DIAMOND HILL

INVESTED IN THE LONG RUN

# Core Bond Strategy

As of 30 Sep 2024

### Team


**Mark Jackson, CFA**
Portfolio Manager

**Henry Song, CFA**
Portfolio Manager

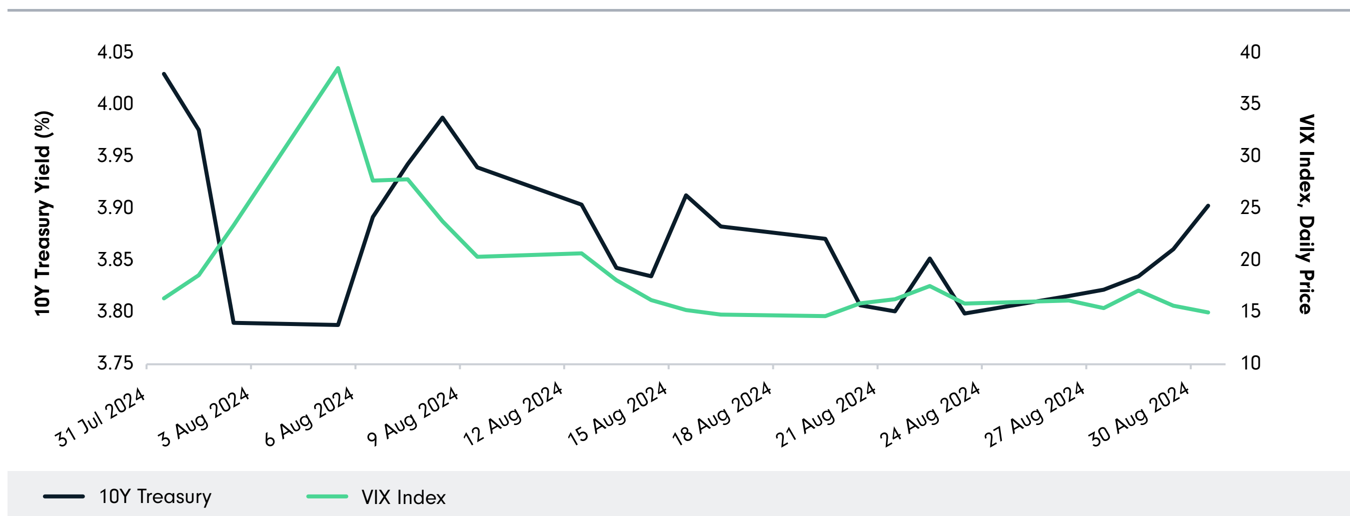
**Douglas Gimple**
Senior Portfolio Specialist


In Q3, investors experienced a little bit of everything. It started with some relatively dovish comments following August's FOMC meeting, with Jerome Powell laying the groundwork for future rate cuts. Unlike anything we've seen since the early days of COVID (March 2020), early August saw volatility, with the CBOE Volatility Index (VIX) spiking due to a culmination of events. The Bank of Japan raised rates on July 31, a hawkish move that contributed to a strengthening yen. A lower-than-expected non-farm payroll report for July (+114,000 vs expectations of +175,000) and expectations for a more dovish move from the Federal Reserve fueled the unwind of the yen carry trade, wreaking havoc on the equity markets.

However, the volatility was short-lived. Stronger-than-expected US economic data (robust retail sales, falling CPI) and a relatively dovish Jerome Powell speech at Jackson Hole helped stabilize markets. Daily volatility for the VIX peaked at 38.57 on August 5 (Exhibit 1), the highest end-of-day level since late October 2020. Exhibit 2 illustrates intraday volatility during August, illustrating that the VIX reached nearly 70 in the early morning of August 5 before settling at 38.57 at the end of the day. The index had not reached levels of this magnitude since 16 March 2020, when it finished the day at 82.69.

