DIAMOND HILL

INVESTED IN THE LONG RUN

# Short Duration Investment Grade Strategy

As of 31 Mar 2024

## Resilient Labor Market, Stubborn Inflation Test Fed's Rate Cut Path

2023 finished on a powerful note, fueled by near-historic performance in November and December, pushing the Bloomberg US Aggregate Bond Index into positive territory and potentially setting the tone for an ongoing recovery from 2022's challenges. Alas, this was not to be the case.

## Team


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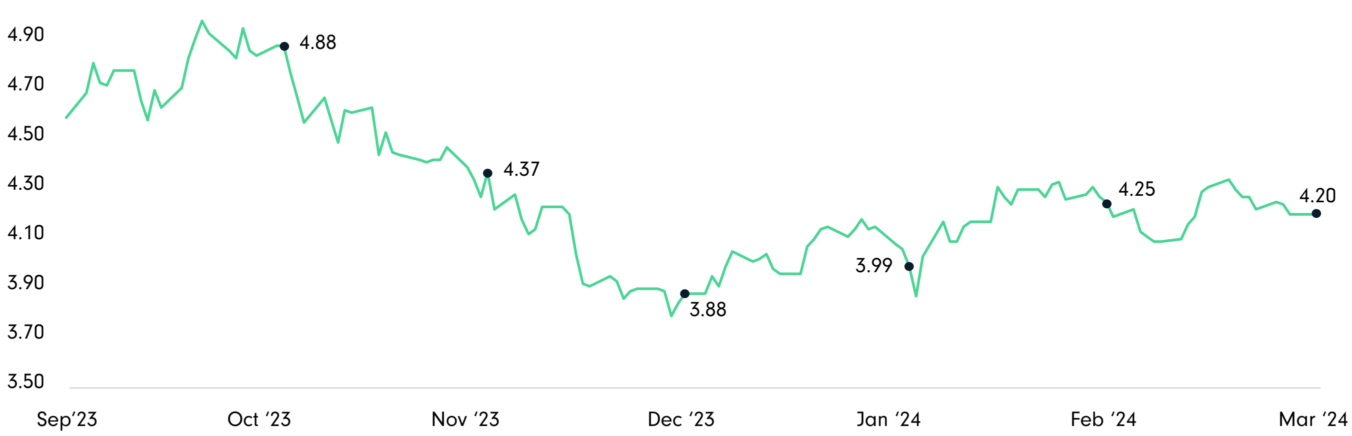
Stronger-than-expected economic reports about the labor market and inflation spurred interest rates higher, generating negative returns for the overall fixed income markets in Q1 2024. The first quarter was almost a replica of 2023 — starting slow with negative returns in January and February, with a strong recovery in March. But March's return of +0.92% was not enough to offset the loss of -1.68% in January and February.

The index's performance reflected interest rate movements as the 10-year Treasury climbed from 3.88% at the end of 2023 to finish February at 4.25% before maintaining some stability in March to finish the quarter at 4.20%. The shift higher in the curve reflected the market's expectations coming in line with the Federal Reserve's projected path of interest rates for 2024.

At the end of 2023, market expectations were still pricing more than six 25-basis point (bps) rate cuts by year-end 2024, despite the Fed repeatedly communicating plans for three 25-bps rate cuts. By the end of the quarter, market expectations had shifted to match the Fed's outlook, with roughly three 25-bps cuts priced into the futures market. Consistently better-than-expected labor market news and stubborn inflation numbers supported the Fed's agenda of "higher for longer."

