PIMCO

CYCLICAL OUTLOOK

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Securing the Soft Landing

The fixed income outlook remains strong across multiple economic scenarios as the U.S. Federal Reserve joins other central banks in cutting interest rates.

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KEY TAKEAWAYS

In the wake of pandemic shocks, economies appear more "normal" than at any time since 2019. Yet policy rates remain elevated. As central banks cut interest rates to more neutral levels, key questions include how fast they get there and what those neutral levels will look like. Here are our near-term economic views:

- The factors that supported relative U.S. economic strength are diminishing. That suggests some recoupling with the rest of the world and further progress on curbing inflation.
- Developed markets (DM) appear on track to return to target inflation levels in 2025, driven by normalizing consumer demand and increased competition for limited job openings. In the U.S., labor markets appear looser than in 2019, heightening the risk of rising unemployment. The Fed, like other DM central banks, is expected to realign monetary policy to this new cyclical reality.
- The U.S. economy, like others, appears poised to achieve a rare soft landing – moderating growth and inflation without recession. But there are risks, such as the upcoming U.S. election and its implications for tariffs, trade, fiscal policy, inflation, and economic growth. High budget deficits will likely persist, limiting the potential for further fiscal stimulus and adding to economic risks.

As developed economies slow and potential trade and geopolitical conflicts loom, investors should favor caution and flexibility in portfolio positioning. These are our near-term investment views:

- We expect yield curves to steepen as central banks lower short-term rates, creating a favorable environment for fixed income investments. Historically, high quality bonds tend to perform well during soft landings and even better in recessions. Moreover, bonds have recently resumed their traditional inverse relationship with equities, providing valuable diversification benefits.
- Bond yields are attractive in both nominal and inflation-adjusted terms, with the five-year area of the yield curve particularly appealing. Cash rates are set to decline alongside policy rates, while high government deficits may drive long-term bond yields higher over time.
- We maintain a cautious stance given some complacency we see in corporate credit due to tighter valuations, favoring higher-quality credit and structured products. Lower-quality, floating-rate private market areas appear more vulnerable to economic downturns and interest rate changes than prices suggest, with credit risks poised to rise just as yields fall, potentially benefiting borrowers but hurting investors. U.S. agency mortgage-backed securities (MBS) offer an attractive and liquid alternative to corporate credit.[1] Additionally, asset-based sectors, in both consumer and non-consumer areas, provide appealing opportunities for private market investors, particularly relative to corporate lending.
- In foreign exchange, we are somewhat underweight the U.S. dollar as the Fed cuts rates, while diversifying into currencies from both DM and emerging markets (EM).

1 Liquidity refers to normal market conditions.

Economic outlook: Recoupling and a reframing of risks

The U.S. economy distinguished itself in 2023 and 2024, achieving growth rates of 2.5%–3%, while DM peers largely stagnated at 0%–1%. U.S. productivity has also outpaced DM peers since the pandemic. In our April 2024 *Cyclical Outlook*, "Diverging Markets, Diversified Portfolios," we identified two main drivers:

- **Fiscal policy:** A larger cumulative fiscal stimulus since 2021 has led to greater private wealth accumulation in the U.S., which has taken longer to dissipate.
- **Monetary policy:** The pass-through of higher interest rates to households has been slower in the U.S., largely due to the existing stock of low-rate, long-term mortgages.

