

AUTHORS



Daniel J. Ivascyn
Group Chief Investment Officer
Portfolio Manager



Esteban Burbano
Executive Vice President
Fixed Income Strategist

Income Strategy Update: Navigating Rate Cuts With Flexibility and a High Quality Focus

We seek to capitalize on today's attractive yields while staying mindful of economic and market uncertainties.

SUMMARY:

- Given starting yields along with the economic and market outlook, we believe investors can seek attractive inflation-adjusted returns in fixed income. Active management can help bond investors navigate possible volatility.
- In the Income Strategy, we are close to neutral on duration and currently target the five- to 10-year segment of the yield curve.
- U.S. agency mortgages remain a high conviction allocation, as spreads remain uncharacteristically high versus those of investment grade corporates.
- We have a lower-than-usual allocation to corporate credit due to tight spreads and economic uncertainty, though credit fundamentals are generally sound.

Yields remain elevated, adding to the appeal of bonds, while volatility and economic uncertainty create a prime environment for active asset management, in our view. 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 for current high yields and the potential path for central bank policy rates. We believe the U.S. is most likely headed for a soft landing, but we're also mindful of rising economic and geopolitical uncertainty.

Q: WE SAW SIGNIFICANT MARKET AND ECONOMIC ACTIVITY IN THE PAST FEW MONTHS. WHAT ARE YOUR MAIN TAKEAWAYS?

A: One major development was the U.S. Federal Reserve kicked off a rate-cutting cycle: It lowered its policy rate 50 basis points at its September meeting, and another 25 basis points in November. Although the Fed will likely continue to be data-dependent, we expect the central bank to continue easing over the next few quarters. Interestingly, after

the September rate cut, yields on longer-maturity securities rose by a significant amount. We have not seen this dynamic in quite some time, and we're monitoring it closely as we assess duration and yield curve positioning.

The U.S. election was another event investors watched closely. While the longer-term ramifications aren't clear, post-election market movements suggest many investors anticipate a fiscal and regulatory policy environment that supports U.S. growth. And this means we should also be watching closely for signs of inflation reigniting.

On that point, U.S. inflation has generally continued to moderate, but the numbers have been bumpy. And after some signs of economic weakness, more recent data indicate a more resilient economy.

The upshot is that although we are very excited about yields, including inflation-adjusted yields, macro trends have us anticipating a volatile market environment ahead. Periods of volatility amid less synchronized global economic cycles are generally great times for active asset management.

Our base case, which seems to be generally shared by investors, is a soft landing for the U.S. economy, which has been expanding at about a 3% annual rate. Of course, this scenario has been priced into credit and equity markets, spreads have tightened, and we believe that optimism is leading to complacency in certain segments of lower-quality credit markets.

Risk awareness is crucial. If the economy continues to expand, and the trend is generally positive, it can be challenging to discern a resilient investment versus a more aggressive investment with more downside risk. We see a lot of uncertainties, and our job is to target higher-quality areas of the market where we believe we can generate yields similar to those typically found in more economically or geopolitically sensitive areas of the marketplace, but with appropriate risk mitigation.

Q: HOW ARE YOU THINKING ABOUT THOSE KEY RISK FACTORS, INCLUDING DURATION (INTEREST RATE RISK), IN THE CONTEXT OF THE INCOME STRATEGY?

A: It's been a target-rich environment the last couple of years across our Income Strategy and other PIMCO strategies. We have been much more active in tactical duration management than we had been over the previous decade or so, and we believe this has contributed to our performance versus passive approaches.

Today, we are right around neutral on duration, considering what the market is pricing in for Fed cuts as well as election implications. On the margin, we may even classify our exposure as a bit defensive on duration versus passive benchmarks.

I'll add that we have a flexible, global opportunity set outside the U.S. We're using that flexibility to target interest rate markets in Australia and the U.K., for example, along with select higher-quality emerging markets that have even higher inflation-adjusted yields than in the U.S.

Q: FOLLOWING UP ON THE DURATION COMPONENT, ESPECIALLY IN THE U.S., COULD YOU PROVIDE SOME DETAIL ON THE STRATEGY'S YIELD CURVE POSITIONING?

A: We think the curve steepening will have implications for demand for fixed income assets in general. For several years, the cash rate offered such an attractive yield that a lot of money flowed into strategies that target front-end exposures.

Now front-end yields are coming down, and economic uncertainty is increasing. We've held a curve-steepening position for some time, and we currently tend to favor the five- to 10-year portion of the curve.