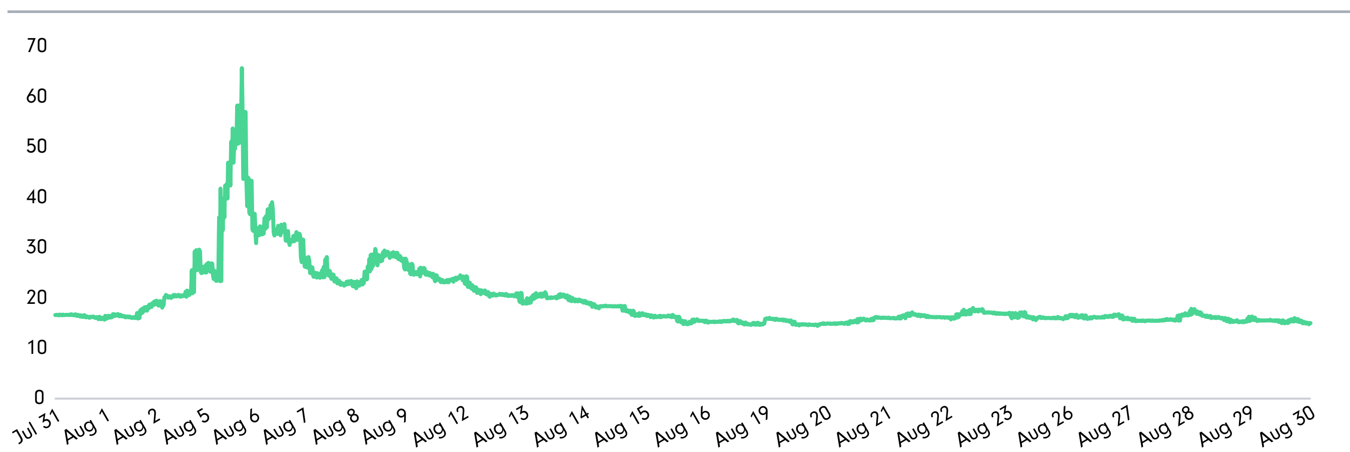
Even the annual Bureau of Labor Statistics revision on August 21 of the prior year's (April '23 – March '24) nonfarm payroll numbers was not enough to upend the market after the early volatility in August. The preliminary estimate of the benchmark revision indicated an adjustment to the April 2023 to March 2024 total nonfarm employment of -818,000 (-0.5%), an eye-watering and potential market-shaking event, but not so much. For the National Current Employment Statistics employment series, the annual benchmark revisions over the last 10 years have averaged plus or minus one-tenth of one percent of total nonfarm employment. For context, an adjustment of 818,000 lower translates into roughly +174,000 jobs added per month from April 2023 to March 2024, compared to the pre-adjustment figure of +242,000 per month. Last year, the August 2023 release (covering April 2022 – March 2023) first showed revisions of -306,000 but was revised a final time to -187,000.

**Exhibit 1 — Volatility Ramped Up in August Then Settled Down (%)**




Source: Bloomberg.

**Exhibit 2 — VIX Index, August's Intraday Volatility**




Source: Bloomberg.

After August's uncertainty and market fluctuations, the calendar turning over to September was a welcome sign. For the first time in a long time, markets were uncertain as to what actions the Federal Reserve would take at its upcoming meeting. A survey of various talking heads would most likely have resulted in a wide variety of potential action: 25 basis point (bps) cut with dovish tilt, 25 bps cut with hawkish tilt, 50 bps cut with dovish tilt, etc. Some were even calling for 75 bps in cuts. On September 18, the FOMC lowered the fed funds rate by 50 basis points, the largest initial cut for an easing cycle not tied directly to some extraneous event (March 2020 COVID, January 2001 surprise cut, September 2007 Housing Crisis).

September performance in fixed income markets (Bloomberg US Aggregate Bond Index, +1.34%) put the finishing touches on one of the best quarters of performance for the overall fixed income market since the turn of the century, second only to Q4 2023, when the index advanced +6.82%.

The FOMC also released the most recent iteration of the dot plot, a chart that illustrates Fed expectations for future rate cuts. Expectations for the remainder of 2024 include an additional 50 bps in cuts, split between the November 7 and December 18 meetings, bringing the year-end fed funds rate to 4.375% (4.25 – 4.50% range). This contrasted with market expectations, as measured by fed fund futures, which indicated a year-end level of 4.125% (4.00 – 4.25% range). At that time, the 25 bps difference between the Fed and the markets reflected the market's less than enthusiastic opinion of economic activity and the Fed's data-dependent viewpoint.