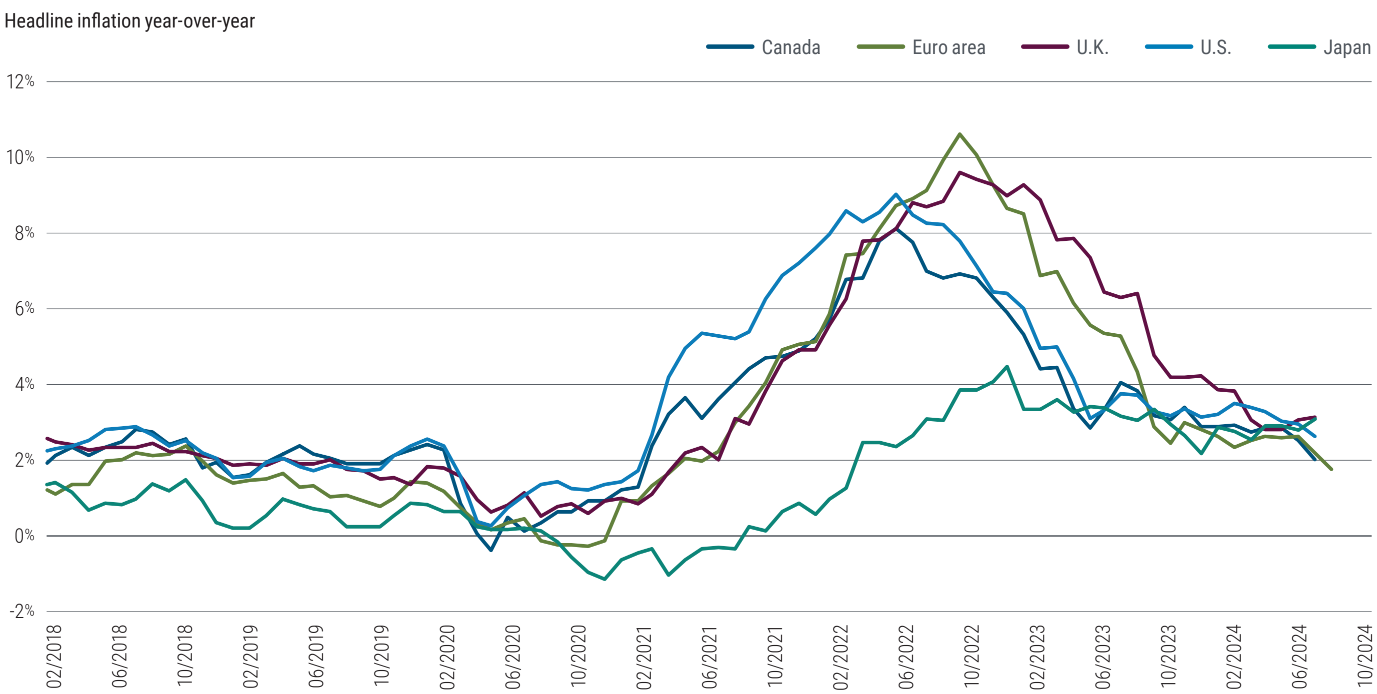
Additionally, the prominence of U.S. private credit markets has likely kept financial conditions more accommodative. An influx of investor capital in lower-quality corporate lending has intensified competition for deals while providing financing for weaker companies that may struggle to access other markets.

The U.S. has also been less affected by international spillovers from Chinese economic weakness. European countries, and Germany in particular, have been hurt by weaker trade with China and greater Chinese import competition. Financial gains and capital accumulation from generative artificial intelligence (AI) have also relatively benefited the U.S.

The U.S. also made more modest progress in 2024 than DM peers in reducing inflation. Core personal consumption expenditures (PCE) inflation, the Fed's preferred gauge, is expected to finish this year near where it ended 2023, as tough base effects are likely to lift the reported year-over-year rate in the next several months.

In contrast, core inflation in other DMs has likely slowed by 1–1.5 percentage points during that period (see Figure 1). Europe achieved additional inflation progress as weak demand and corporate margin compression offset still-elevated unit labor cost inflation.

Figure 1: Headline inflation continues to normalize toward pre-pandemic levels



Source: Various global statistical agencies, Haver Analytics, and PIMCO calculations as of August 2024

The factors that supported U.S. outperformance are fading, suggesting some recoupling with the global economy. Measures of U.S. real wealth balances more closely resemble those of other DMs. The monetary policy shocks that have impeded growth elsewhere are also abating.

