PIMCO

Income Strategy Update: Capitalizing on the Global Opportunities in Fixed Income

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With the potential for higher-for-longer yields across countries, we see the global fixed income opportunity set as the most attractive in years.

Summary:

- High yields and global divergence are leading to one of the most attractive opportunity sets in global fixed income markets in recent history, in our view.
- We have added to duration versus the start of the year and diversified outside the U.S. We believe fixed income offers a compelling return profile.
- We are diversifying interest rate exposure into the U.K. and Australia, where we see attractive value versus the U.S. and stronger government debt dynamics.
- We maintain a core holding in investment grade credit space, while moving up in quality with exposure to agency mortgages.

The path of interest rates has defied expectations, again, leading to multiple opportunities across fixed income markets around the world. Here, Dan Ivascyn, who manages the PIMCO Income Strategy with Alfred Murata and Josh Anderson, talks with Esteban Burbano, fixed income strategist. They discuss how the portfolio is positioned for elevated bond yields, mixed inflation data, and global divergence.

Q: STARTING AT A HIGH LEVEL, WHAT IS OUR GLOBAL MACRO OUTLOOK FOR THE NEXT 12 MONTHS?

Ivascyn: Across the major economies, the U.S. stands out for its ongoing resilience. The U.S. economy is less rate-sensitive than most other markets, due partly to the prevalence of 30-year fixed-rate mortgages. When interest rates were lower amid the pandemic, homeowners were able to lock in low mortgage rates. Technological innovations, such as artificial intelligence advancements, are also spurring U.S. economic activity and equity markets.

However, high inflation and geopolitical conflicts as well as the lingering consequences of the pandemic have affected the European economy, as well as overall global sentiment.

The trajectories among major economies may potentially diverge. In the U.S., although growth likely peaked in 2023, a soft landing remains a clear possibility – and perhaps even a no-landing scenario of continued strong economic growth, though that isn't our base case.

Of course, the outlook for U.S. resilience, especially relative to other economies, also creates uncertainty around the future of inflation. While inflation remains sticky in the U.S., it is mixed in other countries. Thus, central banks (particularly in developed markets), which tightened policy in unison to curb the pandemic inflationary spike, may follow varied paths when cutting interest rates. This could contribute to global divergence in 2024.

We discuss all this in more detail in our latest *Cyclical Outlook*, "Diverging Markets, Diversified Portfolios."

Q: LET'S SHIFT TO PORTFOLIO POSITIONING IN THE INCOME STRATEGY, STARTING WITH DURATION, I.E., INTEREST RATE EXPOSURE. HOW WOULD YOU SUMMARIZE OUR CURRENT POSITIONING?

Ivascyn: We're highly tactical in both the amount and composition of interest rate exposure, including maturities and our holdings around the globe. We've been especially tactical the last couple of quarters. We held a high amount of interest rate exposure in early October of last year. Then we had a market rally that we felt got ahead of itself with misplaced optimism about the prospects for monetary easing, which allowed us to pivot to more defensive positioning during the first quarter, relative to passive strategies, as economic data remained strong.

Also, we have diversified away from U.S. interest rate duration somewhat, investing more in other developed countries such as the U.K. and Australia – we see attractive valuation of interest rate duration in those markets whose economies are more interest rate sensitive than the U.S. and benefit from stronger government debt dynamics. The U.S. economy, by contrast, is arguably overheating a bit, leading to unwanted inflation. And looking over the long term, U.S. deficit spending is significant, and neither candidate for president is emphasizing deficit reduction. While we are not conducting a major shift from U.S. to global, we may selectively increase global exposure in the Income Strategy as we see significant value in select bond markets that offer strong return potential.

We tend to concentrate a majority of our interest rate exposure around the five-year mark in the yield curve, although the front end of the curve also looks interesting now that markets have shifted pricing for central bank policy easing out to year-end or beyond.

In a nutshell, we have a bit more duration than we had at the start of this year, and with more diversification.

Q: WHAT IS YOUR ASSESSMENT OF CREDIT MARKETS OVERALL, AND HOW IS THIS REFLECTED IN THE PORTFOLIO?

Ivascyn: The U.S. economy is resilient, and amid the pandemic many companies were able to lock in low rates for an extended period. This has helped capital flow into the riskier segments of the credit markets. However, credit spreads are tight, and we see perhaps too much optimism in the public equity markets and in certain more risky segments of the credit markets.

