

# Fixed Income Perspectives



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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 March 31, 2015, Voya Investment Management managed \$129 billion in fixed income strategies in the United States.

## Bond Market Outlook

**Global Interest Rates:** The selloff in Treasuries appears done for now. The yield curve is pricing a Fed rate hike in September at the earliest.

**Global Currencies:** We think that the euro/dollar rate will have a hard time increasing much beyond current levels thanks in part to the ECB's efforts.

**Corporates:** Earnings have been a headwind, but the steady recovery in oil has provided sufficient support for spreads to move tighter.

**High Yield:** While fundamentals are good, deterioration in industrial revenues or a stronger U.S. dollar could hurt credit statistics.

**Mortgages:** With improved relative value and marginally higher interest rates, the outlook for CMBS has improved.

**Emerging Markets:** Flows into hard-currency markets are likely to continue to support the technical picture.

## Macro Overview

- As the springtime riddle goes, "If April showers bring May flowers, what do May flowers bring?" While those of us in the grips of a brutal allergy season may offer "sneezing fit" as an answer, rate watchers would probably point toward a convulsion of another kind, this one in the markets. The season's flowers brought with them a pollen rich with uncertainty about the direction of central bank balance sheets, sparking a selloff in global fixed income markets.
- It appears that we have entered a period during which central bank activity is more likely to increase volatility than dampen it. We saw this in the Federal Reserve-inspired "taper tantrum" of 2013 as well as in early 2015's "franc fiasco" attributable to the Swiss National Bank. Now we are seeing a "bund blowup" in Germany, where yields on ten-year issues approached zero before quickly spiking higher as investors appeared to come around to the idea that the European Central Bank's asset purchases would indeed continue and be supportive of growth. In each of these examples, investors fled the markets as expectations about central bank policy — and specifically balance sheet activity — changed markedly.
- This latest selloff has lost steam in recent weeks, however, for several reasons. First, not only does the ECB appear unwavering in its commitment to buying bonds through mid-2016, the central bank also has indicated that it will be bring forward some of these asset purchases into the more active pre-summer trading period. Meanwhile, U.S. economic sluggishness persists, for the most part, presenting a challenge to the recovery story; in fact, the Economic Surprise Index has dipped to 2009 levels, suggesting a softening of expectations. Given that it's unlikely the soft patch in the recovery is reflective only of a seasonal downturn, we see no reason for the Fed to jump into a hiking cycle before the time line implied by the forward fed funds rate.
- Consequently, in managing our risk budgets we have been modestly reducing our allocation to spread assets in an effort to keep some powder dry. In addition, we have become more constructive on tactically shifting to modest long-duration positions at higher yield levels.

### Spreads, Returns and Yields

Index	Percentage of Index	Spread (bps)	Returns (%)	
			May 2015	YTD 2015
Barclays U.S. Aggregate	100	44	-0.4	1.2
Treasury	36.2	0	-0.5	1.1
Investment Grade Corporates	23.6	128	-0.7	1.6
Fixed-Rate MBS	27.9	17	0.0	1.1
Other				
High Yield		439	1.2	3.8
Global Aggregate		41	1.1	-0.9
Emerging Markets		339	1.8	4.2

  

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			May 2015	YTD 2015
U.S.	2.03	EUR/USD 1.12	4.3	-7.3
Germany	0.37	USD/JPY 119	0.3	0.3
Japan	0.34	USD/BRL 3.01	-5.0	-11.8
Brazil	12.80			

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

- We believe the current selloff in Treasuries is done for now. The front end of the yield curve is pricing in a federal funds rate hike no earlier than September, and the latest domestic economic data give no reason either for the date of first hike to be pulled forward or for the terminal rate to be higher. Furthermore, ten-year inflation breakeven rates — at 1.90% — do not leave much room for an increase, unless we see a large spurt in commodity prices or the market re-prices to express a belief that the Fed is seriously behind the curve. Therefore, at current yields we are constructive on a modest long duration position.

### Global Currencies

- We think the euro/dollar exchange rate will have a hard time increasing much beyond 1.15. Should the euro approach this level, the ECB is likely to talk it down; for example, recent comments made by an ECB executive board member that the bank would speed up the pace of its bond purchases before summer sent the euro tumbling against the dollar. We like to be long dollar at current levels.

### Investment Grade Corporates

- While first quarter earnings came in much better than expected — forecasts had projected year-over-year earnings growth to be down to 2009 levels — they were still the worst since 2012. Given the shrinkage on the top line and the increase in both gross and net leverage, we've grown slightly negative. Modest positive flows into the sector and limited issuance during earnings season have provided a technical boost.
- Spreads and valuations remain modestly attractive. Our outlook is still constructive given the supportive backdrop from improving U.S. and European growth. The biggest concern to us is the potential for uncertainty around the path of U.S. monetary policy; any negative surprises here could weigh on spreads regardless of an improved economic environment.

### High Yield Corporates

- The high yield market's strength in April was driven by energy, which returned nearly 4% as spot oil prices rallied. High yield energy companies continued to access both the debt and equity markets, as we are in the unusual position of both equity and debt holders favoring deleveraging strategies. Non-energy lagged thanks to weak domestic economic data.

- Corporate fundamentals generally remain in good shape, though weakness in general industrial revenues, the impact of a stronger U.S. dollar and declining energy earnings are beginning to negatively impact credit statistics. While the energy impact is generally well understood, the sluggishness in the U.S. economy remains a wild card; should the weakness prove more lasting than we expect, credit deterioration could become more pronounced.
- Spreads continue to bounce around in the mid-400 level, which appears more than adequate to compensate for anticipated credit losses. Given the steepness of the credit curve and the differential between energy and ex-energy spreads, continued excess returns in high yield likely depend on outperformance by the energy sector and lower-quality issues.

### Mortgages

- Agency mortgages responded well to the selloff in rates during April, as prepayment fears subsided. Strong demand from traditional sources along with the weekly Fed sponsorship overwhelmed seasonal supply, and mortgages posted their strongest relative returns of the year. Interest rate volatility remains a significant risk, as global economic growth weighs on the markets. However, spreads should remain tight as supply/demand technicals continue to provide a strong tailwind.
- Price stability and improving underlying fundamentals continue to fuel the appetite for non-agency RMBS. While the thawing of credit access for borrowers continues to be slow to materialize, it does have the potential to move credit spreads tighter. The recovery in housing has momentum but presents a longer-term risk from an affordability standpoint; early signs of improvement in the market for home purchases in 2015 re-solidifies positive outlook for home-price appreciation.
- With slightly improved relative value, marginally higher interest rates and a manageable new-issue pipeline, the outlook for CMBS has improved. From a longer-term strategic perspective, certainty around the depth of problems in commercial real estate has increased; this has positive implications for higher-quality tranches (i.e., the junior AAAs and above). Going forward, there will be a premium on security selection as losses begin to materialize and valuations disperse.

### Emerging Markets

- We affirm our neutral to positive outlook for emerging markets debt after the recent strong rally. The main performance driver of the asset class will be the current yield and income. While further inflows into hard-currency credit markets will support the technical picture, volatility in U.S. rates and equity markets could put emerging markets bond prices under pressure from time to time.

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