PIMCO

CYCLICAL OUTLOOK

JANUARY 2025

Uncertainty Is Certain

Amid an unsettled global economic outlook and elevated equity valuations, bond markets present attractive yields and important diversification benefits.

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WRITTEN BY:

Tiffany Wilding
Managing Director
Economist

Andrew Balls
Chief Investment Officer
Global Fixed Income

KEY TAKEAWAYS

The change in U.S. leadership increases global economic uncertainty in 2025. The incoming administration's protectionist proposals have the power to reshape trade relationships and alter economic dynamics worldwide. With actual policies and their impacts still uncertain, we foresee a wide range of potential outcomes. Here are our near-term economic views:

- **Uncertainty is certain:** Proposed U.S. policy pivots have broadened the spectrum of potential growth outcomes. Inflation risks in the U.S. and recession risks in many non-U.S. economies have both increased. Our baseline expectation is for economically manageable U.S. tariff increases on China and other trading partners. However, more forceful efforts to rectify longstanding trade imbalances could disrupt the global economy and financial markets. Across developed markets (DM), we expect inflation to continue converging toward target levels, enabling DM central banks to keep cutting interest rates. However, price level adjustments from higher tariffs could delay additional progress, especially in the U.S. Greater policy uncertainty amid a generally strong U.S. economy argues for a more gradual, data-dependent approach.

While the range of potential outcomes has widened in both directions – from brighter upsides to bleaker downsides – U.S. risk assets increasingly rely on optimistic scenarios. Buoyed by expectations of lower taxes and relaxed regulations, U.S. stocks have scaled new heights while credit spreads are near record lows. Although this momentum could continue, history indicates limited room for further sustained gains at current valuations. In contrast, bonds present an appealing opportunity in both the near term and over a longer horizon. Here are our investment views:

- **Bonds are better positioned:** Bonds are poised to play a crucial role in portfolios in 2025. We believe bond yields are attractive at a time when equity valuations and credit spreads are not, giving high quality fixed income a favorable starting point. Unlike cash, bonds stand to benefit from capital appreciation as policy rates fall, enhancing bonds' role as a diversifier and stabilizer for equity exposure in portfolios.
- **Use relative value as a guide:** Exploring investments across diverse markets provides a broader perspective. Elevated U.S. deficits and divergent global economic paths enhance already appealing global diversification opportunities. Uncovering innovative, structural sources of return can also reduce reliance on directional bets related to economic growth or interest rates.

In this context, we see promising fixed income opportunities in the U.S. and other DM countries, particularly the U.K. and Australia, as well as in select emerging markets (EM). We also prefer agency mortgage-backed securities and asset-based investments over other credit sectors in both public and private markets.

Economic outlook: Uncertainty is certain

In our October 2024 *Cyclical Outlook*, "Securing the Soft Landing," we said the U.S. economy, like others, appeared poised for a rare soft landing – moderating growth and inflation without recession. We said DM economies appeared on track to return to target inflation levels in 2025. We saw risks stemming from the U.S. election and persistently high sovereign debt levels.

The broad contours of that forecast remain in place. We expect global real GDP growth to slow modestly. Lower immigration and higher tariffs are likely to temper U.S. growth despite an otherwise robust economy. Meanwhile, Europe continues to lag with subpar economic performance.

China's economic outlook remains precarious, with growth and inflation risks tilted downward due to still-cautious fiscal support, a deleveraging housing sector that has contributed to anemic private sector credit demand, high real interest rates, and excess manufacturing capacity. Despite a prolonged property sector downturn, China maintained a 5% growth target in 2024, bolstered by expanded manufacturing – particularly in semiconductors and technology – alongside infrastructure investment and export growth.

However, this growth model is faltering under the weight of escalating trade tensions, a sluggish consumer base, and longer-term declines in population and productivity growth. Central government officials are likely to lower the growth target to around 4.5% for 2025, with core inflation likely to remain subdued. This expectation already assumes a stimulus package of about 1.5 trillion Chinese yuan (1%–1.5% of GDP) will be necessary to bolster consumption in the year ahead.

The DM outlook for inflation gradually converging toward central bank targets remains intact, although higher U.S. tariffs could delay this process. Looser labor markets and declining inflation should allow DM central banks to keep cutting rates. We expect 50 to 150 basis points (bps) of DM central bank rate cuts in 2025, depending on the region.

