PIMCO

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Economic and Market Commentary

Welcome Back, Balanced Portfolio

Balanced portfolios are back: Higher bond yields are restoring fixed income's role as both a potential source of income and a powerful diversifier.

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Key takeaways

- **Bonds have regained their place in multi-asset portfolios.** Higher yields have restored fixed income's dual role: In a good state of the world, bonds can deliver attractive income; in a bad state, high quality duration can help protect against equity drawdowns. Put simply, investors are once again being compensated to be hedged.
- **The benchmark matters when judging whether bonds hedge portfolios.** Many critiques of fixed income's defensive role use broad bond benchmarks that include investment grade credit, but credit is a risk asset. In our view, the cleaner test is duration – especially government bonds – which is the component designed to diversify risk when growth weakens.
- **Many portfolios remain anchored to the last regime.** After years of exceptional equity returns, allocations are still heavily tilted toward stocks even though the income available in high-quality bonds is difficult to ignore. High quality bond yields are now broadly comparable to equity earnings yields, providing investors with greater visibility and less reliance on continued valuation expansion.

For much of the past decade and a half, investors saw little reason to favor bonds over equities. Yields were low and returns were muted, especially in passive strategies. Equities seemed to offer a much clearer path to long-term capital appreciation. For many investors, bonds were, at best, ballast: a dull but generally stable component of a broader portfolio. Then the experience of 2022 had investors questioning even that view, as areas of high-quality fixed income generated equity-like losses that eroded much of the prior decade's real return.

But the starting point has changed. The 2022 episode was the culmination of years of historically low yields. Now, bond yields are broadly on par with equity earnings yields, offering attractive income, renewed diversification, and better visibility into future return potential. Even amid the recent global rise in yields, bonds can potentially provide sufficient income to offset related price declines, and broader bond market performance has remained resilient.

Many portfolios, however, remain anchored to the assumptions of the 2010–2022 regime. In today's investing regime, we see a strong case for boosting bond allocations and restoring more balance to portfolios that are heavily exposed to equity markets – and equity risks. With yields near their highest levels in two decades, bonds have the potential to generate income for portfolios if economic strength endures and serve as a shock absorber if growth slows.

In this article, we address investors' most common questions about balanced portfolios.

Why revisit the case for balanced portfolios now?

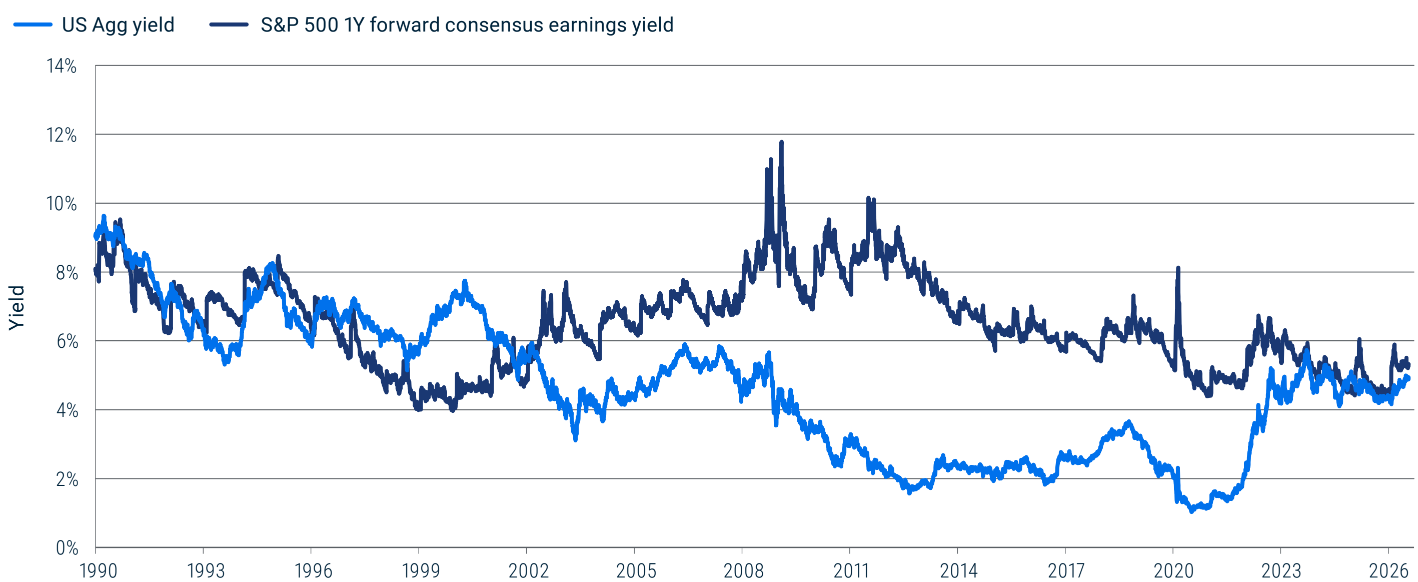
Because the relative valuation case has shifted: Bond yields have reset to higher levels, offering more visible return potential, while the premium for taking incremental equity risk now looks unusually thin.

After more than two decades of trailing equity earnings yields, bond yields are on par once again (see Figure 1). This shift does more than improve the relative value proposition of bonds versus stocks; it also gives investors greater visibility into forward return potential. For high quality bonds, starting yield historically remains the best predictor of medium-term returns – a trendline clearly visible in Figure 2. This means the 5.03% yield on the Bloomberg US Aggregate Index as of 3 September 2026 could translate, roughly, into a similar annualized return over time.

