

Fixed income perspectives:

What inflation data giveth, labor taketh away

A tight labor market is keeping the Fed in a rate-hiking mode. All this job creation is re-calibrating expectations for the Fed and that, we think, is good news for fixed income investors.



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The labor market supports the Fed's forecast of no near-term rate cuts

The labor report for December was a blowout. The seemingly unstoppable US economy created 517,000 jobs, nearly three times more than the consensus forecast, forcing markets to play catch-up. In the week following this single economic report, the 2-year Treasury yield rose by about 40 bp and fed funds futures markets priced in an about-face: The Fed was no longer expected to cut rates in 2023. This scenario has been broadcast by the Fed for some time, and we've seen no reason to disagree.

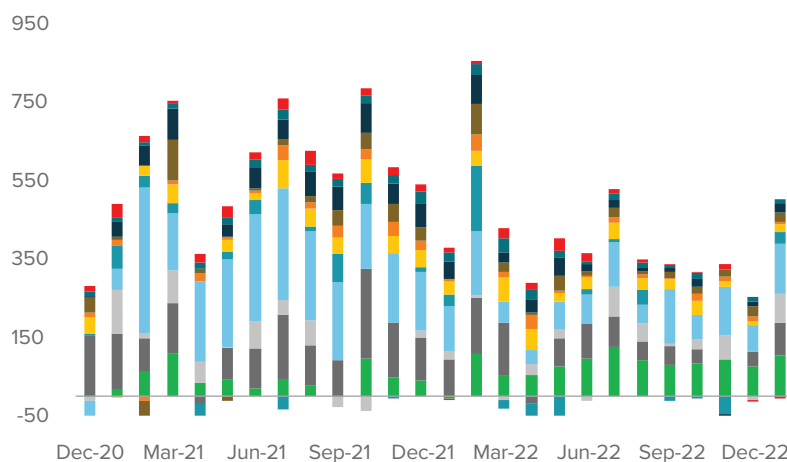
The most recent jobs report revealed a 3.4% unemployment rate, the lowest since the '60s. Jobs remain plentiful, with job openings per seeker above a 1.5 ratio. Although the "quit rate"

is declining and other signs of economic slowing are emerging, we believe the economy's strength as signaled by the jobs market will forestall any serious economic distress caused by the rising fed funds rate.

Recent job layoff headlines are misleading. Although press reports have highlighted job losses at major tech firms like Amazon and Meta, the labor market remains strong (Exhibit 1). The tech industry represents only about 2% of the workforce and doesn't represent the state of the economy at large. We think the much-heralded recession — if it comes — is unlikely to result in a major credit contraction. Consumer and corporate balance sheets are in good shape. The economy is proving resilient, and able to withstand a higher rate environment.

Exhibit 1: Nearly all industries are adding jobs

Monthly changes in jobs, by industry



| Industry | Jobs (millions) | % of US labor mkt |
|---------------------|-----------------|-------------------|
| Education/Health | 24.9 | 16.1 |
| Prof/Biz Services | 22.9 | 14.8 |
| Government | 22.4 | 14.4 |
| Leisure/Hospitality | 16.5 | 10.6 |
| Retail trade | 15.5 | 10.0 |
| Manufacturing | 13.0 | 8.4 |
| Financial services | 9.1 | 5.9 |
| Construction | 7.9 | 5.1 |
| Transport/Warehouse | 6.7 | 4.3 |
| Wholesale Trade | 6.0 | 3.9 |
| Information | 3.1 | 2.0 |

Source: Bureau of Labor Statistics and Voya Investment Management
As of 01/31/23.

Despite January's robust jobs market, we expect the Fed's hikes to be wrapping up soon. The increments of the rate moves have declined from 75 bp to 25 bp, and disinflation, according to Fed chair Powell, has begun. We agree with his observation and think the rate of inflation will continue to decline as the impact of rate rises takes effect and as the housing market cools. Though rates should remain elevated for some time, uncertainty centered around Fed policy and bond yields should diminish, leading to a decline in bond volatility.

