DIAMOND HILL

INVESTED IN THE LONG RUN

Wait…What Just Happened?

Mar 2023

Markets rang in the New Year with joy and redemptive performance, rebounding from the disaster of 2022 that witnessed the S&P 500 lose -18% and the Bloomberg Barclays US Aggregate Bond Index fall -13%, by delivering +6.28% and +3.08% returns, respectively.

Everything was coming up roses after a rough calendar year, but a disconnect between the markets and the Federal Reserve lurked in the background. Despite the Fed's repeated statements about holding the line on its commitment to battling inflation via rate hikes, the market continued to disagree, pricing in a lower terminal rate and rate cuts by the end of 2023.

That changed over a two-week period in February, fueled by an incredibly strong non-farm payroll (NFP) report with 517,000 jobs added in January and an additional 71,000 jobs added through revisions to the previous two months, as well as a decrease in the pace of disinflation (reduction of the overall inflation level).

What are the implications for fixed income markets? First, let's recap what's happened over the past several months to understand the disconnect between the Fed's stance on tightening and the market's expectations. Then, we'll examine the impact to fixed income markets in February.

August 2022 Jackson Hole Economic Symposium

Federal Reserve Chairman Jerome Powell lays the groundwork for continued tightening, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

Despite these comments, the market continued to price in rate cuts by the end of 2023.

Speech/Meeting Date	Fed funds rate post-meeting	Futures terminal rate post-meeting	Dot plot estimate for year-end 2023
August 2022	2.25% to 2.50%	• 3.79% in March 2023 • 3.42% year-end 2023	3.75%

September 2022 FOMC Meeting

Powell: "...we're committed to getting inflation back down to 2% — because we think that a failure to restore price stability would mean far greater pain later on."

Weakening economic data — including contracting purchasing manager indexes and slowing inflation — led the market to believe the end of the cycle was near and future cuts would be needed to stave off a recession. But various members of the FOMC hit the financial talk show circuit to dispel the notion that the Fed would be pausing or cutting rates by year-end 2023, which the market continued to disregard.

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September 2022	3.00% to 3.25%	• 4.60% in May 2023 • 4.23% year-end 2023 (one to two 25 bps cuts)	4.63%

November 2022 FOMC Meeting

Powell: "It's very premature, in my view, to think about or be talking about pausing our rate hike. We have a way to go."

Up to this point, this was Powell's most pointed comments to the market regarding any kind of rate cut in the near (or long-term) future, which the market continued to ignore.

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November 2022	3.75% to 4.00%	• 5.08% in May 2023 • 4.79% year-end 2023 (one 25 bps cut)	4.63%

December 2022 FOMC Meeting

Powell: "Historical experience cautions strongly against prematurely loosening policy. I guess I would say it this way: I wouldn't see us considering rate cuts until the Committee is confident that inflation is moving down to 2% in a sustained way. So that's the test I would articulate. And you're correct. There are not rate cuts in the SEP for 2023."

This was Powell's most direct statement regarding the prospect (or lack thereof) for rate cuts in 2023, barring any kind of unforeseen cataclysmic event.

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December 2022	4.25% to 4.50%	• 4.87% in May 2023 • 4.34% year-end 2023 (two 25 bps cuts)	5.125%

February 2023 FOMC Meeting

Powell: "It's important that the markets do reflect the tightening that we're putting in place. As we've discussed a couple times here, there's a difference in perspective by some market measures on how fast inflation will come down. We're just going to have to see. I mean, I'm not going to try to persuade people to have a different forecast, but our forecast is that it will take some time and some patience and that we'll need to keep rates higher for longer..."

One could interpret this as Powell stating that "you can think what you'd like but the Fed is going to continue doing what we've said we would do — raise rates and hold the line," which the market continued to disregard, until stronger economic data started coming in over the following weeks.

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December 2022	4.25% to 4.50%	• 4.87% in May 2023 • 4.34% year-end 2023 (two 25 bps cuts)	5.125%
February 2023	4.50% to 4.75%	• 4.89% June 2023 • 4.40% year-end 2023 (two 25 bps cuts)	5.125%

The February FOMC meeting was at the beginning of the month, and as the month progressed, the divergence between the Fed and the markets continued to shrink, as outlined in Exhibit 1. Early in the month, June was assumed to be the targeted meeting for reaching the terminal rate (4.92% at the time) but by the first day of March, the September FOMC meeting became the expected meeting at which the terminal rate (at 5.47% on March 1) would be reached. This shift higher over a longer period reflects the market capitulation to stronger economic data as well as continued comments from various FOMC members that they were going to continue pushing higher.

