

Income Strategy Update: A New Bond Cycle Is Dawning

AUTHORS



Dan Ivascyn
Group Chief
Investment Officer



Alfred Murata
Portfolio Manager,
Mortgage Credit



Joshua Anderson
Portfolio Manager,
Income and Asset-
Backed Securities



Esteban Burbano
Fixed Income Strategist

SUMMARY

- We believe fixed income markets offer better value than they have in years. Real yields are the highest since 2008 and spreads are robust, which could be conducive to both attractive income generation and potential capital gains.
- We are focused on high quality, highly liquid securities, which we believe should provide resilience in a recession, while allowing us to take advantage of the mispricings we expect to see across markets in the coming months.
- Agency mortgage-backed securities' (MBS) spreads are at attractive levels, which most recently were obtained during the 2020 COVID-19 crisis and during the global financial crisis (GFC). We like the higher-coupon issues, but are more cautious on lower coupons, which in the past were supported by U.S. Federal Reserve (Fed) purchases, but may be more exposed as the Fed pares back its balance sheet.
- Overall, we favor high quality securitized products over generic corporate credit assets because they offer ample collateral and robust spreads in our view – though we do see some attractive corporate credit areas that we believe have economic resilience.
- We have increased our interest rate exposure amid higher global market rates and the potential for a mild recession.

Bond markets are offering the highest yields, spreads, and total return potential in years. Here, Dan Ivascyn, Alfred Murata, and Josh Anderson, who manage PIMCO Income Strategy, talk with Esteban Burbano, fixed income strategist. They discuss how the portfolio is currently positioned to benefit from the favorable environment, as well as from market volatility and a possible mild recession.

Q: THE BLOOMBERG US AGGREGATE AND US HIGH YIELD INDICES LOST 13% AND 11%, RESPECTIVELY, IN 2022, AS THE FED INITIATED ITS HIKING CYCLE AND U.S. 10-YEAR TREASURY YIELDS MORE THAN DOUBLED TO 4%. WHAT DROVE THESE MARKET MOVES LAST YEAR?

Ivascyn: Extreme economic and geopolitical uncertainty, accelerating inflation, and

aggressive global central bank policy tightening drove the sell-off in both high quality and economically sensitive areas of the market, leaving few places to hide. Going into 2022, inflation was elevated amid lingering COVID supply chain bottlenecks. Additionally, the breakout of war spiked commodity prices, intensifying inflation and uncertainty over whether central banks can bring inflation down without causing a deep recession.

Q: HOW ARE YOU VIEWING THE LANDSCAPE FOR FIXED INCOME INVESTING OVER THE NEXT SIX TO 12 MONTHS?

Ivascyn: Despite potential for a mild U.S. recession this year, we believe fixed income markets can offer better value than they have in the last few decades. Yields are dramatically higher than the near-zero levels of a year ago, and inflation appears to be moderating. Short-term U.S. Treasuries are offering yields above 4% and on high-quality assets, we can potentially provide yields in the 6% to 7% area. Even on an inflation-adjusted basis, real yields have reached levels not seen since the global financial crisis (GFC) in 2007–2008.

We think this is an attractive risk/reward proposition, and that this may be the time for those sitting on the sidelines to consider getting back in.

We do expect uncertainty around economic growth, inflation, and geopolitical tensions to remain elevated, fueling ongoing market volatility and decoupling the synchronized global growth we've seen over the past several years. Yet this volatility should provide fertile ground for active managers with a broad, flexible opportunity set.

Q: U.S. INFLATION WAS PERSISTENTLY STICKY AT THE END OF LAST YEAR, WITH HEADLINE HOVERING AROUND 6.5% TO 7%. HOW ARE YOU THINKING ABOUT INFLATION RISK MOVING FORWARD?

Murata: We believe inflation will continue to moderate as the effects of central bank tightening take hold, but will remain above the Fed target longer than markets expect. The drivers of inflation in 2022 should, we think, fade this year. Supply bottlenecks have eased, commodity prices have fallen, industrial orders have waned, and consumers have depleted elevated savings. As a result, we anticipate core inflation (excluding food and energy) will end 2023 at around 3.5%. Still, we think some key categories will remain “sticky,” including wage, shelter, and rent inflation, and therefore it will take longer for inflation to approach the Fed's 2% target.

Yet, the market is pricing in a far more rapid drop in inflation – to slightly above 2% by summer. To hedge against what we believe may be higher-than-expected inflation, we hold U.S. Treasury Inflation-Protected Securities (TIPS), which can benefit if actual inflation exceeds what the market is pricing in today.

Q: THE MARKET IS PRICING IN ADDITIONAL FED RATE HIKES IN THE FIRST HALF OF THE YEAR.

WHAT ARE PIMCO'S VIEWS ON THE PATH FOR POLICY RATES VERSUS WHAT MARKETS ARE PRICING IN?

Anderson: Currently, the market expects the fed funds rate to rise from 4.25%–4.5% today to 4.9%–5% at midyear, then decline to about 4.25% about one year forward. In general, that's consistent with PIMCO's view, given our expectations for moderating inflation, creating a favorable environment for fixed income investing.

Q: WHAT INVESTING THEMES ARE YOU FOCUSING ON? AND HOW ARE YOU THINKING ABOUT MACRO RISKS IN BOND PORTFOLIOS?

Ivascyn: Although our macro outlook calls for moderating inflation and a mild recession, there are significant tail risks to this outlook presented by geopolitical and economic uncertainty. We're investing with a wide range of tail scenarios in mind, while maintaining liquidity to allocate to opportunities as they become available.

