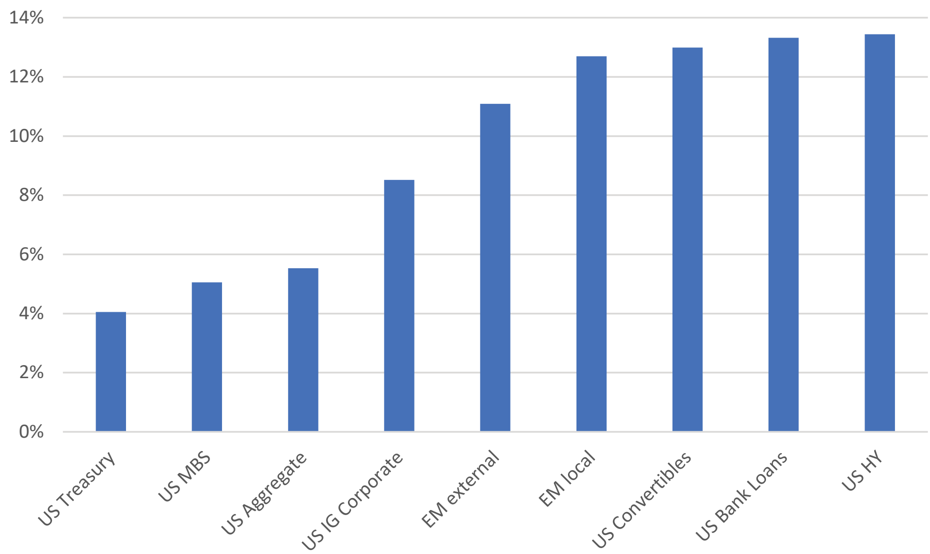
A Crucial Year for Fixed Income

Bond markets extended their rally into December with investors convinced that most central banks were done hiking interest rates. Whether those expectations are fulfilled in 2024 remains to be seen.

FIGURE 1: Fixed Income Rallied Strongly in 2023



As of 12/31/23. **Past performance does not guarantee future results**. Indices are unmanaged and not available for direct investment. Representative indices—US Treasury: **Bloomberg US Treasury Index**; US MBS: **Bloomberg US MBS Index**; US Aggregate: **Bloomberg US Aggregate Bond Index**; US IG Corporate: **Bloomberg US Corporate Bond Index**; EM external: **J.P. Morgan EMBI Global Diversified Index**; EM local: **J.P. Morgan GBI – EM Global Diversified Index**; US Convertibles: **ICE BofA All US Convertibles Index**; US Bank Loans: **Morningstar/LSTA Leveraged Loan Index**; US HY: **Bloomberg US Corporate High Yield Bond Index**. Please see page 8 for index definitions. Data Sources: Wellington Management and Hartford Funds.

Insight from sub-adviser Wellington Management

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What's Driving Markets…

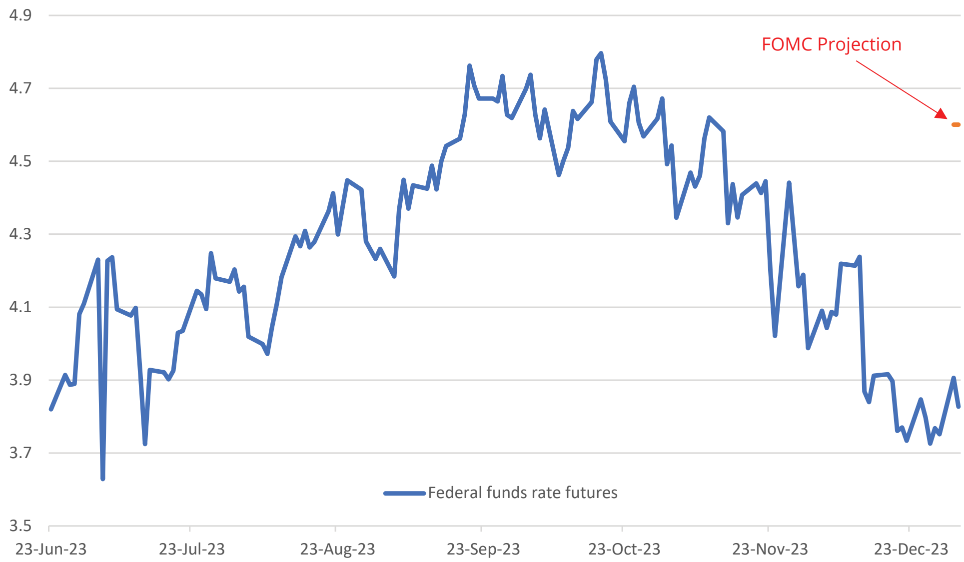
1. **Federal Reserve (Fed) communications once again captured the attention of market participants during the month.** Fed Chair Jerome Powell emphasized that the central bank was likely finished with rate hikes and would actively discuss cuts in 2024. Moreover, Powell mentioned that rate cuts could commence even in the absence of a recession.

