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: gradually rising rates in United States, steady in Europe and Japan

Global Currencies: U.S. dollar strengthens vs. euro and yen; steady vs. pound, weaker vs. select emerging market currencies

Investment Grade Corporates: solid fundamentals and continued economic growth drive spreads tighter despite recent pullback

High Yield Corporates: slightly increasing exposure after pullback left attractive entry point; fundamentals remain decent, default risk low

Securitized Assets: maintain a positive stance on CLOs and CMBS while underweight agency RMBS

Emerging Market Debt: remain constructive on EMD but country differentiation still is key

Counting the Days Until December

With year-end approaching, we're closing in on the Federal Open Market Committee's (FOMC) final meeting of 2017. The FOMC left rates unchanged in October and kept an upbeat stance, asserting the labor market continues to strengthen and economic activity is "rising at a solid rate." The Fed continues to guide market expectations towards a third hike in December, which is now fully priced in after the October core CPI print came in above expectations and wage growth trended higher. With Jerome Powell set to succeed Janet Yellen as Fed Chair, the gradual approach to policy normalization and balance sheet reduction should continue under the new regime.

The European Central Bank announced an extension of its quantitative easing program to September 2018 at a reduced pace, and promised to continue negative policy rates beyond the end of QE. While eurozone GDP is strengthening, core inflation is lagging; which is why President Draghi is maintaining a dovish policy. With his term set to end in October 2019, it's unlikely Draghi will get to hike rates.

Meanwhile, what has been dominating headlines, and markets, is the uncertainty about the prospects for tax reform. We believe some variation of reform focused more on corporations will make it through Congress. Such a measure would be more supportive of longer-term growth than tax cuts alone, which would provide merely a short-term bump in growth.

Recent doubts whether any meaningful reform will be enacted have led to a pullback in risk assets and a widening of spreads. Instead of a broad risk sell-off, we see this pullback as a modest correction in areas that may have been stretched too far. It therefore opens an attractive entry point for certain asset classes. Accordingly, we are tactically increasing allocations to investment grade and high yield bonds, while maintaining a positive stance on securitized assets such as collateralized loan obligations (CLOs) and commercial mortgage-backed securities (CMBS). We still like select emerging markets as global growth continues to improve. Finally, we continue to hold a shorter duration stance across multi-sector strategies in anticipation of modestly higher rates in the United States.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			Oct. 2017	YTD 2017
Bloomberg Barclays U.S. Aggregate	**100.0**	**38**	**0.1**	**3.2**
Treasury	37.0	0	-0.1	2.1
Investment Grade Corporate	25.3	98	0.4	5.6
Fixed-Rate MBS	28.2	22	0.0	2.3
Other				
High Yield		341	0.4	7.5
Global Aggregate		36	-0.4	5.8
Emerging Markets		246	0.4	7.9

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			Oct. 2017	YTD 2017
United States	2.38	EUR/USD 1.16	-1.42	10.74
Germany	0.36	USD/JPY 114	-0.99	2.92
Japan	0.07	USD/BRL 3.27	-3.33	-0.65

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 Overviews

Investment Grade Corporates

The IG market rallied to post-crisis tights before experiencing a pullback of late. The market continues to be broadly supported by earnings, fundamentals and lower supply. Higher rates and a stronger U.S. dollar support foreign buying of U.S. credits. While valuations suggest further upside is limited, favorable fundamentals, strong technicals and a supportive macro outlook mean a grind tighter into year-end is the most likely path. We like the valuation gap of financials and think BBB spreads can still compress slightly.

High Yield Corporates

The backdrop for high yield remains constructive, and we still expect to see an improved pace of growth as we move through the end of 2017. For the market as a whole, credit fundamentals continue to trend positively, resulting in low default expectations. The technical picture remains positive despite recent outflows, as the search for yield continues and new supply remains manageable. Spreads closed in on their post-crisis tights before pulling back recently. We still see the potential for continued near-term outperformance supported by growth, both domestically and abroad, and will look for pullbacks to take advantage of attractive opportunities.

Securitized Assets

Agency residential mortgage-backed securities (RMBS) finished the month with slightly tighter spreads vs. U.S. Treasurys. At current spread levels, near-term mortgage performance is skewed to the downside as Fed tapering will result in increased supply. Therefore, we maintain our underweight to the sector.

Non-agency RMBS will continue to be driven by a recovering housing market. Upside remains as credit availability increases, home ownership bottoms and the burgeoning millennial demographic engages. As a result, we remain constructive, particularly from a fundamental perspective, but note that tight valuations may limit near-term upside potential. Within non-agencies, the outlook for credit risk transfer (CRT) securities has improved as data from hurricane-impacted areas increase the certainty of loss projections. Nevertheless, with valuations close to recent tights and elevated volatility still in the rearview mirror, we have subdued enthusiasm for CRT and have trimmed our allocation to the sector.

Asset-backed securities (ABS) remain well supported by consumer spending and no signs of broad consumer credit degradation. Subprime auto borrowers remain a concern, but we still don't believe the auto sub-sector's troubles will spill into other sub-sectors. We remain constructive on spread levels.

We maintain a positive near-term outlook for collateralized loan obligations (CLOs) for their attractive relative value and stable risk prospects. Demand remains strong even with elevated supply. As rates move higher, potential relative total return performance leans towards CLOs.

We hold a positive near-term view of commercial mortgage-backed securities (CMBS), because of favorable technical factors and sustained relative value. Longer term, the fundamental story has somewhat plateaued as concerns remain about property valuations and the vitality of the retail sector.

Emerging Market Debt

Growth momentum and macro fundamentals within emerging markets (EM) remain on an upward trend as external accounts continue to improve and EM corporations enhance their liability management and reduce debt. Country differentiation remains key as valuations are tight. Of late, uncertainty stemming from the anti-corruption raid in Saudi Arabia has produced some volatility in oil prices and subsequently slowed the rally. Nonetheless, we remain constructive on EM as global growth continues to improve.

Global Rates and Currencies

U.S. rates gradually increased in October, with the long end slightly lagging the short end, resulting in modest flattening of the yield curve. We see this trend of higher yields continuing, driven by prospects of improving growth – manufacturing levels continue to remain elevated – and stronger inflation – the October CPI print should give the Fed comfort as inflation continues to trend towards its 2% target. In the eurozone, continued dovish policy by the ECB, largely due to lagging inflation, will keep rates low; resulting in an increasing yield differential between U.S. and German government bonds. Across the channel, the Bank of England raised rates for the first time in a decade, but like its Yankee counterpart, stressed that further tightening will be gradual and limited.

The U.S. dollar has slowed after strengthening over the better part of the last two months. We expect it to regain its form and continue to appreciate versus other developed market currencies, but lag select EM currencies tied to faster-growing economies. The euro will weaken largely due to policy decoupling among the U.S., U.K. and eurozone. Finally, we expect the yen to weaken as it remains highly inversely correlated to the global risk rally.

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