Specifically, we are emphasizing liquidity and quality in the Income portfolio. We believe higher-quality, more liquid segments of the market have very attractive yield levels and should be resilient should the economy fall into a worse-than-expected recession. And we plan to use that liquidity to take advantage of the valuation overshoots we expect to see across markets over the next several months.

Q: WITH GLOBAL RATES HIGHER, HOW ARE YOU POSITIONING INTEREST RATE RISK IN THE INCOME PORTFOLIO?

Anderson: We've taken our interest rate exposure higher against a backdrop of higher interest rates and a potentially mild recession upcoming. We're running a little less than four years duration (interest sensitivity) across the Income Strategy, with the bulk of that in the U.S. We continue to hold an underweight position in Japanese duration (interest-sensitive securities), which has benefited in the last few months as the Bank of Japan let longer-term yields fluctuate more than in the past.

Q: THE INCOME STRATEGY ADDED HIGHER-COUPON U.S. AGENCY MORTGAGE-BACKED SECURITIES (MBS) THROUGHOUT THE YEAR, TO ADD HIGH QUALITY EXPOSURE TO THE PORTFOLIO. WHAT IS THE OUTLOOK FOR THIS SECTOR, AND FOR THE BROADER REAL ESTATE MARKET?

Murata: We find segments of the agency MBS market very attractive. The asset class is historically liquid and offers an

implicit government guarantee, which should provide resilience across a range of economic scenarios. Spreads have widened to levels usually seen during crises, such as in the COVID lockdowns of 2020 or the GFC fallout in 2008-2009. We like the higher-coupons, but are more cautious on lower-coupons, which in the past were well supported by Fed purchases, but may be more exposed as the Fed pares its balance sheet.

The recent sharp rise in mortgage rates comes on the heels of a steep run-up in housing prices and has made housing far less affordable than in 2020 and 2021. While we think U.S. housing prices are likely to weaken further (after peaking in mid-2022), tighter post-GFC lending standards and a lack of housing supply should temper price declines to levels far less severe than in 2008. Additionally, within the Income Strategy we emphasize senior secured legacy mortgages that we believe are more insulated from the possibility for moderating home prices, due to a cushion of home equity which has been building up over the past decade, with many loans now having a mark-to-market loan-to-value ratio below 50%.

Q: WHAT ARE YOUR VIEWS ON THE NON-AGENCY MBS SECTOR?

Anderson: We think high quality structured credit offers very attractive valuations. Spreads have widened about 50 to 75 basis points over last year, with security yields approaching levels last seen around the GFC. In non-agency MBS, we like both the legacy mortgages – which have built up significant equity from years of price appreciation – and the new issue AAA securities that are coming in with spreads around 200 basis points.

The sector's limited supply is also favorable for investors. The sector's limited supply is also favorable for investors. New issuance dwindled last year and we expect high underlying loan rates (ie. 6%–7%) to curtail new supply this year. If banks or other asset managers were to come into the market taking large positions, we think this sector could see very significant price appreciation.

Q: CORPORATE CREDIT OFFERS HIGH STARTING YIELDS, YET SOME SEGMENTS MAY BE VULNERABLE IN A RECESSION. HOW ARE WE BALANCING GENERATING YIELD WITH A POTENTIAL DOWNTURN?

Murata: We remain cautious on corporate credit overall, but see attractive opportunities that we believe will be resilient even in a recession. The healthcare and telecom sectors are two sectors we favor, with spreads that have widened

significantly since the end of 2021.

Senior financials remain a core focus, particularly banks. We think fundamental credit quality is strong. Amid post-GFC regulations, banks raised their tier 1 capital ratios to 13%–14%, from just 3%–4% in 2007, and focused on more stable, fee-based business lines, such as wealth management. Spreads have doubled over the last year to about 200–300 basis points – more than we think fundamentals suggest they should – providing attractive potential return.

We also hold certain corporate credit indices that help us to increase spread, improve liquidity, and bolster resilience in the portfolio. For example, the high yield CDX (credit default swap) index offers better liquidity than cash bonds and currently trades at spreads of about 50 basis points over cash bonds, which we find significant since the index generally trades at tighter spreads. In the event of a worse-than-expected economic downturn, we would expect the index to outperform cash bonds, which would face selling pressure from high yield funds meeting shareholder redemptions.

Q: HOW IS THE INCOME PORTFOLIO POSITIONED IN EMERGING MARKETS?

Ivascyn: We continue to hold exposure to emerging markets as a source of prudent diversification, though we've trimmed our position over the last year. We are focused on high quality, liquid, less economically sensitive areas of emerging markets. That means primarily sovereign and quasi-sovereign exposure. We also have targeted exposure to non-U.S.-dollar currencies, particularly some of the commodity exporting nations that have performed quite well in this higher inflationary environment. A soft economic landing could be a catalyst for some of these non-dollar investments to begin to outperform.

Q: WHAT SHOULD INVESTORS EXPECT HEADING INTO 2023?

Ivascyn: Going into the year, bond markets are offering better opportunities than we've seen in years, even as volatility and uncertainty remain. Yields are the highest in decades. Spreads have widened to very attractive levels. And although it's difficult to time the opportunity precisely, bond markets are currently offering attractive income along with the prospects for price appreciation. In this environment, the Income Strategy's flexibility gives us the potential to seek better returns than we have in many years, while mitigating downside risk. This may be the time for those sitting on the sidelines to consider getting back in.

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