Fixed Income Perspectives

Bond Market Outlook

Global Rates: policy rates stay low, ten-year U.S. Treasury yield ranges between 0.75–1.25%

Global Currencies: U.S. dollar trends weaker against DM, EM currencies

Investment Grade: valuations less compelling entering 2021, but elevated dispersion remains

High Yield: hunt for yield and improving macro trends supportive of high yield as spreads remain reasonable on long-term basis

Securitized: massive monetary and fiscal support, both current and expected, as well as vaccine roll-out optimism, position the consumer and housing markets well heading into the new year

Emerging Markets: while a recovery supported by strong manufacturing and exports was realized, its sustainability will depend on a rebound of employment, domestic consumption and investments

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Voya Investment Management's fixed-income strategies cover a broad range of maturities, sectors and instruments, giving investors wide latitude to create a new portfolio structure or complement an existing one. We offer investment strategies across the yield curve and credit spectrum, as well as in specialized disciplines that focus on individual market sectors. We build portfolios one bond at a time, with a critical review of each security by experienced fixed income managers.

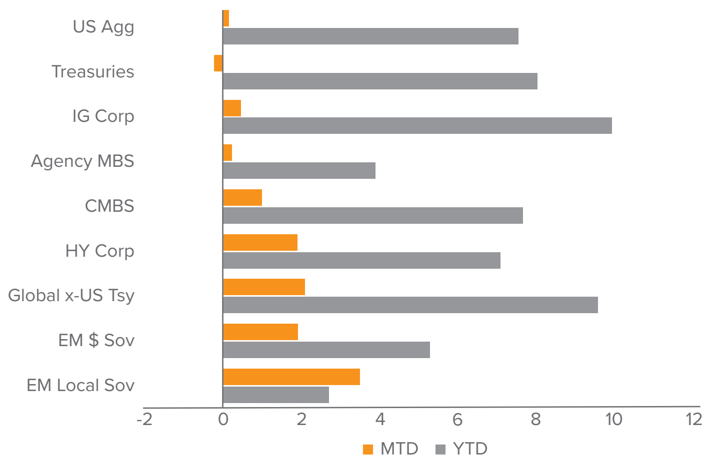
Inflation on the Horizon? Don't Take the Bait

Given rapid money growth, expectations for above trend growth, heavy fiscal spending and continued accommodative monetary policies from the Fed, inflation has topped the list of investors' concerns in 2021. We explored these inflation concerns in detail in our 2021 outlook. Since then the chorus of those calling for growing inflation has become louder. We continue to believe that inflation will prove to be a cyclical phenomenon, not a structural risk. The return of service demand will create localized but less globally transmissible pockets of inflation. Historically, headline inflation has transmitted to core inflation, but the lead time has been roughly 18 months. This suggests that a sustainable lift in core inflation is more likely to come into play in 2022 or 2023.

With respect to inflation, headline inflation correlates with corporate sales and profit growth, which means a recovery in inflation also signals an improving economy. In addition, while headlines suggest an extremely bleak outlook for consumers, personal income data tells a much different story. Last year, we wrote about a "K-shaped" economy defined by uneven pressures that are creating a "two speed" recovery. The dispersion in labor income underscores the "K-shaped" disparities across economic sectors. This is particularly true within the leisure and hospitality sector where proxies for employment and labor income remain roughly 24% below pre-pandemic levels. However, in aggregate, labor income has made a substantial recovery and is only down ~1-2% from pre-pandemic levels. When you add stimulus related transfer payments, personal income is set to surge to a new record high as additional fiscal stimulus takes hold in the first quarter of 2021.

From this perspective, the market backdrop for cyclical sectors remains extraordinarily positive. Consumers, supported by excess savings, robust net worth and additional fiscal aid, will drive a recovery in discretionary spending, leading to a full re-engagement of the service sector. Against this backdrop, cyclical sectors across securitized credit, corporate credit and emerging market debt are relatively attractive. We believe that a rebound in economic growth, fostered by a duality of fiscal and central bank support, will push spreads uncomfortably tight in 2021.