The Bank of Japan (BOJ) remains the exception. We expect the BOJ to hike by 50 bps as higher inflation expectations support underlying inflation despite currency volatility.

RISKS AND POTENTIAL OUTCOMES

The U.S. election has expanded the range of potential economic outcomes. Our baseline scenario assumes economically manageable U.S. tariff hikes against China and other trading partners, while tax, spending, and trade policies leave net U.S. fiscal deficits unchanged around 6%–7% through 2025 and 2026 – an outcome with more limited economic implications.

However, the risk is that the incoming administration pursues more aggressive policy pivots (see Figure 1) to address persistent trade and fiscal deficits – policies that the administration argues will lead to more sustainable and equitable U.S. growth over time. Achieving meaningful changes in global trade imbalances would require altering global savings and investment patterns, reducing the consumption share of GDP in the U.S. and the manufacturing share elsewhere (e.g., China).

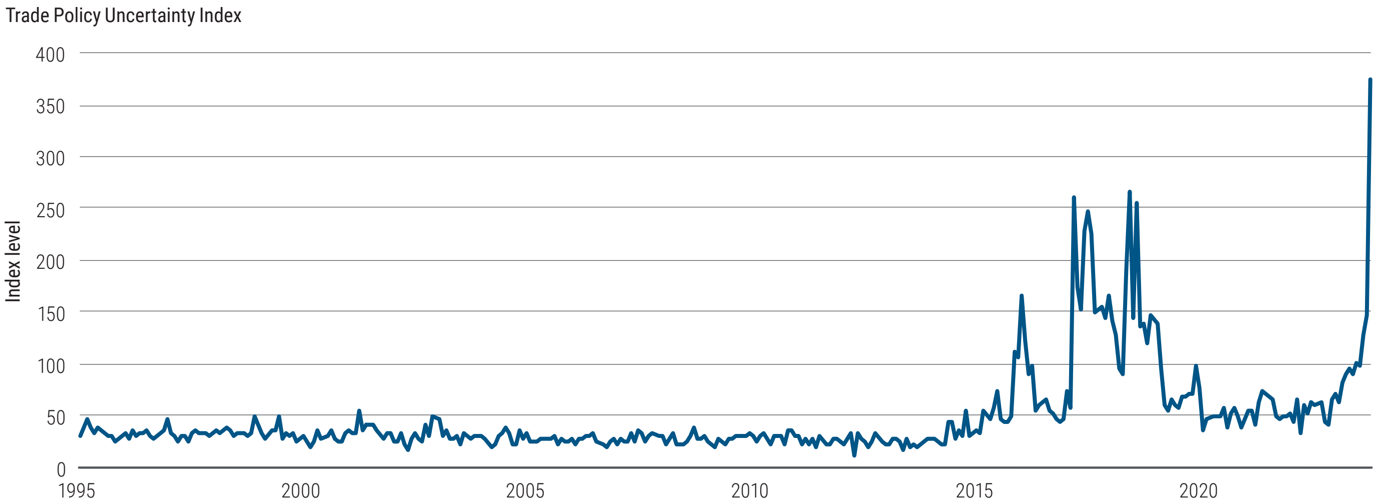
Without reforms in China or other trade surplus countries to cut implicit manufacturing subsidies and stimulate consumption, the U.S. could try to implement interventionist trade policies (e.g., a system of universal tariffs or foreign direct investment taxes) to compel these changes. However, distributing the burden of the U.S.'s global reserve status by making U.S. assets more expensive to hold would likely raise the cost of capital and – absent more aggressive fiscal deficit reduction – increase U.S. government borrowing costs.

Such aggressive short-term measures to reverse long-term trends would likely contribute to economic disruptions, near-term currency volatility, and U.S. equity market underperformance, even if they were to succeed at creating stronger, more balanced global growth longer term. Hence, President-elect Donald Trump's tolerance for U.S. equity market volatility is a key question for the outlook.

These proposed policy pivots amplify both upside and downside risks to U.S. growth – especially as the exact combination, timing, and scope of any such policies remain unclear. However, we think the balance of potential policy outcomes increases near-term U.S. inflationary risks while posing greater downside risks to growth for non-U.S. countries, particularly those with high global trade exposure that run persistent surpluses with the U.S.

