Voya Intermediate Bond Strategy

Dynamic Core Bond Strategy

Strategy overview

Total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment-grade securities.

Key takeaways

- Monetary policy continued to produce market volatility in the second quarter of 2023.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value basis. Security selection and sector allocation added to performance, while duration and yield curve decisions detracted.
- We expect growth to continue to slow, and the threat of recession to remain elevated and our strategy remains broadly defensive, with a preference for high quality spread opportunities.

Portfolio review

For the quarter ended June 30, 2023, the Strategy outperformed the Index. Sector allocation and security selection contributed, while duration and yield curve decisions detracted.

Monetary policy continued to produce market volatility in the second quarter of 2023. Despite the failure of a fourth U.S. Regional Bank just two days prior, the U.S. Federal Reserve delivered another 25 basis points (bp) hike at their meeting in May. That said, with inflation trending in the right direction, and lending from banks expected to tighten, it was widely believed that this hike might be the last. Inflation data over the next couple of months was relatively well behaved. While the numbers remained elevated, they avoided moving higher. Meanwhile, the labor market remained strong. Monthly job gains surpassed already elevated expectations, with each monthly gain exceeding the previous one. While the Fed did not deliver a hike at their meeting in June, these upside surprises in the labor market all but eliminated hope of a "pause", with market participants instead viewing the Fed's inaction as a "skip".

In corporate credit markets, spreads moved to the tightest levels of the year after setting recent wides post bank failures in March. While First Republic became another casualty, remaining regional banks found sufficient support in the Fed's bank term lending facility and deposit outflows were not as bad as feared. On the earnings side, 1Q23 figures came in much better than expected (albeit negative) which was also supportive of credit spreads.

The fallout from the bank failures also had implications for other sectors of the bond market, particularly agency mortgage-backed securities (MBS) given the Federal Deposit Insurance Corporation (FDIC) needed to liquidate roughly $90 billion. To the surprise of many, MBS overcame this challenge and posted decent excess returns for the quarter as money manager demand for high quality assets was high.

Across other securitized markets, performance was also positive. While the challenges in commercial real estate (CRE) are ongoing, commercial mortgage-backed securities (CMBS) took a break from recent spread widening and managed to post modest excess returns. Collateralized loan obligations (CLOs) were supported by the performance of their bank loan collateral and asset-backed securities (ABS) continued to be supported by mostly strong consumer balance sheets. The economy and financial markets in 2Q23 could best be described as "resilient". And this may be best illustrated by activity in the housing market. As mortgage rates moved from multi-decade lows to multi-decade highs in relatively short order, many expected a quick and substantial drop in home prices. Not only has that yet to occur, but home prices have been moving slightly higher over the last couple of months, supporting the non-agency residential mortgage-backed securities (RMBS) and credit risk transfer (CRT) segments.

Sector allocation and security selection added to performance, while duration and yield curve positioning detracted. A positive risk sentiment tone meant that our underweight to U.S. Treasuries and allocations across a range of sectors contributed. Allocations to non-agency RMBS and CRTs added nicely, buoyed by the durability of the U.S. housing market and U.S. Consumer. Security selection contributions were broad, with the largest contributions sourced from investment grade corporates, ABS and agency RMBS. IG corporate selection contributions reflected a rotation out of utilities into financials and specifically banking issuers that had widened during the regional bank turmoil. Gains in ABS security selection which included high quality (CLOs) added to relative returns as the sector's yield advantage and collateral performance in the broader loan market positively contributed. Agency RMBS selection was supported by collateralized mortgage obligations (CMOs) and other non-standard pool investments. Notable changes in portfolio positioning including a reduction in our allocations to CLOs later in the quarter, as recent performance has reduced the relative attractiveness of the sector. We deployed a modest amount of risk to IG corporates as concerns over regional banks continued to fade. We continued to make tactical shifts in agency RMBS, adding to our exposures in 30-year mortgages in April and then removing that exposure as the market outperformed. In aggregate, duration and yield curve detracted while positive security selection within U.S. Treasuries which reflects our overall strategy helped to mute this impact.

Current strategy and outlook

We expect growth to continue to slow, and the threat of recession to remain elevated. With corporate earnings in decline, leverage ratios are beginning to move higher. And while most corporate borrowers termed out their debt at very low fixed rates, this is not the case for senior bank loan issuers, where leverage is higher. Meanwhile, Commercial Real Estate (CRE) financing markets remain challenging, which could become problematic as many loans are approaching their maturity date. And finally, while consumer spending is supported by the strength in the labor market, this strength is also keeping inflation elevated, in turn motivating the Fed to keep rates higher for longer.

Portfolio strategy remains broadly defensive, with a preference for high quality spread opportunities. Having increased our dry powder and improved liquidity over the last few quarters, we continue to look for the right opportunities to redeploy capital but would need to see markets more appropriately discount the risks mentioned above. From a duration perspective, while we do recognize the additional yield pick-up in going shorter, we believe the diversification benefit between bonds and stocks has finally returned and have chosen to remain close to neutral.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot invest directly in an index.**

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