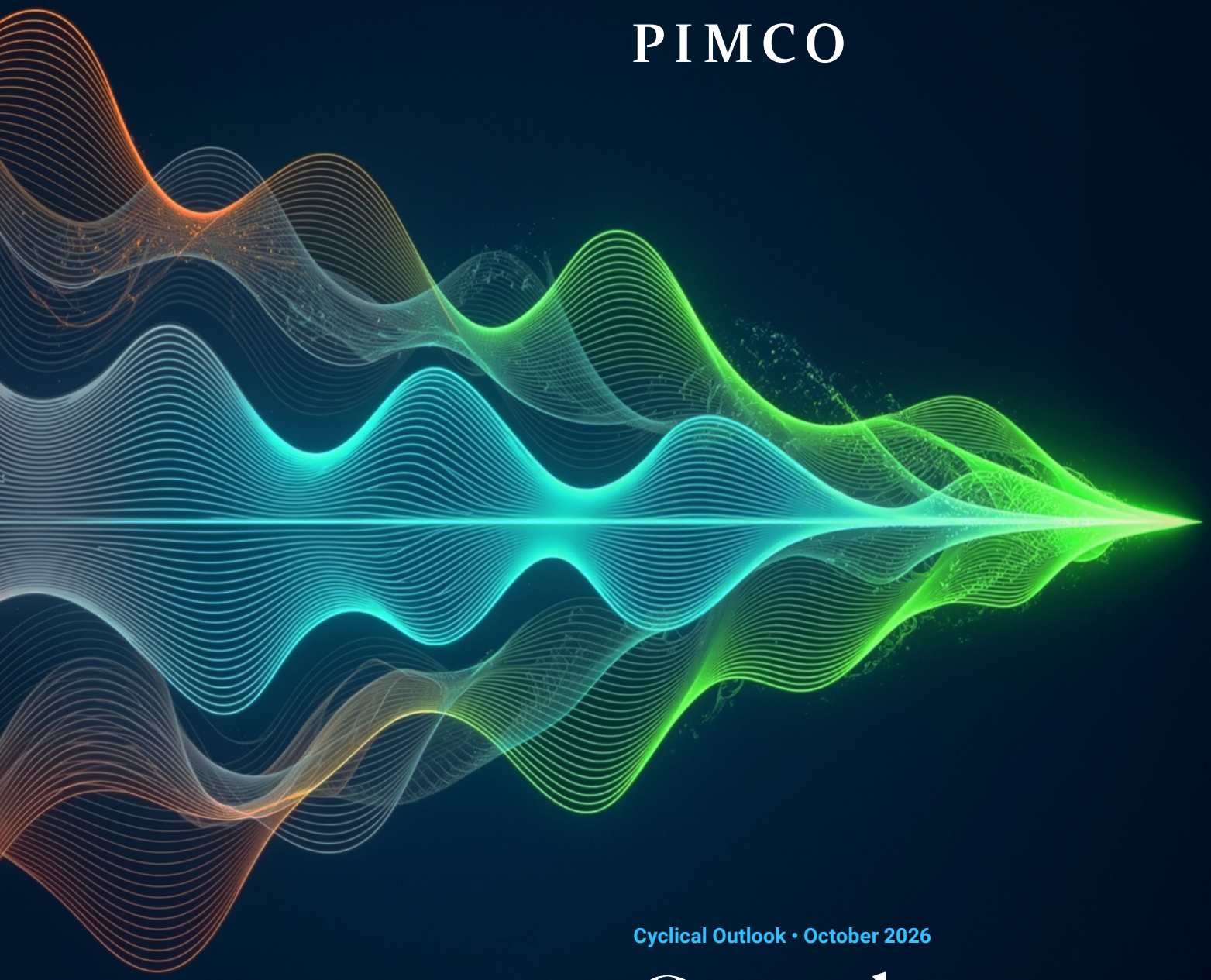
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Cyclical Outlook • October 2026

Growth Holds, Risks Widen

Powerful long-term shifts in geopolitics and technology are shaping the near-term economic and investment outlook, creating resilience in the baseline scenario and wider risks around it.