**Exhibit 1 — 10-Year Treasury Yield (%)**



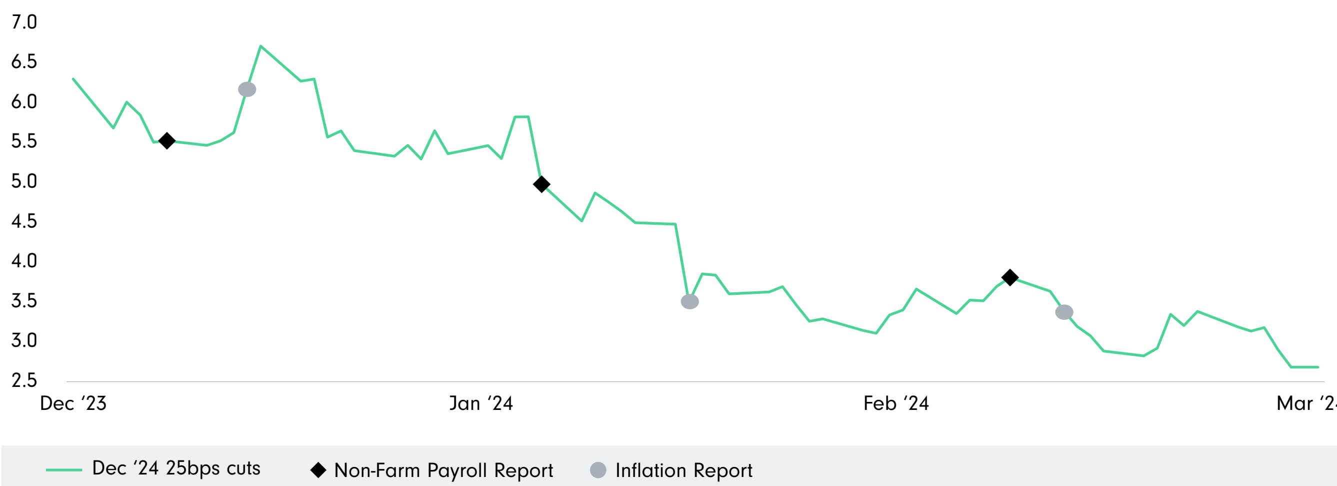

Source: Federal Reserve Economic Data (FRED).

The labor market continued to defy expectations, outpacing economists' estimates. January was the biggest outlier, as the economy reportedly added 256,000 jobs (revised) against expectations of 185,000. February saw 270,000 jobs (revised) created (expectations of 200,000), and March eclipsed the 300,000 level with 303,000 jobs added (expectations of 185,000). This labor market production resulted in a quarterly average of 276,000 jobs added monthly, the best three-month average since March 2023.

Inflation remained stubborn, dropping slightly from January's year-over-year number of 3.9% to 3.8% in February and March. The inflation data has remained stubborn in recent months. The core CPI increased at a 4.5% annualized rate in Q1, the fastest pace since May 2023. And Federal Reserve officials appear to be using public speeches and interviews to imply that "higher for longer" isn't going away anytime soon.

Governor Christopher Waller delivered his speech titled, "There's Still No Rush," on March 27 of this year, encapsulating the Fed's viewpoint that the future path of rates remains uncertain. In perhaps the strongest comment to date, Federal Reserve Governor Michelle Bowman said it's not time for the US central bank to consider cutting its interest rate target and noted that more hikes could be on the table if progress on lowering inflation stalls.

**Exhibit 2 — Rate Cut Expectations Fall with Economic News (%)**




Source: Bloomberg.

With the stronger economic news and expectations for a hold on rates for the foreseeable future, the Fed heads into dangerous territory. Suppose we assume the Fed is in a holding pattern until more economic data becomes available. In that case, we must consider the potential political implications of an initial rate cut occurring in September, seven weeks ahead of the 2024 Presidential election.

The Fed strives to avoid the perception that politics motivates actions. However, the stubbornness of first-quarter inflation indicates it would be challenging to make the first cut without additional information. Recent economic data appears to have removed May and June from the mix for a rate cut, and even July seems unlikely without a dramatic shift in the economic trajectory.

All things equal, a rate cut in September fueled by pertinent economic data might make the most sense but would face the scrutiny of attempting to influence the election despite the Fed's true intentions. The updated dot plot after the June meeting could provide a lifeline to the Fed, allowing it to communicate expectations for the remainder of the year well ahead of September.

