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. 10-year rates to stay range-bound, Fed action leads to flatter yield curve

Global Currencies: U.S. dollar to weaken further against euro and emerging market currencies

Investment Grade: Valuations look more attractive after recent spread widening given solid earnings stemming from tax reform, ongoing macro momentum

High Yield: Valuations are fair given still-improving fundamentals, low default risk; trade war rhetoric a near-term risk

Securitized Credit: Collateralized loan obligations will benefit from increasing yield potential, stable fundamentals; agency mortgage risks skew negative

Emerging Markets: Election-related risks and trade uncertainties could lead to volatility, but growth fundamentals still positive

Volatility Unpacks its Bags, Plans to Stay

Volatility has returned, and we believe it is here to stay. Market volatility spiked higher in February after rising real yields, coupled with a firmer January wage growth and inflation report, led investors to fear that Jerome Powell and the Federal Reserve would have to tighten monetary policy faster and further than previously expected. Volatility was initially limited to the rates and equities markets but eventually spilled into credit markets, albeit to a lesser degree than in previous bouts. Nonetheless, spreads for investment grade, high yield and emerging market debt now sit well above their February tights.

Since the initial spike in early February, we have seen sporadic pockets of less severe volatility. February inflation data came in cooler, weighed down by declining rents. Retail sales missed for a third straight month; wage growth was muted despite a blowout jobs report. We expect further bouts of volatility caused by a variety of factors besides fluctuating wage growth and inflation data. Fed leadership has conveyed somewhat more hawkish rhetoric, leading to raised expectations for a recalibration of the Fed's dot plot. In addition, the European Central Bank (ECB) is beginning to appear less dovish. What's more, continued uncertainty from Washington, whether it be staffing, concerns over rising deficits or potential for a trade war, will keep markets uneasy.

At this stage in the cycle, volatility creates opportunity and we continue to stress the importance of security selection. We maintain our positive stance on securitized assets, most notably collateralized loan obligations, non-agency residential mortgages and commercial mortgage-backed securities, while staying underweight agency mortgages. Within corporate credit, volatility has led to increased dispersion among industries and issuers. Therefore, we look to these recent, volatility-induced pullbacks to find value in credits that we believe will benefit most from the solid macroeconomic backdrop. We continue to hold a favorable view of emerging markets debt, particularly local rates, where we have added positions in countries that we think are less vulnerable to a more protectionist U.S. stance. Finally, we are neutral duration given our expectations that an acceleration higher is unlikely and rates are likely to remain range-bound.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			Feb. 2018	YTD 2018
Bloomberg Barclays U.S. Aggregate	**100.0**	**37**	**-0.95**	**-2.09**
Treasury	37.0	0	-0.75	-2.10
Investment Grade Corporate	25.4	96	-1.62	-2.56
Fixed-Rate MBS	28.2	26	-0.66	-1.82
Other				
High Yield		336	-0.85	-0.26
Global Aggregate		35	-0.89	0.29
Emerging Markets		285	-1.99	-2.03

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			Feb. 2018	YTD 2018
United States	2.86	EUR/USD 1.22	-1.77	1.57
Germany	0.66	USD/JPY 106	2.35	5.63
Japan	0.05	USD/BRL 3.25	-1.87	1.87

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

Fed Chairman Jerome Powell's testimony to Congress suggested there is room for a faster pace of rate hikes given the continued improvement in the economic outlook. This is the primary driver of our expectations for a flatter U.S. yield curve. We expect 10-year U.S. rates to trade in a 2.75–3.00% range, with higher yields likely leading to greater demand from foreign buyers.

The ECB's recent meeting conveyed a hawkish tone that was short-lived. While Draghi noted expectations for growth continue to increase, the outlook for inflation is still subdued. We doubt any potential policy tightening will occur before 2019.

Despite elevated rates, strong growth abroad coupled with concerns over rising deficits will lead to a weaker U.S. dollar, particularly versus the euro and select emerging market currencies.

Investment Grade Corporates

Investment grade spreads gave up all of January's gains and now sit at their widest levels since September. More liquid sectors led the widening, while the front end of the credit curve came under pressure from more hawkish Fed rhetoric and tax repatriation. With spreads now outside 100 basis points (bp), valuations look more attractive. Fourth quarter earnings came in strong and largely beat expectations. The technical picture looks mixed: increased volatility and heavy new March supply could put pressure on spreads. Nonetheless, a move higher in yields should increase demand for U.S. credit from overseas as well as more traditional domestic investors, specifically pension funds. While we expect near-term volatility, the outlook for the market remains solid given the strong macro environment, supportive fundamentals and technicals and more-reasonable valuations.

High Yield Corporates

Credit fundamentals for the high yield market remain supportive and continue to trend mildly positive, with the potential for greater momentum from tax-code changes and increased infrastructure spending. The technical environment is slightly negative due to massive outflows and lower liquidity. We believe spreads are at fair value around the 340-bp range and that a lift in GDP could lead to near-term outperformance. A spike higher in rates and increased rhetoric around a trade war are likely the biggest near-term risks. Given the ongoing supportive fundamentals and our belief that rates have broadly plateaued, we remain constructive on high yield.

Securitized Assets

Agency residential mortgage-backed securities (RMBS) continued their January underperformance into February, weighed down by increasing volatility. Performance should remain tied to volatility with little change to fundamentals. As we move into spring, Fed tapering will increase supply and uncertainty surrounding the direction of rates could lead to greater volatility.

Non-agency RMBS continue to be driven by a recovering 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 credit-risk transfer securities.

Asset-backed securities (ABS) excess returns matched those of the broader index for February. After limited widening, ABS spreads are no longer at their YTD tights. We continue to look for yield advantage through exposure to non-benchmark sectors, which command higher spreads. While valuations remain relatively tight, we expect the sector to outperform through the current bout of volatility.

Our largest overweight within the ABS allocation remains collateralized mortgage obligations (CLOs). We maintain a positive tactical outlook for CLOs, as we expect increasing yield potential and stable risks to preserve performance over the near term. In spite of recent spread compression, technical factors remain satisfactory. The potential for future rate hikes is positive for this floating rate sector and its underlying loans, especially relative to other risk markets.

We hold a positive tactical outlook for commercial mortgage-backed securities (CMBS). While supply and relative value have declined, demand appears robust at higher all-in yields. Longer term, the fundamental story 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 positive 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. Country differentiation remains key: alongside election related risks, trade uncertainties are a new factor that may affect EM dynamics. We still favor local currency debt, which we believe will remain supported by weakness in the U.S. dollar, relatively benign inflation and loose global monetary conditions.

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