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Macroeconomic takeaways

1. Longer-term themes are driving cyclical trends.

As geopolitical fragmentation continues, most major economies are absorbing higher energy prices and tariffs better than expected. In our baseline, we expect global growth to remain resilient over our six- to 12-month cyclical horizon while inflation moderates.

2. Three buffers may support ongoing resilience.

A booming AI investment cycle, the ability of consumers and China to absorb higher costs, and an incremental approach by central banks may help support growth while containing inflation.

3. We may see a range of outcomes if those buffers falter.

The drivers of today's resilience are increasingly interconnected and may be challenged if the AI boom fades, the energy shock worsens, or financial conditions deteriorate – particularly as asset valuations may not fully reflect these risks.

Investment takeaways

1. Central banks' commitment to containing inflation can provide a supportive framework for bonds.

The Middle East conflict sparked an energy price shock, leading investors to price in higher interest rate expectations. Recent policy actions may bolster the credibility of the Federal Reserve and other central banks, which can help reduce investor uncertainty around the medium-term outlook for yields.

2. Elevated yields offer potential income and downside mitigation, while global diversification supports resilience.

High starting yields have the potential to help income do more work across a variety of scenarios. Global diversification can harness attractive sources of income, building portfolios designed to withstand a range of outcomes.

3. Be selective within credit and the AI investment buildout.

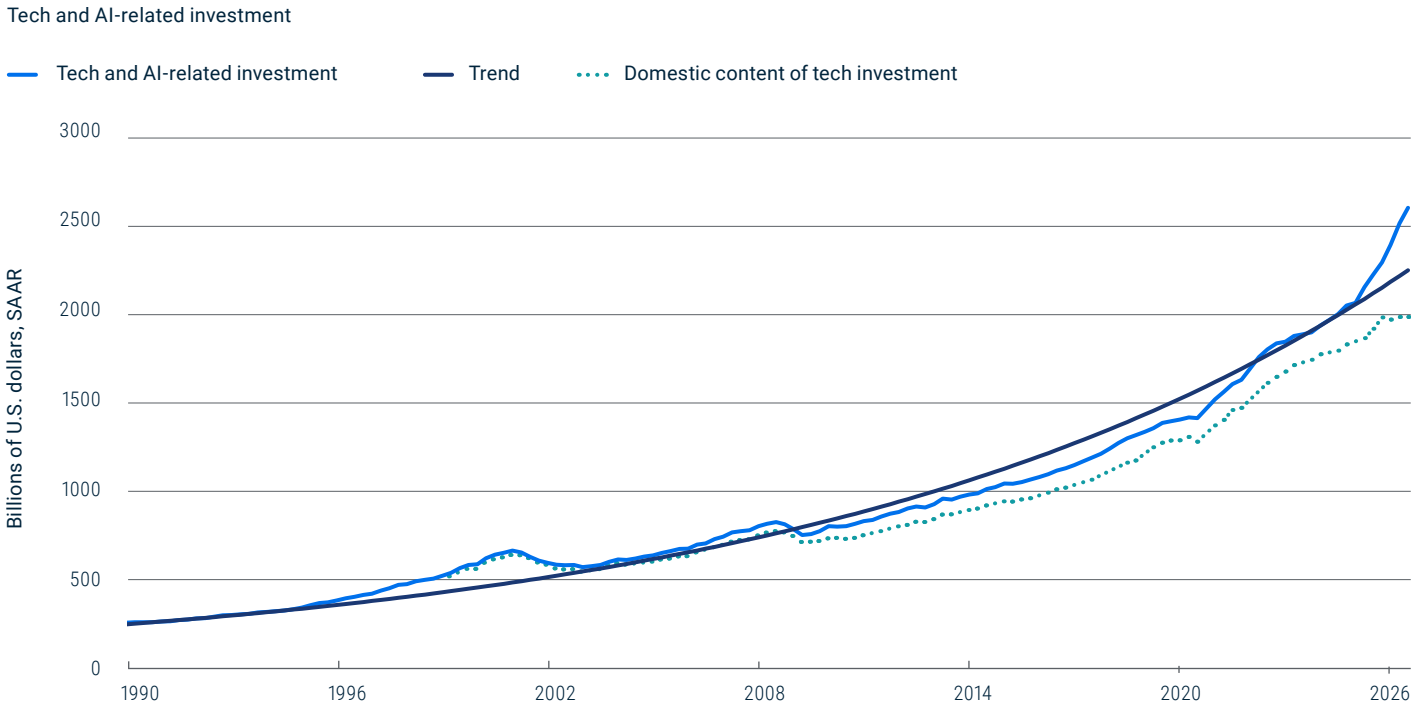
We focus on value and downside mitigation, aiming to ensure adequate risk compensation. In AI-related credit, that can mean seeking more compensation for regulatory and legal risks and politics tied to the U.S. midterm elections.

