Fixed Income Perspectives

These are the seven major themes influencing positioning across our fixed income portfolios in the first half of 2022.

Bond Market Outlook

Global Rates: Yields edge higher driven by ongoing inflation worries and 2022 rate-hike expectations

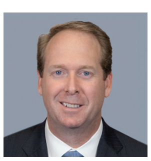
Global Currencies: U.S. dollar remains resilient versus DM, EM currencies, acting as a market barometer of COVID concerns

Investment Grade: Despite Fed and virus uncertainty, we see spreads widening as an opportunity to selectively add risk, given strong fundamental backdrop

High Yield: Strong fundamentals and muted default rate expectations for 2022 will underpin valuations

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

Emerging Markets: Growth remains positive even if pace of developed market growth fades, but still unsynchronous amid supply chain uncertainties and rebound in trade



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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.

Seven Themes to Monitor in the First Half of 2022

Supply/Demand Mismatch

The pandemic-driven goods shortage primarily reflects excess demand, exacerbated by an inability of supply chains to adjust quickly. The fading of COVID related fears will drive a shift back toward services spending as inflated goods demand recedes, with total activity sufficient to drive robust labor demand.

U.S. Labor Participation

Workers will gradually re-enter the workforce as COVID fears wane and excess savings are depleted, but the participation rate will not fully recover to pre-pandemic levels. Continuing wage pressures will benefit workers in the near term but also will provide incentive for companies to invest in labor saving technology.

Capital Expenditures (Capex)

Productivity enhancing investment, along with the green energy transition, will generate significant public and private spending. Investments in human capital and infrastructure will increase potential growth rates as societies seek to adapt to post-pandemic paradigm shifts.

Inflation

Global inflation, accentuated by energy and commodity prices, will peak in early 2022, but the rate of decline will vary across economies. U.S. inflation will decline only gradually and will remain above the Federal Reserve's target as wage-driven services inflation and rising shelter costs offset a retracement in COVID-driven goods inflation.

Central Banks

Given their historical failure to meet inflation targets, developed market central banks will be slow to remove accommodation. The Fed will accept above-trend inflation as long as core inflation is decelerating and real wages are rising. With wage pressure less acute in Europe, the European Central Bank (ECB) will not begin to raise rates.

Global Growth

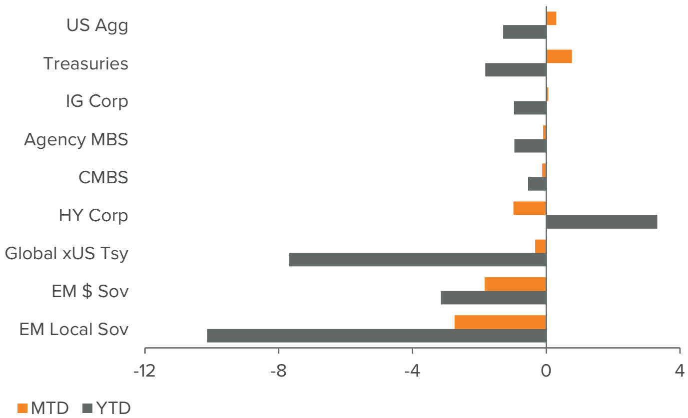
The combination of pent-up demand for services, spending of excess savings and inventory restocking will support growth in the near term. The durability of global growth will benefit from multiple drivers including a more balanced Chinese economy and enhanced U.S. and European investment.

Markets

Relatively full asset valuations are supported by above-trend growth and positive fundamentals, but the limited upside increases the need for downside protection. As health, inflation and growth variables conspire to impact central bank policy, periodic episodes of volatility will provide tactical market opportunities, with a bias towards being long credit risk versus duration. As U.S. rates reach an equilibrium and U.S. dollar strength abates, emerging market debt securities will prove attractive.

