# Fixed Income Perspectives — Extended Markets

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Voya Investment Management's fixed income strategies cover a broad range of maturities, sectors and instruments, giving investors wide latitude to create a new portfolio structure or complement an existing one. We offer investment strategies across the yield curve and credit spectrum, as well as in specialized disciplines that focus on individual market sectors. We build portfolios one bond at a time, with a critical review of each security by experienced fixed income managers. As of December 31, 2014, Voya Investment Management managed $125 billion in fixed income strategies in the United States.

## Macro Overview

- As spring tries to finally loosen us from an insistent Old Man Winter's icy grasp, we're witnessing another tug of war between the world's major economies and its central banks. Despite ample signs of slowing economic growth in the U.S., Fed members and watchers alike have continued to talk up the need for near-term normalization of interest rates. A mirror image is visible in Europe, where a nascent upswing in economic activity is being accompanied by a European Central Bank steadfast in its commitment to asset purchases through September 2016 to help the green shoots take hold across the region.
- So what can we expect as these competing forces pull on either side of the macroeconomic rope? First, *observed* volatility of U.S. interest rates will remain low; just as spring temperatures can have a hard time establishing themselves after a long winter's chill, it will be hard for Treasury yields to rise in the face of prolonged softness in domestic data. At the same time, however, markets will find it difficult to mount a rally with the possibility of rate hikes still looming. U.S. interest rates, as a result, will continue to fluctuate within a fairly tight range, creating a lower-volatility environment that is good for U.S. credit and negative-convexity products like mortgages.
- At the same time, the standoff between central banks and economic data — with a boost from the hedging needs of the pension and insurance sectors in light of rock-bottom interest rates — has engendered higher *implied* volatility (that is, estimates of future volatility) relative to the recent past. Any release of this tension — if the ECB decides to taper its QE efforts ahead of schedule, for example, or if Fed rhetoric grows decidedly more hawkish — could trigger a spike in observed volatility in interest rates and currencies. At the end of the day, the striking contrast between implied and observed volatility in the rates and currency markets suggests investors would be well advised to maintain exposure to risky assets while protecting against tail events.

**Spreads, Returns and Yields**

| Index | Percentage of Index | Spread (bps) | Returns (%) | |
|---|---|---|---|---|
| | | | Mar. 2015 | YTD 2015 |
| **Barclays U.S. Aggregate** | **100.0** | **46** | **0.5** | **1.6** |
| Treasury | 36.0 | 0 | 0.6 | 1.6 |
| Investment Grade Corporates | 23.6 | 129 | 0.3 | 2.3 |
| Fixed-Rate MBS | 28.0 | 20 | 0.4 | 1.1 |
| **Other** | | | | |
| High Yield | | 466 | -0.5 | 2.5 |
| Global Aggregate | | 42 | -1.0 | -1.9 |
| Emerging Markets | | 375 | 0.6 | 2.3 |

| Country | Yield on Ten-Year Bonds (%) | Currency | | Returns (%) | |
|---|---|---|---|---|---|
| | | | | Mar. 2015 | YTD 2015 |
| U.S. | 1.91 | EUR/USD | 1.07 | -1.2 | -11.7 |
| Germany | 0.10 | USD/JPY | 120 | 0.3 | 0.0 |
| Japan | 0.32 | USD/BRL | 3.20 | 6.5 | -12.4 |
| Brazil | 12.58 | | | | |

Source: Barclays, JPMorgan, Standard & Poor's

**Note:** All spreads are to Treasuries and option adjusted except for Emerging Markets, which is nominal. All returns are total returns including dividends expressed as percentages. All returns in U.S. dollars.

# Sector Overviews

## Global Rates

- The Fed will likely wait until late this year or perhaps 2016 before introducing a fed funds rate hike. The markets reflect a small amount of hike embedded in the forward rates. We expect the level and slope of the yield curve to remain stable until the Fed gives a clearer message about rate normalization.
- With the European Central Bank buying €60 billion of bonds per month, interest rates in the euro zone will continue to be driven by liquidity and supply-demand technicals. ECB purchases could drive the nominal yield on 30-year German bunds below zero. A shift in ECB focus to the periphery would be very positive for issues from these countries, while signs of premature tapering would push the market the other way.

## Global Currencies

- The conflict between central banks' policy outlook and the direction of economic data has kept developed market currency rates fairly directionless versus the dollar since Fed Chair Yellen's mid-March press conference. We think the greenback is at or near its short-term peak against developed market currencies. Further decline in crude oil prices or an increase in the terminal fed funds rates could trigger another dollar rally, but neither are likely within the next couple of months.
- Euro/sterling cross-volatility is somewhat elevated due to the uncertainties regarding the outcome of the U.K. elections.

## Investment Grade Corporates

- Earnings estimates for the first and second quarters of 2015 have seen significant downward revisions, with growth expected to be negative for both before picking up in the second half of the year. The revisions suggest that the market is not yet willing to price in potential upside to the consumer industries from lower commodity prices. Despite an expected uptick in leverage, overall corporate fundamentals are still supportive of current valuations.
- M&A activity continues to gain steam, though at this point we have yet to see the leveraging transactions that defined past cycles. With inflows strong and the seasonal near-term supply slowdown upon us, we see a window for corporate spreads to outperform this month. Valuations in the middle of the year-to-date range look reasonable.

