Income Strategy Update: Where Income Meets Resilience

Group CIO Dan Ivascyn explains why resilience, quality, and global diversification matter more than reaching for risk amid geopolitical conflict, credit stress, and the AI boom.

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- **Uncertainty is certain:** respond with resilience. With geopolitical conflict, stress in private credit, and AI rapidly reshaping markets, the Income Strategy is leaning defensive, favoring quality, liquidity, and global diversification instead of reaching for incremental risk.
- **Bonds look cheap:** let yields do the heavy lifting. Yields across high-quality fixed income remain near 20-year highs and attractive versus both cash and equities. Elevated starting yields represent a meaningful return driver.
- **The opportunity set is ripe:** remain diversified. The most compelling opportunities span agency mortgages, securitized credit, and government bond markets across developed and emerging markets, while corporate credit exposure sits near all-time lows as spreads remain tight. We are staying nimble to step in as stress creates entry points.

Markets are contending with conflict in the Middle East, growing stress in private credit, and an AI boom with the potential to reshape the global economic landscape. PIMCO Group CIO Dan Ivascyn talks with strategist Prerna Gupta about the importance of emphasizing resilience with high quality bonds.

Q: Over the secular horizon across the next five years, what forces will drive the global economy, and what are the implications for investors?

A: Uncertainty is the one constant, and it continues to rise. Politics and geopolitics are increasingly driving economic outcomes rather than the reverse – we're seeing it in tariffs, in the Middle East, and in tensions between China and the West. With inflation still elevated and limited fiscal space, central banks and governments have less room to steer markets, and economies are becoming desynchronized. That brings more risk, but also more room for active management to add value, with clearer winners and losers worldwide.

Technology is another big theme we highlighted in our *Secular Outlook*. In our base case, we believe that over the long run, AI should support productivity and growth and be disinflationary over time. The AI boom is widening gaps between economies, with countries tied to AI innovation, such as the U.S., Korea, and Taiwan, doing well while much of continental Europe lags. That gap is generating relative value opportunities.

Q: With so much happening at once, how does PIMCO expect growth and inflation to play out in the near term, and what could push things off course?

A: The conflict in the Middle East has led to an energy shock that looks to be escalating again. That means inflation may stay above target for longer, with risk on both sides. Higher near-term inflation brings potential central bank tightening back into the equation, and with equity and credit valuations elevated, that could lead to downside volatility. That said, if the conflict settles down, energy prices could normalize, while AI can generate disinflationary pressures.

Growth is a similar story. Energy shocks usually create inflation problems first. But if they aren't resolved quickly, they can tend to evolve into growth problems. PIMCO's base case assumes some stability in the Middle East, and we remain positive on growth in the U.S. and in other economies benefiting from new technology. We're cautiously optimistic, and we are stress-testing portfolios against scenarios where inflation stays high and growth slows. That combination can be difficult for credit markets, and it's why we're leaning toward resilience in our income strategies.

Q: With central bank policy diverging, how are you thinking about the Fed for the rest of the year under the new chair?

A: We've been encouraged by Federal Reserve Chair Warsh so far. For now, the Fed's focus appears to be getting inflation under control. Right now, we expect the Fed to hold rates steady through year-end, though that's very data dependent. We lean slightly toward rates ending lower than the market expects. Encouragingly, there are many ways to seek returns today that do not depend on forecasting the Fed's next move.

Q: In a market where resilience matters more than reaching for risk, how is the team positioning the Income Strategy, including duration and yield curve exposure, to pursue attractive income and capital appreciation?

A: Our focus remains on delivering a steady, competitive income stream and seeking to preserve capital across market conditions, while still pursuing capital appreciation. Yields in the higher-quality parts of the market are about as high as we've seen in roughly 20 years, and not just in the U.S. Some of the more attractive opportunities are abroad, in economies running smaller deficits with stronger credit quality, or areas that are less prone to overheating because they aren't riding the same AI boom. By actively managing a global opportunity set, we believe we can add value over time.

We've slightly increased our duration positioning or interest rate exposure as rates have risen, and our positioning is more diversified. After years concentrated in shorter maturities, we've seen a sharp global sell-off in longer-dated bonds, so we've shifted some exposure into longer maturities at yields we haven't seen in decades. Outside the U.S., we hold rate positions in Australia, the U.K., and prefer the higher-quality parts of emerging markets (EM), trading actively across them in an effort to add return and reduce volatility.

Q: Agency mortgage-backed securities (MBS) are one of the strategy's higher-quality allocations. Has your view shifted this quarter?

A: Mortgage rates recently hit local highs, and our long-standing valuation models are indicating that mortgage valuations look fair. Fair is quite appealing when corporate credit spreads are close to their tightest levels ever. Importantly, agency mortgages carry a U.S. government or U.S. agency guarantee[1] – they're high quality, have a favorable liquidity profile, and are reasonably high yielding.

With the recent rate volatility, we've traded the exposure actively while maintaining a meaningful allocation. We're making some adjustments on which mortgages we own: For years, we favored higher-coupon mortgages, and that worked, but as yields backed up, we've optimized holdings across the coupon stack to what we believe offers compelling value.

