

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.

Fixed Income Themes Update

Our semi-annual themes provide a framework for our investment decisions. Our holistic view of the economy and global monetary policy helps determine the overall risk budget and portfolio positioning to capitalize on relative value across sectors, while helping inform our bottom-up security selection process. As the second half of 2017 gets underway, here is how we are seeing the investment landscape.

Investment Themes

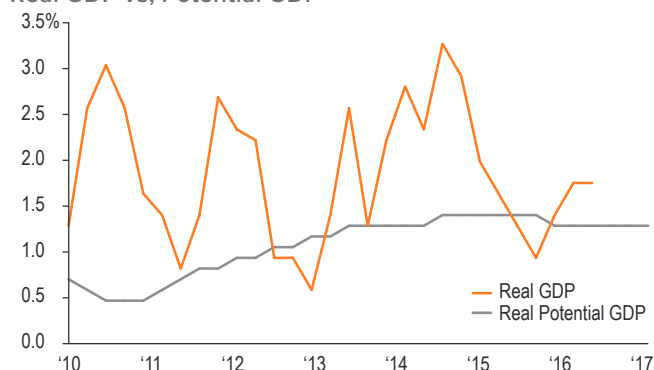
- 1. U.S. Economic Growth:** Near-term growth in the United States will be closely tethered to trend level. The benefit from demand-oriented policy (tax cuts) is likely to be limited and short-lived. Supply-oriented policies, such as significant deregulation or true tax reform, are unlikely but would have more lasting benefits on growth.
- 2. Wages and Inflation:** Wage pressure within the U.S. economy will continue to increase, albeit unevenly across industries. Overall inflation pressure will be limited by global excess supply. Wage increases for lower income workers will help offset current spending constraints and improve debt service capacity.
- 3. Fed Policy Outlook:** Balance sheet reduction will be the near-term focus of the Federal Reserve; a cautious pace of rate normalization guided by market expectations will continue later. Continued easy monetary policy will keep volatility uncomfortably low, supporting full but sustainable valuations of risk assets.
- 4. Europe:** Growth within Europe will continue at an above trend pace, as declining political volatility allows more cooperation within the European Union. The European Central Bank will stop expanding its balance sheet later this year, but with no pressure from inflation will be patient to raise rates.
- 5. China:** Policy-makers will continue to manage growth within a narrow band as the country transitions from an "old economy" industrial base to a more consumer-oriented economy and implements financial system reforms. In the near term, China's high potential growth rate will allow the central government sufficient policy tools to address any resulting instability.
- 6. Emerging Markets:** Growth within EM will remain robust, supported by a contained U.S. dollar, low global interest rates and sustained developed market growth. Risks within EM are primarily idiosyncratic, except for largely priced-in systematic risks from China and the associated effects on commodity prices.
- 7. Credit Markets:** With limited overall input cost pressure, corporate profit margins will be resilient. The combination of improving credit fundamentals and continued easy monetary policy will push credit spreads to new post-crisis tightness even as we move closer to the end of the current cycle.

U.S. Economy: Slow but Above-Trend Growth Ahead

The optimism that drove the so-called “Trump trade” in the first half of 2017 has all but evaporated. The market is questioning the possibility of a tax deal, but policy analysts still expect some fiscal stimulus, which they believe would add 0.3–0.5 percentage points to GDP in 2018. Even if this view proves correct, policy action is likely to be slow and unlikely to boost the economic growth trajectory much above its current 1.5–2.0% trend for any sustainable time period.

Figure 1. Sustainable Growth Acceleration Has Proven Elusive

Real GDP vs. Potential GDP

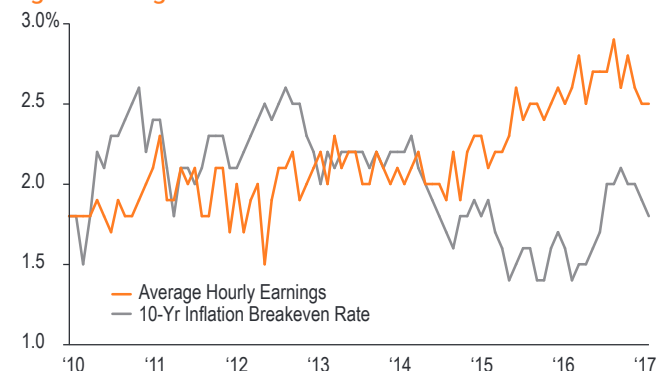


Source: Federal Reserve Economic Data

With that in mind, we believe subdued productivity and consumers' ongoing aversion to leverage will continue to limit growth potential over the longer term. Therefore, any benefits from demand-oriented policies such as tax cuts are likely to be limited and short-lived. Supply-oriented policies, e.g., significant deregulation or true tax reform, would provide more lasting benefits to growth but are unlikely to be delivered.

