

Income Strategy Update: Positioning for the Long Term



Dan Ivascyn
Group Chief Investment Officer
Managing Director

Following the volatility in the bond market over the past few weeks, U.S. Treasury yields are again near record lows. Here, Dan Ivascyn, who manages the Income Strategy with Alfred Murata and Josh Anderson, talks with Esteban Burbano, fixed income strategist, about the interest rate rally, current positioning in the Income Strategy, and PIMCO's outlook.



Esteban Burbano
Executive Vice President
Fixed Income Strategist

Q: IN THE LAST TWO MONTHS, THE FEDERAL RESERVE HAS CUT ITS POLICY RATE, TRADE TENSIONS BETWEEN THE U.S. AND CHINA HAVE INCREASED, AND THE MARKETS HAVE PRICED IN A MUCH HIGHER PROBABILITY OF A RECESSION IN THE U.S. HAVE PIMCO'S VIEWS CHANGED?

Ivascyn: When we hold our Secular Forum every May, we look at major trends impacting the economy and markets over a three- to five-year period or even longer. So the events over the last several weeks, while contributing to our long-term thinking, wouldn't typically cause a major swing in our long-term mindset.

Recently, we have seen further slowing in growth around the world, more uncertainties around trade, and, perhaps less noticed, increasing discussion of the tools outside of monetary policy that governments can use to stimulate their economies. In addition to the significant deficit spending in the U.S. and talk of new stimulus from the Trump administration, fiscal stimulus is being discussed in Germany for the first time in many years, which would impact growth in Europe and around the world.

Since the financial crisis, central banks have been the key drivers of policy, but over the course of the next several years, fiscal stimulus may well replace monetary policy as a means of trying to maintain growth. We are concerned, however, about the current lack of focus on fiscal deficits and global debt levels, and another round of fiscal spending around the globe could be unfavorable for bond investors. So from a long-term perspective, we are closely watching this potential shift, especially in the low-interest-rate environment.

Over the shorter term – the next 12 to 24 months – we have become a bit more cautious in our outlook. We're not yet ready at PIMCO to declare that a recession in the U.S. is imminent, but we expect the economic data to remain weak, especially while we have such uncertainty around trade.

Q: TURNING TO THE INCOME STRATEGY, HOW WAS THE PORTFOLIO POSITIONED EARLIER THIS YEAR, AND WHAT CHANGES HAVE YOU MADE IN LIGHT OF RECENT MARKET DEVELOPMENTS?

Ivascyn: From an asset allocation perspective, the portfolio has not shifted too much over the course of this year. That tends to be our

approach: We want to find areas of the market that we think are structurally attractive, stick with them, potentially enhance returns, and be fairly measured in the amount of trading we do.

Our primary objective in the Income Strategy is to seek a responsible and consistent dividend yield. Our secondary objectives over the long term are capital preservation and total return. We don't think that these are mutually exclusive. We look for opportunities to generate attractive yields, in particular when frictions in the market drive yields higher, without exposing our investors to significant downside risk.

To that end, we have steadily added to our exposures this year in housing-related investments and financials. Both sectors have seen significant regulation since the financial crisis, and as a result, fundamentals are very strong. For banks, regulations have forced them to hold much more capital than they did before the financial crisis and have discouraged them from taking the risks they used to. Although the banking sector can be more volatile than other segments of the market, we see very low overall credit risk, even if the economy were to deteriorate. So that continues to be one of the highest-conviction trades within the strategy, and, I think, a key differentiator versus other similar strategies.

We have also reduced interest rate exposure, or duration, a bit this year, and gradually shifted some of that exposure from U.S. Treasury bonds into agency mortgage-backed securities. To the extent that agency mortgage-backed securities continue to look attractive, we very well may add to our holdings.