## Portfolio Performance & Positioning

The surge in interest rates in Q1 was the main driver of performance for fixed income markets as yields climbed along the curve, reflecting the market's capitulation to the Fed's expected path of interest rates. Most of the damage occurred in January and February as the yield on the 10-year Treasury climbed from 3.88% to 4.20%, and the yield on the 2-year Treasury climbed from 4.25% to 4.62%.

The curve shift in March was much more subdued, with the 10-year and 2-year Treasury yields tightening roughly five basis points from the end of February to the end of the quarter. The move higher for yields in Q1 resulted in the Treasury market (as measured by the Bloomberg US Treasury Index) losing nearly -1%. The long-term impact of the move higher in yields is indicated in Exhibit 3, with the near doubling of the coupon return when compared to the same period in 2022.

**Exhibit 3 — Bloomberg US Treasury Index, Impact of Higher Yields**

| | Price Return | Coupon Return | Total Return |
|---|---|---|---|
| **January '22** | -2.02 | 0.13 | -1.89 |
| **February '22** | -0.78 | 0.12 | -0.66 |
| **March '22** | -3.25 | 0.14 | -3.11 |
| **January '24** | -0.51 | 0.23 | -0.28 |
| **February '24** | -1.54 | 0.22 | -1.31 |
| **March '24** | 0.40 | 0.25 | 0.64 |

Source: Bloomberg.

It is important to note our portfolio works to provide yield for investors while focusing on the shorter end of fixed income markets. We believe there are opportunities to add incremental yield over the benchmark by investing in structured products across the investment-grade quality spectrum.

As of March 31, the portfolio had a yield-to-worst (YTW) of 7.11% with an effective duration of 1.29 years, compared to a YTW of 7.23% and an effective duration of 1.26 years at the end of 2023. The decrease in yield is reflective of the rally that occurred in the securitized market, particularly among non-agency or private-label commercial mortgage-backed securities, combined with an increase in cash positioning.

Since the beginning of the year, the story in the securitized market has been the strength in the non-agency or private label commercial mortgage-backed securities market. This sector, which has received quite a bit of negative press, rebounded with a nearly +2% return in Q1 (as measured by the Bloomberg US Non-Agency CMBS Index) as investors migrated to this beaten-down sector due to attractive spread levels in anticipation of later-in-the-year rate cuts from the Federal Reserve.

Returns in the sector were differentiated by credit quality, with the A-rated portion of the index returning +7.3% during the quarter, followed closely by the BBB-rated segment (+6.7%). While positive, the higher quality segments of the index trailed the lower-rated segments, with AAA-rated returning +0.7% and AA-rated returning +0.6% during the quarter. Our underweights to corporate debt and Treasuries detracted from the portfolio's relative performance. However, the strong performance in the securitized sector was more than enough to compensate for the setback.

We continue to search for opportunities in the marketplace while maintaining an attractive yield relative to the benchmark.

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

## Period and Annualized Total Returns (%)

| | Since Inception (30 Nov 2021) | 1Y | YTD | 1Q24 |
|---|---|---|---|---|
| Gross of Fees | 2.45 | 7.64 | 1.89 | 1.89 |
| Net of Fees | 2.09 | 7.26 | 1.80 | 1.80 |
| Bloomberg US 1-3 Yr. Gov./Credit Index | 0.44 | 3.49 | 0.42 | 0.42 |

## Calendar Year Returns (%)

| | 30 Nov 2021 - 31 Dec 2021 | 2022 | 2023 |
|---|---|---|---|
| Gross of Fees | -0.09 | -3.64 | 7.86 |
| Net of Fees | -0.12 | -3.98 | 7.49 |
| Bloomberg US 1-3 Yr. Gov./Credit Index | -0.15 | -3.69 | 4.61 |