# Fixed Income Perspectives

## Hawkish Fed Begins New Era of Monetary Tightening

The U.S. Federal Reserve met expectations and increased interest rates by 25 basis points.

Through the melee of mounting inflation, flaring geopolitical risks and subsequently volatile capital markets, the U.S. Federal Reserve met market expectations and increased the target federal funds rate by 25 basis points (bps) while also validating market assumptions for how far the U.S. central bank will need to go to control inflation. That said, the Fed's long term view for the fed funds rate remains unchanged, reflecting their expectation that they can navigate the current environment.

Early in the year, market pricing suggested that a 50-bp increase was possible, not least due to a tightening labor market and persistent inflation. That possibility was dashed after Russia invaded Ukraine in late February, and volatility roiled global financial markets. Virtually all asset classes pulled back simultaneously as the Russia-Ukraine conflict flared, allowing investors little relief from the turbulence. A few investments managed gains, foremost among them commodities given Russia's status as one of the world's largest producers of oil, gas and, along with Ukraine, wheat. U.S. Treasuries also briefly rallied in a flight to quality. The other asset classes that posted gains were U.S. small cap stocks and U.S. Treasury inflation-protected securities (TIPS).

Should the Russia-Ukraine conflict persist, it could lead to further tightening of financial conditions via elevated energy prices, slowing economic growth on the margin. This may limit the Fed's desire to hike rates at the accelerated pace the market is currently projecting and should be mildly positive for bonds and neutral for equities. The key to sustained growth, in our view, will be a handoff from accommodative fiscal and monetary policies to a period of increased capex and investment from the private sector. Facing higher wages and input costs, companies have increased incentives to invest in productivity enhancing technology.

With corporate credit spreads appearing more attractive, we continue to look for opportunities to rotate some exposure from securitized credit. However, we believe volatility will continue until investors digest the comments made from today's Fed meeting. Until then, we remain selective on adding risk in the near term, despite cheaper valuations, and vigilant in our approach to duration.

## Bond Market Outlook

**Global Rates:** Yields edged higher driven by continued improvement in the labor market and persistent inflation

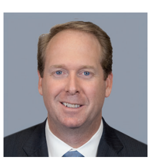
**Global Currencies:** U.S. dollar moved higher in a flight to quality

**Investment Grade:** Spreads continued to widen amidst broader turmoil, but fundamentals remain solid and valuations more attractive

**High Yield:** Technicals and fundamentals have settled from earlier in the year and poised for opportunity

**Securitized Credit:** Prefer areas in CMBS and CLOs where yield opportunities remain; residential credit still facing prepayment headwinds, but outlook is positive

**Emerging Markets:** Growth projections weakening amid headline turmoil and growing stagflation concerns



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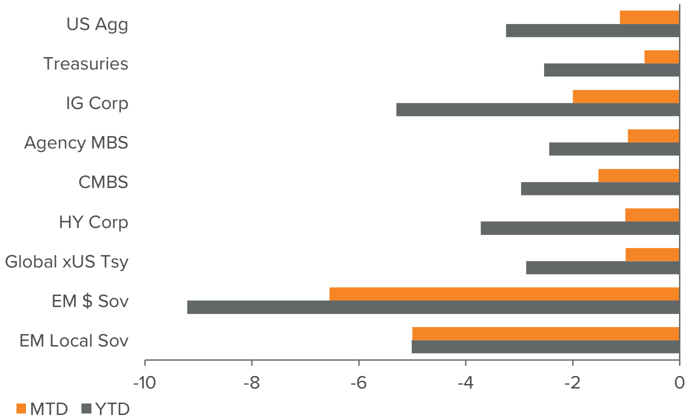
Voya Investment Management's fixed-income strategies cover a broad range of maturities, sectors and instruments, giving investors wide latitude to create a new portfolio structure or complement an existing one. We offer investment strategies across the yield curve and credit spectrum, as well as in specialized 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.