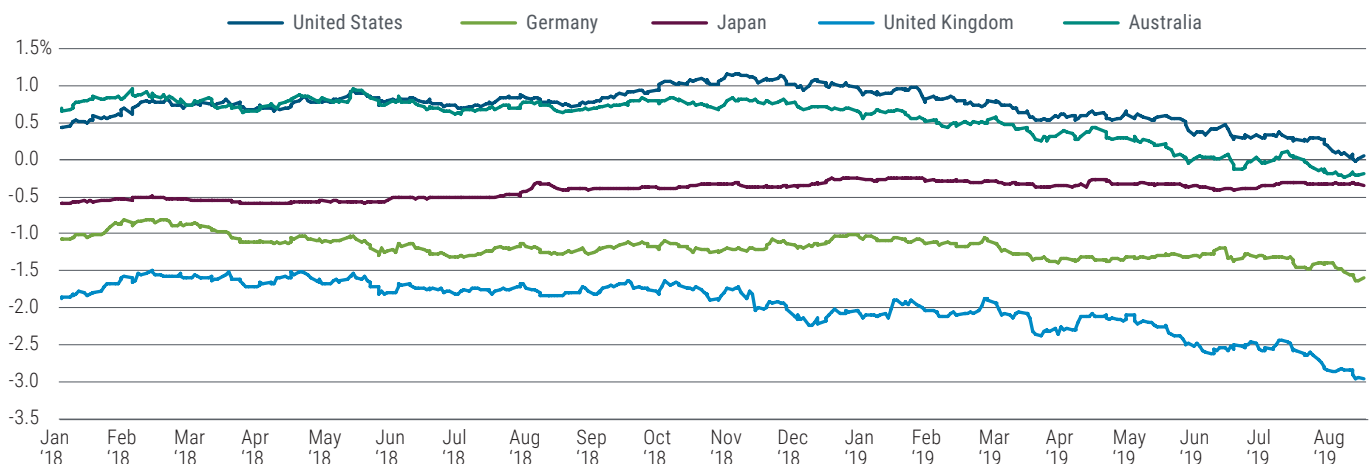
Q: CAN YOU WALK US THROUGH THE RATIONALE FOR LOWERING DURATION IN THE INCOME STRATEGY?

Ivascyn: Because our primary focus is to seek consistent dividend income, we look at high-quality bonds not only for diversification but also for yield. We have gradually reduced duration this year because from a fundamental perspective, we just don't see much value in long-term government bonds.

Yields around the world today are not keeping pace with anticipated inflation, and at their worst, they are outright negative. Negative nominal rates are simply not consistent with our primary income objective. Even a 10-year U.S. Treasury bond currently yielding about 1.5% would lock in a negative real return based on PIMCO's long-term forecast for inflation (see Figure 1). In Australia, a high-quality bond market where we've had exposure in the past, intermediate rates are less than 1%, and in Germany and Japan, rates are deeply negative even in nominal terms. Investors are literally paying to lend money in those markets.

To be sure, the Income Strategy still has a core position in high-quality bonds, but has migrated some of that into agency mortgage-backed securities and into markets offering more attractive relative yields, including the U.S. Although expensive markets could get even more expensive in certain scenarios, there is also considerable risk that better economic news, especially some sort of resolution on trade, could cause yields on high-quality bonds to experience a snapback.

Figure 1: Real yields on many 10-year government bonds are at or below zero



Source: Bloomberg as of 19 August 2019. The real yield is the nominal yield of a bond minus the rate of inflation.

In retrospect, if we had foreseen the aggressiveness of the bond market rally of the past few months, we certainly would have had higher duration in the Income Strategy. But today at these extremely low yields, we are comfortable maintaining a lower duration than at almost any point in the strategy’s history.

