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Executive Summary

- While U.S. markets continue to climb a wall of worry, many fretful investors have missed out as they await the pullback that never truly comes.
- Recent data suggest the consumer will help rouse the economy from its first quarter sluggishness.
- Given the impact that tightening would have on already-elevated global risks, we don't expect a Fed rate hike this summer.
- Broad, global diversification continues to shield investors from volatile markets, over both the short and long term.

U.S. Equities Lead Way in May

Index	May 2016	YTD 2016
Equity		
S&P 500	1.8	3.6
S&P MidCap 400	2.3	7.5
S&P SmallCap 600	1.7	5.6
Global REITs	0.0	5.4
EAFE	-0.8	-0.7
Emerging Markets	-3.7	2.4
Fixed Income		
Corporate	-0.1	5.3
U.S. Treasury 20+	0.9	8.8
Global Aggregate	-1.3	5.9
High Yield	0.6	8.1
Senior Loans	0.7	3.8

Data as of 05/31/2016

Source: FactSet, FTSE NAREIT,
Voya Investment Management

Markets Climb a Wall of Worry in May

We have seen this — a stealth bull market — before. Despite negative corporate earnings, weak economic growth, anemic business spending and the prospect of a summer Fed rate hike, U.S. markets have rallied across the board. Given the scary headwinds, however, investors seem to lack faith in this market, with many seemingly content to wait for the pullback that never truly comes.

Consumer in a Virtuous Cycle

Despite generally weak economic growth, there is good news, especially from the consumer. We have said before that the consumer is in a virtuous cycle due to low unemployment, positive wage gains and strong housing, not to mention low mortgage rates, low inflation levels and low energy prices. The misplaced concern about the lack of consumer spending was put to rest after the blowout April report in which PCE jumped 1%, the largest gain in nearly seven years. This robust figure signals that consumers are helping the U.S. economy move on from its tepid start to 2016, and we expect a much higher contribution to second quarter GDP growth. There are other signs that consumer strength is sustainable:

- New-home sales astounded in April, rising 16.6% to 619,000. It was the largest monthly percentage increase since January 1992.
- The S&P/Case-Shiller Home Price Index covering the entire nation rose 5.2% year-over-year in March. The hottest markets in the country, primarily those on the West Coast, continued to show double-digit price gains.
- Employment remains strong despite a disappointing non-farms payroll report for May that showed only 38,000 jobs added.
- U.S. household wealth is at the highest levels ever, reaching \$86.8 trillion.

Global Risks and the Fed

In addition to the strong consumer, the U.S. economy has benefitted of late from renewed manufacturing strength (three straight months of expansion) and a rebound in oil prices to near \$50. That said, the U.S. economy continues to be hamstrung by weak global growth, low commodity prices and declines in business fixed investment, making the Fed's next step somewhat uncertain. For its part, the Fed seems increasingly focused on risks from abroad:

- **China.** Despite enormous reserves and tolerance for debt to sustain the economy, China's rate of growth is slowing as has its contribution to the emerging markets.
- **U.K.** On June 23 the United Kingdom will hold a national referendum to ask voters whether the country should remain a member of the European Union or go forward on its own (the so-called "Brexit" option). While we expect the status quo to prevail, a British departure would be extremely disruptive to the region.
- **Europe.** The European Central Bank held off on additional stimulus at its latest meeting but on June 8 will begin buying corporate bonds, as previously announced. Economic growth in the region has slowed in the second quarter after a strong first quarter GDP print.

- **Japan.** “Abenomics” thus far has been mostly a failure, prompting Prime Minister Abe to postpone next year’s planned sales tax hike until late 2019 and to announce “bold” fiscal stimulus for this fall.
- **OPEC.** The cartel demonstrated its loss of oil market influence as oil prices rose despite its decision to not set a production ceiling.

