

## Core Fixed Income Finds Its Footing

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Over the past decade, the world of core fixed income strategies has navigated through tumultuous storms. The era of quantitative easing brought about suppressed interest rates, causing a seismic shift in the traditional role of bonds as the shock absorbers of portfolios. This led to a period of dwindling income generation, sparking debates on the time-honored 60/40 stock-bond allocation strategy.

However, as we fast forward to 2023-2024, core fixed income is making a solid comeback, powered by the systematic tightening from the Federal Reserve. Benchmark rates have bounced back to levels unseen in over a decade, breathing new life into the dual roles of fixed income: income generation and portfolio diversification. With this resurgence, core bond portfolios are primed to regain their status as fundamental portfolio components.



Henry Song, CFA  
Portfolio Manager

### The Renaissance of Income Generation

Between 2012 and 2021, the Bloomberg US Aggregate Bond Index yielded an average of 2.2%, even dipping to its lowest at 1.0% in August 2020. However, the winds have changed direction. Federal Reserve rate hikes totaling 525 basis points have catapulted the yield to nearly 4.8% today — a figure significantly above the 2% inflation target and the current inflation rate of 3.4%. Using disciplined security analysis and diversified sector allocation, astute managers can potentially elevate yields into the 6-7% range.

For those incorporating core fixed income into their portfolio now, the benefits are twofold: the opportunity to tap into yield levels that haven't been seen in years and the potential for principal return if the Fed proceeds with rate cuts in 2024 and beyond. Bonds have transformed from mere counterbalances for equities to investments that offer cash flow capable of outpacing annual inflation.

Even in the face of a potential recession, which could force the Fed to slash rates, fixed income is expected to deliver attractive real income compared to the last decade. The era of bountiful yields may be behind us, but bonds continue to reward investors for weathering periods of volatility.

### The Rekindling of Diversification Dynamics

Yet, income generation is just one piece of the puzzle. Core fixed income also acts as a shield against systemic equity risk. When geopolitical fluctuations and economic downturns threaten to erode equity returns, core bond portfolios stand ready to offer principal and income as a lifeline for investors. Current income levels provide a robust buffer against moderate rate increases, offering a stark contrast to the minimal loss tolerance of recent years.

In the event of an economic slowdown leading to Fed rate cuts or geopolitical unrest in the coming months, there could be significant upside from principal appreciation as prices rally amidst a flight to quality or simply falling rates.

While past performance is not indicative of future results, the rejuvenation of core fixed income's roles in mitigating volatility and diversifying equity gives investors a reason to be optimistic.

### Key Insights for Investors

There's no sugarcoating it – the past decade has been challenging for traditional core bond strategies. However, with the resurgence of income generation and portfolio diversification, and the potential for rate cuts on the horizon, core fixed income has reasserted its relevance as a cornerstone of portfolios.

This doesn't suggest that core bond portfolios should entirely supplant credit or niche strategies. These satellite holdings have their rightful place alongside broad market bonds. Yet, the classic 60/40 allocation may be making a comeback as the optimal strategy for certain investment objectives.

With yields now hovering in the 4-6% range and the potential for more if the Fed adopts a dovish stance, the allure of bonds as a stabilizing force in portfolios is undeniable. As investors reassess their allocations, core fixed income deserves a second look as portfolios adjust to rising rates.

**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](https://diamond-hill.com/disclosures) for a full copy of the disclaimer.

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