

Fixed Income: Examining the Past to Understand the Future

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As anyone in the investment industry knows, past performance does not indicate future results. This month's commentary isn't meant to serve as a crystal ball but rather an examination of the past to understand where the fixed income markets stand relative to history.

After a solid start to the year, with three out of the first four months delivering positive returns, fixed income markets have reverted to the negative ways of 2022, with the past six months generating negative returns. This dramatic reversal has shifted expectations for the possibility of a third consecutive calendar year of negative returns for a market that had never experienced two consecutive years of negative returns before 2021 and 2022.

The Federal Reserve has kept its resolve in attacking inflation by continuing its tightening cycle and holding the line on rate increases until the latter part of this year – though holding off on hiking in three of the last four meetings. While there may be one final increase in the near future, it seems we're approaching the end of this cycle. Where do fixed income markets go from here if this is the end of the cycle? Of course, no one knows, but we can look to the past to understand what we may expect going forward.

Before 2021, the Bloomberg US Aggregate Bond Index had only lost money in three calendar years (1994, 1999, 2013) while delivering 6.75% annualized returns from 1980 through year-end 2020. Following the negative years, the index returned 18.47% (1995), 11.63% (2000) and 5.97% (2014) as markets rebounded. Each of those markets experienced its nuances and challenges, whether it was an overly aggressive Federal Reserve (1994), emerging from the ashes of Long-Term Capital Management's collapse and into the dotcom bubble (1999) or the Taper Tantrum (2013), so there is no one similarity to rely on. To better understand where fixed income markets may be headed, let's look at the three most recent tightening cycles and how they behaved once the Fed finished its rate hikes. Other factors are at work here, but we'll at least have some form of symmetry by looking at these specific periods.

1999-2000 Cycle – Dot-com bubble, 9/11 terrorist attacks, World Com/Enron

The Federal Reserve launched its tightening cycle with a 25 basis point (bps) hike in interest rates after the June 30, 1999, meeting and would continue with 25 bps increases for the subsequent four meetings before finishing the cycle with a 50 bps move to bring interest rates to 6.50% at its meeting in May 2000.

The Fed held rates steady through the end of 2000 before beginning the next easing cycle with a 50 bps reduction at the first meeting of 2001 in January. The easing cycle continued into the middle of 2003, albeit at a much-reduced pace, including an inter-meeting reduction on the heels of the 9/11 terrorist attacks.

Looking at the three years, starting with the final rate hike in May 2000, the Bloomberg US Aggregate Bond Index delivered a cumulative return of 37.28% or 11.14% annualized. Over the three years, the US 10-year Treasury yield dropped from 6.42% to 3.42%, while corporate spreads relative to Treasury yields dropped considerably from their starting level despite the fallout from the largest (at the time) bankruptcy filing by Enron, which shook financial markets in December 2001.

WorldCom would supplant the record bankruptcy brought by Enron seven months later in July 2002. Despite the volatility brought on by the collapse of both Enron and WorldCom, corporate markets (as measured by the Bloomberg US Corporate Bond Index) recovered and delivered cumulative returns of 42.90% or 12.64% annualized, while the securitized market (as measured by the Bloomberg US Securitized Bond Index) returned 32.02% or 9.72% annualized.

Exhibit 1 – Post 1999-2000 Tightening Cycle, Bloomberg US Aggregate Bond Index (%)



Source: Bloomberg.

2004-2006 Cycle – Global Financial Crisis, Precipice of European Debt Crisis

The subsequent tightening cycle began in June 2004 as the world economy was moving on from the dot-com bubble and the WorldCom/Enron scandals. The first increase came in June 2004, with a 25 bps increase that was followed by sixteen consecutive 25 bps increases, which brought the fed funds rate from 1.00% to 5.25%. By the time of the final rate hike in June 2006, the yield on the 10-year Treasury had only climbed from 4.62% to 5.25%, but the 2-year Treasury rose from 2.68% to 5.15%, in line with the 10-year.

Unlike the prior post-tightening cycle, the return stream for the index is not consistently higher but is interrupted by significant market events. As the once red-hot housing market crumbled, the US government took drastic steps to prop up the economy – from consumer tax rebates to creating various lending facilities to support financial institutions.

In the fall of 2008, the US government dealt with significant bank failures (IndyMac, Washington Mutual) and placed Fannie Mae and Freddie Mac into receivership. The crisis culminated in the bankruptcy of Lehman Brothers in mid-September, followed by the government bailout of AIG and the auto industry.

While fixed income markets were severely challenged during the early days, the recovery in subsequent months was significant, and the Bloomberg US Aggregate Bond Index finished the year up 5.24%. Despite the uncertainty and instability brought about by the financial crisis, investment grade fixed income markets were resolute and over the three years beginning with the final rate hike of 2006, in which the Bloomberg US Aggregate Bond Index delivered a cumulative return of 20.99% or 6.55% annualized. The corporate market (as measured by the Bloomberg US Corporate Bond Index) generated a 7.56% annualized return over the three years, while the Bloomberg US Securitized Bond Index returned 6.89%. The worst-performing segment of the overall index was Treasuries, advancing 4.61% annualized.

Exhibit 2 – Post 2004-2006 Tightening Cycle, Bloomberg US Aggregate Bond Index (%)

Source: Bloomberg.

