DIAMOND HILL

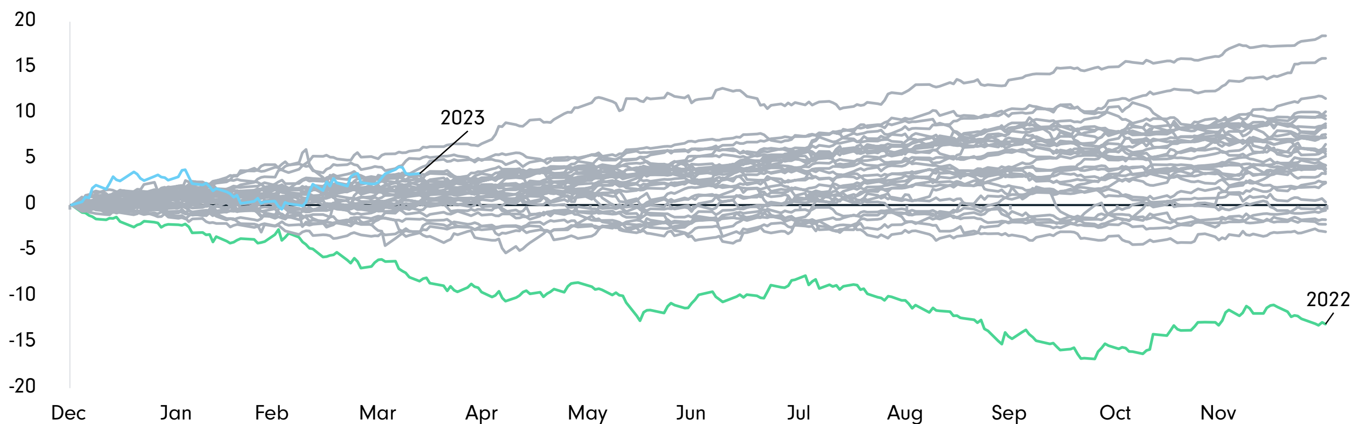
INVESTED IN THE LONG RUN

1Q23 Bond Market Insights

Apr 2023

Fixed income markets moved on from what was likely the most difficult year ever for the asset class by delivering an up and down quarter that, thankfully, was more up than down. The Bloomberg US Aggregate Bond Index was up +2.96% in Q1, which is the best quarterly performance since Q1 2020 (+3.15%). Exhibit 1 is an update to a chart we shared last quarter, illustrating the historic calendar year returns since the turn of the century as well as the first quarter progression for comparison purposes.

Exhibit 1 — Bloomberg Aggregate Total Return, Year to Date (%)

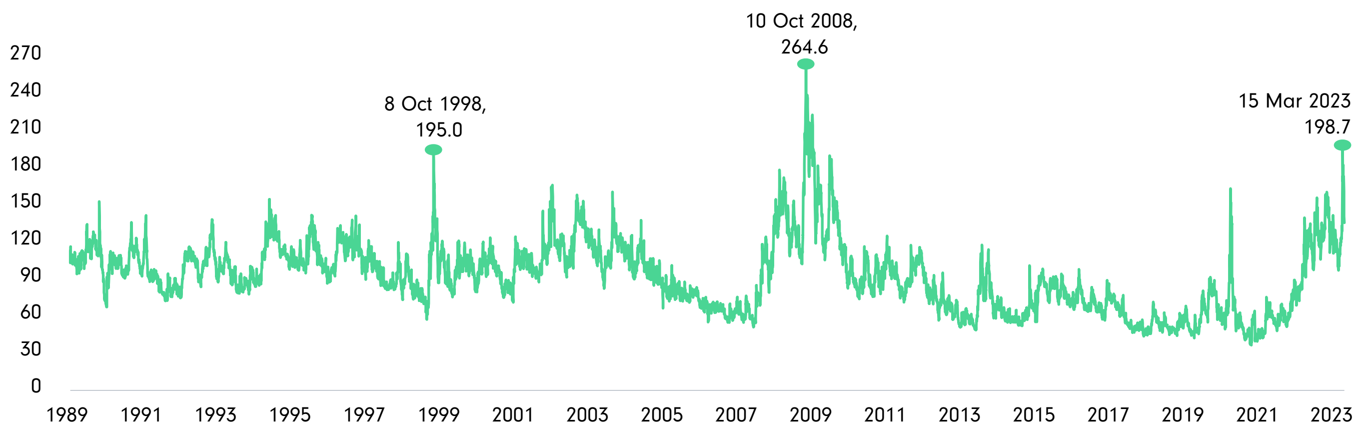


Source: Bloomberg.

The year started on a positive note with strong employment news (+517k jobs added), rising consumer confidence, China reopening and continued disinflation (decrease in the level of inflation). Despite the solid economic news, which would entail further Fed tightening, the markets continued to disagree with the Fed and projected a lower terminal rate and eventual cuts. This divergence between the Fed and markets slowly broke down as continued strong employment news in February (+311k jobs added) coupled with slower disinflation brought the markets nearly in line with the Federal Reserve's tightening schedule. And then we reached March 9, and the markets were upended as Signature Bank and Silicon Valley Bank failed, and Credit Suisse was rescued by the Swiss government and UBS. The subsequent dislocation in the market and upheaval abruptly shifted market expectations for Fed action.

