PIMCO

Income Strategy Update: Compelling Yields Today, Potential Price Appreciation Tomorrow

Many investors remain in cash, but we think it's time to shift exposure to bonds.

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Key Points

- We think value is back in high quality bonds in the U.S., U.K., Europe and Australia. However, equity and fixed income markets appear too optimistic about how quickly central banks will cut rates and underestimate the risk of a downturn or inflation rekindling.
- Over the last year we have shifted out of lower-rated and more economically sensitive corporate credit into higher-quality, liquid securitized markets that could potentially provide resilience and price appreciation in a range of economic scenarios.
- We have reduced the strategy's interest rate exposure a bit from its peak last year. It's primarily focused on U.S. duration in the five- to 10-year range and includes a position in U.S. Treasury Inflation-Protected Securities.
- Cash yields may have peaked. When the Fed begins to cut rates, we believe price appreciation could further lift the Income Strategy's returns, at the same time cash returns are declining.

Today's bond market offers the potential for equity-like returns with less risk thanks to the highest yields in recent history. 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 portfolio is positioned not only for higher yields currently, but for potential resilience and price appreciation across a range of future economic scenarios.

Q: WHAT CONTRIBUTED TO THE INCOME STRATEGY'S STRONG PERFORMANCE IN 2023?

Ivascyn: It was a challenging but exciting year for fixed income. Yields ended the year about where they started, but with tremendous volatility in between. This volatility provided opportunities to tactically adjust duration (interest rate sensitivity), add exposure around the globe in areas with attractive relative value, and diversify our sources of return. Rallies can happen quickly. For investors reluctant to shift out of cash, I think 2023 offered a good example of how being patient and able to withstand a little volatility in bond markets can lead to additional return above what is already an attractive yield.

Q: INTEREST RATE MARKETS EXPECT MANY DEVELOPED MARKET CENTRAL BANKS TO START CUTTING RATES, WHICH SUGGESTS A SLOWDOWN. ON THE OTHER HAND, CREDIT SPREADS REMAIN TIGHT, INDICATING PERHAPS A MORE OPTIMISTIC MACRO OUTLOOK. WHAT IS PIMCO'S OUTLOOK FOR U.S. FEDERAL RESERVE POLICY AND THE U.S. ECONOMY?

Ivascyn: Our base-case forecasts anticipate inflation will continue moderating, though sticky wages may prevent it from quite reaching central bank targets. The progress on inflation means that many developed market central banks, the Fed included, will likely cut rates this year in an effort to support growth. Still, we think the markets – both equity and fixed income – appear too optimistic about how quickly central banks will cut rates.

We think the market is rightly suggesting that a soft landing in the U.S. is possible. However, credit spreads and equity valuations factor in a very low probability to the risk of either a recession or of inflation reigniting. Monetary policy takes time to filter through the economy, and we see supply and demand growth across developed markets stagnating. In our view, this suggests a higher risk of recession in many developed market economies than markets are currently pricing.

Q: WHAT IS YOUR OUTLOOK FOR BOND RETURNS VERSUS EQUITIES OR CASH?

Ivascyn: We think the next few years look quite bright for actively managed income-oriented bond strategies like the Income Strategy. Fixed income markets tend to be more predictable and less volatile than other segments of the financial markets, and starting yields historically are a great forecaster of returns over the next three to five years. In this environment, we think bonds can generate equity-like returns with less risk. When the Fed begins to cut rates, we believe price appreciation could lift returns above even the high levels achieved last year. Cash yields may have peaked and those returns are fleeting. When interest rates decline, we could have a situation where the return on cash comes down as the return on bonds goes higher.

Q: HOW DOES YOUR ECONOMIC OUTLOOK INFORM PORTFOLIO POSITIONING?

Ivascyn: Fixed income markets have the potential to weather multiple macroeconomic outcomes. Yields are still close to 15-year highs. Valuations actually appear more expensive in the higher-risk segments of the market, so we don't have to give up much yield to shift exposure into better-quality, more resilient, more liquid areas.

To help mitigate the risk of an economic hard landing, over the last few quarters we have significantly shifted out of lower-rated and more economically sensitive corporate credit – which has limited covenants to support investors – into higher-quality, liquid securitized markets. Being more liquid gives us the agility to target what very well could be some interesting opportunities this year and beyond.

We think our global positioning in more resilient areas of the market differentiates the Income Strategy from other multi-sector or strategic income bond strategies.

Q: THE INCOME TEAM IS VERY ACTIVE IN DURATION POSITIONING. WHAT SPECIFIC POINTS OF THE YIELD CURVE AND WHICH MARKETS AROUND THE WORLD OFFER THE BEST VALUE?

