

# Fixed Income Perspectives

## Bond Market Outlook

**Global Rates:** policy rates stay low, further curve steepness limited in near term

**Global Currencies:** U.S. dollar trends weaker against DM, EM currencies

**Investment Grade:** spreads were flat in January, as tighter levels curbed some enthusiasm, but the macro, technical and fundamental story remained intact

**High Yield:** following a strong close to 2020, the market began the new year choppy and in search of direction, even as another monthly new issuance volume was set

**Securitized:** massive monetary and fiscal support, both current and expected, as well as vaccine rollout optimism, position the consumer and housing markets well heading into the new year

**Emerging Markets:** the recovery supported by strong manufacturing and exports continued, though its sustainability will depend on a rebound of employment, domestic consumption and investments



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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.

## Navigating Inflation: Does Your Concern Match Your Hedge?

As the chorus of inflation concerns grows louder by the day, it's important to take a step back and remember that inflation is not inherently *bad*. Inflation, nominal GDP, and corporate sales are all highly correlated. When prices rise gradually, it's an indication of positive economic momentum. This important detail is often lost in the echo chamber of headlines that like to paint *all* inflation scenarios as nefarious.

Since the publication of our annual outlook, we have maintained the view that inflation is more of a "cyclical" phenomenon rather than a "structural" risk. Structurally "bad" inflation is defined by rapidly increasing input costs that cannot be passed on to consumers, a dynamic that helps feed a vicious feedback loop of higher unemployment and declining nominal GDP. In the U.S., this type of "stagflation" was last experienced in the 1970s, the decade most often cited in today's media frenzy about potential inflation doomsday scenarios looming on the horizon. In the 1970s, geopolitical events caused a sudden and unexpected disruption to the supply of oil, which sent prices sharply higher in a short period of time. In an economy that was already facing high unemployment, corporations could not pass these higher prices to consumers, and inflation contributed to the overall economic malaise.

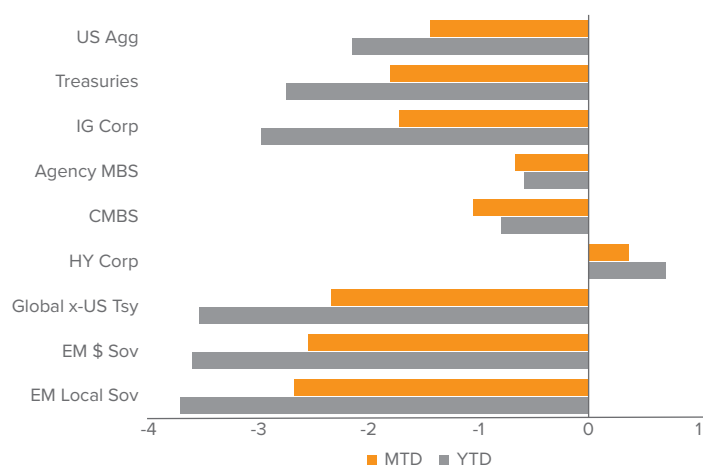
Compare the stagflation of the 1970s with today's environment. Broadly speaking, inflation pressure has been muted. Of course, investors' concerns about inflation are not backward looking. With the Biden administration's \$1.9 trillion stimulus package and ongoing vaccinations creating a bridge to a fully reopened economy, investors are viewing inflation through the lens of what's to come. In most market commentary regarding inflation fears, the logic goes something like this. Consumers, flush with inflated bank accounts from stimulus checks will unleash a purchasing frenzy that will lead to higher prices, i.e. inflation. But remember, even if this plays out, it's not inherently *bad*. In this scenario, consumer demand would create higher inflation, which should lead to higher corporate sales growth and be a net benefit for the economy.

Others have pointed to the recent rise in some input costs as an omen for "stagflation" ahead. However, here again, consumer demand has been more than enough to offset rising input costs. Homebuilders are a great example of an industry that is prospering despite strong input cost inflation. Lumber prices have surged, yet homebuilder margins are expanding because of strong home sale pricing power and robust consumer demand.

The example of homebuilders reinforces the important "K-shaped" dynamic of the economic recovery. It has been our view since last year that the pandemic led to a "two-speed" recovery that created winners and losers with broad strokes across the economy. As this relates to inflation, there will certainly be companies that are unable to pass through higher input costs to consumers. However, these companies will be contained to certain pockets of the economy and broadly speaking there will be more "winners" than "losers" from a corporate perspective.

As we signaled in our 2021 outlook, spreads across sectors are approaching levels that are uncomfortably tight. In this type of narrow spread environment, what you avoid is just as important as what you invest in. The same is true for the risks you seek to hedge. Given our current view of inflation, we believe TIPS are overvalued and that higher inflation is appropriately priced in to the TIPS market. While inflation is a risk we will continue to monitor, we have avoided TIPS thus far based on our outlook. In the current market backdrop, many investors are choosing to hedge against rising inflation. In our view, this hedge is premature and may ultimately prove to be futile.