For example, any larger-than-expected U.S. government spending cuts, aggressive trade actions, or immigrant deportation could pose cyclical downside risks to both U.S. and global growth. Conversely, greater U.S. tax cuts and deregulation could enhance U.S. growth prospects, potentially aiding consumer and business confidence and risk asset performance. A focus on achieving fairer global trade, more efficient markets, and a sustainable U.S. debt trajectory could help maintain rising U.S. living standards. Thoughtful immigration overhauls that expand the productive labor force, streamlined regulations that encourage investment, and opening export markets for U.S. projects could also yield benefits for U.S. businesses and workers.

Figure 1: Trade policy uncertainty has soared



Source: U.S. Federal Reserve as of 30 November 2024. The Trade Policy Uncertainty (TPU) Index is constructed by staff in the International Finance Division of the Federal Reserve Board and measures media attention to news related to trade policy uncertainty. The index reflects automated text-search results of the electronic archives of seven leading newspapers: Boston Globe, Chicago Tribune, Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post (accessed through ProQuest Historical Newspapers and ProQuest Newsstream). The index is scaled so that 100 indicates that 1% of news articles contain references to TPU. For details on the TPU Index, see "The economic effects of trade policy uncertainty," by Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo, Journal of Monetary Economics, Elsevier, vol. 109(C), 2020.

In the very near term, higher trade policy uncertainty could weigh on global industrial production, investment, and trade regardless of actual policy outcomes. While these isolationist, pro-U.S.-growth policies offer mixed risks for U.S. growth, they are generally more likely to be inflationary, especially since the U.S. economy is currently estimated to be operating at or near its potential.

The U.S. Federal Reserve (Fed) has taken note of these changing risks. In December, when the Fed cut its policy rate by 25 bps, officials revised projections to indicate fewer expected cuts in 2025 amid greater uncertainty around continued inflation progress. Fed Chair Jerome Powell said that some officials had factored potential Trump administration policies into their revised projections.

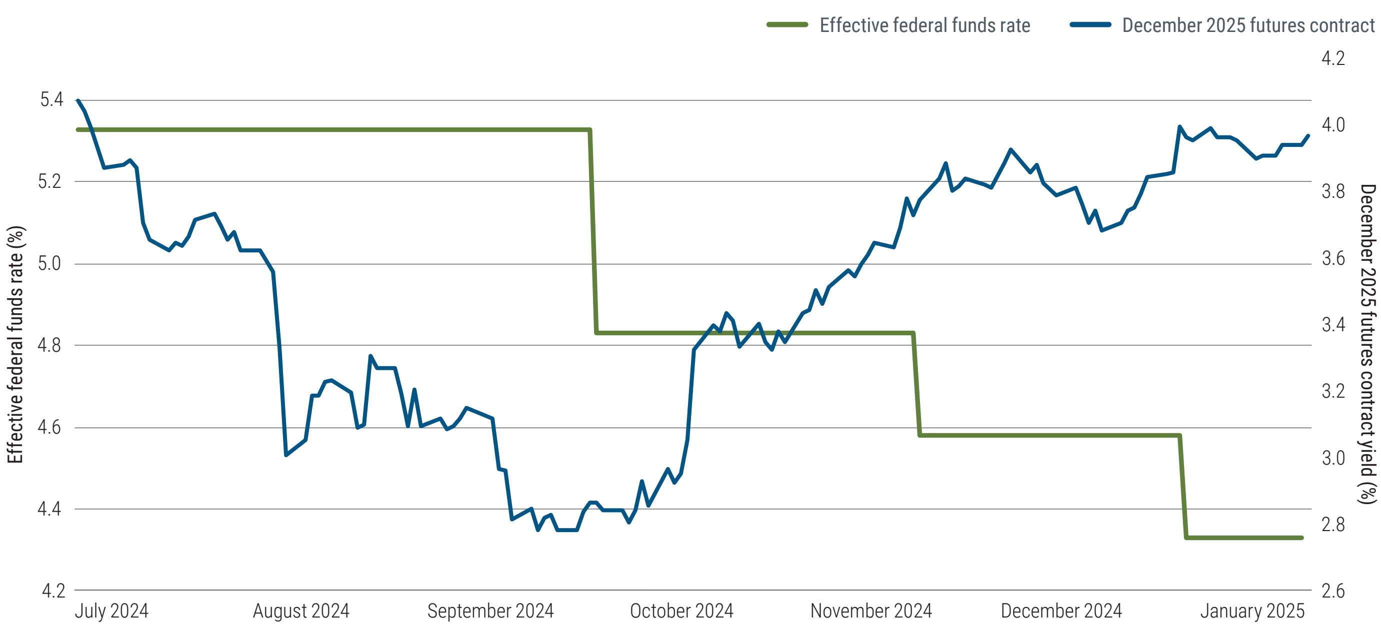
Although conventional wisdom suggests that central banks should look through one-off price level adjustments, such as those from tariffs, any tariffs that are accompanied by other pro-U.S.-growth policies could come with more persistent inflationary pressures. In various scenarios, Fed officials could remain concerned about the knock-on effects of rising inflation expectations and elevated wage growth. As a result, they could react by cutting less than previously expected, at least at first.

