Voya Perspectives | Market Series | March 2017

Fixed Income Perspectives

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Voya Investment Management's fixed income strategies cover a broad range of maturities, sectors and instruments, giving investors wide latitude to create a new portfolio structure or complement an existing one. We offer investment strategies across the yield curve and credit spectrum, as well as in specialized disciplines that focus on individual market sectors. We build portfolios one bond at a time, with a critical review of each security by experienced fixed income managers. As of March 31, 2016, Voya Investment Management managed $129 billion in fixed income strategies in the United States.

Bond Market Outlook

Global Interest Rates: Central banks continue to respond slowly to improving economies, resulting in bear steepeners in the United States and Europe

Global Currencies: U.S. dollar expected to weaken as other economies gain momentum

Investment Grade Corporates: Supportive macro outlook, strong demand and improving fundamentals support IG spreads

High Yield: Current spread levels seem fair given positive earnings momentum

Securitized Assets: Higher rates reduce prepayment risks for mortgages, but uncertainty over Trump policies limits spread tightening potential

Emerging Markets: Country by country opportunities continue to arise with improved economic activity

The Ides of Accommodative Policy? Not so Fast.

- With the market pricing in a near certainty of a March hike, the Federal Reserve delivered by raising interest rates another 25 basis points. This was quite the turnaround from a few weeks ago, when market expectations for a hike in March were below 30%. Despite these low expectations, the Fed pushed the market for the first time in years with a stream of hawkish commentary, as evidenced by the almost 70% jump in implied probability of a hike in just a week.
- In our opinion, Yellen and company acted with good reason. The February employment report was strong across the board, with the unemployment rate declining by 0.1% to 4.7% even with an uptick in the labor force participation rate. Several indicators signaled further reduction in labor market slack, most notably wage growth, which continued to inch above the anemic levels seen throughout the recovery. In addition to these economic indicators, there was ample rationale to hike now. The move allows the Fed more control and latitude on future tightening as it gets one hike out of the way. Therefore, the Fed will not have to rush towards its stated goal of three hikes for the year should the first quarter GDP growth print fall flat as many expect. Instead, hiking now allows the Fed to revert to a more dovish stance going forward and let the market guide expectations as to the appropriate pace of further hikes.
- In addition to watching the Fed, policy and geopolitical uncertainty such as healthcare and tax reform, infrastructure spending and the French elections, among others, continue to dominate headlines, indicating numerous catalysts that could result in near-term volatility. Therefore, we are maintaining a shorter duration posture across our portfolios and we expect rates to rise in the near term; longer term, we maintain our belief that structural issues will keep a cap on how far they can rise. Additionally, while keeping some dry powder, we continue to favor domestically oriented risk such as non-agency residential mortgages and collateralized loan obligations, as well as selective allocations to emerging markets.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			Feb. 2017	YTD 2017
Barclays U.S. Aggregate	**100.0**	**43**	**0.7**	**0.9**
Treasury	36.0	0	0.5	0.7
Investment Grade Corporates	25.8	115	0.8	1.2
Fixed-Rate MBS	28.0	22	0.5	0.4
Other				
High Yield		363	1.5	2.9
Global Aggregate		46	0.5	1.6
Emerging Markets		263	1.7	3.0

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%)	
				Feb. 2017	YTD 2017
United States	2.4	EUR/USD	1.06	-2.1	0.6
Germany	0.2	USD/JPY	113	0.0	3.7
Japan	0.1	USD/BRL	3.11	1.3	4.5
Brazil	10.2				

Source: Barclays, JPMorgan, Standard & Poor's. All spreads are to U.S. Treasurys and are option-adjusted except for emerging markets, which are nominal. All returns are total returns including dividends, expressed as percentages, in U.S. dollars.

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Sector Overviews

Global Rates

- We expect the acceleration of global growth and the increase of inflation to persist through 2017 driven largely on global industrial production, which is firing on all cylinders. This will lead real rates and inflation break-evens to increase.
- Developed market central banks have become less accommodative, but generally are allowing economic activity to continue to improve. Political uncertainty should keep the European Central Bank accommodative. The Bank of Japan's (BOJ) monetary policy has diminished to sustaining the status quo. With no target date for its 2% inflation objective, the bank's operational goal now is to suppress volatility in hopes that 80 trillion yen's worth of purchases can hold 10-year Japanese government bond (JGB) yields at zero and encourage some more growth. This is a futile goal.

Global Currencies

- The U.S. dollar should continue to weaken as other economies gain more economic momentum, their central banks shift posture and undervaluations result in trade flows. The euro zone is deeply underinvested, and the euro remains cheap. The lows were set in January so the rebound is relatively early at this stage. Australia's exports growth is accelerating with iron ore prices up over 25% in 2017, which we expect will continue to support the Australian dollar.

Investment Grade Corporates

- The IG market continues to grind tighter, driven by strong technicals but also supported by slightly improved fundamentals. From a technical standpoint, foreign demand remains robust as the yield differential between U.S. and global rates still remains attractive. Fundamentally, year-over-year revenue and EBITDA growth turned positive across most sectors in the fourth quarter, while leverage ticked down. We believe spreads have some room to tighten further given continued demand and fundamentals that are less of a headwind, but current valuations are keeping us in a neutral posture, waiting for a pullback.

High Yield Corporates

- Fundamentals have continued to show signs of improvement, particularly in the industrial and commodity-related sectors; however, exceptions remain, most notably in retail and supermarkets. Inflows have continued to be steady and the new issue calendar has been moderate. Spread levels around 390 are fair and the market is beginning to price in a stronger earnings environment. We remain constructive and hold a modest overweight to the sector, but have recently reduced our allocation due to richening valuations. That said, we are looking to increase our risk budget to the sector as opportunities arise in the market.

Securitized Assets

- Agency mortgage spreads have improved but have not reached attractive levels. Policy and headline risk, as well as the tapering of Fed reinvestments, outweigh potential upside of the asset class, and we maintain a negative outlook as a result.
- Both the technical and fundamental environment for non-agency RMBS are supportive, particularly in the legacy space, due to continued strong demand, increased prepayments and lower defaults. We believe the space will be driven by a housing market that continues to improve; despite fairly rich valuations, we are maintaining an overweight to the asset class.
- We hold a modest overweight to CMBS on the expectation that fundamentals for the sector, while strong, have broadly plateaued. We look for CRE price growth to slow and perhaps stall in 2017 as a meaningful portion of the legacy universe faces refinance challenges. However, strong fundamentals combined with limited primary issuance create a favorable supply/demand environment.

Emerging Market Debt

- We believe developed market stability and local structural reforms have created selective pockets of value within EM despite the headwinds of a stronger dollar and higher global interest rates. Therefore, we have added selectively to our allocation by maintaining a country by country approach, with preference towards Brazil, Russia, and Hungary, while closely monitoring idiosyncratic risks in Mexico, Turkey, and Venezuela.

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