

Income Strategy Update: Focused on Optimizing Income Amid an Evolving Rate Market

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We see compelling opportunities for fixed income investments amid economic uncertainty and optimistic equity valuations.

Summary

- With high starting yields, high quality fixed income looks attractive, in our view, as the Federal Reserve has resumed easing and equity valuations remain lofty.
- We favor an overweight to agency mortgage-backed securities in the Income Strategy, given their higher quality and attractive yields versus investment grade corporates.
- We continue to see attractive return potential and resilience in senior structured credit, particularly investments linked to higher-income consumers. We have more limited exposure to corporate credit, given tight spreads.

Fixed income markets continue to enjoy elevated yields, adding to their appeal as the U.S. Federal Reserve (Fed) cuts rates and equities continue to reach all-time highs. Here, Dan Ivascyn, who manages the PIMCO Income Strategy with Alfred Murata and Josh Anderson, responds to questions from Esteban Burbano, fixed income strategist. They discuss the macroeconomic landscape and how the investment team is positioning the Income Strategy in the current environment.

Q: PIMCO's latest *Cyclical Outlook, "Tariffs, Technology, and Transition,"* analyzed growing tension among macro forces. How might this shape the global economic landscape?

A: The Trump administration's trade policy continues to create uncertainty. Tariffs are likely to put some downward pressure on growth with perhaps a bit of upward pressure on inflation, at least over the next few months.

Meanwhile, enthusiasm for AI and technological innovation – and the related capital spending – supports growth and may help offset tariff-related uncertainty.

We expect the net effects will include positive but limited growth in the U.S. – perhaps in the 1.5% to 2% annualized range – with a relatively low risk of recession, while economies outside of the U.S. may face greater challenges. Overall, we expect global growth will return to a trend-like 3% pace in 2026, with near-term risks tilted to the downside.

With tariffs exerting upward pressure on prices, inflation in the U.S. will likely remain above the Federal Reserve's 2% target over the near-term horizon. Longer-term expectations priced into markets suggest inflation will trend down over time.

We are cautiously optimistic about the outlook for modest growth amid notable uncertainty. But I'll note that today's record equity valuations and tight credit spreads reflect potentially excess optimism.

Q: What is our outlook for the Fed and other central banks?

A: Most central banks will likely continue easing. At the Fed, we think we could potentially see another cut in December or January, but it depends on macro data. Eventually, the fed funds rate should settle at about 3%. The Fed also announced the end of balance sheet reduction, yet we do not anticipate it will add to the balance sheet anytime soon. The bottom line: We see the Fed willing to provide some accommodation, especially if it sees further weakness in the labor market, but its approach is likely more data-dependent.

The Bank of England and Reserve Bank of Australia appear likely to cut more aggressively in the coming months as disinflation resumes, while we expect the European Central Bank and Bank of Canada – which are closer to neutral policy levels – will make smaller adjustments. The Bank of Japan remains an exception, with policy below neutral.

Q: What is PIMCO's outlook on the U.S. dollar, including its status as the world's reserve currency?

A: We do not think the dollar is at risk of losing its reserve currency status. However, we expect holders of the dollar or dollar-denominated assets to gradually diversify away over the next several years. Reasons for this could include the expensive levels of U.S. financial assets as well as U.S. trade and fiscal policy and related uncertainty.

This diversification theme is one reason we favor a slight underweight to the dollar, even though it is off its peak value from late last year. Of course, the dollar may be prone to bouts of strength.

Q: How are you thinking about positioning in the Income Strategy, beginning with interest rate risk?

A: This is an exciting environment for active investing. Given still-elevated yields in the U.S. and other developed markets, such as the U.K. and Australia, we see value in high quality interest rate exposure (i.e., duration) in the Income Strategy. Our duration is in the 4- to 5-year range, albeit lower than it was earlier in the year when the 10-year U.S. Treasury yield was closer to 5%.

For some time, we have anticipated a steeper yield curve, particularly in the U.S., and have tended to concentrate our rate exposure in short to intermediate maturities. This has played out well this year as the long end of the yield curve has underperformed meaningfully. As Fed rate cuts have been priced into the front end of the curve, we have shifted some exposure from one- or two-year maturities to the five- to 10-year maturity range.

We also maintain selective exposure in other high quality sovereign bond markets with attractive yields, such as the U.K. and Australia.

A final point: Historically, starting yields have strongly indicated a bond portfolio's total return potential going forward. We view that as an attractive proposition when U.S. inflation is at 3%, equities are at all-time highs, and credit spreads are extremely tight.

Q: Agency mortgage-backed securities (MBS) remain a focus in the Income Strategy. What is your outlook for the position?

A: We continue to like agency MBS. They have been trading at wider spreads than investment grade corporates, which is highly unusual as corporates tend to be more sensitive to economic fundamentals. Also, the market for agency MBS offers an attractive liquidity profile, enabling us to remain nimble.

Agency mortgages tend to benefit from periods of low interest rate volatility, which has generally been the case this year, though the situation is evolving. Agency MBS also tend to perform well when the yield curve steepens as the Fed cuts short-term rates. Also, the Fed ending its balance sheet reduction should be another tailwind for the asset class.

We are often asked about the potential privatization of the government-sponsored enterprises (GSEs). Treasury Secretary Scott Bessent has clearly stated that any action on the GSEs must not raise borrowing costs or disrupt the mortgage market. Thus, we see privatization as a minor risk.

Q: With corporate credit spreads tight, where are we seeing opportunities?

A: We see generally solid fundamentals in the corporate credit sector; the economy has avoided a sustained period of economic weakness for some time. However, at these tight spreads and considering the uncertain macro outlook, we prefer more limited exposure to corporate credit in the Income Strategy. Instead, we favor other fixed income segments with more attractive relative value, such as higher-quality structured products.

We favor senior structured credit and investments linked to higher-income consumers. In aggregate, the U.S. consumer is in a good position after years of positive home price appreciation and balance sheet strengthening in the more carefully regulated markets that followed the global financial crisis.

We are less interested in floating-rate segments of the market, broadly syndicated loans, or mid-market direct lending. Those borrowers tend to have leveraged business models or capital structures and could be vulnerable to technological disruption or significant economic weakness.

Overall, we do seek to be opportunistic in the sector, looking for unique credit situations where we can leverage the firm's size and sourcing capabilities to find investments that are more attractive than generic forms of corporate credit.

Q: We have received questions from clients about what a rate-cutting cycle means for yields going forward. How are you thinking about this in the context of the Income Strategy?

A: Considering valuations from a multiyear perspective, we believe high quality yields remain quite attractive today, especially when one considers elevated equity valuations and tight credit spreads.

As I mentioned, we believe this is an optimal environment to construct a high quality, globally diversified portfolio with an attractive starting yield and potential opportunities to add alpha.

With the Fed cutting, the return on cash is coming down, and soon the rate on cash could approach that of the lowest yield on the Treasury curve. Investors with a significant cash position may want to consider moving out along the yield curve and locking in higher rates for years to come.

Q: Any final thoughts?

A: At a high level, what we're aiming to do today is to take advantage of the full toolkit we have as active global investors to target more liquid and higher-quality areas of the market, and to construct a highly diversified portfolio of income-oriented assets.

If there is an unanticipated shock to markets and the economy, then we believe the Income Strategy is positioned to remain resilient. It's poised to mitigate the downside and maintains the flexibility to target attractive opportunities in that kind of environment. We don't anticipate such a challenging environment as a base case, but we've focused on building a robust, resilient portfolio that seeks to deliver attractive income across a range of macro and market scenarios.

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