Commentary | 2Q25

Voya Core Plus Fixed Income SMA

Seeks total return through security selection, sector allocation and risk management

Strategy overview

A total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment grade securities.

Key takeaways

- In Q2 2025, markets continued to be driven by trade policies. Tensions peaked early in the quarter, driving volatility, but quickly eased allowing markets to recover. Meanwhile, resilient labor conditions and easing inflation prompted the U.S. Federal Reserve to hold rates steady.
- For the quarter, the Voya Core Plus Fixed Income SMA outperformed its benchmark, the Bloomberg US Aggregate Bond Index (the Index) on a both gross- and net-of-fees basis. Both sector allocation and security selection decisions contributed while duration and curve positioning detracted.
- With spreads back to recent tights, further upside appears limited, despite supportive fundamental factors across most fixed income sectors. As a result, portfolios remain positioned with a higher quality, shorter spread duration bias.

Market review

The second quarter of 2025 opened with a surge in global trade tensions as the United States implemented sweeping tariffs on a broad range of trading partners. The move branded "Liberation Day," caught markets off guard with tariff rates significantly higher than expected. The tariffs imposed on China stood out since the severity of the levy — along with further escalation and retaliatory measures—effectively erased the economic incentive for U.S.-China trade. Markets reacted swiftly and negatively: equities dropped into correction territory, credit spreads widened sharply—many sectors hit 12-month wides—and U.S. Treasuries, which had been rallying on expectations of slower growth, sold off as investor sentiment toward U.S. assets deteriorated.

Just days later, the U.S. administration announced a temporary reprieve, significantly reducing tariff rates to allow for negotiations. This reprieve, set to expire on July 9, 2025, helped stabilize markets. Although uncertainty remained, the easing of trade tensions allowed risk assets to recover gradually through the remainder of the quarter.

Economic data released during the quarter painted a mixed picture. 1Q25 gross domestic product (GDP) came in at –0.5%, marking the first contraction in three years. The decline was largely driven by a surge in imports, as businesses rushed to front-run the anticipated tariffs. This was mirrored by a buildup in private inventories and a rise in equipment investment. Consumer spending, the largest component of GDP, remained positive but slowed to just 0.5%, reflecting growing caution among households.

Despite the economic slowdown, the labor market remained resilient. Nonfarm payrolls averaged 135,000 new jobs per month in March, April, and May, while the unemployment rate held steady at 4.2% throughout the quarter. These figures suggest a labor market that is cooling but not collapsing—normalizing rather than deteriorating. This moderation in labor conditions has also helped ease wage pressures, bringing wage growth more in line with pre-pandemic norms.

Inflation continued its gradual descent from the elevated levels of 2022. Core personal consumption expenditures (PCE) inflation stood at 2.5% year-over-year by the end of April, edging closer to the Fed's 2% target. The decline was driven by easing services inflation, as wage growth slowed, and by a moderation in shelter inflation, which is still catching up to real-time rent indicators. Core goods prices remained flat, further contributing to the overall disinflationary trend.

Against this backdrop, the Fed held interest rates steady throughout the quarter. Market participants scrutinized every speech, set of meeting minutes and projection release for clues about the Fed's next move. On one hand, the current fed funds rate is widely viewed as restrictive, and with inflation nearing target and the labor market showing signs of balance, further rate cuts could be justified. On the other hand, the uncertainty surrounding the impact of tariffs on goods prices has made the Fed cautious. With unemployment still low and memories of past policy missteps fresh—particularly the Fed's delayed response to post-pandemic inflation—policymakers appear reluctant to move prematurely.

In fixed income markets, this uncertainty translated into heightened volatility. Treasury yields initially spiked on the tariff news, then retraced as the reprieve and softer inflation data took hold. Credit markets experienced a sharp widening in spreads early in the quarter, followed by a partial recovery as risk sentiment improved. Investors remained focused on balancing trade uncertainty against the potential for a soft landing.

Overall, the second quarter of 2025 was a study in contrasts: geopolitical shocks met with central bank restraint, economic weakness offset by labor market strength, and inflation easing just as new risks to price stability emerged. As the July 9, 2025, tariff reprieve deadline approaches, markets remain on edge, with the next chapter in trade policy likely to shape the trajectory of both the economy and financial markets in the second half of the year.

