

# 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:** We believe the U.K. will avoid a recession, while the ECB will extend QE later this year

**Global Currencies:** We expect the U.S. dollar to weaken versus commodity currencies, EM currencies and the euro

**Investment Grade Corporates:** Improved fundamentals, continued strong demand and lower new supply will support spreads

**High Yield:** A pullback in spreads will offer buying opportunities

**Mortgages:** Maintaining overweights to CMBS and non-agency RMBS; our outlook for agency RMBS remains neutral

**Emerging Market Debt:** We prefer EM local currency bonds over hard currency and corporates

## Let the Speculation Begin

- Speculation about a December rate hike began almost immediately following the Federal Reserve's decision in September to keep rates unchanged. The consensus opinion that the Fed will hike in December received additional support following the release of the FOMC minutes, which confirmed that the September vote was a closer call than investors originally thought.
- However, roadblocks to a December hike do in fact exist. While the Fed is eager to make a move, the subdued September jobs report not only eliminated the likelihood of a November rate hike, but also introduced a thread of uncertainty about December. There are three conditions that have deteriorated since the September Fed meeting: The U.S. dollar has strengthened, resulting in downward price pressure on imports; GDP forecasts have been downgraded; and the unemployment rate has increased. At her press conference, Fed Chair Janet Yellen stated that higher labor force participation seen in that last jobs report indicates the economy has more slack and therefore can run hotter. Furthermore, in a more recent speech, Yellen argued that holding interest rates low in order to run a "high-pressure economy" may create robust aggregate demand that tightens the labor market in a self-perpetuating dynamic. While we believe the Fed will still hike in December provided that the October and November labor reports do not disappoint, the message is clear that the pace of tightening will be extremely shallow to allow for workers to reenter the labor force and consumers to re-leverage.
- Meanwhile, the stabilization of global trade volume, a recovery in global inflation and continued growth in Asia support credit spread appetite. The behavior of yields has been relatively orderly and therefore should support the ongoing performance of risky assets as cyclical and structural forces evolve. Against this backdrop, we have a more constructive approach to risk taking in our fixed income portfolios. While maintaining our overweight to CMBS and non-agency RMBS, we have increased our tactical allocation to emerging markets local debt and investment grade corporate credit, but remain neutral on high yield.

### Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			Sept. 2016	YTD 2016
Barclays U.S. Aggregate	100.0	47	-0.1	5.8
Treasury	36.3	0	-0.1	5.1
Investment Grade Corporates	26.0	138	-0.3	9.2
Fixed-Rate MBS	27.5	14	0.3	3.7
Other				
High Yield		480	0.7	15.1
Global Aggregate		43	0.6	9.9
Emerging Markets		314	0.2	12.8

  

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			Sept. 2016	YTD 2016
United States	1.6	EUR/USD 1.12	0.7	3.4
Germany	-0.1	USD/JPY 101	2.1	18.6
Japan	-0.1	USD/BRL 3.26	-1.1	21.6
Brazil	11.6			

Source: Barclays, JPMorgan, Standard & Poor's. All spreads are to U.S. Treasuries 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

- Global yields have increased in recent weeks, led by a spike in U.K. Gilts as fundamentals have improved and inflationary pressures have intensified following the steep depreciation of the pound. Despite the “Brexit” disruption, we believe the U.K. economy will circumvent a recession. Elsewhere in Europe, the European Central Bank (ECB) all but confirmed an extension of quantitative easing later this year, likely in December, as its minutes revealed widespread concern over the failure of inflation to pick up.

### Global Currencies

- While the rally in the U.S. dollar has looked strong, it has appreciated only 2% since September 1. Given the Fed’s broad dovish stance, we view the dollar bid as vulnerable, particularly versus commodity-linked EM currencies. Meanwhile, the euro has been linked to the pound’s depreciation, while the yen has reacted to a combination of better growth and incoherent monetary policy.

### Investment Grade Corporates

- Q3 earnings will provide a better view into the evolution of investment-grade credit fundamentals. We expect the sequential improvement seen over the past two quarters to continue. Meanwhile, the trend in oil prices and the U.S. dollar remain supportive for fundamentals, or at least will not be headwinds. By some measures, overall leverage in the investment grade corporate market actually fell slightly in 2Q16 as debt growth slowed and EBITDA rebounded. M&A volume is down and share buyback activity is off recent highs, which suggests further support for near-term fundamentals. While we think much of the improvement in fundamentals has been priced into the market during the spread rally since February, the market could gain even more comfort from a strong third-quarter earnings season. With supply set to slow in Q4 and continued demand from foreign investors, spreads look poised to make a move tighter.

### High Yield Corporates

- The lack of improvement in economic growth continues to limit revenue and cash-flow growth for high yield issuers. Credit statistics have stabilized over the last two quarters, however, and earnings are likely to show year-over-year gains in coming quarters. We believe the spike in commodity-related defaults is behind us; we continue to see companies take steps to improve strained balance sheets. While we have witnessed a small uptick of intentional leveraging, there have been fewer transactions than we would expect this late in the credit cycle.

- We are maintaining our neutral tactical view on high yield. Areas of risk include dislocation from an interest-rate hike or a reversal of the commodity run as China continues to try to cool down an overheated property market. Spreads at 470 basis points (bp) are reasonable, and with the potential for modest improvement in reported results, we would consider a market pull-back as an opportunity to add exposure.

### Mortgages

- Agency mortgages continue to benefit from low rate volatility and steady demand. Continued outperformance will depend on a stable rate environment and persistent demand from the Fed’s agency MBS re-investment program.
- Non-agency RMBS fundamentals remain supportive as upside from increased prepayments, lower defaults and stable severities should continue to provide uncorrelated sources of returns. Technicals for the space remain strong and the depth of liquidity is encouraging.
- We maintain our positive tactical outlook for CMBS, as attractive relative value and another round of risk-retention-compliant issuance should lead to near-term outperformance. Over the long term, however, we remain neutral on the expectation that fundamentals have broadly plateaued.
- Mortgage derivatives should continue to benefit from investors’ overreaction to prepayment fears. Large rate moves tend to create diverging opinions on prepayments and hedge ratios; therefore, we have moved tactically positive on the space. Prepayments in the latest report jumped 35% from the previous month. This increase was largely expected, given a three-day increase in day count, seasonal highs in housing turnover and the lowest mortgage rate since 2012. Seasoned and call-protected collateral, which accounts for the vast majority of mortgage derivatives, experienced smaller increases.

### Emerging Market Debt

- After continued strong performance in EM, determining relative value opportunities and the differentiation among countries’ macro evolution are key factors for the remainder of the year. While broad EM may experience some underperformance due to seasonality and increased supply, carry and the continued continuing demand for yield will drive performance for the coming weeks as more opportunities arise within the local EM rate markets.

### 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.

CMCC-FIMONTHLY 102016 • IM1017-28317-1017 • 163124

PLAN | INVEST | PROTECT

voyainvestments.com

