Voya Perspectives | Market Series | January 2019

Fixed Income Perspectives

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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.

Bond Market Outlook

Global Rates: Fed to pause interest rate hikes in 1H19, with two total hikes expected in 2019

Global Currencies: U.S. dollar to weaken against euro and select EM currencies

Investment Grade: valuations look more attractive after recent sell-off but technical forces dominate near-term spread moves

High Yield: yields nearing 8% make the asset class more attractive, particularly given low defaults and a pause from the Fed on the horizon

Securitized: maintain preference to non-agency RMBS, CMBS and higher quality single-A tranches of CLOs

Emerging Markets: trade uncertainties and busy election cycle to create idiosyncratic opportunities

Navigating Volatility: Six Macro Themes for the First Half of 2019

In our 2019 outlook, we highlighted the importance of positioning portfolios to avoid downside velocity. In this issue, we provide a more granular look at the key macroeconomic developments we expect to help determine our overall risk budget and inform our bottom-up security selection process.

1. **U.S. Growth:** Weaker global growth and fading benefits from U.S. fiscal policy and monetary stimulus will lead to deceleration in U.S. growth towards trend. Domestic investment and improved productivity, however, will continue to support modestly higher potential growth
2. **Federal Reserve:** The tightening effect of previous actions, softer payroll growth and lack of inflationary pressure will lead the Fed to pause its hiking program
3. **European Growth:** International headwinds and tepid internal consumption will result in lackluster growth with political uncertainties, skewing risks to the downside. The ECB will not tighten its policy stance
4. **China:** Large fiscal capacity will allow China to manage the deceleration of economic growth. China will favor fiscal over monetary stimulus to support growth and mitigate the impact of trade uncertainty and ongoing structural reforms.
5. **Trade:** The uncertainty created by the U.S.–China trade war will incrementally limit investment and tighten financial conditions, which will continue to weigh on global growth. Reduced global trade is a lose-lose proposition and the eventual stepping back by both parties will provide the scope for an upside impulse
6. **Markets and Volatility:** Markets have repriced to reflect lower growth, and will overshoot as investors overestimate downside risks. We believe this will provide opportunity as a more benign scenario plays out

Spreads, Returns and Yields

			Returns (%)	
Index/Sector	**Percentage of Index**	**Spread (bp)**	**Dec. 2018**	**FY 2018**
Bloomberg Barclays U.S. Aggregate	**100.0**	**54**	**1.84**	**0.01**
Treasury	38.9	0	2.15	0.86
Investment Grade Corporate	24.3	153	1.47	-2.51
Fixed-Rate MBS	28.2	35	1.81	0.99
Other				
High Yield		526	-2.14	-2.08
Global Aggregate		55	2.02	-1.20
Emerging Markets		415	1.35	-4.26

			Returns (%)	
Country	**Yield on Ten-Year Bonds (%)**	**Currency**	**Dec. 2018**	**FY 2018**
United States	2.69	EUR/USD 1.15	1.33	-4.48
Germany	0.24	USD/JPY 110	3.54	2.73
Japan	0.03	USD/BRL 3.88	-0.21	-14.61

Source: Bloomberg, 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 Outlooks

Global Rates and Currencies

With headlines painting the yield curve inversion as a precursor of economic doom, it is important for investors to remember that an inverted yield curve represents fear of a recession, it does not cause a recession. Investors still should assess the fundamental picture. While we see a deceleration in U.S. growth towards trend, we expect investment and improved productivity will support a modestly higher level of potential growth.

We expect rates in the Eurozone to trade higher, with 10-year German Bunds in a 30–60 basis point (bp) range. Meanwhile, long-end interest rates continue to push higher in Japan. Since 2016's drop in yields to 0%, the Government Pension Investment Fund (GPIF) has been reallocating JGB positions to short-term assets. The rise in yields is not yet enough to entice the GPIF back to JGBs.

Investment Grade Corporates

Investment grade (IG) spreads continued to widen through December as Fed rhetoric and declining oil prices rattled investors, while a number of idiosyncratic events weighed on different parts of the IG market. Most notably, concerns about oversupply of BBB-rated credits dominated the press, and we saw BBBs underperform by the most all year. Overall, the outlook for credit remains solid with earnings reinforcing a supportive fundamental picture. Valuations look more attractive after the recent sell-off, but technical forces are likely to dominate near-term spread moves.

High Yield Corporates

The pullback in high yield that began in October ended up pulling the market into negative territory for the year. Fundamental fears continued to deepen around Chinese and European growth, along with a slowdown in U.S. housing. The massive plunge in oil prices further pressured to the downside, as did concerns around the Fed tightening cycle. Valuations have become considerably more favorable as the market has repriced. Market yields are nearing 8%. With a pause from the Fed on the horizon, coupled with continued low default rates, these levels start to look attractive. We believe positive technicals and improved valuations should lead to near-term outperformance.

Securitized Assets

Collateralized loan obligations (CLOs) experienced volatility in December, driven primarily by concerns regarding looser lending standards and heavy new issuance. Concerns about demand also weighed on the CLO market, since U.S. regulations imposed after the financial crisis have effectively forced out highly leveraged, short-term investors. Asset managers and insurance companies have emerged to take their place; these more stable longer-term oriented investors currently represent a significant portion of CLO market participants. We believe this new market dynamic will help curb outflows and spread widening. Overall, we are neutral on CLOs, preferring higher quality single-A tranches.

Agency residential mortgage-backed securities (RMBS) performance bounced around before firming up towards year-end. Fundamentals remain solid with subdued prepays while the Fed's transparency has helped the market adjust to the additional supply. Lack of Fed demand should impair the performance/financing rates for the production coupons, but slower prepays should provide a buffer for premium coupons.

We maintain a positive but moderating outlook on non-agency RMBS: sector attributes resonate with investors even as the housing market slowdown continues. For credit risk transfer, relative value has improved somewhat and demand remains firm for this floating-rate asset class. For legacy product, the opportunity set continues to dwindle. We expect stout technicals and strong credit performance to sustain a bid.

Credit spreads of commercial mortgage-backed securities (CMBS) were wider in December, but the sector still outperformed corporate credit markets. With relatively firm investor interest, a manageable new issue pipeline and supportive fundamentals, we look for CMBS to perform well into the start of 2019.

Emerging Market Debt

EM growth momentum has been slowing — headwinds include trade uncertainties, continued U.S. dollar strength, tighter financial conditions, weaker PMIs and declining commodity prices. China's stimulus plan to counteract trade war impacts will determine the path of commodity prices and consequently the outlook for EM corporate fundamentals for 2019. Heightened political risks add noise to investor strategies, notably election risks in Nigeria, Indonesia and South Africa, as well as newly-elected presidents in Brazil and Mexico.

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