   This last comment should not have surprised markets, since it's consistent with Powell's remarks in the summer of 2023. Then, he indicated rate cuts may be necessary even if inflation had not yet declined to 2% because by keeping the policy rate steady, the Fed would actually be tightening monetary policy in real terms if inflation was declining. Moreover, Governor Waller (the second most influential Fed Governor since the departure of Lael Brainerd) indicated, using his version of a modified Taylor Rule,[1] that cuts were highly likely in 2024.

   The overall impact of Powell's comments cannot be understated; he is (whether explicitly or not) stating that there is substantial chance of a soft landing—not quite spiking the ball in American football parlance, but near it. Fed officials attempted to walk back some of the dovishness in the ensuing days, but markets have fully embraced the pivot and are pricing in more aggressive cuts than the Fed projects. **FIGURE 2** shows the large discrepancy between markets' forecast of Fed rate cuts, pricing in nearly six 25-basis-point (bps)[2] cuts, and the Federal Open Market Committee (FOMC) forecast of three cuts.

FIGURE 2: Markets Are Predicting Deeper Rate Cuts Than the Fed in 2024

Federal Funds Rate Futures (%) vs. the Federal Reserve's Forecast of Three Rate Cuts



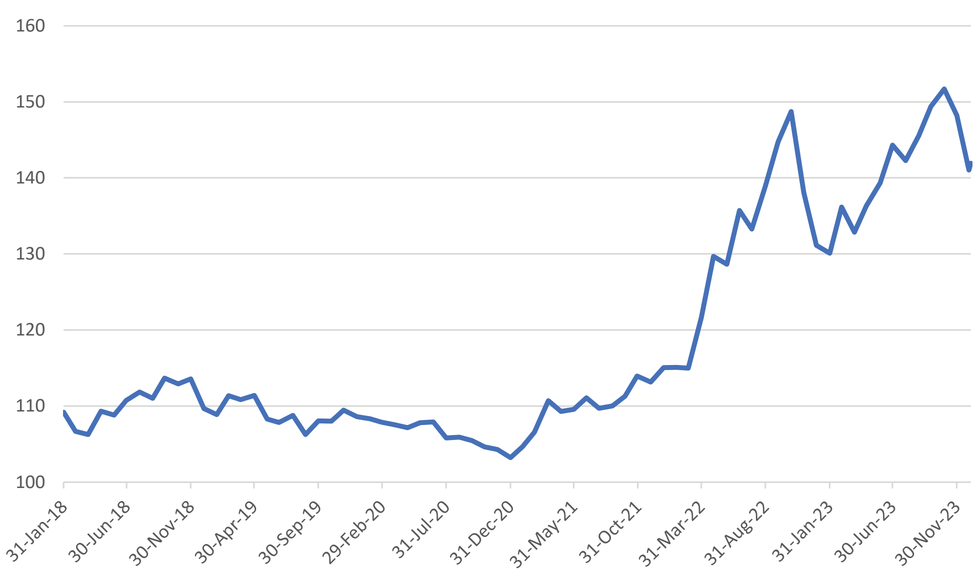
As of 1/2/24. Sources: Bloomberg, Wellington Management, Hartford Funds.