Equities, by comparison, offer no such anchor and less visibility based on historical trends (see Figure 3). With many common equity valuation measures near multi-decade highs, forward returns are likely to be lower than those delivered through much of the decade-plus that followed the global financial crisis (GFC). The timing of this shifting trend is uncertain, but the direction appears clear.

Figure 1: Since late 2023, bond yields have been comparable to equity earnings yields

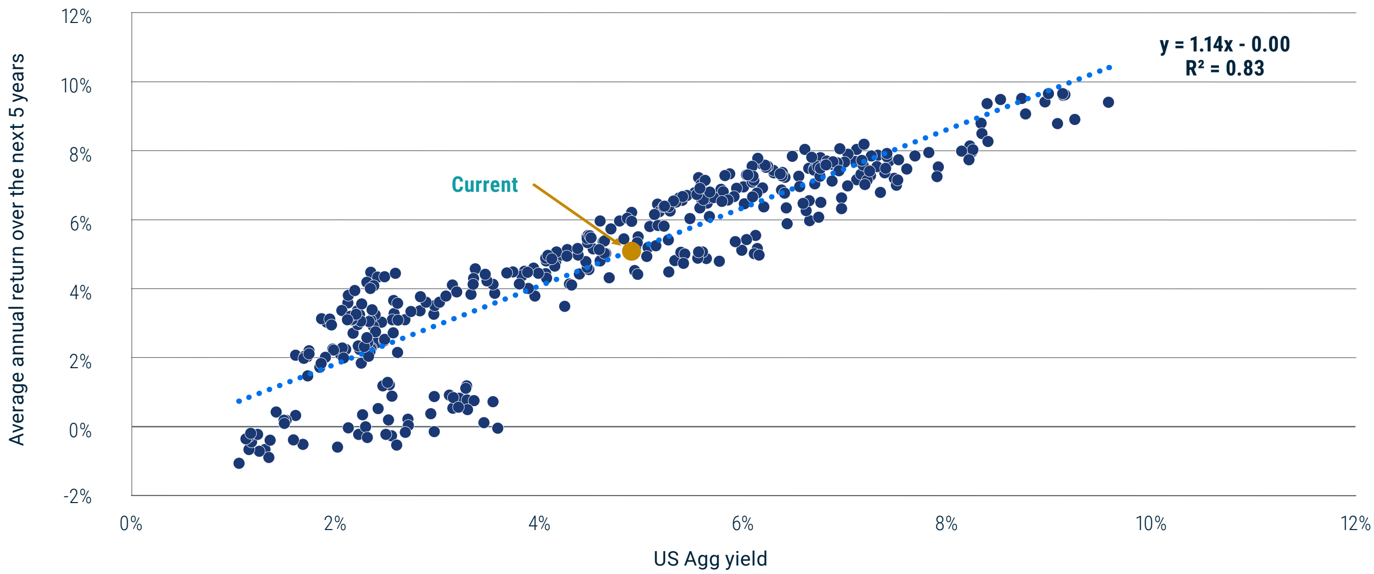
Equity earnings yields vs. bond yields through time



Source: Bloomberg and PIMCO as of 20 August 2026. Bond yields are represented by the yield-to-worst on the Bloomberg US Aggregate Index.

Figure 2: Starting fixed income yields historically have been a strong indicator of future expected returns

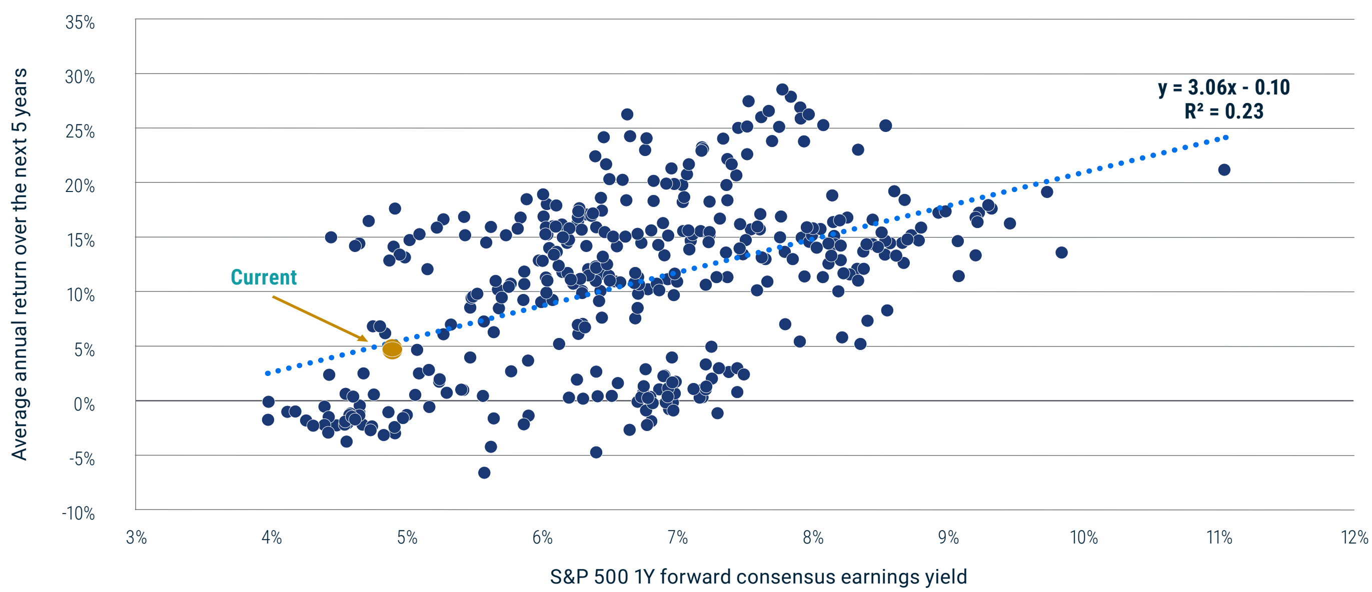
US Agg yields vs. 5-year average annual returns