## Rates, Spreads and Yields

Fixed Income Sector Total Returns




| | | 28-Feb | 31-Dec | 1Y Low | 1Y High |
|---|---|---|---|---|---|
| Yields | US 2 Yr | 1.45 | 0.73 | 0.11 | 1.63 |
| | US 10 Yr | 1.83 | 1.51 | 1.17 | 2.05 |
| | GER 10 Yr | 0.14 | -0.18 | -0.50 | 0.31 |
| | JPN 10 Yr | 0.19 | 0.07 | 0.01 | 0.23 |
| | EM Local Sov | 6.29 | 5.72 | 4.68 | 6.33 |
| Spreads | IG Corp | 122 | 92 | 80 | 124 |
| | Agency MBS | 28 | 31 | 7 | 38 |
| | CMBS | 130 | 105 | 92 | 130 |
| | HY Corp | 359 | 283 | 262 | 372 |
| | HY x-Egy Corp | 357 | 276 | 252 | 370 |
| | EM $ Sov | 470 | 369 | 330 | 470 |

As of 02/28/22. Source: Bloomberg, Bloomberg/Barclays, JPMorgan and Voya. **Past performance is no guarantee of future results**.

## Sector Outlooks

### Global Rates and Currencies

Global growth overall appears to be bouncing back as Omicron restrictions loosen. While PMIs (purchasing manager's index) are likely to decelerate, the key question is, to what extent. Some suggest a decline below 50, but that is likely not a majority view among market participants, nor is it ours. Elsewhere, while there is evidence of easing supply chain pressures, there is still a long way to go to normalize supply chains. The sustainability of robust goods consumption will play a role in this shift. Meanwhile, a few dynamics that have us concerned include the impacts from central bank liquidity withdrawal potentially being underestimated by the markets and restrictive Covid policies in Asia continuing to weigh on the supply chain recovery. Also, uncertainty around wages keeping pace with prices are likely to continue and commodity price inflation may be more persistent than many realize given the Russia-Ukraine war. On that note, geopolitical developments have created a new threat to global growth.

The U.S. economy continues to show robust resiliency. Indeed, nominal goods spending still shows above trend strength while services spending is returning to trend. The Fed has turned more hawkish but remains data dependent. In our view, monetary policy tightening will have more of an impact on the risky assets than on the U.S. Treasury curve. Looking longer term, the seeds have been sown for capital expenditure (capex) to take the baton from the Fed but will they grow? The green transition, supply chain constraints and geopolitical conflicts all point to a need for local and global capex, but post the global financial crisis, investors have yet to take the bait. Will the mentality change?

Like the Fed, the Bank of England and the European Central Bank have been trending toward the hawkish side, but their more direct exposure to the Russian-Ukraine conflict could increase economic uncertainty and add to headline inflation. On balance, we think this is likely to dampen their hawkishness, at least over the short term. Nonetheless, the European Union is expected to outperform the U.S. in growth terms, primarily because NextGenerationEU disbursements are expected to be heavy this year, so less fiscal cliff risk than the U.S., and goods consumption having lagged in Europe thus far leaves room for the pent-up demand. However, after 2022, growth is expected to converge with the U.S. and then slip below.

### Investment Grade Corporates

New debt issuance was below expectations as a spike in volatility caused some sales to be pushed back. Investment grade (IG) spreads widened another 16 bps in February as geopolitical risks sparked uncertainty and are now 30 bps wider year-to-date and 40 bps wider than the tights of October 2021. We think it makes sense for IG spreads to find a new equilibrium level given higher volatility, and there are some signs that the current levels are enticing investors. Despite higher volatility, the fundamental picture looks solid, supporting our view that credit will be fine once uncertainty around Fed action and the geopolitical environment abates. We see an opportunity to add select IG risk and thus upgrade our outlook to slightly positive. The 30-year segment is starting to look attractive, and sector wise, we like still telecommunications, utilities and technology.

### High Yield Corporates

High Yield's rocky start to 2022 carried through into February, notwithstanding the Russia-Ukraine conflict. In fact, because the selloff happened earlier in the month on interest rate and inflation concerns, high yield's response to the conflict was rather muted. Weak technical dynamics that carried over from January slowly abated as February carried on and are now expected to be a modest tailwind. Fundamentals remain solid, albeit off their peak, and valuations, while not cheap, look reasonable. More broadly, we still caution that the big downside scenario would be persistent inflation forcing the Fed to hike into a weaker growth environment. The upside would be an alleviation of supply chain issues into a strong demand environment, resulting in growth with reduced inflation picture and a less hawkish Fed.

