DIAMOND HILL

INVESTED IN THE LONG RUN

April Turns Fixed Income Market on Its Head

Apr 2024

While our monthly commentary typically focuses on exploring different areas of the fixed income market, we felt that April's performance (or lack thereof) should be addressed in a more traditional format. The Bloomberg US Aggregate Bond Index's loss of -2.53% was the worst monthly return since September 2023's loss of -2.54% and ranks as the ninth worst month since the turn of the century.

A challenging April brought the year-to-date performance for the index to a loss of -3.28%, which ranks as the worst start to a calendar year through April since the historically painful year of 2022. Outside of 2022, this year's performance in the fixed income markets ranks as the largest loss since 1994's loss of -3.64%. The continued challenges in the fixed income markets have tested investors' patience as expectations for a more accommodative Federal Reserve brought hope to investors who lived through the carnage of 2022 and the late-inning rally in 2023. Stronger-than-expected economic data has pushed investor expectations for rate relief to the latter part of 2024, a dramatic shift from the early days of the year. Let's examine the key components that led to such challenging performance in April.

Robust Economic Data Pushes Rate Expectations

Labor market remains strong.

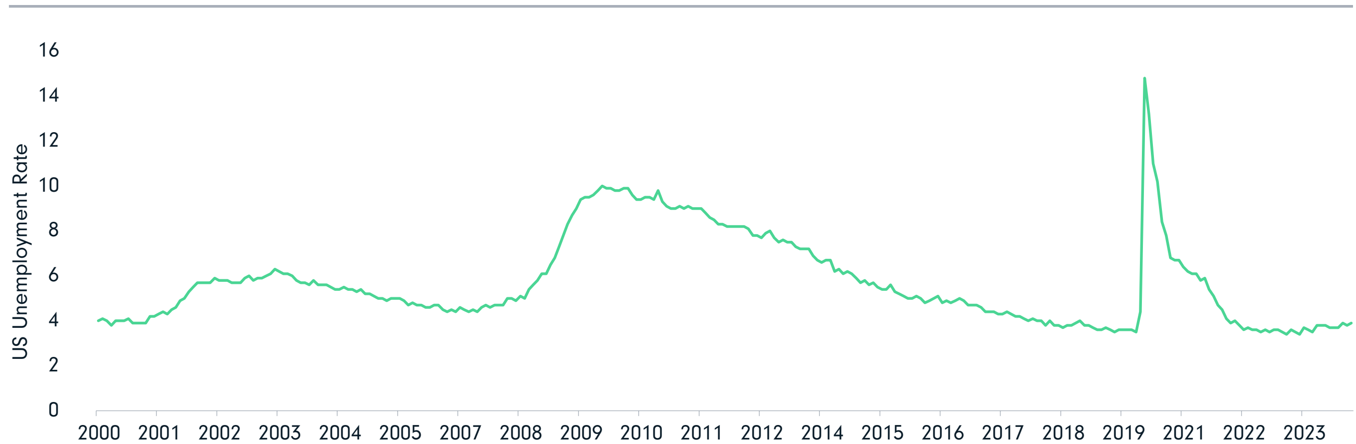
The labor market continues to defy expectations, delivering over one million new jobs since the beginning of the year. While job creation lags the level reached through the first four months of last year, the 1.1 million jobs added through April 2024 is well ahead of the historic average over the same period from 2001-2019. The unemployment rate remains near historic lows despite the most recent number climbing from 3.8% to 3.9% in April. The labor market's continued strength firmly anchored expectations that the Federal Reserve will remain on the sideline (higher for longer) for the foreseeable future with solid employment and stubborn inflation.

Exhibit 1 — Nonfarm Payroll Employment, Seasonally Adjusted (in thousands)

	Average 2001–2019	2023	2024
January	102	517	353
February	90	311	275
March	76	236	303
April	112	253	175
Year to date	379	1,317	1,106

Source: Bloomberg.

