Fixed Income Perspectives

Worried About Inflation? Pay Attention to Labor Participation

Worried about inflation? Pay close attention to how labor market dynamics unfold over the next three months

U.S. consumer prices see their largest increase since 2008, topping all estimates. That summarizes headlines about recent inflation data. Since the beginning of this year, our view has been that the change in the Fed's framework would lead to higher "cyclical" inflation, but that the near-term pickup in prices would ***not*** translate to structural long-term inflation, i.e. cause the Fed to pump the brakes on accommodative policy earlier than expected.

Recall that under the Fed's new inflation targeting approach, after periods of persistently low inflation, the Fed said it would tolerate inflation moderately above 2% "for some time," to allow the economy to solidify a recovery. Of course, "for some time" is open-ended and subjective language. As with anything new and subjective coming from the Fed, the market likes tangible events to help it interpret what it *actually* means for policy decisions. Well, with the July inflation print, the market certainly received something tangible. Consumer prices increased 5.4% in July and the Fed did not blink. For market skeptics who have yet to take the Fed at its word, the Fed's response to July inflation should be another indicator that the Fed is in no hurry to deviate from its path of easy monetary policy until the economic recovery is fully underway and solidified.

To fully understand and prepare for the potential risk of inflation, we believe it is essential to disentangle price increases from the reopening of the economy from the more structural price increases that are part of a new business cycle. In our view, to do this, it is essential to monitor wage trends outside of the industries most heavily affected by the pandemic. We are closely monitoring unemployment benefits, which are rolling off on different schedules across each state. With this more nuanced perspective, we believe we will be able to better assess the full scope of the inflation threat, and have a better understanding of how wage trends and labor participation is likely to play out over the next several months.

Bond Market Outlook

Global Rates: Policy rates stay to stay low over the near term as investors digest growth, monetary policy outlook post-reopening rebound

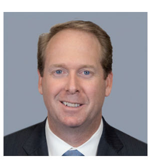
Global Currencies: U.S. dollar to remain resilient vs DM, EM currencies

Investment Grade: Near-term outlook for IG credit remains positive, but still tight valuations warrant defensive positioning

High Yield: We are optimistically neutral, acknowledging that potential summer weakness could produce opportunities, but feel momentum overall is generally positive heading into the last few months of 2021

Securitized: Agency RMBS beginning to look cheap versus other spread sectors; non-agency RMBS battling elevated prepayment risk in near term

Emerging Markets: EM continued continues its unsynchronized growth; fiscal behavior and strategy will remain under scrutiny as renewed lockdowns loom



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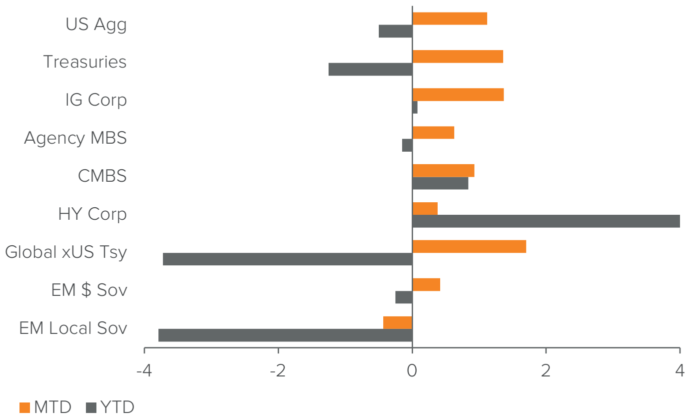
CIO Fixed Income

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.

Rates, Spreads and Yields

Fixed Income Sector Total Returns



		31-Jul	30-Jun	1Y Low	1Y High
Yields	US 2 Yr	0.19	0.25	0.11	0.26
	US 10 Yr	1.22	1.47	0.51	1.74
	GER 10 Yr	-0.46	-0.21	-0.64	-0.10
	JPN 10 Yr	0.02	0.06	0.01	0.16
	EM Local Sov	4.92	4.98	4.19	5.06
Spreads	IG Corp	86	80	80	140
	Agency MBS	31	27	7	69
	CMBS	96	95	92	188
	HY Corp	294	268	262	537
	HY x-Egy Corp	280	257	252	492
	EM $ Sov	356	340	330	446

As of 07/31/21. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya. **Past performance is no guarantee of future results.**

Sector Outlooks

Global Rates and Currencies

Heading into the final stretch of 2021, some of the key concerns we're paying close attention to include global growth, i.e. whether developed markets will face the same fate as China when the reopening-driven booms end, and the impact on global liquidity from the U.S. Treasury's General Account drawdown, the ECB's Quantitative Easing, and softening in China. We're also keeping a close eye on the synchronization of the U.S.-led recovery with the rest of the world, and perhaps even more so on the efficacy of COVID vaccines toward new variants, as the threat of renewed or even prolonged lockdowns could impact the reopening of central business districts.

