DIAMOND HILL

INVESTED IN THE LONG RUN

Light at the End of the Tunnel Isn't a Train After All?

Nov 2023

The past few years have been challenging for fixed income markets, with only small pockets of good news. From the beginning of 2022 through October 2023, the Bloomberg US Aggregate Bond Index has lost -15.42% on a cumulative basis (-8.73% annualized), generating negative performance in 16 out of 22 months. Could we finally be emerging from this painful period of history? Could the light at the end of the tunnel be sunlight and not a freight train? For all the storm clouds fixed income markets experienced since the start of 2022, this past month was akin to a beautiful summer day with nary a cloud in the sky. November was a month to remember, delivering some of the best performance across various sectors in years, even decades in some cases.

Chatter from the Federal Reserve was mixed with Richmond Fed president Barkin continuing with a hawkish tone ("want to have the option of doing more on rates") while Atlanta Fed president Bostic and Cleveland Fed president Mester expressed that "the downward trajectory of inflation will likely continue" and "monetary policy is in a good place", respectively.

But the solid economic narrative continued with strong data, including a reinforcement of the Q3 GDP number reported earlier with an upward revision from 4.9% to 5.2%. This coincides with the downward revision to the personal consumption expenditures price index (PCE Index) and core PCE inflation, the measure of inflation most watched by the Fed. The PCE revision from +2.9% to 2.8% and core PCE from 2.4% to 2.3% was another sign that the economy could be headed in the much-desired soft-landing direction. But has the Fed achieved its goal of a soft landing? Has it put a bow on the most aggressive tightening cycle in history just in time for the holidays? Or is this a short-lived head fake by the markets with higher rates somewhere in our future?

Who is to say? But it does feel as though we are emerging from the doldrums of persistently increasing yields and investors may be able to enjoy some relative stability.

November Impacts

Overall fixed income market

November delivered the best performance for the Bloomberg US Aggregate Bond Index (+4.53%) since May 1985 (+5.23%), and it could have been even better if not for the loss of 46 basis points (bps) on the final day of the month. There were only five days of negative performance for the index in November out of 22 trading days, which equates to the lowest percentage of negative return days in a month for 2023 (22.7% compared to the preceding 10-month average of 52.8%).

But it wasn't all sunshine and roses. The degree of losses in November on those negative days was the highest average since the beginning of the year, with an average daily loss of -0.53%, compared to the prior 10-month average of -0.37%. So, there were fewer negative days during the strongest monthly performance since 1985, but those down days were quite impactful. Overall, it was an impressive return to positive territory for some of the financial markets that had suffered for quite some time.

The major sectors of the Bloomberg US Aggregate Bond Index delivered their best performance since 2008, or in the case of the Bloomberg US Securitized Index, ever. (The securitized index came into existence in 1997 via the combination of the RMBS, ABS and CMBS portions of the Aggregate index.) Specifically, the Bloomberg US Corporate Bond Index returned 5.98% in November, the sector's best performance since the global financial crisis, December 2008 (6.80%). The Bloomberg US Treasury Index delivered its best return (3.47%) since November 2008 (5.31%).

Exhibit 1 — Brighter Days in November

Bloomberg US Aggregate Bond Index	Negative Days	Positive Days	Total Business Days	% Days Negative	Average Daily Loss
January	10	10	20	50.0	-0.25
February	10	9	19	52.6	-0.48
March	11	11	22	50.0	-0.40
April	10	11	21	47.6	-0.30
May	15	7	22	68.2	-0.31
June	8	13	21	38.1	-0.42
July	9	11	20	45.0	-0.37
August	13	9	22	59.1	-0.31
September	13	7	20	65.0	-0.30
October	11	10	21	52.4	-0.52
November	**5**	**17**	**22**	**22.7**	**-0.53**

Source: Bloomberg.

	Total Return of Bloomberg Indices (%)			
	Aggregate	Treasury	Corporate	Securitized
November 2023	4.53	3.47	5.98	5.02
Best since	May 1985 (5.23)	Nov 2008 (5.31)	Dec 2008 (5.80)	Ever

Source: Bloomberg.

Treasury yield curve

Since 2002, there has been much discussion around the inversion of the Treasury yield curve, specifically the spread between the 2-year and 10-year Treasury yields, whose inversion has historically preceded recession.

The current inversion began in June 2022, largely due to the Fed's actions. When inflation emerged as a major issue in 2021 and 2022, the Fed's reaction was to significantly increase the short-term federal funds target rate in what became the most aggressive tightening cycle since the 1980s. The Fed has raised the target rate — which was at a range of 0.00% to 0.25% in early 2022 — 11 times to varying degrees to its current range of 5.25% to 5.50%.

As one would expect, shorter-term yields moved in conjunction with the rate increases, and while longer-term bonds also moved higher, they did not do so to the same degree. The result? Higher rates on shorter-term Treasuries than what was being delivered on longer-term Treasuries, thus an inverted yield curve with the 2-year Treasury higher than the 10-year Treasury.

Through 2022 and the first half of 2023, the inversion of the yield curve only grew. The difference between the two reached a maximum spread of 108 bps in early July 2023 — matching levels not seen since 1981 — almost one year after the initial inversion.

