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

- Bond markets ended the year with a spirited rally, with expectations not only was the U.S. Federal Reserve done raising rates, but rate cuts were on the horizon.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Sector allocation drove outperformance, while duration and yield curve decisions were a modest contributor and security selection detracted.
- As the market focus shifts from inflation to growth concerns, duration will become an effective offset to risky asset drawdowns.

Portfolio review

For the quarter ended December 31, 2023, the Strategy outperformed the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Sector allocation drove outperformance, while duration and yield curve decisions were a modest contributor and security selection detracted.

Rates continued to sell-off into October as strong economic data faded hopes for a Fed "pivot". In particular, the labor market showed significant strength, with September's payroll data reporting an impressive pace of job gains. This was followed by the initial reading for third-quarter gross domestic product growth which exceeded already elevated expectations, coming in well above trend. By the end of October, the 10-year Treasury yield had breached 5%, a level not seen since 2007. As rates moved higher, credit spreads widened reflecting the increased risk that comes with a prolonged period of restrictive policy.

Then came November and with it, a notable turn in sentiment. Inflation data, which had already been declining for several months, continued to decline resulting in more balanced market expectations. One Fed governor even suggested the possibility of rate cuts ahead of reaching the 2% inflation target. Additionally, while payroll gains remained strong, they were more measured over the next couple of months, and September's blockbuster gain was revised downward by a meaningful amount. As a result, rates rallied and credit spreads tightened.

In the final month of the quarter, the Fed appeared to confirm renewed market expectations that a less restrictive stance was in the near future. The updated dot plot showed that every single participant believed the hiking cycle had concluded, and the median participant projected 75 basis points worth of cuts in 2024. This affirmation from the Fed further contributed to the tightening of credit spreads, and a fall in rates. The experience of November and December stood out from the first 10 months of the year. Rates experienced a significant decline, and the Bloomberg US Aggregate Index rallied, resulting in a 6.82% return for the quarter, with more than 4% coming from November alone. One thing that was consistent throughout the year was that lower credit sectors produced strong excess returns however even higher quality sectors posted respectable outperformance. For example, agency mortgage-backed securities (MBS), which struggled earlier in the quarter due to inconsistent demand, rallied into falling rate volatility and ended the quarter on a high note.

Sector allocation drove outperformance, while duration and yield curve decisions were a modest contributor and security selection detracted. The brisk rally into year-end, meant our overweight to credit sectors and underweight in Treasuries contributed broadly. High yield (HY) was the largest individual contributor, due to the sector's higher beta as well as tactical exposure we held during November's strong rally. Offsetting some of this performance was our asset backed securities (ABS) overweight, which was expected as this sector typically lags during risk on rallies. Security selection results were mixed, and in aggregate detracted. Security selection within agency MBS detracted from results, as our investments in off-benchmark collateralized mortgage obligations (CMO) did not keep up with the strong rally in benchmark MBS. Commercial mortgage-backed securities (CMBS) security selection also detracted due to idiosyncratic events within more credit sensitive investments. Meanwhile ABS security selection that included off-benchmark subsectors and higher yielding collateralized loan obligations (CLO) contributed to security selection. During the period, the most notable change in allocations included a reduction in agency residential mortgage-backed securities (RMBS). We have been tactical in this sector throughout the year and expect that to continue in the period ahead. The outperformance in 4Q 2023 was regarded as an opportunity to reduce our exposures and look to redeploy as market valuations become more attractive. Other changes were modest, with small reductions in our overweights within investment grade (IG) corporates and ABS, with a focus on trimming higher-yielding CLOs. In both cases, this reflected the strong outperformance and a reflection of our relative value assessment. Duration and yield curve decisions had minimal contribution to relative performance as we were modestly long for most of the period and then reduced duration as we believed the market has become too optimistic for Fed actions.

Current strategy and outlook

Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend. The increased cost of capital will likely curb consumption and investment, however ongoing government support measures at a global level are expected to partially offset these effects. In particular, China's growth focused investment and advanced economies efforts to enhance supply chain security are anticipated to bolster growth in the short term.

As the market focus shifts from inflation to growth concerns, duration will become an effective offset to risky asset drawdowns. Rate volatility, though receding from recent peaks, will remain above pre-pandemic levels due to uncertainty about the timing of rate cuts and concerns about government debt levels. Elevated real rates will incent investors to increase allocations to fixed income, creating opportunities during bouts of volatility. That said, many corners of the market appear to be priced for a soft landing. While this has become a more likely outcome, we believe the risks to this outcome materializing are being ignored. Labor markets are coming into better balance which, while good news for inflation, could cause concern among workers that a turn in the cycle is approaching. This in turn could compel workers to boost savings rates which would limit consumption and act as a challenge to growth.

With this dynamic in place, portfolios have a moderate level of risk with focus on higher quality credit, and allocations are skewed towards sectors with better relative value. For example, securitized credit markets are currently trading with wider spreads relative to comparably rated corporates bonds. Meanwhile, the dark clouds facing the sector due to concerns over CMBS appear to be fading as lower rates make refinancing existing loans less challenging. Within corporate credit, we prefer IG, however to the extent we are willing to drift into lower quality, we prefer HY over senior loans given the latter is most directly impacted by higher financing costs. Outside of credit, agency MBS remain attractive relative to Treasuries due to historically wide spreads despite minimal prepayment risk and episodic market volatility will present tactical opportunities.

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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