Voya Core Plus Fixed Income SMA

Seeks total return through security selection, sector allocation and risk management

Strategy overview

A total return approach, investing across full spectrum of the fixed income market including up to 20% in below investment grade securities.

Key takeaways

- Spreads widened and rates moved higher, but the magnitude was small enough to allow for modestly positive results across fixed income.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Aggregate Bond Index (the Index) on a net asset value (NAV) basis. Security selection and sector allocation decisions contributed while duration and yield curve decisions had minimal impact.
- While the macro backdrop looks favorable, valuations are rich however all-in yields remain historically attractive, allowing investors to capture high quality yield without overstretching into risk.

Portfolio review

The second quarter of 2024 was marked by a series of evolving and, at times, conflicting economic signals. The interplay between labor market dynamics, inflation and consumer behavior painted a mixed picture for investors and policymakers alike.

The quarter began with a significant upside surprise in the March Non-Farm Payroll (NFP) report, contradicting other employment indicators such as Institute for Supply Management (ISM) Employment and National Federation of Independent Business (NFIB) hiring intentions. Notably, job growth was primarily concentrated in part-time employment, potentially masking broader weakness that was evidenced by a decline in full-time employment that had been ongoing since peaking in May 2023. One month later, NFP missed to the downside, which helped to quell reflation fears but was still strong enough to avoid igniting concerns of a recession. Altogether, the trend over the quarter signaled a return to a more “balanced” labor market, with the pace of wage gains slowing, the quit rate declining and the unemployment rate ticking up modestly off extreme lows.

Similarly, consumer spending, which has led growth over the last several quarters, showed signs of softening, with modest growth numbers reported in both personal spending and retail sales data. Rising credit card delinquencies and a low savings rate further underscored the financial challenges facing some consumers.

The disinflationary narrative, which came into question in 1Q24 following a series of upside surprises, regained credibility in 2Q24 as the data came in mostly in line with expectations. That said, U.S. Federal Reserve officials maintained a cautious stance, and emphasized that no immediate rate cuts were necessary. The Fed’s updated dot plot in mid-June revealed a relatively hawkish stance, projecting only one rate cut through the end of the year, compared to three in the March projection.

Markets, like the Fed, were very data dependent. With better growth data reported at the beginning of the quarter, spreads continued to trade at tight levels and credit sectors posted solid excess returns. Interest rates also responding by continuing the selloff that was sparked by the hot inflation data in 1Q24, but ultimately finished the quarter only slightly higher.

Corporate credit sectors were further supported by 1Q24 earnings, which again exceeded analyst expectations. While leverage and coverage ratios continued to slowly deteriorate, aggregate fundamental factors remained acceptable, and ratings trends continued to be positive overall. From a technical standpoint, both investment grade (IG) and high yield (HY) sectors were well bid due to higher all-in yields, despite tight spread levels.

Securitized credit sectors also benefited from the positive macro backdrop. For example, commercial mortgage-backed securities (CMBS) managed to outperform as easier financial conditions and improved primary market activity has allowed for an easier path to refinance existing loans. Meanwhile on the residential side, primary activity remains subdued, however so did delinquencies and defaults as the employment picture still remains favorable along with borrowers having locked-in low mortgage rates during the Covid era. Asset-backed securities (ABS) spreads also managed to tighten, despite the continued increase in delinquencies across subprime borrowers. Collateralized loan obligations (CLO) represented one of the best sources of excess returns on the quarter, likely due to the sectors floating rate attribute in an environment of still elevated rates.

Security selection was the largest contributor to relative performance for the quarter. The largest gain was sourced within CMBS. Selection results within ABS were also positive, driven by off-benchmark subsectors such as CLOs and whole business. Sector allocation decisions also added, but to a lesser extent. Our off-benchmark allocation to non-agency residential mortgage-backed securities (RMBS) was the top individual contributor, while overweights to CMBS, ABS and agency mortgages also contributed. Duration and yield curve decisions had minimal impact on relative performance as we remained close to benchmark throughout the quarter.

Outlook

From a fundamental perspective, the outlook has undoubtedly improved. Inflation has managed to decline without significantly impacting growth, and labor markets have managed to rebalance without a meaningful uptick in unemployment. We believe inflation will continue to trend lower, as the lagged impact of declining rent prices will take hold in the coming months, and overcapacity in China will keep goods prices in deflation. We expect growth to remain positive but will continue at a more measured pace. Consumption growth will likely slow due to slowing wage gains and higher prices but will remain positive as the wealth effect (stock prices and home values at all-time highs) continues to be supportive. Similarly, high financing costs will likely curb private investment, however this will be at least partially offset by investment in artificial intelligence technology.

Stress on lower income consumers is, unfortunately, a key outlier in this otherwise positive dynamic. While not a systemic risk, we do think this will allow the Fed to cut rates prior to the election. That said, with the labor market still intact and consumer spending still supportive in aggregate, along with inflation still above 2%, we believe the extent to which the Fed will cut will be limited and the pace will be slow.

While the macro backdrop looks favorable, valuations are rich, for example, the IG corporate index carried a spread of less the 100 basis points (bp) and HY was slightly above 300 bp. Securitized credit sectors appear more attractive from a relative value perspective, as such, we continue to favor an allocation to these sectors, however we are still avoiding the most vulnerable areas (subprime consumer ABS, non-qualified mortgage RMBS, subordinated CLOs). Meanwhile, duration-oriented risks are poised to benefit from the implementation of central bank policy and the resulting decrease in rate volatility.

Over the quarter, we reduced allocations to more volatile areas of the market, particularly those trading at tight spread levels, and added to areas with better relative value. The most notable change occurred across our IG allocation, where we shifted our exposure from long dated bonds into shorter dated bonds.

While strong fundamental factors will continue to support tight spreads, periods of volatility spurred by expectations of lower growth and post-election policy changes will provide opportunities to episodically add risk.

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