

# Income Strategy Update: Seeking Stability With High Quality Fixed Income

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We focus on high quality investments with compelling yields in an environment of elevated uncertainty.

## Summary

- Amid continuing volatility in our global economic outlook, we seek to invest in high quality fixed income where we see compelling yields.
- We maintain an overweight position in U.S. agency mortgages in the Income Strategy, as spreads remain high versus investment grade corporates, and agency mortgages should be resilient in the unlikely event of a harder landing.
- U.S. deficits are concerning, and we favor an underweight to the dollar, though we expect it will remain the world's reserve currency.
- We see attractive return potential and resilience in senior structured credit, particularly investments linked to higher-income consumers. We have limited exposure to corporate credit, considering tight spreads.

Uncertainty remains high, but so are bond yields, leading to attractive opportunities for active investors, in our view. 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 PIMCO's outlook for the global economy and how that frames positioning in the Income Strategy.

## Q: Can you summarize our outlook on the key themes shaping the investment landscape?

**A:** In our recently published outlook, "[The Fragmentation Era](#)," we shared views from our annual Secular Forum. We identified rising government debt, a more multipolar world, and persistent volatility as dynamics shaping the global economy and financial markets over the next five years. These forces will likely

lead to less synchronized economic, political, and central bank cycles, which should result in less correlated markets. Indeed, it's what we've seen over the last few years.

Over a multiyear period, we expect more economic and inflation volatility to create some risks for financial markets but also to present potential relative value opportunities. We are constructive about the ability to generate return versus passive approaches in this environment. We view starting valuations in fixed income as quite attractive, and markets that were perhaps boring in the past now look exciting with volatility across yield curves, currencies, industries, and economies.

All this is going on at a time of disruptive technological innovation. We recognize artificial intelligence could be a game changer for long-term productivity, but significant increases in productivity may disrupt certain segments and single names within corporate credit.

**Q: What's our base case for growth and inflation in the U.S. and elsewhere?**

**A:** Our base case is that growth will continue to slow around the world. Eurozone growth may decelerate from an annual trend of roughly 1% pre-pandemic to about 0.5% over the next five years. China's economy is shifting to a lower growth path amid rising debt and challenging demographics.

We expect the U.S. to settle at around 1.5% annual growth, and in our base case the U.S. avoids recession in the foreseeable future, though the risks to that outlook are considerable – and market pricing suggests some complacency around those risks. There is also substantial uncertainty about how the current U.S. administration calibrates policy based on incoming economic data and other signals. Although we have become more constructive than we were right after the 2 April tariff announcements, we do think economic risks are a bit more elevated than what is currently priced in.

Regarding inflation, we think tariffs will lead to at least a temporary increase in the overall price level. Over the next few years, however, we expect U.S. inflation to trend lower than where it is currently, approaching the Federal Reserve's target. Certain other developed economies could see inflation move a bit in the other direction, again, leading to interesting relative value opportunities.

**Q: What is PIMCO's outlook for central bank policy around the world?**

**A:** We believe most central banks are considering further rate cuts, and over time we expect the U.S. Fed will cut its target rate gradually down to about neutral – roughly 3%. It could cut further if recession occurs (not our base case, but a risk), or it could maintain a more restrictive stance if the economy is robust and inflation remains elevated or reaccelerates (also not our base case). I can't stress enough that we continue to be in an environment of significant uncertainty, which can affect monetary policy.

Looking abroad, at the Bank of England we see the prospect of a lower policy rate path than what's currently priced into the market. Both the European Central Bank and the Bank of Japan appear to be on hold for now, with the former potentially considering one more cut if warranted, and the latter maintaining a longer-term tightening bias.

**Q: What are your views regarding the U.S. deficit, U.S. debt sustainability, and the role of the dollar?**

**A:** We do not believe the U.S. dollar will lose its reserve currency status anytime soon. However, we have had a small underweight to the dollar in the Income Strategy; the dollar has underperformed

other global assets. We expect the dollar to continue weakening versus other currencies over the next few years.

The deficit is a concern. Even if the U.S. economy continues to expand, we expect annual deficits in the 5% to 7% range, pushing the debt-to-GDP levels to previous highs. Yet, considering the dollar's unique reserve currency status, the many structural advantages of the U.S. economy, and the strong U.S. military, the U.S. should be able to run such deficits and operate at higher debt-to-GDP levels than other developed countries could afford to do without causing significant disruption across the yield curve.

That being said, the U.S. isn't the only high quality interest rate market in the world. There are other places where governments are seeking to balance their budgets with lower debt levels and even more economic fragility. This presents attractive opportunities for us to diversify our interest rate exposure globally.

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

**A:** In the uncertain world I have described contrasted with the generally optimistic markets we're seeing, I would first highlight that we are focusing on resilience and flexibility, while looking to capitalize on attractive yields across the global opportunity set.