2. **The Bank of Japan (BOJ) also kept duration[3] markets relaxed** with its decision not to exit negative policy rates. Moreover, the BOJ didn't offer additional guidance as to when it would initiate such a move. It's our understanding that yield-curve policy normalization is still the ultimate goal of the BOJ, but the central bank wants to avoid volatility at nearly all costs. One has to admire the tenacity of the BOJ in this last cycle; a key concern over the last several months was that the depreciation of the yen vs. the US dollar (USD) would eventually prove intolerable for Japan, particularly because of the inflation pass-through. However, now that a US rate-cutting cycle is in play, yen pressure is beginning to ease (**FIGURE 3**). The yen has already strengthened to 141 vs. the US dollar, and the 1-year forward[4] is now at 133.

We believe yield-curve policy normalization is still the Bank of Japan's ultimate goal, but the central bank seeks to avoid volatility at nearly all costs.

FIGURE 3: Expectations for Fed Rate Cuts Are Easing Pressure on Japan's Currency

Value of the Yen vs. the US Dollar (January 2018–November 2023)

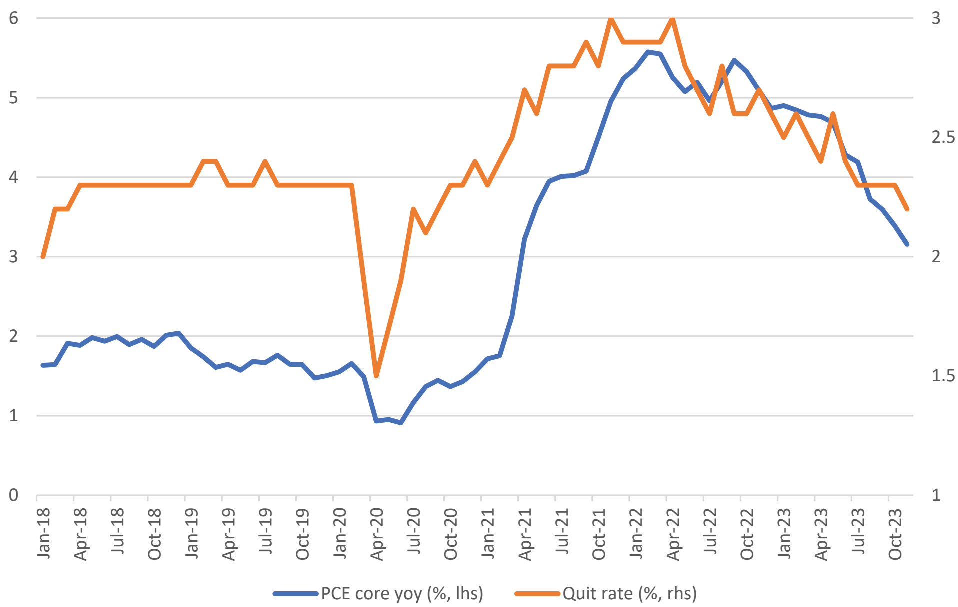


As of 1/2/24. Source: Bloomberg, Wellington Management, Hartford Funds.

3. **Economic data appears to be sending conflicting signals,** with the Fed's preferred inflation gauge making further progress toward its 2% target despite continued strength in the labor market. While the unemployment rate declined to 3.7% in November, our Wellington economists' leading indicators point to a slowdown in hiring and a rise in the unemployment rate toward 4.5% by the second quarter. The declining quits rate[5] paints a weaker picture of the labor market that's more consistent with falling inflation (**FIGURE 4**). We believe inflation should further decelerate, with signs of a more balanced labor market easing upward pressure on wages, enabling the Fed to cut rates, though its policy will adjust to evolving economic data and financial conditions.

