

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, 2016, Voya Investment Management managed \$129 billion in fixed income strategies in the United States.

Bond Market Outlook

Global Interest Rates: U.S. Treasuries are overextended so expect a small pullback. There is no fundamental reason for higher yields, so global decline will resume.

Global Currencies: Sterling will depreciate further, euro is likely bottoming; U.S. dollar is unattractive.

Corporates: Technical demand implies spread tightening, but global uncertainty could provide buying opportunities.

High Yield: Spreads offer fair compensation for near-term risks as demand for U.S. dollar assets with yield increases.

Mortgages: Continuing support from global demand; fundamentals support non-agency MBS with increased prepayments and lower defaults.

Emerging Markets: We favor sovereigns and corporates for carry, still neutral on local currency.

Britain's Exit, On and Off the Pitch

While the continent cheered England's exit from the Euro Cup at the hands of Iceland, there was little celebration days before when the British voted to exit the European Union. Not only England's football future looks uncertain: economic and political uncertainty have spread well beyond the pitch. The U.K. economy has been slowing since 2014, with growth expected to dip below 1% for 2016. The PMI index is at its weakest level in three years, and vulnerabilities exist through the business confidence channel and through the previously red-hot real estate market.

The euro zone, the U.K.'s largest trading partner, also has been slowing. While the Bank of England has pledged support for the U.K. financial system, the European Central Bank is running out of ammo and is reluctant to ease much further for fear of hurting bank profitability. Its QE program ends in March 2017, but the ECB has stated it will keep buying bonds until euro zone inflation approaches its 2% target. The ECB expects inflation to be 1.3% next year, so bond purchases likely will continue beyond March.

Political uncertainty is weighing as well: David Cameron is out as prime minister, Scotland may pursue a second independence referendum, as may Spain and Italy. The latter is currently in negotiations for capital injections for Italian banks.

The United States may not hold an advantage with regards to its national soccer team, but it is clearly ahead in terms of economic stability, even if the numbers are not quite boastworthy. Britain's actions will have minimal direct spillover to the U.S. economy but the resulting uncertainty, already softening GDP growth and cooling payrolls, leads us to believe that a rate hike by the U.S. Federal Reserve is off the table for 2016. The euro zone, U.K. and Japanese economies are slowing, while growth in China is stable. So while Clint Dempsey may not be Wayne Rooney, the relative stability stateside is not looking too bad right now.

Spreads, Returns and Yields

Index	Percentage of Index (%)	Spread (bps)	Returns (%)	
			June 2016	YTD 2016
Barclays U.S. Aggregate	100.0	55	1.8	5.3
Treasury	35.6	0	2.2	5.4
Investment Grade Corporates	25.4	155	2.3	7.7
Fixed-Rate MBS	27.5	27	0.8	3.1
Other				
High Yield		585	0.9	9.1
Global Aggregate		51	2.9	9.0
Emerging Markets		357	2.9	9.4

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			June 2016	YTD 2016
U.S.	1.5	EUR/USD 1.11	-0.2	2.3
Germany	-0.1	USD/JPY 103.20	7.3	16.5
Japan	-0.2	USD/BRL 3.21	12.4	23.4
Brazil	12.1			

Source: Barclays, JPMorgan, Standard & Poor's

Note: All spreads are to U.S. Treasury securities and option adjusted except for emerging markets, which are nominal. All returns are total returns including dividends expressed as percentages. All returns in U.S. dollars.

Sector Overviews

Global Rates

- We expect lower yields due to slowing GDP growth in H2, cooling payrolls, benign core inflation and compelling Treasury valuations. Yields have declined to our 1.5% target and U.S. Treasuries look overextended. We expect rising yields near term, but afterward the global yield decline will resume.

Global Currencies

- We expect sterling to decline, although the Brexit impact has largely been priced in. The U.K. will flirt with negative growth and the BoE will try stimulus. The euro zone faces its own, mild growth downturn; we expect the ECB to wait until autumn before restrained policy easing. The euro is likely to outperform. The U.S. dollar is unattractive, with the Fed on hold, slowing growth and core inflation still at 2%.

Investment Grade Corporates

- We still expect range-bound spreads near term, although Brexit increases the odds of intra-range volatility. Recent strength in manufacturing is constructive for the industrial sector; lower rates, a flatter yield curve and Brexit hinder financials.
- Strong technical demand implies investment grade spreads towards the tighter end of their range for the near term, but global growth concerns and Brexit should provide opportunities to add exposure at wider levels.

High Yield Corporates

- The energy and commodities sectors continue to drive returns higher. Fund flows have accelerated post-Brexit, as the continuing descent of global yields forces more money into U.S.-dollar-based assets.
- Spreads in the mid-500s, ex-energy/metals, seem attractive given our belief that the credit cycle is not rolling over. Credit fundamentals have weakened, though, and we are likely to endure further headline shocks. With the spread back-up in June and the seemingly insatiable appetite for U.S.-dollar assets with yield, we are modestly more constructive on high yield than a month ago.

Mortgages

- Agency MBS gave up some performance post-Brexit, but the global search for high-quality bonds with yield has kept demand strong. Currently, the greatest risk to MBS is elevated prepayments due to prolonged low rates, but the effects of a “burnout” are being felt as borrowers are slow to refinance.
- Non-agency RMBS liquidity remains encouraging and fundamentals are supportive as upside from increased prepayments, lower defaults and stable severities will provide uncorrelated sources of return for investors.

Past performance does not guarantee future results.

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- Diminished relative value and limited spread tightening potential have dimmed our near-term view of CMBS. We remain neutral long term, believing that while still strong, fundamentals have plateaued. Given the current macro uncertainty, consumer ABS may underperform despite strong fundamentals.

Mortgage Derivatives

- Prepayments remain subdued, particularly for seasoned mortgages. Since Brexit the sector has held up well; there are no signs of a refinancing boom despite low mortgage rates. Should rates decline further we might see spread widening in those subsectors that are most responsive to rate incentives. In our view, the sector continues to present good value and our outlook remains positive, particularly for more seasoned HARP-eligible collateral.

Commercial Mortgage Loans

- Life company loan volume is up for 2016 due to the uncertain impact of impending risk retention rules. Even with lower Treasury yields, loans have remained flat — many life companies have implemented floors, which should help near term. These floors may disappear if rates stay low. Of current concern is oversupply of hotel and urban, multifamily loans; supply and demand remain in balance elsewhere.

Private Credit

- Demand for private credit remains steady and low borrowing costs continue to drive issuance. The PC market remained open and funded a European credit deal after Brexit. Currently, U.S. PC spreads are wide at 150–250 basis points, reflecting credit concerns in the broad economy and among commodity and materials sectors. We continue to find good value in new investment grade issues.

Senior Loans

- Through the market turmoil, loans — as expected — have remained stable while providing attractive risk adjusted return. Fundamental credit performance remains reasonably good, as evidenced by default activity that has remained within market expectations. Nearly two-thirds of institutional issuance so far this year has been new deal flow, while net refinancing YTD is down significantly compared to last year. We have, however, recently seen an increase in opportunistic activity.

Emerging Markets

- Emerging markets have rallied post-Brexit, supported by demand for higher yield. Any economic spill-over from Brexit likely will be limited to lower cross-border financing and concentrated in Eastern Europe. Dovish central bank rhetoric and a stable China should continue to support EM; we favor carry offered by sovereign and corporate debt but are neutral on local currency bonds.