Fixed Income Observations

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Bonds Are Back

Global sovereign markets staged a strong November rally as market participants repriced expectations for future monetary-policy rate moves.

What's Driving Markets…

1. **Treasury markets reverse course.** During November, the 10-year US Treasury yield declined sharply, signaling a stunning turnaround from the end of October. Key drivers of the rate move included the following:

   a. Treasury's more reserved refunding statement,[1] indicating that the Treasury Department would not rapidly accelerate duration[2] supply into the market.

   b. Communications from the Federal Reserve (Fed) reiterated its belief that inflation was on its way back to more normalized levels and that financial conditions were already tight, with monetary policy appropriately restrictive. The market interpreted these statements as an indication that additional rate hikes were likely off the table and repriced 2024 rate cuts. This includes comments from Fed Governor Christopher Waller, which have now fueled expectations of a March rate cut.

   c. Inflation data gave credence to the Fed's forecast as realized core and headline Consumer Price Index (CPI)[3] measures came in below expectations. Indeed, the month-over-month change in headline CPI was actually 0.0%, the lowest print since July 2022.

   d. A plethora of other data indicated a cooling economy, including ISM[4] (both services and manufacturing), consumer confidence, non-farm payrolls, and initial jobless claims.

   e. Short covering[5] by investors taking short-duration[6] positions accelerated this trend.

Long-maturity US Treasuries[6] were the biggest winners as the yield curve[7] flattened (**FIGURE 1**, left). For some return perspective, the duration of the on-the-run 30-year Treasury bond[8] is just over 16 years, and its yield rallied 60 basis points,[9] translating into a 9.7% price return. We have also seen a selloff in the US dollar (USD) as markets began to price the path of USD deposit rates moving lower relative to a basket of other developed-market currencies (**FIGURE 1,** right).

Insight from sub-adviser Wellington Management

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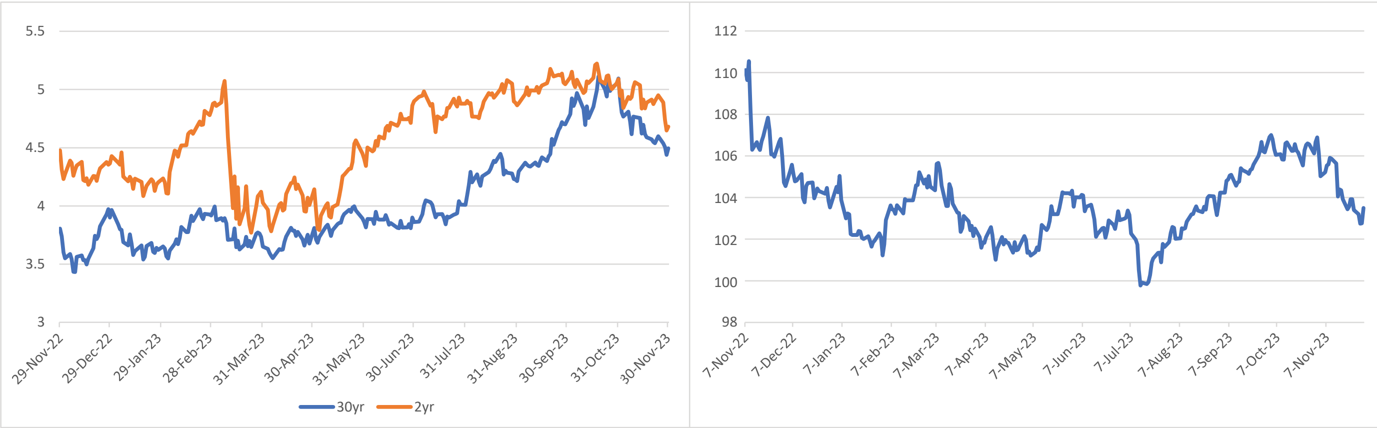
FIGURE 1: Long-Maturity Treasuries Gained as the US Dollar Sold Off

The Change in Yields and the Dollar in November Followed a Flattening Yield Curve