FIGURE 4: A Declining Quits Rate Suggests a Weaker Labor Market

Personal Consumption Expenditures Index and Labor Market Quit Rates (2018-2023)



As of 11/30/23. Source: Bloomberg, Wellington Management, Hartford Funds.

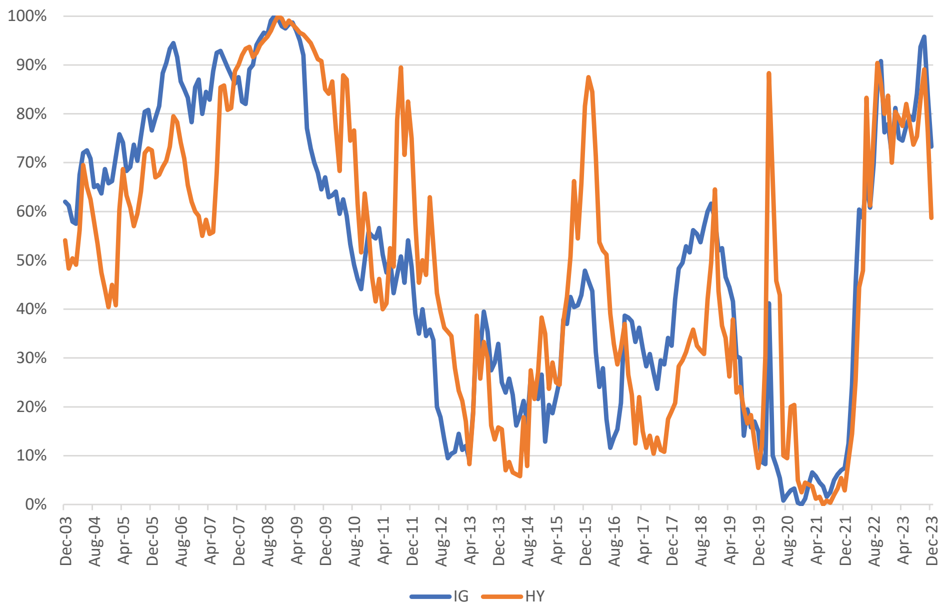
4. **The Fed pivot has bolstered credit markets.** Credit spreads[6]—both investment grade and high yield—tightened further during December, buoyed by more explicit guidance from the Fed on accommodative monetary policy in 2024. While there is likely limited scope for further compression (the recent post-holiday sell-off reinforces that view), credit markets are likely to remain supported by a strong technical backdrop. Many companies have already termed out maturities[7] and locked in low borrowing costs while demand should remain strong given elevated yields.

   The investment-grade (IG)[8] and high-yield (HY)[9] index yields finished the year at the 73rd and 59th percentile, respectively, of monthly observations over the last 20 years (**FIGURE 5**). Moreover, if a soft landing is in the works, this may lead to default rates rising slowly and/or modestly.

Economic data appears to be sending conflicting signals. The Fed's preferred inflation gauge has made progress toward its 2% target in spite of labor-market strength.

FIGURE 5: The Fed's Rate-Cutting Signals Have Tightened Credit Spreads

High-Yield and Corporate Yield-to-Worst[10] Percentile Rankings (2003-2023)



As of 12/31/23. Sources: Bloomberg, Wellington Management, Hartford Funds.