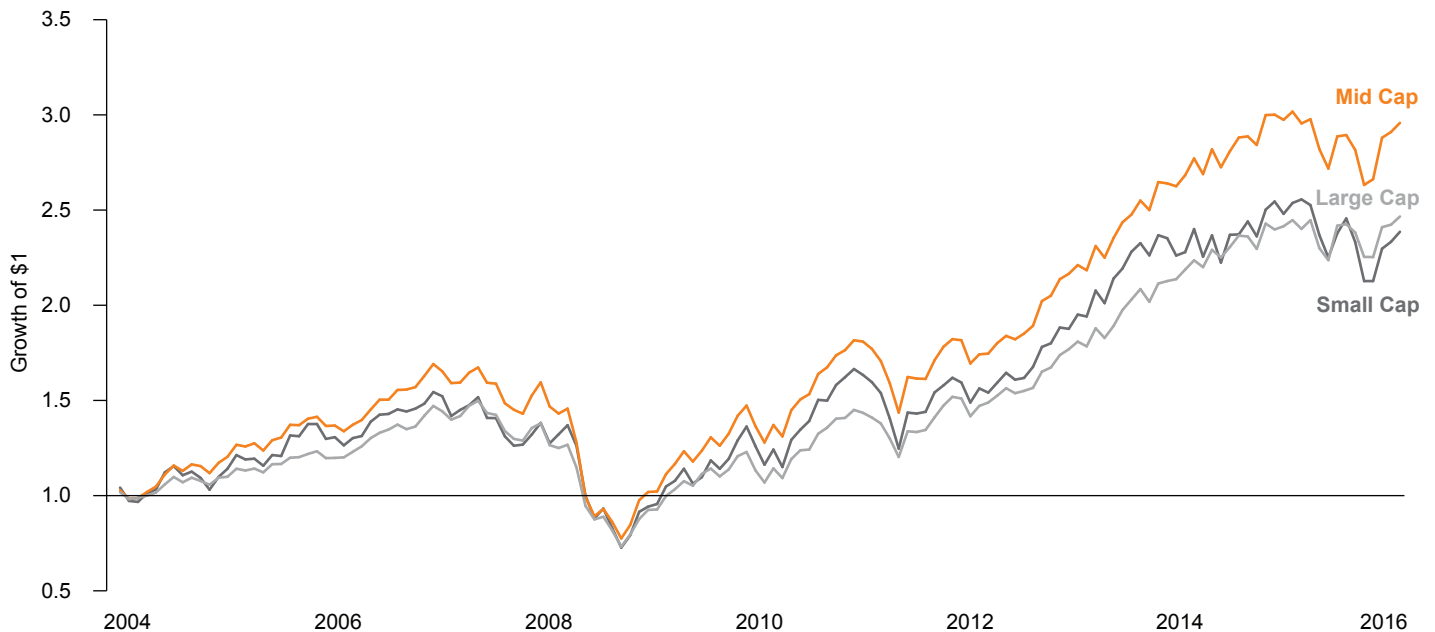
The central bank next meets on June 15 and July 27; while a hike likely would give markets pause, we wouldn’t bet on a move this summer, for a number of reasons. The Brexit vote will come just days after the Fed’s June meeting, for example, and July’s date lacks a scheduled post-meeting press conference. But the main logic is that there is only weak economic support for raising rates, mainly from strong jobs reports (until May, at least); the Fed’s other mandate — a 2% inflation target — seems to be slipping away, as core inflation has lost its upward momentum. Meanwhile, the Fed has grown increasingly anxious about the impact tightening — and the resultant dollar strength — would have on global risks. A stronger dollar would be a significant headwind to U.S. exports, U.S. corporate earnings, commodities prices, and emerging markets and subsequently global growth. Just the hint of a rate hike sent emerging markets down nearly 4% in May. Thus the conundrum: While the Fed wants to get back on the normalization track, doing so would likely fuel any number of global headwinds already facing the domestic economy.

Market Review

U.S. markets were positive in May, led by surging mid-cap equities; mid caps are up 7.5% year to date, more than double the return of large caps. The best sector of the market in May, with a big comeback, was by far the technology sector. International and emerging markets succumbed to a strengthening U.S. dollar and weak global growth during the month. Fixed income continues to shine, led by long U.S. Treasuries and high yield bonds.

