Fixed Income Perspectives

Knowing the stakes, the Fed is likely to keep surprises to a minimum.

Bond Market Outlook

Global Rates: U.S. yields biased higher and curve steeper but further room to run is limited

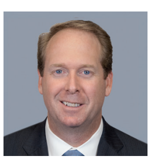
Global Currencies: U.S. dollar moved higher in a flight to quality

Investment Grade: After a late-March rally in spreads, we return to a neutral stance and await a better entry point; fundamentals expected to remain solid in Q1 earnings

High Yield: All-in yields look better but spreads aren't screaming cheap after late March tightening; fundamentals solid but pockets of weakness continuing to grow

Securitized: Prefer areas in CMBS and CLOs where yield opportunities remain; residential credit still facing prepayment headwinds, but outlook is positive

Emerging Markets: Growth projections weakening amid headline turmoil and growing stagflation concerns



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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.

Monetary tightening to remain on track to combat inflation

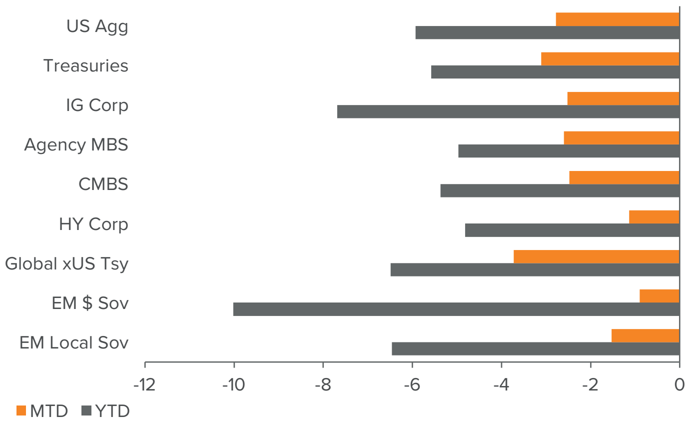
Entering the second quarter of 2022, the United States Federal Reserve is expected to continue to tighten monetary policy in order to combat elevated inflation with the hope of achieving a soft landing. Despite a much-welcomed March inflation print that modestly missed expectations to the downside, we believe the U.S. central bank will still raise rates at every meeting through the remainder of this year, with two or three of the hikes being 50 basis points (bps). Additionally, the Fed released details of its balance sheet runoff plans, which is expected to be around $1 trillion per year. There is still $1.7 trillion of excess liquidity in the Fed's reverse repo facility, meaning we will be in an excess liquidity environment for at least one more year.

While the risk of a recession continues to increase, we believe market disruptions resulting from tightening policy will be manageable if the Fed does not surprise investors and inflation begins to wane. The market is also starting to have more faith in a soft-landing scenario, as the Treasury curve has steepened fairly quickly after briefly inverting around quarter-end. With supply chains still highly challenged — exacerbated by China's zero-COVID policies — and wage inflation persisting, corporations have an elevated incentive to invest. This potential handoff to a CapEx cycle should help to alleviate inflation pressure and increase the likelihood of a soft landing.

In the near term, investors can take comfort in the fact that corporations and households remain fundamentally sound. Corporate profits grew at record levels in 2021 as consumers flush with cash readily absorbed price increases. And while home prices have risen significantly over the last 18 months, data shows that the rise has not been fueled by increased debt. Nonetheless, while not our base case the probability of a mild recession has moved definitively higher, and investors would be wise to increase liquidity in their portfolio and reduce exposure to sectors where valuations are tight. With spreads having rebounded in late March after a steady move wider for much of the quarter, we took the opportunity to reduce risk across investment grade and high yield corporates, increasing dry powder to wait for a better entry point with the expectation that spreads will remain volatile. With rate volatility increasing and the Fed moving off the zero-lower bound, duration has reemerged as an interesting tool to balance credit risk.