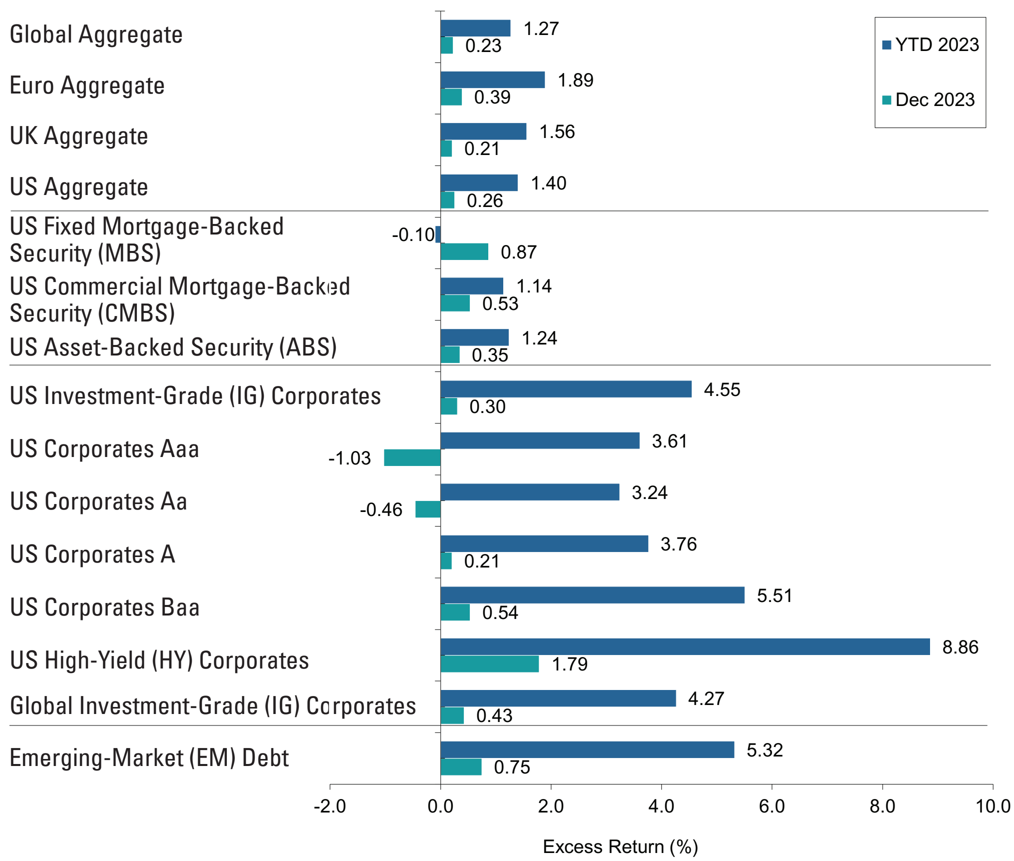
What's Keeping Us Up at Night…

1. **The fiscal impulse[11] is likely to transition to a drag in 2024.** Government spending exceeded most forecasts by adding 1% to GDP in 2023, but we expect it to detract 0.5% from growth in 2024. While government transfers are set to fade this year, we see upside risks from excess savings at state and local governments, higher use of Inflation Reduction Act credits for climate change, and a potential supplemental defense-spending bill to cover Ukraine, Israel, and border security.
2. **Quantitative tightening (QT),**[12] and the debate on its ending, will likely rear its head in 2024. While Chair Powell has indicated that QT could continue after rate cuts, there's some recent speculation that a debate is underway on whether QT should end earlier than anticipated in order for the system to have more than ample reserves (and not cause strain on banking intermediaries and capital markets with either reserve shortfalls or unequal distribution of reserves). This debate is a hotly discussed topic among portfolio strategists.
3. **Geopolitical tensions continue to escalate in the Middle East.** Iran-backed Houthi rebels attacked ships traveling through the Red Sea during December. Meanwhile, Iran deployed a warship to the Red Sea in early January, a move intended to challenge US forces in the key trade route and one which may embolden the Houthi militants disrupting shipping in the waterway to protest Israel's invasion of Gaza. The danger remains of a broader regional flare-up.
4. **Reacceleration risk** is real, but not our base case for 2024. What do we mean by this? The loosening of financial conditions, the robust position of the consumer, and still-strong labor markets could reaccelerate aggregate-demand conditions. In this case, it's questionable whether the ongoing tailwinds to disinflation can continue.

