Rates are in the driver's seat

US markets have not taken kindly to the Fed's renewed course of monetary tightening, but the effects of the Fed's actions are stretching far beyond US shores.

Tactical indicators

Economic growth (negative)

After two quarters in a row of negative GDP growth, we expect 3Q to register positive growth before heading into year-end.

Fundamentals (neutral)

US earnings expectations have adjusted down and as of the beginning of the reporting season, have generally been in line with forecasts.

Valuations (positive)

Earnings multiples on US equities have compressed by roughly 30% since the start of the year. Small caps have given back all of their stimulus-driven gains, sitting at levels last seen in early 2020, now at forward P/E ratios materially lower than those of large caps.

Sentiment (neutral)

Markets are oversold according to a host of technical indicators, including the AAII Index, put/call ratios and various moving-average measures, suggesting cyclical assets could be poised for a counter-trend rally.

US interest rates are calling the shots

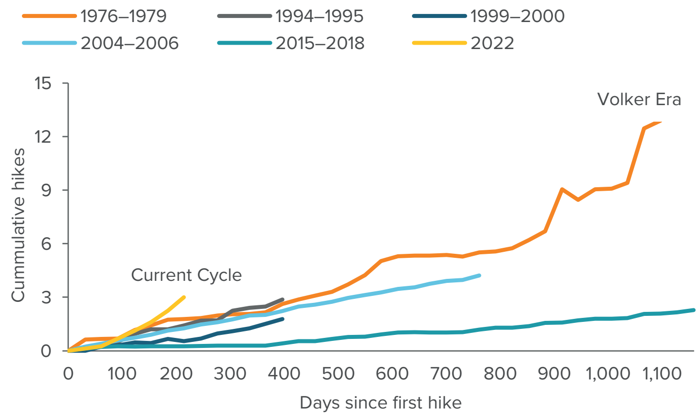
Amid ongoing market volatility, Treasury yields across the curve have been rising dramatically, up more than 1% since early August. The less accommodative policies of the Federal Reserve, including substantial rate hikes and reduction of its vast Treasury and mortgage bond holdings, are set to continue for some time, leading to stress in markets, domestically and abroad. We highlight the lead role of US interest rates across asset classes, and how we are positioning ourselves to take advantage of the resulting opportunities.

The Fed is committed to quashing inflation no matter the cost. With a string of 75 basis-point (bp) rate hikes behind it, the Fed is likely to continue its aggressive stance into early next year at least. We believe inflation is peaking and will decline markedly into next year, giving the Fed breathing room to pause. In the meantime, the ripple effects of the Fed's actions to date are spanning the globe.

Hawkish Fed action is likely to result in a shallow but potentially prolonged recession. The drastic tightening of financial conditions driven by short rates is rising at historically extreme velocity (Figure 1). Conditions are on course to worsen before they get better. Labor markets remain strong despite a decline in job openings, with demand for workers continuing to surpass supply, providing a key buffer to economic weakness. Nonetheless, given stresses in other areas of the economy, we are holding our neutral equity position with a generally defensive tilt.

Figure 1: The Fed is raising rates at the fastest pace in modern times

Major Fed funds rate hike cycles



As of 09/30/22. Sources: Voya Investment Management and Bloomberg.