Thus, after 100 bps of policy rate reductions in 2024, the timing of further Fed cuts has become less certain, indicating a more gradual, data-driven approach in 2025. The futures market has reflected this uncertainty in recent months (see Figure 2). Despite the Fed cutting its policy rate by 100 bps during this period, market pricing removed the expectation of 100 bps of additional easing in the year ahead.

The long-term outlook for U.S. government debt is likely to remain a significant concern. Nevertheless, there is a possibility of some incremental deficit improvement with the potential for rollback of certain Biden administration policies – such as renewable energy investment credits and other elements of the 2022 Inflation Reduction Act – and cuts to Medicaid. Higher tariffs could also reduce deficits through increased government revenue collection.

Still, any meaningful deficit improvement will be difficult, with the expected extension of the Tax Cuts and Jobs Act – Trump's first-term bill – and some additional tax cuts, including, for example, provisions to raise state and local tax (SALT) deduction caps. Although some spending reductions could be found through policies to improve government efficiency and reduce waste, any larger-scale cuts, including reforms to Social Security and Medicare programs, will require an act of Congress and likely be difficult to pass given the narrow Republican majorities, especially in the House of Representatives.

Figure 2: The futures market has priced in more uncertainty around Fed policy



Source: Bloomberg as of 7 January 2025

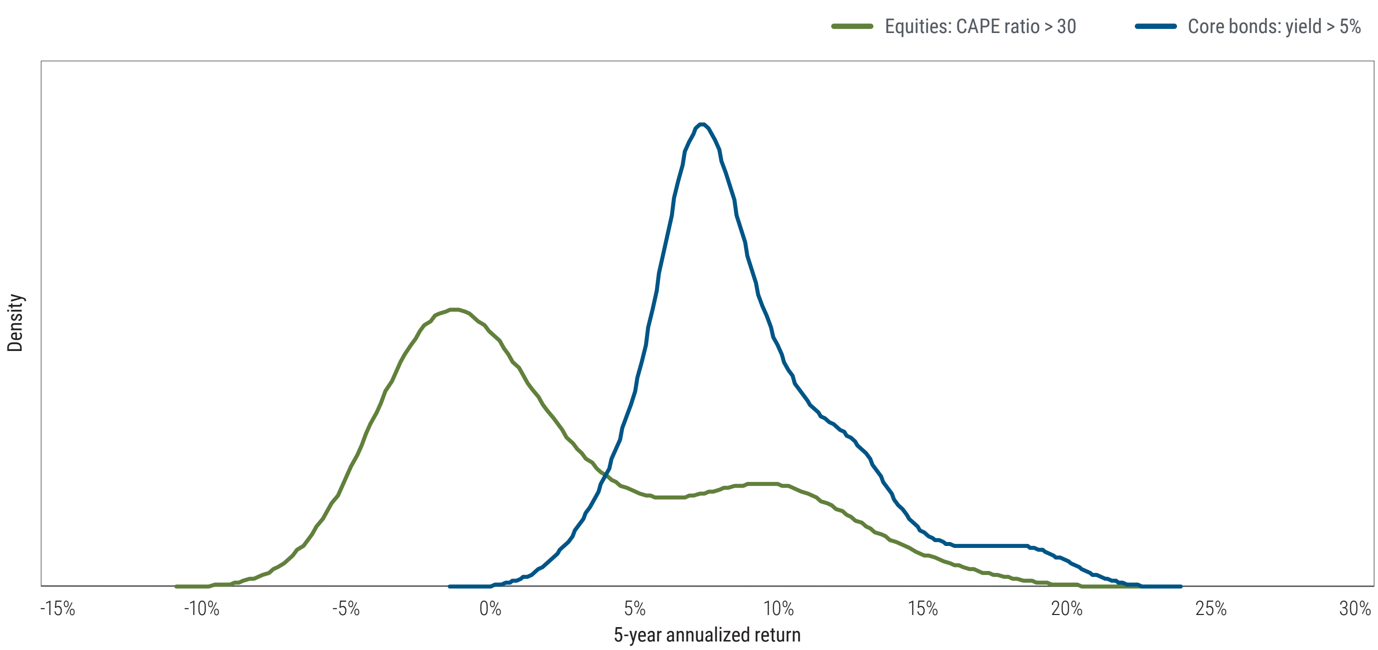
Investment implications: Bonds are better positioned