How shaky did things get in the fixed income markets during the final month of the quarter? The MOVE Index, which measures Treasury rate volatility through options pricing, experienced its wildest daily shifts and highest level since the 2008 global financial crisis. As shown in Exhibit 2, the index peaked the Monday following the collapse of Signature Bank and Silicon Valley Bank, surpassing the level reached during the 1998 Long Term Capital Management crisis and ranks as the highest level reached second only to the levels seen during the 2008 crisis. As the market moved past the unrest associated with regional banks, and concerns ebbed on widespread contagion, the MOVE index settled back into familiar territory, ending the month at 135.93.

Exhibit 2 – MOVE Index (1989–2023)



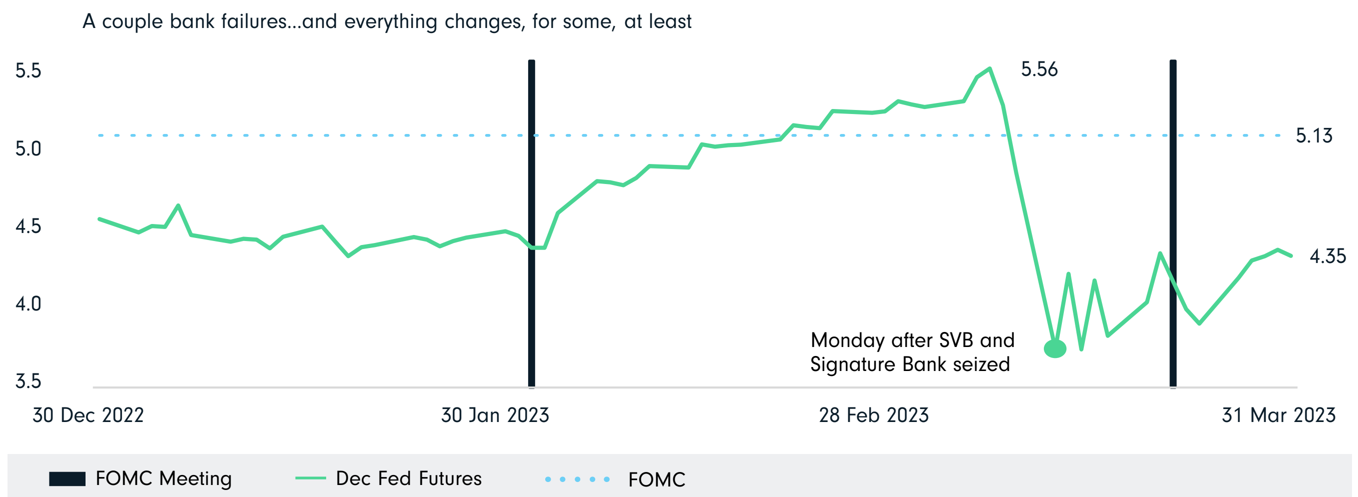
Source: Bloomberg.

Fed vs Market Expectations, Part Deux

It appeared as though the Fed's stalwart reinforcement of its much-publicized terminal rate (5.125% in both the December and March Statement of Economic Projections or SEP) had finally convinced the markets of its commitment to its tightening plan. The markets, as measured by fed funds futures, had stubbornly refused to accept both the aforementioned terminal rate and the well communicated pause through year-end 2023, instead pricing in a lower terminal rate and subsequent cuts by year end.

Stronger economic news and a slowdown in the pace of disinflation prompted the market to finally get on board with the Fed's plan of a terminal rate north of 5% and holding the line until at least the end of the year. Exhibit 3 illustrates market expectations for the fed funds rate in December 2023, which by mid-February had finally fallen in line with the Fed — even exceeding the FOMC estimate for the terminal rate (5.62% priced on March 7) though still projecting a potential cut by year end.

Exhibit 3 — Fed Funds Rate Futures (%)



Source: FRED.

All of that changed on the Monday following the Signature Bank and Silicon Valley Bank failures. Expectations for Fed action plunged on March 13 as concerns around potential contagion and a redux of the 2008 global financial crisis reverberated throughout the economy. The volatility that plagued the equity and fixed income markets came to a head with the most anticipated and uncertain FOMC meeting since the 2008 crisis.

Given the stronger economic data and stubbornly resilient labor market, pre-regional bank crisis expectations had been growing for a 50 basis-point (bps) hike at the March 22 meeting, but on the heels of the mid-March events, uncertainty loomed. Fed Chairman Jerome Powell announced the 25-bps hike and, despite the SEP showing a terminal rate for 2023 holding fast at 5.125%, the market continued to show a lower terminal rate as well as rate cuts before year end.

We've returned to a period similar to earlier this year, with the Fed holding the line and the markets expecting something different. Economic data is beginning to show the impact of the Fed's tightening cycle and the regional bank crisis has served to slow aspects of the economy, so we could be near the end of this tightening cycle. But if we've learned nothing else from Q1 of this year, it's that the best laid plans are also susceptible to the unknown.

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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