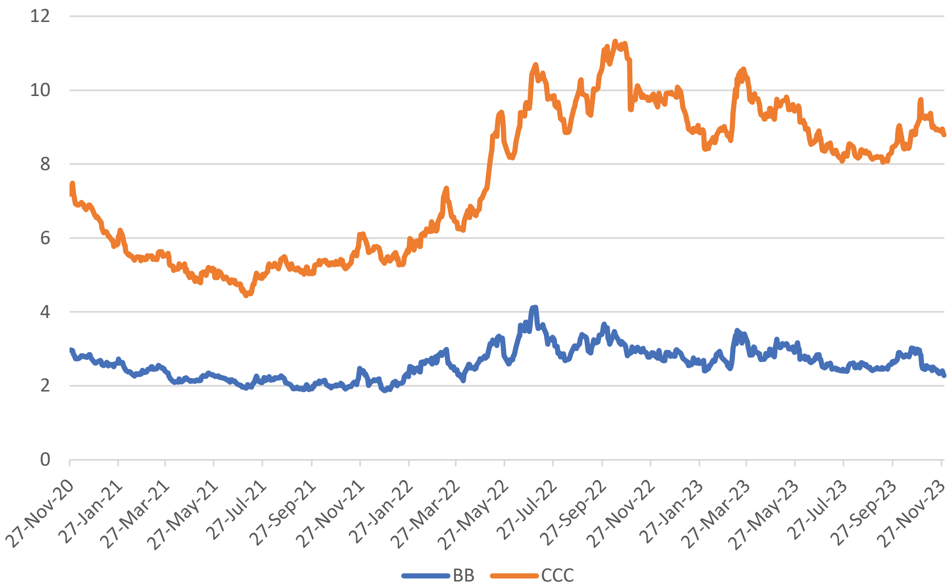


As of 11/30/23. Sources: Bloomberg, Wellington Management, Hartford Funds.

2. **Credit markets have exhibited quality biases in recent weeks** as the lowest-rated buckets have lagged their higher-quality counterparts. Using the Bloomberg US Corporate High Yield Bond Index[10] as a proxy, we're seeing BB-rated bond spreads[11] trade close to their post-pandemic tight levels while CCC-rated[12] bond spreads are wide and have experienced more volatility.

FIGURE 2: Credit Markets Have Tilted to Quality in Recent Weeks

Option-Adjusted Spreads[13] (%) in BB-Rated Issues vs. CCC-Rated Issues



As of 11/30/23. **Past performance does not guarantee future results**. Sources: Bloomberg US Corporate High Yield Index, Wellington Management, Hartford Funds.

3. **The US House of Representatives averted a government shutdown** and passed a two-tiered continuing resolution. The tier strategy allowed for a certain number of agencies to receive funding up to January 19, 2024, while others would receive funding until February 2, 2024. We expect renewed negotiations to keep the government open to start immediately in the new year.

4. **Oil and gasoline prices suffered further declines**, driven by increased US production and seasonal demand factors. The US Department of Energy said it wants to purchase 1.2 million barrels of oil at an average price in the high US$70s. This is part of the new usage of the Strategic Petroleum Reserve as a way to manage an "almost corridor-like"[14] system for energy prices. While energy prices primarily impact headline inflation (energy prices are excluded from core inflation measurements), the Fed, in general, remains concerned about these energy inputs because they're believed to impact consumer inflation expectations.

