Voya Multi-Asset Perspectives

The Red Dragon Is Breathing Fire. Will the Rest of World Get Roasted?

Multiple forces conspired to reduce the outlook for U.S. and global growth over the last three months. Equity market pricing reset lower in September, as Covid continued to confound health experts and frustrate those anxious to resume normal life. Its overhang on businesses is much reduced and varies regionally, but the delta variant's rise shows that coronaviruses are not going away. As countries strive to contain and adapt, their approaches to this endeavor probably will continue to impact output for the foreseeable future. What matters more, however, is inflation and central banks' attempts to manage it.

Ongoing global supply chain strains, excess demand and raw material shortages are keeping upward pressure on prices, but strong secular suppressants – globalization, automation, demographics, etc. – are compounding confusion, as uncertainty around inflation forecasts remains high. The Federal Reserve continues to communicate its belief that inflation is transitory, and recently confirmed its plan to begin tapering asset purchases this year and completely unwind the program by next summer. The Fed's dot plot, which is rarely right but directionally useful, showed about half the voting members expecting one rate hike in 2022 and the rest anticipating no increase until 2023. Inflation in Europe also is expected to be temporary for similar reasons and, as a result, the European Central Bank is likely to keep policy on hold. Adding to the case that inflation stays under control is the slower growth agenda emerging out of China.

Over the last several months, Chinese government authorities have unleashed a highly aggressive, "socialist smackdown" upon businesses. Chinese Communist Party (CCP) actions range from anti-trust probes and cyberspace crackdowns, to targeted prevention of the "disorderly expansion of capital." Local stocks, real estate and low-quality credit have gotten clobbered; high yield spreads are gapping out to levels last seen in 2011 (Figure 1), indicating a very worried market. There are fundamental concerns as well, with contracting credit and China's non-financial corporate debt at ~160% of GDP – about twice that of the United States. Against this backdrop, investing in Chinese companies now appears unappealing.

Tactical Indicators

Economic Growth (Positive)
Full year 2021 U.S. real GDP growth is tracking between 5–6%, which we expect will be driven by a release of pent-up demand and spending down of elevated savings

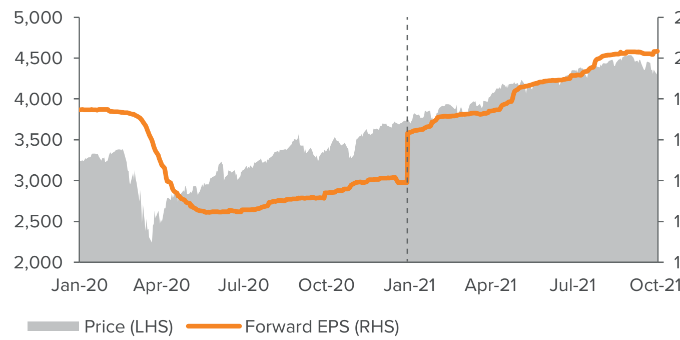
Fundamentals (Positive)
S&P 500 earnings grew roughly 90% in 2Q21 and are expected to grow by almost 30% in 3Q21

Valuations (Neutral)
Stocks are expensive by most historical measures, but low rates keep the equity risk premium wide enough for stocks to remain attractive

Sentiment (Negative)
Voya's sentiment indicator, a collection of U.S. market-based measures, is neutral but approaching oversold territory

Figure 2. Corporate earnings growth has been the sole driver of higher stock prices in 2021

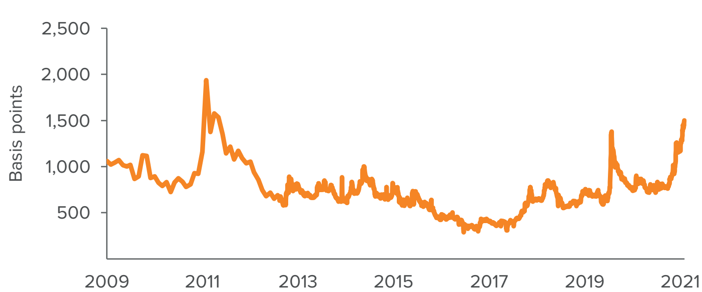
S&P 500 Index Price and Forward EPS



Source: Bloomberg, Voya Investment Management, as of 10/5/21.

Figure 1. China credit spreads are flashing signs of distress

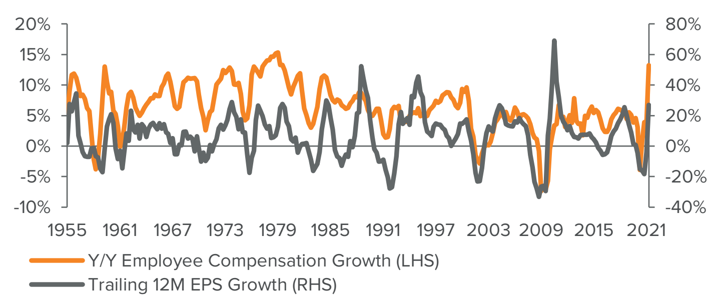
China High Yield Spreads



Source: Bloomberg, Voya Investment Management, as of 9/30/21.

