

Income Fund Update: Building Resilience and Harnessing Yield in High Quality Assets

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Despite economic uncertainty, we see compelling value in high quality, liquid assets that we view as more resilient in the face of a potential recession.

- Amid sharply higher interest rates and a looming recession, we've increased our interest rate exposure slightly but remain somewhat defensive. We prefer shorter maturity, high quality fixed income, which offers better yields than we've seen in more than a decade and the potential for attractive total returns should interest rates decline.
- We remain conservatively positioned across the credit markets, focusing on high quality and more senior positions – especially in the securitized credit markets – where we can potentially earn yields in the 6% to 6.5% range without taking excessive risk.
- We have been steadily adding U.S. agency MBS. These securities are designed to offer a guarantee from the government or an agency of the government, ample liquidity, historically attractive spreads, and complexity that creates inherent inefficiencies – providing potential advantages for skilled active managers.
- Our corporate credit exposure is largely limited to select names and sectors in the investment grade market and the higher-rated segments of the high yield market that look attractive as motivated sellers drive prices down.
- In emerging markets, we have reduced our exposure, particularly in areas such as Europe and China that are mired in geopolitical uncertainty. Our positions remain mostly in high quality sovereign or quasi-sovereign exposure.

Bond markets offer compelling value, even as economic uncertainty mounts – but caution and selectivity are warranted. Here, Dan Ivascyn, who manages the PIMCO Income Fund with Alfred Murata and Josh Anderson, talks with Esteban Burbano, fixed income strategist. They discuss how the Fund is positioned to try to capture the higher yields fixed income is now offering, while striving to remain insulated from a deep recession.

Q: WHAT IS OUR LATEST VIEW ON TIMING AND MAGNITUDE OF A RECESSION ACROSS DEVELOPED MARKETS, AND HOW DOES IT IMPACT POSITIONING IN THE INCOME FUND?

Ivascyn: In our base case, we think the U.S. economy will slow meaningfully in response to global central bank tightening, likely sliding into at least a mild recession. Of course, stalling or slightly declining growth leaves

economies highly vulnerable to unanticipated shocks, adding uncertainty to our outlook. And we expect inflation in the U.S. and Europe to end the year above central bank targets, limiting central banks' ability to ease policy if we have a hard landing. Although we don't expect a dire economic scenario, such as what occurred in the Great Financial Crisis, we do think investors should be cautious.

In our view, the good news is that the sharp rise in interest rates has created much better value in the fixed income markets and, as value has returned, we don't need to be as aggressive in the more economically sensitive areas of the marketplace to generate attractive returns. We see compelling value in high quality, liquid assets that will be steadfastly resilient in a deeper-than-expected recession and provide the potential for total return should central banks begin easing. Investors can be more cautious while harnessing attractive yields – and in some areas, spreads – than we've seen in a long time.

Q: THE MARKETS ARE PRICING IN RATE CUTS BY THE END OF THE YEAR. WHAT IS PIMCO'S VIEW ON THE PATH OF POLICY RATES, ESPECIALLY VERSUS WHAT MARKETS ARE PRICING IN?

Ivascyn: In our view, U.S. inflation will likely run comfortably above 3% toward the end of this year versus the Federal Reserve's (Fed) 2% target, as "stickier" categories related to wages will likely moderate slowly. After lifting its policy rate by 25 basis points this month, the Fed signalled its willingness to pause further rate hikes. With ongoing banking sector stress and tightening lending standards, we think this will likely be enough to tame inflation, but we don't expect it to get to the Fed's target until at least 2024. As such we think it is less likely that the Fed will cut rates as much as the market is currently pricing in.

In Europe, we believe the European Central Bank (ECB) will need to raise further its 3.25% policy rate to 3.5% to 4% to subdue stubbornly high inflation – which ran at 7% for the headline number in April.

Q: MOVING TO FISCAL POLICY, WITH ELEVATED LEVELS OF GOVERNMENT DEBT, DO YOU THINK THAT MARKETS ARE FULLY PRICING IN WHETHER OR NOT THE GOVERNMENT CAN STEP IN AND PROVIDE MORE SUPPORT?

Ivascyn: We think to some degree, pockets of the market are pricing in an elevated risk of a hard landing, but not a

high enough risk in our view. While some more economically sensitive areas are trading at wider spreads than they would otherwise, the broader market has grown accustomed to a near-immediate and powerful policy response anytime you have a sustained period of economic weakness, volatility, or uncertainty. Elevated government debt makes that less likely. It's been a long time since we've had a significant downgrade or default cycle, particularly outside the financial sector, and that has made the markets a little complacent. To that end, we think investors should be cautious in riskier equities and in the most economically sensitive areas of the fixed income market.

Q: HOW IS THE INCOME FUND POSITIONED IN INTEREST RATE RISK?

Ivascyn: With interest rates higher, we've taken our interest rate exposure up a bit, but we remain somewhat defensive with duration (interest rate sensitivity) in the low three-year range. In the Income Fund, we can run from zero to eight years, with a slightly smaller range in our lower-duration versions. We would be running higher duration if inflation and government debt – both in the U.S. and globally – were under better control. We prefer shorter-maturity, high quality fixed income, which currently offers yields ranging from 4% to 4.5% in the Treasury market and the potential for higher returns in high quality spread products. Recent heavy volatility in two- and three-year maturities has given us more opportunities to tactically trade across the curve than we've had in some time.

