

DIAMOND HILL

INVESTED IN THE LONG RUN

Short Duration Investment Grade 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%).

Mark Jackson, CFA
Portfolio Manager

Henry Song, CFA
Portfolio Manager

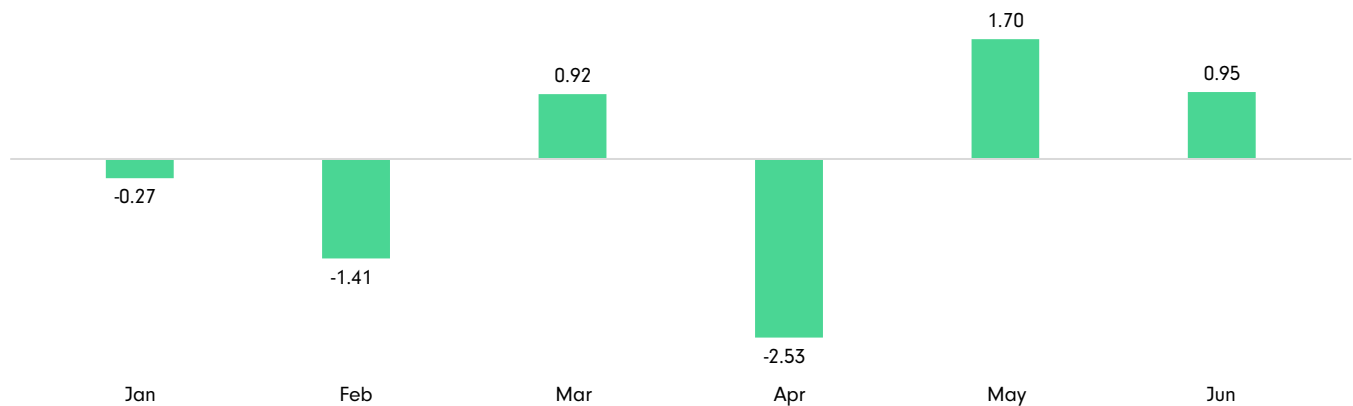
Douglas Gimple
Senior Portfolio Specialist

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 (%)

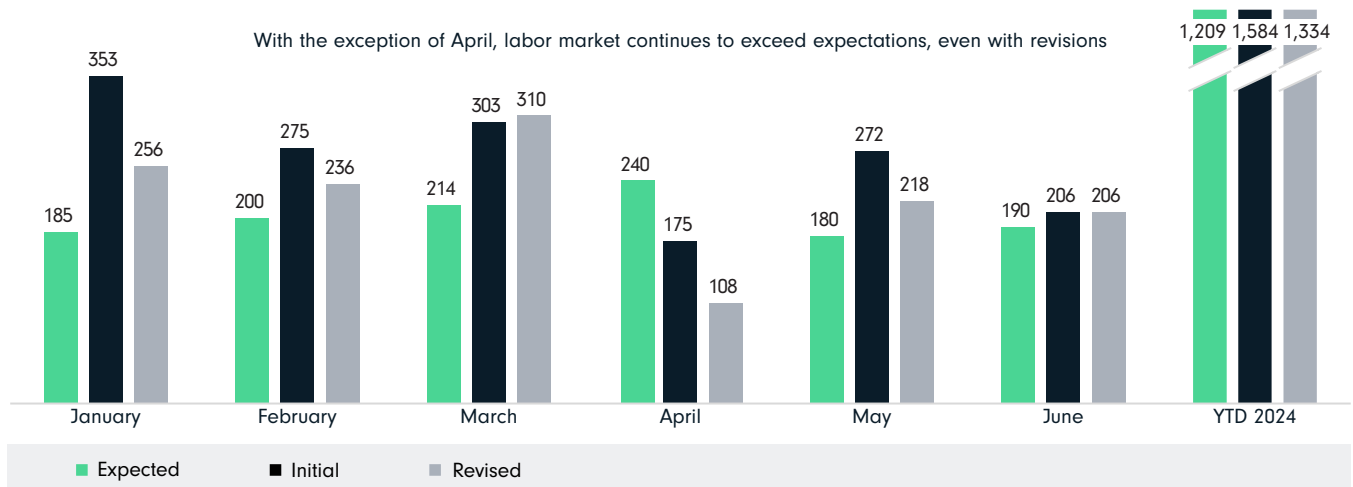


Source: Bloomberg.

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.

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 June 30, the portfolio had a yield-to-worst (YTW) of 7.03% with an effective duration of 1.31 years, compared to a YTW of 7.11% and an effective duration of 1.29 years at the end of Q1. The decrease in yield is reflective of the rally in the securitized market, particularly non-agency or private-label commercial mortgage-backed securities, combined with an increase in cash positioning.

The story in the securitized market since the beginning of the year has been the strength in the non-agency or private label commercial mortgage-backed securities market, which continued into Q2. The sector delivered a return of +0.75% (as measured by the Bloomberg US Non-Agency CMBS Index) as investors continue to delve into this beaten-down sector due to attractive spread levels in anticipation of a second half-of-the-year rate cut from the Federal Reserve. Strength in security selection and our allocation to non-benchmark securities benefited the portfolio. Specific to CMBS, Single-Asset Single Borrower and Commercial Real Estate Collateralized Loan Obligations (CRE CLO) were a major benefit to performance with those sectors combining to return nearly 2% during the quarter.

The portfolio's allocation to and diversification within the ABS sector was also a positive contributor to relative performance as the sector significantly outpaced the Treasury and corporate sectors. Our underweight to corporate debt and Treasuries slightly detracted from 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	2Q24
Gross of Fees	2.92	8.75	3.73	1.81
Net of Fees	2.56	8.37	3.55	1.72
Bloomberg US 1-3 Yr. Gov./Credit Index	0.76	4.87	1.38	0.95

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

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 institutional investors through mutual funds and separate accounts. DHCM claims compliance with the Global Investment Performance Standards (GIPS®). The Short Duration Investment Grade Composite is comprised of all discretionary, non-fee and fee-paying, non-wrap accounts managed according to the firm's Short Duration Investment Grade 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 by investing in investment grade fixed income securities. The Short Duration Investment Grade strategy generally invests in a diversified portfolio of investment grade, fixed income securities and may invest a significant portion or all of its assets in asset-backed, mortgage-related and mortgage-backed securities. The portfolio will typically maintain an average portfolio duration of less than three. 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, ssapleton@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.