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: European Central Bank and Bank of Japan still accommodative, whereas U.S. policy continues to tighten

Global Currencies: U.S. dollar weakens further against euro, select EM currencies

Investment Grade: fundamentals and technical picture are supportive, but valuations make security selection even more important

High Yield: fundamentals improving, default risk still low, valuations are fair after recent pullback

Securitized Assets: securitized credit still holds attractive relative value overall, while agency mortgage risks skew to the downside

Emerging Markets: economic momentum, stable commodity prices will support EMD

It's Not Too Quiet Anymore — Volatility Returns

In our 2018 outlook, we argued that market conditions were likely to lead to a return of volatility. As the saying goes, be careful what you wish for — volatility has returned in a big way. Though equities made headlines, warning signs first emerged in the fixed income market. In December, as the U.S. dollar continued to weaken amid rising energy prices, the 10-year inflation breakeven rate — the difference between nominal and inflation-adjusted Treasury yields — started to increase. Interest rate volatility, which had been declining for more than a year, soon followed suit. This set the stage for the market's reaction to the strong February 2 payroll report. Volatility accelerated on fears that inflation would rapidly pick up steam, prompting a more aggressive policy stance from the Federal Reserve.

While we saw pockets of turbulence in high yield and emerging market debt, recent volatility was not a credit spread event — it was primarily driven by interest-rate volatility and large swings in short-term equity positions. Years of historically low and largely range-bound interest rates created complacency. The recent rate volatility is a reminder of the fixed income market's power to send shockwaves across broader capital markets and the economy. We will be paying close attention to the 10-year yield. We think a near-term move to 3% is likely, and that an acceleration through 3%, while unlikely, would intensify volatility. Nonetheless, we believe that yields above 3% represent attractive value and might adjust our tactical positioning to capitalize on what we would view as an opportunity.

Volatility has returned and we believe it is here to stay, however, conditions are only returning to normal following last year's prolonged, unusual absence. The reappearance of volatility does not change our outlook for strong global growth and a cautious pace of interest rate normalization and balance-sheet reduction from the Fed. We continue to favor selling into strength in spread assets rather than buying on weakness. We remain modestly overweight spread assets, favoring collateralized loan obligations and non-agency residential mortgage-backed securities.

Spreads, Returns and Yields

			Returns (%)	
Index/Sector	Percentage of Index	Spread (bp)	Jan. 2018	YTD 2018
Bloomberg Barclays U.S. Aggregate	100.0	34	-1.15	-1.15
Treasury	36.9	0	-1.36	-1.36
Investment Grade Corporate	25.6	86	-0.96	-0.96
Fixed-Rate MBS	28.1	25	-1.17	-1.17
Other				
High Yield		319	0.60	0.60
Global Aggregate		33	1.19	1.19
Emerging Markets		262	-0.04	-0.04

			Returns (%)	
Country	Yield on Ten-Year Bonds (%)	Currency	Jan. 2018	YTD 2018
United States	2.71	EUR/USD 1.24	3.38	3.38
Germany	0.70	USD/JPY 109	3.03	3.03
Japan	0.09	USD/BRL 3.19	4.38	4.38

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 & Currencies

The European Central Bank and Bank of Japan are still accommodative in policy, whereas U.S. policy continues to tighten. Combining these commitments from global central banks leaves policy accommodative overall, which can continue to support but may also distort asset prices. An unexpected pullback of accommodation, particularly out of Europe, could cause market disruption.

We expect the U.S. dollar to continue to weaken further against the euro and certain emerging markets as growth in these areas will likely continue to outpace that of the U.S.

Investment Grade Corporates

The backdrop for corporate credit continues to improve with strong global growth, Q4 earnings supporting a strong fundamentals picture and still-accommodative monetary policy. The move higher in interest rates should result in increased demand for U.S. investment grade credit as higher yields continue to attract overseas investors as well as more traditional domestic investors and pension plans. Fourth quarter earnings have already begun to beat expectations, further supporting a move tighter in spreads. The technical picture remains solid as well, as light supply and solid fund flows into the asset class continue to support spreads. While valuations suggest further upside is limited, strong fundamentals, favorable technicals and a supportive macro outlook should lead to further moderate spread tightening.

High Yield Corporates

High yield credit fundamentals for the market overall continue to trend mildly positively. The technical environment may leave risk assets more vulnerable to a pullback given fund outflows and underperformance by high yield ETFs. While we view spreads at month-end as modestly tighter than fair value, we would not be surprised to see them tighten further before the end of the current credit cycle. The energy, retail, healthcare and telecommunications sectors still trade wide to the overall market; therefore, we expect them to be key drivers of performance through the year.

Securitized Assets

Agency residential mortgage-backed securities (RMBS) — despite recent spread widening, RMBS remain sensitive to further upticks in volatility, Fed tapering and uncertain demand. Further spread widening is required before a neutral allocation is justified.

Non-agency RMBS continue to be driven by a recovering housing market. Upside remains as credit availability increases, home ownership bottoms and the burgeoning millennial demographic engages. These dynamics will benefit the amortizing legacy universe as well as next generation submarkets like credit risk transfer securities (CRTs) and newer forms of securitization. The outlook for CRTs is good and we have added some exposure since hurricane-related concerns have receded.

Asset-backed securities (ABS) sectors are at or near their year-to-date credit spread tights despite risks among subprime auto and marketplace loans. With broader market volatility picking up, we expect ABS to outperform. We look for yield advantage through exposure to high quality, non-benchmark sectors that command higher spreads than benchmark asset classes. Also, we continue to favor seasoned subprime autos.

Our largest overweight is to collateralized loan obligations (CLOs) within our ABS allocation. CLOs still command fixed income investor attention as a viable source of relative value, as HY and IG credit spreads remain narrow. We maintain a positive outlook for CLO markets as increasing yield potential and stable risk outlooks are expected to preserve performance over the near term.

While we maintain allocations to commercial mortgage-backed securities (CMBS) due to continued momentum in commercial real estate prices, security selection is key; fundamentals have broadly plateaued and the longer-term picture remains clouded by elevated property valuations and uncertainty surrounding the ongoing transition in American retail.

Emerging Market Debt

We expect growth within emerging markets (EM) to remain solid through the first half of 2018, with all regions contributing despite the ongoing economic transition in China. The supportive global growth backdrop and stable commodity prices will continue to lead to EM capital flows and anchor EM fundamentals. Idiosyncratic risks still exist, particularly in South Africa regarding its political landscape, turmoil in Venezuela and concerns on how potential changes to NAFTA may affect Mexico. We are maintaining a slight overweight to select emerging markets, with a bias towards local interest rate risk, and Latin American sovereigns.

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