Moving into the year's final quarter, economic data points will carry more weight as the market works to interpret their impact on the Fed outlook and the global geopolitical implications (US election, Ukraine-Russia conflict, Middle East conflict).

## Portfolio Performance & Positioning

With the Federal Reserve embarking on what could be a prolonged easing cycle, Treasury spreads rallied across the curve in Q3, with the biggest shift coming on the shorter end of the curve. Though the longer end of the curve didn't move as much as the shorter end (Exhibit 3), the longer end significantly outperformed the shorter end thanks to the impact of duration. As rates decrease, bond prices increase, and the longer the duration, the more impactful the move in interest rates. Even with the strong performance in Q3, the longer end of the Treasury curve still trails the shorter end on a year-to-date basis due to the longer end's negative performance during the first two quarters and the steady returns for the shorter end since the beginning of the year.

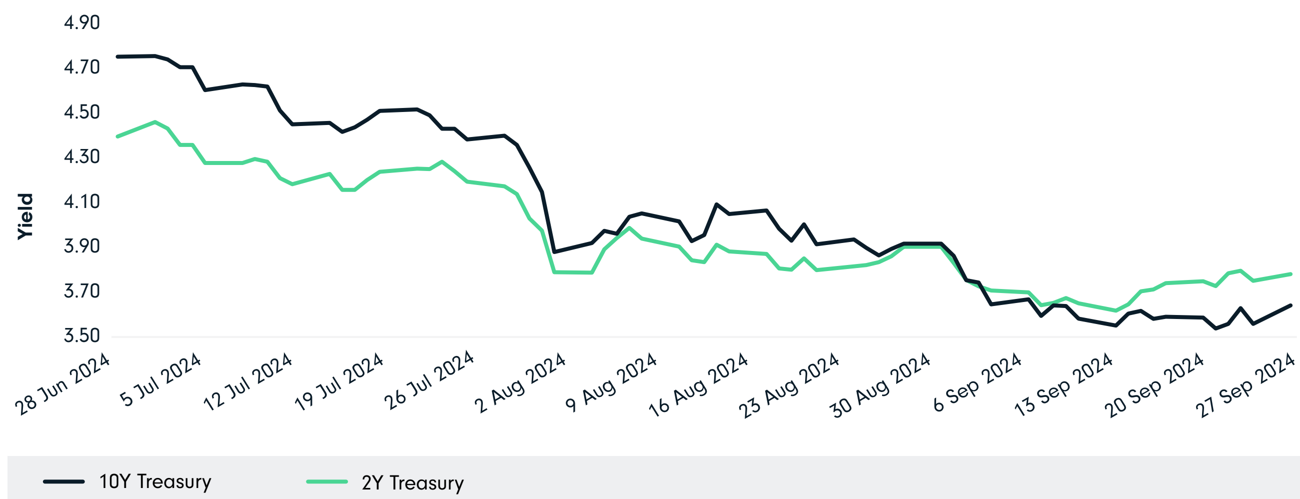
**Exhibit 3 — Yield Curve Shift in Q3 (%)**

| | 30 Jun 2024 | 30 Sep 2024 | Change |
|---|---|---|---|
| **3M** | 5.36 | 4.62 | (0.74) |
| **6M** | 5.32 | 4.40 | (0.92) |
| **1Y** | 5.11 | 4.00 | (1.11) |
| **2Y** | 4.75 | 3.64 | (1.11) |
| **5Y** | 4.38 | 3.56 | (0.82) |
| **10Y** | 4.40 | 3.78 | (0.62) |
| **30Y** | 4.56 | 4.12 | (0.44) |

Source: Bloomberg.

With the shift in the curve, the inversion between the 2-year and 10-year Treasury that has been in place since July 2022 has finally reverted to the more natural relationship between the tenors as the 10-year ended the quarter 14 basis points (bps) higher than the 2-year.