Source: Bloomberg and PIMCO as of 27 August 2026. Date range for data (current yield and annualized returns over next 5 years) is February 1990 through July 2026. **Past performance is not a guarantee or a reliable indicator of future results.**

Figure 3: The relationship between equity valuations and future returns is less robust

S&P 500 valuations vs. average annual returns over the next five years



Source: Bloomberg and PIMCO as of 27 August 2026. Date range for data (1-year forward earnings yield and annualized returns over next 5 years) is February 1990 through August 2026. **Past performance is not a guarantee or a reliable indicator of future results.**

The challenge is amplified by unusually high U.S. equity market concentration. With index performance tied to a small group of companies (themselves heavily exposed to risks in the technology sector), headline equity exposure may be less diversified than it appears. Investors are therefore accepting full equity downside and concentration risk for relatively limited incremental expected return over high quality bonds.

To be clear, the point is not that bonds will necessarily outperform stocks, it is that their expected returns are now more comparable, while the risk distribution and the visibility of those returns are different.

Haven't bonds lost their ability to protect multi-asset portfolios?

No. But the hedge should be tested against high quality duration, not broad bond benchmarks that mix in credit risk.

Recent critiques argue that bonds failed to protect portfolios during equity sell-offs, such as the COVID shock or the 2022 episode. But many of these arguments make a category error by including investment grade corporate credit in the hedge. The classic stock/bond correlation hypothesis is more nuanced than "every bond rises when equities fall." It is *high quality* duration (interest-rate exposure), especially a government bond allocation, that is best positioned to mitigate portfolio risk when growth weakens and risk aversion rises.

Investment grade corporate bond returns are driven by two broad components: the base government bond yield and a spread component that, loosely speaking, compensates investors for taking default and liquidity risk. The government yield component provides a boost when growth slows and risk appetite weakens. But the spread component is different: it widens in bad states, when investors demand more compensation for bearing risk. That is what makes corporate credit a risk asset.

The same logic applies across credit markets, including high yield bonds, leveraged loans, direct lending, and other private credit. These assets may differ in structure and volatility, but they still embed compensation for default and liquidity risk. And while private assets may appear more stable because their valuations are updated less frequently and are not continuously tested through market-clearing transactions, smoother price marks suppress measured volatility but do not remove the exposure.

To be clear, this does not mean investment grade credit cannot deliver resilient total returns in an adverse economic scenario. The reason is that today's stronger yield support: higher starting yields provide a stronger buffer than the one investors had in the low yield era. In a conventional growth shock, that will likely allow declining Treasury yields to, at least partially, offset the impact of spread widening and thus mitigate portfolio risk. The key point is that this resilience comes from duration and income, not from the spread component itself.

Does duration still hedge equity drawdowns?

Historically, yes, though the relationship is nonlinear.

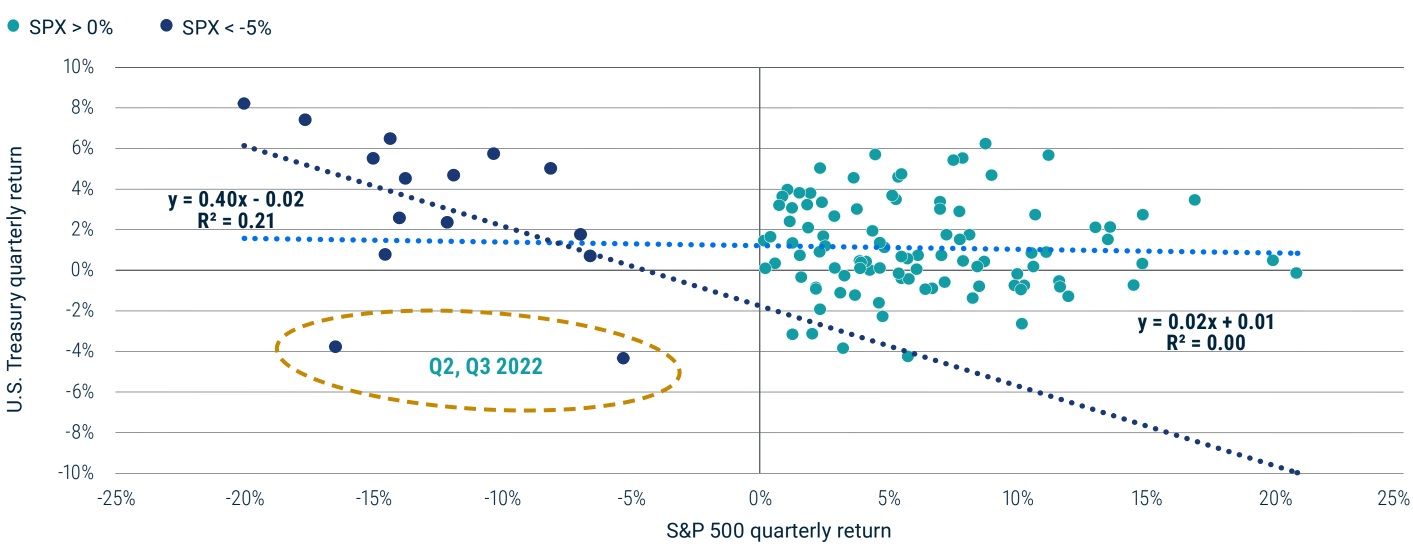
It's important to evaluate a hedge based on its performance when the risk it is designed to offset manifests – i.e., when it is doing its job of hedging. The hedge should not be judged by its average correlation across all environments.