Conditions have lined up to favor a “carry” environment

After a very difficult 2022, the stage is set for clearer bond skies. Bonds typically do well in the year following a strong

rise in rates, and the carry of higher yield levels provide some protection for total returns should rates head higher. At its current level, the real 10-year Treasury rate (its nominal yield minus implied “breakeven” inflation) has risen to its long-term average of over 1% for the first time in more than a decade, keeping bond investors ahead of inflation. The economy appears to be cooling as the Fed had hoped, another boon to bonds. In addition, strong labor markets should prevent a deep recession that could negatively impact credit bonds, and the drop in volatility we're expecting should favor fixed income of all stripes. After a very choppy year for bonds, we see smoother sailing ahead.

Bond market summary

Investment grade

Spreads look too tight in our view, but in all yields look attractive and continue to draw inflows.

High yield

Valuations look squeezed, but fundamentals are generally decent and default expectations remain low.

Senior loans

Technicals have recently improved, but the upticks in downgrades and last month's default are keeping us cautious.

Securitized credit

We're positive on non-agency RMBS and high quality CMBS and CLOs, with attractive yields, high credit quality, and more room for relative outperformance.

Agency RMBS

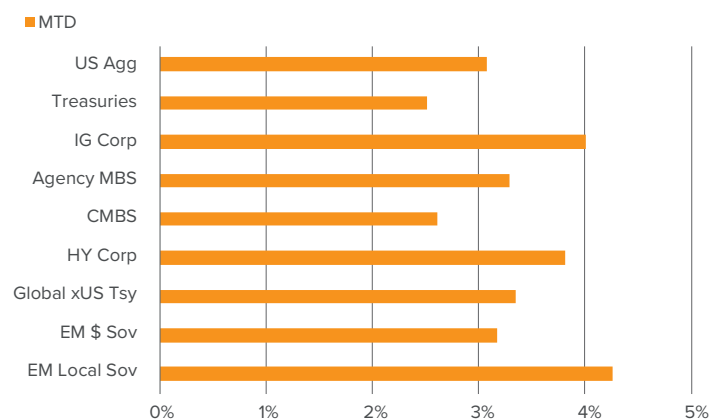
We have moved to neutral from overweight as rate volatility led to strong performance in January.

Emerging markets

Though the sector continues to perform well, we're reducing idiosyncratic risk and prefer high quality names given global economic fundamentals.

Rates, spreads and yields

Fixed income sector total returns as of 01/31/23



| | | 31-Jan | 31-Dec | 1Y Low | 1Y High |
|--------------|---------------|--------|--------|--------|---------|
| Yields (%) | US 2 Yr | 1.78 | 4.40 | 1.16 | 4.73 |
| | US 10 Yr | 3.51 | 3.88 | 1.73 | 4.24 |
| | GER 10 Yr | 2.29 | 2.57 | -0.07 | 2.57 |
| | JPN 10 Yr | 0.50 | 0.42 | 0.14 | 0.53 |
| | EM Local Sov | 6.61 | 6.86 | 5.89 | 7.63 |
| Spreads (bp) | IG Corp | 117 | 130 | 105 | 165 |
| | Agency MBS | 41 | 51 | 18 | 88 |
| | CMBS | 175 | 193 | 106 | 207 |
| | HY Corp | 420 | 469 | 309 | 583 |
| | HY x-Egy Corp | 433 | 484 | 313 | 594 |
| | EM \$ Sov | 444 | 453 | 372 | 593 |

As of 01/31/23. Sources: Bloomberg, JP Morgan and Voya Investment Management. Past performance is no guarantee of future results.

