

Seeks total return, balancing income and diversification potential

Strategy overview

The Voya High Yield Bond SMA (the SMA) strategy seeks to maximize total return over a full market cycle by taking a broadly diversified and well-balanced approach to discovering risk-adjusted opportunities within the below investment grade (IG) corporate bond sector.

Key takeaways

- The Bank of America Merrill Lynch High Yield Master II Index (the Index) returned 7.06% for the quarter.
- BB rated bonds returned 7.34%, while B rated securities returned 6.78% and CCC rated securities returned 6.60%.
- The SMA underperformed the Index during the quarter.

Portfolio review

Rates continued to sell-off into October as strong economic data faded hopes for a U.S. Federal Reserve “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 SMA Strategy underperformed the Index on a net asset value (NAV) basis. Although the Strategy's higher-quality nature provided a benefit during the quarter given the outperformance of higher-rated bonds, it was offset by security selection within BBB-rated securities. In contrast, security selection in BB-rated bonds added to performance. From a sector perspective, security selection in technology as well as media and entertainment sectors detracted, while notable contributions resulted from security selection within financials and automotive sectors.

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 high yield (HY) market.

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 the HY market, credit spreads have remained resilient given the growing soft-landing narrative and supportive market technical factors. However, due to late-cycle dynamics, 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 **Bank of America Merrill Lynch High Yield Master II Index** is a market value-weighted index consisting of U.S. dollar-denominated, non-investment grade bonds not currently in default and limits any individual issuer to a maximum of 2% benchmark exposure.

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