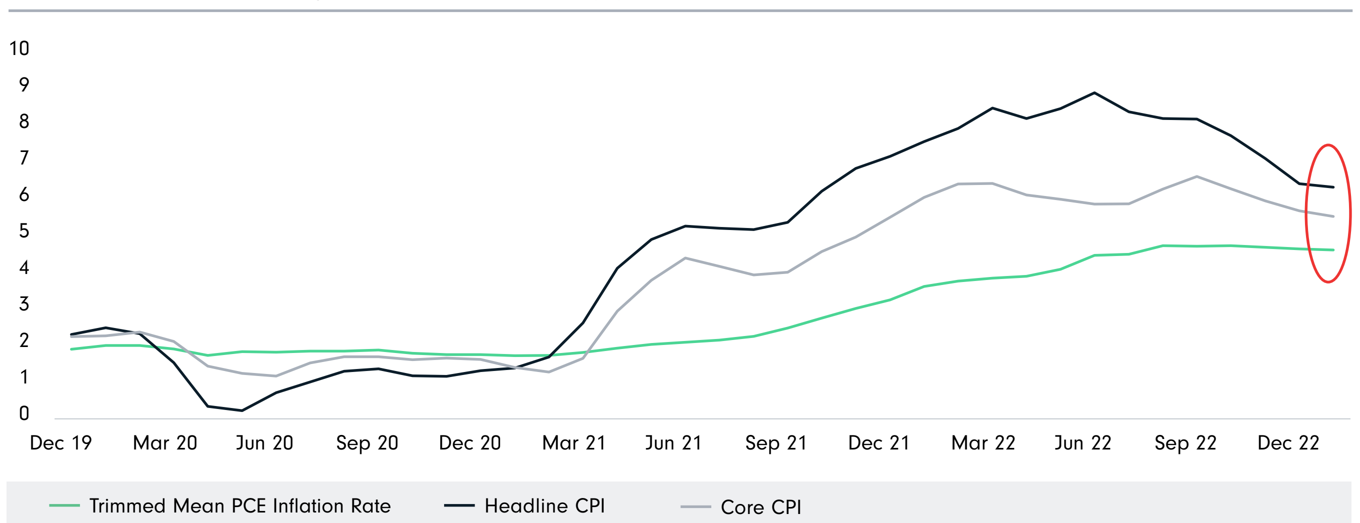
Exhibit 1 — Market Expectations Shift for Terminal Rate (%)

Source: Bloomberg.

The Fed has continued to emphasize its focus on defeating inflation through the tightening of financial conditions by raising the fed funds rate and allowing the balance sheet to continue to run off. By tightening financial conditions, the Fed hopes to reduce the pace of inflation as well as job growth. Exhibits 2 (inflation), 3 (historic periods of disinflation) and 4 (non-farm payrolls) illustrate that while the Fed's efforts have been somewhat successful, the most recent data and historical data show the potential need to push harder on rates to slow inflation more and cool the red-hot jobs market. Thus, the shift in market expectations and a painful month of February for fixed income markets.

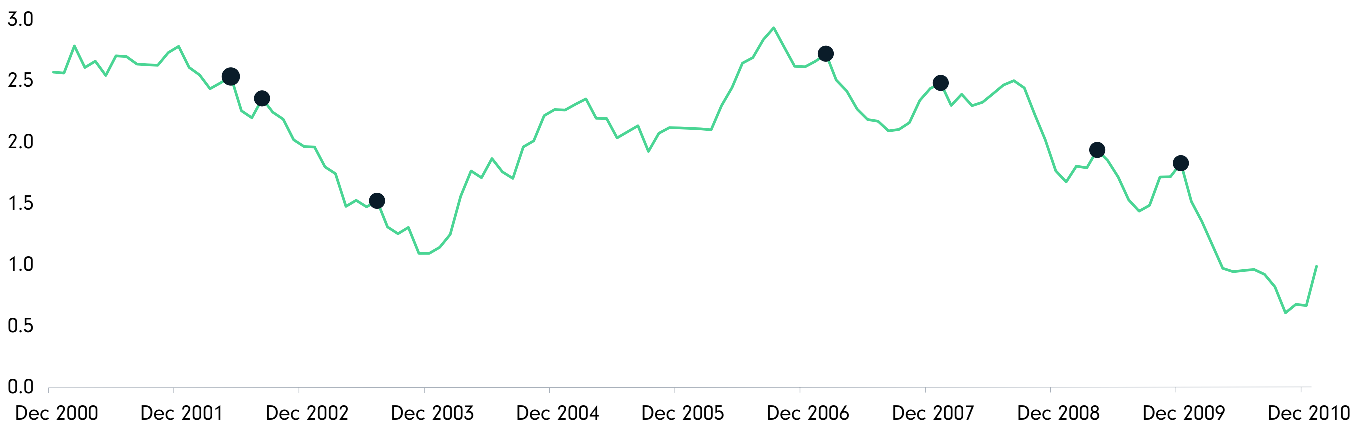
Core inflation (headline inflation minus the more volatile food and energy component) appeared to have turned the corner in September 2022. But the slowdown in the pace of disinflation (reduction in the level of inflation), which Powell referenced 11 times in his February post-FOMC press conference, became apparent in January when inflation dropped from 5.70% to 5.55% (decrease of 2.7%), after averaging a decrease of 5.0% per month over the preceding three months. As market historians know, disinflation never moves in a straight line, as outlined in Exhibit 2, so we could be in for some more volatility in the coming months.