Economic outlook: Structural forces, cyclical implications

Longer-term secular forces are driving the six- to 12-month cyclical outlook. Our June 2026 *Secular Outlook*, "Rupture and Resilience," explored the fraying of traditional trade, security, and financial alliances that we had first highlighted in our 2025 *Secular Outlook*, "The Fragmentation Era." This means geopolitics shape growth and inflation more directly.

As globalization recedes, governments and businesses have stronger incentives to invest in building more resilient societies and supply chains. That imperative has coincided with the emergence of artificial intelligence, creating a powerful interaction between technological innovation and economic security. Rapid AI investment, development, and deployment is motivated by both corporate and national priorities. The result is a capital spending cycle comparable to the telecom and internet buildout of the 1990s but at an even faster pace (see Figure 1). The paradox is that a growth-fueling investment boom is also generating new sources of uncertainty, amid concerns that AI's capabilities could evolve faster than governance and safety policies surrounding it.

Figure 1: U.S. capital spending linked to technology



Source: U.S. Bureau of Economic Analysis National Income and Product Accounts data through 30 June 2026. SAAR = seasonally adjusted annualized rate.

Energy prices, driven sharply higher by the conflict in the Middle East, have increased headline inflation. That has sparked a shift in monetary policy expectations since the conflict began, with markets pricing in interest rate hikes and pushing bond yields higher. The knock-on effects include higher U.S. mortgage rates and increased debt-service costs for companies and governments, all of which could potentially hamper growth.

And yet the global economy has remained resilient, including energy-importing countries and U.S. trading partners that face higher tariffs. The main exception is China, where a prolonged and ongoing housing downturn, weak domestic demand, and abundant existing manufacturing capacity weigh on activity and inflation.

The rise in energy costs has had only modest spillovers into core inflation and nominal wage growth. Central banks have remained focused on inflation risks and on keeping inflation expectations well-anchored. The additional monetary tightening expected across developed (DM) and emerging market (EM) economies has been well-communicated and is now largely reflected in market pricing. Our baseline is that the Federal Reserve and other major central banks ultimately won't need to fully deliver the amount of interest rate hikes currently priced into markets.

We therefore expect stable global growth to continue in our baseline while inflation moderates as the energy price shock fades. This relatively benign base case rests partly on the assumption that energy prices decline over time in line with expectations priced into futures markets, but an escalation or resolution of the Iran conflict could potentially swing prices significantly. More fundamentally, the benign outlook relies on three economic buffers:

1. The global AI capex cycle continues without generating cyclical overheating. AI-related demand continues to exceed supply. The largest hyperscalers have shifted from financing the infrastructure buildout through operating cash flow and balance-sheet capacity to debt issuance and off-balance-sheet commitments. AI infrastructure investment is also accelerating globally, even as the U.S. and China remain the leaders.

2. Households and China continue to absorb the global hit from higher energy prices. Strong household balance sheets have allowed consumers to uphold spending by drawing down savings. China has absorbed higher input costs through weaker margins, inventory drawdowns, and domestic demand shifts toward renewable energy sources, limiting the pass-through into global goods prices.

