Voya Enhanced Yield Fixed Income SMA

Higher Credit Quality Approach, Selective High Yield Exposure

Strategy overview

A total return strategy that uses a multi-sector approach with a higher-quality posture through the use of Treasury, agency and corporate credit securities, both investment-grade and below, with 1-10 year maturities.

Key takeaways

- The second quarter of 2024 was marked by a series of evolving and, at times, conflicting economic signals, as the interplay between labor market dynamics, inflation and consumer behavior painted a complex picture for investors and policymakers alike.
- In corporate credit markets, spreads remained resilient.
- Strong fundamental factors will continue to support tight spreads, while periods of volatility spurred by expectations of lower growth and post-election policies changes will provide opportunities to episodically add 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 complex 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 tick up modestly off of extreme lows.

Similarly, consumer spending, which has led growth over the last several quarters, showed signs of weakening, with only modest growth numbers reported in both personal spending and retail sales data. Major retailers like Walmart, Target and Dollar Tree reported cautious outlooks in their earnings reports, reflecting the strain on lower-income consumers. 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. In addition, primary markets have been very active this year across both segments following a relatively muted year of issuance in 2023. The IG market has already seen about U.S. $850 billion in new supply, while HY supply is tracking over $160 billion for the same period.

For the quarter, the Voya Enhanced Yield Income SMA performed in line with the custom benchmark on a net asset value (NAV) basis. Security selection within corporate credit was additive to results given the SMA's higher quality focus, as higher-quality credits generally fared better during the quarter, particularly within HY. From a sector allocation standpoint, an overweight to IG contributed to returns, while an underweight in HY detracted.

Current strategy and 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 (AI) 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.

All of this points to the realization of a soft landing for the economy. A scenario thought to be impossible only one year ago. While this would otherwise compel us to be more active in taking credit risk, spreads remain tight in corporate credit sectors. Meanwhile, duration-oriented risks are poised to benefit from the implementation of central bank policy and the resulting decrease in rate volatility. Strong fundamental factors will continue to support tight spreads, while periods of volatility spurred by expectations of lower growth and post-election policies changes will provide opportunities to episodically add risk.

The **Bloomberg Barclays Intermediate US Credit Index** measures the investment-grade, US-dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities. **Investors cannot invest directly in an Index.**

The **Bank of America Merrill Lynch U.S. High Yield Master II Constrained Index** is an unmanaged market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default. The Merrill Lynch U.S. High Yield Master II Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure. **Investors cannot invest directly in an index.**

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