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Income Strategy Update: Attractive Yields, Resilient Returns

We see compelling value in high quality, liquid fixed income assets that may offer potential resiliency if the economy weakens.

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With proper positioning, today's bond market may offer the potential for equity-like returns with less risk. Here, Dan Ivascyn, who manages the PIMCO Income Strategy with Alfred Murata and Josh Anderson, talks with Esteban Burbano, fixed income strategist. They discuss how the strategy is positioned to seek higher yields and the potential for price appreciation that fixed income is now offering, while striving to remain resilient in the face of economic uncertainty.

Q: Recent inflation reports suggest the Fed may be near the end of its rate-hiking cycle, yet the economy has considerable momentum, particularly the labor markets. What is your outlook and how does that impact portfolio positioning?

Ivascyn: Our base case projections anticipate core inflation will trend lower but linger above central bank targets for several quarters in the U.S., Europe, and some other developed economies. This path to central bank targets may also be bumpy and could include a slight reacceleration in core inflation over the next few months. Monetary policy takes time to filter through the economy, though, raising the risk of a recession when the full impact of the sharpest tightening cycle in decades is felt. We think the risk of at least a mild recession before central banks get inflation back near target levels may be greater than half.

With that in mind, we've increased credit quality in the Income portfolios, while seeking ample liquidity to pursue resilience and flexibility in the face of an uncertain economic trajectory. These high quality assets can provide compelling yields, with potential downside resilience and price appreciation should we slide into a recession. Our flexibility has already enabled us to take advantage of market dislocations in high quality assets that have been caused by fear or sudden shifts in economic expectations. We expect volatility across the globe to continue into 2024, providing fertile ground for active managers.

Q: The key risks in a fixed income strategy are that interest rates rise or credit deteriorates, both of which would cause bond prices to decline. Looking at interest rate risk, or duration, how are you positioning the Income Strategy along the yield curve and across different countries?

Ivascyn: As shorter-term yields have risen, we've increased our interest rate exposure, particularly in the front and intermediate portion of the curve. The inverted yield curve, where short-term rates are higher than long-term rates, enables us to seek attractive income without taking significant interest rate risk further out the curve. If yields were to rise meaningfully from here, we may increase our interest rate exposure across our portfolios further. One of the many advantages we have over passive alternatives is the ability to tactically manage interest rate exposure, as we did in 2022, and that helped protect capital.

Our interest rate exposure is focused primarily in the United States, where rates are higher than other developed countries, though we have very modest positions in emerging markets, and we have a small underweight to Japanese interest rates. Localized volatility in interest rate markets has given us opportunities to trade our exposure more actively along the yield curve.

Q: The other key risk to fixed income strategies is credit risk. How are you positioning the Income Strategy to pursue attractive returns and resilience this late in the economic cycle? Let's start with corporate credit.

Ivascyn: We've significantly shifted out of lower-rated and more economically sensitive corporate credit – which has limited covenants to support investors – into higher-quality, liquid securitized market segments, especially agency mortgage-backed securities (MBS). We've used this liquidity to capitalize on heavy market volatility, which we expect to continue. When spreads on corporate credit spiked earlier this year after the collapse of three regional banks, we tactically added high quality credit exposure. Now that we're in the midst of a credit and equity market rally – with valuations that don't appear to incorporate the possibility of a hard landing – we've started to reduce our exposure.

We're a bit more neutral on investment grade corporate credit. In the high yield segment, we've been more tactical, focusing on higher-quality issues.

We also remain cautious around the senior secured loan space. These loans have floating interest rates, leaving borrowers – many of which are smaller, heavily leveraged companies – facing sharply higher debt service costs. We believe credit fundamentals in this sector may likely deteriorate, leaving it a vulnerable area of the market in the event of a harder landing.

Q: Let's dive deeper into other segments of the credit markets, starting with securitized credit. After selling much of our MBS exposure during the pandemic when Fed buying drove up prices, we've returned. How are you viewing the market?

Ivascyn: Agency MBS is one of our strongest conviction areas in the Income Strategy. This asset class is particularly liquid and benefits from an implicit government guarantee, which can provide resiliency in a range of economic environments. Valuations are enticing: The sector is trading at spread levels that we haven't seen since the global financial crisis. We have added MBS over the last several months, taking advantage of price weakness when some banks began selling agency MBS during the banking sector volatility we experienced in March. The Fed is also shrinking its exposure, which has contributed to attractive valuations. We will continue to evaluate the space, possibly adding more exposure should we see further weakness and continuing to trade based on relative value across varying coupons and maturities

Q: Shifting to other areas of the securitized credit market, what are your views on non-agency MBS and other areas of potential opportunity?

Ivascyn: We think high quality securitized credit continues to offer attractive yields and downside resiliency. Spreads in many areas of asset-backed securities have stayed quite wide, in part because banks, which are typically large investors, have been less active or are selling risk. These securities can provide the strong covenants that corporate credit often lacks.

In the non-government guaranteed mortgage sector, we remain focused on diversified pools of legacy loans that have benefited from over 15 years of robust home-price appreciation and have high equity levels. We believe these loans should be resilient even in a protracted recession.

We also like other areas of asset-backed credit, including securities collateralized by pools of high quality automobile and student loans. We typically focus on senior tranches of these pools because they get paid before more junior tranches, which can offer some cushion in the event of an economic downturn. In fact, these investments often outperform in periods of economic weakness.

Q: What are your views on the financial sector given recent regional bank turmoil?

Ivascyn: Most banks, particularly the larger, systemically important global banks, are well-capitalized as a result of post-global-financial-crisis regulations. We expect even more regulation after the recent collapse of three regional banks. In our view, financials are generally good, solid credits. Going into a possible recession, however, we've become more cautious about financials and reduced our positions, particularly more subordinated exposures. We don't anticipate major concerns but we're seeing better value in other areas that may offer even more resiliency.

Q: How is the Income Strategy positioned in emerging markets (EM) credit amid geopolitical risks?

Ivascyn: While we don't have major geopolitical concerns, we have reduced our emerging markets exposure over the last couple of years. We continued to trim last quarter as we've shifted into more defensive sectors like agency mortgages and other structured products. Our remaining exposure includes a small, diversified basket of higher-quality EM currencies that has performed quite well over the last several quarters. As the Fed nears the end of its tightening cycle, we think the U.S. dollar looks very expensive against many other global currencies, including some in emerging markets. We think our EM position, though small, has been a prudent source of diversification for the overall strategy.

Q: Investors today have multiple options, including sitting in cash. Why should they consider bonds and, more specifically, why should they evaluate a multi-sector strategy like Income?

Ivascyn: We recognize cash currently provides attractive levels of yield, but cash may only allow you to lock in that rate overnight. Longer-maturity fixed income assets have the ability to lock in an attractive yield for longer and offer the potential for price appreciation, particularly if the economy weakens and the Fed begins easing.

Multi-sector strategies, like the Income Strategy, have the flexibility to invest across a range of sectors, geographies, credit qualities, and maturities. They also can take advantage of opportunities created by volatility and market inefficiencies by pivoting to areas with better relative value. In the Income Strategies, we're fortunate to be able to leverage PIMCO's broad and deep global expertise across sectors, credit specialties, and markets around the world.

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