In addition, with recent volatility in macro data and shifts in views toward Fed policy, we've engaged in more precise trading around the trajectory and timing of Fed rate cuts. For example, just a few months ago, we noticed that there was a bit too much easing embedded in the front end of the curve, in our view, which provided the opportunity to exploit those views in relative curve positioning.

We don't have a lot of exposure to longer maturities, given our baseline outlook. And if we get into a more challenging economic environment where central banks need to cut policy rates much more aggressively than what's priced in, then the curve positioning that we hold should help provide additional resilience to our strategy.

Q: LET'S DELVE INTO SECURITIZED ASSETS AND THE CREDIT PORTION OF THE STRATEGY, STARTING WITH MORTGAGES. CAN YOU SUMMARIZE OUR VIEWS?

A: U.S. agency mortgage spreads are wider than investment grade corporate spreads, which almost never happens. We have a core holding in agency mortgages. We see a strong case for investing in these securities backed directly or indirectly by the federal government and for receiving a yield advantage over most investment grade corporate bonds.

Elsewhere in mortgage markets, we look to source seasoned non-government-guaranteed mortgage risk. Even if we experience a recession, while borrowers would feel the strain, current equity within the U.S. mortgage market is at all-time highs, providing a cushion. During the second and third quarters of this year, we creatively leveraged the size of the Income Strategy to source billions of dollars of risk within this space. Over many years we have established a lot of relationships, we are one of the largest players, and we leverage the strategy's size to drive sourcing. We look to do so either in securitized form or by sourcing loans that we then securitize into integrated instruments.

One related area to mention is consumer lending, both in the U.S. and Europe. When a household has substantial equity in their home, we generally are comfortable investing in their automobile loans and student loans, etc.

Q: COULD YOU DISCUSS THE CREDIT ALLOCATIONS OUTSIDE MORTGAGES?

A: Our corporate spread exposure is near the lower end of where we've been historically. It's not because we expect a massive downgrade or default cycle anytime soon – fundamentals and technicals are both supportive of credit.

Rather, we view the exposure as more economically sensitive risk that currently is priced very tight. We've been slightly reducing exposure to riskier credit positions and shifted higher into the investment grade segment of the capital structure.

Also, we have a more cautious view of the floating-rate segments of the market, such as senior secured bank loans and much of private credit. For years, the economic backdrop was great for these sectors: We haven't had a major, lasting recession since 2009. However, we could be at a significant turning point. The Fed began cutting rates, and if we were to see some economic weakness, then investors in floating-rate instruments could face a situation of falling yields as macro risks are rising, unlike fixed-rate credit, where if market yields are declining, then the value of the instruments increases. We stand poised to take advantage of any dislocation in that space.

Within corporate credit, we're also looking at special situations where we could leverage our size in markets to gain positions of significant control, taking advantage of unique idiosyncratic opportunities as they arise.

Q: INVESTORS HAVE BEEN ASKING ABOUT OUR VIEWS ON PUBLIC VERSUS PRIVATE CREDIT. HOW ARE YOU THINKING ABOUT VALUATIONS IN THOSE SPACES?

A: We don't really focus on that in the Income Strategy, beyond noting that much of the growth in private credit markets has been in the floating-rate segments of the opportunity set. With yields coming down as economic uncertainty or geopolitical uncertainty increases, there very well could be a shift in investors' mindset over the next several quarters.

And again, we stand poised to take advantage of any opportunities arising from this shift in overall sentiment, at times looking to find and source less liquid opportunities and then package them in more liquid form. It's not something that we focus on too significantly, but I will say this: In a world of considerable post-election, macro, and geopolitical uncertainty, it's great to have liquidity.

Q: HOW IS THE INCOME STRATEGY POSITIONED IN EMERGING MARKETS? AND WHAT IS THE STANCE ON CURRENCIES?

A: We continue to take a targeted approach to emerging markets, with a lot of room to add if we see opportunities. Emerging markets tend to be the more volatile areas of the global opportunity set, and currently spreads are somewhat thin. We see reasonable valuations in certain areas; some of the local yields make sense as small diversifying positions. Brazil, Mexico, and South Africa are examples where we've been active on a small scale.

We've tended to have modest baskets of currency positions, and today we have more of a relative value orientation. Our currency activities year to date have generated some positive incremental returns, but overall directional exposures regarding the U.S. dollar are relatively small.