European growth is likely to recover to a more normal pace as rates decline and trade conditions improve after the energy price spikes of 2022. This will help offset curtailed government spending and a weak global manufacturing environment. Immigration – which bolstered growth in many DMs, particularly the U.S. – is expected to become a growth headwind as policies implemented in mid-2024 to limit immigration appear to be working.

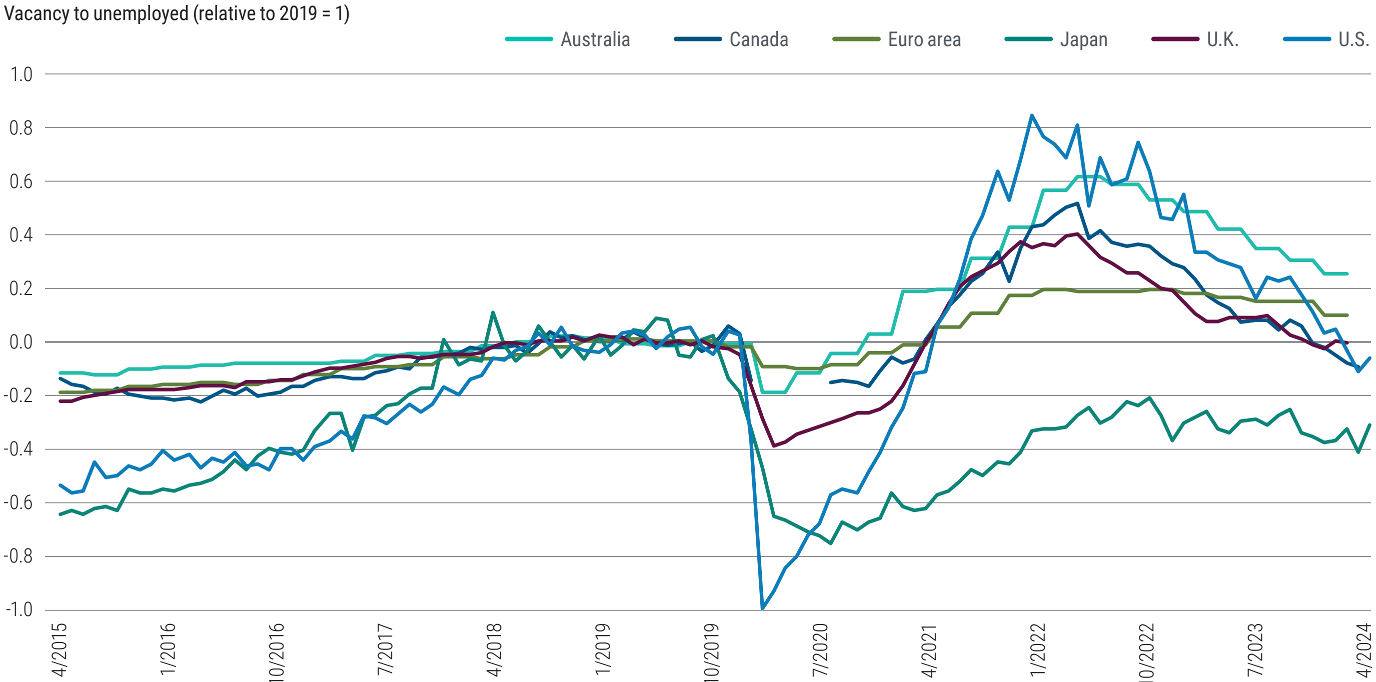
Despite some cyclical growth recoupling, we believe the U.S. economy maintains some distinct advantages. Notably, robust capital spending and AI investment trends present significant upside growth potential, especially compared with Germany and other EU countries that are more exposed to Chinese competition and more reliant on imported energy sources. Recent economic data revisions that have left the U.S. savings rate within pre-pandemic ranges should moderate concerns of an overextended U.S. consumer.