Rates, Spreads and Yields

Fixed Income Sector Total Returns



		30-Nov	30-Sep	1Y Low	1Y High
Yields	US 2 Yr	0.55	0.29	0.11	0.60
	US 10 Yr	1.45	1.49	0.84	1.74
	GER 10 Yr	-0.35	-0.20	-0.64	-0.09
	JPN 10 Yr	0.06	0.07	0.01	0.16
	EM Local Sov	5.68	5.30	4.19	5.80
Spreads	IG Corp	99	84	80	105
	Agency MBS	34	27	7	49
	CMBS	107	95	92	149
	HY Corp	337	289	262	412
	HY x-Egy Corp	327	281	252	377
	EM $ Sov	392	357	330	392

As of 11/30/21. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya. **Past performance is no guarantee of future results.**

Sector Outlooks

Global Rates and Currencies

With COVID fears subsiding and the global economy continuing to reopen, growth has clearly turned up in the United States and Europe is stable, but China is gradually easing. That said, the new Omicron COVID variant poses risks, as renewed lockdowns materialize in certain areas and travel restrictions spread. Aside from near-term growth effects, more lasting sentiment impacts could hinder normalization of spending. Longer-term risks include the ongoing supply chain bottlenecks, persistently low levels of U.S. labor force participation, and further COVID mutations. Meanwhile, as tapering has arrived in the U.S. and Europe, we nonetheless expect that central bank balance sheets will remain in expansionary states.

The U.S. remains the leader in growth among major economies, due in part to less stringency on lockdowns. While the Delta variant did cause a dip in activity, it has since re-accelerated strongly. And although the Omicron variant does pose a risk to activity levels and normalization, information on the variant is evolving rapidly and may provide a better read on whether or not the Omicron impact will be of lesser magnitude than Delta. At its December meeting, the Federal Open Market Committee (FOMC) confirmed that it will accelerate its tapering schedule beginning in January. The rate-hike threshold remains high, but risks remain skewed toward earlier, rather than later, rate hikes. Some have argued that Fed Chair Jerome Powell's reappointment implicitly endorses his more hawkish shift in tone. In our view, a faster taper is consistent with Powell's retiring of the word "transitory" in describing inflation, given the likelihood of a more lasting impact of recent price increases and the breadth of the pricing strength. However, the idea of stickier labor participation seems to be sinking in, with persistently high inflation a threat to a prolonged labor market recovery. Also, incoming inflation data have reaccelerated after a minor lull in Delta infections. The recent surge in energy prices poses a risk to sentiment and expectations despite the Fed's focus on core CPI. Ultimately, though, the impact from the surge in energy prices will filter through to core. New restrictions could inflame or prolong existing supply disruptions and hinder a recovery in labor force participation, thereby supporting wage growth.

European PMI levels have largely equalized and held steady following the recent surge there and the moderation in the U.S. That said, the likelihood of stricter activity curbs within Europe should lead to a new phase of U.S. outperformance. Similar to the U.S., re-opening frictions have contributed to higher inflation in Europe, but the odds of stickiness seem lower. Energy inflation poses more of a risk to European growth given greater oil and gas dependency. Meanwhile, the ECB has started modest tapering, but the December meeting is the important one that will decide the future of Pandemic Emergency Purchase Program, which likely to conclude as scheduled in March 2022. Still, the Omicron variant could delay the ECB's decision on setting the ongoing purchase pace for its Asset Purchase Programs.

Investment Grade (IG) Corporates

IG spreads widened 12 basis points (bp) in November and are now wider YTD. Spreads initially drifted 7 bp wider on macro concerns, i.e., inflation and subsequent rate volatility, as well as technical dynamics such as bloated dealer balance sheets with overseas accounts pulling back and a healthy December supply pipeline. As the month progressed, however, spreads widened a further 5 bp as news of Omicron rattled markets on Black Friday. That said, we generally see the widening as an opportunity to add some risk despite uncertainty around COVID variants. November supply was 12% above the five-year average of $99 billion, and above street expectations. Increased tender activity was again a factor, as companies looked to once more lower coupon payments ahead of Fed tapering. The December pipeline could be as much as $50–60 billion, at least double the average of the past four Decembers, which could pressure technicals to start the month. As the near-term outlook for credit remains positive from a fundamental perspective, we are changing our strategic and tactical rating to Neutral/Positive. We continue to see the most value in seven- to ten-year bonds with the long-end of the Treasury curve flattening. Sector wise, we like telecommunications, utilities, and technology.

High Yield Corporates

The churn we've been expounding about these past few months turned into a tidal wave as HY rolled over in November. The market was already struggling with the combination of rate, inflation, and supply chain concerns – not to mention the stretched valuations and heavy new issuance calendar weighing down – then Omicron hit the headlines, and the thin market washed out. While fundamentals are mostly intact, though post-peak, oil finally re-priced, cash levels are meager, and the Street has inventory; valuations are a bit more enticing. With all that said, we 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.

