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Income Strategy Update: Standout Returns, Powered by Active Management

We believe today's mix of attractive starting yields, global economic divergence, and shifting markets create a compelling environment for active fixed income.

SUMMARY

- Global divergence and elevated valuations create a powerful backdrop for active fixed income.
- We are actively capitalizing on opportunities globally, including high quality securitized assets, selective exposure to emerging markets, and relative value rate and currency positions with the aim of enhancing yield and diversification.
- We remain focused on resilience and flexibility, emphasizing high quality assets, diversified global exposures, and the ability to capitalize on evolving yield curve and credit conditions through active management.

Fixed income investments had a strong year in 2025, and the backdrop heading into 2026 continues to look very constructive. Attractive starting yields, diverging global economic conditions, and changing markets have created what PIMCO believes is one of the best opportunities for active fixed income in over a decade. Here, Dan Ivascyn, who manages PIMCO Income Strategy with Alfred Murata and Josh Anderson, answers 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, "Compounding Opportunity," discusses a world defined by divergence. How might this widening dispersion influence the investment landscape?

A: We live in a world with less correlated growth paths and policies globally, which presents an exciting backdrop for active investment management. At the same time, equity valuations remain elevated and cash rates across many markets are moving lower, while intermediate- to longer-maturity fixed income continues to offer attractive value.

In the U.S., we expect strong absolute and relative growth supported by solid fundamentals for middle- and upper-income households, locked in low mortgage rates, and broad tailwinds from artificial intelligence (AI), technology, and energy infrastructure capital expenditures. Fiscal stimulus from last year is still filtering through as well. While inflation will likely stay above the Fed's target and remain bumpy, we expect it to trend lower over the year.

Outside the U.S., many economies appear more fragile as they lack several of these factors supporting the U.S. economy. The global divergence in growth trajectories and shifting policy trends are creating significant opportunities as markets become less correlated.

Q: You mentioned strong growth and easing inflation. What risks or disruptions could challenge our outlook?

A: There are meaningful risks to keep in mind. We've already seen substantial geopolitical tension year-to-date – developments in Venezuela and Greenland caught markets off-guard and continue to add uncertainty. The U.S. administration's broader foreign policy approach has come into focus. There is also fundamental uncertainty around inflation; it remains above central bank targets in the U.S. and in other regions such as Japan, Australia, and the U.K.

All of this means we're likely to see continued differentiation across global economies, along with ongoing inflation-related risks. But these dynamics also create opportunities in global diversification for active managers – whether through thoughtfully sized local-rate positions or selective currency exposures. When managed appropriately, these positions may not only contribute to attractive income profiles but also to compelling all-in return potential.

Q: What's our outlook for the U.S. Fed and other central banks?

A: Most developed market (DM) central banks are looking to cut rates as inflation moves closer to target. We expect broad-based easing across DM, with Japan as the key exception, where market dynamics may push rates higher. In the U.S., growth should stay solid, and we think the Fed will aim to lower the policy rate, probably later this year, down toward about 3%. That said, the path remains highly data-dependent. Given this backdrop, our positioning is more balanced, maintaining flexibility to take advantage of localized volatility.

Q: What's our outlook on the U.S. dollar amid easing, fiscal pressures, and shifting global investment?

A: The dollar looks fairly valued to slightly expensive, so we're maintaining a modest underweight. The more compelling opportunity is in relative value across increasingly unsynchronized global cycles. Local currencies and non-U.S. rates continue to offer attractive avenues for diversification and potential return.

Q: How would you summarize Income Strategy's positioning for 2026?

A: The Income Strategy is positioned with a focus on resilience and flexibility, especially as parts of the market – corporate credit and equities in particular – continue to be priced for perfection. We're prioritizing diversification and focusing on keeping liquidity high so we can respond quickly if markets move too far. That means staying cautious on areas where spreads do not adequately compensate investors for economic sensitivity, keeping a clear tilt toward higher-quality assets, and using our global toolkit to target attractive yields.

From a rates perspective, we're maintaining slightly lower duration relative to the aggregate bond benchmark but concentrated in the intermediate part of the curve (5–10 years), which we believe offers a better balance of attractive yield and flexibility. We remain less constructive at the very long end of the curve. Geographically, we've broadened exposure across the U.K., Australia, and select emerging markets (EM), including Colombia, South Africa, Brazil, and Mexico. While these allocations tend to be conservative, they are intended to enhance both yield and diversification.

Yield-curve steepening was one of our highest-conviction themes last year, and as valuations evolve, longer maturities are starting to look more appealing. We expect they may play a bigger role later in 2026 as the opportunity set continues to shift.

Q: How are we thinking about credit today across both structured credit and the broader corporate credit markets?

A: In structured credit, we continue to emphasize higher-quality segments – areas supported by strong underwriting and healthy household balance sheets. That includes consumer-focused exposures such as residential mortgage credit, auto asset-backed securities (ABS), private student-loan ABS, and lending to middle- and upper-income borrowers. We're also active in the U.K. and Australia securitization markets, where senior tranches still offer attractive risk-adjusted return potential. By contrast, we're more selective in infrastructure-related deals tied to technology and energy buildouts. These opportunities can be compelling but tend to carry more volatility and behave more like corporate credit.

Across public and private corporate credit, spreads remain tight. Although performance has been strong since the global financial crisis, we're seeing early signs of deterioration, including a few notable defaults. In this environment, we remain cautious on generic corporate credit beta and continue to favor higher-quality government and mortgage-backed exposures. This positioning helps keep the portfolio defensive while preserving ample liquidity – giving us the flexibility to seek to capitalize on technical reversals or bouts of volatility that may offer more attractive entry points.

Q: Has our view on agency mortgage-backed securities (MBS) changed given recent policy developments?

A: Our overall view on agency MBS remains constructive. The sector has been a key position thanks to strong liquidity, high quality credit, and historically attractive valuations – those fundamentals are unchanged.

What has shifted is the technical backdrop. The Fed's balance-sheet runoff had pressured the sector, but the Trump administration's agency-buying program tightened spreads and boosted recent performance. With spreads now narrower, our conviction in the position has moderated a bit, and we may adjust exposure as conditions evolve. Even so, agency MBS continues to offer solid relative value versus tight corporate spreads and remains an important defensive anchor in the portfolio. Active positioning across coupons, maturities, and structures should continue to add value as we move forward.

Q: You mentioned having exposure to EM. What's our approach to EM in Income Strategy?

A: EM delivered strong results last year and still looks attractively valued relative to more crowded areas. We use EM exposure with the aim to enhance yield and diversification through high quality EM currencies, certain local sovereign opportunities, and select special situations sourced by our EM team. While the allocations are measured, they contribute nicely to the strategy's overall diversification.

Q: Any final thoughts?

A: At a high level, the Income Strategy aims to take advantage of the full toolkit we have as active global fixed income investors to construct a highly diversified portfolio of income-oriented assets.

It's important to note that starting yields tend to be strong predictors of long-term returns, and today's yields support a compelling three- to five-year outlook. While cash rates are expected to fall and equity valuations remain stretched, we believe fixed income continues to provide a robust value proposition supported by global diversification and flexibility.

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