Fixed Income Perspectives


Christine Hurtsellers, CFA, CIO Fixed Income
Matt Toms, CFA, Head of Public Fixed Income

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 June 30, 2015, Voya Investment Management managed $125 billion in fixed income strategies in the United States.

Good Grief!

- Investors anticipating a federal funds rate hike are likely feeling a bit like Linus waiting for the Great Pumpkin to rise out of his patch on Halloween. With the FOMC in September again deciding against unwinding its zero interest rate policy (ZIRP), most investors are focused on the December Fed meeting as the next chance for liftoff. Given the divergent messages from individual Fed governors, however, the timing remains anything but certain. While Yellen, Dudley and Williams insist there will be a bump in the fed funds rate before the end of the year, Brainard and Tarullo have publicly challenged the need for a hike in the near future. The market appears to be siding with the latter camp, assigning only a 30% chance of a December hike.
- We believe a fed funds rate increase — just like Linus's elusive Great Pumpkin — will go unseen again this year. Though two meetings remain on the calendar, we think the window of opportunity for a 2015 hike has already closed, for three main reasons. First, financial conditions in the economy have tightened of late due to a stronger dollar and wider credit spreads. By some estimates, these factors represent the equivalent of a 75 basis point hike in short-term rates and as a consequence have driven domestic growth forecasts lower for the rest of this year and 2016. Second, the inverse relationship between unemployment and inflation — the so-called Phillips curve — has broken down, as pointed out in a recent speech by Governor Brainard. The lack of wage pressure despite robust job growth over the last three years — the result of globalization of supply chains and the rapid adoption of labor-saving technologies — suggests the unemployment rate can continue to decline toward 4% without creating significant inflation pressures. Last, the cost of having to undo hikes if the economy reacts negatively to normalization could be very large indeed given the zero interest barrier, implying the Fed will act only when it's very confident the economy can withstand an increase.
- With the short-term interest rates likely to remain lower longer, we prefer building in a carry advantage by allocating to high-quality U.S. corporates and to sectors closely tied to domestic real estate recovery like CMBS and non-agency mortgages.

Spreads, Returns and Yields

Index	Percentage of Index	Spread (bps)	Returns (%)	
			Sept. 2015	YTD 2015
Barclays U.S. Aggregate	**100**	**59**	**0.7**	**1.1**
Treasury	36.5	0	0.9	1.8
Investment Grade Corporates	24.0	169	0.8	-0.1
Fixed-Rate MBS	28.1	31	0.6	1.6
Other				
High Yield		630	-2.6	-2.5
Global Aggregate		54	0.5	-2.3
Emerging Markets		437	1.3	0.3

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%)	
				Sept. 2015	YTD 2015
U.S.	2.0	EUR/USD	1.12	-0.3	-7.7
Germany	0.6	USD/JPY	120	1.1	-0.1
Japan	0.4	USD/BRL	3.95	-8.3	-32.7
Brazil	15.4				

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

- An environment of declining inflation break-evens and a flagging economic growth outlook has pushed a bullish flattening of the yield curve. We think ten-year Treasuries could hover around the 2% level for a while. We expect the spread between German and U.S. interest rates will gradually compress from the current level of around 180 basis points due to a somewhat positive European growth story contrasted with a declining outlook for U.S. growth.

Global Currencies

- We like to be long in the yen relative to dollar. Declining inflation in Japan will push the yen higher, while it also will act as a flight-to-quality buffer against any negative events in China and other Asian markets. We also like long euro, especially against the British pound, given the improving growth outlook in Europe.

Investment Grade Corporates

- The investment grade market rallied leading up to the September 17 Fed policy announcement but sold off in the aftermath. Going forward, the main issue facing the asset class will be how to balance the headwind of slower global growth with the tailwind of U.S. monetary policy that may be easier for longer. Recent market strength suggests the latter is driving investor sentiment so far in October.
- The recent rebound in risk sentiment could gain support if third quarter earnings surprise to the upside, but the longevity of any impact remains uncertain. From a longer-term perspective, we expect the deteriorating trend in corporate fundamentals to continue, although a rebound in U.S. or global growth could mitigate the impact.

High Yield Corporates

- The high yield market posted a fourth consecutive month of negative returns in September. A lack of confidence in the Fed, continued negative news from emerging markets and signs that the U.S. economic expansion may be weakening increased equity volatility and weighed on risk appetite. High yield weakness broadened beyond energy and commodities, as any negative news has driven severe price action, re-pricing specific companies and entire sectors.
- Our fundamental view has become somewhat more negative based on weaker U.S. economic data and increased signs of late-cycle activity. The key question is the durability of the U.S. expansion; our base case remains that it continues, though we acknowledge the risks to that scenario have clearly increased.