Bank Loans

While investor demand marked another banner month for the loan market, broad-based volatility related to the Omicron variant skewed performance into negative territory for November. The S&P/LSTA Leveraged Loan index returned -0.16% during the month, marking only the second negative monthly reading for the asset class in 2021. Unsurprisingly, riskier credits experienced more significant selling pressure relative to higher quality during November. For CCC-rated issues, November was the worst performing month since last March's historic sell-off. Moving up the credit quality scale, Single-B- and BB-rated loans posted marginally negative but still better returns. New loan issuance amounted to $61.3 billion in November, and continued to be underpinned by robust M&A activity, which has tracked a record pace the last three months, totaling over $100 billion during that time.

Securitized Assets

Agency mortgage-backed securities (MBS) underperformed Treasuries as heightened rate volatility and flight-to-quality sentiment due to macro uncertainties overwhelmed. The Omicron variant, the Fed's surprisingly hawkish tone, and more negative convexity fears impaired mortgage performance. Among issuers, conventional returns lagged as the Fed started tapering daily purchases, while GNMA suffered less due to modest overseas interest. Net issuance in 2021 is expected to be about $900 billion while the outlook for 2022 year-end is expected to be the second highest on record, at roughly $650 billion. In the near-term, active Fed tapering and a potential increase in MBS taper size imply that bond purchases could end in mid-March 2022. This suggests early Fed rate hikes and may lead to higher overall volatility. Nonetheless, the Fed is expected to make net purchase at least $65 billion of mortgages for the next two months.

Now two months into our fresh, positive outlook for mortgage credit, we reaffirm our conviction. The space continues to benefit from the best credit conditions we have ever seen; between housing market dynamics, economic growth and a well-positioned consumer, all the key elements are aligning well. Although the prepayment outlook isn't ideal, we look for a more favorable set of conditions into year-end, which will improve sponsorship in this already "credit-risk blessed" space. Affordability is a key risk to housing market dynamics, but it stops short of threatening strong mortgage credit behavior through the horizon, and could perhaps prove a tailwind if it plays a role in moderating new issue supply from its current pace.

The weaker sentiment in the broader markets has leaked into commercial mortgage-backed securities (CMBS), adding to strains from a year of elevated issuance across. While CMBS had navigated the new issue calendar reasonably well, some fatigue was experienced through late Fall and is now conspiring with weaker, less liquid market conditions to drive our continued negative assessment. Credit appetite is deep and perceptions of risk have shifted definitively lower, so we expect widening to prove short-lived and pounced-upon when sentiment improves, perhaps on the basis of better certainty around the Fed's intentions and Omicron's real risk.

The asset-backed securities (ABS) market successfully navigated its pre-holiday surge of new issuance, displaying deep sponsorship across a broad range of subsectors and issuers. Indeed, ABS have continued to perform well fundamentally and earn their allocations in a broad range of strategies. While valuations remain on the rich side with spreads at or through pre-COVID tights, the apparent turn lower in broader market sentiment should allow ABS to shine. We maintain our assessment as positive and increase our conviction. The fiscally improved profile of the U.S. consumer coupled with ABS structural dynamics were already believed to provide the sector with a solid footing to withstand this sustained period of elevated, albeit improving, unemployment.

Emerging Market (EM) Debt

We continue to expect EM economic recovery to carry through into 2022, even if the pace of U.S. and European growth eases on supply chains bottlenecks, embedded nature of inflation and COVID variants. That said, as re-openings materialize, regional divergences in economic paths are likely to remain, which will impact inflation differently. We expect global capital flows to EMs will correlate to favorable global financial conditions. The multi-speed and unsynchronous EM growth rebound is expected to continue, with most countries struggling to close the output gap. Parts of EM are facing inflationary pressures, with supply-side constraints in focus amid rising domestic and external demand, and high commodity prices. A number of proactive central banks in Central and Eastern Europe, the Middle East and Africa, and in Latin America, remain hawkish; while Asia, excluding Korea, remains accommodative. EM corporates continued to see earnings improvement, led by commodity producers that are benefiting from rebounding oil and metal prices.

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