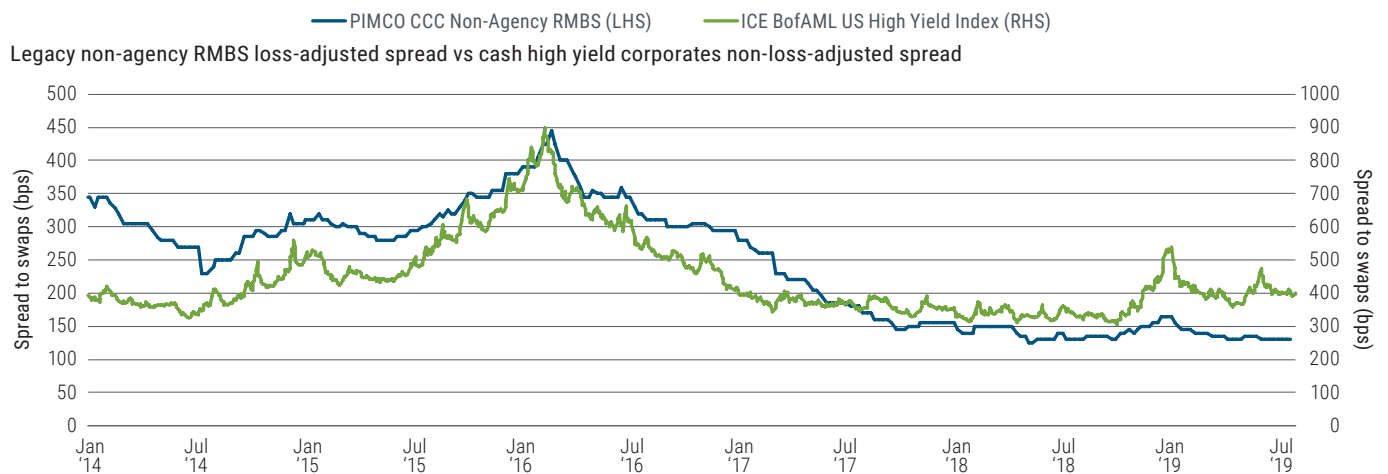
Q: WHAT ARE YOUR CURRENT VIEWS ON MORTGAGE-BACKED SECURITIES, BOTH AGENCY AND NON-AGENCY, ESPECIALLY GIVEN THE DROP IN INTEREST RATES?

Ivascyn: Agency mortgage-backed securities are high quality and very attractive to us from a valuation perspective.¹ However, the rally in interest rates this year has led to higher prepayments as homeowners refinance their mortgages, which can cause agency mortgage-backed securities to mature earlier than

expected. So typically when prepayments rise, agency mortgage prices struggle, and as a result, our allocation to agency mortgages has had a negative impact on relative returns year-to-date. Looking long-term, however, we still find the asset class attractive for its liquidity and potential resiliency.

On the non-agency mortgage side, prepayments are not generally a big factor, and fundamentals continue to look solid. Spreads have been stable this year, while corporate credit spreads have tightened after widening significantly in the fourth quarter last year (see Figure 2). So on a relative-value basis, these housing-related investments look even better to us than they did at the beginning of the year. Although non-agency mortgages have lagged in performance this year, we think these positions will continue to be fairly stable, while corporate credit spreads are likely to be more volatile.

Figure 2: Housing-related spreads have remained more stable than corporate credit



Source: ICE BofAML US High Yield Index and PIMCO as of 31 July 2019. PIMCO CCC Non-agency RMBS is a proprietary index created by PIMCO, measuring weekly spread levels observed by PIMCO’s trading desk.

Q: CAN YOU TALK ABOUT YOUR VIEWS ON CORPORATE CREDIT AND WHY YOU SEE POTENTIAL FOR VOLATILITY?

Ivascyn: I’d categorize our corporate holdings in the Income Strategy into two buckets: tactical exposures, which we typically take in the more liquid segments of the market, often in response to sharp market moves; and long-term investments in “bend but not break” assets, which we think will be resilient in a more difficult market environment. In general, we tend to favor corporate bonds that are high in the capital structure and

thus offer some insulation for investors from a downturn in the market or in that particular industry or credit.

