Commentary | 4Q24

Voya Enhanced Yield Fixed Income SMA

Higher Credit Quality Approach, Selective High Yield Exposure

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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

- Overall, the fourth quarter of 2024 was characterized by resilient labor market dynamics, strong economic growth and sticky inflation. The impact on fixed income performance was mixed, with yields rising and credit spreads tightening, leading to modestly negative returns for most fixed income sectors.
- For the quarter, the Voya Enhanced Yield Income SMA underperformed the custom benchmark on both a gross- and net-of-fees basis.
- Looking forward, we continue to expect economic growth will remain resilient.

Market review

Strong economic data continued to come through in the final quarter of 2024, which had the impact of driving spreads tighter while reversing the rate rally experienced in 3Q24. The credit spread of the HY bond market closed out the year at 292 basis points (bp) on an option-adjusted basis (OAS) basis, having grinded 11 bp tighter since last quarter and 47 bp since the start of the year. Market technical factors remained positive, driven by strong investor demand given attractive all-in yields.

Labor market dynamics continued to show signs of softening without entering a state of deterioration. Job gains remained reasonable, and although the unemployment rate resumed its upward trajectory, it remained below the high watermark set earlier in the year. Meanwhile, wage growth remained strong, which helps explains both the resilience of consumer spending and the stickiness of services inflation.

While the Fed continued to deliver rate cuts at both the November and December meetings, the December cut was accompanied by more "hawkish" elements. Specifically, the Fed's Dot plot indicated only two cuts projected for 2025—down from four in the previous iteration. Additionally, officials moved their projection for both growth and inflation higher, while their projection for the unemployment rate moved lower and only slightly above the current level.

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Portfolio review

For the quarter, the Voya Enhanced Yield Income SMA underperformed the custom benchmark on both a gross- and net-of-fees basis. The SMA's higher quality focus within both investment grade and high yield corporates detracted from relative performance, as lower quality generally outperformed across both markets given the strong macro environment.

Outlook

Looking forward, we continue to expect economic growth will remain resilient. The recent election outcome further strengthens this view due to election optimism and productivity gains from deregulation. Meanwhile, we expect inflation to resume its downward trend, driven by moderating service prices. In this area however, the election result lowers our conviction as an adverse policy mix of deficit spending, tariffs, and stricter immigration limits would sustain higher levels of demand while constraining supply. That said, we believe a negative market reaction would likely compel the administration to temper those policies before they derail growth.

Assuming this is the case, and inflation does not reaccelerate, we expect the Fed will tolerate inflation that is slightly above their target and deliver a few more rate cuts in an effort to preserve the current cycle.

Overall, this backdrop should be favorable for credit sectors, and outweigh currently extended valuations in the near term. In the medium term, investors may have opportunities to capitalize on short-lived market dislocations as the Trump administration looks to find the right balance in implementing its policy goals. For fixed income portfolios, security selection and flexibility in sector allocations will be key to generating outperformance. We continue to favor high-quality, shorter-dated assets and if spreads widen, we will look to add market risk further out the curve.

Read our strategy brief

Returns are benchmarked to a customized blend of 60% Bloomberg Intermediate Gov/Credit Index and 40% Bank of America US High Yield Master II Constrained Index, rebalanced on a monthly basis, which does not incur management fees, transaction costs, or other expenses associated with a composite portfolio. Securities prices used to value the benchmark index for the purposes of calculating total return may or may not differ significantly from those used to value securities held within composite portfolios. Index returns do not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension, and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition. The strategy may invest in mortgage-related securities, which can be paid off early if the borrowers on the underlying mortgages pay off their mortgages sooner than scheduled. If interest rates are falling, the strategy will be forced to reinvest this money at lower yields. Conversely, if interest rates are rising, the expected principal payments will slow, thereby locking in the coupon rate at below market levels and extending the security's life and duration while reducing its market value. High yield bonds carry particular market risks and may experience greater volatility in market value than investment grade bonds. Foreign investments could be riskier than U.S. investments because of exchange rate, political, economics, liquidity, and regulatory risks. Additionally, investments in emerging market countries are riskier than other foreign investments because the political and economic systems in emerging market countries are less stable.

The Composite performance information represents the investment results of a group of fully discretionary accounts managed with the investment objective of outperforming the benchmark.

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