Exhibit 2 — Unemployment Remains Steady (%)

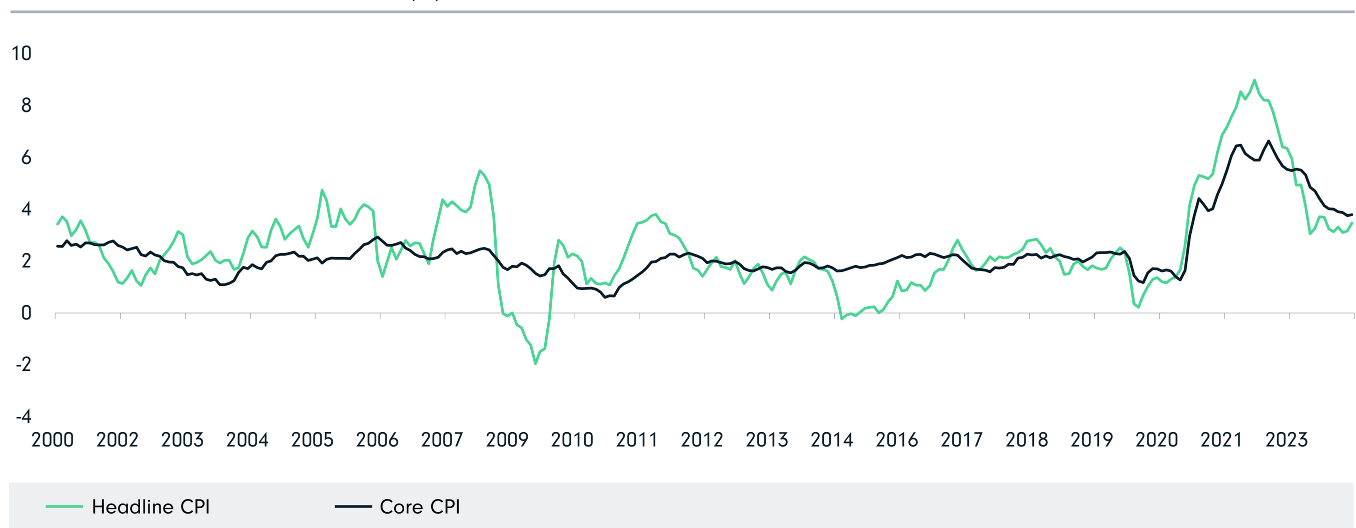


Source: FRED.

Inflation proves more resilient than expected.

No matter how you look at it, inflation has held steady for longer than expected. Core inflation, which excludes the more volatile food and energy pricing impacts, follows a similar trajectory as overall inflation, though with less volatility. Nonetheless, after peaking during the summer of 2022, core inflation fell during the subsequent period before steadying in the low 4% to upper 3% range on a year-over-year basis. And therein lies the problem. The Fed is achieving a slowdown in pricing pressures. Still, the slowdown is slowing, forcing the markets to reconsider expectations for the Fed's future path of interest rates with potentially stickier inflation.

Exhibit 3 — Year-Over-Year Inflation (%)



Headline CPI   Core CPI

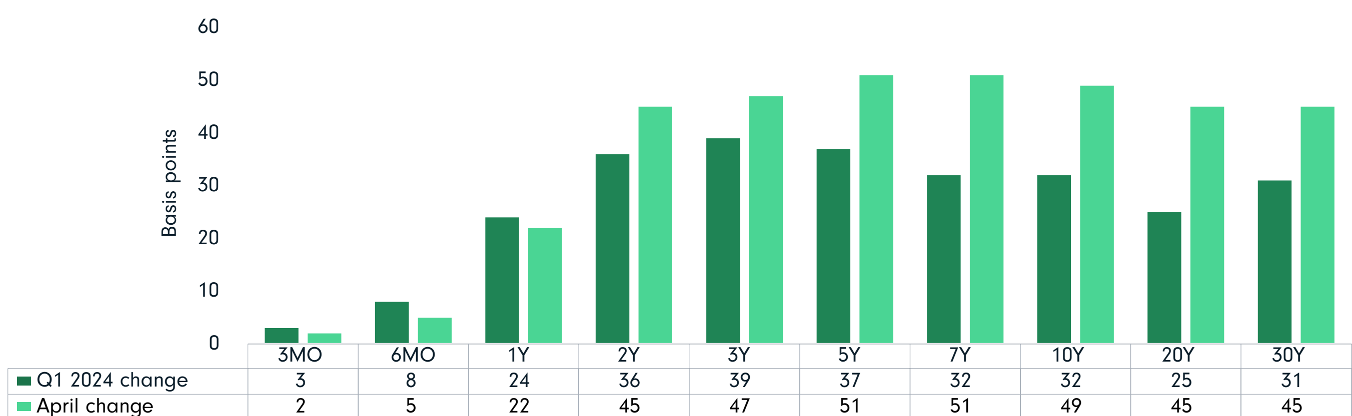
Source: Bloomberg. Headline – All items. Core – All items less food and energy.