3. An incremental central bank policy approach and AI-related risk appetite help keep financial conditions relatively stable. Wage growth and unit labor cost pressures are moderating, long-term inflation expectations remain anchored, and much of the current inflation pressure reflects energy and other non-labor costs. We expect the Fed under Chair Kevin Warsh to preserve its broad policy framework and 2% inflation target, although changes in Fed communication could generate volatility in front-end rates.

Underneath these buffers, AI is reshaping the composition of growth and inflation. Investment is raising the prices of some required inputs, while expectations of AI-led productivity growth are supporting equity prices and generating a wealth effect.

AI may already be contributing to structural labor market changes (for more, see our 19 August 2026 *Macro Signposts*, "Counterintuitive Labor Market Shifts Constrain Measured U.S. Wage Gains"). Hiring has weakened disproportionately in some higher-paid, technology-exposed occupations, while wage pressures have moderated. If these trends deepen, AI could simultaneously raise productivity and restrain labor-cost inflation – with offsetting effects on broader inflation.

A benign baseline, but fat tails

If our baseline depends on the durability of the three buffers mentioned above, the principal downside risks are that one or more of those buffers could fail. Because AI capex, household wealth, and financial conditions have become increasingly interconnected, a failure of one buffer could place additional pressure on the others. We see a broad range of possible outcomes on either side of the baseline (i.e., "fat tails") due to these key risks:

RISK 1: AI INVESTMENT, THE PRINCIPAL ENGINE OF ECONOMIC GROWTH, SLOWS OR CONTRACTS

An outright AI capex bust appears unlikely over the cyclical horizon, in our view. The buildout of data centers, power generation, and communications infrastructure is in its early stages, while investment in chips, computers, and related equipment remains robust.

However, AI investment does not need to contract to become less supportive of growth. If investment growth slows, its contribution to GDP growth will fade. AI safety concerns, security failures, political opposition (particularly ahead of the U.S. midterm elections), and infrastructure constraints could all slow investment, as could tighter financing conditions. Economic resilience would then become more dependent on AI-driven productivity gains arriving quickly enough to replace the fading capex impulse.

Over the multiyear secular horizon, an AI bust remains a significant risk, although the timing is deeply uncertain. Adoption could continue even if monetization and utilization disappoint relative to assumptions. A repricing of AI-related equities could generate a meaningful negative wealth effect, even if high quality AI credit remains comparatively insulated. Both U.S. households and foreign private investors now have substantial exposure to U.S. equities.

RISK 2: THE ENERGY SUPPLY SHOCK WORSENS AND ENERGY PRICES EXCEED MARKET EXPECTATIONS

Middle East tensions are disrupting oil flows and depleting inventories, even as U.S. Energy Department reports indicate that flows through the Strait of Hormuz have picked up in recent weeks. El Niño could create additional inflation risks through food, fertilizer, and shipping channels. A more severe or persistent energy shock – in addition to increasing the risk of a central bank policy response – could impose a larger real-income burden on households and businesses, while testing China's capacity to continue absorbing higher input costs.

RISK 3: FINANCIAL CONDITIONS TIGHTEN ABRUPTLY

Compounding supply shocks simultaneously spur inflation and erode demand. This could contribute to tighter global financial conditions – i.e., higher interest rates, stricter lending standards, wider credit spreads, and other factors that broadly tend to hamper growth.

More restrictive central bank policy is one potential catalyst. After several years of above-target inflation and supply shocks, central banks may place greater weight on the risk that another temporary shock becomes embedded in inflation expectations. In this scenario, policymakers would deliver more tightening than markets currently price.

Financial conditions could also tighten for other reasons. Investors may demand greater compensation across a broad range of assets as uncertainty rises, particularly if confidence in the AI investment cycle weakens while energy prices remain elevated. Higher rates could uncover vulnerabilities and raise the risk of financial market accidents.