Rates, Spreads and Yields



		31-Dec	30-Nov	1Y Low	1Y High
Yields	US 2 Yr	0.12	0.15	0.11	1.59
	US 10 Yr	0.92	0.84	0.51	1.92
	GER 10 Yr	-0.57	-0.57	-0.86	-0.16
	JPN 10 Yr	0.02	0.03	-0.16	0.08
	EM Local Sov	4.22	4.36	4.22	6.08
Spreads	IG Corp	96	104	93	373
	Agency MBS	39	49	28	132
	CMBS	129	149	84	363
	HY Corp	360	412	315	1100
	HY x-Egy Corp	333	377	272	973
	EM $ Sov	352	380	290	721

As of 12/31/2020. Past performance is no guarantee of future results. Source: Bloomberg, Bloomberg/Barclays, JP Morgan and Voya

Sector Outlooks

Global Rates and Currencies

Reflation optimism continues, as Wall Street appears uniformly bullish on growth and risky assets. More broadly, while we believe that not all economies will recoup their COVID-19 losses in 2021, recovery and convergence should be a core theme throughout the year, as disparities between winning and losing segments of the global economy narrow. The highly anticipated next round of monetary stimulus injections came-and-went, with central banks opting mostly to extend easing, rather than increase the cash flow volume. As such, the focus is still on fiscal policy. And while the peak impulse for fiscal stimulus has likely passed, it will still play an important role in 2021. Vaccine distribution is the most important development to watch this year, as it is the key to looser mobility restrictions and a stronger embrace for contact-intensive consumer spending. Also, geopolitical risks remain, as the transitioning of U.S. presidential administrations could impact fluid dynamics in the Middle East, as well as evolving relations with developed markets and China.

2020 closed out with some disappointments in consumption and personal income, as the fading of fiscal stimulus weakened the abnormally strong gains in personal income. Despite this, personal income in December remained above the pre-COVID, February 2020 level, and while consumption disappointed for the month, it still closed the year near its post-COVID high, with further gains likely. Over the shorter term, the stimulus deal that was passed will meaningfully aid GDP growth in the first quarter: The $600 per person stimulus checks should provide an immediate lift to consumption, although fear and mobility restrictions remain the biggest drag on spending; renewed funding for the popular PPP loans, should keep payrolls from pulling back while we wait for the latest surge in COVID cases to fade and mass vaccinations to begin.

The U.S. political landscape shifted to a more even balance following Democratic gains in the Senate. In our view, while the more Progressive proposals probably will not make it through the 60-vote threshold, higher taxes remain a possibility over the longer term. Environmental objectives will surely be pursued - given regulatory leeway - and healthcare may face margin pressure. Technology will also be exposed to the risk of higher interest rates, regulation, and personal and corporate taxes. Infrastructure will probably be discussed too, and if done right could pay economic dividends over time. Monetarily, uncertainty about the Fed's implementation approach to its new average inflation targeting policy remains, with questions on the level and magnitude of tolerated inflation overshoots and the ultimate definitions of what full employment will mean. These questions seem likely to come into greater focus as we approach mid-year but for now dovishness remains.

The European Union is also entering 2021 with additional fiscal stimulus, but its economic impact will be less immediate, as funds need to be allocated, disbursed, and spent. While the economic impact will likely be felt more in the medium term, there is some risk that the stimulus money gets substituted for allocations from sovereign budgets, which could weaken the stimulus' impact. Strength in the euro will likely remain a topical issue with the euro at its highest level since 2018. Also, renewed and extensions of lockdowns in the UK and portions of the EU pose a risk to 1Q21 GDP growth.

