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: Expect yields to inch higher as developed market (DM) central banks become less accommodative

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

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

The Eurozone Gets a Reprieve, for Now

- Independent centrist Emmanuel Macron won the French presidential election this month, defeating far-right candidate Marine LePen by a significant margin. While Mr. Macron's win was viewed as the most favorable outcome for France and the European Union, it was broadly expected. Market reaction was muted with the exception of the move in the euro, which broke above the $1.10 barrier versus the U.S. dollar for the first time since November. One of Macron's main challenges will be to reduce unemployment, which has stubbornly held above 10%. Another key challenge will be to advance his desired strong ties to the European Union without inflaming further populist sentiments. However, with political risks more or less easing and continued strong economic data out of Europe, all eyes will be on Mario Draghi and the European Central Bank as they consider tapering their quantitative easing program. This will lead euro area yields higher, led by German Bunds, and subsequently strengthen the euro.
- Meanwhile in the U.S., geopolitical headlines and sluggish economic data have pushed Treasury yields lower. This move lower in yields has also been supported by recently benign core inflation readings; a trend that we view as short-lived. Similarly, we expect retail sales data to bounce back from recent softness as indicated by increased retail hours worked.
- Given our belief that these recent economic misses were more blips on the radar than significant concerns, we think the Federal Reserve will stay on its tightening track. Market expectations are pricing in a 90% chance of an interest rate hike in June. This would allow the Fed to continue towards its previously stated goal of three hikes for 2017, while leaving an additional meeting to announce plans for possible balance sheet normalization. Therefore, our portfolios maintain a short duration posture to both U.S. and German interest rates, while keeping sector overweights to high yield and select emerging markets.

Spreads, Returns and Yields

			Returns (%)	
Index/Sector	Percentage of Index	Spread (bp)	April 2017	YTD 2017
Barclays U.S. Aggregate	100.0	43	0.8	1.6
Treasury	36.8	0	0.7	1.4
Investment Grade Corporate	25.1	116	1.1	2.3
Fixed-Rate MBS	28.3	27	0.7	1.1
Other				
High Yield		371	1.2	3.9
Global Aggregate		44	1.1	2.9
Emerging Markets		259	1.2	4.6

			Returns (%)	
Country	Yield on Ten-Year Bonds (%)	Currency	April 2017	YTD 2017
United States	2.3	EUR/USD 1.09	2.3	3.6
Germany	0.3	USD/JPY 111	-0.1	4.9
Japan	0.0	USD/BRL 3.18	-1.7	2.3
Brazil	10.3			

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

- With uncertainty over the French elections lifted, the rotation is underway from safe-haven assets such as U.S. Treasury securities. Repositioning into European risk assets will be phased in.
- The market is misevaluating U.S. GDP growth. The first quarter report was particularly weak because inventories subtracted a point from GDP. Going forward, we believe exports will be the main driver of GDP in 2017. The Fed is already looking beyond weak Q1 growth, and all developed market central banks have become less accommodative.
- The market consensus is for 2.50% on the 10-year U.S. Treasury yield, and yield momentum indicates over-bought conditions. High frequency data and medium-term frameworks point to a 10-year yield in the 2.75–3.00% range. We expect real yields to lead this repricing, though break-evens also will increase.

Global Currencies

- The euro zone is deeply underinvested, and the euro remains cheap. Lows were set in January, so the rebound is still in its early stages. The U.S. dollar has continued to weaken against the Australian and New Zealand dollars, the euro and pound; as those economies gain momentum, foreign central banks shift posture and under-valuations compel trade flows. Against emerging market (EM) currencies, the dollar will be mixed.

Investment Grade Corporates

- The improved outlook for growth will be supportive of corporate spreads. Fundamentals continue to improve and 1Q17 earnings are coming in strong on a year-over-year basis, driven mainly by the energy sector. Spreads are tighter year-to-date and have room to tighten further as fundamentals are less of a headwind, demand remains strong and the macro environment is supportive. We continue to like the valuation gap of financials and believe BBBs can continue to compress as the market grinds tighter. Additionally, we see value in the long end of the curve given its underperformance so far this year.

High Yield Corporates

- High yield corporate fundamentals remain reasonable after a somewhat mixed bag for the Q1 earnings season. Industrial and commodity-related earnings have shown clear signs of improvement, but the recent decline in oil below $50 has the potential to weigh on the market. OAS in the 370s is fair given our belief that the credit cycle is not rolling over and defaults are expected to remain benign. Despite certain idiosyncratic risks in the retail sector and modest weakness in oil prices, we remain constructive on high yield given enough signs of economic growth and reasonable spread levels.

Securitized Assets

- Agency residential mortgage-backed securities (RMBS) have been trading sideways due to slower prepayments. Excess return from spread tightening remains unlikely with subdued demand, negative policy risk and potential tapering of Fed reinvestments. 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) on the expectation that fundamentals, while strong, have plateaued. We look for price growth to slow and perhaps stall in 2017 as a meaningful portion of the legacy universe faces refinance challenges. Nevertheless, tactical opportunities will emerge.
- We hold a positive tactical outlook for collateralized loan obligations (CLOs), as attractive valuations and improving risk profiles should drive near-term performance. New issue supply has picked up but remains manageable, while much of the secondary market is priced at a premium, which could prove a drag on further excess returns. Regardless, as rates move higher, potential relative total return leans towards CLOs.
- 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 associated with the U.S. consumer are generally supportive; however, we are beginning to see slight weakness in the auto market. Volatility in swap spreads risks excess returns, irrespective of credit spread dynamics. As various risk sectors remain generally well bid, expect ABS to continue to lag.

Emerging Market Debt

- EM debt continues to benefit from constructive domestic credit dynamics. Regional economic growth generally is on an uptrend, and is expected to continue into 2018 and further support the asset class. We look for Asian EM currencies to outperform, whereas Latin America should be weaker. 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 and South Africa.

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