## High Yield Corporates

- Weakness in the energy sector and the sluggish U.S. economic data have started to cloud the fundamental outlook, as leverage continues to creep higher. We still do not foresee a near-term spike in defaults, through there will likely be a slight uptick from weaker energy names. Technicals remain generally supportive, as fund flows have been positive and stocks have held near all-time highs.
- The differentiation of the energy "haves" and "have-nots" continues, as weaker companies struggle to find funding while better-positioned firms have accessed both debt and equity markets in recent weeks. Energy sector returns in March trailed the broad market, as weaker operators continued to drift lower. With the credit curve steep and energy trading well wide of the market, near-term return prospects remain dependent upon the performance of energy and lower-rated credit.

## Mortgages

- The muted prepayment environment of 2014 is a distant memory, as 2015 has brought lower rates and decreased government guarantee fees. Still, mortgages have held in well versus Treasury hedges, as robust domestic bank demand and low net issuance buoy the market. Government sponsorship continues to provide a tailwind and the implication of a longer/slower Fed hiking cycle should dampen convexity-related fears. Ultimately a view on mortgages is essentially a call on rates, as mortgages have continued to outperform during a selloff and vice versa. We maintain a neutral stance on mortgages based on our expectation for range-bound rates given balanced domestic and global economic pressures.
- Consumer ABS remains insulated from the energy price collapse, currency volatility and Europe's persistent sluggishness; recent signs of improving home purchase fundamentals supports a positive outlook for home-price appreciation. As non-agency mortgages continue to season, fundamental outcomes become more certain and the carry advantage for bond holders will provide greater protection even if spreads widen.

## Emerging Markets

- We affirm our slight positive outlook for emerging markets debt after a healthy market rebound following the latest FOMC meeting. The recovery of commodity prices in general and oil prices in particular coupled with the likely delay of any Fed action is leading

# Bond Market Outlook

**Global Interest Rates:** Expect range-bound rates and low realized volatility near term, though implied volatility will remain high.

**Global Currencies:** U.S. dollar has likely peaked in relative value; weaker oil prices or a rate hike would be needed to trigger a further rally.

**Corporates:** With the Fed on hold and supply technicals favorable, corporates look poised to outperform near term.

**High Yield:** We remain generally constructive on credit fundamentals despite the sluggish economic data and weakness in energy.

**Mortgages:** Strong demand and limited supply have supported agencies. Demand for secondary CMBS paper remains strong.

**Emerging Markets:** A healthy rebound post-FOMC has inspired our slightly positive outlook.

**Private Credit:** Demand remains strong, and yields are presenting good value.

**Mortgage Derivatives:** Prepayment fundamentals remain supportive, as do technicals given limited CMO production.

**Commercial Mortgage Loans:** Prices remain stable, as lender floors have pushed spreads wider to compensate for falling coupon yields.

to improvement in emerging market technicals and surge in appetite for higher-yielding assets. While the main performance drivers will be current yield and income, when assessing the asset class one cannot exclude price volatility driven by external factors like the equity markets and the dollar.

### Private Credit

- Demand for private credit assets should remain robust. While historically low yields are driving exceptionally heavy deal flow by issuers looking to capture the opportunity, U.S. private credit spreads — at 100–200 basis points — remain relatively wide compared to public investment grade credit. The majority of new issuance is coming out unrated but of mid-BBB credit quality and is senior unsecured from repeat issuers. We continue to see good value for new-issue investment grade U.S. private credit.

### Mortgage Derivatives

- Prepayment speeds increased more than expected for recently originated loans with good credit, high loan sizes and already-low interest rates. Speeds were largely unchanged for other types of loans, however, including loans originated before the HARP program deadline of June 2009 and loans with small balances. This once again demonstrates the benefit of focusing on pools of mortgages that face non-rate-related obstacles to rapid prepayments.
- Most interest-only and other mortgage derivative bonds continued to do well in March on overall solid prepayment fundamentals, and near-term upside seems limited after the outperformance. However, we continue to see potential for the asset class over the longer term, and securities in a number of subsectors still look attractively priced. Meanwhile, the supply/demand picture remains rather supportive for mortgage derivatives, as CMO issuance continues to be modest.

### Commercial Mortgage Loans

- Prices for commercial mortgage loans remain fairly stable, as many lenders have floors in place that create wide spreads while coupon yields continue to compress. The government-sponsored entities (Freddie and Fannie) have already about run through their annual allocations. This will mean opportunities for life companies in the multi-family space; when this occurred two years ago we saw increased loan volume and wider-than-typical spreads for multi-family, to the great benefit of portfolio and CMBS lenders.
- We expect more opportunity in the core-plus lending space (i.e., higher-risk real estate deals like bridge or mezzanine loans), as an increasing amount of CMBS loans originated ten years ago come due. Many of these are un-stabilized and are not ready for core permanent financing, meaning higher-leverage lenders will see volume and good risk-adjusted pricing.

**Past performance does not guarantee future results.**

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