

Unconstrained, multi-sector focus on global risk-adjusted opportunities

Strategy overview

An unconstrained, multi-sector fixed income strategy focused on maximizing total return by seeking risk-adjusted opportunities across the globe.

Key takeaways

- The second quarter of 2024 was marked by a series of evolving and, at times, conflicting economic signals.
- Duration and yield curve positioning detracted from returns, while sector allocation added and security selection positively contributed.
- From a fundamental perspective, the outlook has undoubtedly improved.

Portfolio review

For the quarter ending June 30, 2024, the Voya Strategic Income SMA underperformed the custom benchmark on a net asset value (NAV) basis. Duration and yield curve positioning detracted from returns, while sector allocation added and security selection positively contributed.

The second quarter of 2024 was marked by a series of evolving and, at times, conflicting economic signals. The interplay between labor market dynamics, inflation and consumer behavior painted a mixed picture for investors and policymakers alike.

The quarter began with a significant upside surprise in the March Non-Farm Payroll (NFP) report, contradicting other employment indicators such as Institute for Supply Management (ISM) Employment and National Federation of Independent Business (NFIB) hiring intentions. Notably, job growth was primarily concentrated in part-time employment, potentially masking broader weakness that was evidenced by a decline in full-time employment that had been ongoing since peaking in May 2023. One month later, NFP missed to the downside, which helped to quell reflation fears but was still strong enough to avoid igniting concerns of a recession. Altogether, the trend over the quarter signaled a return to a more “balanced” labor market, with the pace of wage gains slowing, the quit rate declining, and the unemployment rate ticking up modestly off extreme lows.

Similarly, consumer spending, which has led growth over the last several quarters, showed signs of softening, with modest growth numbers reported in both personal spending and retail sales data. Rising credit card delinquencies and a low savings rate further underscored the financial challenges facing some consumers.

The disinflationary narrative, which came into question in 1Q24 following a series of upside surprises, regained credibility in 2Q24 as the data came in mostly in line with expectations. That said, U.S. Federal Reserve officials maintained a cautious stance, and emphasized that no immediate rate cuts were necessary. The Fed’s updated dot plot in mid-June revealed a relatively hawkish stance, projecting only one rate cut through the end of the year, compared to three in the March projection.

Markets, like the Fed, were very data dependent. With better growth data reported at the beginning of the quarter, spreads continued to trade at tight levels and credit sectors posted solid excess returns. Interest rates also responding by continuing the selloff that was sparked by the hot inflation data in 1Q24, but ultimately finished the quarter only slightly higher.

Corporate credit sectors were further supported by 1Q24 earnings, which again exceeded analyst expectations. While leverage and coverage ratios continued to slowly deteriorate, aggregate fundamental factors remained acceptable, and ratings trends continued to be positive overall. From a technical standpoint, both investment grade (IG) and high yield (HY) sectors were well bid due to higher all-in yields, despite tight spread levels.

Securitized credit sectors also benefited from the positive macro backdrop. For example, commercial mortgage-backed securities (CMBS) managed to outperform as easier financial conditions and improved primary market activity has allowed for an easier path to refinance existing loans. Meanwhile on the residential side, primary activity remains subdued, however so did delinquencies and defaults as the employment picture still remains favorable along with borrowers having locked-in low mortgage rates during the Covid era. Asset backed securities (ABS) spreads also managed to tighten, despite the continued increase in delinquencies across subprime borrowers. Collateralized loan obligations (CLO) represented one of the best sources of excess returns on the quarter, likely due to the sectors floating rate attribute in an environment of still elevated rates.

Duration and yield curve positioning detracted from returns, while sector allocation added and security selection positively contributed. Asset allocation within CMBS, non-agency residential mortgage-backed securities (RMBS) and ABS contributed most positively. Within security selection, HY contributed while IG detracted. We maintained overweights to CMBS, ABS, non-agency RMBS and emerging market hard currency sovereigns, while staying underweight in IG and HY.

Current strategy and outlook

From a fundamental perspective, the outlook has undoubtedly improved. Inflation has managed to decline without significantly impacting growth, and labor markets have managed to rebalance without a meaningful uptick in unemployment. We believe inflation will continue to trend lower, as the lagged impact of declining rent prices will take hold in the coming months, and overcapacity in China will keep goods prices in deflation. We expect growth to remain positive but will continue at a more measured pace. Consumption growth will likely slow due to slowing wage gains and higher prices but will remain positive as the wealth effect (stock prices and home values at all-time highs) continues to be supportive. Similarly, high financing costs will likely curb private investment, however this will be at least partially offset by investment in artificial intelligence technology.

Stress on lower income consumers is, unfortunately, a key outlier in this otherwise positive dynamic. While not a systemic risk, we do think this will allow the Fed to cut rates prior to the election. That said, with the labor market still intact and consumer spending still supportive in aggregate, along with inflation still above 2%, we believe the extent to which the Fed will cut will be limited and the pace will be slow.

While the macro backdrop looks favorable, valuations are rich, for example, the IG corporate index carried a spread of less than 100 basis points (bp) and HY was slightly above 300 bp. Securitized credit sectors appear more attractive from a relative value perspective, as such, we continue to favor an allocation to these sectors, however we are still avoiding the most vulnerable areas (subprime consumer ABS, non-qualified mortgage RMBS, subordinated CLOs). Meanwhile, duration-oriented risks are poised to benefit from the implementation of central bank policy and the resulting decrease in rate volatility. While strong fundamentals will continue to support tight spreads, periods of volatility spurred by expectations of lower growth and post-election policies changes will provide opportunities to episodically add risk.

Disclaimers

The custom benchmark is a blend of 80% the Bloomberg US Corporate Bond 1–5 Year index and 20% the Bloomberg US High Yield index. Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot directly invest in an index.**

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The strategy employs a quantitative investment process. The process is based on a collection of proprietary computer programs, or models, that calculate expected return rankings based on variables such as earnings growth prospects, valuation, and relative strength.

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