Q: WHEN SHORT-TERM RATES ROSE IN 2022, CASH DEPOSITS AND MONEY MARKET FUNDS GREW SIGNIFICANTLY. NOW, EVEN THOUGH THE FED HAS BEGUN CUTTING RATES, THE CASH DOES NOT SEEM TO BE REALLOCATING RAPIDLY. WHAT ARE YOUR VIEWS ON THIS?

A: Cash yields have declined and are likely to continue to decline. But it's not clear how quickly they will fall. Cash has done well lately, so it's not surprising that many investors are lingering perhaps too long in cash right now.

It's important to note that given starting yields along with the economic and market outlook, investors can seek an attractive inflation-adjusted return today in fixed income. Investors sitting in cash are not locking in that potentially very attractive return. My suggestion to investors is to assess your own situation, determine how much true cash liquidity you need, and strongly consider whether it makes sense to move up the yield curve to lock in some of these attractive nominal and real yields that we haven't seen in almost two decades.

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

Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Investing in **foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. References to Agency and non-agency mortgage-backed securities refer to mortgages issued in the United States. U.S. agency mortgage-backed securities issued by Ginnie Mae (GNMA) are backed by the full faith and credit of the United States government. Securities issued by Freddie Mac (FHLMC) and Fannie Mae (FNMA) provide an agency guarantee of timely repayment of principal and interest but are not backed by the full faith and credit of the U.S. government. **High-yield, lower-rated, securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. **Management risk** is the risk that the investment techniques and risk analyses applied by an investment manager will not produce the desired results, and that certain policies or developments may affect the investment techniques available to the manager in connection with managing the strategy.

