PIMCO

Income Strategy Update: Poised for Resilience and Potential Price Appreciation

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We see meaningful value in high quality, more liquid bonds that offer compelling yields and potential price appreciation should the economy weaken.

Key Points

- We're focusing on higher-quality, more liquid, less economically sensitive assets that offer not only robust yields and flexibility today, but also potential resilience and price appreciation in a recession.
- We have been adding interest rate exposure since 2021, which we believe should benefit in an economic downturn. We're primarily targeting U.S. duration in the five-to-10-year portion of the curve, while underweighting the long end of the curve.
- We continue to prefer higher-rated securitized risk. This includes residential agency mortgage-backed securities (MBS), securities backed by non-agency mortgages, higher quality student and auto loans.
- We have been steadily reducing our credit exposure over the last few months and think floating-rate corporate loans in particular are vulnerable to higher rates and a slower economy.

Many investors have taken a wait-and-see approach, but we think the time to add exposure to bonds is now. Here, Dan Ivascyn, Alfred Murata, and Josh Anderson, who manage PIMCO Income Strategy, talk with Esteban Burbano, fixed income strategist. They discuss the uncertain economic outlook and how they are positioned not only for attractive yields today, but for potential resilience and price appreciation tomorrow.

Q: INFLATION, AND WHAT IT MEANS FOR INTEREST RATES, HAS BEEN A KEY DRIVER OF MARKET VOLATILITY OVER THE PAST TWO YEARS. WHAT IS PIMCO'S OUTLOOK FOR FED POLICY AND THE ECONOMY?

Ivascyn: Inflation remains well above the US. Federal Reserve's 2% target, but the labor market appears to be slowing. Recent payroll, unemployment, and income data were weak. October manufacturing and services indexes were also weaker than expected. We now think it's likely the Fed will remain on pause through year end. Still, these reports have been noisy, with major prior-month revisions, and much uncertainty remains. If inflation remains sticky – a possibility next year – the Fed will likely leave restrictive policy in place or raise rates again in 2024. In contrast, the market is pricing in a very low chance the Fed will hike again.

Tighter monetary policy for longer would raise the prospect of a hard landing as we enter 2024. Indeed, for inflation to return to the Fed's target, some economic weakness is necessary and appears likely as much of the post-pandemic fiscal stimulus begins to wane, chipped away by inflation and strong consumer spending.

Central banks have not had a great historical record in bringing inflation down from these elevated levels and avoiding a hard landing. We also must acknowledge the geopolitical uncertainty ignited by wars in the Middle East and Ukraine. We are in a highly uncertain environment.

Q: COULD YOU ELABORATE ON THE HARD LANDING SCENARIO, AND WHAT IT MEANS FOR PORTFOLIO POSITIONING IN THE INCOME STRATEGY?

Ivascyn: We see about a 50% probability of a recession over the next 12 to 18 months. By market pricing, we think consensus is a bit more optimistic than we are. However, a 50/50 chance of recession means there's a 50% chance that we avoid one. Given this outlook, we did take the opportunity when spreads were tighter to reduce exposure to the most economically sensitive areas of the portfolio and looked to upgrade into higher-quality, more resilient assets.

Today we're focusing on the higher-quality, more liquid areas of the market with strong, resilient yields, and we're letting the "risk-free" or low-risk rates do much of the heavy lifting across the portfolio, while providing flexibility. We want to stay as nimble as possible because we anticipate attractive alpha-generating opportunities over the next 12 months amid elevated market volatility.

Q: HOW DOES PIMCO'S OUTLOOK ON INTEREST RATES FACTOR INTO HOW THE TEAM IS MANAGING THE INCOME STRATEGY?

Murata: We think duration, or interest rate exposure, is attractive and will enhance portfolio returns over the coming years.

We have been adding duration over the last two years, going from close to one year in 2021 – a near historic low for the strategy – to effective duration of 4.74 years at the end of September. We expect duration to be negatively correlated to credit spreads, meaning should credit spreads materially widen – which is likely in an economic downturn – we think duration will rally. That's not what happened in 2022, when credit spreads widened and duration went higher as well. We therefore believe it's prudent to have a healthy amount of duration in the strategy – though it is still underweight duration versus broader fixed income indices like the Bloomberg U.S. Aggregate Index.

Q: COULD YOU PROVIDE MORE DETAILS ON HOW THE INCOME STRATEGY IS POSITIONED ACROSS THE U.S. YIELD CURVE AND IN NON-U.S. INTEREST RATE MARKETS?

Anderson: Most of the strategy's duration remains in the U.S. and is held in the belly of the curve, at five to 10 years of maturity. We remain underweight the long end of the curve.

We are cautious on U.K. and European duration, as we see some upside inflation risk in those countries. We remain short Japanese interest rates. We think there's risk that once the Bank of Japan starts to raise rates, those markets could materially price higher. Finally, we've been looking globally at areas where higher rates flow through the economy more quickly, such as Canada and Australia, where the bulk of home loans feature floating rates. We see potential for rates to decline in those countries more rapidly.

Q: YOU HAVE BEEN ADDING AGENCY MORTGAGE-BACKED SECURITIES (MBS) TO THE INCOME STRATEGY THROUGHOUT THE YEAR. CAN YOU RECAP WHAT WE'VE SEEN IN THIS SECTOR, AND WHAT WE EXPECT GOING FORWARD?

