Commentary | 4Q24

Voya High Yield SMA

Seeks total return, balancing income and diversification potential

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Strategy overview

Total return approach, investing in below-investment grade corporate securities with a bias towards higher quality and a concentrated posture.

Key takeaways

- The Bank of America Merrill Lynch High Yield Master II Index (the Index) returned 0.16% for the quarter.
- The SMA underperformed the Index during the quarter on both a gross- and net-of-fees basis, primarily due to its higher quality focus.
- The strong macro backdrop and easing cycle is expected to provide ongoing support to credit fundamental factors in the high yield (HY) market.

Market review

Strong economic data continued to come through in the final quarter of 2024, which had the impact of driving spreads tighter while reversing the rate rally experienced in 3Q24. The credit spread of the HY bond market closed out the year at 292 basis points (bp) on an option-adjusted basis (OAS) basis, having grinded 11 bp tighter since last quarter and 47 bp since the start of the year. Market technical factors remained positive, driven by strong investor demand given attractive all-in yields.

Labor market dynamics continued to show signs of softening without entering a state of deterioration. Job gains remained reasonable, and although the unemployment rate resumed its upward trajectory, it remained below the high watermark set earlier in the year. Meanwhile, wage growth remained strong, which helps explains both the resilience of consumer spending and the stickiness of services inflation.

While the Fed continued to deliver rate cuts at both the November and December meetings, the December cut was accompanied by more "hawkish" elements. Specifically, the Fed's Dot plot indicated only two cuts projected for 2025—down from four in the previous iteration. Additionally, officials moved their projection for both growth and inflation higher, while their projection for the unemployment rate moved lower and only slightly above the current level.

Overall, the fourth quarter of 2024 was characterized by resilient labor market dynamics, strong economic growth and sticky inflation. The impact on fixed income performance was mixed, with yields rising and credit spreads tightening, leading to modestly negative returns for most fixed income sectors.

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Portfolio review

For the quarter, the SMA underperformed the Index on both a gross- and net-of-fees basis. The SMA's focus on higher quality bonds detracted from returns versus the Index, as lower-rated credits significantly outperformed during the quarter.

Outlook

Looking forward, we continue to expect economic growth will remain resilient. The recent election outcome further strengthens this view due to election optimism and productivity gains from deregulation. Meanwhile, we expect inflation to resume its downward trend, driven by moderating service prices. In this area however, the election result lowers our conviction as an adverse policy mix of deficit spending, tariffs and stricter immigration limits would sustain higher levels of demand while constraining supply. That said, we believe a negative market reaction would likely compel the administration to temper those policies before they derail growth.

Assuming this is the case, and inflation does not reaccelerate, we expect the Fed will tolerate inflation that is slightly above their target and deliver a few more rate cuts in an effort to preserve the current cycle.

The strong macro backdrop and easing cycle is expected to provide ongoing support to credit fundamental factors in the HY market. While valuations are on the richer side, high carry should continue to cushion returns and protect from spread-widening events absent an external shock. In the medium term, investors may have opportunities to capitalize on short-lived market dislocations as the Trump administration looks to find the right balance in implementing its policy goals. For fixed income portfolios, security selection and flexibility in sector allocations will be key to generating outperformance.

Read our strategy brief

Returns are benchmarked to the **ICE Bank of America U.S. High Yield Master II Constrained Index**, which does not incur management fees, transaction costs, or other expenses associated with a composite portfolio. The ICE Bank of America High Yield Master II Index is a market value-weighted index consisting of U.S. dollar-denominated, non-investment grade bonds not currently in default and limits any individual issuer to a maximum of 2% benchmark exposure. Securities prices used to value the benchmark index for the purposes of calculating total return may or may not differ significantly from those used to value securities held within composite portfolios. Index returns do not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. High-Yield Securities, or "junk bonds", are rated lower than investment-grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. The strategy may use Derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses and have a potentially large impact on performance. Foreign Investing does pose special risks including currency fluctuation, economic and political risks not found in investments that are solely domestic. Risks of foreign investing are generally intensified in Emerging Markets. As Interest Rates rise, bond prices may fall, reducing the value of the share price. Debt Securities with longer durations tend to be more sensitive to interest rate changes. Other risks include but are not limited to: Credit Risks; Other Investment Companies' Risks; Price Volatility Risks; Inability to Sell Securities Risks; and Securities Lending Risks.

The Composite performance information represents the investment results of a group of fully discretionary accounts managed with the investment objective of outperforming the benchmark.

The Fund discussed may be available to you as part of your employer sponsored retirement plan. There may be additional plan level fees resulting in personal performance to vary from stated performance. Please call your benefits office for more information.

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