MONETARY POLICY IS NORMALIZING …

More resilient U.S. growth and inflation delayed the Federal Reserve in commencing its rate-cutting cycle relative to other central banks. However, forward-looking inflation indicators suggest that further progress toward the Fed's 2% inflation target is likely in 2025. Factors supporting this outlook include unit labor cost inflation nearer to 2%, a vacancy-to-unemployed ratio lower than 2019 levels (see Figure 2), and a rising unemployment rate that may risk overshooting the Fed's comfort zone of around 4.2%.

Figure 2: Labor markets, like inflation levels, look more like they did in 2019

Vacancy to unemployed (relative to 2019 = 1)



Source: Various global statistical agencies, Haver Analytics, and PIMCO calculations as of August 2024

Elsewhere across DM, weaker demand, loosening labor markets, and anchored inflation expectations also point to near-target inflation in 2025. Canada stands out as a DM economy where inflation is most likely to undershoot target levels, while labor market indicators in Australia point to somewhat slower progress there.

Consequently, central banks, especially the Fed, are focused on returning monetary policy rates to estimated neutral levels. We expect DM central banks to cut rates by 175–225 basis points (bps) in 2025.

The Bank of Japan (BOJ), which still has a policy rate below neutral estimates, remains the notable outlier. We expect the BOJ to continue with gradual rate hikes despite recent market volatility and yen strength. Japan has been the one economy where elevated inflation has raised inflation expectations, while wage inflation remains firm.

… BUT WHAT IS NORMAL?

With DM economic conditions now resembling their pre-pandemic baseline more than at any time since 2019, the focus now turns to the question, "What is 'normal' monetary policy?"

Factors that could support a somewhat higher neutral rate than a decade ago include higher government debt levels, potentially higher defense spending, generally stronger private sector balance sheets, and increased investment needs associated with secular global transformations, such as realigned trade relationships and the rapid development of AI.

However, given longer-term trends in demographics and wealth disparity, and the uncertain pace and magnitude of investment cycles, we've maintained our 0%–1% estimate for the long-run neutral real rate, as we detailed in our latest *Secular Outlook*, "Yield Advantage." That suggests a neutral nominal policy rate in the range of 2%–3%. When we published that *Secular Outlook* in June, we noted how market pricing at the time implied that the neutral policy rate was unlikely to fall below 4%. Since then, market pricing has moved more in line with our expectations.

Given the uncertainty around the level of neutral policy rates, it's natural for central banks to embark on a series of cuts to see how their economies respond. If growth reaccelerates and upside inflation risks reemerge, central banks can always pause or slow easing. Otherwise, if growth plummets or employment falters, there is capacity to cut more aggressively. Across a range of scenarios, we believe there is room for central banks to cut rates.

RISKS AND UNCERTAINTY

Risks to the global outlook have shifted. Inflation risks have diminished – but not disappeared – as supply/demand in labor markets and beyond have come into better balance. Growth is slowing. While DM economy recessions are not our base case, we believe the risks are somewhat elevated compared with historical average frequency. There are also scenarios where economic growth proves more resilient and inflation could reaccelerate.

In the U.S., the main risk is that slower activity and labor market growth fuel self-stoking cycles, ultimately resulting in a more pronounced downturn. Other DMs appear more stable. Still, their continued low growth makes them susceptible to negative shocks, such as market mishaps or escalating geopolitical situations.

> Recession is not our base case, but the risks are still somewhat elevated compared with the average chance in any given year.

China faces its own challenges. Its growth model, reliant on exports and manufacturing investment, seems to be hitting limits. It faces a significant housing inventory overhang, weak consumer demand, and rising trade tensions. In response, China's government recently announced measures designed to boost asset prices and mitigate the decline in housing prices.

However, the efficacy of these policies may hinge on a return of confidence and whether the efforts will provide more widespread direct government support to households. Fiscal response is also likely and may help generate momentum for growth in the next one to two quarters.