Murata: We think the agency MBS sector has extremely attractive long-term value potential. Spreads on agency MBS – or bonds backed by pools of residential loans that are issued and guaranteed by the U.S. government or its agencies – have widened to very attractive levels. In fact, we haven't seen them this attractively priced since the global financial crisis. We can invest in high quality, liquid agency mortgage-backed securities at yields in excess of 6.5% – a good fit for the Income Strategy, where we're seeking to generate an attractive level of income while hedging against downside risk.[1]

We believe today's attractive pricing is due to poor market technicals. In 2020 and 2021, the Fed was aggressively buying agency MBS, and many banks were also actively buying. Then we had the sell-off in rates in 2022, and the Fed began quantitative tightening. Both the Fed and most banks have stopped buying agency MBS. We expect as time passes, if we see a reduction in interest rates, it's likely the Fed will start buying agency MBS again, and banks could also start buying again, potentially adding further upside to our positions.

1 References to liquidity refer to normal market conditions.

Q: TURNING TO THE NON-GOVERNMENT-GUARANTEED PORTION OF THE SECURITIZED CREDIT PORTFOLIO, WHERE ARE YOU FINDING OPPORTUNITIES TODAY?

Anderson: We continue to focus on the highest-quality segments of the market, including legacy non-agency mortgages and other asset-backed securities, where valuations are meaningfully more attractive than other forms of corporate credit. Spreads in some sectors are 1% to 2% wider than they were pre-COVID, with yields of 6% to 8% for more liquid, AAA securities.

This is one of our favorite sectors, benefiting from a wide variety of collateral types – such as residential mortgages to higher quality student and auto loans – which enables investors to target segments of the credit markets that may offer significant resiliency relative to corporate credit.

The supply of capital remains low relative to the demand for financing. Regional banks generally are not buying securitized assets – as they have their own funding challenges – and in some cases the banks are selling assets, which is contributing to higher yields, wider spreads, and better investment opportunities.

Q: WHAT ARE YOUR VIEWS ON THE CORPORATE CREDIT MARKET TODAY?

Ivascyn: We seek resilient areas of the market that should perform well even in a hard landing.

We have been steadily reducing our credit exposure over the last few months. We were adding exposure earlier this year when there was substantial uncertainty about regional banks, and spreads on high yield bonds briefly rose above 600 basis points. We then reduced that exposure when those same spreads dipped into the low-400 range.

We believe investors should be careful when considering floating-rate corporate credit securities. Senior secured loans – or loans issued to small- and mid-size businesses that are generally highly levered ¬– are almost all floating rate. Investors naturally tend to focus on floating-rate instruments because they're insulated from interest rate risk. The problem, of course, is that companies are now forced to pay a higher rate, which places them under significant pressure.

Thus, we have limited exposure to senior secured loans, and that small exposure tends to be in senior AAA rated collateralized loan obligations – I define a AAA rating both by rating agency standards and our own internal ratings. Our bottom line for corporate credit: We have been reducing exposure, while favoring high quality areas of the market that are still trading at attractive spreads.

We think this is a big differentiator of our Income Strategy versus some others in the marketplace. There may be a time next year when senior loans experience a correction in valuations and we may perhaps shift the strategy out of high quality, more liquid areas of the market back into these corporate credit sectors.

Q: HOW ARE YOU THINKING ABOUT EMERGING MARKETS, GIVEN THE RISING RISK OF A HARD LANDING IN THE U.S. AND ELEVATED INFLATION IN MUCH OF THE WORLD?

Murata: We are cautious on geopolitical risk, but emerging markets make up a very large and diverse investable universe with some attractive opportunities. For example, many emerging markets are focused on natural resource production, which we expect would benefit if there is a rise in inflation.

Also, in 2021, when developed market central banks generally were on hold, many emerging market central banks raised interest rates aggressively, and today, while there's still potential for rate increases in developed markets, many emerging markets are considering rate cuts.

In all, we see select opportunities in emerging markets, and we have substantial resources at PIMCO to help uncover these opportunities and review them for inclusion in the portfolio.

Q: WHY SHOULD INVESTORS CHOOSE AN ACTIVE BOND STRATEGY OVER INVESTMENTS IN SINGLE BONDS?

Ivascyn: An active bond strategy, particularly one with a broad global opportunity set, offers several advantages over owning single bonds. These include not only the diversification derived from owning a portfolio of bonds across geographies, sectors, and issuers, but also the manager's ability to move in and out of them and calibrate the portfolio's interest rate and credit risk as their outlook changes. In these ways, an active manager with deep resources can work to potentially outperform passive solutions while limiting the downside risk that single bonds could suffer, earning potentially higher risk-adjusted returns.

Q: WHAT SHOULD INVESTORS BE PREPARED FOR HEADING INTO THE END OF 2023 AND THE BEGINNING OF 2024?

Ivascyn: We expect the trajectory of the economy and geopolitical events will remain uncertain, creating substantial market volatility. While such an environment can feel uncomfortable for investors, we believe it's an exciting time for active investment management. The combination of elevated volatility with less synchronized global growth cycles and markets that can decouple with increasing frequency creates significant opportunity to generate alpha.

If we can hedge client portfolios from excessive interest rate risk, unnecessary inflation sensitivity, and in particular harder-landing scenarios, then we're confident given the broad set of global opportunities that we can generate attractive returns by taking advantage of potential volatility.

We acknowledge cash rates are attractive, but cash rates only target immediate yield. If we do have a hard landing next year, interest rates likely would fall, which means a strategy like the Income Strategy has the potential to not only earn an attractive yield today, but also attractive price appreciation tomorrow.

The "risk-free" rate can be considered the return on an investment that, in theory, carries no risk. Therefore, it is implied that any additional risk should be rewarded with additional return. All investments contain risk and may lose value.

Past performance is not a guarantee or a reliable indicator of future results.

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