PIMCO

Income Strategy Update: High-Yielding, High Quality Global Opportunities

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With yields high and policy rates beginning to drop, we see a compelling global opportunity set for bond investors.

SUMMARY:

- We believe investors should consider locking in today's higher yields for the potential to generate attractive returns for years to come.
- We see value in positioning the Income Strategy in high quality assets with sufficient liquidity to navigate market volatility over the cyclical horizon.
- Our position in agency mortgage-backed securities has increased steadily over recent years, with agency MBS offering the potential for attractive long-term value as market factors have shifted.
- We generally concentrate our interest rate exposure in intermediate maturities, given the outlook for central banks to ease policy.

Bond yields are high, inflation is moderating, and some central banks have begun lowering interest rates – an excellent scenario for bond investors. Here, Dan Ivascyn, who manages the PIMCO Income Strategy with Alfred Murata and Josh Anderson, talks with Esteban Burbano, fixed income strategist. They discuss how the portfolio is positioned for current high yields and market volatility amid diverging economic scenarios and interest rate reduction paths across the globe.

Q: HOW ARE MARKETS RESPONDING TO MACROECONOMIC TRENDS THIS YEAR?

Ivascyn: Many investors are focusing on macroeconomic data, and they should, since central banks are also focused on that data. Back in December, inflation numbers were easing enough that central banks, particularly the U.S. Federal Reserve, were optimistic and signaled there could be several rate cuts in 2024. But then first-quarter inflation and growth were more resilient than anticipated, and market participants priced out a lot of the cuts that previously had been embedded in rates markets.

Recent data have been weaker, and have provided more evidence that inflation is moderating. Obviously the July U.S. employment data raised fears of a U.S. downturn. We still believe it's possible the U.S. has the resilience to avoid recession, though it's by no means guaranteed. Growth has slowed across many other countries, including China, and globally we are seeing less synchronized growth, inflation, and policy decisions.

Markets tend to respond quickly, and sometimes sharply, to new macro data – recent volatility is a clear example of that. In our portfolios we're focused on high quality assets that we believe can perform well in soft landing scenarios but also provide meaningful mitigation of downside risks.

Q: LOOKING OVER OUR CYCLICAL HORIZON OF SIX TO 12 MONTHS, WHAT ARE THE PATHS FOR INFLATION AND THE ECONOMY?

Ivascyn: We think inflation will continue to downshift this year and next, though it could be bumpy, and there's still a decent amount of uncertainty. We anticipate overall resilience in the U.S. economy, while the data continues to suggest some slowing in key areas, and the fiscal picture is concerning. Outcomes will vary depending on who is elected president and whether the same party controls one or both houses of Congress. Monetary policy will also be a key factor; the Fed is likely to start cutting rates in September.

Q: LET'S DISCUSS THE LONGER TERM. WE RECENTLY PUBLISHED OUR *SECULAR OUTLOOK*, 'YIELD ADVANTAGE.' WHAT IS THE YIELD ADVANTAGE, AND WHAT DOES IT MEAN FOR PORTFOLIOS?

Ivascyn: As investors, it's important to tune out the noise, look beyond the short term, and assess valuation. Following that approach, we see compelling value in fixed income, and the opportunity to take advantage of a high quality global opportunity set that also offers liquidity and defensive characteristics.

For the Income Strategy, given starting yields today and the potential to generate return going forward, we believe it bodes well for future returns over the next three to five years. Several major central banks have already cut rates, with the Fed very likely to follow this year, providing a great opportunity to potentially lock in those yields for some time. And we don't need outsize interest rate exposure, either, to position the portfolio for attractive return potential, given the income and capital appreciation opportunities we see in markets around the world today.

Consider the appeal of the high starting yields today when core inflation is around 3% and slowing. And if, as active investors, we can capture these yields, then the portfolio becomes even more attractive versus equities, and certainly attractive versus cash. Cash yields have begun to fall from their elevated levels in many countries in Europe and in Canada. We see a high probability they will fall in the U.S. as well. While fixed income investing is not without risk, staying in cash has also become riskier than in the past few years when considering the likely opportunity costs.

Q: COULD YOU DISCUSS THE OVERALL OBJECTIVE AND CURRENT HIGH-LEVEL APPROACH OF THE INCOME STRATEGY?

Ivascyn: Yes – we seek to generate attractive, consistent, and responsible income for investors. We also seek to provide significant value versus passive alternatives, and I believe this is one of the most target-rich environments we've seen in many years to look to provide that value. Active asset management is especially critical in uncertain times, and given the shifting policies, political scenarios, and geopolitical unrest worldwide today, we also maintain an eye toward portfolio resilience and risk management.