Investment Implications for Consideration

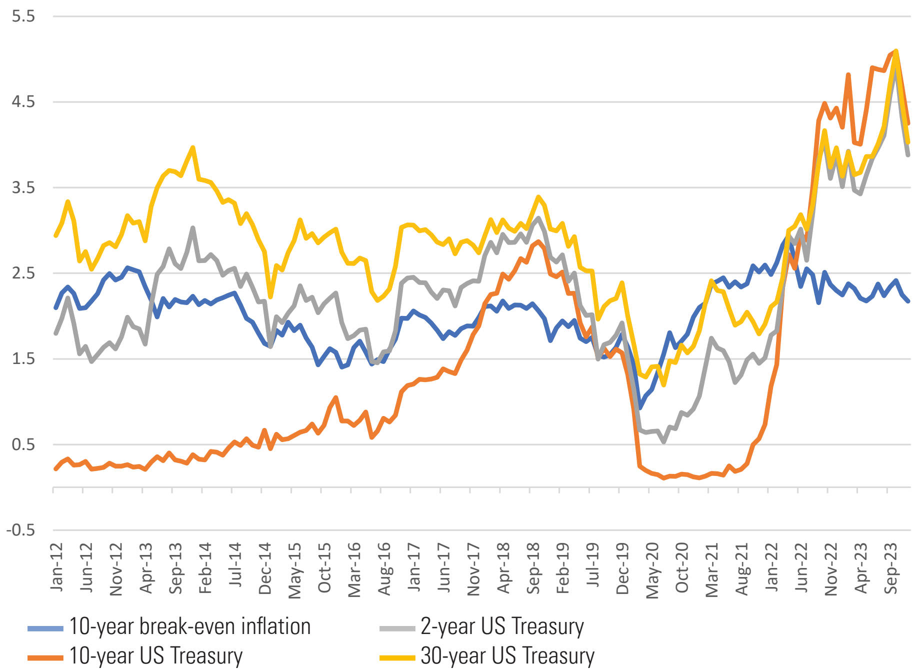
- Given how drawn out and uncertain the rate cycle has been year-to-date, we still favor higher-quality total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods or "go-anywhere"[13] strategies that may be able to navigate the late cycle.
- We acknowledge the tumult of rate markets this year. But, given where spread levels are in many sectors, core-bond and core-bond-plus[14] positions may make sense as we (gradually) approach the end of the tightening cycle. The gradual cooling of inflation and slowing of the economy makes higher-quality fixed income potentially attractive from a recessionary perspective, as well as for positive convexity.[15]
- Securitized credit[16] could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.
- High yield, despite its excellent performance year-to-date, warrants a cautious approach given how late in the cycle we are and the normalizing of default rates relative to current spreads. However, we acknowledge there's a substantial rate cushion that should provide some potential total-return risk mitigation in the event of a risk-off event. Given the robust carry,[17] this may be a good equity substitute. For all higher-yielding credit, including high yield, bank loans, and convertible debt, we advocate an "up-in-quality" issuer bias in case the slowing economy undershoots a soft-landing scenario and default/downgrade rates accelerate.