As shown in Figure 4, Treasury returns have had little correlation with positive equity returns. But when the S&P 500 has fallen by at least 5% in a quarter, the relationship has been much stronger.

Put another way, duration's diversification benefits are most visible during meaningful drawdowns, not at every bout of volatility. A brief equity decline that does not change expectations for growth or monetary policy says little about duration's hedging capacity.

Figure 4: For decades, U.S. Treasuries have typically provided a hedge in longer equity selloffs

S&P 500 vs. US Treasury quarterly returns



Source: Bloomberg and PIMCO as of 30 June 2026, based on Bloomberg US Treasury Total Return Unhedged USD Index. The global financial crisis years of 2008 and 2009 are excluded. Observations are quarterly, from 1990 through the second quarter of 2026. **Past performance is not a guarantee or a reliable indicator of future results.**

Why did bond markets struggle in 2022?

Because very low starting yields offered little buffer against a major inflation shock and the abrupt tightening in monetary policy.

Figure 4 shows that duration failed to protect portfolios in 2022, but that negative return reflects two unusual conditions rather than a long-term breakdown: starting yields were exceptionally low, and markets were rebuilding inflation and term premia as policy adjusted away from a decade of near-zero rates and negligible inflation. With minimal yield support to absorb the shock, equities and government bond prices fell together, wiping out a decade's worth of fixed income gains. Even so, Treasuries' roughly 3.78% decline in the second quarter of 2022 was far milder than the 16.45% equity drawdown.

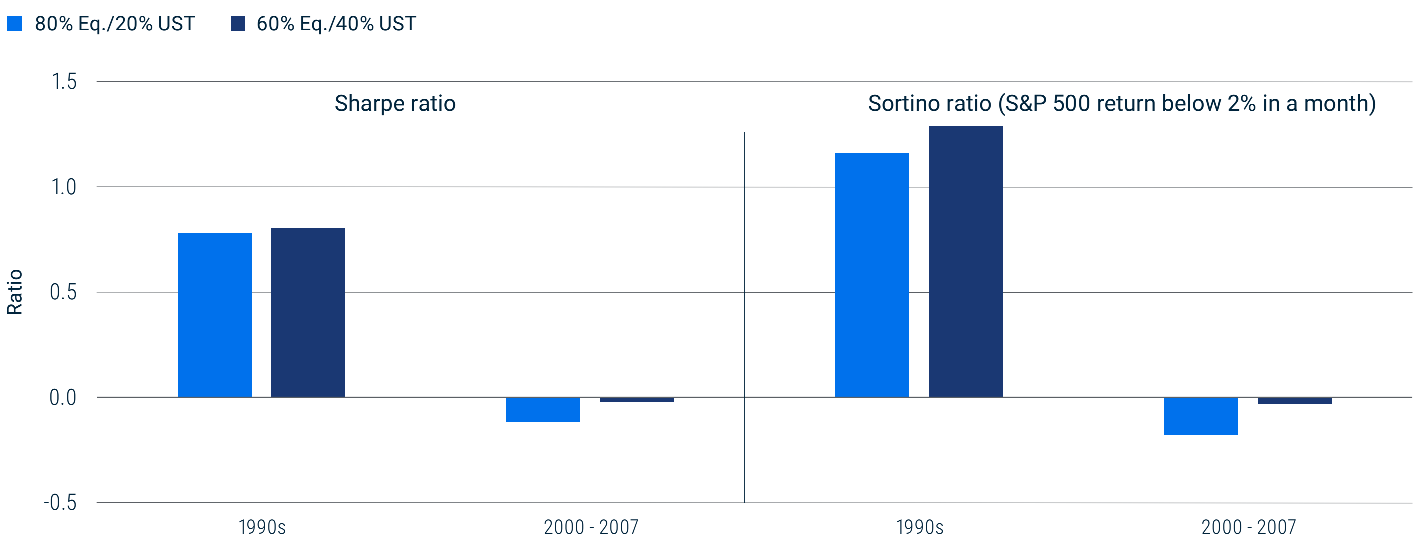
Today's starting point is different. Government bond yields can of course rise further, but they are now high enough to provide a meaningful buffer against price declines and reduce the risk of deeply negative total returns.

If starting yield is both an effective predictor of future bond return potential and a key determinant of defensive capacity, then 2022 is the wrong baseline. Higher-yielding periods such as the 1990s and early 2000s are more relevant comparisons given their resemblance to starting yields today (see Figure 5).

Another episode like 2022 is possible, but it would require many trends to align – and bonds yielding 4.5% nominally would behave very differently in such a scenario than bonds yielding 2%. The real-yield starting point also looks much healthier today. When the Fed began hiking in 2022, the 10-year Treasury real (or inflation adjusted) yield was negative (around -1%); today, it is near the high end of its range over the past two decades, at roughly 2.4%.

Figure 5: Higher starting yields have historically improved the risk-adjusted performance of balanced portfolios

Annualized performance ratios, monthly returns



Source: Bloomberg and PIMCO as of 31 July 2026. Equities are represented by the S&P 500 Index; bonds are represented by the Bloomberg US Treasury Total Return Unhedged USD Index. **Past performance is not a guarantee or a reliable indicator of future results.**

Could secular pressure on yields prevent duration from doing its job in the next downturn?

