Commentary | 1Q25

Voya Core Plus Fixed Income SMA

Seeks total return through security selection, sector allocation and risk management

Strategy overview

A total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment grade securities.

Key takeaways

- The first quarter of 2025 was marked by volatility the fixed income markets, primarily driven by tariff policies and associated economic uncertainty.
- For the quarter, The Voya Core Plus Fixed Income SMA outperformed its benchmark, the Bloomberg US Aggregate Index (the Index) on gross-of-fees but slightly underperformed on net-of-fees basis. With an underweight to U.S. Treasuries in favor of credit, sector allocation decisions detracted from relative performance as spreads widened during the quarter.
- Looking ahead, fundamental factors should remain supportive, although the probability of recession has increased.

Market review

The first quarter of 2025 was marked by volatility the fixed income markets, primarily driven by tariff policies and associated economic uncertainty. Despite robust job gains and a low unemployment rate, fixed income spreads widened, leading to broadly negative excess returns.

The labor market remained strong, with job gains averaging around 200,000 per month and an unemployment rate only slightly above 4%. However, tariff policies were the primary driver of market moves. President Trump announced tariffs on Mexico, Canada and China at his inauguration, with tariffs on China going into effect on February 1st. Tariffs on Mexico and Canada were delayed until March 4th, and additional tariffs on China were imposed on the same day. The uncertainty surrounding these tariffs, along with the potential for an escalating trade war, negatively impacted risk assets, with credit spreads finishing the quarter wider, despite solid labor market dynamics. Similarly, rates fell during the quarter in response to lower growth expectations, which helped deliver positive total returns for most sectors.

The U.S. Federal Reserve maintained a cautious stance in the first quarter of 2025, resisting further interest rate cuts after having cut rates by 100 basis points in 2024. The Fed cited stronger than expected economic data, including robust job gains and a low unemployment rate, as reasons for not cutting rates further. However, in response to tariffs, the updated Summary of Economic Projections (SEP) released following the March meeting showed the median projection for growth moving lower. Meanwhile, the median projection for inflation moved higher, however there was no change to rate expectations, with the median projection still indicating one to two cuts through year end, and another two cuts in 2026.

In markets, spreads began to widen in mid-February when tariff threats intensified. Investment Grade (IG) corporates and asset-backed securities (ABS) delivered negative excess returns, as did High-yield (HY) corporates, although the higher carry profile of HY helped the sector modestly outperform its IG counterpart. Agency mortgage-backed securities (MBS) experienced a roller-coaster ride, but ultimately finished the quarter flat. Premium-priced pools (coupons of 6% or higher) outperformed, while lower coupons, particularly 2.50%, performed negatively. Commercial mortgage-backed securities (CMBS) was flat at the benchmark level, but similar to HY, higher carry allowed non-agency to outperformed agency, and below IG outperformed investment grade. Non-agency residential mortgage-backed securities (RMBS) was a notable exception, with the sector outperforming, led by Prime Jumbo.

For the quarter, The Voya Core Plus Fixed Income SMA outperformed its benchmark, the Index on gross-of-fees but slightly underperformed on net-of-fees basis. With an underweight to Treasuries in favor of credit, sector allocation decisions detracted from relative performance as spreads widened during the quarter. Our underweight to Agency MBS was the largest individual detractor, as this was the best performing sector in the Index. This was partially offset by allocations to non-agency RMBS and credit risk transfers (CRTs), as the sector delivered positive performance, driven by strong fundamental factors and attractive yields. Meanwhile, security selection decisions contributed. This was most notable in IG corporates, due to our bias towards higher quality, shorter dated bonds which were less impacted by spread widening. Security selection results were also strong across CMBS, driven by our bias towards higher yielding private label deals. Finally, with a shorter duration relative to the benchmark, duration and yield curve positioning detracted from relative performance.

Outlook

Looking ahead, fundamental factors remain supportive. Growth has been roughly 2–3% for the last 3 years, most recently delivering 2.5% in 4Q24. The labor market is healthy with only 4.1% UE. And on the consumer side, balance sheets remain healthy.

That said, survey data has indicated tariffs have negatively impacted both business and consumer sentiment. We have already seen consumers pull back (negative growth numbers in both personal consumption expenditures (PCE) and retail sales numbers for January) and we will likely see a similar reaction on the business investment side. Even if tariffs are watered down, the associated uncertainty will remain a headwind.

That said, while a recession is not our base case, the probability has clearly increased. While there will likely be an impact on personal consumption and investment, household and corporate balance sheets still remain healthy. In addition, the downside to growth should be limited as the Fed has the room to cut rates, especially if employment numbers weaken. However, much depends on how much, and for how long, the announced tariffs remain in place.

Over the past several quarters, we have been constructive on fundamental factors, but believed valuations were ignoring potential risks. As a result, we came into the quarter positioned with a higher quality, shorter spread duration bias. While spreads have widened, the macro-outlook has clearly weakened. As a result, the overall risk profile of the portfolio has changed only marginally, while quarter over quarter portfolio changes are more reflective of relative value opportunities. For example, towards the middle of the quarter, we added to short-dated corporates, as valuations appeared more attractive. Looking forward, as spreads continue to widen, we are well positioned to add risk where appropriate.

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