## Rates, Spreads and Yields



	28-Feb	31-Jan	1Y Low	1Y High
Yields	US 2 Yr	0.13	0.11	0.82
	US 10 Yr	1.39	1.08	1.53
	GER 10 Yr	-0.26	-0.52	-0.19
	JPN 10 Yr	0.16	0.05	0.16
	EM Local Sov	4.71	4.27	6.94
	IG Corp	90	97	88
Spreads	Agency MBS	20	18	11
	CMBS	94	96	94
	HY Corp	327	363	317
	HY x-Egy Corp	305	337	292
	EM \$ Sov	357	351	261
	EM Local Sov	4.71	4.27	6.94

As of 02/28/21. Past performance is no guarantee of future results. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya

## Sector Outlooks

### Global Rates and Currencies

After the sharp move higher during the last week of February, we expect Treasury yields to remain range bound in the near term. The yield curve will continue to gradually steepen through year end, likely with bouts of intermittent volatility amid strong growth expectations and inflation concerns. Markets seem to be wrestling with the idea of peak central bank intervention receding, at least in terms of tangible action, and are now trying to determine which among the vaccine roll out, U.S. fiscal stimulus, or better economic and corporate data, will be the next main catalyst driving sentiment and activity. While the Bank of Japan is reviewing the Japanese Government Bond 10-year band and is thinking of beginning to taper in April, the European Central Bank said it may not need to fully employ its Pandemic Emergency Purchase Program (PEPP) and China has let SHIBOR rise above the three-year sovereign bond rate. Also, trade data has been improving and bodes well for global growth. However, if strong data does not materialize by March, markets may once again force Central Banks into dovishness.

In Europe, the main surprise has been on inflation: The January flash HICP country prints have so far surprised to the upside; prior to the country releases, consensus expectations were for euro-area January HICP of 0.54%, year-over-year. Given the country prints, it seems reasonable to expect 0.75%, year-over-year. Also, vaccine rollout has been very disappointing and puts downside risk to the growth.

### Investment Grade (IG) Corporates

IG spreads were flat in January as tighter levels curbed some enthusiasm, but the macro, technical and fundamental story remained intact. The move higher in interest rates to start the year led to a slight risk off sentiment, but as rates settled at the new higher level, yield-based buyers stepped in to support

spreads. Despite the negative total return for IG during the month, inflows continued, led mostly by BBgBarc U.S. Aggregate Bond Index-based funds. Supply was in line with expectations at \$123 billion, but lower 30-year new issuance helped support some modest credit curve flattening. We continue to expect spreads to move sideways to start the year and see overall levels as less attractive at this point.

### High Yield Corporates

Following a strong close to 2020, the market began the new year choppy and in search of direction. Triple-C rated issues had a strong January, benefiting from carryover from the fourth quarter's risk-on appetite. Higher rated issues showed signs of sluggishness as the month bore on, mostly due to interest rate sensitivity and downward price pressure from a particularly heavy new issuance calendar. Indeed, January notched yet another monthly new issuance volume record. Elsewhere, credit ratings have mostly stabilized and defaults are still trickling through, but we do not think a new wave currently on the horizon.

### Securitized Assets

Following a strong closing to 2020, Agency MBS continued to outperform comparable Treasuries in January, driven by a strong technical environment in the higher coupons. Lower coupons were overwhelmed with heavy originations, despite heavy Fed buying, while the higher coupons were well bid by money managers and banks in response to the rate sell off. For 2021, net supply is projected to be between \$400-500 billion, due to an increase in home sales and cash-out activity driven by the low rate environment, which will likely offset the headwinds of high unemployment and economic uncertainty. The Fed will remain the largest source of demand for the foreseeable future, and with an

uncertain economy and a "blue-heavy" political environment, the chance of a near-term taper event is low.

We maintain our positive tactical outlook for mortgage credit, as low mortgage rates, a robust housing market, and overall solid consumer credit worthiness foster sponsorship. Layering in monetary policy and the most recent fiscal stimulus package, mortgage credit is well supported fundamentally even if progress in trimming unemployment continues to be slow.

Building from a strong December, CMBS is poised to continue its spread recovery. A busy, but manageable new-issuance calendar and reflationary impulses from monetary and fiscal policy - as well as optimism from the vaccine roll-out - are extremely supportive of CRE fundamentals. Ultimately, markets are likely to translate these factors into broader and deeper demand for CMBS risk. Near term, off the back of the year-end surge in COVID cases, which led to more shutdowns in broader areas, risks scarring from a fundamental standpoint, so caution from a security selection point of view remains warranted.

Non-benchmark ABS is likely to continue to perform well, as the consumer oriented sub-sectors will further attract sponsorship due to strong fundamentals, solid technicals and relative value. 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. Indeed, Recently enacted stimulus is acting as a fortifying bridge to the end of the pandemic.

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## Emerging Market (EM) Debt

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The EM economic recovery has been supported by strong manufacturing output, new orders, exports (excluding China) and global trades volumes, even while services were stalling and global supply delays and delivery times rose in January. Uncertainties related to COVID are likely to prevail, and related precarity will remain a drag for consumption; COVID eradication and vaccine rollout schemes are likely to take more time and not fully reach the broader EM universe until 2H21. China's marked slowdown contrasts with the rest of EM Asia, where factory growth kept accelerating. Growth in Africa and Central and Eastern Europe maintained momentum, while LatAm appears to be stalling. EM headline inflation was driven slightly higher by volatile food prices and an oil rally. Core inflation remains subdued overall as domestic demand is projected to lag well into 2021, which should allow central banks to remain supportive, despite the market pricing in some rate hikes. We expect QE to continue into 2021 and for Fiscal activity and strategy to remain under scrutiny as governments will weigh potential renewed support versus needed fiscal consolidation.

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