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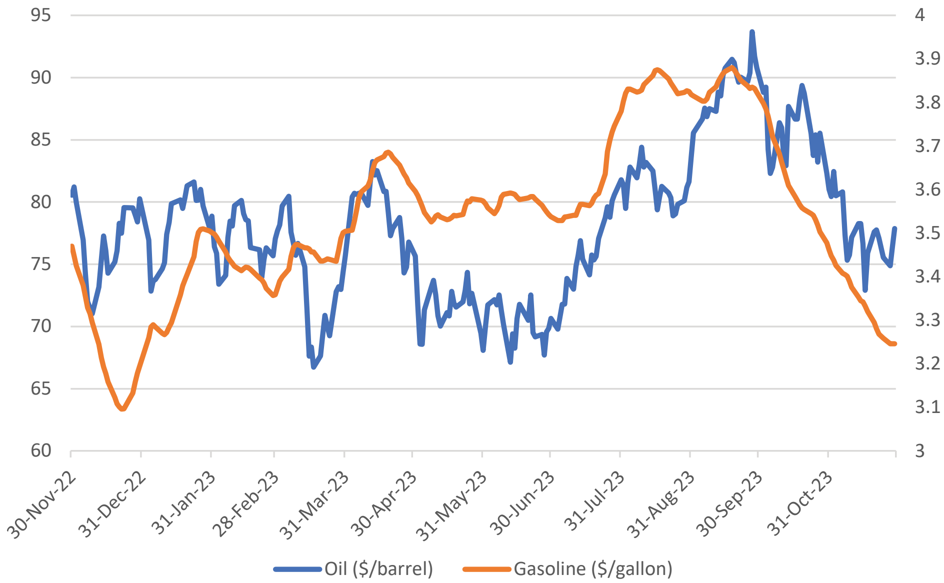
FIGURE 3: US Production and Seasonal Factors Helped Sink Energy Prices

Crude Oil and Gasoline Prices Fell Sharply from September Through November



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

What's Keeping Us Up at Night…

1. **Houthi forces seized an Israeli-owned cargo ship in the Red Sea**; other ships in the area appear to have come under direct attack and/or harassment in recent weeks. While we don't expect immediate escalation, there still remains a substantial risk of an expanded regional conflict. Tensions de-escalated later in the month after Israel and Hamas agreed to a short-term ceasefire in Gaza and conducted exchanges of hostages and prisoners.
2. **It appears that most developed-market central banks have reached the end of their rate-hiking cycles.** Still, a policy mistake remains top of mind. Despite assurances from Chair Jerome Powell that the Fed is prepared to raise rates as the data warrants, markets have fully embraced the pivot. Because the Fed remains vigilant about achieving its inflation mandate, it may keep rates too high for too long and thus fail to achieve the elusive soft landing. This is all complicated by the propensity for monetary policy to work in long and variable lags.
3. **Commercial real-estate fundamentals continue to deteriorate** with a notable pickup in downgrade and default activity concentrated in the office and retail sectors, while multi-family housing remains relatively strong. Substantially higher borrowing costs and slowing credit availability from regional banks is restricting borrowers' access to capital, which adds to downward pressure on property prices. The elevated number of loans in special servicing indicates defaults are likely to increase, placing emphasis on skilled security selection, though higher-rated bonds are likely to be more insulated from today's hostile environment.

