

DIAMOND HILL

INVESTED IN THE LONG RUN

Short Duration Investment Grade Strategy

As of 30 Sep 2024

Team

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 v. 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. Strong-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.

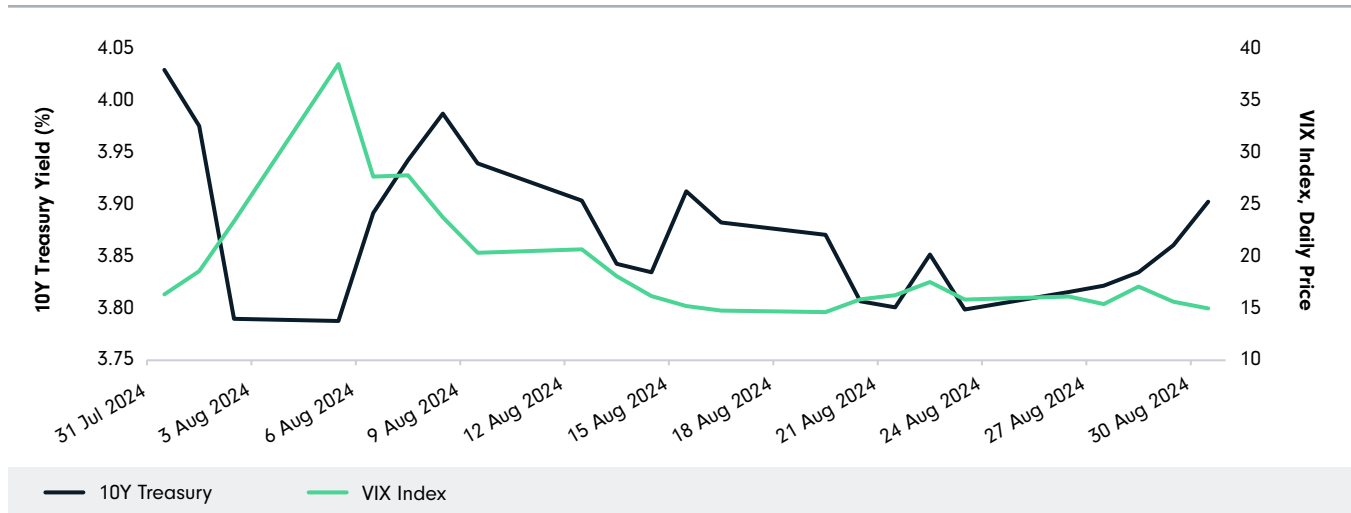
Even the annual Bureau of Labor Statistics revision on August 21 of the prior year's (April '23 - March '24) nonfarm payroll numbers was not enough to upend the market after the early volatility in August. The preliminary estimate of the benchmark revision indicated an adjustment to the April 2023 to 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.

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Portfolio Manager

Henry Song, CFA
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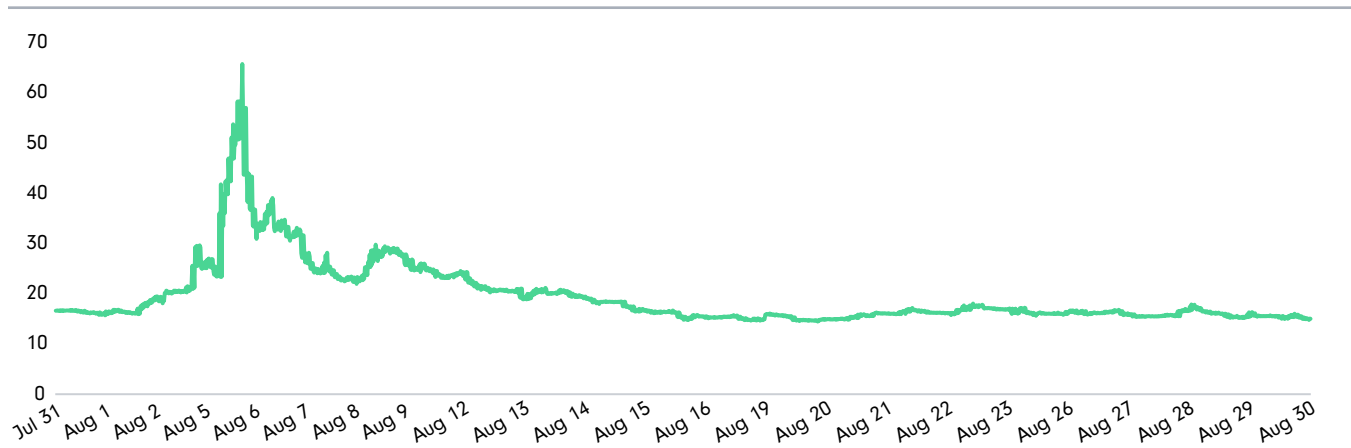
Douglas Gimple
Senior Portfolio Specialist