Not necessarily: Yields may settle at a higher long-run level, but they can still fall cyclically in recessions when growth weakens and disinflation takes hold.

Persistent fiscal deficits, rising debt, and debt-funded investment in areas such as AI infrastructure could put structural upward pressure on yields. Indeed, sovereign yields around the globe have risen in recent weeks amid related concerns. These forces are real, and today's U.S. fiscal trajectory is unusual for a peacetime economy near full employment (for more, see our 21 August 2026 PIMCO Perspectives, What's Pushing Long-Term Bond Yields Higher?).

But secular pressure on the level of yields should be distinguished from cyclical movements in yields during a downturn. Structural forces may raise term premia, keep yields higher in expansions, and prevent a return to post-GFC lows. They do not necessarily prevent yields from falling when growth weakens.

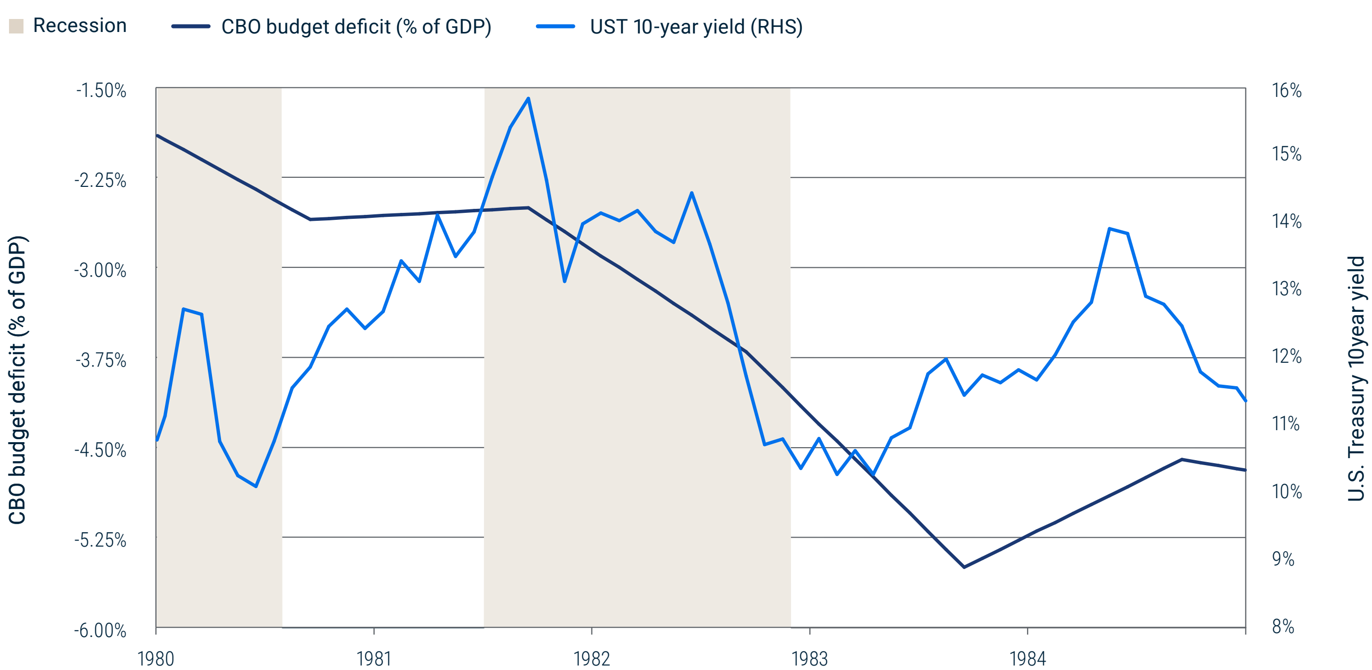
For example, from the 1970s through 1983, the U.S. federal deficit steadily widened, reaching 5.9% of GDP (see Figure 6). Yet duration – proxied by 10-year U.S. Treasuries – still provided relatively good risk-adjusted returns during the 1980 and 1981–1982 economic downturns as recession, disinflation, and falling policy rate expectations drove yields lower.

The takeaway is that fiscal risk is still relevant to bond investments (and broader markets), but fiscal deterioration need not prevent duration from doing its job – hedging macroeconomic risk – when cyclical weakness dominates. In a downturn, weaker demand, a wider output gap, and disinflation would likely lead to lower interest rates. High quality duration could therefore appreciate even if the longer-term equilibrium level of yields remains higher.

In other words, the secular and cyclical arguments can both be true. Yields may average higher over the next decade than they did over the past decade while still falling enough in recessions to provide an attractive portfolio hedge.

Figure 6: Despite deteriorating fiscal positions, duration still hedged portfolios against economic downturns in the early 1980s

US budget deficit vs. US Treasury 10-year yield (1980-1984)



Source: U.S. Congressional Budget Office (CBO), National Bureau of Economic Research (NBER) recession data, Bloomberg, and PIMCO as of 31 July 2026.

Does the opportunity set extend beyond U.S. duration?

