

Higher Credit Quality Approach, Selective High Yield Exposure

Strategy overview

A total return strategy that uses a multi-sector approach with a higher-quality posture through the use of Treasury, agency and corporate credit securities, both investment-grade and below, with 1-10 year maturities.

Key takeaways

- The last two months of the fourth quarter were marked with strong optimism regarding the likely end to the U.S. Federal Reserve hiking cycle, as rates rallied sharply from their peak in October.
- In corporate credit markets, spreads remained resilient.
- Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend.

Portfolio review

Rates continued to sell-off into October as strong economic data faded hopes for a Fed “pivot”. In particular, the labor market showed significant strength, with September’s payroll data reporting an impressive pace of job gains. This was followed by the initial reading for third-quarter gross domestic product growth which exceeded already elevated expectations, coming in well above trend. By the end of October, the 10-year Treasury yield had breached 5%, a level not seen since 2007. As rates moved higher, credit spreads widened reflecting the increased risk that comes with a prolonged period of restrictive policy.

Then came November and with it, a notable turn in sentiment. Inflation data, which had already been declining for several months, continued to decline resulting in more balanced market expectations. One Fed governor even suggested the possibility of rate cuts ahead of reaching the 2% inflation target. Additionally, while payroll gains remained strong, they were more measured over the next couple of months, and September’s blockbuster gain was revised downward by a meaningful amount. As a result, rates rallied and credit spreads tightened.

In the final month of the quarter, the Fed appeared to confirm renewed market expectations that a less restrictive stance was in the near future. The updated dot plot showed that every single participant believed the hiking cycle had concluded, and the median participant projected 75 basis points worth of cuts in 2024. This affirmation from the Fed further contributed to the tightening of credit spreads, and a fall in rates, leading to strong total returns across fixed income.

For the quarter, the Voya Enhanced Yield Income SMA underperformed the custom benchmark on a net asset value (NAV) basis. While the Strategy benefited from security selection within high yield (HY) bonds due to our focus on higher-rated bonds within HY (which outperformed in 4Q23), it was offset by an underweight allocation to the HY sector relative to the custom benchmark.

Current strategy and outlook

Looking forward, the outlook has improved marginally, however we still expect growth to slow below trend. The increased cost of capital will likely curb consumption and investment, however ongoing government support measures at a global level are expected to partially offset these effects. In particular, China's growth focused investment and advanced economies efforts to enhance supply chain security are anticipated to bolster growth in the short term.

As the market focus shifts from inflation to growth concerns, duration will become an effective offset to risky asset drawdowns. Rate volatility, though receding from recent peaks, will remain above pre-pandemic levels due to uncertainty about the timing of rate cuts and concerns about government debt levels. Elevated real rates will incent investors to increase allocations to fixed income, creating opportunities during bouts of volatility.

That said, many corners of the fixed income market appear to be priced for a soft landing, including the corporate credit markets. While this has become a more likely outcome, we believe the risks to this outcome materializing are being ignored. Labor markets are coming into better balance which, while good news for inflation, could cause concern among workers that a turn in the cycle is approaching. This in turn could compel workers to boost savings rates which would limit consumption and act as a challenge to growth.

In corporate credit, spreads have remained resilient given the growing soft-landing narrative and supportive market technical factors due to strong all-in yields and limited new-issue supply. However, we expect corporate fundamental factors to come under increased stress going forward in what is likely a below-trend growth environment. Our portfolio strategy remains broadly defensive, with a preference for high quality corporate issuers.

The **Bloomberg Barclays Intermediate US Credit Index** measures the investment-grade, US-dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities. **Investors cannot invest directly in an Index.**

The **Bank of America Merrill Lynch U.S. High Yield Master II Constrained Index** is an unmanaged market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default. The Merrill Lynch U.S. High Yield Master II Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure. **Investors cannot invest directly in an index.**

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension, and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition. The strategy may invest in mortgage-related securities, which can be paid off early if the borrowers on the underlying mortgages pay off their mortgages sooner than scheduled. If interest rates are falling, the strategy will be forced to reinvest this money at lower yields. Conversely, if interest rates are rising, the expected principal payments will slow, thereby locking in the coupon rate at below market levels and extending the security's life and duration while reducing its market value. High yield bonds carry particular market risks and may experience greater volatility in market value than investment grade bonds. Foreign investments could be riskier than U.S. investments because of exchange rate, political, economics, liquidity, and regulatory risks. Additionally, investments in emerging market countries are riskier than other foreign investments because the political and economic systems in emerging market countries are less stable. Returns are benchmarked to a customized blend of 60% Bloomberg Barclays Intermediate Gov/Credit Index & 40% Bank of America Merrill Lynch US High Yield Master II Constrained Index, rebalanced on a monthly basis, which does not incur management fees, transaction costs, or other expenses associated with a composite portfolio. Securities prices used to value the benchmark index for the purposes of calculating total return may or may not differ significantly from those used to value securities held within composite portfolios. In December 2006, the High Yield portion of the custom-weighted benchmark was changed from the Citigroup High Yield Cash Pay Index to the Bank of America Merrill Lynch US High Yield Master II Constrained Index, effective from June 1, 2005 to the present. The reason for the change was due to a fundamental change in the composition of the Citigroup index that made it unrepresentative of the strategy's investment process. **Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing, and investors cannot directly invest in an index. Source: Bloomberg Barclays and Merrill Lynch and Voya Investment Management.**

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