DIAMOND HILL

INVESTED IN THE LONG RUN

Intermediate Bond Strategy

As of 30 Jun 2024

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%).

Team

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

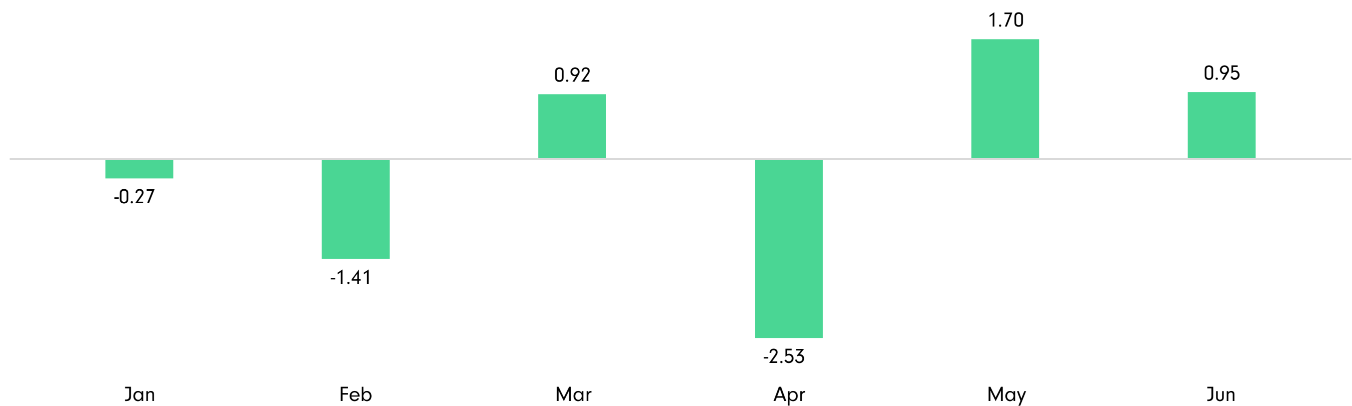
Douglas Gimple
Senior Portfolio Specialist

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 (%)

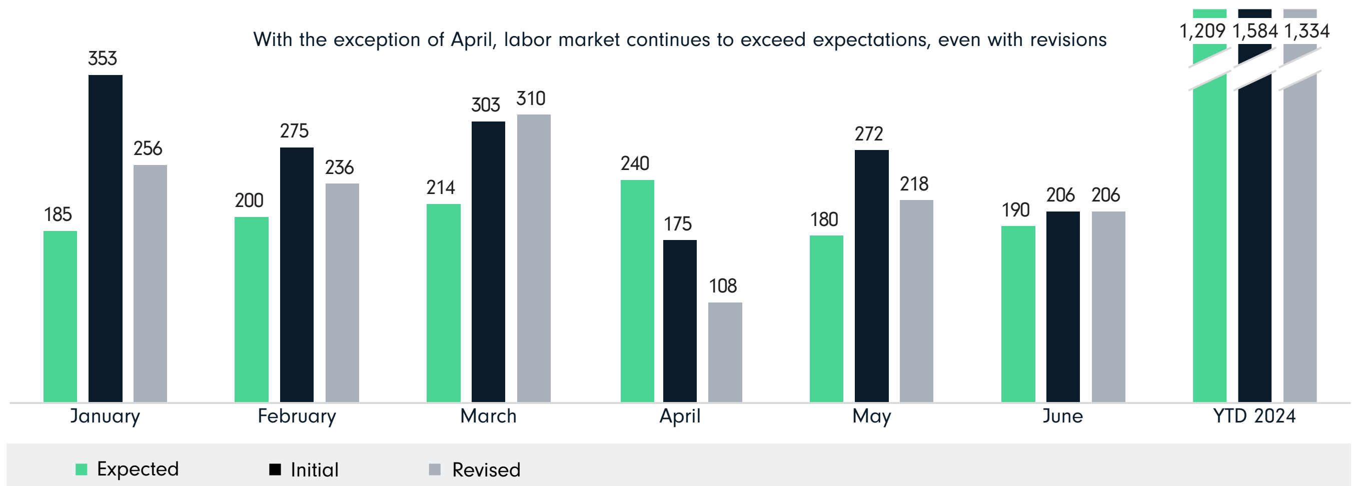


Source: Bloomberg.

