Fixed Income Perspectives

Contributors

Global Rates: U.S. rates to trade range bound; 10-year yield to remain in the 0.50 – 1.00% range

Global Currencies: U.S. dollar to weaken against DM, EM currencies

Investment Grade: despite continued rally, opportunities remain in the intermediate segment of credit curve, select BBBs

High Yield: with defaults largely priced in, valuations remain attractive long term, particularly among B-rated and higher issuers; CCCs more selective

Securitized: recent rally starting to aid fundamental repair, enhanced relative value perceptions; long-term risk drivers (U.S. consumer, real estate) are well positioned

Emerging Markets: EM benefitting from uptick in domestic demand and stimulus measures coordinated by G20, IMF to minimize liquidity shortfalls and potential defaults

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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.

Six Fixed Income Themes for the Second Half of 2020

As we look ahead to the next six months, we expect investors will continue to favor high-quality spread product in an environment where market participants must weigh the risks from lingering COVID-19 impacts, China-related tensions, and political strife versus the benefits of unprecedented public policy support. While the tail is narrower, asset prices will reflect starkly different outcomes, highlighting the importance of security selection. Below are the six key themes we expect will play out in the second half of the year.

1. **Populism, Politics and COVID**

   The uneven economic impact of the COVID-19 shutdown and recovery efforts will further inflame global income and wealth inequality related tensions. The resulting rise in tensions will lead to more uncertainty regarding political and regulatory policy changes for investors, consumers and businesses.

2. **China**

   A coordinated pushback from the developed world will lead to growth headwinds for China, benefitting other emerging economies, as supply chain diversification and re-shoring of production lead to weaker foreign investment. This will force China to accelerate its transition to a consumer driven economy, which will partially offset the slowdown in manufacturing, leaving China's overall growth rate below the pace of recent years.

3. **Central Banks**

   Developed market central banks will continue their aggressive and expansive use of nonconventional policy tools given the near exhaustion of conventional monetary policy. Emerging market central banks will aggressively deploy conventional policy with a minority constrained by limited means. The Fed will not resort to negative rates given their questionable effectiveness, instead favoring tools such as yield curve control and lending programs.

4. **Fiscal**

   Global governments will provide additional fiscal stimulus to bridge income disruptions. While necessary and effective, the consequences from burgeoning deficits will manifest over a long time period, with negative implications for productivity and potential growth, most notably among developed economies with structurally lower potential growth rates.

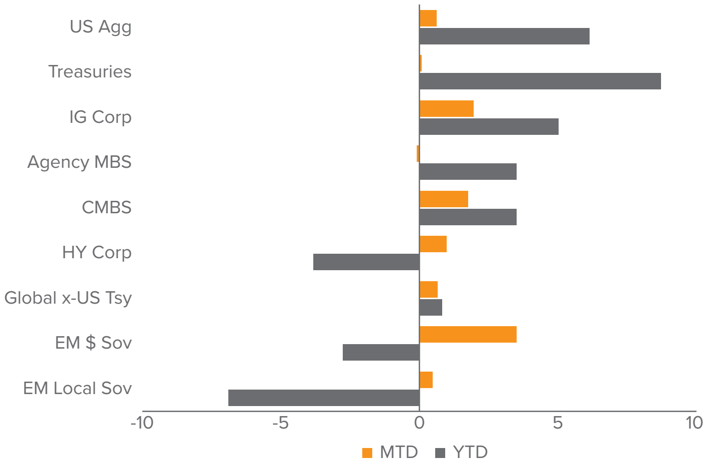
5. **Growth**

   The global growth recovery will be rocky and asynchronous with government support and pent up demand fostering a substantial initial retracement. Stimulus will temporarily bridge the income gap but will recede before rehiring has fully taken place, exposing global growth to a stubbornly persistent weakness in demand that will limit the pace of the recovery.

6. **Inflation**

   The disinflationary impact of the severe demand shock will outweigh inflationary influences of rapid money growth and higher operating costs in a post-COVID environment. Unprecedented stimulus instead will manifest itself through higher asset prices.

Returns, Spreads and Yields



Current Yields and Spreads

		30-Jun	31-May	1Yr Low	1Yr High
Yields	US 2 Yr	0.15	0.16	0.14	2.41
	US 10 Yr	0.66	0.65	0.54	2.14
	GER 10 Yr	-0.45	-0.45	-0.86	-0.16
	JPN 10 Yr	0.03	0.01	-0.29	0.08
	EM Local Sov	4.51	4.54	4.50	6.08
Spreads	IG Corp	150	174	93	373
	Agency MBS	70	73	28	132
	CMBS	210	248	83	363
	HY Corp	626	637	315	1100
	HY x-Egy Corp	575	574	272	973
	EM $ Sov	474	521	290	721

Past performance is no guarantee of future results. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya.

Sector Outlooks

Global Rates and Currencies

As with the depth and speed of the COVID 19-driven economic contraction, economists now find themselves catching up with the initial rebound, as recent data surprises have exceeded expectations and caused some upward revisions in the U.S. and Europe. That said, China remains the global benchmark for activity as the first major economy to shut down and reopen. While Chinese Manufacturing and Services have returned to expansion territory, they've only barely done so. Also, geopolitical risks have resumed with China being center stage.

