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.

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Key takeaways

- Rates marched higher as strong data kept the U.S. Federal Reserve in a hawkish position.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Security selection drove outperformance, while sector allocation was a modest contributor and duration and yield curve decisions detracted.
- The end of the Fed tightening is within sight, but rate cuts are still a way away.

Portfolio review

For the quarter ended September 30, 2023, the Strategy outperformed the Index on a NAV basis. Security selection drove outperformance, while sector allocation was a modest contributor and duration and yield curve decisions detracted.

Rates marched higher as strong data kept the Fed in a hawkish position. The third quarter of 2023 contained an abundance of strong data, casting aside thoughts about a recession in the near-term and the prospect of a soft landing, which seemed like a dream at the start of the year, gained credibility. Inflation continued to trend in the right direction. Core Personal Consumption and Expenditures (PCE), which peaked at year over year rate of 5.6%, fell to 3.8% by the end of August. Meanwhile, the U.S. economy continued to add jobs at a fast pace. The combination of falling inflation and a strong labor market allowed consumers to continue spending which is important since consumption is the largest component of U.S. gross domestic product (GDP). The Fed maintained a data dependent stance and responded to the better-than-expected data by hiking rates at their July meeting. At the same time, they continued to stress that monetary policy would need to remain in restrictive territory until the economy softens and inflation is clearly in the rearview mirror. In September, the Fed resisted delivering another hike, however their updated dot plot reinforced their "higher for longer" message. As a result, rates resumed their march higher. By quarter-end the 10-year Treasury yield had risen by 73 basis points (bp), to 4.57% as the market continued to digest the higher for longer message, with the 2-year rising modestly by 18 bp, to 5.05%. This set the stage for negative total returns across most fixed income markets, with the Bloomberg US Aggregate Bond Index falling by –2.54% for the period.

Credit sectors broadly outperformed U.S. Treasuries, mitigating some of the pain inflicted by higher rates. Responding to the economic data, higher beta sectors such as high yield (HY), senior loans and collateralized loan obligations (CLOs) were the top performing sectors in both nominal and excess returns. Non-agency residential mortgage-backed securities (RMBS) and Credit Risk Transfer securities (CRTs) also posted strong returns, supported by the resilient economy, low unemployment and continued strength in house prices. Higher quality sectors such as investment grade (IG) corporates and asset-backed securities (ABS) also produced positive excess returns, albeit to a lesser degree. Even commercial mortgage-backed securities (CMBS) outpaced the Treasury market, however rising delinquency rates and declining property values remain a concern dogging the sector. One sector that did not follow the positive excess returns was agency RMBS. The sector was the worst performing sector due to higher rates, continued rate volatility, a steeper yield curve (less inverted), and a lack of demand.

Security selection drove performance, while sector allocation decisions were muted, and duration and yield curve positioning detracted. A positive risk sentiment tone meant that our more credit sensitive security decisions contributed meaningfully for the quarter. The largest contributions were sourced across securitized sectors. Agency RMBS added the most, supported by collateralized mortgage obligations (CMOs). ABS contributed as a result of investments in off-benchmark sectors as well as high quality CLOs, driven by collateral performance and the sector's yield advantage. CMBS security selection also contributed as attractive yields helped to support outperformance. Corporate security selections across IG and HY corporates also added but were smaller contributors. Sector allocation was mixed and in aggregate yielded a modest contribution. The largest contributor was from investments in non-agency RMBS and CRTs, buoyed by the economy, housing market and resiliency of the U.S. consumer. Meanwhile, our overweight to agency RMBS was the largest detractor as the sector lagged in the wake of higher rates and rate volatility. Notable changes in our allocations included an increase in agency RMBS as relative valuations offer attractive high-quality yield. We added to CMBS, with a preference to higher quality tranches and trimmed allocations in ABS which included a reduction in CLOs after the continued strong performance leaves the sector with less upside. In aggregate, duration and yield curve detracted while positive security selection within U.S. Treasuries which reflects our overall strategy helped to offset much of this impact.

Current strategy and outlook

The end of the Fed tightening is within sight, but rate cuts are still a way away. While market participants debate whether the Fed has a 'final' rate cut on the horizon, we think the discussion on rate increases has run its course and investors should focus on how long the Fed might maintain official rates. We think moderating inflation allows the Fed to pause, yet a clear downturn in labor and the economy will be required for the Fed to pivot to substantive cuts. As a result, we expect the timeline for a rate cut is further out, reflecting the robustness in labor markets. We expect growth will slow and continue to monitor threats for a possible recession. With households well supported by higher wages, moderating inflation and a liability structure that is primarily fixed rate and corporations exercising discipline with regard to balance sheet management, we see the limited scope for a sharp downturn in the U.S. economy.

Allocating in fixed income is less complicated against a backdrop of higher nominal and real yields. While the path of higher rates since the beginning of the Fed tightening cycle has been painful, investors should not fear the destination. Investors are being rewarded with attractive nominal and real yields without needing to overextend credit risk. Our preference for 'up in quality' investments is higher than it has been in the recent past, but as opportunities present themselves, we are willing to deploy capital to take advantage of these opportunities. From a sector allocation perspective, agency RMBS is an area we find attractive. With market comfortable with the Fed in runoff mode (QT) and prepayment risk virtually non-existent, the market is now priced at levels should attract buyers. CMBS is another area of focus. Ongoing concerns on commercial real estate and specifically office will remain a challenge, but security selection opportunities within this sector are abundant. We prefer seasoned deals, which have gone through some degree of deleveraging, over newer vintages. On the corporate side, financials have lagged the rally, enhancing the relative value opportunity within the IG sector. Meanwhile in leveraged credit, allocations are modest, and we prefer for HY corporates over senior bank loans. Borrowers in the loan market continue to be plagued by rising interest rates and the slowdown in CLO origination means refinancing maturing debt could be difficult. While an array of economic outcomes is adding volatility to interest rate markets, we believe real yields remain an anchor to valuations and maintain a duration profile in line with the benchmark.

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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The strategy employs a quantitative model to execute the strategy. Data imprecision, software or other technology malfunctions, programming inaccuracies and similar circumstances may impair the performance of these systems, which may negatively affect performance. Furthermore, there can be no assurance that the quantitative models used in managing the strategy will perform as anticipated or enable the strategy to achieve its objective.

The strategy is available as a mutual fund or variable portfolio. The mutual fund may be available to you as part of your employer sponsored retirement plan. There may be additional plan level fees resulting in personal performance that varies from stated performance. Please call your benefits office for more information.

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