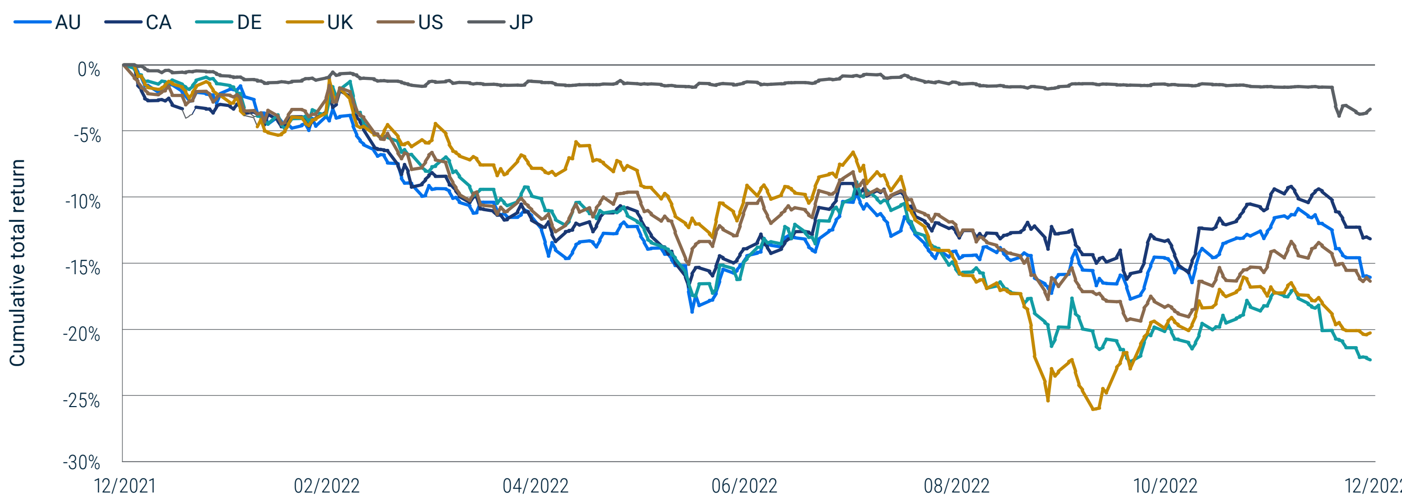
Yes. The global opportunity set appears to have improved because yields are higher and economic and policy paths are less synchronized.

In 2022, yields across most developed markets rose together as central banks responded to a common inflation shock. That synchronization limited geographic diversification and produced a coordinated fixed income sell-off (see Figure 7).

Today's backdrop is more dispersed. Differences in growth, inflation, fiscal policy, and central bank reaction functions create more scope for country selection, curve positioning, and relative value (see Figure 8). Investors today are being paid more to own duration and have more ways to actively express duration views than during the synchronized adjustment of 2022.

Figure 7: Low starting yields and synchronized inflation shocks drove the global fixed income sell-off in 2022

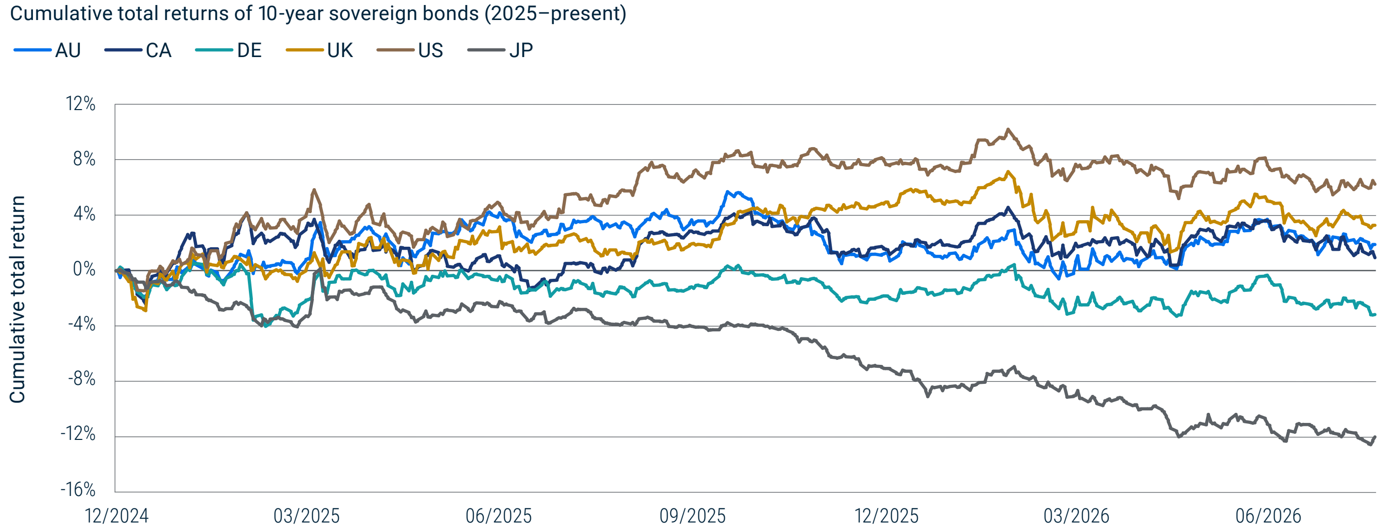
Cumulative total returns of 10-year sovereign bonds (2022)



Source: Bloomberg, Haver, PIMCO as of August 2026. Figures show sovereign total returns from the 10-year point on the curve from the on-the-run sovereign bond for the respective countries. **Past performance is not a guarantee or a reliable indicator of future results.**

Figure 8: Greater macroeconomic dispersion has expanded the opportunity set for active duration management

Cumulative total returns of 10-year sovereign bonds (2025–present)



Source: Bloomberg, Haver, PIMCO as of 31 August 2026. Figures show sovereign total returns from the 10-year point on the curve from the on-the-run sovereign bond for the respective countries. **Past performance is not a guarantee or a reliable indicator of future results.**