Rates, Spreads and Yields

Fixed Income Sector Total Returns



		31-Mar	31-Dec	1Y Low	1Y High
Yields	US 2 Yr	2.32	0.73	0.11	2.34
	US 10 Yr	2.34	1.51	1.17	2.48
	GER 10 Yr	0.55	-0.18	-0.50	0.65
	JPN 10 Yr	0.22	0.07	0.01	0.25
	EM Local Sov	6.23	5.72	4.85	7.47
Spreads	IG Corp	116	92	80	145
	Agency MBS	24	31	7	38
	CMBS	129	105	92	136
	HY Corp	325	283	262	411
	HY x-Egy Corp	328	276	252	416
	EM $ Sov	400	369	330	526

As of 03/31/22. Source: Bloomberg, Bloomberg/Barclays, JPMorgan and Voya. **Past performance is no guarantee of future results**.

Sector Outlooks

Global Rates and Currencies

While much uncertainty abounds globally, we're most focused on six key questions over the coming weeks and months: Terminal rates are currently priced to go above neutral in many economies, but will it be enough to bring inflation down without causing recession; why are risky assets resilient in the face of much tighter monetary conditions; will the global savings glut come to an end as the new world order and status of the U.S. dollar as the reserve currency of choice becomes less certain; what will be the impact of quantitative tightening when liquidity is already poor in Treasury markets; how will China hit 5.5% growth for 2022 with lockdowns spreading and having eased so little; will the Bank of Japan abandon Yield Curve Control?

The U.S. remains the leader in growth among major economies despite the looming fiscal cliff, as it is the least dependent on energy imports. While the Fed is unambiguously hawkish, it has acknowledged being behind the curve. With that, the market is pricing fed funds to be at 2.5% by end of 2022, which is above neutral by many measures. Quantitative Tightening will have a greater impact on risky assets than on the Treasury curve, in our opinion, unless the Fed decides to sell assets.

And just like Fed and Bank of England, the European Central Bank was unambiguously hawkish relative to expectations. This has put upward pressure on peripheral yields and Core European Government Bond yields. Europe is expected to underperform the U.S. in terms of growth after the oil shock emanating from the Russia-Ukraine conflict, which makes ECB pricing vulnerable.

Investment Grade (IG) Corporates

IG spreads widened 23 bps to 145 bps over comparable Treasuries by mid-March before staging a huge rally and finishing 6 bps tighter at 116 bps for the period. The drivers of the rally remain somewhat unclear, as the macro and geopolitical risks that contributed to the widening remained. The huge move in rates seemed to pull in yield-based buyers while not creating significant retail selling, despite increasingly negative total returns. Supply was well above expectations at $288 billion but was generally well absorbed by the market. The technical environment improved somewhat, with many factors suggesting fairly negative positioning by IG investors. However, the fundamental picture looks solid despite heightened volatility with first quarter of 2022 earnings getting started this week. Thus, we lower our tactical rating back to Neutral and wait (again) for an opportunity to add IG risk. The 30-year segment continues to look attractive, and sector-wise we like still financials, communications, utilities, and technology.

High Yield Corporates

High Yield's rocky start to 2022 got worse in March, with excess returns looking much better than absolute performance. The resetting of interest rates was the main culprit driving pushback in March. The technical environment remained choppy, especially with the large new issuance calendar looming on the horizon. In the meantime, outflows from the high yield continued. Nonetheless, valuations seem reasonable, if slightly on the cheaper side. More broadly, we still caution that the big downside scenario would be a Fed forced into rate action due to inflation, even against a weaker growth picture. The upside would be an alleviation of the supply chain issues into strong demand environment, resulting in growth with reduced inflation picture and a less hawkish Fed. Thus, we keep our tactical call leaning positive.

