Commentary | 2Q24

Voya Index Solution Portfolios℠

Multi Asset Strategies and Solutions

Strategy overview

These portfolios are only offered as an investment option within variable products and retirement programs.

You should consider the investment objectives, risks, and charges and expenses of the variable product and its underlying fund options; or mutual funds offered through a retirement plan, carefully before investing. The prospectuses / prospectus summaries / information booklets contain this and other information, which can be obtained by contacting your local representative or by calling (800) 992-0180. Please read the information carefully before investing.

Key takeaways

- U.S. stock and bond markets initially struggled with high inflation expectations but rebounded as improved May inflation data boosted hopes for U.S. Federal Reserve rate cuts, leading to gains in broad equity markets, particularly in large-cap and growth stocks.
- In our view, a softening labor market should contribute to slower yet steady economic growth and declining inflation, but no immediate expectations of a recession. We continue hold a balanced posture between stocks and bonds and favor higher quality U.S. assets.
- The Portfolios' posted positive absolute returns for the period but underperformed their strategic composite benchmarks on a net asset value (NAV) basis.

Market review

U.S. stock and bond markets faced challenges at the beginning of the second quarter, as hot inflation readings dampened expectations for Fed rate cuts. Towards the end of the quarter, however, the outlook improved as favorable May inflation data increased investor confidence in potential Fed rate reductions by September. This, along with continued strength in the labor market and rising earnings optimism helped broad equity markets post gains for the period. Large-cap stocks outperformed small caps and growth beat value. Within the S&P 500 Index, technology, communication services and utilities sectors led, while materials, industrials and energy lagged.

International stocks also moved higher, with emerging markets (EM) outperforming developed. China and India, the two largest countries within the EM equity index, both performed well. Chinese equities were helped by government support for the real estate sector and improving industrial production, while Indian equities saw strong performance continue after general elections concluded and Prime Minister Modi secured his third term in office. Japanese stocks underperformed in the period primarily due to uncertainty surrounding the Bank of Japan's monetary policy normalization and the expected appreciation of the yen, which raise concerns about the competitiveness of Japanese exports.

Fixed income markets had mixed performance but declined in aggregate as the U.S. Treasury yield curve rose slightly. High yield (HY) bonds performed well due to strong corporate earnings pulling spreads tighter. Like international equities, EM bonds outperformed developed market issues, as French government bonds dropped on political uncertainty.

Outlook

The impact of high interest rates is evident as growth trends below normal, putting downward pressure on prices. Recent data shows a quarterly gross domestic product (GDP) growth slowdown to 1.4% and a slight increase in unemployment to 4.1%. While employment indicators suggest a softening job market, a rise in job openings to 8.1 million indicates a gradual cooling. Disinflationary trends are resuming, which should support real incomes aligned with 2% inflation. While higher rates counteract some easing financial conditions, we expect inflation to continue decreasing without spiking unemployment, thus averting a recession. Equity markets may not see significant gains soon, especially with expected volatility as U.S. elections approach. In this late-cycle environment, we maintain a neutral stance between stocks and bonds, balancing the risks associated with both asset types.

The current global economic landscape and market dynamics favor U.S. assets, particularly large cap stocks. Despite macroeconomic challenges, the United States is better positioned than most regions. U.S. capital markets, a global destination for investor flows, benefit from stable economic conditions, technological innovation and robust financial markets. Consequently, the U.S. is our preferred region, with large cap stocks appealing for their earnings quality, growth potential and momentum. Technology-driven sectors offer unrivaled pricing power, promising positive real returns regardless of inflation levels. However, earnings expectations have outpaced actual earnings, and with nominal GDP growth declining, sales growth will be challenging. While high profit margins and returns on equity may support valuations, they are too high to expect further expansion. Much depends on the earnings growth of U.S. technology megacaps, which have driven recent gains but face scrutiny over their artificial intelligence (AI) investments. These firms must eventually demonstrate revenue and earnings from these investments, but immediate results aren't necessary as AI infrastructure providers are generating significant cash flows. Companies need time to transition from training to production models before making accurate assessments. We also value the stability of large companies to buffer against global economic and geopolitical uncertainties, offering a compelling risk-reward opportunity.

