PIMCO

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

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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.