. The production in the residential mortgage space is expected to continue slowing as higher rates challenge potential new homeowners. Existing home sales have now fallen for eleven consecutive months and 2022 overall home sales (new and existing) are down 18% compared to full year 2021. But is there a light at the end of the tunnel? Pending home sales were up 3% in December from the prior month, the first monthly increase since October 2021. It seems that homebuyers may have recovered from the initial shock of mortgage rates above 7% as those rates now hover just north of 6%.

The asset-backed securities segment of the market delivered its best performance since 2009, though on an absolute basis trailed other segments of the investment grade fixed income markets. Consumers continued to burn through the roughly $2.5 trillion in excess savings accumulated during the COVID years thanks to government stimulus and lower spending habits. With the savings rate now below pre-pandemic levels, consumers are turning to credit cards once more, building up credit balances in lieu of depleting what remains of their savings. The good news for consumers? Inflation may have finally peaked, given the most recent trajectory, which should help ease the burden of higher prices of the past year or so. The most recent report on average savings from the US Bureau of Economic Analysis shows that the consumer may have turned the corner, with the savings rate increasing from 2.9% in November to 3.4% in December.

Exhibit 3 — Personal Savings Rate (%)



Source: US Bureau of Economic Analysis, Federal Reserve Bank of St. Louis.

Despite the specter of rising interest rates and the potential impact on the overall market, commercial mortgage-backed securities (CMBS) fared well during January. But there is a definite bifurcation within the sector as rising interest rates weigh on both commercial and residential securities. High-quality CMBS spread levels tightened even as lower quality experienced some widening.

What does it all mean?

Have we officially turned the corner on the worst two-year stretch in fixed income markets? Given the price action we've seen in fixed income markets since the end of third quarter last year and the fact that the Federal Reserve has once again tapped on the brakes with a 25-bps rate hike on February 1, it is quite possible. For the first time in a long time, a diversified portfolio of investment grade fixed income has an attractive component of income that will help mitigate any unforeseen rate volatility. Prognostication is a dangerous and difficult job, too many variables can impact the future path of the markets and the economy. But it is hard to envision a scenario wherein we replicate the performance of 2022 or even 2021 given the current level of interest rates and expectations from the Federal Reserve. Solid core fixed income portfolio yields going forward combined with some relative stability in interest rates over the longer term should deliver compelling returns in fixed income markets for the foreseeable future.

A few years ago, the question, "Is core dead?" was brought up many times and debated ad nauseum. And it was a legitimate question in an environment of prolonged low rates and the specter of the impact of rising rates on interest rate sensitive securities. But now that we've emerged from the wreckage of 2022 and investors have survived the pain it inflicted, we believe core fixed income is well positioned to deliver on its key role of managing portfolio risks and lowering the probability of unexpected outcomes.

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, 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.

S&P 500 Index measures the performance of 500 large companies in the US.

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