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

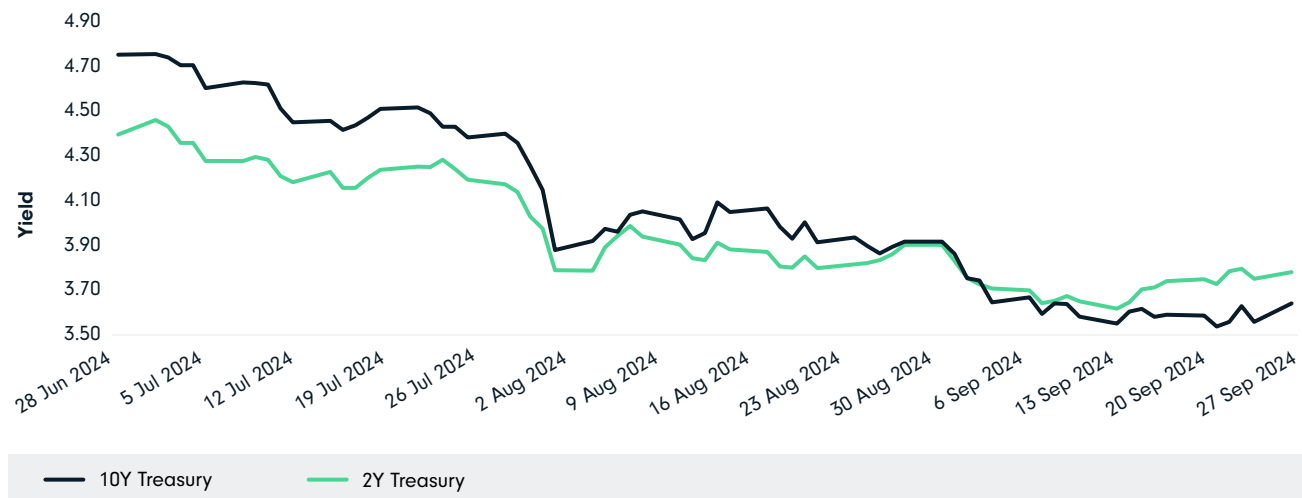
With the Federal Reserve embarking on what could be a prolonged easing cycle, Treasury spreads rallied across the curve in Q3, with the biggest shift coming on the shorter end of the curve. Though the longer end of the curve didn’t move as much as the shorter end (Exhibit 3), the longer end significantly 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.

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 September 30, the portfolio had a yield-to-worst (YTW) of 6.16% with an effective duration of 1.21 years, compared to a YTW of 7.03% and an effective duration of 1.31 years at the end of the second quarter. The decrease in yield is reflective of the move lower in rates as well as the spread tightening that has occurred in various segments of the securitized market, though the portfolio maintains a healthy level of option-adjusted spread over comparable duration Treasuries.

The corporate allocation within the portfolio trailed the benchmark's allocation during the quarter, which slightly detracted from relative performance. It was a similar story in the Treasury allocation, which dominates the benchmark weighting (69% at quarter end) and therefore exacerbated the impact on relative performance.

Our securitized allocation marginally outpaced corporates and Treasuries, fueled by the performance in the non-agency and agency residential mortgage-backed securities (RMBS). Within the securitized sector, non-agency RMBS such as Home Equity Conversion Mortgages (more commonly known as reverse mortgages) and Residential Transition Loans (fix and flip loans) led the way while the asset-backed securities (ABS) allocation was fueled by strong performance in the auto sector.

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	3Q24
Gross of Fees	3.68	9.84	6.69	2.85
Net of Fees	3.32	9.46	6.41	2.76
Bloomberg US 1-3 Yr. Gov./Credit Index	1.74	7.19	4.38	2.96

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

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