In the U.S., we remain focused on how fast excess savings are spent as the economy reopens. Indeed, while Q2 GDP was somewhat weak, two key positives were strong private sector investment and solid consumption. Other key elements to note are the infrastructure deal is finally happening and the size will likely between $2.5-$4.5 trillion.

Eurozone growth was revised higher, led by members on the periphery, and the region is enjoying the benefit of a rebound in goods and services.

Investment Grade (IG) Corporates

Rates continued to be the story in July with the technical unwind of short positions creating further downward pressure. We saw some signs of lower demand from yield-based buyers, and what appeared to be some opportunistic new issuance. The market continues to shake off elevated inflation numbers, with the FED narrative of transitory inflation remaining the market expectation for now. Vaccine news continues to be generally positive and should continue to support the recovery, led by consumers and pent up savings. Higher expected 2021 US GDP is supportive for Corporate fundamentals. While our near-term outlook for credit remains positive, we keep our strategic and tactical rating at Neutral. Despite the lack of an identifiable catalyst, with think risk-reward is skewed to the negative so we suggest maintaining a defensive position. We see less value in 7- to 9-year bonds with the Treasury curve flattening and swap back into 10-year, on the run bonds, where attractive. Sector wise, we continue to like Utilities and Financials to help maintain a defensive posture.

High Yield Corporates

July saw a bit of a reversal from previous months in that higher credit quality issues continued their summer rally, but riskier bonds showed some cracks on growing concerns about the spread of COVID's Delta variant and its impact on global growth. However, the good news is high yield is lapping some previously harsh quarters, and momentum is generally positive. So far, there seems to be enough pricing power to maintain or even improve margins. Indeed, ratings are trending positively and the default rate is plunging. Of course, Delta remains the wild card in this story. Our current expectation is for a short, steep wave, like what other geographies have experienced, and it probably have a limited impact. On the new issue front, a slow start to July brought volumes slightly below expectations, but we get the sense that it's just a delay of inevitable: Expectations for the Fall pipeline continue to be robust, which will keep a lid on gains for the next few months.

Securitized Assets

Agency MBS underperformed Treasuries as rates rallied and volatility increased. However, mortgages did recoup some losses following the Fed's FOMC meeting, which confirmed that there is little support for tapering MBS earlier than Treasuries. Although spreads are expected to widen as FED tapering approaches, bank buying should support mortgages and continued strong-roll financing should help mortgages out-carry Treasuries in the near-term. Additionally, prepayment speeds are slowing and dampened taper talk from the Fed meeting should renew appetite for MBS outside the Fed if rates can stabilize.

We continue to carry a cautious outlook for Mortgage Credit, but with a different qualification than earlier in the Spring. With prepayment risk, duration modeling and call risk all still issues for total return driven market participants, the space is poised to continue to lag. Add in significant supply spillover from overloaded GSEs, elevated Prime Jumbo issuance and a better focused non-QM ecosystem, RMBS can add technically induced sloppiness to prepay risk catalyzed negatives.

CMBS's strong start to the year has extended well into the summer, as credit appetite is deep and perceptions of risk are shifting lower, justifying tighter spreads further down the capital structure. While euphoria from the vaccines, reopening, etc., is fading, sentiment remains generally positive on the back of continued repair of distressed situations. We believe we will see this going forward in a more measured pace of tightening but tightening none-the-less. As spreads in competing risk sectors continue to rally, CMBS cheapness remains and this becomes clearer as fundamentals continue to evolve mostly favorably.

Non-benchmark ABS will continue to perform well fundamentally and command strong sponsorship from money managers with low-vol, low-return seeking strategies. However, with spreads now at, or through, pre-COVID tights after a strong June, outperformance is likely to be limited, with returns coming from carry and idiosyncratic tightening from ratings upgrades. We maintain our assessment as positive and increase our conviction. The fiscally improved profile of the US consumer coupled with ABS structural dynamics were already believed to provide the sector with solid footing to withstand this sustained period of elevated, albeit improving, unemployment. Indeed, recently enacted stimulus is acting as a fortifying bridge to the end of the pandemic.

Emerging Market (EM) Debt

The momentum and strength of the US economy coupled with the gradual re-opening in Europe continued to be supportive of the global recovery, as demand switches from goods to services. As such, we expect global capital flows to EMs will correlate to favorable global financial conditions. The multi-speed and unsynchronized EM growth rebound is expected to continue, along with a strong rebound in goods trade as demand picks up, but supply chain uncertainties are a concern. Headline inflation continues to rise due to consumer demand, forex pass-through and higher commodity prices. EM corporates continued to see earnings improvement, led by commodity producers that benefited from rebounding oil and metal prices.

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