For the quarter, The Voya Core Plus Fixed Income SMA outperformed its benchmark, the Index on a both gross- and net-of-fees basis. With an underweight to Treasuries in favor of credit, sector allocation decisions contributed to relative performance as spreads retraced back to recent tights during the quarter. Our overweight to investment grade (IG) corporates was the largest individual contributor, followed closely by our allocation to high yield (HY) corporates. Security selection decisions also contributed, most notably within commercial mortgage-backed securities (CMBS), due to our preference for higher yielding private label deals. This was partially offset by negative selection results within IG corporates, due to our higher quality bias. Finally, our slightly longer duration profile detracted from relative performance, as longer-term rates finished the quarter higher.

Outlook

Looking forward, our outlook is shaped by a complex mix of policy shifts, structural labor dynamics and evolving inflation trends. Corporate investment has slowed in response to trade volatility, and higher import costs are expected to weigh on consumption. However, proposed tax cuts would support household incomes while deregulation efforts should improve business efficiency. As a result, we expect growth to slip below trend in the near term, but stage a gradual rebound further out.

On the inflation side, we expect the transmission of tariffs to consumer prices to be relatively slow, largely due to limited corporate pricing power and the fluid nature of trade policy. This should cap the "peak" in inflation, while extending its duration. Encouragingly, both shelter and services inflation should continue normalizing, reinforcing the underlying disinflationary trend. These developments should help anchor inflation expectations, even monthly prints tick higher.

As for labor markets, employers still appear wary from recent labor shortages and are reluctant to lay off workers. This has created a "low hiring–low firing" environment. We expect this dynamic to continue and lead the unemployment rate to drift higher. Similarly, wage growth should remain subdued, especially at the entry level, where artificial intelligence adoption is exerting downward pressure. However, stricter immigration policies may support wages for lower-income workers by tightening labor supply in certain sectors.

With the labor market showing signs of softening and inflation expectations remaining anchored, we expect the Fed's focus to shift toward supporting employment, and resume cutting interest rates toward a more neutral level.

For fixed income investors, elevated yields offer the potential for attractive total returns however, policy uncertainty will continue to drive episodes of volatility. That said, the current administration's sensitivity to bond market reactions should help limit the severity and duration of these disruptions, but we have positioned the portfolio with a higher quality bias so we can take advantage of these disruptions.

Credit markets have largely recovered from the "Liberation Day" shock, with spreads tightening back to levels that appear rich. As of quarter-end, IG corporate spreads were just 83 bp, a level that suggests markets are once again pricing in a near-perfect scenario. While corporate fundamental factors remain supportive, spreads at these levels leave little room for error, particularly as it relates to trade or policy risk. As a result, we further reduced our exposure to IG corporates during the quarter, with a focus on selling BBB-rated issuer names. HY corporates also look stretched from a valuation perspective, while securitized credit sectors offer more compelling opportunities. CMBS, in particular, is still in the early stages of recovery, and there is growing risk appetite for select office properties—albeit within a narrow subset. CMBS remains one of our top sector overweights, at just over 10% (9% relative) as of quarter end. High quality collateralized loan obligations (CLO) also stand out as a relative value play. For example, AAA-rated CLOs were offering spreads of over 130 bp at quarter-end, significantly wider than similarly rated corporate bonds. Our CLO allocation stood at roughly 8% as of quarter end, with 5% in tranches rated AAA.

In sum, our outlook is one of cautious optimism. Growth is likely to remain subdued in the near term but should improve as clarity on trade emerges, a more favorable mix of policies are implemented, and productivity gains take hold. Inflation is well off its peak, expectations remain anchored, and the Fed is poised to ease policy in response to labor market softening. While credit valuations in corporate sectors appear stretched, the fundamental picture is broadly positive. Meanwhile, opportunities remain in securitized markets, where early cycle dynamics and relative value are lined up to provide attractive outperformance. Navigating this environment will require selectivity, but the backdrop remains supportive.

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