For some time, our general view toward corporate credit has been that it is probably the riskiest segment of the fixed income market right now. Issuance has been high relative to history, many investors are chasing yield, and, not surprisingly, we have seen a meaningful deterioration in underwriting standards. As a result of all this, we think corporate credit is prone to sharp swings if there is a sudden shift in investor sentiment. We are very comfortable over the long term being underweight generic corporate credit exposure – even if spreads tighten from here.

¹ High quality based on the Bloomberg Barclays U.S. MBS Index, whose average credit quality is AAA as of 31 July 2019 according to Bloomberg. Securities issued by Ginnie Mae (GNMA) are backed by the full faith and credit of the United States government. Securities issued by Freddie Mac (FHLMC) and Fannie Mae (FNMA) provide an agency guarantee of timely repayment of principal and interest but are not backed by the full faith and credit of the U.S. government.

Q: HOW DO YOU THINK ABOUT EMERGING MARKETS FOR THE INCOME STRATEGY?

Ivascyn: We have taken advantage of opportunities in emerging markets (EM) throughout the history of the strategy, mainly to diversify the portfolio. We aim to keep individual position sizes relatively small. Over the last several years, the strategy has held a small basket of local bonds that provide attractive incremental yield potential, and we have some targeted exposures to external emerging market bonds, which are in hard currencies. Generally, we see less complacency in EM than in corporate credit today.

Many of our EM exposures have performed well this year, including positions in Mexico, Russia, and Peru. Of course, the big negative performer has been Argentina, where we've had approximately a 2% position, with 1% in local currency government exposures and 1% in external government debt. Like some others in the market, we were surprised by the primary election result in early August: President Mauricio Macri received a far smaller percentage of the vote than expected, which sparked a selloff in Argentine assets. Although this is an example of an EM position that didn't perform well, it was in our higher-risk bucket, which means we took a very small position with a very high yield. If Argentina's markets stabilize down the road, returns could improve.

EM will continue to play a role in the strategy, especially as a way to diversify away from areas of the market where we have greater long-term concerns.

Q: HOW DO YOU VIEW THE PERFORMANCE OF THE STRATEGY OVERALL IN TERMS OF ITS LONG-TERM GOALS AND THE YEAR SO FAR?

Ivascyn: We do have a longer-term orientation in the Income Strategy, and as we mentioned, consistent income is the primary objective of the strategy.

Looking at performance versus the popular benchmarks like the Bloomberg Barclays U.S. Aggregate and Global Aggregate indexes, the strategy underperformed due to our defensive positioning in duration and in corporate credit. In retrospect, we wish we had had more hard duration exposure so far this year to generate higher total return. But in the area of generic corporate credit, we're not disappointed that we gave up some short-term return, because that's not a segment of the market where we want to allocate in the hopes of gaining a bit of spread tightening. We'd much rather let corporate credit run for a bit while we prepare a more resilient and robust income-oriented portfolio.

Going forward, we feel this positioning should allow the strategy to perform well through many different return environments. We are always on the lookout for new market opportunities, and we constantly fine-tune the Income portfolio with our long-term goals in mind.

Past performance is not a guarantee or a reliable indicator of future results.

All investments contain risk and may lose value. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Investing in **foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. **High-yield, lower-rated, securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

The **credit quality** of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The quality ratings of individual issues/issuers are provided to indicate the credit-worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody's, and Fitch respectively.