We expect China's growth to slow to 4%–4.5% in 2025 from 5% in 2023 and 2024, while the country continues to export deflation globally. Demand for commodities, especially related to construction, may get some support from the recently announced policies but isn't likely to rise as much as in past cycles, given controls on new housing supply.

Geopolitical risks continue to loom large as a source of uncertainty – from the conflicts in the Middle East and Ukraine to elections across many countries during our cyclical horizon, with implications for broad market sentiment and specific countries and sectors.

The upcoming U.S. election is one such source of uncertainty, with pivotal policy implications:

- U.S. deficits will be the biggest loser no matter which party wins. Tax reform will dominate Washington next year, when the individual provisions of the 2017 Tax Cuts and Jobs Act are set to expire. We do not expect much additional fiscal stimulus, given likely narrow majorities or a divided government and lack of fiscal space. However, fiscal consolidation isn't expected either. Annual deficits are likely to remain high (6%–7% of GDP) before any additional policy changes, due to lack of political will to curb entitlement spending as well as few offsets to pay for extending most of the 2017 tax cuts. This reinforces our curve steepening view in the U.S.
- The direction of travel of tariffs is also clear regardless of who wins. However, the potential for globally disruptive trade policies appears greater under a second term for former President Donald Trump, while Vice President Kamala Harris seems more likely to continue the current more targeted approach should she prevail. In the short run, higher tariffs would likely be inflationary and drag on growth. Tariffs could make tangible U.S. investments more expensive, hurt U.S. export sectors by making them less competitive, and weigh on demand. Tariffs would likely also be inflationary for close U.S. trade partners – to the extent that their governments retaliate with similar trade barriers – but deflationary elsewhere, as slower global growth from rising trade uncertainty could weigh on commodities, while goods previously supplied to U.S. markets could be redirected. The relative implications of tariffs will create a tough economic environment for the Fed. Monetary policymakers will have to be mindful that higher short-run inflation (as the additional costs of tariffs are passed on to consumers) risks rising inflation expectations, despite the downside risks to growth as real incomes fall.

Investment implications: Favorable conditions for high quality bonds

Uncertainty, global dispersion, and potential volatility create a favorable environment for active fixed income investors, especially as falling interest rates provide a tailwind for bonds. Historically, bonds tend to perform well during soft landings and even better in harder landing scenarios. Recently, bonds have resumed their traditional inverse relationship with equities, offering diversification and hedging benefits for portfolios. Additionally, bonds appear inexpensive compared with other assets such as stocks, in our view.

We expect yield curves to continue to steepen – in line with their performance in past easing cycles – as the Fed and other central banks continue cutting short-term rates. While recession is not our baseline, economic risks remain a source of uncertainty as U.S. growth slows. The risks are compounded by uncertainties around the upcoming U.S. election, particularly the outlook for global trade. This context calls for a careful approach to position sizing and maintaining flexibility in portfolios.

> Historically, bonds tend to perform well during soft landings and even better in harder landing scenarios.

RATES AND CURVE

We see U.S. Treasury yields as broadly fair at current levels. The five-year area of the yield curve appears particularly attractive in both the U.S. and other DM countries. As central banks lower policy rates, it creates reinvestment risk for cash and other short-term instruments. We prefer locking in attractive yields on intermediate-duration bonds, which can benefit from price appreciation and historically have tended to perform well during rate-cutting cycles. Meanwhile, we remain cautious on long-duration bonds as high government deficits could push long-term yields higher over time.

The anticipated pace of Fed easing priced into the front end of the curve appears reasonable, given current economic conditions and the Fed's half-point initial cut in September. Expectations for the terminal rate also look reasonable given our baseline view on the long-run neutral rate (0%–1%), as discussed above, although we remain mindful of potential inflationary tail risks. If a recession hits, there is room for terminal rates to drop significantly.