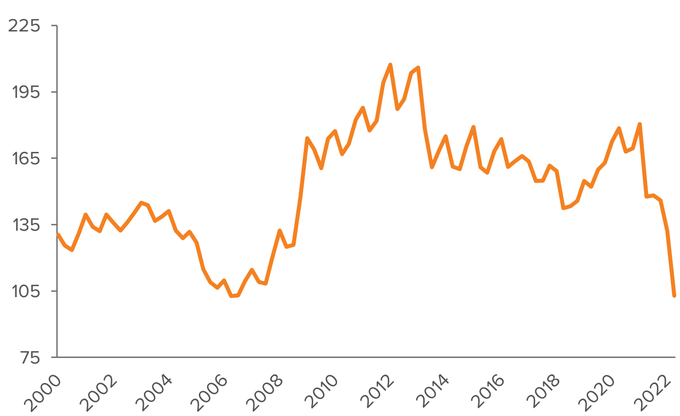
Portfolio positioning

Equities	Neutral	
U.S. large cap	○–○–●	Bigger US firms are better positioned to withstand prolonged inflationary pressures and have more durable earnings streams than companies of other regions or sizes.
U.S. small cap	○–○–●	Small caps have retraced all their stimulus driven gains and now trade at a discount to large caps. We believe severely oversold conditions could unwind and small caps would disproportionally benefit from the bounce.
International equity	●–○–○	Europe is likely to enter a recession as it contends with energy supply issues and heightened geopolitical risks. Japan's efforts to stem currency weakness are at odds with yield curve control, a program it may need to end to meaningfully impact exchange rates.
Emerging market equity	●–○–○	Outlook mixed by region. Covid driven lockdowns across China have disrupted economic activity. China and EM Europe are adversely exposed to Russia–Ukraine conflict.
REITs	●–○–○	REITs remain expensive; we see other income investments as better alternatives.
Fixed income	**Neutral**	
U.S. core	○–○–●	Favor high quality credit given yield pickup over sovereign bonds, generally healthy corporate balance sheets. We have extended duration as we think growth will slow faster than expected and drag down long dated yields.
Inflation (TIPS)	●–○–○	Breakevens are meaningfully cheaper, but actual inflation likely has peaked and could fall quickly.
Non-investment grade	●–○–○	High yield spreads have widened but do not provide sufficient compensation for likely rise in defaults that will accompany looming recession.
International debt	●–○–○	Low relative yields and scope for stronger US dollar keep us favoring US bonds.

Underweight ● Neutral ● Overweight ●

Rising rates are taking their toll on housing following several years of extremely strong home demand and price increases. This newfound weakness in housing should flow through to the "shelter" component of the CPI, tugging down inflation. Since the start of the year, the average US 30-year mortgage rate has more than doubled and now sits near 7%, decreasing home affordability to the lowest levels since 2006 (Figure 2). In response, home builder sentiment and new and existing home sales have plummeted. This has resulted in a decline of the closely watched Case-Shiller home price index for the first time since 2019, breaking three years of continuous price increases. Another sign of weakening housing demand is the price of lumber, now lower than prior to the pandemic.

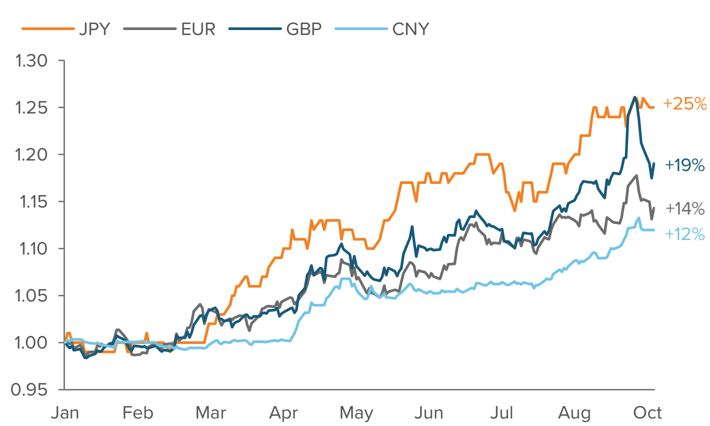
Figure 2: U.S. home affordability dropped sharply to levels last seen in 2006



As of 09/30/22. Source: Bloomberg.

A stronger dollar is complicating the global economic picture as the US central bank has been far more hawkish than those of other developed countries (Figure 3). The dollar has become a high-yielding currency. We expect it to remain strong, though see it is overbought on some technical measure and could be due for a short-term correction. Meanwhile, the ECB is plotting a less aggressive course, Japan has stood by its extremely accommodative policies, and the BoE recently announced it would buy "unlimited" Gilts to maintain low rates, a policy of the newly installed UK administration. US dollar strength is evidence of the relative safety and stability of the greenback and serves as one of the reasons we continue to prefer the US over other regions during this period of heightened volatility.

Figure 3: Since bottoming mid-2021, the U.S. dollar has risen substantially against other developed market currencies



As of 10/05/22. Source: Bloomberg. Past performance is no guarantee of future results.

Despite the BOJ's unlimited bond purchases, bond yields are testing the 0.25% ceiling. While other global bond market yields have risen, Japan's has so far been static at the BOJ's chosen rate peg. As a result, the yen has weakened considerably. The BOJ has (for now) chosen to intervene in currency markets, dipping into its dollar reserves to prop up the yen. We're skeptical of the BOJ's ability to defend the yen while maintaining yield curve control. We cut our exposure to Japan and are closely monitoring signals from authorities that indicate they are more committed to supporting their currency than current actions and history suggest.

With US interest rates rising alongside the dollar, we think inflation will fall faster and farther than the consensus. We believe declining energy and core goods prices, reduced shelter costs, softening labor market, and decreased domestic demand will pull inflation down to the 4–5% range by the middle of next year. The necessary drop in nominal GDP or expectation thereof should weigh heavily on long dated yields. As a result, we have extended duration in fixed income portfolios and maintain our preference for high-quality credit bonds.

Paul Zemsky, CFA
Chief Investment Officer,
Multi-Asset Strategies

Barbara Reinhard, CFA
Head of Asset Allocation,
Multi-Asset Strategies

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 its 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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