### Bank Loans

While the loan market was not immune to the risk off environment in early February, the sector outperformed most other asset classes leading up to the Russian invasion of Ukraine. Primary market activity slowed considerably over the course of the month with the aggregate volume of $24.7 billion, representing a 66% drop from January levels. Unsurprisingly, many deals broke for trading lower than their initial price talks. Nonetheless, demand for loans remained strong in the face of increased volatility. Collateralized loan obligation (CLO) issuance picked up after a relatively slow start to the year, as managers printed $13.8 billion of new vehicles for the month. Also, retail loan investors continued to flock to the asset class, seeking protection from rising rates. Default activity remained non-existent for a third consecutive month, and all signs point to continued low default activity in the near term, barring a material worsening of economic and credit conditions.

### Securitized Credit

Agency mortgage-backed securities (MBS) in February underperformed U.S. Treasuries due to hawkish Fed speak, increased interest rate volatility and geopolitical risk in Europe. While no issues along the coupon hierarchy gained for the month, the 2% segment suffered the most as the Fed continues to move its buying into the higher coupons. Among issuers, GNMA outperformed conventional mortgages due to strong technical support from commercial mortgage obligation (CMO) related buying and light origination. Domestic bank demand also contributed to GNMA's strength. In the near-term, mortgages will carefully balance the increase in rate volatility, while benefiting from an improved fundamental landscape. Looking further ahead, the known headwinds of Fed run-off, rate hikes, geopolitical turbulence, and elevated private market supply will be countered by improved carry and a more attractive prepay environment. However, performance will not be smooth as mortgages get caught between bouts of risk-on and risk-off events.

After the volatile turn in the credit risk transfer (CRT) market in late January/early February, other Non-Agency RMBS sub-sectors came under pressure in the subsequent days before stabilizing with more balanced flows. Supported by an array of positive credit conditions – indeed, the best we have ever seen – these wider levels are likely to offer continued stability even amidst today's choppy environment. Clearly, risk remains as technicals can turn negative on a dime. However, these risks exist across markets and if they materialize, we do not expect disproportionately negative results.

With January's outperformance a distant memory, commercial mortgage-backed securities (CMBS) picked up correlation with broader risk markets in February and traded materially weaker. With the move fueled by elevated issuance across SASB and CRE CLO in an environment of broad market volatility, we believe the move is technical in nature. While new issuance pipelines remain full and sponsorship is less robust, we have seen issuers reconsider timing. The appetite for credit risk remains deep and perceptions of risk have shifted definitively lower, so we expect widening to soon reach a ceiling and get purchased, but are not convinced as to when.

After initially being well received and catalyzing spread tightening, Asset Backed Securities (ABS) new issuance is likely to continue to be less well received and struggle to improve into quarter-end, absent a broad risk-on rally. Improved yield profiles are likely to attract more interest from income-focused buyers, but the competition from wider sectors limits outperformance potential. Still weak relative value versus CMBS and corporate credit, selling pressure could emerge should risk-off sentiment persist and redemption pressures mount. Furthermore, we continue to expect benchmark asset types that are more closely tied to the end of quantitative easing to experience weaker sponsorship, as the buyer base shifts from banks back to money managers.

### Emerging Market Debt

We are considering revising lower our 2022 EM growth outlook as stagflation concerns mount. Adding to the downward pressures is the continued lower fiscal impulse, high input prices, supply chain constraints and soaring energy prices. Emerging market (EM) growth rates have returned to pre-pandemic levels on average, but the outlook is differentiated. Asia is expected to exceed pre-pandemic levels for the fourth quarter of 2022, but CEEMA is expected remain range-bound while Latin America is expected to lag. EM fiscal paths are likely to be tested amid a redirection of expenditure towards subsidies (energy and utilities) and away from pandemic relief measures as Omicron wanes. Some Asian IG countries remain fiscally generous, even if restrictions ease. In Latin America, further fiscal deterioration is possible with more populist candidates leading in several major election races.

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