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 finished Q2 at a shorter duration posture than the Bloomberg US Intermediate Aggregate Bond Index at 4.09 years compared to 4.23 years, respectively. While closer to the benchmark's duration than in recent times, the portfolio remains shorter relative to the benchmark at roughly 97% of the benchmark's duration. This position reflects the likely end of the Fed's rate hiking cycle and higher for longer stance, which has been reinforced by recent economic news and Federal Reserve talking points. The shorter positioning relative to the benchmark was a slight negative to overall performance in Q2 with rates moving higher.

The Bloomberg US Intermediate Corporate Index delivered a positive return (+0.74%) during Q2, benefitting from its shorter duration posture relative to the overall Bloomberg US Corporate Bond Index (down -0.09%). The Intermediate Corporate Bond Index lost ground in April (down -1.35%) but rallied in May and June (+1.41% and +0.69%), respectively. As a way of comparison, the Bloomberg Long US Corporate Index lost -1.74% during the quarter, reflecting the impact of longer duration and the shift higher in rates.

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 but remain at historically tight levels and tighter than at the start of the year. Security selection within the corporate sector was in line with the benchmark, and the overall impact on the portfolio during the quarter was de minimis.

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 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.

Period and Annualized Total Returns (%)

	Since Inception (31 Jul 2021)	1Y	YTD	2Q24
Gross of Fees	-0.40	6.14	1.61	1.04
Net of Fees	-0.69	5.83	1.47	0.97
Bloomberg US Intermediate Aggregate Bond Index	-2.06	3.55	0.04	0.46

Calendar Year Returns (%)

	31 Jul 2021 - 31 Dec 2021	2022	2023
Gross of Fees	-1.02	-7.83	6.60
Net of Fees	-1.14	-8.09	6.29
Bloomberg US Intermediate Aggregate Bond Index	-1.17	-9.51	5.18

Diamond Hill Capital Management Inc. (DHCM) is a registered investment adviser and wholly owned subsidiary of Diamond Hill Investment Group, Inc.; registration does not imply a certain level of skill or training. Diamond Hill provides investment management services to individuals and institutions through mutual funds and separate accounts. DHCM claims compliance with the Global Investment Performance Standards (GIPS®). The Intermediate Bond Composite is comprised of discretionary, non-fee and fee-paying non-wrap accounts managed according to the firm's Intermediate Bond strategy, including those clients no longer with the firm. The strategy's investment objective is to maximize total return consistent with the preservation of capital. The Intermediate Bond strategy generally invests in a diversified mix of investment grade, fixed income securities and may invest a significant portion or all of its assets in mortgage-related and mortgage-backed securities. The portfolio will typically maintain an average portfolio duration within 20% of the Bloomberg US Intermediate Aggregate Bond Index duration. The Bloomberg US Intermediate 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) with a maturity greater than 1 year and less than 10 years. 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. To receive a complete list and description of all Diamond Hill composites and/or a GIPS® report, contact Scott Stapleton at 614.255.3329, sstapleton@diamond-hill.com or 325 John H. McConnell Blvd., Suite 200, Columbus, OH 43215. The performance data quoted represents past performance; past performance does not guarantee future results. Composite results reflect the reinvestment of dividends, capital gains and other earnings when appropriate. Net returns are calculated by reducing the gross returns by the highest stated fee in the composite fee schedule. Only transaction costs are deducted from gross of fees returns. Prior to 30 September 2022, actual fees were used in calculating net returns. All net returns were changed retroactively to reflect the highest fee in the composite fee schedule. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. The US Dollar is the currency used to express performance.

The views expressed are those of Diamond Hill as of 30 June 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal.