PIMCO

Income Strategy Update: Focus on Stability Amid Turbulence

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We maintain a focus on resiliency as elevated yields within high quality fixed income continue to offer attractive opportunities.

Summary

- Despite some exemptions, pauses, and negotiations around U.S. tariff policy, trade-related uncertainty remains elevated, driving continued market volatility and underscoring our conviction in high quality, globally diversified fixed income.
- Equity valuations remain tight, and with the potential for front-end interest rates to come down in the second half of the year, intermediate-maturity fixed income remains attractive versus both equities and cash, in our view.
- With a flexible, global toolkit and robust liquidity, the Income Strategy remains well-positioned to capitalize on opportunities amid volatility.

Markets have roiled from the dramatic and evolving tariff policies of the Trump administration. Here, Dan Ivascyn, who manages the PIMCO Income Strategy with Alfred Murata and Josh Anderson, responds to questions from Esteban Burbano, fixed income strategist, about market volatility and uncertainty. They discuss the importance of stability in this uncertain macro environment and the attractive opportunities in bonds, as yields remain high.

Q: Markets have been volatile as the Trump administration pursues a new tariff regime. How do you view the volatility in the context of the macro environment?

A: This period of volatility is unique in that it is related to a conscious policy decision and style of implementation rather than an exogenous shock. We had expected uncertainty from President Donald Trump's policies, as he widely telegraphed that resetting global trade would be a key priority. Trump has been a proponent of tariffs since the 1980s, long before he held office. But we, and many others, were surprised by the absolute level of tariffs and the Trump administration's method of calculating them.

The macro ramifications could be troubling. We believe the extreme level of proposed tariffs announced on 2 April would meaningfully raise the chances of a U.S. recession and higher inflation. Subsequent negotiations and reprieves have lowered the temperature somewhat, but trade-related uncertainty is likely to persist.

Our base case is there will be further productive negotiations with many of the U.S.'s trading partners seeking to limit or avoid reciprocal tariffs, while the universal 10% tariffs will remain. More targeted tariffs on select industries are likely here to stay.

While April's market volatility was significant – and many investors were unnerved in particular by the sharp rise we saw in the 10-year U.S. Treasury yield – bond yields overall remain high and are attractive in our view, both in absolute terms and relative to other segments of the market. Additionally, we expect such periods of uncertainty and volatility to create opportunities.

Q: The dramatic market volatility has led to some questions about whether markets remain well-functioning. What are you seeing?

A: Markets are functioning fine; they're just moving around a lot. As with previous episodes of volatility, we see some early selling in higher-quality assets as investors liquidate what they can to de-risk, deleverage, or raise liquidity. This in turn can lead to some spread widening in the higher-quality segments of bond markets. These segments are generally default-resistant, in our view, with limited material risk of downgrades or defaults.

However, we are mindful of more credit-oriented borrowers that are highly leveraged. A recessionary shock at a time when covenants are weak and spreads are tight could pose challenges, and there's arguably a bit of complacency in these markets.

As a result, we continue to believe in this environment that it's wise to maintain resilience by focusing on high quality assets and by seeking stability, as we mention in our latest *Cyclical Outlook.*

Q: How do you see the Federal Reserve navigating this period of uncertainty?

A: The Fed is in a difficult position, facing the potential for stagflation. As I said, tariffs could accelerate inflation even further above the Fed's target, and even if we see enduring trade deals, inflation is likely to remain elevated for longer. At the same time, these trade policies can weigh on growth.

We expect the Fed will look for greater clarity over tariffs and other policies of the Trump administration. We think it's likely the Fed will be patient to the degree that markets continue to function in an orderly manner, and Fed officials will be very careful about appearing to provide more direct stimulus to the economy at a time when inflation is running above central bank targets. That said, a sharp decline in economic data, especially if unemployment rises significantly, could prompt the Fed to cut rates more aggressively in the latter half of 2025.

Q: With such extreme volatility, how should investors think about bonds versus other assets?

A: Things are highly fluid, but as of this conversation, while equity valuations have loosened somewhat, they remain tight on a historical basis, particularly when compared with high quality bonds. Similarly, credit spreads have widened but still remain relatively narrow versus recent history.

An interesting question now is why have valuations in riskier assets not sunk further? One reason is very powerful technicals – think of a coil wound tight. A great deal of credit has shifted to private markets, where it's not typical to mark to market that risk. Another reason is that recent market volatility has clearly resulted from Trump administration policy decisions, with investors unsure of the extent to which the administration will calibrate policy to market reactions.

The silver lining is that if investors get greater clarity on the administration's reaction function, markets could snap back, particularly in those higher-quality areas where spreads have widened recently. Indeed, we have already seen the administration appear to demonstrate some sensitivity to Treasury market moves, and how markets can rebound following adjustments in tariff policy.

Q: How are you thinking about duration and curve positioning in this environment in the context of the Income Strategy?

A: We are generally neutral to slightly overweight on duration, but if the market overshoots, we would certainly consider adding a bit more interest rate exposure.

Considering the significant macro and policy uncertainty, we are generally underweight the long end of yield curves, favoring more short- to intermediate-term maturities. And alongside U.S. exposures, we continue to diversify our interest rate risk globally, favoring the U.K. and Australia, for example. Additionally, duration in Europe is an interesting space to watch as parts of the region commit to greater spending on defense.

Q: How are you thinking about credit and positioning credit exposure in the Income Strategy?

A: We continue to see attractive return potential in higher-quality assets, especially as we have seen some repricing while fundamental risks have not appeared to increase. Despite credit spreads becoming gradually more attractive, we remain patient given elevated uncertainty, and we stand poised to add credit exposure should we see more significant selling of corporate cash bonds. Currently, we tend to maintain a preference for senior structured credit.

Consumer asset-backed risk remains generally resilient, in our view, as U.S. consumers overall are in a fundamentally strong financial position. For years, home prices have risen, and we are seeing loan-to-value ratios across pools of mortgage assets below 50%. Such homeowners are compelling prospects to provide an auto loan or co-sign on a student loan. We also look for opportunities globally to capitalize on attractive consumer fundamentals outside of the U.S.

Q: What are your views on agency mortgage-backed securities (MBS)?

A: Agency MBS continue to look attractive on a relative basis. While we have seen some spread widening versus Treasuries amid recent interest rate volatility, the asset class has generally performed well this year, exhibiting its traditional defensive characteristics. We continue to have the unusual situation where agency mortgage spreads are actually wider than investment grade corporate spreads, allowing us to pick up additional yield in an asset class that benefits from a U.S. agency or U.S. government guarantee.

To that point, our base case is that the mortgage agencies (often called government-sponsored enterprises or GSEs) will likely remain part of the U.S. government. Outside of the base case, if the Trump administration looks to privatize the GSEs, we believe privatization would be done in a way that maintains the high quality of agency MBS.

Q: How is the Income Strategy positioned in emerging market (EM) investments?

A: We remain selective in our exposure to emerging markets given broader geopolitical and macro uncertainty. Nonetheless, we maintain a modest allocation to EM debt as a source of yield and diversification, focusing on countries with attractive levels of real yield versus the U.S.

While we anticipate continued trade tension with China, negotiations with trading partners in Southeast Asia and South America may provide a favorable tailwind for longer-term performance.

Q: Finally, let's end on currencies. While not necessarily a large portion of the Income Strategy, currencies are a critical component of a global toolkit. What are your views on the U.S. dollar versus other currencies?

A: The administration's policies could lead to further dollar weakness over the long term. Strong demand for the dollar has long reflected both its status as the global reserve currency and U.S. exceptionalism, the latter of which has been at least partially eroded over the last couple of months. Thus, we are tending to maintain a slight underweight to the dollar with an eye to move further underweight as markets develop. (For details, please see our recent *PIMCO Perspectives*, "Trade Wars and the U.S. Dollar.") With the adjustments to global trade underway, we see a very exciting environment to take advantage of relative value in currency trading across a handful of developed and emerging market currencies.