In the U.S., monetary policy has stabilized but remains very accommodative and proven responsive to any sharp weakening in financial conditions. The Federal Reserve remains intent on driving liquidity spreads back towards pre-virus levels, although fundamentals in some cases argue for less than a full recovery in spreads. The urgent need for a further fiscal policy response has faded, but additional stimulus seems likely. While the force of the fiscal policy response has been apparent with personal income growth up sharply year over year in the face of record high unemployment, May's 4% month-over-month drop in income serves as a reminder that the public to private sector transition is indeed in the early stages.

European growth has also surprised to the upside which has led to some upward growth revisions. Virus case trends have been more favorable than in the U.S. which suggests less risk to the growth path, and a smoother and perhaps a faster recovery. However, fiscal support remains dependent upon local government programs with coordinated aid still a slow-moving work in progress, although upcoming meetings in July may help clarify potential paths forward. On the monetary side, threats to the euro zone asset purchasing program via Germany's Constitutional Court challenge seem to have eased and the ECB has maintained its resolve to press ahead with this and other programs.

Investment Grade (IG) Corporates

Investment Grade spreads finished June strong, rebounding from a brief mid-month widening bout. The main factors driving spreads significantly tighter through the second half of June were positive momentum stemming from COVID-19 shutdown re-openings and the Fed's purchasing of IG cash bonds in the secondary market as well as ETFs. It's worth noting that while the Fed's primary market facility has yet to be tapped, it remains an important backstop for the market.

New issues continued to flow in June, but slower than the record-setting months of March, April and May 2020. Nonetheless, at over a $1 trillion year-to-date, IG new supply for the year is already nearing the expected $1.2 trillion level. While those expectations have been revised up to $1.6 trillion, we believe that a meaningful slowdown in new supply is likely through year-end, leading to a robust technical environment in the secondary market. Elsewhere, the market continues to look through current fundamentals for now, and instead is focused on what appears to be a cautiously optimistic view of reopening from COVID-19 lockdowns. It is the sequential improvement in auto sales, credit card spending and air travel that appear to be the focus rather than the actual level of activity.

High Yield Corporates

The Spring rally that began at the end of March abated during the second half of June, as demand waned for the robust flow of new supply. While economic data continues to show some encouraging recovery signs, the potential for a summer COVID flare-up may slow that progress. Nonetheless, strong equities, a willing Fed and low interest rates combine to create a stable technical environment that can continue to absorb the torrent of new issuance, albeit at a more measured pace.

Securitized Assets

The RMBS market produced positive excess returns toward the beginning of June, as economic data topped estimates, the Fed maintained its dovish stance, and the curve bear-steepened. However, that outperformance diminished as the month bore on due to investor fears inflected by heavy origination, prepayment risk, and COVID-related macro uncertainty. Nonetheless, Agency RMBS does have the potential to improve versus Treasuries, in our view, due to three factors: favorable mortgage supply as Treasury net issuance is estimated to be approximately $3 trillion due to fiscal stimulus; attractive spreads and reduced convexity; improved mortgage-carry due to the Fed's cleansing effect on the dollar-roll market.

We hold on to our positive tactical outlook for the non-agency RMBS market as low rates, reasonable fundamentals, and improved relative value should support the asset through these choppy waters. Any correction on housing values in mortgage indices will be a second or third order impact of the current crisis, and not a challenge to the value proposition of housing.

We have updated our overall tactical assessment of CMBS to neutral, as we expect more relative value driven catch-up in spreads for the beleaguered sector. While valuations in some parts of the CMBS sector appear attractive on a relative and historical basis, we expect that uncertainties regarding the duration and severity of the economic fallout, combined with greater idiosyncratic risks in commercial real estate, will impair risk taking in these segments. Although backward looking fundamental metrics continue to register positive, dramatic change is forthcoming, as the damaging implications from the pandemic for parts of the CRE universe - such as student housing, hotel and retail, and potentially office and multifamily longer term - are undeniable.

Elsewhere, ABS has led the recovery for securitized credit, with some benchmark subsectors completely retracing the sell-off while other higher spread subsectors still have further room to tighten. The key drivers (primarily TALF) are firmly in place and close to fruition and have been supported by the slow re-opening of the global economy. We expect the rally to spread, both outward in terms of sub-sectors and downward in terms of the capital structure of ABS deals. Consumer related sub-sectors will most directly benefit. Overall, the strength of the U.S. consumer heading into the pandemic coupled with ABS structural dynamics provide the sector with relatively solid footing to withstand the eroding fundamental backdrop.

Emerging Market (EM) Debt

Full year 2020 EM GDP expectations have been revised down due to a weaker than anticipated first half of the year, but a rebound in the second half is expected, as noted by high frequency and confidence indicators rebounding for second month in a row in June. Indeed, we expect inflation to remain subdued and in line with domestic demand, which is picking up. Going forward, while monetary policy is expected to remain supportive, some EM central banks are running out of space and we expect more unorthodox measures like asset purchases could be coming. On the fiscal front, massive support across EM to counter the economic slowdown has be a net positive, but concerns are growing among rating agencies if loosening are not curbed over the long-term. Overall, we expect to see a wide divergence in growth across EM economies due to stark differences in COVID measures, fiscal & monetary support, and political and institutional stability.

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