A key tenet of our investment strategy is to seek high quality alternatives to more economically sensitive credit. We've brought down our exposure to credit risk, while moving up in quality. We have also increased the liquidity, or the flexibility, of the portfolio. Thus, if we have more downside volatility later in the year, we can go on offense in more economically sensitive sectors.

Q: WHERE IS THE INCOME STRATEGY FOCUSING WITHIN CORPORATE CREDIT MARKETS?

Ivascyn: We would prefer a bit more risk premium in corporate credit, but fundamentals and technicals look quite good. We have a core holding in the investment grade space, with investments in senior financials. We have lowered that exposure slightly, not because we're worried about financials, but we prefer the risk/return profile of other sectors.

In high yield, fundamentals remain quite strong. The market has evolved: Much of the more aggressive lending that used to occur in high yield has migrated into senior secured loans. Our preference remains in relatively higher-quality opportunities, including industries and companies we favor, as well as positions offering yield advantages or protective covenants. We are cautious on floating-rate loans, where covenants generally have weakened and companies are paying considerably higher rates.

Q: CAN YOU GIVE US AN OVERVIEW OF AGENCY MORTGAGE-BACKED SECURITIES (MBS) TODAY?

Ivascyn: We continue to see agency MBS as an attractive sector. These securities offer a U.S. agency or government guarantee and complexity that creates inherent inefficiencies, which provide opportunities for active managers. It's a very liquid asset class and should be quite resilient under harder landing scenarios. We have steadily accumulated agency MBS positioning, and this likely represents a significant portion of the Income Strategy's performance.

Agency MBS continue to trade at wide spreads, though not because people are concerned about credit risk or recession. Investors have been reacting to changes in expectations for policy rate cuts by the U.S. Federal Reserve, as well as the Fed reducing MBS holdings on its balance sheet.

Q: WHAT ARE YOUR VIEWS ON THE U.S. REAL ESTATE MARKET MORE BROADLY?

Ivascyn: Residential real estate tends to reflect the health of the consumer, and consumer credit fundamentals are strong, with generally healthy household balance sheets. In addition, stricter bank regulation following the global financial crisis has helped keep housing market excess in check. In a sense, the market has shrunk rather than grown, and we see attractive credit risk in the residential sector.

In commercial real estate, on the other hand, we see a lot of uncertainty. The office sector especially continues to struggle. The Income Strategy's exposure to commercial real estate tends to be a modest, diversified percentage of the portfolio, and nearly all our commercial mortgage-backed security exposure is senior in the capital structure. We have limited office exposure.

Q: WHAT ARE YOUR THOUGHTS ON U.S. TREASURY INFLATION-PROTECTED SECURITIES (TIPS)?

Ivascyn: Core U.S. inflation will likely remain above the Fed's 2% target for some time. In the Income Strategy we have held a fairly consistent exposure to TIPS, which also have diversification benefits, and given current yields and the inflation outlook we have no intention to meaningfully adjust that allocation.

Q: COULD YOU SUMMARIZE THE INCOME STRATEGY'S APPROACH TO EMERGING MARKETS?

Ivascyn: While the fundamentals and technicals look good in emerging markets (EM), we have reduced our overall EM risk exposure. We have some small, high quality interest rate positions in countries such as Brazil and Mexico that have made progress taming inflation and have an attractive yield advantage versus the U.S.

We significantly reduced the negative U.S. dollar bias that prevailed across the portfolio last year. We have been operating a small but meaningful set of relative value expressions within currencies, mainly in EM. We see it as an actively managed, diversified set of exposures that contributed to positive incremental return this year versus passive alternatives.

Q: WE STILL SEE MANY INVESTORS SITTING IN CASH. WHAT INSIGHTS WOULD YOU OFFER THEM?

Ivascyn: Well, it's understandable. 2022 was an unpleasant period for markets, with just about all financial assets declining. 2023 was more mixed, but still volatile. The fourth quarter of last year was a reminder that rallies can happen very quickly and that moving from cash to fixed income can potentially generate more attractive returns. And although the time frame for Fed rate cuts is uncertain, cash rates won't stay at current levels indefinitely. Fixed income, especially at today's starting yields, offers a compelling risk-adjusted return profile.

We are not suggesting investors assume massive interest rate risk, but rather we see benefit in diversifying further out the yield curve. This is an exciting time for bond markets and for value, especially in some markets outside the U.S. that haven't represented great value in some time. Just a few years ago, we were talking about negative yields in Japan and Europe. Today we view the global opportunity set as the most attractive we have seen in a very long time, and we believe it's an exciting time for active management to seek to generate returns for investors.

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