

# DIAMOND HILL

INVESTED IN THE LONG RUN

## Core Bond Strategy

As of 30 Jun 2024

### Team

After a rough start to the year, fixed income markets stabilized and returned to positive territory. The second quarter of 2024 began with some challenges, as the fixed income markets (as measured by the Bloomberg US Aggregate Bond Index) lost -2.53% during April, the biggest monthly drop since September 2023 (down -2.54%).

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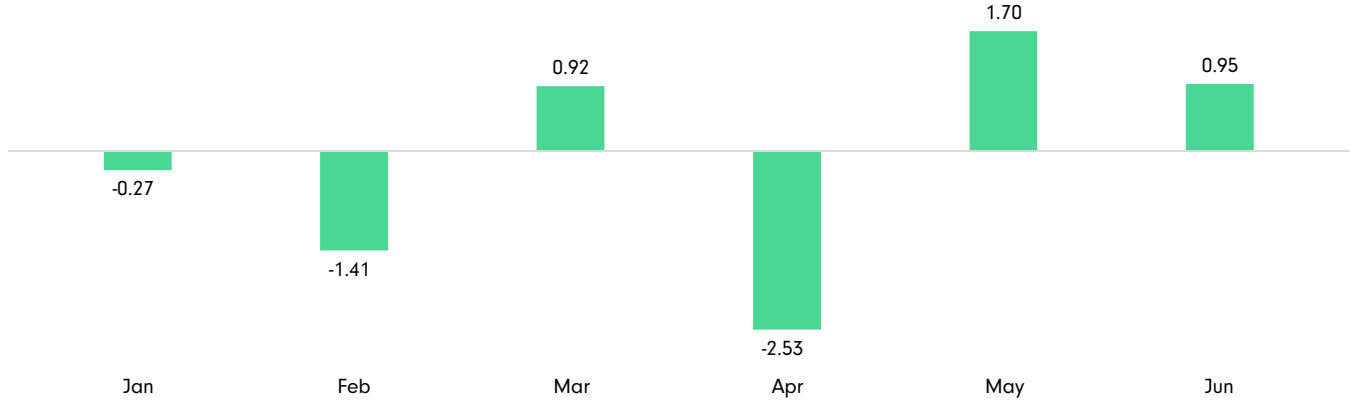
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Ongoing strength in the labor market and stubborn inflation pushed rate expectations further and further into the future and cemented the Fed mantra of “higher for longer.” Even as grumblings continued to grow for a possible rate hike before year-end, Jerome Powell used the FOMC meeting at the beginning of May to push back on the idea, assuring markets that the Fed’s next move was most likely lower, barring any significant shift in economic data.

The June meeting served as another opportunity for the Fed to reinforce the higher for longer approach to interest rates. It did so with the Statement of Economic Projections (which includes the dot plot) indicating a reduction of expected rate cuts – from three 25-basis point (bps) cuts to one 25-bps cuts by year-end 2024 and from five 25-bps cuts to four 25-bps cuts in 2025. The resulting rebound in the fixed income markets in May (+1.70%) and June (+0.95%) helped bring the quarterly return into positive territory for the quarter (+0.07%).

The only other significant development from the Federal Reserve during Q2 was the announcement that the Fed would slow the reduction of Treasury holdings, starting the process in June. The Fed set a monthly redemption cap of \$60 billion for Treasury securities, meaning that anything greater than \$60 billion in maturities would be reinvested into the Treasury market. That redemption cap has now been reduced to \$25 billion, meaning that only \$25 billion, at most, will roll off the Treasury balance sheet monthly starting in June. While the cap for Treasuries has been reduced, the cap for agency debt and agency mortgage-backed securities remains unchanged at \$35 billion. According to the New York Federal Reserve, the FOMC balance sheet has decreased from \$8.4 trillion in June 2022 to its current level of \$6.6 trillion at the end of the second quarter, with roughly 79% of the roll-off coming from Treasuries and the remainder from RMBS.