Investment Grade (IG) Corporates

IG spreads continued to rally in December after U.S. election concerns faded and positive vaccine news fueled optimism for a 2021 rebound. Spreads were another 8bps tighter, capping the year on a strong note, although only 3 bps tighter for the period at 96 bps. New issuance for December was lower than expected at $39 billion and helped with spread compression. However, even though December's supply was lower than expected, it brought 2020 IG new issuance volume to a record $1.76 trillion. Supply expectations for 2021 remain much lower, as cash rich companies look to reduce leverage into a recovery next year. We still expect 2021 volume to reach over $1.2 trillion, but increased M&A could be the wildcard for supply expectations. Inflows into IG remain robust and hit a record high in 2020, however a move higher in rates may dampen demand to start the year.

High Yield Corporates

A strong close to 2020 was rooted in the positive move across the ratings board, with the most strength coming from the bottom of the ratings scale, as any bonds trading at discount were bid strongly higher. Some of last year's gains are thus far carrying into 2021, which leaves the market a bit more susceptible to a slowdown. Despite the torrid pace of new debt sales issue throughout 2020, a reasonable shadow calendar remains, and it is likely to add downward pressure levels in some of the tighter trading issues. We remain neutral as we look for a pullback in the first quarter but remain optimistic on decent spreads and supportive monetary and fiscal regimes.

Securitized Assets

Agency MBS finished the year outperforming comparable Treasuries in December, driven by a strong month-end technical environment and lighter supply. For November, gross supply was at $354 billion – up 5% - and net supply was at a record $100 billion. For 2021, net supply is projected to be between $400-500 billion, due to an increase in home sales and cash-out activity driven by the low rate environment, which will likely offset the headwinds of high unemployment and economic uncertainty. The Fed will remain the largest source of demand for the foreseeable future, and with an uncertain economy and a "blue-heavy" political environment, the chance of a near-term taper event is low.

Mortgage credit performance was solid in December, but after a robust run since the summer, relative value diminished. The sector should benefit with stabilized technicals to start the year, as well as the low risk profile given a robust fundamental backdrop. That said, we maintain our positive tactical outlook for mortgage credit, as low mortgage rates, a robust housing market, and overall solid consumer credit worthiness foster sponsorship

Building from a strong December, CMBS is poised to continue its spread recovery. A busy new-issuance calendar and reflationary impulses from monetary and fiscal policy - as well optimism from the vaccine roll-out - are extremely supportive of CRE fundamentals. Ultimately, markets are likely to translate these factors into broader and deeper demand for CMBS risk. Near term, the current wave of COVID cases risks yet more shutdowns in broader areas and will hurt fundamentals. While this is especially true for hotel and retail property types, further downside beyond already depressed levels seems limited as opportunistic capital is actively being put to work.

Non-benchmark ABS is likely to continue to perform well, as the consumer oriented sub-sectors will further attract sponsorship due to strong fundamentals, solid technicals and relative value. We maintain our assessment as positive and increase our conviction. The fiscally improved profile of the US consumer coupled with ABS structural dynamics were already believed to provide the sector with solid footing to withstand this sustained period of elevated, albeit improving, unemployment. Indeed, recently enacted stimulus is acting as a fortifying bridge to the end of the pandemic.

Emerging Market (EM) Debt

Emerging markets experienced an economic recovery that was supported by strong manufacturing output, new orders, and exports, even while employment and services stalled. Nonetheless, while abundant liquidity remains and is supportive of activity, the sustainability of the upturn will depend on a rebound of employment, domestic consumption and investments. Uncertainties related to COVID will prevail in the coming year, and related precarity is likely to remain a drag for consumption. China and EM Asia outperformed in 2020, followed by Africa, while the positive momentum in LATAM and Central & Eastern Europe faded. Looking ahead, headline inflation has been slightly higher, driven by volatile food prices and a rally in oil. Core inflation remains subdued overall, as domestic demand is projected to lag well into 2021. This should allow central banks to remain supportive, despite the market pricing in some rate hikes. We expect EM quantitative easing to continue into 2021, and the fiscal trajectory to remain under scrutiny as governments will weigh renewed support against needed fiscal consolidation.

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