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 Rates: look for higher yields in U.S. and Europe; steady in U.K. and Japan

Global Currencies: U.S. dollar to strengthen vs. developed market currencies, weaken vs. emerging markets; expect euro rally to slow

Investment Grade Corporates: remain constructive after a solid earnings season, continued strong demand

High Yield Corporates: we remain modestly overweight despite tight valuations

Securitized Assets: remain neutral agency mortgage-backed securities (MBS) despite expected new supply from balance sheet unwinding; tempered overweight to non-agency RMBS on valuations

Emerging Market Debt: EM growth still yields attractive opportunities to select countries; however, momentum beginning to fade

Balance Sheet in Focus, Tightening Still on Horizon

- As we approach the end of summer, the near-term focus for the bond market is the expected announcement detailing the Federal Reserve's plans for reducing its balance sheet. The reduction in holdings should start with $6 billion in U.S. Treasurys and $4 billion in agency debt and mortgage-backed securities, gradually rising to $20 billion per month over a year. The Fed is not the only central bank in play. Mario Draghi, head of the European Central Bank, will address the Jackson Hole Economic Symposium later this month and may offer some clues on the ECB's path to normalization. The outlook for Europe is firm, as the peripheral countries continue to help drive growth. As a result, we see U.S. yields ticking up modestly, but this move higher will be capped by continued demand for yield, particularly from foreign investors and banks. We also anticipate higher European yields; however, we believe the rally in the euro has gotten ahead of itself.
- Softer inflation and wage growth prompted the Fed to leave rates unchanged in July; as a result, market expectations for another hike this year have fallen below 40%. The collective "unwinding" of central banks' holdings is an indirect policy move and the Fed will no doubt be monitoring market reactions as well as economic data as it considers an additional 0.25% rate hike in December. We believe recent economic data keep the door open for the Fed to raise rates. Q2 GDP was good, as consumption and business investment shone. Inventories lagged unexpectedly but should contribute in the second half. What's more, July non-farm payrolls topped estimates and wages showed stabilization.
- As a solid earnings season wraps up, we remain constructive on corporate credit despite tight valuations; we also maintain modest overweights to select emerging markets (EM). We remain neutral on agency mortgage-backed securities, and have tempered our overweight to non-agencies on a valuation basis. We expect the U.S. dollar to strengthen against most developed markets but underperform EM currencies. Given our expectations for gradually rising rates, we continue to hold shorter duration postures across portfolios.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%) July 2017	Returns (%) YTD 2017
Barclays U.S. Aggregate	**100.0**	**40**	**0.4**	**2.7**
Treasury	37.1	0	0.2	2.0
Investment Grade Corporate	25.4	102	0.7	4.6
Fixed-Rate MBS	28.2	28	0.5	1.8
Other				
High Yield		352	1.1	6.1
Global Aggregate		38	1.7	6.2
Emerging Markets		262	0.9	6.0

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%) July 2017	Returns (%) YTD 2017
United States	2.3	EUR/USD	1.18	3.6	12.6
Germany	0.5	USD/JPY	110	1.9	6.1
Japan	0.1	USD/BRL	3.13	5.8	4.0

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

- We expect the trend of higher yields to continue in the United States and Europe, though this tightening cycle will be a gradual process with a number of digressions. We look for U.S. 10-year yields in the range of 2.50–2.75% with a steeper curve. Despite generally improving conditions, eurozone inflation data remain well below the European Central Bank's target, thus limiting their ability to raise short-term rates.
- The Bank of Japan has unofficially dropped its quantitative easing target, instead intervening in the markets to maintain a 10-year yield near zero with its 2% inflation target date pushed back to 2020. The Bank of Canada hiked and said it expects the nation's output gap to close around year-end, with inflation reaching its 2% target in mid-2018. The market is pricing in one more hike for 2017.

Global Currencies

- The euro has benefited from investment flows prompted by stronger eurozone growth, stable inflation and fading systemic risks. It should further appreciate against the U.S. dollar. The dollar should gain against select developed market currencies, particularly the pound and yen, but depreciate against select emerging market currencies.

Investment Grade Corporates

- The IG market had a strong month in July. Corporate spreads finished at +102 basis points (bp), tighter for the month and YTD. The long end had another strong month, leaving the credit curve looking more fairly valued. While the IG market remains well supported, spread tightening may be limited given the extremely strong performance over the last two months. We keep our rating at neutral given our original view for about 10 bp of tightening for full year 2017. We still expect to see tighter spreads given the continued demand for IG credit, fundamentals that are less of a headwind and a supportive economic environment. We like the valuation gap of financials and think BBB credits can benefit as the market grinds tighter.

High Yield Corporates

- Returns were strong as the search for yield continued to drive the HY market. Oil bounced back in July and the energy sector responded in kind, if not in magnitude, as the fundamental picture revealed that oil prices in the $45–50 range are still not great for a lot of HY producers. Fundamentals remain mildly positive though there are discernable pockets of weakness. Technicals appear balanced. The July rally has made valuations less compelling. At 352, option-adjusted spreads (OAS) have hit the level we consider fully valued; in fact, OAS ex-energy is now well below that level at 333. We remain modestly overweight.

Securitized Assets

- Agency RMBS have seen weak overseas demand YTD, and net supply is expected to increase by $180 billion in 2H 2017. What's more, Fed tapering could increase net supply about $12 billion by year-end. Despite this, we remain neutral on the asset class.
- A surge of new supply will generate some headwinds for commercial mortgage-backed securities (CMBS). While some fundamentals are more stressed, we maintain our overweight based on the high quality yield advantage versus other high quality sectors.
- Our outlook for collateralized loan obligations (CLOs) is positive due to attractive valuations and improving risk profiles. Tighter liability spreads have fostered arbitrage but also have moved much of the secondary market into premium pricing. As rates move higher, total return potential still favors CLOs, albeit less so than before.
- Asset-backed securities (ABS) fundamentals are becoming more of a question because of problems among subprime auto borrowers. Nonetheless, we do not believe the auto troubles will spill over into other sub-sectors and we expect ABS to continue to provide stable income.

Emerging Market Debt

- Growth within emerging markets (EM) will remain robust, supported by a contained U.S. dollar, low global rates and developed market growth. While some momentum is fading, we maintain our constructive stance on EM, with a bias towards hard currency sovereign issues and local currency interest rate risk. Country differentiation remains key, with idiosyncratic risks in Venezuela, Brazil, South Africa.

CMMC-FIMONTHLY 08161717 • IM0814-36483-0818 • **163124**