**Exhibit 1 – Bloomberg US Aggregate Bond Index Monthly Returns (%)**

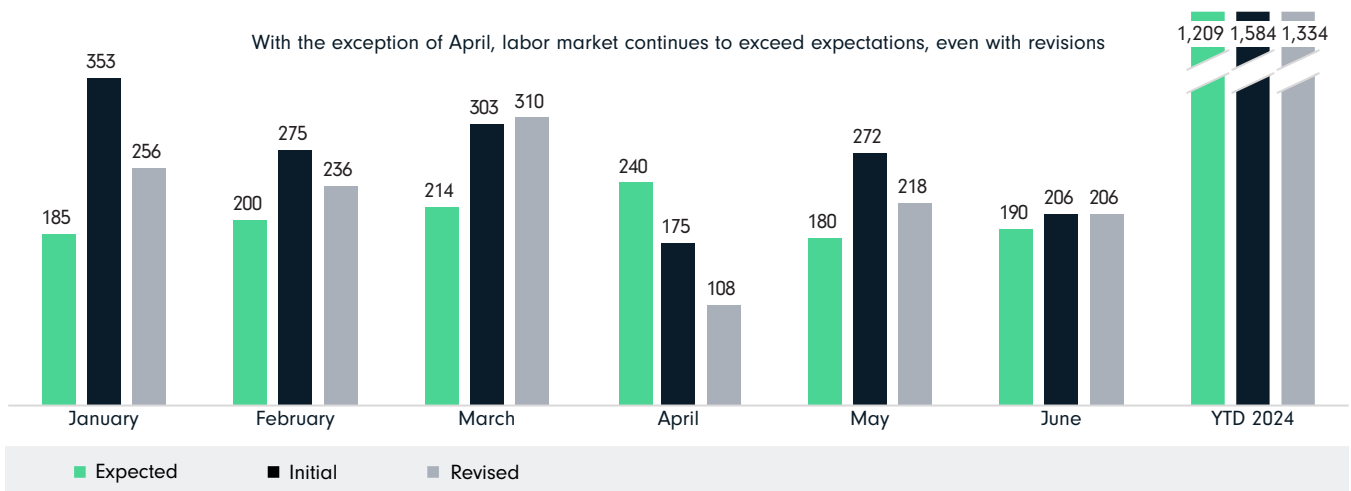


Source: Bloomberg.

The labor market continues to exceed expectations even as the narrative of a soft landing continues to dot the landscape. Even considering revisions made to initial readings that reduced the number of jobs added to the economy by 250,000, the addition of 1.3 million jobs (estimated 1.2 million) since the beginning of the year is welcome news. Over the past 20 years, the labor market has averaged roughly 112,000 jobs added monthly; before 2020, the average was 107,000.

The steady, if slow, reduction in inflation (Core CPI, which excludes volatile food and energy components) continues, with Q2 data coming in at 3.6%, 3.4% and 3.3% on a year-over-year basis from April through June, respectively. This is a welcome continuation of the gradual decrease since the beginning of the year when it stood at 3.9%. The inflation data continues to reinforce the dovish messaging from the FOMC and offers confirmation that the Fed’s tighter policy stance is weighing on consumer price inflation.

**Exhibit 2 – Nonfarm Payrolls (in thousands)**



Source: Bloomberg.

The most recent June data enforce the expectation of inflation continuing to come under control, pushing market expectations for the first rate cut from the end of the year to September. The FOMC meeting at the end of July appears to be a “hold the line” type of meeting, barring any significant geopolitical or economic shift, and there is no meeting in August.

In place of an August meeting, the Kansas City Fed hosts the Jackson Hole Economic Symposium in late August. This is traditionally viewed as an opportunity for the Fed to lay the groundwork for future action. This meeting comes into even greater focus as it will be the most opportune time for the Fed to communicate any potential shift in rate policy for the final four months of 2024.

The September timing presents an interesting dilemma as it is only 48 days ahead of the Presidential election. Still, historically, the Fed has shown a willingness to act in the months leading up to an election, having raised rates twice and lowered rates three times in the month immediately preceding an election year.

### Portfolio Performance & Positioning

Interest rates continued climbing higher in the first quarter, albeit at a more measured pace. The shift higher was front-end loaded, as rates surged in the first month of the quarter and spent the remainder of the quarter gradually contracting. So, while rates moved higher quarter over quarter, the trend has shifted towards lower rates, reflecting the growing momentum for a potential rate cut by the end of the year.

The damage wrought in April was enough to keep the longer end of the Treasury curve in negative territory for the quarter despite the positive efforts in May and June. Specifically, the 10-year Treasury lost -3.46% in April and gained +1.89% in May and +1.29% in June, bringing the second quarter performance to -0.36%, while the 30-year Treasury lost -6.68% in April, gained +2.81% and 1.91% in May and June, respectively, and printing a loss of -2.23% in the second quarter.

#### Exhibit 3 – Treasury Yields (%)

	March	April	May	June	Q/Q change
2Y	4.62	5.04	4.87	4.75	0.13
3Y	4.41	4.88	4.68	4.55	0.14
5Y	4.21	4.72	4.51	4.38	0.17
7Y	4.21	4.72	4.51	4.38	0.17
10Y	4.20	4.68	4.50	4.40	0.20
20Y	4.45	4.90	4.72	4.66	0.21
30Y	4.34	4.78	4.65	4.56	0.22

Source: Bloomberg.