Fiscal deficits remain a challenge

Higher energy prices, which have pressured global yields higher, are adding to government borrowing costs – at a time when debt-to-GDP ratios are near record highs across most economies and fiscal space is limited. However, sovereign debt remains sustainable across most DM countries, in our view, despite the global rise in yields. The U.K., Italy, and Japan remain vulnerable – and Japan increasingly so given recent policies that add to deficits – but their debt trajectories appear sustainable under current fiscal plans.

Two countries stand out with more challenging debt trajectories: the U.S. and France. While a prolonged U.S.–Iran conflict could necessitate additional spending over our cyclical horizon, the U.S. retains important advantages. It issues the global reserve currency. It also taxes less than most other developed economies and therefore has revenue capacity if the political will to use it emerges. Its fiscal position also looks considerably stronger on a debt-to-wealth basis rather than on conventional debt-to-income metrics.

France may have less room for maneuver. Unlike the U.S., its already-high tax burden leaves less room to raise revenue. Fiscal policy will ultimately need to tighten to stabilize the debt path, but a near-term solution looks difficult given presidential election uncertainty and limited appetite for difficult reforms.

Our expectation is that fiscal concerns will continue to drive episodic market volatility across global markets. However, investors are getting higher sovereign bond yields than a year ago to help compensate for these risks. Furthermore, if governments do tackle necessary fiscal reforms – the planned U.K. budget tightening is a good example – yields have room to fall.

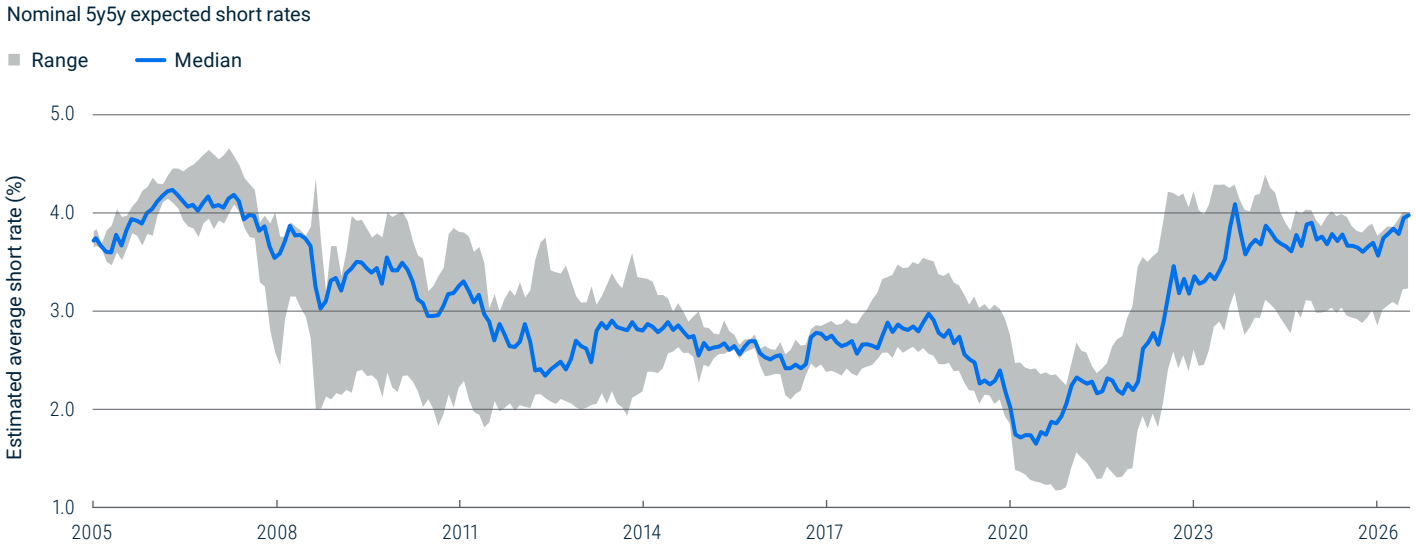
Investment outlook: What rising yields mean for bonds

In our 2024 *Secular Outlook*, "Yield Advantage," we explored how the post-pandemic inflation shock and rate-hiking cycle had produced a generational reset higher in bond yields. This year, the conflict in the Middle East sparked a new inflation shock that has lifted yields further. Today's higher yields may provide income that can help offset price declines to a degree that was not possible in 2022. Still, the path higher has been challenging for investors.