FIGURE 6: Fixed-Income Sector Excess Returns



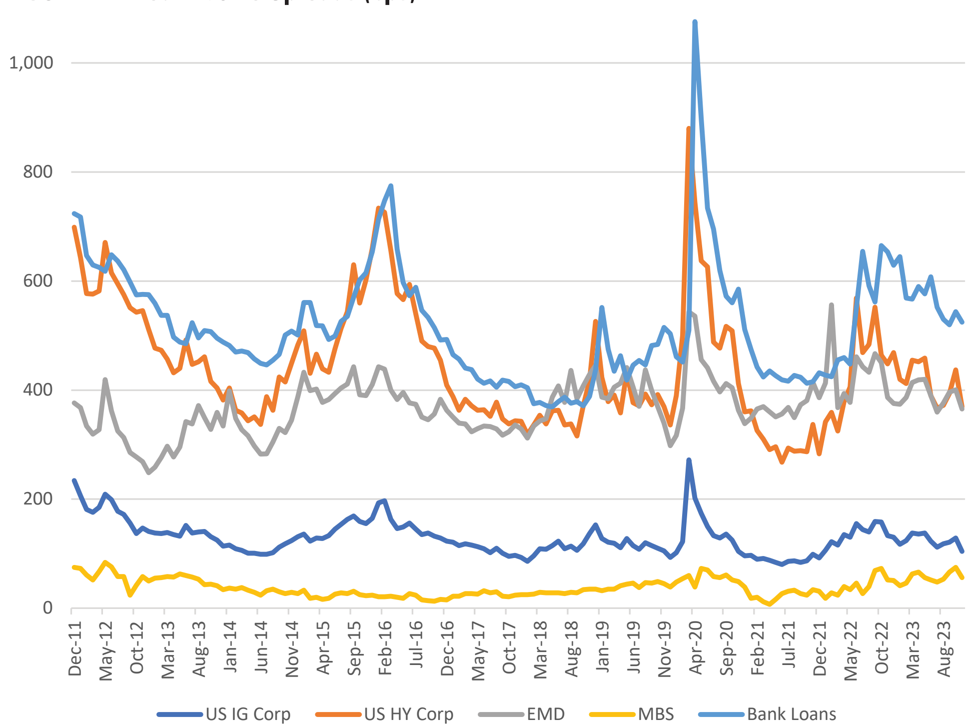
As of 12/31/23. **Past performance does not guarantee future results**. Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, and Wellington Management.

FIGURE 7: US Yields (%)



As of 12/31/23. Sources: Bloomberg, Wellington Management.

FIGURE 8: Fixed-Income Spreads (bps)



As of 12/31/23. US IG Corp is represented by the **Bloomberg US Corporate Bond Index**; US HY Corp is represented by the **Bloomberg US Corporate High Yield Bond Index**; EMD[18] is represented by the **J.P. Morgan EMBI Global Diversified Index**; MBS is represented by the **Bloomberg US MBS Index;** Bank Loans are represented by the **Morningstar/LSTA US Leveraged Loan Index.** See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA, Wellington Management.

[1] The Taylor Rule (sometimes referred to as Taylor's rule or Taylor principle) is an equation linking the Federal Reserve's benchmark interest rate to levels of inflation and economic growth. Stanford economist John Taylor originally proposed the rule as a rough guideline for monetary policy but has subsequently urged a fixed-rule policy based on the equation, a cause adopted by some members in the US Congress who seek to limit the Federal Reserve's policy discretion. The Taylor Rule's formula ties the Fed's key interest rate policy instrument, the federal funds rate, to two factors: the difference between the actual and targeted inflation rates and that between the desired and apparent growth in the real Gross Domestic Product (GDP).

[2] A basis point (bps) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices, and the yield of a fixed-income security.

[3] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement. A short-duration strategy is one where a fixed-income investor is focused on buying bonds with a small amount of time to maturity.

[4] One-year forward: A forward exchange contract (FEC) can be formally defined as an agreement between two parties to exchange currencies in the future. FECs are also known as FX forward contracts. FECs are typically entered into by two parties who want to hedge against the risk of currency fluctuation or improvement and set an agreement for the amount, date, and rate included in the transaction.

[5] The quits rate is the number of persons who quit their jobs during the entire month as a percent of employment.

[6] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[7] Debt term-out is a financial concept used to describe the transfer of debt internally, within a company's balance sheet. This is done through the capitalization of short-term debt to long-term debt. Changing the classification of debt on the balance sheet allows companies to improve their working capital and take advantage of lower interest rates.

[8] Investment-grade (IG) securities are fixed-income securities that are rated at "BBB" or higher by Standard & Poor's or Moody's.

[9] High-yield (HY) securities, or "junk bonds," are rated below-investment-grade because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities.

[10] Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures.

[11] The fiscal impulse is measured as the change in the government budget balance resulting from changes in government expenditure and tax policies.

[12] Quantitative tightening (QT) refers to monetary policies that contract, or reduce, the Federal Reserve System (Fed) balance sheet by either selling Treasuries (government bonds) or letting them mature and removing them from its cash balances. This removes liquidity, or money, from financial markets.