The portfolio’s overall duration began the year at roughly 93% of the benchmark’s duration and has held steady for most of 2024, ending Q2 at 94% of the benchmark’s duration. The portfolio finished Q2 at a shorter duration posture than the Bloomberg US Aggregate Bond Index, 5.77 years compared to 6.13 years, respectively. The longer duration posture in the Treasury allocation relative to the benchmark detracted from performance, and our significant relative underweight in the sector mitigated that impact.

The Bloomberg US Corporate Bond Index followed a similar return pattern as the rest of the fixed income market with a challenging month of April (down -2.54%) and recovery in the subsequent months (May +1.87%, June +0.64%), resulting in a nearly flat Q2 (down -0.09%). As with the performance in Q1, duration played a key role in the breakdown by quality. Longer duration AAA-rated corporates felt the most pain during the quarter, losing -1.35%, followed by AA-rated down -0.64%, A-rated down -0.15%, and BBB-rated finishing the quarter in positive territory, gaining 0.08%. Similar to Q1, financials were the lone bright spot in the sector, delivering +0.49% in Q2, held back by industrials and utilities (down -0.34% and -0.60%, respectively).

Corporate issuance in the year's first half reached nearly \$875 billion, marking the second-highest total on record, trailing only the first half of 2020. Specific to Q2, investment grade corporate issuance increased by 13% relative to the prior 4-year average (ex-2020) with \$343 billion in new issuance, which follows the first quarter's massive \$531 billion in new issues (compared to \$401 billion prior 4-year average, ex-2020).

Corporate spreads widened slightly in Q2 (Bloomberg US Corporate Bond index), climbing from 90.0 bps to 93.9 bps, but they remain at historically tight levels and lower than the start of the year (98.7 basis points). The portfolio's underweight to the corporate sector and strong security selection contributed to performance relative to the benchmark during the second quarter.

The securitized market (as measured by the Bloomberg US Securitized Index) was the lone bright spot during Q2 2024, delivering +0.12%, making it the only major sector to generate positive returns over that period. While non-agency or private label commercial mortgages (as measured by the Bloomberg US Non-Agency CMBS Index) continued a strong run that began in Q1 of this year (+1.97%), the Bloomberg US ABS Index delivered a +0.98% return on the strength of autos (+1.14%) and credit cards (+1.09%).

Within the non-agency CMBS market, lower-rated segments continued to drive overall performance for the sector, with the BBB (+3.43%) and single-A (+2.61%) components benefitting from the continued interest of investors looking to take advantage of a sector in the process of stabilizing.

The residential mortgage component of the benchmark benefitted from the gradual reduction in rates after the move higher at the beginning of the quarter, generating +0.07% in return in Q2 but trailing CMOs (as measured by the ICE BofA US Agency CMO Index), which returned +0.74% over the same period.

Strength in security selection and our allocation to non-benchmark securities benefited the portfolio. Specific to CMBS, only conduit CMBS are included in the benchmark, and the portfolio's allocation to Single-Asset Single Borrower and Commercial Real Estate Collateralized Loan Obligations (CRE CLO) instead of conduit deals was a significant benefit to performance with those sectors combining to return more than 2.3% during the quarter. The portfolio's allocation to and diversification within the ABS sector was also a positive contributor to relative performance as non-benchmark segments of this market far outpaced the index-eligible segments of the market.

The portfolio continues to search for opportunities in the marketplace while maintaining a conservative risk profile relative to the index.

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

<b>Period and Annualized Total Returns (%)</b>	Since Inception (31 Jul 2016)	5Y	3Y	1Y	YTD	2Q24
Gross of Fees	1.97	1.08	-1.36	5.05	1.04	0.88
Net of Fees	1.67	0.78	-1.64	4.74	0.89	0.80
Bloomberg US Aggregate Bond Index	0.64	-0.23	-3.02	2.63	-0.71	0.07

<b>Calendar Year Returns (%)</b>	31 Jul 2016 - 31 Dec 2016	2017	2018	2019	2020	2021	2022	2023
Gross of Fees	-2.44	4.64	2.06	8.56	8.34	-0.55	-11.47	7.06
Net of Fees	-2.56	4.33	1.77	8.24	8.03	-0.84	-11.73	6.75
Bloomberg US Aggregate Bond Index	-3.14	3.54	0.01	8.72	7.51	-1.54	-13.01	5.53

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