To understand where yields may go from here, it is useful to examine why they have risen. Several forces have contributed, some more than others:

- **Higher energy prices, and their impact on monetary policy expectations, have been the main driver pushing real yields higher.** Both real (inflation-adjusted) and nominal yields have shifted meaningfully higher post-pandemic. The latest yield increase reflects higher energy prices, which have overshadowed broader disinflationary trends and caused markets to price in more expected central bank rate hikes than before. Importantly, real yields, not inflation expectations, have been the primary force driving nominal yields higher in recent months, with 10-year breakeven yields showing inflation expectations remain largely unchanged. A prolonged conflict in the Middle East could eventually substantially tighten global financial conditions through a broader range of asset price changes – not just through higher rates – which could potentially hurt growth particularly for energy-importing countries.
- **Real yields reflect two components: The real neutral rate, which has risen, and the term premium, which has not.** Estimates of the real neutral interest rate (known as r*, or r-star) in the U.S. have risen. The midpoint across several U.S. measures suggests r* – the baseline inflation-adjusted interest rate that neither stimulates nor hinders an economy – may have risen to around 1.5% today from roughly 0.5% before the pandemic (for more, see our 23 September 2026 *Macro Signposts*, "A Recalibration, Not a Rate-Hike Cycle"). Higher potential U.S. growth, supported by stronger productivity and investment, appears to account for much of the rise. Estimates of the expected average short-term interest rate embedded in the 5-year, 5-year-forward rate have also risen (see Figure 2). By contrast, the New York Fed's Adrian, Crump, and Moench (ACM) framework indicates that the term premium (i.e., compensation to investors for the risk of holding longer-term bonds) has remained more stable.

Figure 2: Estimates of the expected short-term rate embedded in the 5-year, 5-year-forward rate have risen



Source: PIMCO calculations as of 30 June 2026 based on research by D'Amico, Kim, and Wei (DKW, 2018); Adrian, Crump, and Moench (ACM, 2013); Kim and Wright (KW, 2005); and Christensen, Diebold, and Rudebusch (CDR, 2011). **For illustrative purposes only**.

- **Fiscal concerns have not been a significant driver of the recent rise in yields.** Fiscal challenges are not new and already appear to be factored into market pricing. Yields have risen across maturities, not primarily in long-dated bonds, which tend to be more sensitive to fiscal concerns. Yields have also risen globally, including in countries with stronger fiscal outlooks than the U.S. The main fiscal risk that could push bond yields higher and steepen curves is more fiscal easing.
- **The scale of corporate debt issuance tied to the AI buildout may be a contributing factor.** Hyperscalers borrowing heavily at a time of elevated U.S. Treasury supply could account for some of the rise in yields, although the data paint a more complicated picture (for more, see our 28 September 2026 article, "The Credit Market Lens: Hyperscalers Are Repricing, Not Displacing (So Far)").

Looking ahead, our baseline is that central banks will remain credibly committed to taming inflation. That can provide a supportive framework for bonds by helping reduce investor uncertainty around the medium-term outlook for yields.

Ultimately, this can help restore the negative correlation between bonds and equities that makes duration an effective portfolio hedge. Such negative correlations tend to reassert themselves over time.

Today, investors are being compensated for higher neutral rates. Starting yields – historically highly correlated with five-year forward returns – are what make bonds a potentially attractive income-generating asset, while still being a potentially effective hedge against a more uncertain outlook.

Even after the recent rise, bond yields are back near their long-run historical averages – levels last seen in the 1990s and early 2000s, before the era of suppressed yields that followed the global financial crisis. While real yields could still rise further, today's levels provide income that can be supportive across a range of scenarios. Fixed income does not need yields to decline to be able to generate strong absolute and relative returns, but there are also bullish scenarios if yields do fall – for example, if AI-driven disinflation were to materialize.



