Commentary | 2Q24

Voya Securitized Credit Fund

Tap into Voya's Flexible "Through-the-Cycle" Approach

Strategy overview

Invests in fixed income sectors collateralized by distinct asset types: commercial real estate (CMBS), residential housing (RMBS) and non-mortgage assets such as asset-backed securities (ABS).

Key takeaways

- 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.
- For the quarter, the Fund outperformed the benchmark, the Bloomberg US Securitized Index (the Index) on a net asset value (NAV) basis and posted solid excess returns.
- On balance, we added risk to the portfolio over the quarter as high levels of new issuance resulted in pockets of inefficiency.

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 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.

Securitized credit sectors broadly 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.

For the quarter, the Fund outperformed the Index on NAV basis and posted solid excess returns. CMBS was the top contributing sector to excess returns, with conduit as the leading contributor followed by agency real estate mortgage investment conduits (ReREMIC). Non-agency residential mortgage-backed securities (RMBS) was a close second, with Jumbo 2.0 as the main contributor followed by credit risk transfer (CRT) and investor collateral. ABS and CLOs also contributed, but to a smaller degree. CLOs posted strong excess returns on a per dollar basis, but our allocation to the space is relatively small. Meanwhile, ABS maintained it's role as "Steady Eddy", posting respectable outperformance with very little volatility.

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 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.

During the quarter, we reduced our holdings of CRT and agency ReREMICs as spreads came in. For CRT specifically, part of the reduction was the result of our participation in Freddie's tender offer for some of their higher quality tranches. On balance however, we added risk to the portfolio as high levels of new issuance resulted in pockets of inefficiency specialized managers like ourselves are well positioned to take advantage of. This was most notable in Prime Jumbo where, despite remaining low from a longer term perspective, new issue picked up in June resulting in wider spreads. This dynamic was also in play in CMBS, and we added a few single asset single borrower (SASB) deals as well as investment grade conduit. Lastly, while fundamental factors remain strong, we remain defensive in the most vulnerable areas of securitized, such as subprime consumer ABS, non-qualified mortgage RMBS and subordinated CLOs.

The **Bloomberg U.S. Securitized MBS/ABS/CMBS and Covered Index** includes the MBS, ABS, and CMBS sectors. Indexes do not reflect fees, brokerage commissions, taxes or other expenses of investing, and investors cannot directly invest in an index.

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