Voya Multi-Asset Perspectives

The End is Near, with New Signs of Fear

In an extraordinary shift of fortune, most experts now agree that the worst of the pandemic is behind us — U.S. infections are down ~80% from the early January peak, ~10% of the adult population is fully vaccinated, ~20% have received at least one dose; and there is enough supply to vaccinate all adults by the end of May, according to President Biden. Although coronaviruses are here to stay and there may be new policies and precautions that didn't previously exist, those measures that are economically constraining are almost over. Markets have been frontrunning this scenario for a while, but the economy, which has held up remarkably well all things considered, is preparing to lift off. U.S. 4Q20 economic growth was revised up to 4.1%, 1Q21 is tracking 4.5% and we forecast full year 2021 real GDP growth will be 5.7%.

Investors have responded by aggressively selling U.S. Treasurys. Since bottoming in early August at 0.51%, the 10-year U.S. Treasury yield has soared roughly 100 basis points (bp) to 1.5%. About 40% of this rise has come from real yields and 60% from inflation expectations. The move higher in rates has hurt long duration assets, with the Bloomberg Barclays U.S. Treasury 20+ Year index down nearly 10% YTD. Although only two months in, it's the third largest calendar year drawdown for long dated U.S. Treasurys in over 30 years. Equities fared better than fixed income in February. U.S. small caps led the way again with the Russell 2000 returning 11.6% YTD. U.S. value beat growth by about 6% on the month, thanks to strong performance in the financial and energy sectors. A substantially steeper yield curve (the 2–10 spread widened by ~100 bp since August) helped financials; and a 70% increase in the price of WTI crude since the end of October was much needed for energy shares, which had a dreadful 2020 experience. Emerging market stocks trailed developed markets in February, but are slightly ahead YTD.

Tactical Indicators

Economic Growth (Improving)

Our estimates of 1Q21 and full year 2021 U.S. real GDP growth have been rising and now stand at 4.5% and 5.7%, respectively

Fundamentals (Improving)

S&P 500 4Q20 earnings grew by ~4%; big beats were achieved by consumer discretionary, financial and technology stocks

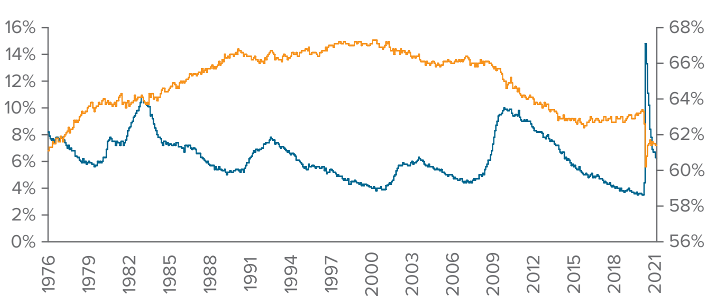
Valuations (Neutral)

Stocks are expensive by most historical measures, but gravitational pull from low rates keeps equity risk premium wide enough

Sentiment (Neutral)

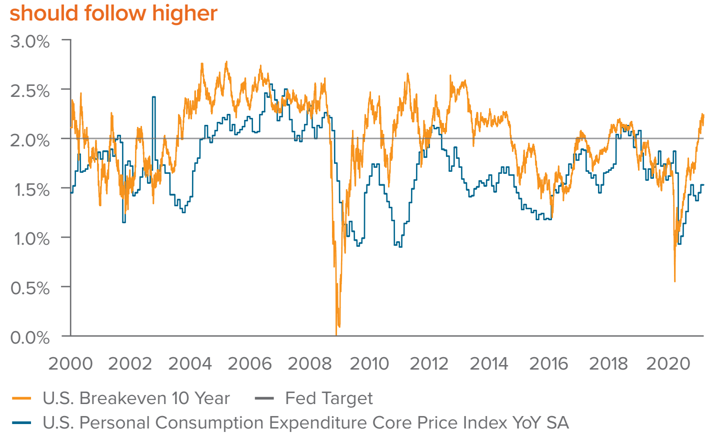
Sentiment is shifting away from high-multiple growth stocks into more value-oriented and less interest-rate sensitive sectors

Figure 1. U-3 (headline) unemployment rate understates labor market slack



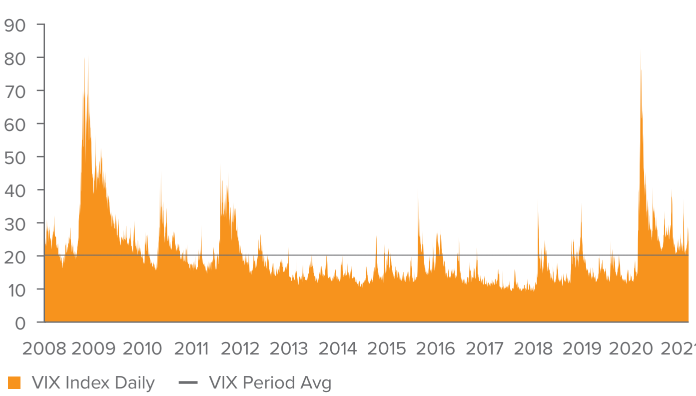
Source: Bloomberg, Voya Investment Management, as of March 5, 2021.

Figure 2. Inflation expectations surpassed 2%, suggesting core PCE should follow higher



Source: Bloomberg, Voya Investment Management, as of March 8, 2021.