Treasury curve shift drives performance.

A stronger labor market plus stubborn inflation results in higher-for-longer expectations for the market. During the first quarter, the Treasury yield curve shifted higher, with the biggest shifts occurring in the belly of the curve as the market came in line with the Federal Reserve dot plot communication of three 25 basis point rate hikes by year-end. As economic data continued to show strength and resolve, market expectations moved past the dot plot-inspired expectations and fed fund futures moved to reflect roughly 30 basis points in rate cuts by year-end.

This expectation shift was evident in the Treasury market as the curve shifted higher in April at a greater pace than in Q1. During the first three months of the year, the yield on the 10-year Treasury climbed 32 basis points, but in April alone, the yield rose 49 basis points (Exhibit 4). The result? The worst month of performance for the Bloomberg US Treasury Index (down -2.33%) since February 2023 (down -2.34%) as the longer end (as measured by the Bloomberg US Long Treasury Index) dragged the broader index lower, losing more than -6%. It was an ugly month across the entire curve, except for the very short end, which delivered some positive performance. Expectations are for some stability in rates now that the market has adjusted to the Fed's viewpoint that rates will remain higher for longer.

Exhibit 4 — Treasury Yields



	3MO	6MO	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
Q1 2024 change	3	8	24	36	39	37	32	32	25	31
April change	2	5	22	45	47	51	51	49	45	45

Source: FRED.

Speaking of the Fed...

In its most recent meeting (concluded on May 1), the FOMC kept rates unchanged, which wasn't surprising given the strength in labor and stubbornness of inflation. The announcement that the Fed will slow the reduction of Treasury holdings starting in June could be considered a slight surprise. The monthly redemption cap on Treasuries will decrease from $60 billion to $25 billion. The agency debt and agency residential mortgage-backed securities (RMBS) redemption cap ($35 billion) will remain unchanged . The FOMC will roll over at auction the amounts of principal payments from System Open Market Account (SOMA) holdings of Treasury securities maturing during each calendar month that exceeds the cap amount for that month.

Per the New York Federal Reserve, the MBS holdings on the Fed balance sheet have decreased from $2.7 trillion in June 2022 (the start of QT) to $2.4 trillion as of early May 2024, a monthly average well behind the monthly cap. The Treasury allocation on the balance sheet has decreased from $5.7 trillion to $4.4 trillion over the same period. During the May press conference, Powell reiterated his expectations for higher for longer, and he refused to put rate hikes on the table, giving the meeting a more dovish tone.

The Investment Grade Corporate Market

The clearest example of duration's impact (the sensitivity of a bond's price to interest rate movements) on the performance of a fixed income sector comes from the investment-grade corporate sector. The longest duration portion of the corporate sector — AAA-rated bonds with an average duration of 10.24 years as of April 30 — was adversely impacted by the much longer duration posture of the bonds within the index (Exhibit 5).