Bond and equity markets have resumed their traditional inverse relationship – meaning the correlation between duration (a gauge of interest rate risk) and equities is negative – so bonds can better hedge portfolios against equity market downturns. That can be especially important at a time of rising geopolitical risks. Adding to an allocation of inflation-linked bonds is appealing, given attractive pricing for inflation protection, with yields attractive on both a real (inflation-adjusted) and nominal basis.

CREDIT OUTLOOK

We maintain a cautious stance on corporate credit due to tighter valuations and somewhat elevated recession risks. We prefer higher-quality credit and structured products over lower-quality credit at this point in the cycle, with an emphasis on liquidity, flexibility, and robust positioning against potential macroeconomic downturns.

Generally, we favor high quality investment grade credit. We set a high bar for considering lower credit quality, especially in portfolios with high quality benchmarks. Elsewhere in credit markets, we're wary of deteriorating covenant protections in leveraged credits, which could lead to lower recoveries during idiosyncratic or systemic shocks.

Agency mortgage-backed securities (MBS) appear attractively valued and provide a reasonably priced, liquid alternative to corporate credit for investors who can tolerate occasional short-term volatility.[2]

2 Ibid.

In private credit markets, we believe that excessive growth and complacency are likely to result in weaker future returns when compared with current yield levels. Significant capital formation has resulted in weaker lender protections and compressed compensation for illiquidity relative to similar returns available to active managers in public credit markets.

We believe many lower-quality, floating-rate borrowers in private markets are more susceptible to economic weakness and interest rate changes than market prices suggest. As the Fed lowers rates to prevent a recession, floating-rate coupons will likely also decrease significantly. This means yields will drop just as economic and credit risks rise, which may benefit borrowers but hurt investors. This could also be the first time these markets are tested during economic downturn scenarios.

Given this backdrop, investors today may be receiving inadequate compensation for risk in lower-quality private corporate credit – especially compared with attractive excess return opportunities in more liquid forms of credit or similarly less liquid opportunities in asset-based lending. (For more, see our 10 July 2024 publication, "Navigating Public and Private Credit Markets: Liquidity, Risk, and Return Potential").

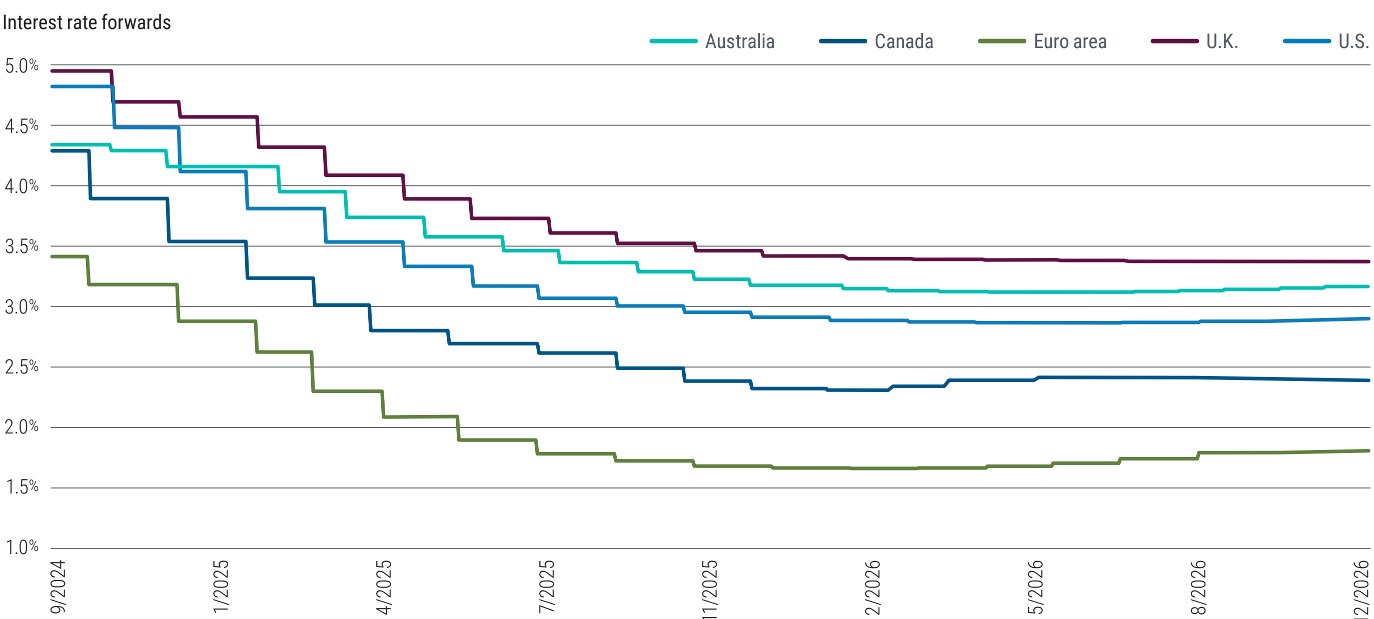
Disruption to bank business models is creating attractive entry points for private capital across a range of asset-based opportunities, including consumer-related (e.g., residential mortgages, student loans) and non-consumer (e.g., aviation, equipment) assets. Relative to private corporate markets, we find many asset-based opportunities benefit from a combination of attractive starting valuations and favorable fundamentals, especially in areas tied to the higher-quality consumer balance sheet. These markets are also less crowded on a relative basis, as capital formation in private asset-based lending remains considerably more scarce than that of U.S. and European corporate lending markets.

