

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 Rates: gradually rising rates in United States and Canada, holding steady in Europe and Japan

Global Currencies: U.S. dollar strengthens vs. British pound and yen; weakens vs. euro, emerging markets

Investment Grade Corporates : demand has picked back up as yields have drifted higher, leading to a narrowing in spreads; underweight on tight valuations

High Yield Corporates: maintain modest overweight with option-adjusted spread (OAS) slightly below full value

Securitized Assets: underweight agency mortgage-backed securities because of valuations ahead of Fed balance sheet reduction

Emerging Market Debt: maintaining slight overweights to select markets as growth rebounds from late spring slowdown

The QE Shoe Drops, Now What?

- As expected, the Federal Reserve Open Market Committee officially announced its plan for the pace, scope and timing of the Fed's balance sheet reduction in its September meeting. Set to begin in October, the Fed maintained its transparency in announcing the details of the reduction of Treasury and agency mortgage securities. While capped on a monthly basis, the balance sheet reduction cap amount is set to increase at a gradual pace. Fed Chair Janet Yellen also kept the door open for a December interest rate hike, which we still expect. She stressed that any potential negative effects on third-quarter economic data as a result of Hurricanes Harvey and Irma likely will be minimal.
- The August inflation print showed some strength, largely driven by corrections in lodging, rent and owners-equivalent rent, all three of which are key components of the Consumer Price Index. This suggests that recent weakness may have been more a transitory effect than a long-term trend. Additionally, encouraging developments in consumer spending, employment and wage growth continue to support another hike. Expectations of a hike rose from under 40% to over 50% following the inflation print, and now sit above 70% following Yellen's conference.
- Away from the U.S., the economic outlook is firm for Europe and Japan. Eurozone growth is above trend and headline inflation is ticking up, both of which, combined with fading systemic risk, are prompting investment flows into Europe and therefore benefiting the euro. Japan's GDP is expected to run above trend for 2017; growth is underpinned by strong domestic demand and export volumes due, in part, to the yen effect. China's fixed asset investment has moderated slightly, while manufacturing and service PMIs have advanced.
- From an investment standpoint, as valuations continue to look stretched we have reduced our allocation to investment grade credit in an effort to moderate corporate risk, while maintaining a bias to high yield via a modest overweight. Additionally, we maintain a slight overweight to select emerging markets, as EM growth momentum has rebounded. After a recent rally and the expectation of the Fed balance sheet reduction, we underweighted agency mortgage-backed securities; we believe risks are skewed to the downside. Finally, in expectation of gradually rising rates, we maintain a bias to shorter duration postures across our multi-sector portfolios.

Spreads, Returns and Yields

Index/Sector	Percentage of Index	Spread (bp)	Returns (%)	
			August 2017	YTD 2017
Barclays U.S. Aggregate	100.0	42	0.9	3.6
Treasury	37.0	0	1.1	3.1
Investment Grade Corporate	25.3	110	0.8	5.4
Fixed-Rate MBS	28.2	30	0.7	2.6
Other				
High Yield		373	0.0	6.1
Global Aggregate		41	1.0	7.2
Emerging Markets		256	1.4	7.4

Country	Yield on Ten-Year Bonds (%)	Currency	Returns (%)	
			August 2017	YTD 2017
United States	2.12	EUR/USD 1.19	0.57	13.25
Germany	0.36	USD/JPY 110	0.25	6.35
Japan	0.09	USD/BRL 3.15	-0.71	3.20

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

- Ten-year U.S. Treasury yields closed August at their lowest level since last November in reaction to renewed tensions with North Korea and the impact of Hurricane Harvey. Still, we expect yields to trend higher in the United States and Europe as central banks move towards tapering their respective quantitative easing programs.
- The ECB is maintaining its negative deposit rate and monthly QE target, and has indicated it will make decisions for QE changes in October. It sees QE running until year-end or beyond, should the outlook worsen. The Bank of Japan is maintaining its goal to keep 10-year yields near zero. The Bank of Canada hiked and expects the nation's output gap to close around year-end, with inflation reaching its 2% target in mid-2018.

Global Currencies

- The U.S. dollar and euro were moved by what Fed Chair Janet Yellen and ECB President Mario Draghi didn't say at Jackson Hole. Yellen neglected to mention how easing financial conditions might affect Fed policy; Draghi ignored the stronger euro's impact on policy decisions. The euro-dollar exchange rate reached fresh YTD highs and extended the divergence of the dollar and real interest rate differentials.
- The euro has benefited from stronger eurozone growth, stable inflation and fading systemic risks, and should further appreciate against the dollar. The dollar should gain against the pound and yen, but depreciate against select emerging market currencies.

Investment Grade Corporates

- Corporate spreads widened in August, giving up nearly half their YTD advance before rebounding early in September. Lower yields and a weaker dollar have moderated foreign demand, but yield differentials still make U.S. credit attractive. Corporate profits rebounded in Q2, a positive for the business cycle. While the IG market remains well supported, spread tightening may be limited with heavy new issuance in September and no sign of higher rates. We like the valuation gap of financials and think BBB-rated credits can still compress slightly. The long end underperformed for the month and may present an opportunity as the technical picture improves.

High Yield Corporates

- High yield suffered a setback as valuations gave pause to investors. Companies reporting light results at the end of earnings season were met with harsh price action. A new issue calendar heavy on credits with

questionable fundamentals did not help. All this added up to a mildly negative August with quality clearly outperforming. Valuation levels look more justifiable as we enter September. Supply and demand appear balanced; heavier August issuance may mean a lighter September calendar. We maintain a bias to high yield via a modest overweight, while looking for attractive entry points over the coming months.

Securitized Assets

- After a recent rally and the expectation of the Fed balance sheet reduction, we have underweighted agency mortgage-backed securities (RMBS); we believe risks are skewed to the downside. GNMA's continue to suffer from oversupply and have underperformed their GSE counterparts year-to-date. Net supply has already exceeded many analysts' full-year estimates, without factoring in the Fed's balance sheet unwinding.
- Despite little change in credit spreads, commercial mortgage-backed securities (CMBS) outperformed in August, leaving them with diminished relative value. That being said, we maintain our overweight position due to valuations versus other asset classes; however, we believe that fundamentals have broadly plateaued. An expected supply surge should generate headwinds; concerns about elevated property valuations and retail sector vitality cloud the story. We expect tactical opportunities to emerge.
- Our outlook for collateralized loan obligations (CLOs) remains positive on attractive valuations and improving risk profiles. Demand for CLOs remains vigorous, aided by global currency and rate dynamics.
- Asset-backed securities (ABS) will remain well bid, although fundamentals for subprime auto borrowers are becoming more of a question; however, we do not believe those troubles will spill into other sub-sectors. With potential market disruptions from supply issues, hurricanes and North Korea, we expect ABS to outperform.

Emerging Market Debt

- Growth within emerging markets (EM) is back up after moderating in spring, prompting us to maintain a slight overweight to select countries. PMIs have strengthened, and EM currencies have rallied as a result of stronger growth expectations, a stronger euro, and weaker U.S. dollar. Risks from China and commodity price volatility are largely priced in; other EM risks are primarily idiosyncratic. Country differentiation remains key, with idiosyncratic risks in Venezuela and North Korea.

Past performance does not guarantee future results.

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