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.

Bond Market Outlook

Global Rates: U.S. yields to trade range-bound as trade concerns limit upward momentum, eurozone and Japan yields to tick higher

Global Currencies: U.S. dollar strength to begin to wane, particularly against euro, select EM currencies

Investment Grade: Strong Q2 earnings underscore fundamental support despite technical headwinds

High Yield: fundamentals remain positive but valuations leave select opportunities

Securitized: spreads for agency RMBS more attractive; securitized credit to continue to benefit from U.S. economic, consumer strength

Emerging Markets: volatility to lead to idiosyncratic opportunities and risk, as select countries' fundamentals continue improving trend

Trade Wars Trigger Headline Volatility

Moving into the second half of 2018, trade concerns continue to dominate the financial market narrative. While the economic impact remains to be seen, ongoing trade tensions are likely to create additional episodes of volatility in the near term. In this environment, we remain focused on our central theme throughout the year: positioning portfolios to avoid downside velocity. In the context of trade concerns, this means reducing exposure to investment grade credit, where issuers have a more global orientation, as well as closely monitoring emerging market debt where opportunities may emerge from the trade-induced volatility.

In addition to trade concerns, the yield curve continues to flatten and investors are beginning to question if an inversion is imminent. Not quite yet — our approach continues to be cautious, not bearish, and several factors continue to support our view. While there is continued flattening pressure on the curve, we believe the Federal Reserve will shift to a more data-dependent approach after two more rate hikes this year. This will limit the upward momentum on the front end of the yield curve despite increased supply from funding needs. Additionally, the move on the long end of the yield curve has been relatively stable, and inflation expectations, while higher, are unlikely to accelerate.

Overshadowed by the headlines about potential trade wars and yield curve inversion is the ongoing strength of the U.S. consumer. Consumer confidence is still strong despite trade rhetoric, while turnover and refinancing in the mortgage space are elevated, showing consumers' willingness to be more aggressive. In addition, the savings rate is declining, which should increase spending. While non-housing segments require monitoring, the expansion in consumer debt is less aggressive than the previous cycle as fewer loans are being issued to borrowers with weaker credit profiles.

U.S. assets look most attractive in this context — particularly floating-rate, securitized instruments, which offer exposure to these strong U.S. fundamentals. We maintain our positive stance on collateralized loan obligations (CLOs), credit-risk transfer securities (CRTs) and commercial mortgage-backed securities (CMBS).

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%) July 2018	Returns (%) YTD 2018
Bloomberg Barclays U.S. Aggregate	**100.0**	**40**	**0.02**	**-1.59**
Treasury	37.9	0	-0.42	-0.49
Investment Grade Corporate	25.0	109	0.83	-2.47
Fixed-Rate MBS	28.1	27	-0.11	-1.06
Other				
High Yield		336	1.09	1.25
Global Aggregate		43	-0.17	-1.62
Emerging Markets		326	2.56	-2.81

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%) July 2018	Returns (%) YTD 2018
United States	2.96	EUR/USD	1.17	0.06	-2.62
Germany	0.44	USD/JPY	112	-0.98	0.74
Japan	0.06	USD/BRL	3.76	3.17	-11.95

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

We believe the Federal Reserve will hike two more times, totaling four hikes, in 2018. This will keep flattening pressure on the yield curve, but for now we are not concerned about an inversion or recession; rather, we think the flattening is a building signal from the market to the Fed that it should slow its pace of rate increases. We expect the 10-year U.S. Treasury yield to increase and trade in a 3.00–3.15% range. Rates drifted lower through June, and with the 10-year rate now below our target range, we continue to hold a higher-rate position.

We expect eurozone rates to trade higher, with 10-year Bunds back in the 50–75 basis point (bp) range. Along with other factors that could push euro rates higher, the increase is likely to correlate with expectations for higher rates in the U.S. Despite announcing the end of asset purchases at the June ECB meeting, the commitment to hold policy rates through the end of summer 2019 was a dovish surprise. This has pushed the 2s–5s and 2s–10s portions of the curve flatter. Further flattening could come if discussions of an operation twist materialize.

Investment Grade Corporates

The outlook for credit remains healthy with earnings reinforcing a supportive fundamental picture and technical factors still favorable longer term. The yield differential between U.S. and global rates continues to support the story for foreign buying of U.S. credit, despite higher hedging costs. Valuations look more reasonable as spreads have rallied since late-June highs. A strong Q2 earnings season, renewed demand from foreign investors and light new supply in July, will likely lead to positive excess returns through year-end.

High Yield Corporates

The themes from the first quarter rolled into the second quarter as the prospect of continued rate increases by the Fed continued to weigh on the Treasury (and investment grade) markets. Political posturing around trade agreements has added to the unease. High yield spreads have been able to absorb some of the increase in rates, and have generally taken the trade noise in stride as fundamentals remain positive. While fundamentals remain sound, volatility remains elevated as trade tensions escalate against a backdrop of the Fed tightening monetary conditions. We are watching the yield curve closely as the resolution of a flat or inverted yield curve could have profound implications for the high yield market. As the economic cycle unfolds, we are gradually reducing exposure to more levered credits.

Securitized Assets

The Federal Reserve will reach full tapering mode in October, which will increase net supply of agency residential mortgage-backed securities (RMBS). Fundamentals remain solid with subdued prepays and valuations remain attractive.

We maintain a positive view of non-agency RMBS as sector attributes continue to resonate with investors. Non-agency RMBS continue to benefit from a strengthening housing market. Upside remains as credit availability increases, home ownership bottoms and the Millennial demographic engages. These dynamics will benefit the amortizing legacy universe as well as next generation submarkets such as CRTs.

The outlook for asset-backed securities (ABS) remains positive, with credit performance strong across almost all sub-sectors. With persistent volatility and strong underlying fundamentals for the U.S. consumer, we expect ABS to outperform. We remain positive on CLOs, even though we expect elevated supply to drive spreads through the near term. The sector continues to benefit from demand for floaters and strong credit performance.

We continue to like commercial mortgage-backed securities (CMBS), as the fundamentals of the commercial real estate market remain solid. Supply factors have proven manageable and new issuance light. In our view, fundamentals will remain stable; relative value and correlations with other risk markets are the most likely catalysts for near-term outperformance potential.

Emerging Market Debt

EM growth momentum has been milder than expected, but still is positive going into 2H18. Though global trade uncertainties dominate the rhetoric, they have not yet had a significant impact on growth. Most sovereign credit metrics are still benefiting from the growth picture, though country differentiation remains key due to changing macro drivers and tighter financing conditions. The stronger U.S. dollar hurt emerging markets in the second quarter, but this headwind shows signs of slowing.

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