Indeed, after the significant sell-off in rates over the past few years, starting yields in global bond markets are compelling, and they appear particularly attractive when hedged back to the U.S. dollar. Our overall interest rate exposure lately is in the four- to five-year range, which is higher than in late 2021 but not the highest it's been and lower than the Bloomberg US Aggregate Index.

We target bond maturities in the range of five to 10 years, which we see as a section of the curve set to benefit from curve steepening and where we believe we could see material outperformance in the event of a harder-landing scenario or if the market prices in higher probabilities of recession.

We also have been active in shorter-dated U.S. Treasury Inflation-Protected Securities. We have invested in TIPS not due to significant inflation concerns, but rather the attractive pricing we see in shorter-term maturities. Finally, we continue to diversify in other high quality markets with elevated yields, including positions in the U.K. and some Australia exposure.

**Q: The Income Strategy has had a less constructive view at the long end of the curve. Could you elaborate on that, given all the market commentary about fiscal deficits?**

**A:** We don't foresee a crisis for long-dated U.S. Treasuries, but we do think the yield curve should move a bit steeper than it is currently, considering an elevated deficit and inflation volatility.

Our view reflects moderate concerns about the U.S. fiscal picture, with the government perhaps needing to sell more longer-dated bonds, as well as the potential for higher inflation volatility compared with the years after the global financial crisis. However, we also recognize that a shock to the economy could lead to a snapback rally on the long end.

**Q: Let's discuss the different sectors of the bond market, starting with what you find most compelling.**

**A:** Agency mortgage-backed securities (MBS) are an example of a high quality sector that offers attractive yields, plus the ability to trade across different maturities and different coupons in an effort to generate additional incremental return. It's also an area that we believe should be quite resilient relative to corporate credit in the unlikely event of a harder landing scenario.

In addition, agency spreads continue to be wider than investment grade corporate spreads, which reflects a unique relative value opportunity as agency MBS are backed by a U.S. agency or the U.S. federal government. There has been some discussion of the Trump administration favoring privatization of the government-sponsored enterprises, but we do not foresee it as a likely outcome.

**Q: Next, could you discuss the strategy's approach to structured credit and corporate credit exposure?**

**A:** We focus on resilience, seeking high quality positions and attractive yields. Hence, we favor structured credit at the upper range of the investment grade ratings. We tend to overweight consumer credit risk, particularly investments tied to higher-income households with considerable home equity.

Regulators don't want to bail out the same sectors twice, and this sector caused troubles back in 2007 and 2008. Now structured credit tends to have robust covenants or documentation along with conservative underwriting. We view this as a sector where you could see significant outperformance if an economic slowdown were to occur, and we believe our exposure continues to be a key differentiator.

In contrast, our corporate credit exposure is near the lowest end of its historical range, consistent with the view that spreads are very tight and there's a little bit of complacency embedded in these markets. One area where we are exhibiting more caution would be the senior secured loan space. These securities fared relatively well during the global financial crisis, and the sector has avoided an escalation in oversight. But we are more cautious about these loans because we've seen a significant rise in issuance and a trend toward more floating-rate loans linked to weaker underlying credits.

I don't mean to sound negative on the corporate credit sector; we see fundamentals as solid, but there are other areas of the market with better risk/reward profiles, in our view.

**Q: How do you view emerging markets?**

**A:** Emerging markets (EM) offer attractive valuations and will likely perform well over the longer term. That said, we've chosen to lower our overall EM exposure over the last couple of years, consistent with the general themes of reducing volatility and increasing resilience. Nonetheless, it's an important source of potential alpha generation for us, even though it's small in percentage terms. We do have small, targeted exposures to select emerging markets and EM currencies, complementing our underweight to the U.S. dollar. For example, we have modest overweights to Brazil, Mexico, Turkey, and South Africa.

**Q: There's a lot of interest from investors in our views on bonds versus cash or bonds versus equities. What should they expect for fixed income allocations moving forward?**

**A:** When you look at absolute levels of yields today, we believe the potential to generate return in fixed income is quite attractive versus equities or cash. In fact, equities are near all-time highs relative to the current level of interest rates. People ask me all the time, well, could rates go higher? They absolutely could, but in an environment of higher rates, equities are likely to underperform, if history is any guide.

As it relates to cash, we see an attractive opportunity for investors to step out along the risk spectrum and lock in elevated fixed income yields by shifting away from cash, where rates can go down very quickly if there's an unanticipated growth shock.

Depending on an investor's overall risk target and investment time frame, they would have different levels of optimal fixed income exposure, but whatever level they had a few years ago should probably be higher today.

Recent market experience bolsters our views. So far this year, the Income Strategy's risk-aware approach, emphasizing stability amid uncertainty, helped drive positive returns.

Bottom line: We see a strong case for having a higher fixed income allocation in one's portfolio today versus during the era of lower rates.

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