[13] Go-anywhere strategies are typically benchmark-agnostic and not bound by limits on exposure by sector, quality, currency, or country. Whereas traditional core-bond-plus strategies generally have flexibility to invest across the fixed-income landscape, they generally have upper limits on the amount that can be invested in securities rated below-investment-grade, domiciled outside the US, non-US-dollar-denominated, or reside in a particular sector (e.g., emerging markets).

[14] Core/core plus strategies typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core-plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

[15] Convexity is the relationship between bond prices and bond yields.

[16] Securitized credit involves pooling a large number of loans into an investable asset. Examples include mortgage-backed or asset-backed securities.

[17] Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

[18] Emerging-market bonds (EMD) are debt instruments issued by developing countries. These bonds tend to offer higher yields than Treasuries or corporate bonds in the US. Emerging-market issues tend to carry higher risks than domestic debt instruments.

To learn more about opportunities in fixed income, please talk to your financial representative.

Representative Indices from Figure 6:
Global Aggregate: Bloomberg Global Aggregate Index; Euro Aggregate: Bloomberg Global Aggregate Index - European Euro; UK Aggregate: Bloomberg Global Aggregate Index - United Kingdom; US Aggregate: Bloomberg US Aggregate Bond Index; US Fixed MBS; Bloomberg US MBS Index; US CMBS: Bloomberg CMBS ERISA Eligible Index; US ABS: Bloomberg Asset-Backed Securities Index; US IG Corporates: Bloomberg US Corporate Bond Index; US Corporates Aaa: Bloomberg Aaa Corporate Index; US Corporates Aa: Bloomberg Aa Corporate Index; US Corporates A: Bloomberg A Corporate Index; US Corporates Baa: Bloomberg Baa Corporate Index; US High-Yield Corporates: Bloomberg US Corporate High Yield Bond Index; Global IG Corporates: Bloomberg Global Credit - Corporate Index; Emerging-Markets Debt: Bloomberg Emerging Markets Hard Currency Index.

Index Definitions:
Bloomberg Global Aggregate Index is a broad-based measure of the global investment-grade fixed-rate debt markets.

Bloomberg Global Aggregate Index - European Euro includes fixed-rate, investment-grade Euro denominated bonds.

Bloomberg Global Aggregate Index - United Kingdom includes fixed-rate, investment-grade sterling-denominated bonds.

Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

Bloomberg US MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg CMBS ERISA Eligible Index measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974.

Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, has three subsectors: credit and charge cards, autos, and utility.

Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt.

Bloomberg Aaa Corporate Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa.

Bloomberg Aa Corporate Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa.

Bloomberg A Corporate Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of A.

Bloomberg Baa Corporate Index is designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa.

Bloomberg US Corporate High Yield Bond Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission.

Bloomberg Global Credit - Corporate Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets.

Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers;

Morningstar/LSTA Leveraged Loan Index is a market-value-weighted index that is designed to measure the performance of the US leveraged loan market based upon market weightings, spreads, and interest payments.

J.P. Morgan EMBI Global Diversified Index is a broad-based, unmanaged index which tracks liquid, US Dollar emerging-market fixed- and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.

J.P. Morgan GBI-EM Global Diversified Index is a widely followed and influential benchmark index that tracks the performance of local-currency-denominatedsovereign bonds issued by emerging-market countries. The index is designed to provide investors with a representative measure of the fixed-income market within emerging-market economies.

Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. The index is a component of the US Aggregate, US Universal, Global Aggregate and Global Treasury Indices. The index includes securities with remaining maturity of at least one year.

ICE BofA All US Convertibles Index is an unmanaged index that consists of convertible bonds traded in the U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk. The value of the underlying real estate of real estate related securities may go down due to various factors, including but not limited to strength of the economy, amount of new construction, laws and regulations, costs of real estate, availability of mortgages, and changes in interest rates. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets.

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