Fixed Income Perspectives

With tapering worries in the rearview, attention has returned to the inflationary environment.

As Tapering Begins, Inflation Returns to Forefront

As expected, the Federal Reserve announced its first round of tapering this month, which as we noted in October, was rightfully a non-event for markets. Starting now and into December, the Fed will reduce monthly purchases by $15 billion. While these reductions are expected to carry into July of 2022, the Fed also said it may augment those reductions, if need be, based on prevailing economic conditions. Once these purchase reductions are complete, we believe the Fed will maintain its balance sheet at the new level via reinvestments of coupon income and maturing proceeds.

With the phantom worries about the onset of tapering now behind us, attention has returned to the grumbling around stagflation. While we continue to believe that stagflation is highly unlikely, we do understand where the angst is coming from: the ever-growing inflationary concerns and softening growth. Sticker-shock gas prices and the now 100-plus tankers standing off the coast of Southern California do little to quell layman sentiment, and markets are taking notice. By now the characterizing of current inflation as “transitory” is losing steam, as it should but, many are wrongly casting it as a structural shift. Rather, we see the current inflationary environment as *cyclical,* i.e. persistent during this phase of above trend growth which is likely to continue over the next 2-plus years.

As expected, inflation will remain a key driver for rates going into year-end and next year. While we see a higher inflation baseline, ultimately, we do not expect structural inflation to take hold such that could create a significant headwind for fixed income investors. As a result, we expect the upside risk to the 10-year Treasury yield to be up to 2% in the coming quarters.

Bond Market Outlook

Global Rates: Yields to edge higher across the curve, driven by inflation, with curve flattening led by the front-end amid 2022 rate hike expectations

Global Currencies: U.S. dollar to remain resilient vs DM, EM currencies

Investment Grade: Near-term outlook for IG credit remains positive, but valuations warrant defensive positioning

High Yield: Overall we remain cautiously neutral as fundamentals feel a touch softer

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

Emerging Markets: Global economic strength helped, and will likely continue to help EM overall, although unsynchronized growth within the cohort is also an ongoing factor

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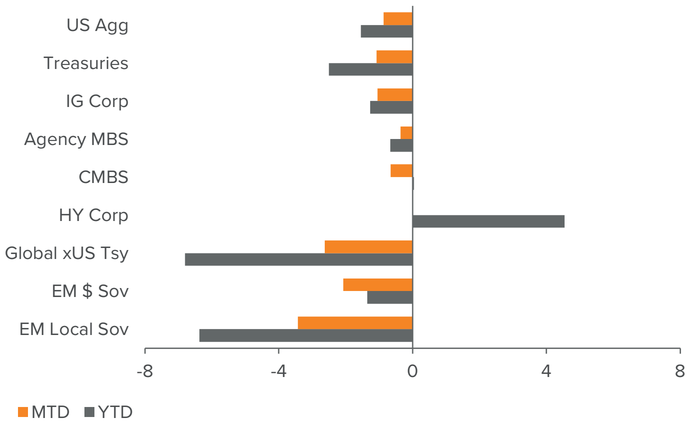
CIO Fixed Income

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.

Rates, Spreads and Yields

Fixed Income Sector Total Returns



		31-Oct	30-Sep	1Y Low	1Y High
Yields	US 2 Yr	0.49	0.29	0.11	0.49
	US 10 Yr	1.56	1.49	0.76	1.74
	GER 10 Yr	-0.11	-0.20	-0.64	-0.08
	JPN 10 Yr	0.10	0.07	0.01	0.16
	EM Local Sov	5.65	5.30	4.19	5.66
Spreads	IG Corp	87	84	80	126
	Agency MBS	24	27	7	54
	CMBS	97	95	92	164
	HY Corp	287	289	262	509
	HY x-Egy Corp	280	281	252	464
	EM $ Sov	358	357	330	423

As of 10/31/21. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya. **Past performance is no guarantee of future results.**

Sector Outlooks

Global Rates and Currencies

The U.S. dollar declined against most G10 currencies in October as G10 central banks have generally shifted towards a more hawkish stance on rate hikes. While there are likely a few reasons among each of the banks for this, one common, reason among them has to do with higher inflation pressures, both current and expected over the short-term. Wage growth, shelter and supply dynamics will influence the trajectory of inflation for the foreseeable future. Furthermore, yield curve flattening has manifested across several developed, sovereign bond markets, although some peripheral markets have seen their spreads gap outward towards the end of the month. As we look at the remainder of 2021, key economic statistics to keep a close eye on include labor force participation rate and consumer spending to gauge the underlying inflation and growth dynamics.