Q: In securitized credit, performance has become more mixed. Where are the most attractive opportunities, and how do we handle the gap between stronger and weaker borrowers?

A: U.S. household balance sheets are strong overall, but under the surface, we're seeing growing divergence. Middle and upper-income homeowners are doing very well with record levels of home equity, while lower-income households are struggling with higher prices and slower wage growth. Given this trend, we have an up-in-

1 U.S. agency mortgage-backed securities issued by Ginnie Mae (GNMA) are backed by the full faith and credit of the United States government. Securities issued by Freddie Mac (FHLMC) and Fannie Mae (FNMA) provide an agency guarantee of timely repayment of principal and interest but are not backed by the full faith and credit of the U.S. government.

quality bias across our securitized credit positions. This is an area of the market that has benefited from improved underwriting and the strength of the upper portion of the K-shaped curve.

That said, this year's story has been weakness in direct lending and lower-quality corporate credit, with private credit problems spreading into other higher-risk areas. We're building a ballast in our portfolio with high quality, resilient exposures in securitized credit, and over the next few quarters, we expect to redeploy gradually into other parts of corporate credit as opportunities arise.

Q: Corporate credit spreads look tight. Where do you still see value, and where are you being more careful?

A: Our corporate credit exposure is near an all-time low for the strategy, precisely because spreads are so tight. Since our base case is that the economy will keep growing at a healthy pace, we're looking for alternatives to traditional corporate credit to help maintain yield while offering risk mitigation if conditions turn. There are high quality substitutes we already own that offer compelling relative value, including agency mortgages, securitized products and Treasury Inflation-Protected Securities (TIPS). Where we do hold corporate credit, we keep liquidity where we can, using diversified indices to trade more generic exposure, seeking to take advantage of how liquid that market has become.

Something we've monitored for many years, but seeing more in recent periods, is financial engineering through securitizations, for example. We're seeing instances where illiquid assets are being turned into liquid ones, low quality risk is being converted and given a high quality rating, and these instances are getting more aggressive and worth monitoring. This argues for a more defensive mindset for the first time since the global financial crisis.

We're also seeing three areas that look increasingly interesting. We've built a small but meaningful book of opportunistic allocations in higher-quality energy and technology infrastructure. We're careful not to hold too much given the uncertainty around these sectors, but the funding needs are so large that we've sourced some attractive deals.

Another is stepping in where direct lending and private credit are under strain, as many private credit managers sit on the sidelines as deal flow picks up. And lastly, in high quality EM credit where the Middle East conflict has created volatility, letting us source compelling deals while staying in higher-rated names.

Q: Staying on that theme of EM and currencies, where do you see the most interesting opportunities, and what's your view on the U.S. dollar?

A: In EM, we still like the asset class as a diversifier, but we prefer to stay up in quality and focusing on larger names that are close to investment grade such as Mexico, South Africa, and Brazil, for example. We've trimmed frontier markets and energy importers since the backdrop warrants caution even where valuations look cheap. The key point is that global diversification should make the portfolio more resilient and can add attractive yield versus stretching into corporate credit at today's tight spreads.

The strategy has a small currency allocation, and we think currencies will keep offering tactical opportunities. The U.S. dollar weakened early in the year, then recovered as the Middle East conflict began and higher U.S. short-term rates came into view. If that uncertainty lasts, the dollar is likely to stay supported. We hold only a small underweight, favoring higher-quality, higher-yielding currencies over less attractive ones.

Q: The bond market looks quite different than it did a few years ago. How should investors think about the role of fixed income now?

A: The main difference is that bonds are much cheaper today than in 2021. Whether you look at nominal yields or real yields – what's left after inflation – we're at some of the more attractive levels in years, versus both cash and equity valuations.

My suggestion is to be patient and think long term. Over a five-year horizon, we believe investors are more likely to earn their yield in high quality fixed income. For a long time, investors assumed that the starting yield was all they could expect. We see it as a floor, with active global allocations working to add incremental returns on top. There will always be noise around policy, central banks, and geopolitics, but by focusing on the abundance of income available today, we can be patient and let yield do the heavy lifting.

Q: Any final thoughts for clients as we look toward the second half of 2026?

A: Thank you for the trust and confidence you have in PIMCO. We're as confident as ever in the value that actively managed bonds offer today. The Income Strategy draws on our full toolkit as active global investors to build a resilient, diversified portfolio, always seeking to deliver strong income and returns over time for our clients.

Past performance is not a guarantee or a reliable indicator of future results.

A word about risk: Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Inflation-linked bonds (ILBs) issued** by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Investing in **foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. References to Agency and non-agency mortgage-backed securities refer to mortgages issued in the United States. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **Private credit** involves an investment in non-publicly traded securities which may be subject to illiquidity risk. Portfolios that invest in private credit may be leveraged and may engage in speculative investment practices that increase the risk of investment loss. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. **Management risk** is the risk that the investment techniques and risk analyses applied by an investment manager will not produce the desired results, and that certain policies or developments may affect the investment techniques available to the manager in connection with managing the strategy. **Diversification** does not ensure against loss.

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