Bank Loans

The U.S. loan market was choppy in March due to geopolitical risks and heightened volatility in global financial markets. Performance was a tale of two halves: The first two weeks were marked by strong declines in loan prices, while the latter two weeks saw a recovery on the back of improving sentiment. More specifically, the average bid price for the S&P/LSTA Leveraged Loan Index reached a low-water mark of 95.88 on March 15 (lowest since December 2020) before recovering 172 bps to 97.60 by the end of the month. All told, the Index squeaked out an advance of 10 bps, primarily driven by coupon carry given the market value decline of 30 bps. Loans continued to outperform other risk assets, as investment grade and high yield bonds along with treasuries all finished the month considerably in negative territory. From a ratings perspective, higher-rated credits outperformed lower quality given the risk-off tone. Turning to market technicals, new-issue supply remained subdued for a second consecutive month amid the uncertain backdrop. Roughly $17 billion of loans were launched into syndication in March with most including investor-friendly terms to get across the finish line.

Securitized Assets

Agency mortgage-backed securities (MBS) in March underperformed U.S. Treasuries due to increased interest rate volatility, with the five- and 10-year segment of the Treasury curve inverting and the two- and 10-year segment bear flattening. Overall MBS performance suffered from hawkish Fed speak and geopolitical risk in Europe. The Fed has officially ended active MBS purchases, and will continue to reinvest paydowns i.e. about $2 billion per day. In the near-term, mortgages will carefully balance the increase in interest rate volatility with an improved fundamental landscape. Looking ahead, the known headwinds of Fed run-off, rate hikes, geopolitical turbulence, and elevated private market supply will be countered by improved carry and a more attractive prepay environment. However, performance will not be smooth as mortgages get caught between bouts of risk-on and risk-off events.

We maintain our positive assessment of mortgage credit. Indeed, the non-agency ecosystem stabilized in March, albeit at materially wider spreads after a difficult first quarter, which in turn leaves relative value as a supportive component. Toward the end of March, the distorted credit risk transfer (CRT) sector posted some spread tightening. More broadly, issuance volumes dropped across sub-sectors, as execution was more favorable in other markets. We expect this dynamic to continue to keep new issue volumes lower in the near term. Fundamentally, the space is supported by an array of positive credit conditions (the best "we have ever seen"), which will drive outperformance as technical conditions continue to improve.

Commercial mortgage-backed securities (CMBS) have picked up correlation with broader risk markets since February, which is expected to continue until new issuance volume recedes. In particular, single-asset, single-borrower and commercial real estate collateralized loan obligation sub-sectors have dominated the issuance calendar, accounting for 75% of issuance volume in the sector's biggest quarter since 2007. Pipelines remain full for the near term although longer term prospects may provide a respite. The appetite for credit risk remains deep and perceptions of risk have shifted definitively lower, so we expect widening to soon reach a ceiling and get purchased, but we are not convinced as to when.

We have upgraded our assessment for ABS to positive: Post quarter-end, we’re more optimistic regarding investor reception of new issue and the potential for selling pressure to meet redemptions. Significantly improved yield/spread profiles are likely to attract more interest from income focused buyers, and the improved relative value versus corporate credit should drive larger orders from more accounts as the second quarter issuance wave is distributed. With higher cash balances purportedly available to meet redemptions and quarter-end in the rearview, we expect a more liquid environment with tight bid-offers, supportive of spreads. Fundamentals should prove supportive in the near-term, as seasonality keeps most payment performance metrics at or inside pre-Covid levels.

Emerging Market (EM) Debt

We are considering revising lower our 2022 EM growth outlook as stagflation concerns mount. Adding to the downward pressures is the continued lower fiscal impulse, high input prices, supply chain constraints and soaring energy prices. EM growth rates have returned to pre-pandemic levels on average, but the outlook is differentiated. Asia is expected to exceed pre-pandemic levels for the fourth quarter of 2022, but CEEMA is expected remain range-bound while Latin America is expected to lag. EM fiscal paths are likely to be tested amid a redirection of expenditure towards subsidies (energy and utilities) and away from pandemic relief measures as Omicron wanes. Some Asian IG countries remain fiscally generous, even if restrictions ease. In Latin America, further fiscal deterioration is possible with more populist candidates leading in several major election races.

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