Figure 3. Despite strong 2021 returns, VIX has remained stubbornly high



Source: Bloomberg, Voya Investment Management, as of March 5, 2021.

Portfolio Positioning

Equities	●	
U.S. Large Cap	○-○-●	Scale brings competitive advantages to large caps; extraordinarily stimulative U.S. policy should further tighten the equity risk premium
U.S. Mid Cap	○-●-○	Larger companies have more compelling risk/return characteristics in the short and medium term
U.S. Small Cap	○-○-●	Small caps tend to lead when the economy is at the beginning of a recovery
International	○-●-○	Deceleration of new COVID cases in Europe and aggressive government intervention through monetary and fiscal policy in both the Eurozone and Japan will help offset economic drags related to the virus and the still-challenged fundamental economic backdrop
Emerging Markets	○-○-●	We expect faster economic growth and a weaker U.S. dollar to help EM equities. Emerging Asia has a better outlook as those countries have had success combatting COVID-19
REITs	●-○-○	Big divergences among REIT sectors, but the underlying trend for commercial real estate is a concern
Fixed Income	●	
U.S. Core	○-●-○	We maintain a neutral duration posture and favor quality investment grade bonds, given yield pickup over sovereign bonds and limited downside risk due to Federal Reserve backing
Inflation (TIPS)	●-○-○	Deflationary pressures may persist for several years
Non-Investment Grade	○-○-●	Government funding programs combined with state re-openings should tighten spreads further; the default profile may be a near-term headwind, but policy support makes the asset class attractive
International	●-○-○	Low absolute and relative yields lead us to favor U.S. bonds

Underweight ● Neutral ● Overweight ●

Investment Outlook

Significant progress in vaccination programs, states reopening, still highly accommodative government policy and the release of massive pent-up demand from excess consumer savings should drive economic growth well above trend throughout 2021. With immunity levels climbing, vaccine supply accelerating quickly, weather warming and people preparing to escape from their yearlong seclusion, the stage appears set for a big ramp-up in activity. Intent on combatting inequality and boosting incomes of lower wage workers, government officials will attempt to force unemployment to historically low levels by keeping their foot on the gas. Although down to 6.2% from its April 2020 high of 14.8%, the U-3 unemployment rate understates labor market slack, as the labor force participation rate is holding near a 45-year low (Figure 1), suggesting ample scope for improvement in the labor to population ratio — which will be critical given the demographic shift to an aging workforce. These circumstances, coupled with ascendant animal spirts, could create an ideal backdrop in which labor and capital can thrive concurrently.

History is always a helpful guide to the future, but the environment upon which we are embarking seems exceptional, which raises the odds of encountering something unforeseen. The prolongation of zero-bound interest rate polices from global central banks and virtually unrestrained fiscal expansion, including the latest $1.9 trillion COVID-19 aid package, certainly raise the specter of inflation and fast rising bond yields. While these are closely watched variables, which somewhat lowers the risk that they could spike out of control, they still pose considerable risks. Budding price pressures are propagating in commodities markets, building up in supply chains through swelling backlogs of key product components, such as micro processing chips, and presenting in purchasing managers surveys and in prices of Treasury inflation protected securities (TIPS).

That said, after two decades of the Federal Reserve's preferred inflation metric — the core personal consumption expenditures deflator (core PCE, Figure 2) — averaging well below its 2% target, we believe deflation remains a greater risk; therefore, the Fed's plan of "running hot" is reasonable. Whether, how much and how fast prices rise are debatable. We believe increases in both inflation and yields will be gradual enough, and the levels low enough, to not drastically tighten financial conditions. Barring an unpredictable, exogenous shock, we are confident that neither will move decidedly lower. As a result, we are content holding more stocks than bonds. Yes, rates are rising and narrowing the equity risk premium, but we see them moving mostly for the right reasons and find the stock/bond trade-off still positive.

The economic tailwinds forming have led to much better than expected 4Q20 earnings growth and should improve visibility going forward. We believe this transition to a more stable macro environment will continue to benefit our preferred asset classes: U.S. small cap and emerging market equities. Last year's equity market returns were largely driven by defensive, pandemic protected businesses and earnings multiple expansion. This year, we anticipate higher corporate profits, particularly from the cyclical areas of the market, which should benefit from reopening and deployment of large amounts of cash on the sidelines.

Valuation multiples relative to history seem decreasingly useful at the asset class level in a world where policymakers' involvement in economic and financial market affairs is so visible. Instead, we are closely gauging investor sentiment, monitoring global liquidity and watching for signs of excess leverage. The path of the U.S. dollar will be a key factor in the success of positioning in emerging markets. Recent dollar strength has been a drag on EM asset performance, but could serve to curtail domestic inflation pressures and ease related investor anxiety, which remains stubbornly high, as measured by the VIX (Figure 3).

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Multi-Asset Strategies and Solutions Team

Voya Investment Management's Multi-Asset Strategies and Solutions (MASS) team, led by Chief Investment Officer Paul Zemsky, manages the firm's suite of multi-asset solutions designed to help investors achieve their long term objectives. The team consists of 25 investment professionals who have deep expertise in asset allocation, manager selection and research, quantitative research, portfolio implementation and actuarial sciences. Within MASS, the asset allocation team, led by Barbara Reinhard, is responsible for constructing strategic asset allocations based on their long term views. The team also employs a tactical asset allocation approach, driven by market fundamentals, valuation and sentiment, which is designed to capture market anomalies and/or reduce portfolio risk.

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