Sector outlooks

Global rates and currencies

- The Fed reduced the size of its hike to 25 bp but doesn't appear to be at the end of its tightening of monetary policy.
- Other central banks, notably Europe's, have a considerable way to go before their goal of low inflation is met.
- Although the Fed has not finished its hiking, with a peak in Fed Funds, we expect US dollar strength to further unwind.

- We believe inflation will dictate a Fed pause, while labor markets and economic data will determine a change in Fed policy.

Investment grade corporates

- Investment grade (IG) performance was very strong in January, with inflows into IG funds totaling \$18 billion vs. outflows of \$157 billion last year.

- Given the strong January performance, IG spreads are at the tighter end of their recent range. However, nominal yields continue to attract buyers and underpin valuations.
- We continued to see fundamentals cooling from a point of strength, yet overall corporations are reasonably healthy, leaving IG companies well-positioned should growth slow in 2023. Debt growth remains about flat over the past 6 quarters.
- Given our cautious outlook, we're neutral on the long end and overweight utilities, financials and high-quality names.

High yield corporates

- The high yield market had a strong January, particularly among CCC names.
- Technicals are somewhat favorable, leading us to be moderately positive on the sector in the near term.
- Our strategic view has not changed, namely that the sector has not priced in a resurgent recession, not to be ruled out in this higher-rate environment.
- Pockets of weakness in fundamentals are growing. We expect top line and margin growth to continue to be under pressure, but to remain elevated overall.
- We're overweight building products and independent energy, underweight financials, consumer cyclicals.

Senior loans

- The supply and demand equation for loans has shifted recently, with limited loan availability and supportive bids from CLOs.
- Despite improved technicals, we're focused on fundamentals and expect a quickening pace in downgrades and defaults.
- One default in the sector last month, (Heritage Power) bumped up the 12-month trailing default rate to 83 bp, still well below its historical average.
- Downgrades have accelerated, triggered by earnings, margin pressure, excess leverage, and increasing borrowing costs. The downgrade to upgrade ratio rose to 2.77x in December from 2.24x in November.
- We maintain a low single-B risk profile, and favor packaging, restaurants, and gaming, while avoiding companies beholden to discretionary consumer spending.

Securitized credit

- Overall we remain net positive on securitized credit, which to us features strong credit quality, attractive yields and the potential for further spread tightening.
- CLO new issuance picked up in January following a low-volume 2022, about 70% of the issuance of the previous year. While technicals are a short-term positive for CLOs, fundamentals remain a headwind, leading us to a neutral position.
- We are positive on RMBS over the short and long term. Any market supply is quickly absorbed and a decline in rate volatility is a tailwind for the sector.
- Regarding CMBS, we're tactically bullish over the next three months, with strong demand and restricted supply. Over the medium term we're neutral, given tighter financial conditions.
- Our assessment of consumer ABS is positive given higher yields and the safe-haven nature of the category. Demand remains brisk, and we don't expect to see an excess of supply.

Agency RMBS

- With the prospect for Fed asset sales still low and the Fed tightening cycle approaching its end, much of the uncertainty clouding the MBS market is removed, along with fixed income volatility.
- The Fed remains in "runoff" mode, while REIT and GSE demand is expected to be immaterial. Bank demand has been subdued with slower deposit growth and the re-emergence of C&I loan demand in 2022.
- January speeds are expected to have decreased, driven by higher rates, lower seasonality and drop in day count term.

Emerging market debt

- Spreads of EM debt came down for the fourth month in a row, though US credit markets outperformed EM on a relative basis last month.
- New issuance picked up considerably following a quiet December, with \$69 billion issued in January compared to only \$3 billion in the previous month.
- We are overweight Latin America and underweight Asia ex Indonesia. In terms of credit quality, we favor higher-rated, higher-quality securities over speculative issues.
- China is contributing to EM strength, having abandoned its "Zero Covid" strategy to focus on its economic reopening.
- Absolute yield levels remain attractive compared to historical norms, though the prospect of a global recession will keep spreads elevated.

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