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 weakens vs. EM currencies, strengthens vs. DM currencies; euro and yen to weaken

Investment Grade Corporates: magnitude for further spread tightening looks limited given strong YTD performance

High Yield Corporates: maintain modest overweight as fundamentals remain decent, default risk low

Securitized Assets: prefer non-agency mortgages, other securitized sectors over agency mortgages

Emerging Market Debt: maintain slight overweights to select hard currency sovereigns as growth rebounds

Proceeding with Caution

- As we begin the fourth quarter, all signs point to a healthy global economy. The IMF increased its 2018 GDP forecasts across all developed and most emerging markets. In the United States, PMI data and job vacancies are at their highest levels in over a decade. Two high profile areas that have lagged, inflation and wage growth, now show signs of life. The September inflation reading supports the notion that the weakness seen earlier this year was more likely transitory, as the Federal Reserve has argued. The latest average hourly earnings release displayed its strongest increase since June 2009 and was further supported by upward revisions to prior releases, setting it on a multi-month acceleration.
- Internationally, eurozone growth continues above trend with inflation still range-bound, supported by both Germany and peripheral economies. Japan is experiencing solid growth driven largely by ongoing domestic demand and strong exports. China and other emerging markets, save a few outliers such as Venezuela and South Africa, are expected to continue their upward trend.
- While everything does seem rosy, many uncertainties still exist. Geopolitical risks such as North Korea and the possible secession of Catalonia from Spain have sparked some volatility. As prospects of tax reform out of Washington hit headlines, yields rose and risk assets surged; however, significant legislative hurdles remain. Central bank uncertainty looms, with a replacement for Janet Yellen still to be decided, while the European Central Bank begins setting its sights on rolling back its quantitative easing.
- Despite strong underlying fundamentals, we view these uncertainties — in addition to markets being at valuations not seen since before the financial crisis — as reasons to pull back risk in our portfolios. We have trimmed our high yield overweight and maintain an underweight to investment grade corporates as spreads sit near post-crisis tights. We continue to prefer securitized assets, specifically commercial mortgage-backed securities and non-agency residential mortgage-backed securities, while keeping underweight agency MBS. Additionally, we continue to like select emerging markets as growth continues to improve, with a bias towards hard currency sovereign bonds. Finally, we have a short duration bias across our multi-sector strategies in the anticipation of modestly higher rates in the U.S.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			Sept. 2017	YTD 2017
Barclays U.S. Aggregate	**100.0**	**38**	**-0.5**	**3.1**
Treasury	37.0	0	-0.9	2.3
Investment Grade Corporate	25.3	101	-0.2	5.2
Fixed-Rate MBS	28.2	22	-0.2	2.3
Other				
High Yield		347	0.9	7.0
Global Aggregate		38	-0.9	6.3
Emerging Markets		246	0.1	7.5

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%)	
				Sept. 2017	YTD 2017
United States	2.33	EUR/USD	1.18	-0.81	12.33
Germany	0.46	USD/JPY	113	-2.30	3.96
Japan	0.07	USD/BRL	3.16	-0.42	2.77

Source: Barclays, 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

Global Rates

- September's core CPI reading partially offset concerns about weaker inflation and 12 of 16 FOMC members foresee a rate hike this year, which has pushed market implied odds to above 80% for December. These expectations should continue to cause a steepening of the yield curve. The Fed's balance sheet unwinding is likely to have a small impact due to its size and pace.
- The European Central Bank (ECB) is expected to announce its tapering plans on October 26 but is signaling that QE could be extended for longer at a slower pace. A larger drop from the current €60 billion per month would be hawkish, but extending purchases makes ECB meetings less critical and defers the rate-tightening decision, since the ECB has said rates will not change until QE is done.

Global Currencies

- The U.S. dollar is expected to appreciate versus developed market (DM) currencies and should be supported by higher yields and a steeper money-market curve. The euro rally will slow as a result of the increasing yield differential between European and U.S. rates.

Investment Grade Corporates

- During September, market rates rose and the U.S. dollar strengthened as geopolitical tensions eased. As a result, foreign buyers moved back into the IG market and spreads retraced most of the prior month's widening. With supply set to slow for the fourth quarter, any IG-market spread widening from now to year-end will require an external catalyst. Third-quarter earnings reporting has begun; earnings for IG companies are expected to improve at a slower pace than the first half but still solid. Fundamental improvement potentially removes a headwind for spreads and supports a neutral outlook. Within IG, we continue to like the valuation gap of financials and believe BBB credits can benefit if the market continues to grind tighter.

High Yield Corporates

- September was a strong month for total and excess returns in high yield. Supply was steady and reasonably well received. Oil prices continued their rollercoaster ride, recovering from the summer sell-off to get back above $50, and led to outperformance from the energy sector. The backdrop for corporate credit remains constructive; we still expect to see an improved pace of growth as we move through the end of 2017. Earnings growth should support at least modest improvement in credit quality and keep the next default cycle beyond the horizon for some time. Macro risks remain, but signs of increased growth elsewhere around the globe should take some pressure off the U.S. and the still-hesitant U.S. consumer. Spreads are near their post-crisis tights, but we believe there is room to tighten if this scenario plays out.

Securitized Assets

- Agency mortgage-backed securities (RMBS) outperformed Treasurys during September, bringing current coupon spreads to their tightest levels since early 2013. Large yield-based buyers could keep spreads tight as tapering ramps up; at current spread levels, however, near-term mortgage performance risk is skewed to the downside and so we remain underweight.
- Anticipated improvement in supply-demand factors and relative value will continue to support commercial mortgage-backed securities (CMBS). The longer-term outlook remains clouded by elevated property valuations and concerns about the vitality of the retail sector. CMBS underperformed in September, leaving the sector with improved relative value. We remain overweight the sector despite the potential longer-term risks due to attractive valuations and strong fundamentals.
- We maintain a positive outlook for collateralized loan obligations (CLOs) as attractive valuations, strong fundamentals and stable risks are expected to drive performance. Currency dynamics have led to a rebound in demand from Japanese investors. As rates move higher, potential relative total return performance leans towards CLOs.
- Asset-backed securities (ABS) remain well supported on strong fundamentals associated with the U.S. consumer and no signs of broad consumer credit degradation. Subprime auto borrowers remain a concern fundamentally, but we still don't believe that sub-sector's troubles will spill into other sub-sectors. We remain constructive on spread levels.

Emerging Market Debt

- Growth within emerging markets (EM) is back up after moderating in the spring, prompting us to maintain a slight overweight to select hard currency sovereign bonds. PMIs have strengthened and EM currencies have rallied as a result of stronger growth expectations, a stronger euro and weaker U.S. dollar. Risks from China and commodity price volatility are largely priced in; other EM risks are primarily idiosyncratic. Country differentiation remains key, with idiosyncratic risks in Venezuela.

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