Fixed Income Perspectives

Matt Toms, CFA, CIO 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 March 31, 2016, Voya Investment Management managed $129 billion in fixed income strategies in the United States.

Bond Market Outlook

Global Interest Rates: "Low-for-longer" is here to stay

Global Currencies: We expect the U.S. dollar to remain weak; the euro and emerging market (EM) currencies will outperform

Corporates: We are constructive on BBBs and financials and expect spreads to trade sideways in the near term

High Yield: While the sector is overdue for a short-term pullback, we view any sell-off as an opportunity to add exposure

Mortgages: We maintain a positive tactical outlook for CMBS, while non-agency RMBS benefit from a strong technical backdrop

Emerging Market Debt: After a strong summer rally, EMD is susceptible to profit-taking

All Eyes on the Fed: To Hike or Not to Hike… Is that Really the Question?

- At the September FOMC meeting, all eyes were once again on the Federal Reserve. The Fed's announcement to keep rates unchanged, while retaining a bias to hike rates later on in the year, is likely the one that will grab headlines. But is it the most important thing investors need to focus on? We believe it's not. In our view, the bigger news came in late August at the Fed's Jackson Hole summit.
- At the Jackson Hole Summit Dr. Yellen provided the following insight into how the Fed would react in the event of another recession: "In addition to taking the federal-funds rate back to nearly zero, the FOMC could resume asset purchases and announce its intention to keep the federal-funds rate at this level until conditions had improved markedly." Dr. Yellen focused on Fed research stating that in a recession the Fed will cut rates from 3% to 0% and buy $2 trillion of assets. This assumes the policy rate can get to 3% before cutting it by 300 basis points, a point that Dr. Yellen also acknowledged, admitting that the Fed can be expected "to have less scope for interest-rate cuts" than it historically has had.
- The bottom line is that unconventional policy tools are here to stay and the Fed's future reaction function appears significantly more complex. This is cause for concern, given that investor confidence in the role of the Fed continues to deteriorate. It also renews questions over the degree to which the use of negative rates can be effective as a policy tool. Furthermore, after hitting recent lows in August, the CBOE Volatility Index (aka the "VIX") spiked as soon as the Fed, ECB, and Bank of Japan came back into the headlines, suggesting central bank involvement may directly increase market volatility. In this environment we continue to favor a cautious approach to risk taking within fixed income portfolios.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%) August 2016	Returns (%) YTD 2016
Barclays U.S. Aggregate	100.0	47	-0.1	5.9
Treasury	36.2	0	-0.6	5.2
Investment Grade Corporates	26.0	135	0.2	9.5
Fixed-Rate MBS	27.4	15	0.1	3.4
Other				
High Yield		490	2.1	14.4
Global Aggregate		44	-0.5	9.2
Emerging Markets		318	1.4	12.6

Country	Yield on Ten-Year Bonds (%)	Currency		Returns (%) August 2016	Returns (%) YTD 2016
United States	1.6	EUR/USD	1.12	-0.1	2.7
Germany	-0.7	USD/JPY	103	-1.3	16.2
Japan	-0.6	USD/BRL	3.23	0.7	22.9
Brazil	12.1				

Source: Barclays, JPMorgan, Standard & Poor's. All spreads are to U.S. Treasurys and are option-adjusted except for emerging markets, which are nominal. All returns are total returns including dividends, expressed as percentages, in U.S. dollars.

Sector Overviews

Global Rates

- Market concerns regarding central bank unwillingness to ease further prompted an increase in rates, a decline in break-evens, curve steepening and an equity rout. The Fed's Rosengren argued for gradual tightening, but even more impactful was the comment by European Central Bank President Draghi that the ECB had not discussed asset purchases at its latest rate-setting meeting. This set off market alarms, but Draghi also highlighted the G-20 commitment to fiscal and structural stimulus; we believe he deemphasized future asset purchases to put the spotlight on fiscal policy makers. We expect ECB QE to be extended later this year.
- The Bank of Japan policy announcement fell short of expectations that it would support a steepening of the curve. The bank maintained its level of asset purchases and targeted the 10-year JGB yield at zero. The bank's framework did not address expectations that it would strive for 2% inflation as soon as possible. Therefore, we expect the yen to continue to appreciate.

Global Currencies

- While the U.S. dollar has sustained a bid, it is actually unchanged on the month. We expect the dollar to remain weak as the U.S. economy softens, Fed tightening expectations are delayed again, yields decline and EM currencies outperform.

Investment Grade Corporates

- Higher than expected supply continues to easily be absorbed by large flows into the asset class. Demand from non-U.S. investors was robust given the attractive yield differential and relative safety of investment grade corporate bonds. Energy was the best performing sector as oil bounced hard off the $40 level and second-quarter earnings showed sequential improvement across most energy sub-sectors.
- While we expect spread tightening to take a breather into continued heavy new issue supply, we believe the strong underlying technical picture should be supportive of corporate bond spreads into year-end. We favor financials, BBB-rated bonds, and the intermediate part of the curve.

High Yield Corporates

- High yield continued to race tighter led by energy, which was driven by both a rally in oil prices and continuing balance sheet repair as high yield exploration and production companies remain willing to use equity to de-leverage. The lack of improvement in overall economic growth continues to limit revenue and cash flow growth for high yield issuers. Credit statistics (ex-commodities) appear to have stabilized over the last two quarters, but results remain uneven and leverage is near historical highs. We continue to believe a near-term spike in defaults outside energy and metals is unlikely, but would expect credit statistics to modestly weaken this late in the credit cycle.
- Spreads to U.S. Treasuries of approximately 500 basis points seem reasonable given our belief that the credit cycle is not rolling over, but revenue and earnings growth are weak and we are likely to have to endure additional macro headlines. Given the market run of recent months, we are probably due for a short-term pull-back, but the continuing global search for yield is likely to provide technical support for the market in the intermediate term.

Mortgages

- Continued strong overseas and bank demand, coupled with attractive cross-market yield differences offered in the low-volatility environment, has resulted in agency MBS spreads trading close to their one-year tights. However, an acceleration in Fed tightening, thus, lower Fed reinvestments, could cause investors to pull back from the market.
- Legacy non-agency RMBS will continue to command the most balanced mix of buying versus selling. The depth of liquidity has remained encouraging across shifting risk regimes, as evidenced by active daily trading volumes (routinely >$1 billion) and continued dealer support. Technical factors for the legacy space continue to be propelled by resolute demand and a shrinking investable universe.
- We maintain a positive tactical outlook for CMBS as improving underwriting standards and attractive relative value position the asset class to outperform over the near term. Demand for CMBS has improved with higher benchmark rates and the successful introduction of the first risk retention compliant deal.

Emerging Market Debt

- After a strong summer rally, EMD is susceptible to profit-taking in the near term as external risks loom. Blue chip EM corporates continue to pursue debt management to benefit from the low yield environment. As a result, they continue to lower their costs of funding while lengthening their maturity debt profile, and have outperformed the broad credit space. EM sovereigns will need to implement more structural reforms to warrant further spread tightening; fragile sovereign credits are still vulnerable to downgrades. After such strong performance thus far in 2016, we believe more selective and cautious positioning within the space may be warranted.

Past performance does not guarantee future results.

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