

Income Strategy Update: Navigating Uncertainty in 2025

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Attractive yields and a broad opportunity set bolster active bond investments amid today's uncertain macroeconomic and market outlook.

SUMMARY

- Attractive yields contribute to a compelling outlook for bonds, in our view, on an absolute basis and relative to equities – which we see as close to fully valued – as well as relative to cash, where yields are dwindling.
- In the Income Strategy, we slightly increased interest rate exposure while still being cautious with respect to longer-maturity bonds.
- We maintain an overweight to U.S. agency mortgages, as spreads remain uncharacteristically high versus those of investment grade corporates.
- As credit spreads tightened, we lowered our corporate credit exposure, though we believe corporate fundamentals are generally sound.

The persistence of attractive yields marks a potentially auspicious period for active fixed income managers, in our view, with economic uncertainty contributing to both risk and opportunity. 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 how the strategy is positioned amid high yields and high uncertainty, including potential shifts in fiscal and monetary policy in the first year of the second Trump administration.

Q: WHAT IS PIMCO'S OUTLOOK FOR THE ECONOMY AND MARKETS OVER THE COMING YEAR?

A: Bond yields remain high relative to the past two decades, and there is considerable uncertainty about the future of policy and economic growth, which likely means elevated

volatility this year. President Donald Trump has been very clear about his focus on raising tariffs, extending tax cuts, and reducing some government spending. The key question for investors will be the degree to which this administration is willing to calibrate policy to economic realities and market signals.

Economic growth cycles around the globe have become less synchronized, and Trump's policies will likely exacerbate this trend. China is experiencing weak growth with disinflationary pressure, while Japan's inflation remains comfortably above their central bank's target. The U.S. continues to exhibit economic momentum, while we see a more mixed picture across Europe, the U.K., and Australia.

We believe the U.S. Federal Reserve (Fed) and other central banks want to lower interest rates further to the extent it's warranted given inflation and other economic data. But central

banks are operating with uncertainty, too, in the sense that fiscal policy has the potential to upend economic trends. This could make central banks more conservative and inclined to stay on hold for a period of time. There are even outlier scenarios – well outside our base case – where elevated inflation, and inflation expectations, prompt the Fed to reverse course and raise rates slightly this year. Or, if growth and job markets slump unexpectedly, the Fed may look to lower rates more quickly.

With so much uncertainty, investors could feel overwhelmed. The bottom line is with such attractive yields available across the global opportunity set, we find great value in fixed income markets today – plus the potential for a significant cushion against volatility.

Q: WITH SOME UNCERTAINTY ABOUT THE PATH OF INTEREST RATES, HOW SHOULD INVESTORS THINK ABOUT BONDS VERSUS EQUITIES OR CASH?

A: Bonds today are attractively priced, in our view, offering compelling yields relative to much of the past decade or two. By just about any metric, we find equities to be fully valued. Comparing the two asset classes, equities are arguably overvalued versus bonds, in our view. We believe this bodes well for bonds on an absolute basis and relative to equities looking five to 10 years out.

Many investors shifted into or stayed in cash in light of the flat yield curve. But with the recent rise in yields on longer-duration bonds, the yield curve is once again upward-sloping, providing attractive compensation for extending maturities even just slightly beyond cash. We will see how these trends evolve in 2025, particularly if central banks continue lowering policy rates.

Q: CONSIDERING PIMCO'S OUTLOOK, HOW ARE YOU THINKING ABOUT DURATION (INTEREST RATE RISK), YIELD CURVE, AND GLOBAL POSITIONING IN THE INCOME STRATEGY?

A: Markets already reflect quite a bit of optimism about U.S. economic growth. We've gradually been lowering our exposure to more economically sensitive areas, and leveraging the global opportunity set in higher-quality fixed income. Also, we used the sell-off late last year to increase the strategy's overall interest rate exposure, while remaining underweight duration versus passive alternatives.

Along the yield curve, we've been mainly emphasizing intermediate maturities for some time now. And with the more recent steepening, we've shifted some exposure a bit further

out the yield curve, adding some 10-year-maturity exposure while still generally favoring the intermediate portion.

Even amid the standout momentum of the U.S. economy, the U.S. government is running a substantial deficit – leading many investors to raise questions about U.S. debt obligations. While we see the deficit as manageable, considering the U.S. dollar is the global reserve currency, we have also utilized markets outside of the U.S. to diversify exposure where we find the fiscal picture is better and economies are not expanding as rapidly. We have modest duration exposure to the U.K. and Australia, and even some of the higher-quality segments of emerging markets.

Q: THE INCOME STRATEGY HAS SIZABLE POSITIONS IN SECURITIZED SECTORS OF THE BOND MARKET. HOW ARE YOU ALLOCATING TO MORTGAGES, AND WHAT ARE YOUR THOUGHTS ON THE FUTURE OF GOVERNMENT-SPONSORED ENTERPRISES (GSES) UNDER THE SECOND TRUMP ADMINISTRATION?