There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

This material contains the current opinions of the manager and such opinions are subject to change without notice. This material is distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This is not an offer to any person in any jurisdiction where unlawful or unauthorized. | **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 is regulated by the United States Securities and Exchange Commission. | **PIMCO Europe Ltd (Company No. 2604517, 11 Baker Street, London W1U 3AH, United Kingdom)** is authorised and regulated by the Financial Conduct Authority (FCA) (12 Endeavour Square, London E20 1JN) in the UK. The services provided by PIMCO Europe Ltd are not available to retail investors, who should not rely on this communication but contact their financial adviser. Since PIMCO Europe Ltd services and products are provided exclusively to professional clients, the appropriateness of such is always affirmed. | **PIMCO Europe GmbH (Company No. 192083, Seidlstr. 24-24a, 80335 Munich, Germany)**, **PIMCO Europe GmbH Italian Branch (Company No. 10005170963, via Turati nn. 25/27 (angolo via Cavalieri n. 4), 20121 Milano, Italy)**, **PIMCO Europe GmbH Irish Branch (Company No. 909462, 57B Harcourt Street Dublin D02 F721, Ireland)**, **PIMCO Europe GmbH UK Branch (Company No. FC037712, 11 Baker Street, London W1U 3AH, UK)**, **PIMCO Europe GmbH Spanish Branch (N.I.F. W2765338E, Paseo de la Castellana 43, Oficina 05-111, 28046 Madrid, Spain)** and **PIMCO Europe GmbH French Branch (Company No. 918745621 R.C.S. Paris, 50-52 Boulevard Haussmann, 75009 Paris, France)** are authorised and regulated by the German Federal Financial Supervisory Authority (BaFin) (Marie-Curie-Str. 24-28, 60439 Frankfurt am Main) in Germany in accordance with Section 15 of the German Securities Institutions Act (WpIG). The Italian Branch, Irish Branch, UK Branch, Spanish Branch and French Branch are additionally supervised by: (1) Italian Branch: the Commissione Nazionale per le Società e la Borsa (CONSOB) (Giovanni Battista Martini, 3 - 00198 Rome) in accordance with Article 27 of the Italian Consolidated Financial Act; (2) Irish Branch: the Central Bank of Ireland (New Wapping Street, North Wall Quay, Dublin 1 D01 F7X3) in accordance with Regulation 43 of the European Union (Markets in Financial Instruments) Regulations 2017, as amended; (3) UK Branch: the Financial Conduct Authority (FCA) (12 Endeavour Square, London E20 1JN); (4) Spanish Branch: the Comisión Nacional del Mercado de Valores (CNMV) (Edison, 4, 28006 Madrid) in accordance with obligations stipulated in articles 168 and 203 to 224, as well as obligations contained in Title V, Section I of the Law on the Securities Market (LSM) and in articles 111, 114 and 117 of Royal Decree 217/2008, respectively and (5) French Branch: ACPR/Banque de France (4 Place de Budapest, CS 92459, 75436 Paris Cedex 09) in accordance with Art. 35 of Directive 2014/65/EU on markets in financial instruments and under the surveillance of ACPR and AMF. The services provided by PIMCO Europe GmbH are available only to professional clients as defined in Section 67 para. 2 German Securities Trading Act (WpHG). They are not available to individual investors, who should not rely on this communication. According to Art. 56 of Regulation (EU) 565/2017, an investment company is entitled to assume that professional clients possess the necessary knowledge and experience to understand the risks associated with the relevant investment services or transactions. Since PIMCO Europe GmbH services and products are provided exclusively to professional clients, the appropriateness of such is always affirmed. | **PIMCO (Schweiz) GmbH (registered in Switzerland, Company No. CH-020.4.038.582-2, Brandschenkestrasse 41 Zurich 8002, Switzerland)**. According to the Swiss Collective Investment Schemes Act of 23 June 2006 ("CISA"), an investment company is entitled to assume that professional clients possess the necessary knowledge and experience to understand the risks associated with the relevant investment services or transactions. Since PIMCO (Schweiz) GmbH services and products are provided exclusively to professional clients, the appropriateness of such is always affirmed. The services provided by PIMCO (Schweiz) GmbH are not available to retail investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Asia Pte Ltd** (8 Marina View, #30-01, Asia Square Tower 1, Singapore 018960, Registration No. 199804652K) is regulated by the Monetary Authority of Singapore as a holder of a capital markets services licence and an exempt financial adviser. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Asia Limited** (Suite 2201, 22nd Floor, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong) is licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance. PIMCO Asia Limited is registered as a cross-border discretionary investment manager with the Financial Supervisory Commission of Korea (Registration No. 08-02-307). The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Investment Management (Shanghai) Limited**. Office address: Suite 7204, Shanghai Tower, 479 Lujiazui Ring Road, Pudong, Shanghai 200120, China (Unified social credit code: 91310115MA1K41MU72) is registered with Asset Management Association of China as Private Fund Manager (Registration No. P1071502, Type: Other). | **PIMCO Australia Pty Ltd** ABN 54 084 280 508, AFSL 246862. This publication has been prepared without taking into account the objectives, financial situation or needs of investors. Before making an investment decision, investors should obtain professional advice and consider whether the information contained herein is appropriate having regard to their objectives, financial situation and needs. To the extent it involves Pacific Investment Management Co LLC (PIMCO LLC) providing financial services to wholesale clients, PIMCO LLC is exempt from the requirement to hold an Australian financial services licence in respect of financial services provided to wholesale clients in Australia. PIMCO LLC is regulated by the Securities and Exchange Commission under US laws, which differ from Australian laws. | **PIMCO Japan Ltd**, Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No. 382. PIMCO Japan Ltd is a member of Japan Investment Advisers Association, The Investment Trusts Association, Japan and Type II Financial Instruments Firms Association. All investments contain risk. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. All profits and losses incur to the investor. The amounts, maximum amounts and calculation methodologies of each type of fee and expense and their total amounts will vary depending on the investment strategy, the status of investment performance, period of management and outstanding balance of assets and thus such fees and expenses cannot be set forth herein. | **PIMCO Taiwan Limited** is an independently operated and managed company. The reference number of business license of the company approved by the competent authority is (112) Jin Guan Tou Gu Xin Zi No. 015. The registered address of the company is 40F., No.68, Sec. 5, Zhongxiao East Rd., Xinyi District, Taipei City 110, Taiwan (R.O.C.), and the telephone number is +886 2 8729-5500. | **PIMCO Canada Corp.** (199 Bay Street, Suite 2050, Commerce Court Station, P.O. Box 363, Toronto, ON, M5L 1G2) services and products may only be available in certain provinces or territories of Canada and only through dealers authorized for that purpose. | **Note to Readers in Colombia:** This document is provided through the representative office of Pacific Investment Management Company LLC located at Carrera 7 No. 71-52 TB Piso 9, Bogota D.C. (Promoción y oferta de los negocios y servicios del mercado de valores por parte de Pacific Investment Management Company LLC, representada en Colombia). | **Note to Readers in Brazil:** PIMCO Latin America Administradora de Cartejas Ltda. Av. Brg. Faria Lima, 3477 Itaim Bibi, São Paulo - SP 04538-132 Brazil. | **Note to Readers in Argentina:** This document may be provided through the representative office of PIMCO Global Advisors LLC AVENIDA CORRIENTES, 299, Buenos Aires, Argentina. | No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America LLC in the United States and throughout the world. ©2024, PIMCO.