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: Central banks are moving slower than fundamentals, should lead to bear steepening in rates

Global Currencies: The U.S. dollar will weaken as other economies gain momentum

Investment Grade Corporates: Market continues to grind tighter, but uncertainty over expectations could introduce volatility

High Yield: Market is beginning to price in stronger earnings; option-adjusted spread seems fair at this point in the credit cycle

Securitized Assets: Higher rates reduce prepayment risks for mortgages, but uncertainty over Trump policies limits spread tightening potential

Emerging Markets: Higher oil prices and U.S. growth prospects support EM credits and higher yielding currencies

Is March Now in Play for the Federal Reserve?

- While headlines have been dominated by policy banter from the Trump administration, markets have stayed resilient due to prospects of higher growth from expectations of tax cuts, deregulation and fiscal policy, as well as from continued strong economic data. Concurrently, U.S. inflationary pressures continue to rise, keeping the already bright spotlight squarely on the Federal Reserve. As previously noted here, we believe that the Fed will continue a cautious pace of rate normalization guided by market expectations. Below we explain why we maintain this view despite recent market developments that suggest the next interest rate hike could come in March.
- Janet Yellen's surprisingly hawkish testimony before Congress, during which she stressed the Fed does not want to fall behind the curve, was the first hint at the possibility of a move. The most recent CPI report showed both headline and core inflation above 2% and rising; the Fed's preferred measure of PCE is on pace to get there shortly. While higher energy and pharmaceutical prices, as well as housing inflation, have been drivers, it is clear that the latest CPI increases have been broad-based. Retail sales remain strong across the board despite muted wage growth and subsequent reduced buying power from the inflation uptick. These reports suggest that the Fed should pick up the pace, and market expectations of a March hike have jumped above 40%.
- Despite this momentum, we believe the Fed will hold off until May for the following reasons. As previously stated, PCE inflation has yet to reach the Fed's 2% target and wage growth is still lagging, indicating some slack in the labor market. Economic policy uncertainty remains high as trade, tax and healthcare policies, among others, will likely take longer to come into fruition. We believe the market is driving the Fed to raise rates, not the other way around, as evidenced by the recent move higher in the short end of the Treasury curve. Therefore, we are maintaining a shorter duration posture in our portfolios with a preference to mortgage credit such as non-agency mortgages, CMBS and CRTs.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%) Jan. 2017	Returns (%) YTD 2017
Barclays U.S. Aggregate	**100.0**	**0**	**0.2**	**0.2**
Treasury	36.1	0	0.2	0.2
Investment Grade Corporates	25.8	121	0.3	0.3
Fixed-Rate MBS	27.9	22	0.0	0.0
Other				
High Yield		388	1.5	1.5
Global Aggregate		45	1.1	1.1
Emerging Markets		277	1.3	1.3

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%) Jan. 2017	Returns (%) YTD 2017
United States	2.5	EUR/USD 1.08	2.7	2.7
Germany	0.4	USD/JPY 113	3.7	3.7
Japan	0.1	USD/BRL 3.15	3.2	3.2
Brazil	10.9			

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

- Global growth and inflation continue to gain momentum, with the yield move in 2017 led by the euro area. Global central banks are all tightening policy more slowly than fundamentals. The European Central Bank (ECB) will extend quantitative easing through 2017, but will reduce the size of purchases. The Bank of Japan (BOJ) recently reinforced a commitment to ultra-easy policy, quashing the buzz that it would lift its cap on rates.
- We expect a bear steepening to move 10-year yields into the 2.50–2.75% range. We anticipate increases in real rates and inflation break-evens, i.e., the yield differentials between Treasuries and TIPS. Break-evens will be driven by fundamentals and increased inflation caused by potential border-adjusted taxation.

Global Currencies

- The U.S. dollar should weaken as other economies gain more economic momentum, their central banks become more hawkish and valuations become attractive. As border-adjusted taxation is implemented, the dollar theoretically should strengthen; however, we expect it could actually weaken due to increasing inflation. The BOJ is concerned about Trump policies impacting the yen's valuation. The yen has appreciated versus the U.S. dollar but depreciated versus other developed currencies.

Investment Grade Corporates

- The investment grade market continues to grind tighter, driven by strong technicals and improved fundamentals. The recent move higher in rates has been absorbed with minimal market dislocation, as foreign demand remains robust due to attractive yield differentials. 4Q earnings have started on a strong note with banks leading the way, and with earnings expectations for 2017 close to 10% the environment should be supportive for investment grade; however, as we move through 2017, uncertainty over how market expectations play out could introduce volatility. We like the valuation gap of financials and think BBB's can compress further.

High Yield Corporates

- Fourth-quarter earnings are off to a solid start and outlooks are showing signs that the stagnant earnings of recent years may be improving. The year started with modest inflows which, combined with light new issuance, continued to support technical conditions for tighter spreads. An option-adjusted spread (OAS) of around 380 seems fair given our belief that the credit cycle is not rolling over. The market is beginning to price in stronger earnings. A policy package from the Trump administration that included fiscal expansion, corporate tax decreases and deregulation could finally help increase nominal growth beyond its anemic level. That would be a strong positive for high yield and would provide fuel to continue the rally; however, a move below 350 OAS would require a reassessment of its sustainability.

Securitized Assets

- Agency mortgage valuations have improved but still are not attractive. Excess return from spread tightening remains unlikely with overseas investors on the sidelines. At this juncture, policy risks and market conditions outweigh the potential benefits owning mortgages.
- Supportive relative value and favorable technical conditions for commercial mortgage-backed securities (CMBS) suggest further near-term outperformance. Further on, higher valuations and increased issuance are likely to dampen the pace of tightening.
- Asset-backed securities (ABS) remain well bid and offer outperformance opportunities. Strong fundamentals and short spread duration across most sub-sectors support tighter or stable credit spreads.
- Non-agency residential mortgage-backed securities (RMBS) will continue to command the most balanced mix of buying and selling. The legacy space continues to be propelled by resolute demand. Fundamentals also support current valuations, as upside from increased prepayments, lower defaults and stable severities continue to keep the asset class attractive.

Emerging Market Debt

- While market participants are analyzing the long-term impact of the Trump administration, emerging market (EM) debt is performing well on the back of last year's OPEC agreement and rallying oil prices. Higher growth prospects in the U.S. will support EM credits and higher yielding currencies. Differentiation and relative value are key: we see selective pockets of value in countries such as Brazil, Peru and Russia, while monitoring idiosyncratic risks from Mexico, Turkey and Venezuela.

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