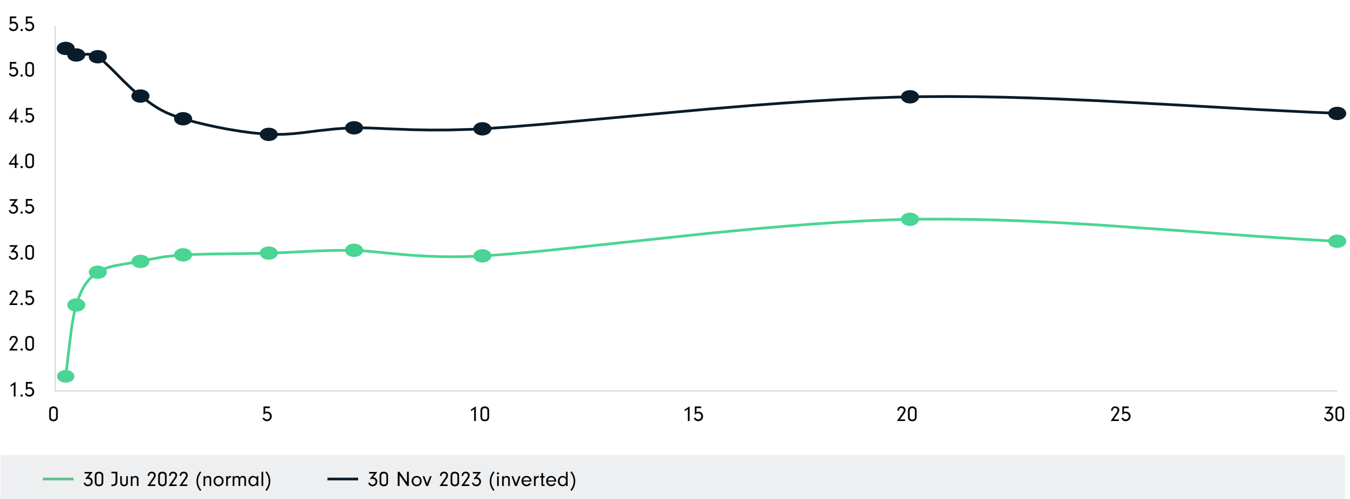
The July 26 FOMC meeting marked what could be the final 25-bps rate hike of this cycle, where the Fed increased the target rate to 5.25% to 5.50%, as it has held the line in subsequent meetings in September and November 2023 with little expectation for a move in December.

Reflecting that shift from the Fed, the inversion trend began to reverse, reaching a low point of 14 bps in October before reversing course again in November. This trend reversed after the Fed meeting on November 1, at which various members discussed the potential of keeping rates higher for longer and even raising rates at least once more. That message kept the spread between the two bellwether securities at an average level of 38 bps in November, finishing the month at 36 bps. While the spread is wider than levels reached in October, it is considerably lower than the average from when the inversion first occurred to the end of October (60 bps).

Exhibit 2 — 2-10s Curve Inversion Much Less Inverted (%)

Source: Bloomberg.

Exhibit 3 — From Normal to Inversion (%)



Source: Bloomberg.

Spread Sector Impact

The corporate and securitized markets were buoyed by the massive rally in rates and the compression of spread levels as investors moved back into risk assets. The Bloomberg US Corporate Bond Index spent much of the month grinding tighter, finishing at 104 bps, its lowest level since January 2022. The ending value was significantly lower than the average since 2000, roughly 151 bps. The lowest-rated tier of the Bloomberg US Corporate Bond Index followed a similar pattern, with the BBB-rated segment of the index rallying from 156 bps of option-adjusted spread (OAS) to 130 bps (lowest since February 2022) and well below the average since 2000 of 193 bps.

The biggest shift in the securitized market was in the interest rate-sensitive RMBS market, which saw spreads tighten from 74.6 bps to 56.5 bps. Shorter duration ABS OAS tightened by less than 2 bps and the CMBS market tightened by just over 6 bps. Nonetheless, all three segments of the securitized market benefited from November's rate move, delivering their best monthly performances in 2023.

Exhibit 4 — Corporate OAS Craters in November

Source: Bloomberg.

What may the future hold?

While the Fed continues to hold the line on "data dependency" and "higher for longer," the markets have spoken via the fed funds futures market, pricing in roughly five 25-bps rate cuts in 2024. As of the end of November, the markets are pricing in the first rate cut in May 2024, with four subsequent 25-bps cuts spread over the remaining seven months of the year, culminating in a projected fed funds rate of 4.00% to 4.25%.

Just because expectations for a cessation of rate hikes have been gaining more steam does not mean rate cuts are on the horizon. The Fed has referenced higher for longer, and there is nothing in its communication to indicate that it plans on cutting rates any time soon, even though the tightening cycle might be ending. As Jerome Powell has pointed out on more than one occasion, the markets can price in whatever expectations they would like via fed funds futures, but the Federal Reserve dictates monetary policy. And while the Fed may be moving from hawkish to slightly less hawkish to maybe even somewhat dovish in the coming months, that does not indicate an expectation for rate cuts but rather a solidifying of current rate policy at these levels. The Fed has spent the last several months reestablishing its credibility, working to restore confidence after the "transitory" inflation debacle a few years ago.

Investors appear to have avoided a historic third consecutive year of negative returns in the broad fixed income market and stand to benefit from the new era of a more normalized rate environment. Fixed income now delivers income and the potential for principal return if rates stabilize or contract going forward.

But, as we've all learned, no one can accurately predict the future so a continued focus on security selection and sector allocation becomes even more important as we embark on a new cycle for the financial markets.

Bonds rated AAA, AA, A and BBB are considered investment grade.

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