Q: WHERE DO YOU SEE OPPORTUNITIES AND WEAKNESS WITHIN THE SECURITIZED AND CORPORATE CREDIT MARKETS?

Ivascyn: We remain conservatively positioned across the credit markets, focusing on high quality and more senior positions, especially in securitized credit. Currently, we can earn yields in the 6% to 6.5% range without taking what we believe is excessive risk. To that end, we have been steadily adding risk in agency mortgage-backed securities (MBS) in lieu of direct corporate credit exposure. These securities benefit from a government (Ginnie Mae) or agency of the government (Fannie Mae, Freddie Mac) guarantee and offer ample liquidity and historically attractive spreads. The agency MBS landscape is more complex and dynamic, which advantages experienced active managers that can identify the most compelling areas of opportunity.

We also see exciting opportunities in various structured products – in our view, these positions differentiate our fund from most other income-oriented strategies. In the non-

government guaranteed mortgage sector, we remain focused on diversified pools of legacy loans that have benefited from years of massive home price appreciation, and have high equity levels. We believe these loans will be resilient, even in a hard economic landing. We also favor senior tranches of certain products backed by other hard assets, including automobiles and high quality segments of the student loan space.

We are much more cautious in corporate credit, particularly in the U.S. We're focused on select names and sectors in the investment grade market and the higher-rated segments of the high yield market that we feel look attractive as motivated sellers drive prices down.

In particular, we are cautious around certain floating-rate debt, like senior secured loans, for example, which we believe are susceptible to further deterioration. We believe many of these highly leveraged borrowers are being squeezed by sharply higher interest rates at a time when earnings are weakening. We expect a wave of credit rating downgrades to wash over the space perhaps beginning later this year. Credit risk in these senior loans is further heightened by the issuers' weak investor covenants. Amid the last several years of historically low interest rates, investors poured capital into both public and private markets, leading lenders to compete and issue deals with some of the highest leverage in history alongside weakened covenants.

Q: HOW IS THE INCOME FUND POSITIONED WITHIN COMMERCIAL REAL ESTATE GIVEN RISKS OF FURTHER WEAKNESS BUT ALSO THE POTENTIAL OPPORTUNITIES FOR A GLOBAL FLEXIBLE FUND?

Ivascyn: We think asset performance in the commercial real estate sector will diverge widely. Our exposure to the commercial mortgage-backed securities (CMBS) market focuses on debt that is senior in the capital structure and has strong covenants, which we believe should provide resilience as the economy weakens. Importantly, we have very little mezzanine exposure to commercial real estate markets (debt that ranks below senior debt and is typically unsecured and convertible into equity). Not only does mezzanine debt take losses before senior risk, the tranches usually consist of just a small number of deals that can trigger heavy downside price volatility in a weakening market.

Q: WHAT ARE YOUR CURRENT VIEWS ON EMERGING MARKETS, AND ON CURRENCY POSITIONING?

Ivascyn: We view emerging market assets as a prudent diversifier, but we have reduced our exposure, particularly in areas such as Europe and China that are mired in geopolitical uncertainty. Our emerging market positions remain focused in high quality sovereign or quasi-sovereign exposure. We also maintain a diversified basket of high quality emerging markets currency positions, a couple of which performed strongly last year when almost every other asset class fell. But we have shifted some of that non-U.S. dollar exposure to developed market opportunities, including small exposures to South Korea, Australia and the Nordic countries. We continue to believe the U.S. dollar looks expensive and think recent dollar weakness could continue if the U.S. Federal Reserve, as we anticipate, is closer to the end of the tightening cycle than the beginning.

Q: INVESTORS HAVE MANY OPTIONS TODAY, INCLUDING – FOR THE FIRST TIME IN A LONG TIME – SITTING IN CASH. WHAT DO YOU SAY TO INVESTORS CONSIDERING OUR INCOME FUND INSTEAD?

Ivascyn: We recognize cash yields haven't been this high for a long time, but cash doesn't offer the potential for price appreciation. We think there's a compelling value proposition in slightly longer maturities. We can stay in relatively low-risk, defensive areas of the market and earn potential yields over 6% in the Income Fund. And if the world confronts a harder-than-expected economic landing and interest rates decline, we would also have the potential for attractive total returns.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus and summary prospectus, if available, which may be obtained by contacting your investment professional or PIMCO representative or by visiting <http://www.pimco.com>. Please read them carefully before you invest or send money.

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It is important to note that differences exist between the fund's daily internal accounting records, the fund's financial statements prepared in accordance with U.S. GAAP, and recordkeeping practices under income tax regulations. It is possible that the fund may not issue a Section 19 Notice in situations where the fund's financial statements prepared later and in accordance with U.S. GAAP and/or the final tax character of those distributions might later report that the sources of those distributions included capital gains and/or a return of capital. Please see the fund's most recent shareholder report for more details.

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