**Exhibit 4 — Benchmark Rates Reflect Easing Cycle Has Begun (%)**




Source: Bloomberg.

The portfolio's duration began the year at roughly 93% of the Bloomberg US Aggregate Bond Index's duration and has held that posture for most of 2024. While the portfolio's overall duration is shorter than the benchmark's, the duration of its Treasury allocation is nearly twice the benchmark duration, a positioning to mitigate the significant underweight from a percentage standpoint. Overall portfolio duration relative to the benchmark detracted from relative performance, but this was partially offset by the longer duration posture in the Treasury market.

The Bloomberg US Corporate Bond Index gained 5.84% in Q3 2024, despite some short-term spread widening in early August due to the market volatility surrounding the unwinding of the yen carry trade and subsequent equity market dislocation. Q3's performance marks the best return for the sector since Q4 2023 and helped offset the struggles earlier in the year, bringing the year-to-date performance to 5.32%.

Performance by credit quality led from the top down. Longer-duration AAA-rated bonds advanced +6.93%, AA-rated were up +6.06%, single-A rated gained +5.86% and BBB-rated advanced +5.76%. However, it should be noted that the index is dominated by single-A (roughly 44% weight) and BBB (approximately 51%). Issuance in the investment-grade corporate space continues to exceed expectations; July and September set new monthly records ($125 billion and $171 billion, respectively) for issuance. All three months in Q3 exceeded their 4-year averages (excluding 2020). Eight of the nine months of 2024 have surpassed their respective four-year averages, and year-to-date issuance has surpassed $1.2 trillion.

The corporate bond market was the best-performing sector in the broader fixed income universe, and the portfolio's underweight detracted from relative performance. However, the portfolio's corporate allocation was its best-performing sector in Q3.

The securitized sector (as measured by the Bloomberg US Securitized Index) delivered the sector's second-best quarterly performance since its inception, trailing only Q4 2023. Spreads across all risk assets tightened quarter-over-quarter despite some mid-quarter volatility. The securitized sector was no different, except for the asset-backed securities (ABS) market, which did experience a bit of spread widening during the quarter.

There was a definite bifurcation in performance by subsector within the securitized market. Agency residential mortgage-backed securities and agency collateralized mortgage obligations (CMOs) (as measured by the ICE BofA CMO Index) led the sector, followed closely by non-agency commercial mortgage-backed securities (CMBS), which benefited from its longer-duration posture than asset-backed securities. ABS delivered positive returns but was the lowest returning sector in the Bloomberg US Aggregate Bond Index, mainly due to not benefitting as much as longer duration securities from the move in rates. Credit card ABS led the overall ABS market but still trailed both Treasury and corporate returns.

Security selection across nearly all subsectors in the securitized market contributed positively to performance. The portfolio's allocation to ABS and agency residential mortgage-backed securities outpaced the benchmark eligible portions of these sectors. The only area that trailed the benchmark was in non-agency or private label CMBS, where conduit deals, which are the only type of deals the benchmark holds, outperformed commercial real estate collateralized loan obligations (CRE CLO) and single asset single borrower (SASB) deals. On a relative basis, the securitized sector overall trailed the benchmark allocation, which was detrimental to performance during the quarter.

We continue searching for opportunities in the market 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 2016) | 5Y | 3Y | 1Y | YTD | 3Q24 |
|---|---|---|---|---|---|---|
| Gross of Fees | 2.54 | 1.62 | 0.27 | 13.25 | 6.29 | 5.20 |
| Net of Fees | 2.25 | 1.32 | -0.02 | 12.92 | 6.06 | 5.12 |
| Bloomberg US Aggregate Bond Index | 1.25 | 0.33 | -1.39 | 11.57 | 4.45 | 5.20 |

## Calendar Year Returns (%)

| | 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 |

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 Core Bond Composite is comprised of all discretionary, non-fee and fee-paying, non-wrap accounts managed according to the firm's Core 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 by investing in a diversified portfolio of intermediate and long-term fixed income securities. The Core Bond strategy generally invests at least 80% of its assets in a diversified portfolio 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 duration of the Bloomberg US Aggregate Bond Index. 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 September 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.**