How to build portfolio resilience

In a world where the central scenario is benign but the tails are fat, investors should look to build portfolios that can be resilient across a variety of scenarios.

OWN A DIVERSIFIED, GLOBAL PORTFOLIO OF HIGH QUALITY DURATION

Attractive starting yields – and the income they can offer – provide a meaningful mitigant against inflationary tail risks while preserving the potential for bonds to hedge a fading AI capex impulse or a shock to growth. A global bond allocation across DM and EM can help diversify country-specific factors, including fiscal risks.

Our yield curve views are becoming more balanced as investors can now find healthy yields across maturities. We still find intermediate (five- to seven-year) Treasuries attractive and are becoming more constructive on longer-dated bonds as yields rise. We see value for patient investors with an intermediate time horizon.

Data show households may remain overallocated to equities and to cash relative to history and underallocated to bonds, even though bond yields today may be comparable with equity earnings yields.

BE SELECTIVE WITHIN CREDIT AND THE AI COMPLEX

The AI buildout is at the heart of the investment opportunity in credit. Much of the AI capital spending forecast has been pulled forward into the cyclical horizon. That said, credit spreads are tight, and AI-related correlations are rising as more debt gets issued in the sector (for more, see our 14 September 2026 publication, "The Credit Market Lens: One AI Trade for Now, Many Trades Later").

We focus on selectivity, relative value, and downside mitigation, aiming to ensure adequate risk compensation. In AI-related credit, that can mean seeking more compensation for regulatory and legal risks and politics tied to the U.S. midterm elections.

At a time of AI disruption, diversification is increasingly important. Investors should be open-minded about what sectors could get disrupted. Software is an obvious candidate, but the possibilities are more widespread, and companies that lag in the AI implementation race are at risk of being left behind. In some areas, heightened AI-enabled competition may not drive companies out of business, but it could pressure margins.

Higher interest rates will affect a credit default cycle that was already well underway. In corporate direct lending, investors face disappointment relative to returns of recent years. The impact could be magnified for some of the most ratings- and liquidity-constrained vehicles that were largely constructed for benign credit and rate environments. Many such vehicles have exhibited significant growth in recent years and now face challenges from both higher rates and credit deterioration.

We seek to be flexible in credit allocations, using relative value as a guide across sectors. We are still finding attractive value in real asset finance and asset-based lending, even as recent outperformance has caused the relative valuation advantage to narrow in some areas.

CONSIDER COMMODITIES AND REAL ASSETS TO HEDGE SUPPLY-SIDE RISKS

In an era of more frequent geopolitical, energy, and other supply shocks, portfolios need mitigation against outcomes in which inflation rises even as growth weakens. Commodities and select real assets can complement duration by providing exposure to the very scarcity and supply pressures that could challenge both economic growth and conventional financial assets.

Conclusion

The baseline for this cycle remains constructive. But part of that resilience relies on an investment boom driven by an unusual combination of commercial opportunity and strategic urgency, and one that could be proceeding faster than the guardrails around it. That combination creates potential upside for productivity and growth, but it also produces unusually fat tail risks.

In our view, portfolios should be positioned to participate in the baseline and withstand those tails. At today's starting yields, that remains a powerful argument for bonds.



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At the Secular Forum, held annually, we focus on the outlook for the next five years, allowing us to position portfolios to benefit from structural changes and trends in the global economy. Because we believe diverse ideas produce better investment results, we invite distinguished guest speakers – Nobel laureate economists, policymakers, investors, and historians – who bring valuable, multidimensional perspectives to our discussions. We also welcome the active participation of the PIMCO Global Advisory Board, a team of world-renowned experts on economic and political issues.

At the Cyclical Forum, held three times a year, we focus on the outlook for the next six to 12 months, analyzing business cycle dynamics across major developed and emerging market economies with an eye toward identifying potential changes in monetary and fiscal policies, market risk premiums, and relative valuations that drive portfolio positioning.

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