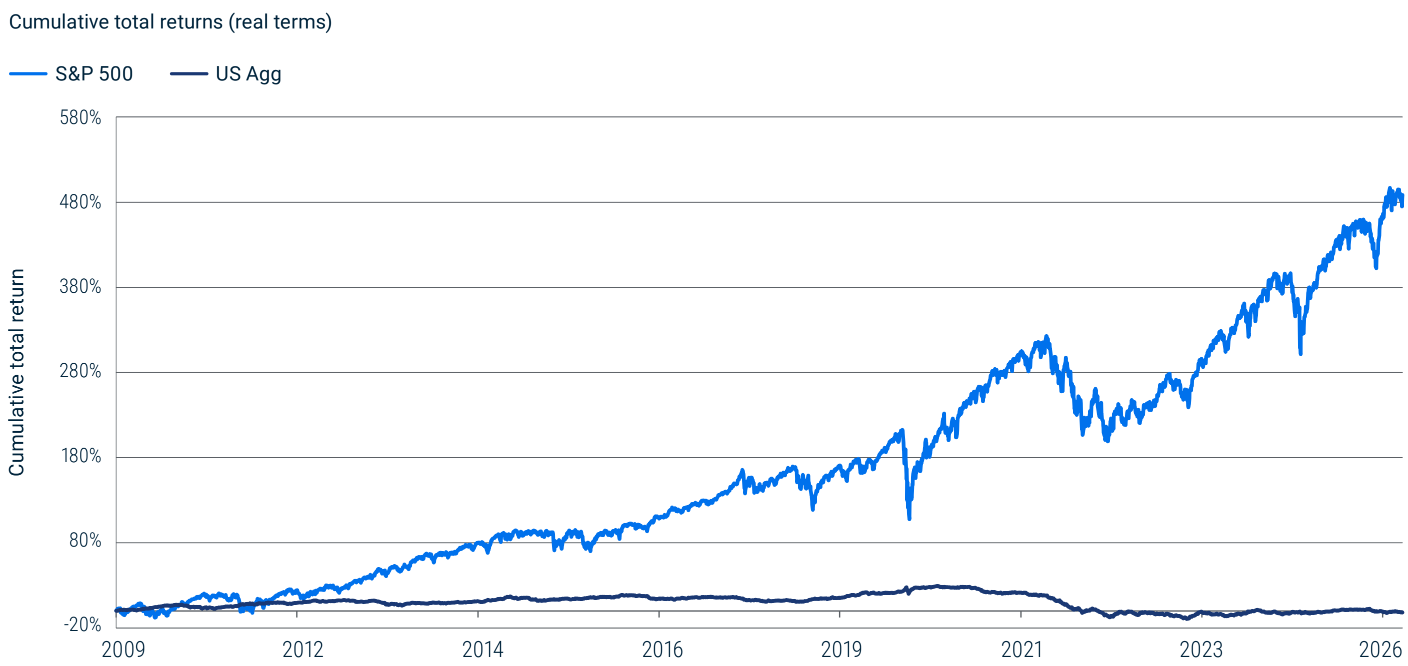
If the opportunity in bonds is so compelling, why has positioning been slow to adjust?

Old habits die hard.

For much of the past 16 years, investors who chose bonds over stocks felt punished, especially given the cumulative returns in the buoyant stock market (see Figure 9). From 2010 through August 2026, the S&P 500 grew more than eightfold in nominal terms and almost fivefold in real (inflation-adjusted) terms, while the Bloomberg US Aggregate Index returned just over 2% annually on average. In the post-COVID years, those modest bond returns weren't even enough to preserve purchasing power. The most striking year came in 2022, when the US Aggregate Index fell roughly 13% and investors learned that a 10-year U.S. Treasury yielding about 1.5% could still suffer a double-digit loss (again Figure 9).

Many investors who endured those losses years ago haven't returned to bonds. That experience still shapes the relative allocation of multi-asset portfolios today. U.S. households hold a record share of their financial assets in equities, public and private pension allocations remain heavily tilted toward stocks (see Figures 10 and 11).

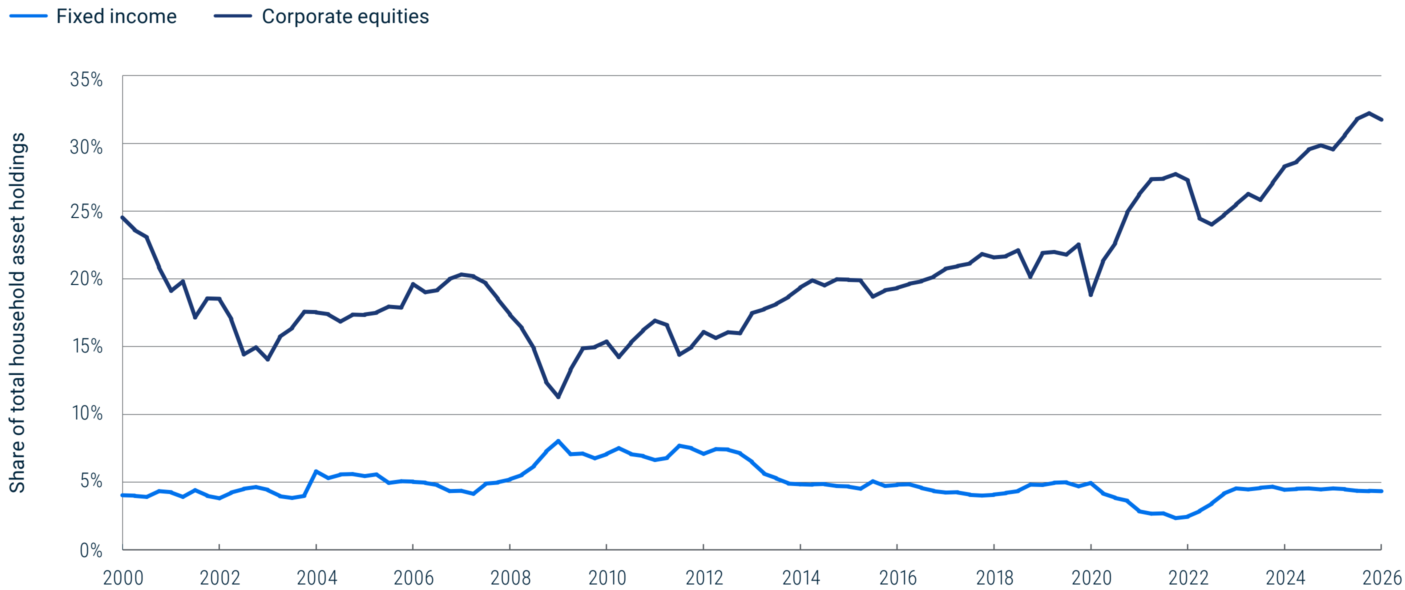
Figure 9: During 2022, the real gains from fixed income over the previous decade were wiped out