Financial markets seem to be pricing in a very positive baseline expectation – reflected in the strength of U.S. and other equity markets in recent months – at a time of elevated geopolitical uncertainty. Historically high equity valuations and U.S. deficits, along with the potential for escalating trade tensions, raise questions about the durability of stock market gains. Risks appear tilted to the downside, with little margin for safety. This environment presents a compelling case for taking some chips off the table.

We believe bond yields are increasingly attractive when measured against equity valuations and credit spreads. High quality fixed income starting yields – which are highly correlated with five-year forward returns – are 5.10% based on the Bloomberg US Aggregate Index, and 4.91% based on the Global Aggregate Index (U.S. dollar hedged), as of 10 January 2025. While continued equity gains would require valuations to be sustained well above long-term norms, bonds simply need historical trends to hold to generate attractive returns in line with starting yields.

Bond market returns can be further enhanced by capital gains in adverse macroeconomic or market scenarios. Historical trends also support bonds as an attractive risk hedge and portfolio diversifier (see Figure 3). Looking back at bond and equity markets on average since 1973, during similar periods when U.S. core bonds are yielding around 5% or greater while U.S. equities' earnings ratios are around 30 or higher, bonds have offered higher five-year subsequent returns, and with potentially lower volatility (for more, see our December commentary, "From Cash to Bonds: A Strategic Shift in Post-Pandemic Investing").

Figure 3: Historically, bonds at today's yields have outpaced equities at today's valuations



Source: Bloomberg data, PIMCO calculations as of 31 December 2024. **For illustrative purposes only.** Chart uses data back to January 1973. Core refers to the Bloomberg US Aggregate Index. CAPE refers to the cyclically adjusted price-to-earnings ratio for the S&P 500. **There can be no guarantee that the trends mentioned above will continue. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Past performance is not a guarantee or a reliable indicator of future results.** It is not possible to invest directly in an unmanaged index.

RATES AND CURVE

Markets are pricing in terminal policy rates for global central bank easing cycles that appear somewhat high relative to our baseline outlook. There is significant near-term potential for lower central bank rates outside the U.S. in the event of more aggressive U.S. trade policies that weaken global growth and weigh on commodity prices (see Figure 4). In the U.S., even as elevated policy uncertainty could lead to a lengthier pause in the Fed's cutting cycle, intermediate-maturity yields look attractive relative to our long-term 0%–1% neutral real interest rate baseline.

Given that, we expect to be overweight duration, a gauge of interest rate risk, particularly after the recent rise in yields.

Over our longer-term secular horizon, we still expect yield curves to gradually steepen, driven by central bank easing and a continuation of the recent rise in term premium amid concerns about elevated sovereign debt (for more, see our December *PIMCO Perspectives*, "Thoughts from the Bond Vigilantes"). However, we see scope for some cyclical flattening in the U.S. due to the possibility of delayed Fed cutting amid potential near-term inflationary pressures and marginal deficit improvement.

Balancing these secular and cyclical views, we are underweight the 30-year area of the U.S. yield curve and overweight in the five- to 10-year maturity range. U.S. Treasury Inflation-Protected Securities (TIPS) also remain a reasonably priced hedge against higher inflation outcomes, in our view.

Figure 4: Monetary policy rules of thumb leave room for additional rate cuts

Source: Bloomberg, Haver Analytics, IMF, PIMCO calculations as of 31 December 2024. We define the Taylor rule as "policy rate = max (neutral real rate + inflation target + a*(core inflation – inflation target) + b* output gap, 0)". We consider six neutral rate estimates: two from internal PIMCO models and add +/-0.5% to each. We consider a=1.25 and 1.5; and b = 0.5 and 1.0. That gives 24 Taylor rule estimates in total. The output gap is annual IMF WEO estimates up until 2023; for 2024, we use quarterly data. The estimates shown above represent the median of these various iterations.

