Voya Perspectives | Market Series | August 16, 2016

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

Bond Market Outlook

Global Interest Rates: Growth will slow in the U.S. and euro zone driven by consumption and business spending, pushing yields lower.

Global Currencies: The U.S. dollar will remain weak due to slower economic growth.

Corporates: Fundamentals have improved, but improving growth is needed to reduce corporate leverage levels.

High Yield: Though low-6% yields may limit upside, the global search for income should continue to support the market in the near term.

Mortgages: Agency MBS spreads have limited upside potential. Fundamentals support non-agency RMBS while technicals support CMBS.

Emerging Markets: Strong performance continues from the hunt for yield, improving fundamentals.

Global Growth Misses Opportunity to Medal

- As the Olympics take center stage in the world of sport, only those paying attention may realize that the world's athletic achievements are outdistancing its economic ones. Once the chalk dust cloud of uncertainty settled from the "Brexit" vote, a strong U.S. payrolls report early in July led to improved investor sentiment and put the possibility of an interest rate hike in 2016 by the Federal Reserve back on the table.
- Then, the U.S. clipped a hurdle with the release of a paltry Q2 GDP print of 1.2%. After a brief jump, yields dove back down into the global pool of low interest rates with the 10-year U.S. Treasury hitting a record low in July. While the U.S. may not be in the deep end of this pool, where Germany and Japan have been anchored for some time, the global hunt for yield has the potential to drag it there. This leaves the U.S. with the lowest first half growth rate in over four years and a dangerously weak context to deliver another interest rate hike without any heat coming from the inflation cauldron. The recent positive payroll report actually complicates the Fed's policy stance as it did not alter the slide in labor growth. What's more, productivity growth for the second quarter was also near the low end of its historical range, having contracted at its worst pace in three years. While there is an argument that lower productivity may prompt the Fed to increase rates sooner, the absence of inflation pressure demands caution on any move.
- Given this mixed bag of economic data, the fact that core PCE inflation is expected to remain below 2% for 2016, and that September is still technically on the table for another hike, we think the Fed should control its message and guide the market towards a possible December hike, if any. Nonetheless, we expect GDP and payroll trends through the second half of the year will halt the Fed in December from crossing the elusive finish line to a 1.0–1.5% rate target and a 2.0% inflation target.

Spreads, Returns and Yields

Index	Percentage of Index	Spread (bps)	Returns (%)	
			July 2016	YTD 2016
Barclays U.S. Aggregate				
Treasury	36.5	0	0.4	5.8
Investment Grade Corporates	25.8	145	1.5	9.3
Fixed-Rate MBS	27.3	24	0.2	3.3
Other				
High Yield		528	2.7	12
Global Aggregate		46	0.8	9.8
Emerging Markets		333	1.5	11.1

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			July 2016	YTD 2016
U.S.	1.5	EUR/USD 1.12	0.9	2.7
Germany	-0.1	USD/JPY 102.06	1.1	17.7
Japan	-0.2	USD/BRL 3.25	-0.1	31.0
Brazil	11.8			

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.

INVESTMENT MANAGEMENT
Reliable Partner | Reliable Investing®

VOYA®

Sector Overviews

Global Rates

- The growth outlook for developed economies has darkened. We expect U.S. yields to decline after consolidating since Brexit. European yields will continue falling and the spike in Japanese government bonds yields will reverse. Investors have accepted lower yields despite higher JGB yields, higher equities and a strong payroll report. The long fixed income view is based on a continued weak GDP trajectory of 1% for H2, cooling payrolls, benign inflation and a thwarted Fed. We expect the curve to flatten decisively.
- We expect euro zone growth to slow in Q3 as consumption and business spending weaken, driven by waning credit creation. Germany will be particularly weak. The ECB will extend its asset purchase program this fall.

Global Currencies

- The U.S. dollar will remain weak as the U.S. economy softens, the Fed delays raising rates and the global yield grab causes emerging market (EM) currencies to outperform.
- The Japanese yen will continue to appreciate with disappointing Q2 growth and negative inflation; the pound will depreciate to adjust for contracting exports and growth.

Investment Grade Corporates

- The 2Q16 earnings season showed YoY aggregate improvement in revenues and operating income, supporting the view that we have seen the trough in corporate fundamentals. We think fundamentals could improve in 2H16 as the negative impacts of lower oil prices and a stronger U.S. dollar lessen. Ultimately, it will take an improved global growth picture to see meaningful reduction of corporate leverage.
- New issuance volume remains heavy but we expect lower merger and acquisition activity to ease supply pressures heading into 2017. Low interest rates and corporate bond purchases by the ECB and BoE will support demand for corporate credit. We expect spreads to remain range-bound for the year.

High Yield Corporates

- High yield ripped tighter in July and the market decoupled from energy, as spreads moved tighter while the energy sectors traded down. Credit statistics (ex-commodities) have stabilized over the last two quarters but results are uneven and leverage is near historical highs. We continue to believe a near-term spike in defaults outside energy and metals is unlikely, but expect credit statistics to modestly weaken this late in the credit cycle.
- Excluding energy and commodities, the "core" of the market looks fairly valued at an option-adjusted spread (OAS) of 494, given our belief that the credit cycle is not rolling over; however, revenue and earnings growth are weak and we are likely to face additional macro headlines. Though the low-6% yield limits upside, the global search for income may continue to provide near-term support.

Mortgages

- Agency mortgages outperformed U.S. Treasuries in July, as a fairly stable U.S yield curve and lower implied volatility brought investors off the sidelines and drove spreads tighter. Investors expect prepayments to increase in the short term; many have turned to specified pools and CMOs, which offer advantages over generic mortgage collateral. As a result, agency MBS spreads are at one-year tights in terms of Treasury OAS and offer little room for further tightening.
- Non-agency RMBS will continue to command a strong balance of buying and selling as liquidity remains encouraging. Technicals continue to be propelled by resolute demand and a shrinking investable universe, while fundamentals also remain supportive. Increased prepayments, lower defaults and stable severities will provide uncorrelated sources of return for investors. The key here will be maintaining bonds with an optimal mix of prepayment risk and de-leveraging potential.
- We raise our near term outlook for CMBS, as increased demand and manageable new supply should position the asset class to outperform. Additionally, CMBS remain attractive from a relative value standpoint after excess returns trailed those of corporate credit.

Emerging Markets

- EM debt continues to surprise with strong performance and resilience to exogenous risks, much of which is due to the global hunt for yield. Fundamentals have bottomed and early indicators suggest a rebound in activity. A weaker dollar has helped EM currencies appreciate, which could positively impact the inflation trajectory in EM countries and support further domestic yield declines. Lower new issuance of sovereigns and corporates is supporting the technical picture, which we believe offers long carry opportunities via selective overweights. With the direction of global trade unclear, we are neutral local currency rates and selective in FX.

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.

©2016 Voya Investments Distributor, LLC • 230 Park Ave, New York, NY 10169 • All rights reserved.

CMMC-FIMONTHLY 081716 • IM0816-26898-0817 • **163124**

PLAN | INVEST | PROTECT

voyainvestments.com