2015-2018 Cycle – Emergence from Zero Interest Rate Policy (ZIRP), Slowdown in global growth, COVID-19 Pandemic

The most recent tightening cycle began in December 2015, with the first rate move in either direction since the January 2009 Fed meeting when the Fed dropped rates to 0% during the financial crisis. This tightening cycle was long, steady and well communicated, with 25 bps increases in December 2015 and 2016 followed by three 25 bps hikes in 2017 and four 25 bps hikes in 2018, bringing the fed funds rate to a range of 2.25% to 2.50%.

During the tightening cycle, the 2-year Treasury increased from 1.00% to 2.67%, while the 10-year Treasury climbed from 2.30% to 2.81%, reflecting the ongoing increases from the Federal Reserve. The global economy in 2019 was slowing, and in response to the slowdown, the Federal Reserve began to cut the fed funds rate, starting at the July 2019 meeting with a 25 bps reduction and subsequent decreases of the same amount in September and October, before holding the line at 1.50% to 1.75%.

As the calendar turned to 2020, rumblings emerged about the potential outbreak of a disease that would eventually bring the global economy to its knees and shut down the world as we knew it. The markets locked up, and the global population faced an unprecedented pandemic. But the short-lived financial dislocation was soon resolved as global central banks rallied to deliver stimulus and support to bring the markets and global economy back from the brink.

The volatility in the financial markets subsided as the summer wore on, and the economy found somewhat stable footing despite the tectonic shift in the global economy. During the latter part of this period, the Bloomberg US Aggregate Bond Index delivered its first negative annual performance since 2013, losing -1.54% in 2021. Despite this decline, the index generated a three-year cumulative return, beginning with the final rate hike of 14.62% or 4.96% annually. It should be noted that the 2022 decline of -13.01% pushed the return since the last rate increase in December 2018 to a cumulative loss of -2.26% through month-end October 2023, which was -0.47% annualized.

Exhibit 3 – Post 2015-2018 Tightening Cycle, Bloomberg US Aggregate Bond Index(%)

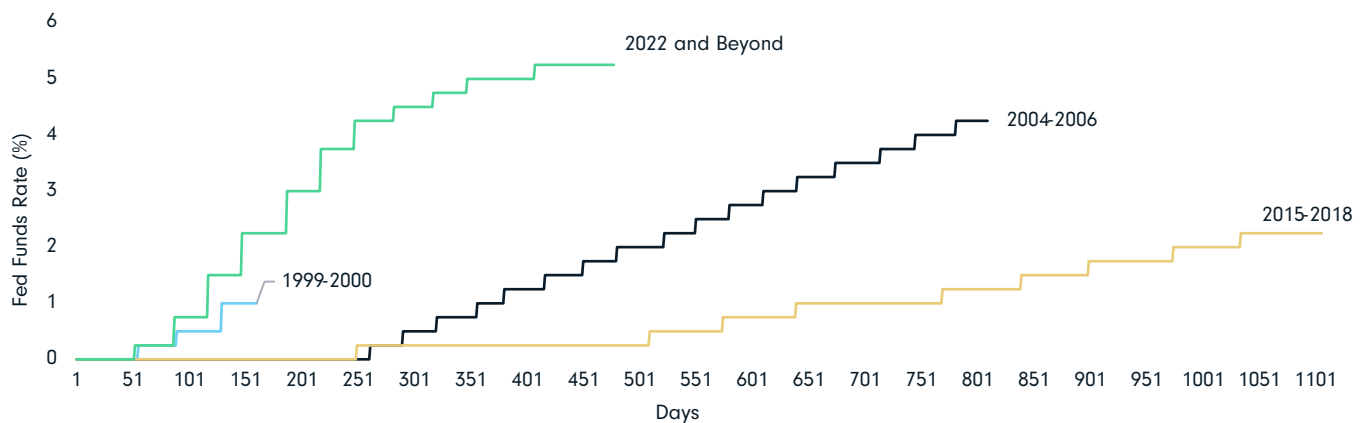


Source: Bloomberg.

Today and Beyond

The current Fed tightening cycle is the most aggressive and rapid in recent history, outpacing the approach during the 2004-2006 cycle in scale and rapidity. Interest rates and fixed income markets have reacted accordingly, as rates have climbed to levels not seen since before the financial crisis, and fixed income returns have been challenging.

Exhibit 4 – Current Tightening Cycle Fastest and Most Aggressive in Recent History



Source: Bloomberg.

But the pain that has been felt since the process began (cumulative loss of -2.26% from December 2018 through October 2023 for the Bloomberg US Aggregate Bond Index) has created opportunities for investors. While credit spreads remain compressed despite expectations for a possible recession in 2024, the securitized market offers compelling value for investors.

The much-maligned commercial mortgage-backed securities market continues to trade at levels not seen in many years, with the entire sector feeling the pain, and more acutely in specific segments such as office. Even as concerns grow regarding the viability of the consumer – with credit card and auto delinquencies increasing – levels have only recently crested those seen before the pandemic. The agency mortgage-backed securities market is offering value not seen since the financial crisis, whether it be discounted legacy lower coupon mortgages or more recently issued last cash flow higher coupon mortgages. For investors willing to research and analyze these areas of the market, opportunities for compelling return profiles can be found.

If we believe the Fed is near the end of this rate cycle and rates stabilize for the foreseeable future, or we consider the possibility of rate cuts in the coming years, we believe fixed income investments are positioned well to deliver compelling returns. Of course, that statement comes with many caveats, the most obvious being that no one can predict the future, how the global economy and financial markets will behave going forward, or what unknown crisis lurks ahead.

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 US Securitized Index** measures the performance of the securitized sector of the Bloomberg US Aggregate Bond Index. 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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