Figure 3. Large company earnings growth has been correlated with wage increases

Employee Compensation and SPX EPS Growth



Source: Bloomberg, Voya Investment Management, as of 9/23/21.

Portfolio Positioning

Equities	●	
U.S. Large Cap	○-○-●	Scale brings competitive advantages to large caps; extraordinarily stimulative U.S. policy should further tighten the equity risk premium
U.S. Mid Cap	○-●-○	Offer a mix of cyclical gearing with multi-national revenue exposure, but less compelling than large caps
U.S. Small Cap	○-●-○	Prefer larger U.S. companies, but with the fourth wave of Covid dissipating and technical factors improving, small cap may present an interesting tactical opportunity
International	○-●-○	Limited fiscal capacity in Europe due to Eurozone construct and rising Covid case count, there and in Japan, temper our near-term view of international stocks
Emerging Markets	●-○-○	Covid struggles in certain countries, China slowdown and heavy-handed government intervention in market affairs lead us to shift positioning to underweight
REITs	●-○-○	Big divergences among REIT sectors, but the underlying trend for commercial real estate is a concern
Fixed Income	●	
U.S. Core	●-○-○	We hold a modestly short duration posture and favor credit, given yield pickup over sovereign bonds and generally healthy corporate balance sheets
Inflation (TIPS)	●-○-○	Inflation is going to temporarily bump higher, but it is likely to be ephemeral; breakevens seem overpriced
Non-Investment Grade	○-○-●	High yield spreads have more room to compress than investment grade; added default risk worth the higher income with policy support in place
International	●-○-○	Low absolute and relative yields lead us to favor U.S. bonds

Underweight ● Neutral ● Overweight ●

Investment Outlook

The inflation debate rages on and we continue to concur with the Fed's expectations for manageable price increases. We think higher wages from more healing in the labor markets and a spend-down in excess savings will eventually be offset by abatement of supply shortages and lower costs for core goods. Furthermore, fast fading fiscal stimulus, which ignited consumer spending in the depths of the pandemic crisis and triggered supply and demand imbalances, will force the private sector to fill the void and allow purchasing power to improve. Should this play out as envisioned, the Fed can conduct monetary operations along its well communicated path, paving the way for reaccelerating, above-trend 4Q21 real GDP growth.

In this environment, corporate earnings should expand, but will they exceed increasingly optimistic estimates? Since the start of the year, the S&P 500 index and forward EPS have moved almost in lockstep (Figure 2). With expectations now at or near all-time highs, outperforming will be difficult, but it's possible and meeting expectations is realistic. Combining that with negative real rates, easy financial conditions and unattractive other options, convinces us to hold our equity overweight.

Our portfolios retain their home country tilts as we continue to assign a premium to U.S. assets. The margins achieved and earnings advantages generated by large and mega cap U.S. companies are staggering. Despite the assertions that margins are being pressured lower by rising wages, our research shows that higher wages don't necessarily translate into slower earnings growth for the large U.S. company cohort. In fact, S&P 500 index earnings per share (EPS) growth has historically been strongly correlated with increasing employee compensation (Figure 3). The robust internal cash flows generated by big U.S. firms and reinvested into innovative products and services, as well as merger and acquisition (M&A) activity, should provide lasting competitive advantages that keep us overweight to U.S. large cap equities.

Our rotation away from smaller companies has been beneficial. The size factor generally doesn't perform well outside the early upswing stage of the business cycle. The pandemic has led to a compressed timeline thus far, with a swift recession and swift recovery. We are likely past peak growth and no longer in the early cycle, when activity indicators such as PMIs tend to accelerate higher. The operating margin spread based on the median large versus median small company has continued to expand and has been a headwind for small caps. In this environment, we think it is unlikely the gap meaningfully narrows and therefore we continue to prefer larger companies over small.

With strict, anti-business regulations likely to continue rolling out in China, we have further lightened our exposure to emerging markets. Contracting credit and a heavily leveraged real estate sector smell uncomfortably similar to the events that precipitated the U.S. housing bust. Although Evergrande doesn't look exactly like a Lehman moment, the sharp drop in housing activity and prices are not good for Chinese consumers, who have approximately 60% of their savings wrapped up in their homes. What's more, sweeping power outages and rising commodity prices are stirring a sense of social unrest and point to the potential for more problems. While the government's willingness to intervene in the private sector markets makes a debt crisis and global market collapse improbable, and valuations have become substantially cheaper, the fundamental reset of CCP policy makes for a much cloudier corporate climate and dissuades us from attempting to catch the proverbial falling knife.

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Multi-Asset Strategies and Solutions Team

Voya Investment Management's Multi-Asset Strategies and Solutions (MASS) team, led by Chief Investment Officer Paul Zemsky, manages the firm's suite of multi-asset solutions designed to help investors achieve their long term objectives. The team consists of 25 investment professionals who have deep expertise in asset allocation, manager selection and research, quantitative research, portfolio implementation and actuarial sciences. Within MASS, the asset allocation team, led by Barbara Reinhard, is responsible for constructing strategic asset allocations based on their long term views. The team also employs a tactical asset allocation approach, driven by market fundamentals, valuation and sentiment, which is designed to capture market anomalies and/or reduce portfolio risk.

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