Exhibit 5 — Corporate Sector Duration and Performance by Quality

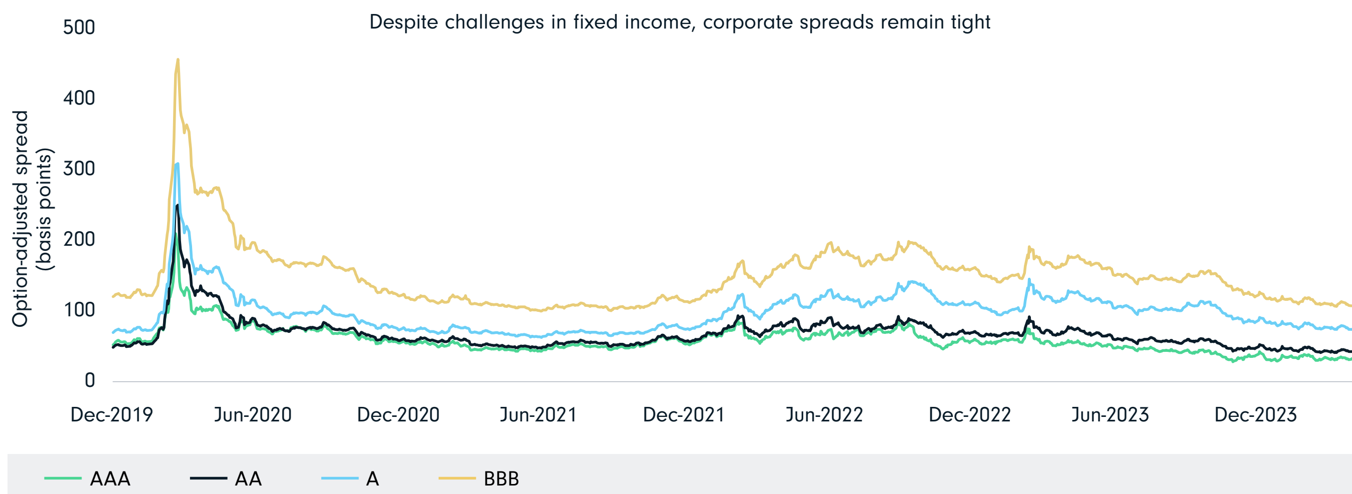
	Duration (Years)	Price Return (%)	Coupon Return (%)	Total Return (%)
Corporate	6.83	-2.91	0.37	-2.54
AAA	10.24	-4.55	0.31	-4.24
AA	7.77	-3.36	0.32	-3.04
A	6.83	-2.91	0.36	-2.55
BBB	6.61	-2.82	0.39	-2.43

Source: Bloomberg.

Comprising a mere 1% of the overall Bloomberg US Corporate Index, the AAA-rated portion contains corporations such as Johnson & Johnson and Microsoft, along with various foundations and higher education institutions . Due to their higher quality, these institutions can benefit from paying lower rates while issuing longer-dated bonds. The lower the credit quality, the higher the yield, reflecting the additional credit risk that an investor requires to assume the incremental risk.

This impact is noted in the higher monthly coupon return as you move down the credit quality spectrum, helping to offset some of the impact of rising rates. Despite the challenging performance in the corporate space, spreads remain compressed and are near their lowest levels since before the market upheaval caused by the COVID-19 pandemic.

Exhibit 6 — Corporate Spreads



Source: Bloomberg. Headline – All items. Core – All items less food and energy.

The Securitized Market

As measured by the Bloomberg US Securitized Index, the securitized market lost -2.91% in April, worse than investment-grade corporate debt and Treasuries. However, there was a definite bifurcation in performance as interest rate-sensitive agency RMBS (residential mortgage-backed securities) were the most impacted by the rate shift. The Bloomberg US MBS Index lost -3.03% during the month , reflecting the impact of higher rates on lower coupon mortgages in the index.

Performance within the RMBS index was tiered by coupon level, with the lowest tier of coupons (longest duration) experiencing the most challenging performance and the higher coupons (shortest duration) holding up well on a relative basis.

Index-eligible non-agency commercial mortgage-backed securities (CMBS) benefitted greatly during the first quarter (+1.97%) as the prospect of lower rates fueled the rally. Though the sector was negative in April, it held up better than other sectors, losing -1.68%. Non-agency CMBS not included in the index (Commercial Real Estate Collateralized Loan Obligations and Single Asset Single Borrower) held up better than their index-eligible counterparts, benefitting from additional yield.

Index-eligible lower-duration asset-backed securities (ABS) held up reasonably well in April, declining a mere -0.62%, making them the best-looking house in an otherwise ugly fixed income neighborhood. Credit card ABS continued to benefit from investor interest, advancing +0.10% in April, while auto ABS declined -0.20%. Other esoteric parts of the market held up well, supported by continued interest in shorter duration, attractively yielding subsectors of the ABS market. Even new instruments securitized with revenue tied to IP addresses or more esoteric collateral, including fine art, wine, spirits, and fine jewelry, were met with open arms and significant interest during the month.

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). **Bloomberg US Corporate Index** measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg Treasury Bond Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **Bloomberg US Long Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years or more to maturity. **Bloomberg US Securitized Index** measures the performance of the securitized sector of the Bloomberg US Aggregate Bond Index. **Bloomberg US Mortgage-Backed Securities Index** measures the performance of fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The indexes are unmanaged, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are 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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