Mortgages

- With the backdrop of macro/global economic headline risk and another delay in Fed policy liftoff, mortgages delivered a mixed performance in September. Tactically, the continuation of ZIRP should be positive for MBS, as it is expected to stabilize rates. Also, a delay in rate hikes means a delay in "tapering" MBS reinvestments from the Fed's balance sheet. On the other hand, MBS valuations versus the U.S. Treasury curve appear fair to slightly rich, and the overall lack of clarity could mean that mortgages continue to trade sideways in the near term.
- We remain positive on the non-agency RMBS and ABS markets despite the volatile macro backdrop. Non-agency RMBS prices have demonstrated resolute stability, as supportive fundamentals from housing and the consumer provide an advantageous backdrop for risk; signs of increasing mortgage credit availability signal further potential upside. Among ABS sectors, we favor the relative safe havens of credit cards and auto loans.
- Our near term outlook for CMBS remains cautious. Diminished relative value, lower benchmark rates and elevated new-issue supply are all current headwinds for the sector. Loosening underwriting standards compound the new-issue concerns, as they adversely impact risk appetite. The longer-term view is more sanguine; wider spreads, negative net supply and strong commercial real estate fundamentals all support CMBS performance.

Bond Market Outlook

Global Interest Rates: Declining inflation and slowing growth has pushed a bullish flattening of the yield curve. Spread between German and U.S. rates likely will compress.

Global Currencies: We like to be long the yen relative to dollar thanks to low Japanese inflation and its role as a flight-to-quality buffer against any negative events in Asia.

Corporates: Market is struggling to balance headwind of slower global growth with tailwind of continued easy U.S. monetary policy.

High Yield: Weakness has broadened beyond energy and commodities, but economic expansion should support high yield market even though risks have increased.

Mortgages: The delay in Fed tightening should be positive for agency MBS, and we remain constructive on non-agency RMBS and ABS despite recent volatility.

Emerging Markets: We favor better-rated credits in sovereigns and corporates; local-currency investments remain more opportunistic.

Mortgage Derivatives: Derivatives look fundamentally look cheap after recent widening, though risk aversion and technical headwinds could remain challenging.

Private Credit: We continue to find good value in new-issue investment grade U.S. private credit, as structural integrity remains sound.

Commercial Mortgage Loans: Ongoing volatility in the CMBS market continues to benefit portfolio lenders for both core loans and higher risk real estate deals like bridge or mezzanine financing.

Emerging Markets

- Emerging market bonds and currencies have recovered from oversold territory, as valuations were inconsistent with most countries' fundamentals. Despite some persistent idiosyncratic risks (e.g., Brazil), investors are again starting to differentiate among countries and corporate issuers. Emerging markets likely will benefit from continued Fed dovishness.
- We favor better-rated credits among sovereigns and corporates over high yield securities or asymmetrical credit profiles. Local-currency investments are opportunistic at this point; for emerging market currencies to enter a structural positive trend, the outlook for growth, global trade and commodities must improve and stabilize. Here in the fourth quarter it's worth noting that investors are still calibrating their emerging market debt allocations as they seek to find the correct blend for the upcoming year.

Mortgage Derivatives

- In contrast to much of this year, spread widening in broader financial markets has begun to spill over into mortgage derivatives. While markets continue to be volatile and there is a certain amount of fear, mortgage derivatives look fundamentally cheap. Moreover, past market dislocations have often provided good alpha opportunities.
- The prepayment report released in early September was mildly positive but insufficient to counter the macro risk-off headwinds. While we expect the next few prepayment reports to be somewhat interest-only friendly, the technical environment remains challenged and could deteriorate further should redemptions or sector reallocations from mortgage derivatives increase.

Private Credit

- Demand for private credit assets remains good, and the low-yield environment continues to drive issuance as companies look to capitalize on historically low borrowing costs. That said, issuance has been somewhat below expectations, as issuers are comfortable keeping short floating bank lines given the steepness of the yield curve. If and when we get a distinct movement upward in rates, issuance should pick up more dramatically.
- U.S. private credit spreads are relatively wide — in the 150–250 basis point range — which is a reflection of credit concerns in the overall economy and specifically some of the commodity and materials sectors. We continue to find good value in new-issue investment grade U.S. private credit, as structural integrity remains sound.

Commercial Mortgage Loans

- Ongoing volatility in the CMBS market continues to benefit portfolio lenders for both core and higher-risk real estate deals like bridge or mezzanine financing. While supply and demand for commercial real estate has remained fairly balanced, there has been an increase in construction; multi-family construction has remained robust and construction of new office and industrial buildings has also picked up. Very little speculative development is happening in these two segments of the market. The majority of rent growth and supply has been in the smaller markets, and this growth has been measured and steady.

Past performance does not guarantee future results.

This commentary has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations, and (6) changes in the policies of governments and/or regulatory authorities.

Voya Investment Management Co. LLC ("Voya") is exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 (Cth) ("Act") in respect of the financial services it provides in Australia. Voya is regulated by the SEC under U.S. laws, which differ from Australian laws.

This document or communication is being provided to you on the basis of your representation that you are a wholesale client (within the meaning of section 761G of the Act), and must not be provided to any other person without the written consent of Voya, which may be withheld in its absolute discretion.

CMMC-FIMONTHLY 102315 • IM-1023-18955-1016 • CN-1001-18169-1117 • **163124**