Voya Limited Maturity Bond Portfolio

Focus on short-duration, US investment grade credit

Strategy overview

The Short Duration High Quality strategy seeks to outperform over a full market cycle via a broadly diversified portfolio, with a focus on risk-adjusted returns, emphasizing opportunities across the full range of US investment grade corporate bonds while maintaining a short duration profile.

Key takeaways

- Rates ended higher and credit spreads tightened due to strong economic data that pushed out expectations for rate cuts.
- The Strategy outperformed its benchmark, the Bloomberg U.S. Gov/Credit 1-3 year Index (the Index) on a gross- and net-of-fees basis. Sector allocation drove outperformance, while duration and yield curve decisions contributed and security selection decisions detracted.
- While spreads for many sectors appear tight, all-in yields remain historically attractive which allows investors to capture high quality yield without overstretching into risk.

Portfolio review

The first quarter of 2024 witnessed a series of positive data points indicating a continuation of strong economic growth that characterized much of 2023. As a result, the S&P 500 Index experienced strong performance, delivering a return of over 10%, and excess returns for most fixed income (FI) sectors finished in positive territory. This robust showing indicated investor confidence and optimism in the overall economic outlook.

Meanwhile, and despite strong excess returns, high-quality bond markets, as represented by the Bloomberg US Aggregate Index, posted modestly negative total returns driven primarily by the move higher in interest rates.

The labor market continued to exhibit signs of strength to start the year. With an exceptionally low unemployment rate and continued job gains, economic growth remained on a positive trajectory. However, there were indications of a gradual shift towards a more balanced labor market, characterized by a decline in the quit rate and a deceleration in wage gains. These developments were welcomed by market participants due to their potential implications on inflation.

That said, inflation remained elevated throughout the quarter while the disinflation dynamic that characterized 2023 began to wane. Additionally, it became apparent that a majority of the disinflation was due to the deflation of goods prices, and that services inflation would also need to be tamed in order for broader measures of inflation to reach the U.S. Federal Reserve's 2% target. Because of this, the Fed signaled a cautious approach to monetary policy, reiterating their commitment to maintaining a restrictive policy stance until further progress was achieved. Markets converged with the Fed's guidance, suggesting a growing consensus on the future direction of monetary policy and a rejection of a more significant pivot that was priced in 4Q24.

In markets, non-agency residential mortgage-backed securities (RMBS) posted a strong quarter of performance. Housing markets stood firm, supported by elevated levels of homeowner equity and the "golden handcuffs" effect, where many homeowners locked in mortgages with highly affordable rates below 5%.

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Commercial real estate (CRE) began its recovery journey, with income growth helping to offset the impact of rising interest rates. Commercial mortgage-backed securities (CMBS) benefitted from this apparent recovery with spreads rallying across the stack. However, challenges persisted within the office property segment due to elevated vacancy levels.

Consumers continued to be well-supported by a robust labor market, healthy financial asset balances, and manageable debt levels. However, lower-income consumers continued to face difficulties due to the cumulative impact of inflation over the past two years.

On the corporate front, 4Q24 earnings were well received with a significant portion of companies beating expectations. Moreover, positive rating trends were observed, with a series of positive upgrades, reflecting the overall health and resilience of corporate balance sheets. These developments underscored the confidence in the corporate sector's ability to navigate challenges associated with restrictive financial conditions, and resulted in both high yield and investment grade spreads rallying to their tightest levels in over a year as well as a meaningful portion of the senior loan market making its way back to par.

Sector allocation drove outperformance, while duration and yield curve decisions contributed and security selection decisions detracted. Once again, our allocation to CMBS was the largest individual contributor. Our allocation to asset backed securities (ABS), which we increased over the quarter, also contributed along with our overweight to investment grade (IG) corporates. Following the rally in 4Q24, we closed our overweight to duration, and therefore did not participate in the selloff that occurred in 1Q24.

Current strategy and outlook

Looking ahead, we expect economic growth in the United States to slow from 2023, but continue to grow close to trend levels, supported by robust consumer spending as real income and the wealth effect bolster economic activity. Meanwhile, we expect inflation to stabilize above the Fed's target, due to the slowing disinflationary trends in the goods sector and continued stickiness in the services sector, the latter of which has been a product of a tight labor market. We are seeing early signs of softness in the labor market, notably a decline in the quits rate. We expect wage growth to moderate, which would also be a positive for inflation.

With this backdrop, along with recent strength in economic data, the Fed's case for maintaining a patient stance on rate cuts has been bolstered. However, the Fed's data-dependent stance will provide flexibility in adjusting policy measures in response to evolving economic conditions, ensuring a balanced approach to supporting economic growth while addressing inflation concerns.

Turning to markets, tight valuations for corporate bonds make the sector less appealing for investors, although technically are likely to remain supportive as higher yields keep yield based buyers active. Agency MBS valuations remain appealing given muted prepayment risk. CMBS exhibit cheap valuations, offering the most compelling relative value compared to other FI sectors. Moreover, outside of the office property type, fundamental factors in CRE are showing early signs of improvement.

As investors navigate the FI landscape in 2024, considerations around risk appetite, yield opportunities, and sector-specific dynamics will be crucial in shaping investment decisions. While spreads for many sectors appear tight, all-in yields remain historically attractive which allows investors to capture high quality yield without overstretching into risk. Monitoring market developments, assessing sector fundamental factors, and staying attuned to macroeconomic trends will be essential for optimizing FI portfolios and capitalizing on opportunities in a dynamic and evolving market environment.

The **Bloomberg US Government/Credit 1-3 Year index** covers US Treasury securities, agencies, publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. The index is fully invested, which includes the reinvestment of income. Indexes are unmanaged and index returns do not include fees or expenses. **An individual cannot invest directly in an index.**

The **Bloomberg US Aggregate index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes US Treasury securities, government-related and corporate securities, fixed-rate agency mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities, both agency and non-agency issues. Indexes are unmanaged and index returns do not include fees or expenses. **An individual cannot invest directly in an index.**

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