Exhibit 2 — Inflation Readings Since December 2019 (%)



Source: FRED.

Exhibit 3 — Periods of Disinflation (%)

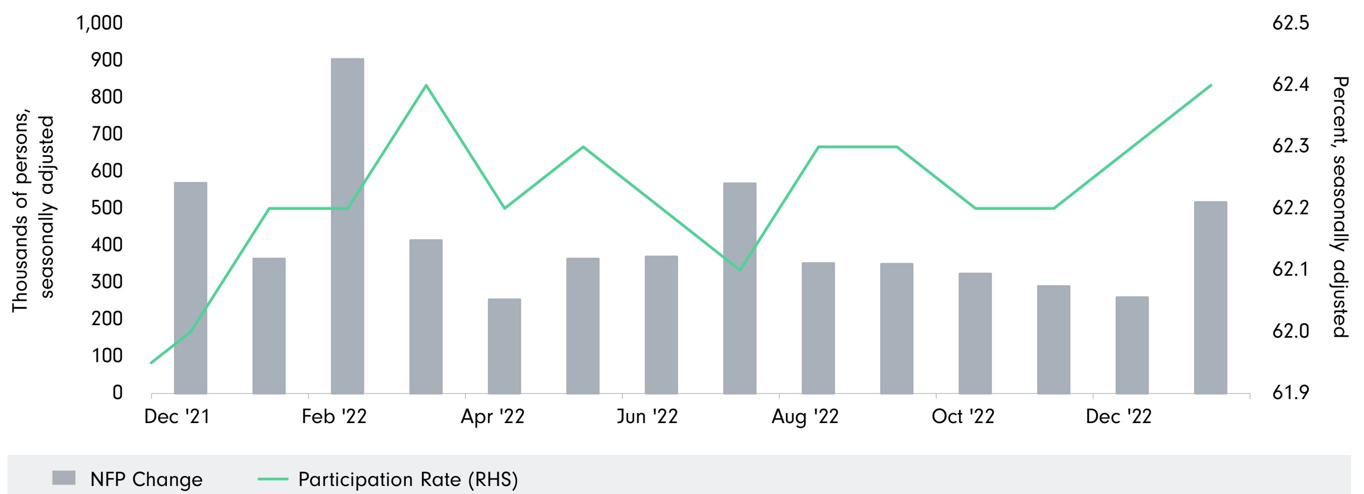


Source: FRED.

The employment picture got a shot in the arm with the release of January's NFP report, which was released just two days after the FOMC meeting. One wonders, if the timing was different and the Fed had the scorching-hot NFP report in its hands prior to the meeting, whether it may have moved forward with 25 bps or jumped to 50 bps. But we'll never know.

The participation rate (the percentage of the population that is either working or actively looking for work) continued its upward trend as well and reached its highest post-March 2020 level. January's NFP report reversed the trend of the prior six months in which the number of jobs added to the economy was slowly decreasing each month. The 517,000 jobs added was 64% higher than the prior five-month average and nearly double the preceding month's 260,000 jobs added. This bullish employment report to start the year reinforced the Fed's expectations for additional rate hikes into the year to battle the strong labor market and cool inflation.