A: We have been overweight U.S. agency mortgage-backed securities for some time. We continue to see a strong case for investing in these securities: They offer a yield advantage over most investment grade corporate bonds – that's a rare occurrence – and they are backed by a U.S. agency or the U.S. federal government. Also, mortgages are typically a very liquid segment of the market, so if fear were to creep back into credit sectors or mortgages became a bit too rich, we could look to shift some assets from agency mortgages to other opportunities.

The Trump administration will likely consider privatizing the GSEs or recapitalizing and releasing them from conservatorship. Whatever happens, we expect either a strong implicit or explicit U.S. government guarantee to be included, because we strongly believe the Trump administration and many members of Congress view the U.S. mortgage market as a model for the rest of the world and want to keep mortgage rates relatively low. In other words, any move to privatize the GSEs would likely drive continuing strength in their underlying credit fundamentals. Even so, any such development could contribute to volatility despite this being a well-known possibility.

Q: COULD YOU DISCUSS ALLOCATIONS TO NON-AGENCY MORTGAGES AND OTHER SECURITIZED CREDIT ASSETS?

A: U.S. households in general have good credit standing these days, with favorable consumer debt-to-GDP ratios and very high home equity. Our holdings of non-government-backed

mortgages tend to be very seasoned; loans we added in the fourth quarter of 2024 typically originated before the global financial crisis and featured loan-to-values below 50%. While these securities can be more complex than corporate bonds, they offer very attractive incremental yield with a downside cushion due to strong home equity levels.

We also favor other consumer credit markets. Regulatory scrutiny on lending to the consumer is robust relative to the non-financial corporate space. We focus on households with considerable home equity, providing owners with other financing, such as auto loans, credit card loans, and parental-guaranteed student loans. We often hold only the investment grade sliver of that risk.

Q: DOES THE STRATEGY HAVE POSITIONS IN THE COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS) MARKET?

A: We currently have limited exposure to CMBS in the Income Strategy, and the majority is AAA senior diversified risk. A higher-for-longer rate environment is not ideal for commercial real estate. Also, if we experience unexpected economic weakness, then commercial real estate markets could soften, as could other floating-rate credit markets. That could be a buying opportunity for us.

Q: HOW ARE YOU VIEWING THE CORPORATE DEBT MARKET?

A: We have been letting our credit beta exposure drift lower over the course of the last several months in response to credit spreads tightening and equity valuations rising.

I don't want to sound alarmist; we believe fundamentals are strong in the traditional, fixed-rate investment grade and high yield segments of corporate credit. Many companies have termed out their debt maturities, net issuance has been relatively low, and earnings have held up. We continue to have some exposure in attractive areas across the fixed-rate credit spectrum, but we are adjusting the allocation simply due to the tighter spreads.

We have been more defensive in floating-rate credit markets, with limited exposure and mostly senior in the capital structure. We see a bit of froth in the senior secured loan space, with more pressure on companies to manage higher-for-longer interest rates, so we don't have much mezzanine or subordinate exposure. With our size and expertise in the marketplace, we typically can assert influence in the corporate credit space, such as pursuing better covenant considerations in deals. M&A activity likely will increase in 2025, and our

position in the market could help allow us to capitalize on unique opportunities, while not necessarily increasing our exposure to credit beta.

Q: AND YOUR THOUGHTS ON BANKS?

A: Banks are fine, in our view. They still face a decent amount of regulatory pressure, and they are not taking the same types of risks that they took in the past. The Trump administration may relax some of the harsher regulations in the U.S., but we still expect the banking sector to remain sound.

With that said, our financials exposure is focused on senior positions in the capital structure. This is not because we are concerned about banks, rather because we are seeing more interesting opportunities in the consumer credit markets.

Q: TURNING TO EMERGING MARKETS, HOW ARE YOU POSITIONING THE INCOME STRATEGY?

A: We have a somewhat smaller exposure to emerging markets (EM) than we've had in the past, which is less about concerns over EM and rather because we see more interesting and resilient opportunities in some other sectors and regions. That said, we have invested in some higher-quality areas where we saw opportunity due to underperformance, including Mexico, some areas in the Middle East, and South Africa. In a world of less synchronized growth, we expect markets outside the U.S., both emerging and developed markets, will present significant opportunities to tactically trade and shift positioning.

We typically seek to run relatively low overall currency risk, and over the last year or so, we have taken an active relative value approach with overweights to select higher-yielding emerging markets and underweights to certain lower-yielding ones.

Q: ANY FINAL THOUGHTS FOR INVESTORS?

A: In the current environment, liquidity, or flexibility, seems a bit underappreciated. We believe the Income Strategy is in a very liquid position relative to the past, which provides flexibility to capitalize on opportunities as they arise. We believe that is important given the degree of uncertainty in the outlook.

And I'll add that patience can be valuable. With such attractive yields today, we can afford to be patient in the higher-quality segments of the fixed income markets. Last year was a good example: We saw many zigs and zags and rates rising toward year-end, yet active bond managers could still generate attractive returns. This year we see even higher bond yields, and with valuations stretched in other asset classes, we believe patience in bonds will be rewarded.

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