Source: Bloomberg, Haver, PIMCO as of 31 August 2026. Figures show sovereign total returns from the 10-year point on the curve from the on-the-run sovereign bond for the respective countries. **Past performance is not a guarantee or a reliable indicator of future results.**

Figure 10: U.S. household equity allocations have reached a record high

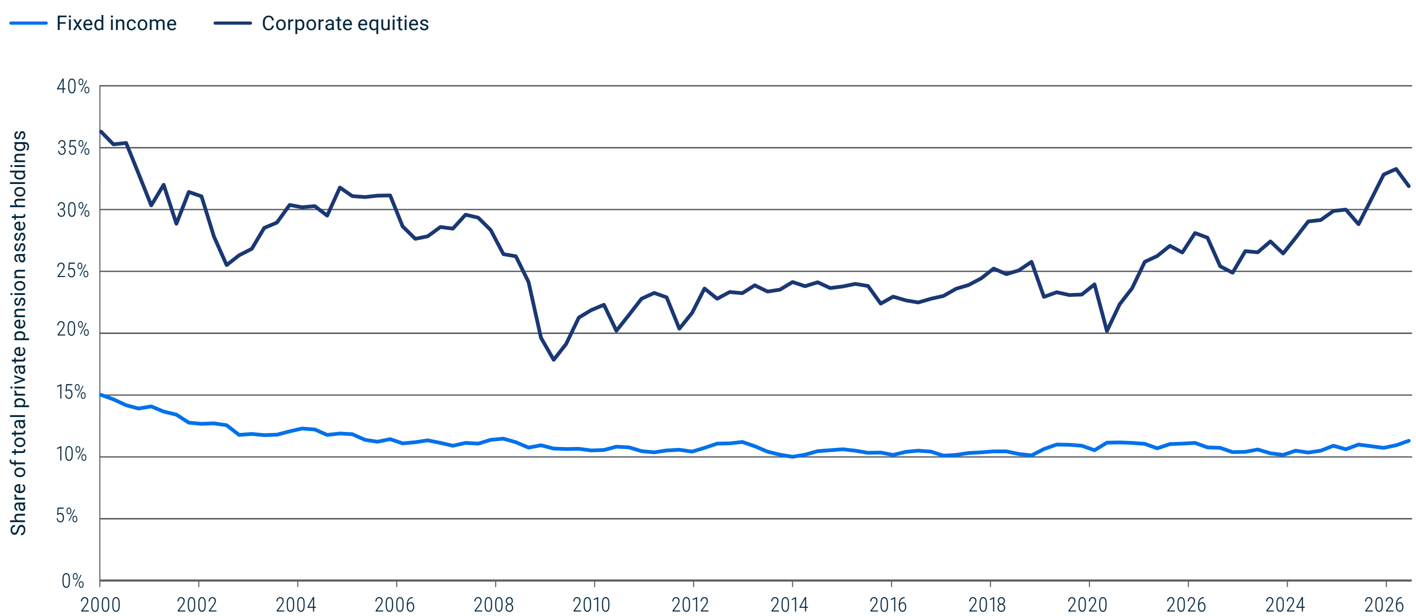
Share of total household asset holdings



Source: Bloomberg, Haver, Federal Reserve Flow of Funds data, PIMCO as of 31 July 2026. Fixed income includes government bonds, corporate bonds, municipal bonds, agency bonds. Corporate equities include directly held corporate equities, including closed-end fund, exchange traded fund, and real estate investment trust shares.

Figure 11: U.S. pension portfolios remain heavily tilted toward equities

Share of total private pension asset holdings



Source: Bloomberg, Haver, Federal Reserve Flow of Funds data, PIMCO as of 31 July 2026. Fixed income includes government bonds, corporate bonds, municipal bonds, agency bonds. Corporate equities include directly held corporate equities, including closed-end fund, exchange traded fund, and real estate investment trust shares. Dataset combines private pension funds, state and local government employee retirement funds, and federal government retirement funds defined benefit plans and defined contribution plans.

What is the bottom line for multi-asset investors?

We believe a more balanced allocation is warranted at this stage of the cycle. The case for owning bonds today isn't that they'll outperform equities – it's that they can once again deliver meaningful income potential and real downside mitigation, two functions low yields had stripped away for over a decade.

Gabriel Cazaubieilh contributed to this report.

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