Exhibit 4 — Employment Market Strength Continues

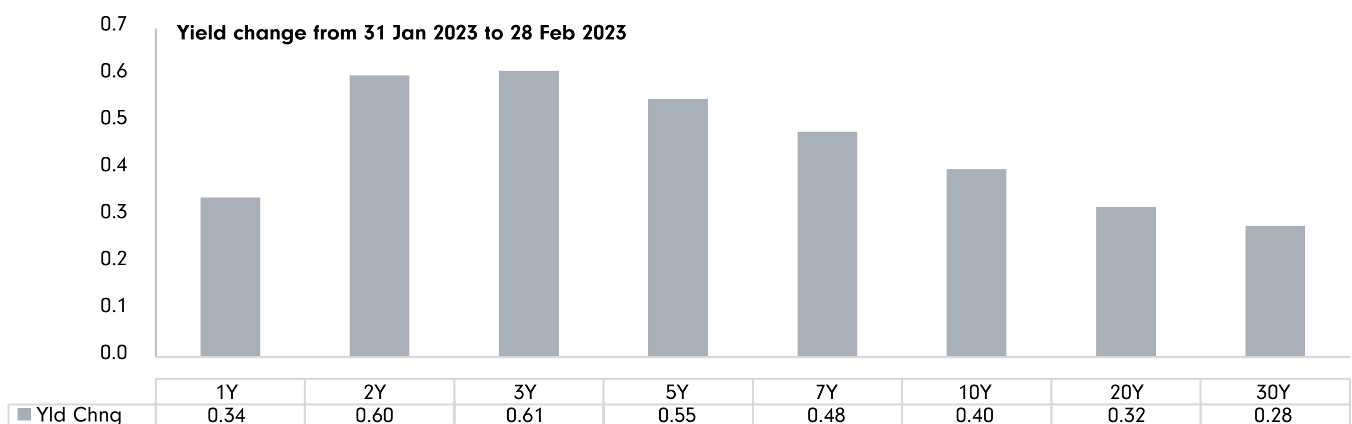


Source: FRED.

January giveth, February taketh away

The disconnect between the Fed and the markets on the future path of rates and the potential impact of a reconciliation was a key talking point in our commentary last month. Little did we know that the reconciliation would occur so quickly, nearly offsetting the substantial gain generated in January. To recap, the Bloomberg US Aggregate Bond Index returned 3.08% in January, which was the third-best single month performance since December 2008's 3.73% return, trailing only November 2022's 3.68%. And how did the markets follow up such strong performance?

Exhibit 5 — Yield Shift Across the Curve (%)



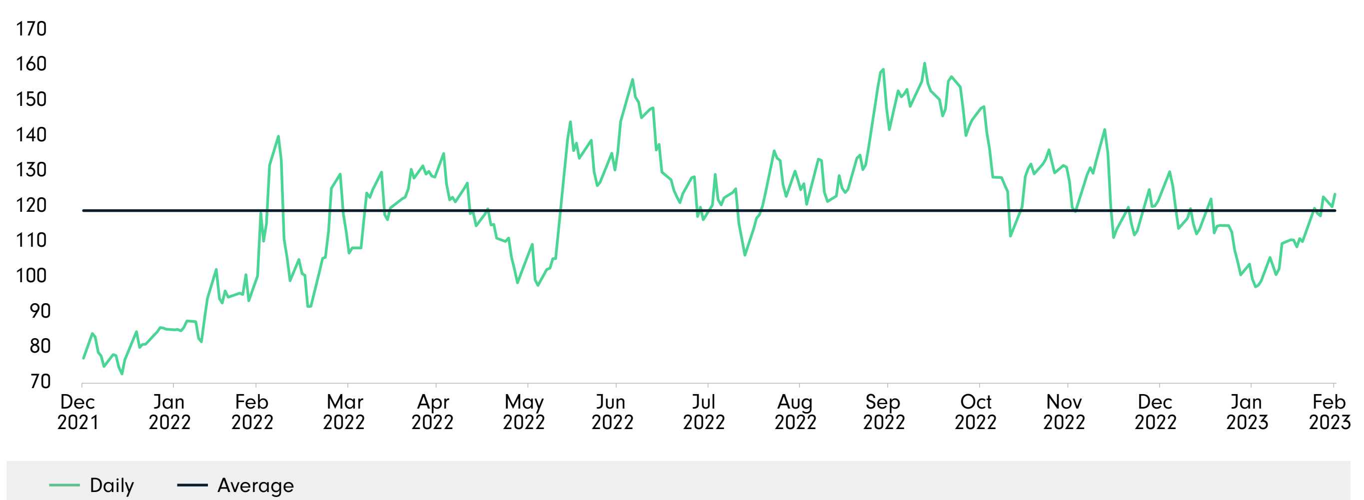
	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
Yld Chng	0.34	0.60	0.61	0.55	0.48	0.40	0.32	0.28

Source: FRED.

The market's mental shift regarding the future path of rates pushed yields higher (Exhibit 5) across the curve, bringing to mind some of the more difficult months of 2022. Overall, the Bloomberg US Aggregate Bond Index lost -2.59% in February, dropping the year-to-date performance for the index to +0.41%, which is a sobering reminder that while it feels as though fixed income markets have turned the corner, we still have a way to go to reach a certain level of stability.

The recent gyrations of the MOVE Index are a clear indicator as to how volatile the markets became in February (Exhibit 6) after the index dropped to its lowest level since May of last year. (The MOVE index measures Treasury rate volatility through options pricing and serves as a reflection of the level of volatility in the fixed income markets). While the final quarter of 2022 and January 2023 demonstrated that we may be nearing the final innings of the tightening game, February was a stark reminder of the prospect for extra innings until we reach the final out.

Exhibit 6 — ICE BAML MOVE Index



Source: Bloomberg.

S&P 500 Index measures the performance of 500 large companies in the US. **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). **ICE BAML MOVE Index** is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries. 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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