Ivascyn: We reduced the strategy's interest rate exposure a bit from its peak last year. It's currently below the midpoint of our historical range, focused in the middle of the curve, the five- to 10-year maturities. We hold a small exposure to the front end of the curve – maturities shorter than five years – but have recently reduced it, as the very short maturities appear overvalued amid too much optimism around how quickly central banks will cut rates. In our view, when the Fed ultimately cuts interest rates – and if, as we expect, inflation lingers at levels higher than we grew accustomed to before the pandemic – yields in longer-maturity bonds could rise further, pressuring prices.

Another reason we favor intermediate maturities is that we are concerned about the long-term sustainability of federal deficits in some countries, particularly the United States. The steep and growing U.S. deficit could lead to heavier Treasury bond issuance and higher rates as the markets absorb that risk. We are beginning to diversify our interest rate exposure into high quality markets outside the U.S., including in Australia, Europe, and the U.K.

We do maintain a position in U.S. Treasury Inflation-Protected Securities to hedge against the risk of U.S. inflation accelerating.

Q: SHIFTING TO MARKET SECTORS, THE ALLOCATION TO AGENCY MBS (MORTGAGE-BACKED SECURITIES) IS NOW A MEANINGFUL PORTION OF THE PORTFOLIO. HOW ARE YOU THINKING ABOUT THAT MARKET GOING FORWARD?

Ivascyn: Agency mortgages historically have performed better amid low interest rate volatility. Currently, agency MBS trade at wide spreads that reflect high market volatility and reduced demand from banks and the Fed, which stopped buying the securities.

We find agency MBS valuations compelling and have been steadily adding to our significant positions. We think developed market central banks will likely loosen policy only gradually, leading to a more constructive environment of less interest rate volatility. This is normally a liquid market with implicit or explicit U.S. government guarantees that trades at very attractive spreads versus their corporate counterparts. Yet the market is very complex and security selection is important. We benefit from an experienced team of mortgage specialists who actively trade agency MBS, looking to add incremental return.

Q: TURNING TO OTHER SECTORS OF THE MARKET, WHERE ARE YOU FINDING VALUE?

Ivascyn: We continue to add exposure to non-agency mortgage-backed securities. Our focus remains on legacy mortgages that have built up significant equity, have low loan-to-value ratios, and therefore don't rely on home prices continuing to go higher or even remaining stable to generate returns. PIMCO is one of the biggest, if not the biggest player in these markets not only in the U.S., but across the U.K. and key segments of Europe.

Other consumer asset-backed credit sectors we find attractive are high quality automobile and student loans. We are also actively positioned in other higher-quality structured products, senior collateralized loan obligations (CLOs), and diversified commercial mortgage-backed securities. These sectors benefit not only from reasonable underwriting quality and diversification, but are backed by hard assets that provide additional support should the economy slide into recession.

One area requiring caution is senior secured bank loans. Nearly all these loans have floating interest rates, leaving borrowers – many of which are smaller, heavily leveraged companies – facing sharply higher debt service costs than they had expected. If short-term rates don't come down, we expect to see continued deterioration across that segment of the credit market, both on an absolute and a relative basis.

Q: WHAT ARE YOUR VIEWS ON THE FINANCIAL SECTOR?

Ivascyn: Most systemically important larger U.S. and global banks are well capitalized. Amid an uncertain economic trajectory, however, we have reduced our exposure overall, cutting our subordinated bank debt to the lowest level in many years. We have, however, been adding high quality bonds that are senior in the capital structure of the major global banks. We acknowledge that some smaller banks may still face risks, but we don't anticipate major concerns in the financial sector; we're simply seeing better value in other areas that may offer even more resilience.

Q: HOW IS THE INCOME STRATEGY POSITIONED IN EMERGING MARKETS (EM) CREDIT AMID GEOPOLITICAL RISKS?

Ivascyn: We have continued to hold modest exposure to emerging markets, instead favoring more defensive sectors like agency mortgages and other structured products. EM debt remains an important diversifier, however. Our positions are focused on higher-quality, resilient segments of the market, including Brazil and Mexico, as well as targeted special situations in Eastern Europe and Asia.

We also hold a small, diversified basket of exposure to higher-yielding currencies, including currencies across Latin America. This was a meaningful positive contributor to returns last year.

Q: HOW WOULD YOU SUM UP THE OUTLOOK FOR FIXED INCOME?

Ivascyn: We're excited about the opportunities bond markets present for 2024 and beyond. Yields and valuations look enticing from a historical perspective, even after adjusting for inflation, compared with public equities and other higher-risk asset classes. Following many years of low or even outright negative yields, we think value is back in high quality bonds in the U.S., U.K., Europe and Australia. It has been a bumpy ride and could remain bumpy for a bit longer, but this volatility presents perhaps the best opportunity for tactical exposures we've seen in years. We continue to leverage our global platform and look to generate strong risk-adjusted returns with a steady income stream in an array of economic environments.

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