Investment Grade (IG) Corporates

IG spreads widened in October and gave back the tightening we saw from the rates sell-off in late September. While earnings were generally solid and supportive of spreads overall, rate volatility weighed somewhat on sentiment, particularly among overseas investors. New supply volume was in line with expectations, but issuance was limited in longer-dated maturities, limiting month-end corporate index extension and associated buying. While the near-term outlook for credit remains positive from fundamental perspective, we are keeping our strategic and tactical rating at Neutral due to valuations. We continue to see the most value in 7- to 10-year bonds with the long-end of the Treasury curve flattening. Sector wise, we like Financials, Communications, Utilities and Technology.

High Yield Corporates

The churn continues with a negative drift. For us, it seems increasingly likely that HY will have a tough time threading the needle next year between the potential for a strong economy, which would mean inflationary pressures continue and the Fed begins possibly raising rates, and a weak economy in which credit fundamentals could suffer. For now, fundamentals are mostly intact, there are inflationary pressures in a lot of spots, technicals are pretty flat, and cash balances seem tame after glut of new supply, a but year-end slowdown in new debt sales could create a tailwind as valuations are compressed. 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

Senior loan performance marked another positive reading in October as the Index advanced by 0.27%, although the pace of gains trailed the prior month. Performance was more mixed among ratings cohorts with less risk-on posturing relative to the last two months. October was another busy month for the loan market, as participants sorted through roughly $50 billion of new-issue supply. In line with the prevailing theme of 2021, M&A continued to underpin new loan formation, accounting for nearly 63% of total deal flow.

Securitized Assets

Agency MBS performed largely in line with Treasuries, as outperformance on the short and long end of the curve made up for weakness in the mid-portion. The technical and fundamental backdrops in the mortgage market remain well balanced for the near term, as robust supply is countered by strong bank and FED demand, and higher rates and volatility will be balanced by a slower prepayment environment and attractive financing rates. On November 3rd, the FED announced MBS asset purchases tapering at $5 billion per-month pace. While tapering could end by July 2022, the FED will continue to re-invest their paydowns.

The stock effect will remain a powerful tailwind to mortgage performance and financing rate in the near term.

One month into our fresh, positive outlook for Mortgage Credit and we have increased 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 the 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.

New issuance has suddenly become the prevailing narrative in CMBS, somehow eclipsing the re-opening of the world as the driver. While the space has navigated a daunting new issue calendar reasonably well, some fatigue was experienced in October, and feels likely to continue with a still-sizeable pipeline, at least through Thanksgiving. Credit appetite is deep and perceptions of risk have shifted definitively lower, so we expect widening to prove short-lived. To be clear, the markets are clearly open for financing, and with the Delta surge seemingly fading and good news with Merck's therapeutic, we continue to like prospects for more seasoned risks.

The ABS market successfully navigated its surge of new issuance in September and October, displaying deep sponsorship across a broad range of subsectors and issuers. Indeed, ABS has continued to perform well fundamentally and earn its allocation 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 really shine. We maintain our assessment as positive and increase our conviction. The fiscally improved profile of the US consumer coupled with ABS structural dynamics were already believed to provide the sector with solid footing to withstand this sustained period of elevated, albeit improving, unemployment.

Emerging Market (EM) Debt

We continue to expect the 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 Delta variants. That said, as reopening’s materialize, a regional divergence 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 unsynchronized EM growth rebound is expected to continue, with most countries failing to close the output gap until the second half of 2022. 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 CEEMEA and LATAM remain hawkish while Asia (excluding-Korea) remains accommodative. EM corporates continued to see earnings improvement, led by commodity producers that benefited from rebounding oil and metal prices.

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