Wage pressures within the U.S. economy will continue to increase unevenly across industries. Wage increases for lower income workers will help offset current spending constraints and improve debt service capacity. Despite this increase in wages, overall inflation pressure will be limited by global excess supply.

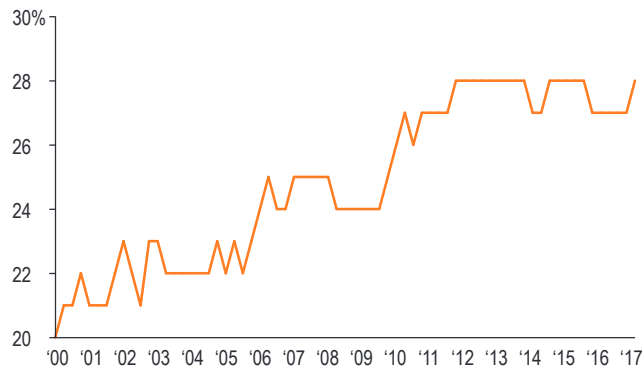
Figure 2. Wage and Inflation Pressures Remain Constrained



Source: Bloomberg

Corporations look healthier as sales growth continues to recover; recent quarterly earnings have shown strong improvement over prior quarters. With limited overall cost pressures, corporate profit margins will be resilient. Leverage is slowly rising but looks supportable, and interest coverage remains elevated.

Figure 3. Profit Margins Show Strong Improvement



Source: JP Morgan

There are advantages to this more stable and therefore more sustainable growth. These include manageable wage and inflation pressures and a slower and limited rise of interest rates, both of which will support consumer spending and encourage business investment. Additionally, we believe this will temper any appreciation of the U.S. dollar. Finally, the combination of improving credit fundamentals and continued easy monetary policy will push credit spreads to new post-crisis highs even as we move closer to the end of the current cycle.

We prefer “spread” assets with potential to benefit from improving global growth:

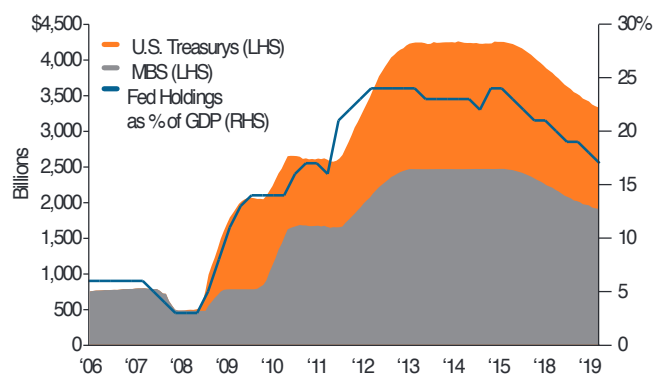
- Emerging market debt
- High yield corporates
- Investment grade corporates

Federal Reserve: Trim Balance Sheet, Slow Path to Normal

The Fed hiked short-term interest rates 25 basis points in June, as expected. The announcement struck a rather hawkish tone, emphasizing moderate economic expansion and downplaying softer inflation data. The Fed also discussed its plan to begin gradually trimming its balance sheet this year, with perhaps another interest rate hike in play as well. Fed Chair Janet Yellen emphasized that employing gradual rate hikes eliminates the potential to fall behind the curve and therefore the need to hike more quickly and risk recession.

With that, we believe the Fed's focus will be on balance sheet reduction for now, before resuming its cautious pace of rate normalization as guided by market expectations. While the Fed did not specify an endpoint for its total balance sheet size, it noted that afterward the level of assets will remain higher than before the financial crisis. It seems that the Fed is signaling it will be less "data dependent" and therefore will be more forecast driven, which has the potential to continue to suppress market volatility. We believe this continuation of easy monetary policy will keep volatility uncomfortably low, supporting full but sustainable valuations of risk assets.

