Voya Perspectives | Market Series | April 2017

Fixed Income Perspectives

Matt Toms, CFA, CIO Fixed Income

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: Developed market (DM) central banks have become less accommodative, yields expected to creep higher

Global Currencies: U.S. dollar continues to weaken as other economies gain momentum; euro remains cheap

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

High Yield: Option-adjusted spreads (OAS) look fair given our belief that credit cycle is not rolling over

Securitized Assets: Policy risk, tapering of Fed reinvestments and mediocre spreads outweigh potential upside of long-term mortgages

Emerging Markets: Country by country opportunities continue to arise with improving economies

Reading the FOMC Tea Leaves

- Despite expectations of a weak first-quarter GDP print and recent lackluster jobs reports, the Federal Open Market Committee (FOMC) signaled in its latest meeting minutes that it still intends to continue policy normalization through various means. While interest rate hikes have dominated the spotlight, ending its balance sheet reinvestment policy and normalizing the size of its portfolio appeared to be further down the road, until now. FOMC participants generally agreed that it would be appropriate to start phasing out reinvestments by "later this year," with a possible start date in December at the earliest. Given its magnitude, the FOMC stressed that a "gradual and predictable" reduction of its balance sheet is favored; to minimize market volatility, reinvestments in both U.S. Treasuries and agency mortgage-backed securities (MBS) will likely be phased out over time. What does this mean for bond markets and for bond portfolios?
- Investors may be quick to expect higher yields as a result of increased supply in the Treasury and mortgage markets. The U.S. Treasury's broader funding strategy does not exist in isolation from Federal Reserve policy, however, and could adjust the maturity schedules for new issuance. Also, banks are likely to eat up a good chunk of the increased supply of Treasuries and mortgages to replace excess reserves held on their balance sheets. Furthermore, low and negative rates outside the United States will continue to drive foreign demand for higher-yielding, high-quality assets. We believe that in the long run these factors will mitigate a significant move higher in rates, allowing the Fed to maintain its cautious pace of rate normalization as guided by market expectations.
- Given this, we are keeping a modestly shorter duration posture across our portfolios, while maintaining our overweight bias to spread assets based on our expectation for higher growth later in the year and into 2018. We view corporate credit as fundamentally attractive against a backdrop of accelerating corporate profits paired with improving default trends, and view any weakness in the market as a buying opportunity. Additionally, select emerging markets such as Brazil and Russia remain compelling as they benefit from better terms of trade and rising global export volumes.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%) Mar. 2017	Returns (%) YTD 2017
Barclays U.S. Aggregate	**100.0**	**44**	**-0.1**	**0.8**
Treasury	36.6	0	0.0	0.7
Investment Grade Corporates	25.1	118	-0.2	1.2
Fixed-Rate MBS	28.3	27	0.0	0.5
Other				
High Yield		383	-0.2	2.7
Global Aggregate		45	0.2	1.8
Emerging Markets		267	0.3	3.3

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%) Mar. 2017	Returns (%) YTD 2017
United States	2.4	EUR/USD	1.07	0.7	1.3
Germany	0.3	USD/JPY	111	1.2	5.0
Japan	0.1	USD/BRL	3.12	-0.4	4.1
Brazil	10.1				

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.

Sector Overviews

Global Rates

- Euro zone growth continues to improve, with headline inflation and core inflation ticking up. The European Central Bank has begun the transition to a taper program through a subtle shift in purchases. This is a marked tack from February's stance in which the ECB claimed to look through headline inflation.
- With no target date for the 2% inflation objective, the Bank of Japan's operational goal is to suppress volatility in hopes that trillions of yen purchases can hold 10-year Japanese government bond (JGB) yields at zero and encourage economic strength. In March, JGB yields were towed higher by rising developed market yields and the curve is steepening. This could reverse: GDP shows signs of stagnation this year and CPI will likely remain zero.

Global Currencies

- The U.S. dollar should continue to weaken as other economies gain more economic momentum, their central banks shift posture and under-valuations 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 export 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

- Fundamentals continue to be less of a headwind and while this has been priced into spreads over the past few quarters, the market expects a gradual improvement in earnings to continue. Robust foreign demand and slowing new issue supply should further strengthen the technical picture. These factors coupled with a supportive macro backdrop should support further spread tightening. We maintain our positive bias towards financials as we view the valuation gap as attractive, and think BBBs can continue to compress tighter. Furthermore, we see value in the long end of the curve given its recent underperformance in March.

High Yield Corporates

- Similar to investment grade, we expect the upcoming earnings season to be supportive, particularly on a year-over-year basis. Technicals remain fairly muddled but inflows are beginning to pick up after seeing some outflows mid-month. Post the month-end rally, we are back to an OAS in the 380s, which we would assess as decent value given our belief that the credit cycle is not rolling over and expectations for defaults continue to drop. A move inside 350 would require a reassessment of the sustainability of the rally as current conditions may not support those levels.

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 any potential value of the asset class. Non-agency RMBS will continue to be driven by an improving housing market. Upside remains as credit availability increases, home ownership bottoms and the millennial demographic engages. These dynamics will benefit the amortizing legacy universe as well as next generation markets such as credit risk transfers.
- We maintain our neutral strategic outlook for commercial mortgage-backed securities (CMBS), believing that fundamentals, while strong, have plateaued. These concerns are countervailed by an improving outlook for technicals, particularly regarding supply in April. CMBS relative value is not overtly rich or cheap, and remains clouded by swap spread dynamics. Tactical opportunities to generate positive excess returns from the long side will emerge.
- We hold a positive tactical outlook for collateralized loan obligations (CLOs) as attractive valuations are expected to drive performance over the near term. New issue supply has picked up but remains manageable. Fundamentals have been overwhelmingly supportive, particularly as the distress in energy and commodities moves further into the rear view. Improving economic conditions, easing lending standards and an extended loan maturity wall should support fundamentals in the year ahead.
- The outlook for asset-backed securities (ABS) remains a function of broader risk sentiment. ABS will remain well bid and offer outperformance opportunities when market beta is negative, and vice versa. Fundamentals remain strong across almost all sub-sectors, fueled by a relatively well positioned consumer, access to non-mortgage credit and supportive labor market conditions.

Emerging Market Debt

- Emerging markets (EM) continue to benefit from improving conditions in developed markets, as well as extremely constructive credit dynamics creating domestic demand. Significant new issuance as of late, particularly out of the Middle East, has been comfortably absorbed as the asset class continues to see significant inflows. We maintain a favorable stance on EM, with a slight bias towards local currency to take advantage of country-specific volatility, while monitoring idiosyncratic risks in Venezuela, South Africa and Turkey.

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