We believe we are closer to a bottom in private real estate markets, but that this will be a slower recovery relative to previous cycles. We favor investments in data infrastructure and debt-related opportunities relative to equity at current valuations. Our emphasis is on sectors and assets tied to data infrastructure, logistics, warehouses, and certain multifamily assets.

GLOBAL VIEWS

Given dispersion in economic outlooks and central bank policy paths, we favor duration positions in the U.K. and Australia, where terminal pricing for the central bank cycles (see Figure 3) still looks somewhat high versus the U.S., the eurozone, and other global markets.

Figure 3: Market expectations vary for central bank policy rate trajectories and terminal levels



Source: Bloomberg data and PIMCO calculations as of 30 September 2024

In the eurozone, the market's terminal rate pricing for the European Central Bank looks reasonable, but there is some uncertainty on the timing of how quickly the easing cycle proceeds. Overall, we are neutral on duration but favor curve steepening positions given the flatness of the curve between the 10- and 30-year points.

Looking at foreign exchange (FX), we prefer an underweight position in the U.S. dollar, given risk of weakening as the Fed lowers rates, while diversifying with EM and DM positions. Careful scaling of positions is needed here, however, given the uncertainties surrounding the U.S. election.

A stable-to-weaker U.S. dollar amid rate-cutting cycles across DM should enable EM central banks to cut rates as well. While the Fed was on hold, many of these central banks had to keep rates higher than their benign domestic inflation would normally require.

We prefer investments in markets with steep yield curves and stable or improving political conditions, such as South Africa and Peru. Turkey also remains of interest given the ongoing pivot to greater economic orthodoxy. The favorable global environment we expect should remain supportive of EM external debt spreads.

Certain commodities can help diversify portfolios and provide hedging properties against inflation risks. The shifting global landscape continues to support gold and precious metals, with EM central banks purchasing gold at unprecedented rates since Russia's invasion of Ukraine. Meanwhile, the desire of OPEC+ to return supply to the market and concerns over global transport demand have limited the upside to oil prices, even as recent events in the Middle East and Ukraine underscore the fragility of global supply chains. The capital spending cycle linked to the energy transition also supports prices of base metals, although lingering downside risks to growth in China pose challenges.

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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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