DIAMOND HILL

INVESTED IN THE LONG RUN

Q3: Bond Market Turmoil Hurts, Creates Opportunity

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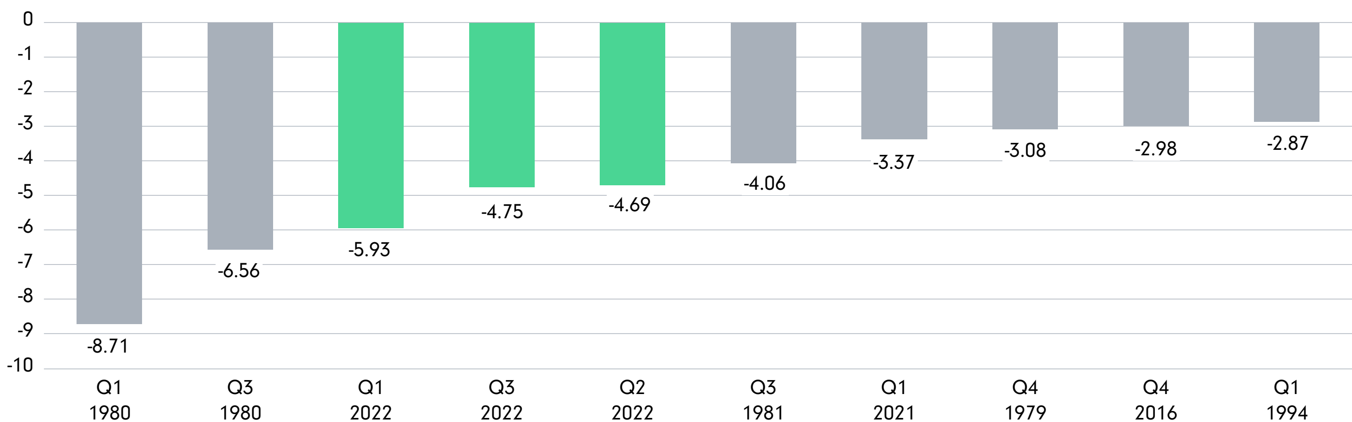
A challenging year for fixed income continued in Q3 as the Bloomberg US Aggregate Bond Index delivered its third consecutive quarter of negative returns, a feat not seen since the nine-month stretch between July 1979 and March 1980. The loss of -4.75% over the past three months ranks as the fourth worst quarter since the index's inception and fits squarely between Q1 2022 (down -5.93%) and Q2 2022 (down -4.69%) in the all-time rankings of worst quarters. Only Q1 1980 (down -8.71%) and Q3 1980 (down -6.56%) are worse than what we've seen so far this year. Considering that Q2 1980 saw a rebound of 18.78% and a calendar year return of 2.71%, markets might be looking back at that volatile period with fondness as 2022 has delivered the worst performance in the history of fixed income markets.

Exhibit 1 — Bloomberg US Aggregate Bond Index, 10 Worst Quarterly Returns (%)



Source: Bloomberg.

Q3 2022 was a mixed bag of monthly performance, with the index up in July as markets took a step back from the carnage of the first six months of the year before plunging further in August (down -2.83%) and September (-4.32%). The silver lining in these apocalyptic clouds? The steady climb higher in interest rates and spread widening has created ample opportunity for longer-term investors who are able to tolerate significant bouts of volatility.

This seismic shift in interest rates has potentially served as a mini-reset — one that was desperately needed after the 10-year Treasury yield reached its all-time low of 0.51% in early August 2020, following a nearly 40-year bull market. There are no expectations that the market is headed to the highs of the early 1980s (mid-teen yields on the 10-year Treasury), but real yields in positive territory and the 10-year flirting with 4% present a compelling opportunity.

Since the turn of the century, the question was always how rising rates would unfold: slowly, and thus limiting the sticker shock on fixed income portfolios; or quickly, causing pain across financial markets as the world adjusted to the new rate outlook. These past three quarters have given us our answer but also provided us with opportunity.

Despite recent jawboning from talking heads in the financial markets, the prospect of a pivot from the Federal Reserve is just that, talk. Determined to hold on to its inflation-fighting credentials, the Fed raised rates by 75 bps at both meetings this past quarter and reinforced its outlook rather tersely at the Jackson Hole Economic Summit in August. While referencing the more recent drop in inflation (from 9.1% in June to a still white-hot 8.5% in July), Powell clearly stated that, while welcome, the drop was not enough to waylay the Fed's plans for additional rate hikes.

With the labor market appearing to maintain its strength (3.7% unemployment for August with 315k jobs added), the Fed is laser focused on battling inflation and the effort to reach a more normalized level. Powell didn't mince words when it came to potential economic fallout of a hawkish Fed, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." Any thought of a 50-bps pivot in September were washed away after those comments. And while there is no meeting in October, various Fed members have been hitting the financial broadcasts, reiterating the need for an additional 75-bps hike in early November. Barring a substantial drop in inflation in upcoming economic reports or a significant disruption to the labor market — both of which are unlikely in the short term — the market shouldn't doubt the Fed's commitment to continue its current path.

Bloomberg US 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). The index is unmanaged, market capitalization weighted, 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.

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