Voya Intermediate Bond Strategy

Dynamic Core Bond Strategy

Strategy overview

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

Key takeaways

- Yields whip-sawed during the quarter. An early rally was unwound in reaction to strong January payroll data and then rallied again late in the period over banking concerns.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index), on a net asset value (NAV) basis. Security selection and sector allocation added to performance, while duration and yield curve decisions detracted.
- High levels of rate volatility illustrate the lack of certainty regarding the direction of the US Federal Reserve, the economy and markets guiding us to a relatively defensive positioning.

Portfolio review

For the quarter ended March 31, 2023, the Strategy outperformed the Index, on a NAV basis. Security selection and sector allocation contributed, while duration and yield curve decisions detracted.

Like a new year's resolution, the new year's bond rally was short-lived. Early in the quarter, bond markets rallied, supported by Purchasing Managers' Index (PMIs) that continued to contract, and the post pandemic boom showed signs of fatigue. Consumer spending began to fall, particularly in the goods sector, and commensurate measures of inflation were also trending lower. This optimism was extinguished with the release of January's payroll report, which showed a massive gain of more than 500,000 jobs. At the same time, wage inflation that had previously been trending lower was revised higher. This was followed by additional economic data showing big month-over-month advances in consumer spending. As a result, rates reversed course with the 10-year Treasury yield testing its 2022 high just as Chairman, Jerome Powell, testified before Congress reaffirming the Fed's commitment to tackle inflation.

In the final month of the quarter, the direction of interest rates reversed course in a flight to quality as three US regional banks failed, with two being taken into receivership by the US Federal Deposit Insurance Corporation. The news sparked concerns over the risk of a systemic banking issue that reached a fever pitch with a Swiss government negotiated takeover of Credit Suisse by rival UBS. Banking regulators were quick to respond to these events. In the United States, the FDIC took the extraordinary measure to backstop all uninsured depositors at these failed institutions, the Federal Reserve instituted a new borrowing facility and the Treasury engaged with financial institutions to support larger regional banks. In hindsight, the most significant issue at these failed banks was on the liability side. For example, Silicon Valley Bank's depositor base was overly concentrated with technology companies with high cash burn rates as well as an abundance of uninsured depositors. This combined with the Fed's aggressive monetary policy made for an unsustainable business model. The result of this turmoil has been a higher cost of capital for banks and an expectation that most banks will look to shore up capital, raising the bar for lending. Given this would put clear downward pressure on growth and inflation, rates rallied and ended the quarter lower, and the Bloomberg US Aggregate returned 2.96% for the period.

In credit markets, total returns were strongly supported by the decline in rates late in the period while excess returns were mixed. Spreads ebbed and flowed throughout the quarter, responding to the macro news. Corporate spreads tightened to start the quarter, widened post banking crisis — particularly in financials, then finished roughly where they started as the risk of contagion seemed to diminish following the launch of a new Fed facility. The elevated rate volatility proved to be a challenge to agency residential mortgage-backed securities (RMBS) for the period and they were unable to keep pace with the Treasury rally. Commercial mortgage-backed securities (CMBS) also struggled and spreads widened disproportionately following the bank failures. With regional banks having such a large presence in the commercial real estate market, a tightening of lending standards will translate to more difficult refinancing conditions for maturing loans.

Security selection and sector allocation added to performance, while duration and yield curve decisions detracted. Security selection drove performance for the period, with notable gains in investment grade (IG) corporates, agency RMBS and asset backed securities (ABS). IG corporate selection included a more defensive allocation with respect to maturities, an overweight to utilities and no exposure to the regional banks capturing the headlines. Agency RMBS selection that included collateralized mortgage obligations (CMOs) and other non-standard pools also added. Gains in ABS security selection that included high quality collateralized loan obligations (CLOs) added to relative returns as the yield advantage positively contributed. Sector allocation in aggregate was positive, with gains from non-agency RMBS and ABS modestly offset by detractions from CMBS, high yield and our decision to be underweight US Treasuries. Our most significant shift during the period was in agency MBS. We entered the year with a significant overweight that we cut on the heels of solid performance in January. We deployed modest allocations in IG Corporates and CLOs as rates sold off and spreads reacted to the rate volatility. While duration was broadly in line, yield curve positioning and the convexity profile of the Strategy weighed on performance and offset some of our gains for the period.

Current strategy and outlook

High levels of rate volatility illustrate the lack of certainty regarding the direction of the Fed, the economy and markets. On the one hand, we believe the left tail risk of reaccelerating inflation has diminished, on the other a new scenario of a more widespread banking crisis has taken its place. While the likelihood of either of these scenarios materializing remains slim, so does the likelihood of a soft landing. All of this adds to the challenges of navigating this environment.

We remain relatively defensive, with a preference for higher quality spread sectors such as IG corporates and agency mortgages. We are comfortable with our mortgage credit exposure (non-agency RMBS and Credit Risk Transfer securities). Commercial real estate will likely face difficult refinancing conditions going forward, testing the CMBS market. However, in a departure from the previous, long-standing paradigm of “location, location, location”, property type has emerged as the key dimension that will likely drive future credit performance. In CMBS, our preference is tilted toward multi-family properties, and away from office. With a bias towards liquidity, tactical trades will most likely take place in the corporate arena.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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The strategy employs a quantitative model to execute the strategy. Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect performance. Furthermore, there can be no assurance that the quantitative models used in managing the strategy will perform as anticipated or enable the strategy to achieve its objective.

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