CREDIT OUTLOOK

Corporate credit spreads are historically tight. While we expect corporate credit can continue to do fine in our baseline scenario, the range of outcomes appears skewed toward wider versus tighter spreads given the balance of global risks. Overall, we favor higher-quality bonds and maintaining liquidity.

We continue to prefer structured products, the investment grade credit default swap index (CDX), and high quality investment grade credit versus lower-quality investments. Given broadly tight credit conditions, we are shifting focus beyond global market-weight spread allocations toward high quality spread in harder-to-source areas. U.S. agency mortgage-backed securities (MBS) remain an attractively priced, high quality, and more liquid alternative to corporate credit.

Within private credit, we continue to prefer asset-based lending, especially assets tied to higher-quality DM consumers and residential mortgages. We also see value in many non-consumer forms of asset-based risk, emphasizing sectors with secular tailwinds such as aviation and data infrastructure. We remain cautious on the existing stock of lower-quality, floating-rate debt outstanding, especially in corporate markets.

We have also observed a trend toward more aggressive financial engineering in some corporate credit areas. That is creating opportunities to use independent credit analysis to identify potential gaps involving perceived credit fundamentals and ratings.

GLOBAL VIEWS

While we see U.S. duration as attractive, at the same time upside and downside risks are more evenly balanced due to trade, fiscal, and regulatory policies. In the rest of the world, the balance of risks leans toward the downside. This environment supports global diversification across bond markets, particularly high quality duration. We favor the U.K. and Australia based on valuations and economic risks compared with the U.S. Tariffs can further bolster the case for global diversification, as many of the biggest disruptions are likely to occur outside the U.S.

EM local debt, external debt, and foreign exchange positions offer reasonable return potential and reduce reliance on U.S. credit, as these markets appear to price in more downside risk than do U.S. equities or corporate credit. We see foreign exchange carry strategies as an attractive and relatively liquid way to generate income from EM exposures, when combined with careful management of the currency basket to avoid excessive U.S. dollar correlation. At the same time, with the U.S. dollar likely to strengthen on tariffs, we favor long U.S. dollar positions versus the euro, Canadian dollar, and Chinese yuan, which can offer reasonable return potential in the baseline scenario and may offer protection against more adverse trade outcomes.

STRUCTURAL TILTS AND ACTIVE MANAGEMENT

As the most accessible markets become increasingly expensive, sophisticated investors can unlock value through more structural strategies. The concept of structural alpha involves identifying repeatable structural inefficiencies in markets – e.g., decisions made by noneconomic investors such as central banks – and creating a diversified portfolio of these inefficiencies, reducing reliance on a directional macro view.

One example of structural inefficiency is home country bias, where investors feel more comfortable investing in their own country than elsewhere. We see this as a growing opportunity as capital markets continue to expand outside of the U.S.

Another example is the rise of passive exchange-traded funds (ETFs). Required daily data disclosure by ETFs has created an information advantage for active asset managers, who can track trading shifts in less liquid market areas. Also, as ETFs gain traction in mainstream sectors such as corporate credit, they enable larger trades. In recent years, synthetic indices of diversified credit instruments have become more liquid than the underlying bonds and have often outperformed those bonds due to technical factors, creating further opportunities to enhance returns.

CONCLUSIONS

Favorable global economic conditions, the capital preservation qualities of fixed income, and the potential for capital gains position bonds as a critical element of portfolios in 2025 and a source of diversification to complement exposure to riskier assets. Short-term volatility presents opportunity for active bond managers, while current yields and historical valuation trends suggest more predictable longer-term returns that are likely to be attractive compared with both cash and equities.

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PIMCO is a global leader in active fixed income with deep expertise across public and private markets. Our investment process is anchored by our Secular and Cyclical Economic Forums. Four times a year, our investment professionals from around the world gather to discuss and debate the state of the global markets and economy and identify the trends that we believe will have important investment implications. In these wide-reaching discussions, we apply behavioral science practices in an effort to maximize the interchange of ideas, challenge our assumptions, counter cognitive biases, and generate inclusive insights.

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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