For as long as we've favored U.S. large caps, we've been underweight real estate investment trusts (REIT) due to rising interest rates increasing borrowing costs and pressuring their performance. The significant amount of commercial real estate debt needing refinancing at higher rates poses financial risks, especially for office and retail sectors facing structural challenges. Additionally, the volatility and potential overvaluation of publicly traded REITs relative to their net asset values raise concerns about their return potential. Given these factors, we see more attractive investment opportunities elsewhere.

International stocks present mixed prospects. Japan struggles with a weak currency and challenges in normalizing monetary policy, despite potential rate hikes influenced by easing U.S. inflation and European Central Bank cuts. Europe faces sluggish growth due to high labor costs, persistent core inflation and geopolitical tensions, exacerbated by domestic political instability, particularly in France. In contrast, the United Kingdom appears more stable and attractive to investors, buoyed by political shifts towards labour under Sir Kier Starmer, anticipated Bank of England rate cuts and favorable macroeconomic data. Meanwhile, China's stock market has rallied, driven by strong GDP growth and robust sectors like electric vehicles and industrial robotics. However, significant risks linger due to its ongoing property crisis and sensitive international relations, especially with the U.S.

We maintain a preference for higher quality within fixed income. Despite limited upside from tight spreads, the supportive macroeconomic environment and solid corporate fundamental factors make the yield from investment grade (IG) bonds appealing. Securitized credit products, particularly consumer-oriented asset-backed securities and residential mortgage-backed securities, are attractive. The commercial mortgage-backed securities (CMBS) sector, though beaten down, offers value opportunities for astute investors. Although higher interest costs impact HY credit quality, defaults remain limited, keeping us neutral due to increasing tail-risks. We lack a strong conviction on the near-term direction of rates but maintain a modest long duration in aggressive, equity-heavy portfolios for added stability. We prefer nominal over real bonds to hedge against equity downturns. With some foreign central banks cutting rates, certain international bond markets are appealing. However, due to a strong U.S. dollar and potential negative currency impacts, we remain underweight on non-U.S. bonds.

Positioning

At the beginning of the period there were no open tactical positions. At the end of February, Portfolios enacted their glide downs, leading to lower strategic equity weights in the 2050-2025 vintages. At the same time, the Portfolios' strategic asset allocations were reset, with all tactical positions at the beginning of the period being subsumed into the revised strategic asset allocation, thereby becoming longer-term views.

In early April, U.S. large cap equites were reduced in favor of U.S. mid cap equities. This shift was made to decrease concentration risk in U.S. large cap stocks after significant outperformance, with large stocks producing their best one-year stretch in versus U.S. mid caps since the 1990s. From a factor perspective, diversifying away from momentum and loading higher on value and size was also a motivation.

Overall, Portfolios continue to favor U.S. assets and maintain balanced posture overall with a preference for U.S. large cap equities and core IG fixed income.

Performance

The Voya Index Solution Portfolios' primary performance objective is to outperform its strategic allocation benchmark over the long term through tactical asset allocation, which involves making short- to medium-term changes in the asset allocation to benefit from temporary mispricings or market inefficiencies. The benchmark return is the weighted average return of indices that represent asset classes included in the strategic allocation benchmark. Index returns are gross of all fees. The Portfolios invest in passive index funds to gain exposure to asset classes. The Portfolios generally are rebalanced monthly and the strategic asset allocations are updated annually to reflect changes to our capital market assumptions. The Portfolios' posted positive absolute returns for the period, but underperformed their strategic composite benchmarks on a NAV basis.

Tactical asset allocation had a negative impact on performance during the period. Portfolios' tactical overweight to U.S. mid cap and underweight in U.S. large cap equities was a detractor. A broadening rally into other sectors and down capitalization size did not materialize, as megacap technology stocks continued to drive market gains. Despite the robust performance of large-cap stocks, the second quarter saw a significant divergence in the U.S. equity market, with most stocks experiencing declines. In fact, gains were primarily seen in the largest and most growth-oriented stocks. Themes of size, quality and momentum continued to dominate, as riskier trades fell behind against a backdrop of underwhelming earnings for most equities.

The Voya Index Solution Portfolios are comprised of passive index funds. The funds may not perfectly track the performance of the underlying asset class benchmarks. During the quarter, index funds' performance differences detracted.

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