With 98% of the index having reported first quarter results, year-over-year earnings growth for the S&P 500 is -6.7%. The consumer discretionary sector delivered the best earnings, while energy fared the worst and will continue to be a drag in the second quarter despite the spike in oil prices. However, given accommodative global central banks, the market seems to be anticipating better times ahead. Counterintuitively, consumer discretionary stocks are up less than 2% year to date compared to more than 12% for energy names

U.S. Markets Have Climbed a Wall of Worry



Source: FactSet, Russell Investments.

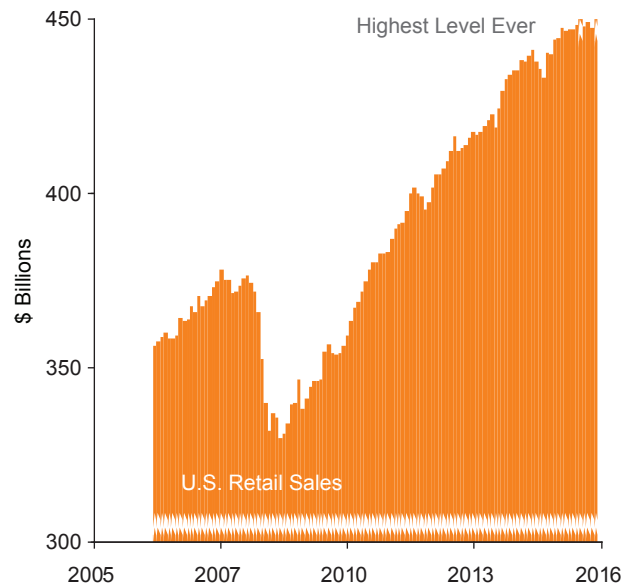
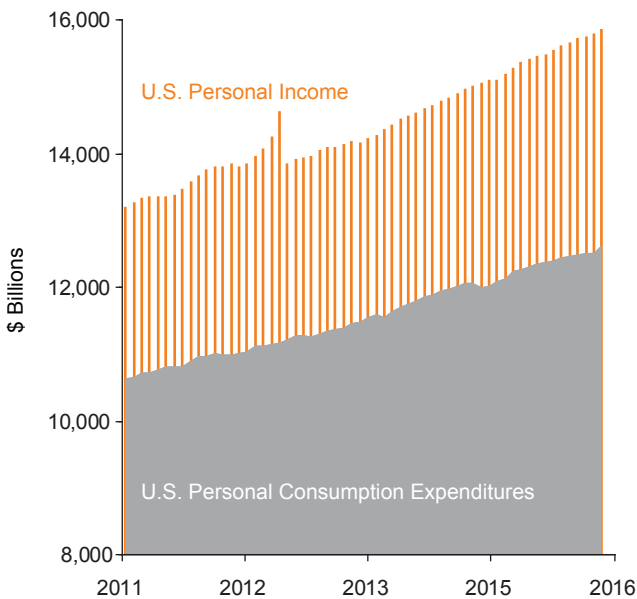
Note: Growth of \$1 and annualized 10-year returns are based on the Russell 1000 Index for Large-Cap, the Russell Midcap Index for Mid-Cap and the Russell 2000 Index for Small-Cap. **Past performance is no guarantee of future results.** Please review important disclosures in the back of this book.

Investor Outlook

There is still plenty to worry about: the Fed teasing rate hikes, sluggish global economic growth, falling corporate earnings and a possible Brexit. Markets are climbing a steep wall of worry but that does not mean to run for the hills just yet: Stay invested and rely on effective diversification to ride out these tumultuous times.

Broad, global diversification continues to shield investors from volatile markets, regardless of their investment horizon; nine out of ten asset classes have delivered positive returns for year-to-date 2016, and the longer-term results are even more persuasive

Recent Concerns About the Health of the Consumer Were Misplaced



Source: FactSet
 Note: U.S. Personal Income and U.S. Personal Consumption as of 04/29/16; U.S. Retail Sales as of 04/29/16

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