We have been utilizing the strategy's full global opportunity set, looking outside the U.S. for sources of resilience, the ability to reduce overall portfolio volatility, and ability to target greater incremental yields in parts of the world where the fiscal picture is stronger than in the U.S.

Q: COULD YOU ELABORATE ON INTEREST RATE EXPOSURE IN THE PORTFOLIO, INCLUDING RELATIVE VALUE ACROSS REGIONS?

Ivascyn: After substantial volatility in the last few quarters, we've returned to a more neutral stance on interest rate risk, generally close to the midpoint of where we can operate, which tends to be a bit more defensive than passive alternatives.

We've also used this opportunity to diversify our positions into high quality interest rate markets outside the U.S. In many of these economies, the central bank policy transmission mechanism into the economy is arguably stronger – in large

part because consumers tend to feel the pain (or relief) from rising (or falling) rates much more quickly than U.S. consumers, where 30-year fixed-rate mortgages have been the norm for decades. Over the last several months, we've added some interest rate risk in the U.K. and Australia.

We broadly agree with current market expectations for central bank cuts over the cyclical horizon, but pricing may even be a bit conservative looking a couple of years out. In light of this pricing, plus a bit of mindfulness around the fiscal picture in the U.S. and some other developed economies (and related market perceptions on sovereign debt), we generally concentrate our interest rate exposure in intermediate maturities: The three- to five-year part of the curve looks quite attractive.

Q: LET'S DISCUSS SECURITIZED MARKETS, AN IMPORTANT AREA FOR THE INCOME STRATEGY. WHAT ARE YOUR VIEWS ON AGENCY MORTGAGE-BACKED SECURITIES, AS WELL AS NON-AGENCY MORTGAGES?

Ivascyn: Several dynamics have been in play for agency mortgages. Curves are inverted, interest rate volatility has been high, and the Federal Reserve has been selling agency mortgage securities. Banks, particularly regional banks, another participant in the agency market, have been in a fragile capital and liquidity condition, so they have been buying less or even selling mortgages into the market. All of this has created an unusual and very intriguing situation: The spread on a typical U.S. agency mortgage today is wider than the spreads we see in investment grade corporates. So in the Income Strategy, we went from minimal agency mortgage exposure a few years ago (when the Fed essentially was buying them all) to a significant position of late.

We have also focused on seasoned mortgage risk that isn't guaranteed by the U.S. government, or non-agency mortgage-backed securities. We have found attractive opportunities over the last several months through bank dispositions, both here in the U.S. and across Europe.

In general, these non-agency mortgage pools tend to be very low-leverage structures, representing groups of borrowers who have been in their homes as long as 15 or 20 years now, likely benefiting from rising home prices. These borrowers aren't likely to default even if we see a big shock to the economy or housing markets – which we don't expect – so the credit risk is relatively low, in our view.

Also, the regulatory regime in the wake of the global financial crisis (GFC) requires tight documentation for non-agency mortgage-backed securities, which helps closely align incentives between the underlying investments and investors. Memories are long when it comes to all the pain these sectors caused during the GFC, and rating agencies continue to be conservative. And we can look to pick up incremental structural return to compensate for the relative complexity of these investments without taking on material additional credit risk. Non-agency mortgages are a key focus for the Income Strategy.

Q: HOW IS THE PORTFOLIO POSITIONED IN CORPORATE CREDIT TODAY?

Ivascyn: We see generic corporate credit trading fairly tight today. We've lowered our exposures in the last few quarters, staying in higher-quality, more liquid positions. We also diversify across developed and emerging market credit, but we've trimmed some of our emerging market exposure recently as part of an overall more defensive profile, not because we don't like emerging markets.

High yield spreads are tight, but high yield fundamentals appear reasonably strong, benefiting from the excess that's developed in the loan space and the private credit space. We focus on more senior structures in our high yield positions.

Q: HOW WOULD YOU SUM UP THE OUTLOOK FOR MARKETS AND FOR OUR INCOME STRATEGY?

Ivascyn: A key element of generating returns is to thoughtfully respond to unanticipated market volatility, such as what we've seen this month. We have a consequential election this year in the U.S., and there has been significant election and geopolitical uncertainty all over the world so far this year. Markets remain fixated on any signals in the macro data, contributing to potential volatility. In addition, we are witnessing market disruption from artificial intelligence and other forms of technological innovation.

The approach of the Income Strategy in this environment is to not only generate a responsible and attractive yield, but also position the portfolio with sufficient liquidity and quality to stand ready for what could be some very interesting quarters across financial markets.

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CMR2024-0729-3752528

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