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From Turbulence to Triumph: Fixed Income Markets Navigate an Eventful Q3

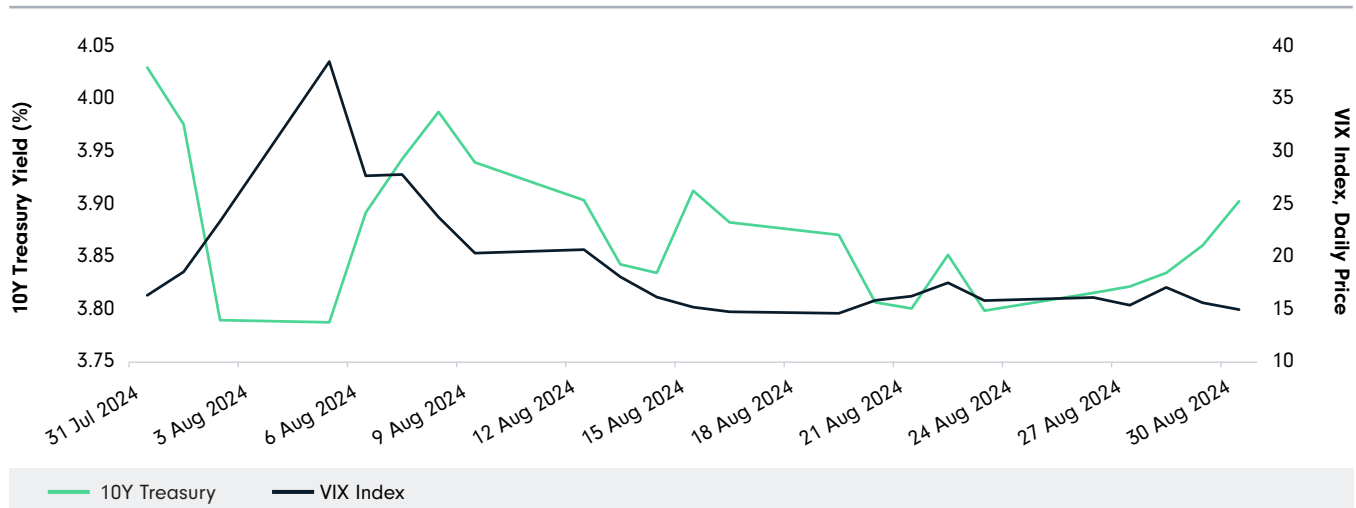
Sep 2024

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.

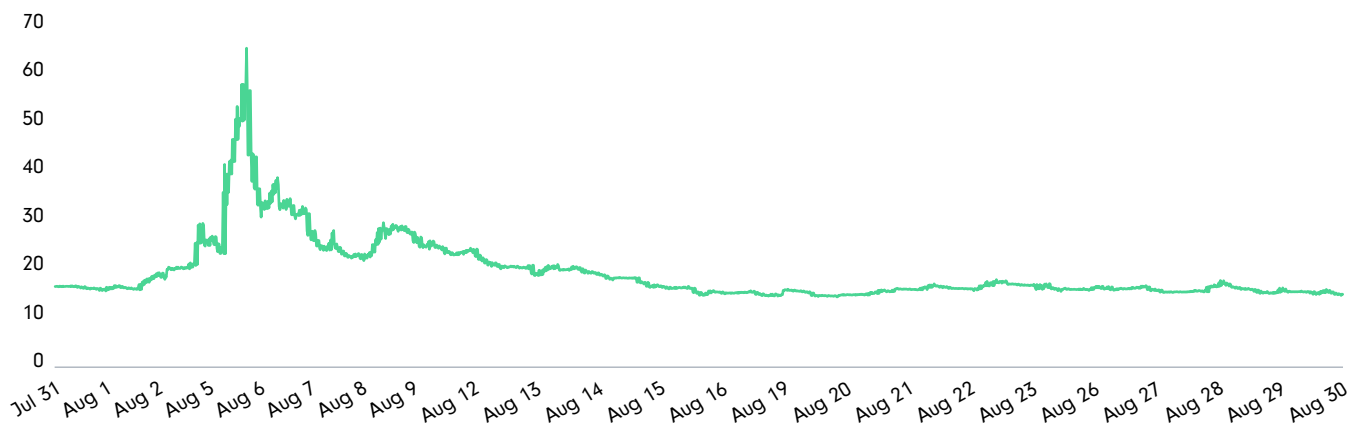
However, the volatility was short-lived. Stronger-than-expected US economic data (robust retail sales, falling CPI) and a relatively dovish Jerome Powell speech at Jackson Hole helped stabilize markets. Daily volatility for the VIX peaked at 38.57 on August 5 (Exhibit 1), the highest end-of-day level 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).

CBOE Volatility Index measures the expected volatility of the US stock market.

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, 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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