Figure 4. Expected Glide Path to Reduce the Federal Reserve's Balance Sheet



Source: Bloomberg, Voya Investment Management

The Fed's intended path informs our portfolio positioning:

- Shorter duration posture
- Neutral stance to agency mortgages

Europe, China and the Emerging Markets

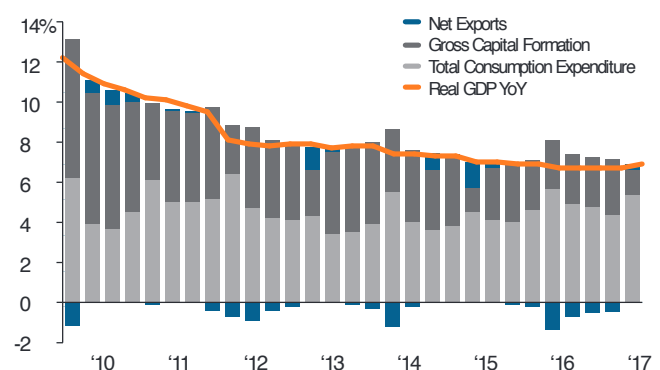
The global growth impulse has shifted now to be more international than U.S.-based, with Europe and the emerging markets seeming to be the most potent growth drivers. Europe posted a higher growth rate than the U.S. in the first quarter of 2017, with low inflation. As increasing political cohesion allows more cooperation within the European Union, Europe's growth will continue at an above-trend pace, spreading positive momentum across the eurozone economy.

As Federal Reserve policy has shifted toward normalizing, the European Central Bank has moved front and center; and is now driving an accommodative global monetary system, as seen by the negative rate on the German two-year note. The ECB will stop expanding its balance sheet later this year, but will be patient to raise rates with no pressure from inflation. While we believe the slow pace will make the rise in rates more sustainable, we hold a negative stance to European interest rate risk.

ECB policies will keep the euro from appreciating too quickly, helping eurozone businesses. The euro's valuation is still low relative to the U.S. dollar and other currencies, which enhances the profitability of EU companies. A cheap euro especially benefits export reliant economies such as that of Germany, the largest driver of eurozone growth.

China will continue to manage growth within a narrow band as the country transitions from an "old economy" industrial base to a more consumer-oriented economy and implements financial system reforms. In the near term, China's high potential growth rate will allow the central government sufficient policy tools to address any instability resulting from reform.

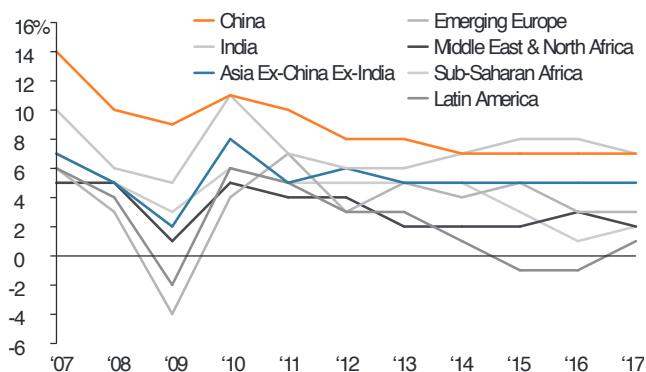
Figure 5. China's GDP Looks Sustainable as Its Economy Becomes Consumption Driven



Source: Haver Analytics, Voya Investment Management

Elsewhere within emerging markets, growth will remain robust, supported by a contained U.S. dollar, low global interest rates and sustained developed market growth. Investment flows into emerging market debt funds continue to pick up as a result. Risks within EM are primarily idiosyncratic, except for largely priced-in systematic risks from China and the associated effects on commodity prices. Despite this, we believe the worst of the commodities rout is behind us.

Figure 6. Emerging Market Growth Looks Robust



Source: Oxford Economics, Voya Investment Management

The global growth impulse has shifted outside the U.S.:

- Europe
- Emerging markets
- ECB now drives accommodative global monetary system
- We take a negative stance to European interest rate risk

Past performance does not guarantee future results.

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Outlook

For these reasons, we are maintaining our preference towards spread assets going into the latter half of the year, specifically those that will benefit from an improving global growth picture such as emerging markets, as well as high yield and investment grade credit despite current valuations. We are also keeping an overweight to securitized products, specifically collateralized loan obligations, commercial mortgage-backed securities and agency credit risk transfer securities. We maintain a shorter duration posture in our portfolios, as we believe rates will continue to rise, albeit slowly. We are keeping a neutral stance to agency mortgages, since the Fed's plan to taper MBS from its balance sheet has mostly met investors' expectations.