This material contains the opinions of the manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

PIMCO provides services only to qualified institutions and investors. This is not an offer to any person in any jurisdiction where unlawful or unauthorized. | **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 is regulated by the United States Securities and Exchange Commission. | **PIMCO Europe Ltd** (Company No. 2604517) and PIMCO Europe Ltd - Italy (Company No. 07533910969) are authorised and regulated by the Financial Conduct Authority (12 Endeavour Square, London E20 1JN) in the UK. The Italy branch is additionally regulated by the Commissione Nazionale per le Società e la Borsa (CONSOB) in accordance with Article 27 of the Italian Consolidated Financial Act. PIMCO Europe Ltd services are available only to professional clients as defined in the Financial Conduct Authority's Handbook and are not available to individual investors, who should not rely on this communication. | **PIMCO Deutschland GmbH** (Company No. 192083, Seidlstr. 24-24a, 80335 Munich, Germany), PIMCO Deutschland GmbH Italian Branch (Company No. 10005170963), PIMCO Deutschland GmbH Spanish Branch (N.I.F. W2765338E) and PIMCO Deutschland GmbH Swedish Branch (SCRO Reg. No. 516410-9190) are authorised and regulated by the German Federal Financial Supervisory Authority (BaFin) (Marie-Curie-Str. 24-28, 60439 Frankfurt am Main) in Germany in accordance with Section 32 of the German Banking Act (KWG). The Italian Branch, Spanish Branch and Swedish Branch are additionally supervised by the Commissione Nazionale per le Società e la Borsa (CONSOB) in accordance with Article 27 of the Italian Consolidated Financial Act, the Comisión Nacional del Mercado de Valores (CNMV) in accordance with obligations stipulated in articles 168 and 203 to 224, as well as obligations contained in Title V, Section I of the Law on the Securities Market (LSM) and in articles 111, 114 and 117 of Royal Decree 217/2008 and the Swedish Financial Supervisory Authority (Finansinspektionen) in accordance with Chapter 25 Sections 12-14 of the Swedish Securities Markets Act, respectively. The services provided by PIMCO Deutschland GmbH are available only to professional clients as defined in Section 67 para. 2 German Securities Trading Act (WpHG). They are not available to individual investors, who should not rely on this communication. | **PIMCO (Schweiz) GmbH** (registered in Switzerland, Company No. CH-020.4.038.582-2), Brandschenkestrasse 41, 8002 Zurich, Switzerland, Tel: + 41 44 512 49 10. The services provided by PIMCO (Schweiz) GmbH are not available to individual investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Asia Pte Ltd** (Registration No. 199804652K) is regulated by the Monetary Authority of Singapore as a holder of a capital markets services licence and an exempt financial adviser. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Asia Limited** is licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | PIMCO Australia Pty Ltd ABN 54 084 280 508, AFSL 246862 (**PIMCO Australia**). This publication has been prepared without taking into account the objectives, financial situation or needs of investors. Before making an investment decision, investors should obtain professional advice and consider whether the information contained herein is appropriate having regard to their objectives, financial situation and needs. | **PIMCO Japan Ltd**, Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No. 382. PIMCO Japan Ltd is a member of Japan Investment Advisers Association and The Investment Trusts Association, Japan. All investments contain risk. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. All profits and losses incur to the investor. The amounts, maximum amounts and calculation methodologies of each type of fee and expense and their total amounts will vary depending on the investment strategy, the status of investment performance, period of management and outstanding balance of assets and thus such fees and expenses cannot be set forth herein. | **PIMCO Taiwan Limited** is managed and operated independently. The reference number of business license of the company approved by the competent authority is (107) FSC SICE Reg. No.001. 40F., No.68, Sec. 5, Zhongxiao E. Rd., Xinyi Dist., Taipei City 110, Taiwan (R.O.C.), Tel: +886 (02) 8729-5500. | **PIMCO Canada Corp.** (199 Bay Street, Suite 2050, Commerce Court Station, P.O. Box 363, Toronto, ON, M5L 1G2) services and products may only be available in certain provinces or territories of Canada and only through dealers authorized for that purpose. | **PIMCO Latin America** Av. Brigadeiro Faria Lima 3477, Torre A, 5º andar São Paulo, Brazil 04538-133. | No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America L.P. in the United States and throughout the world. ©2019, PIMCO.