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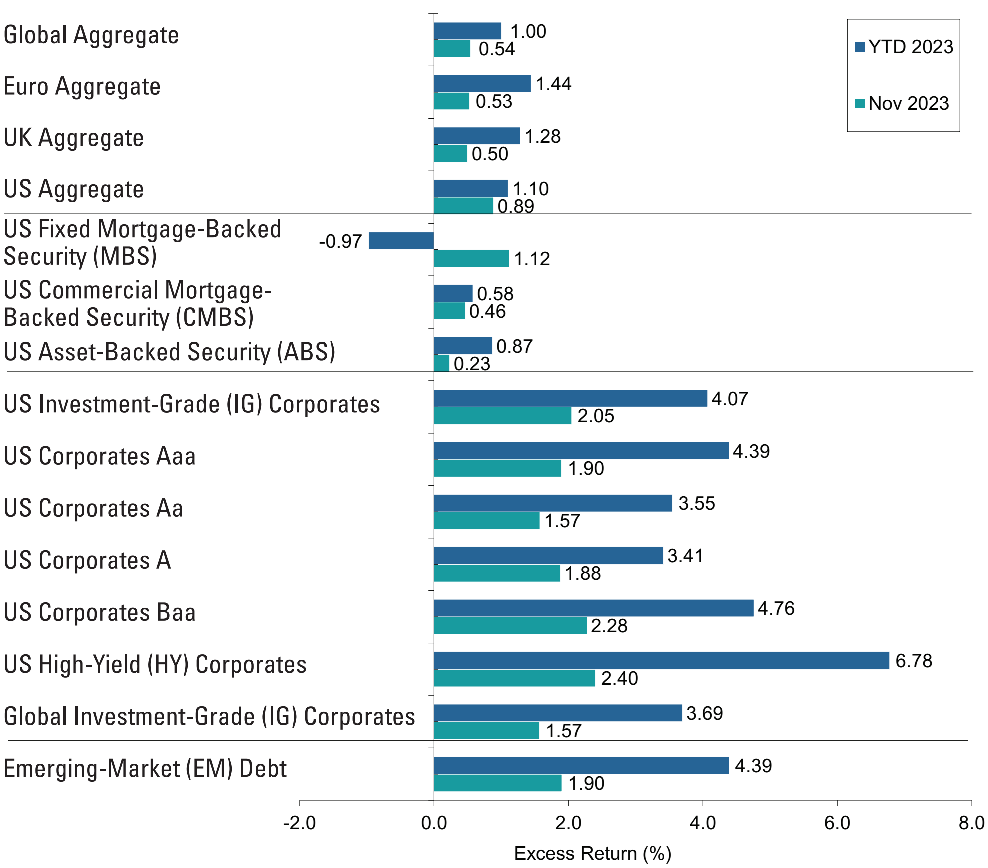
Investment Implications for Consideration

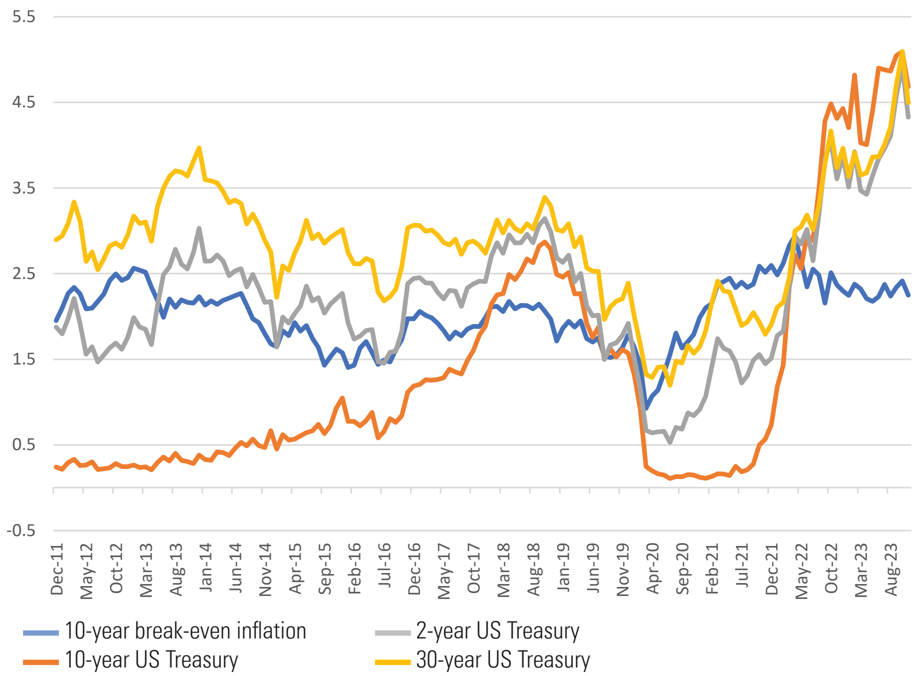
- Given how drawn out and uncertain the rate cycle has been year-to-date, we still favor higher-quality total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods or "go-anywhere"[15] strategies 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[16] positions 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.[17]
- Securitized credit[18] 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,[19] 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, this may be a good equity substitute.

FIGURE 4: Fixed-Income Sector Excess Returns



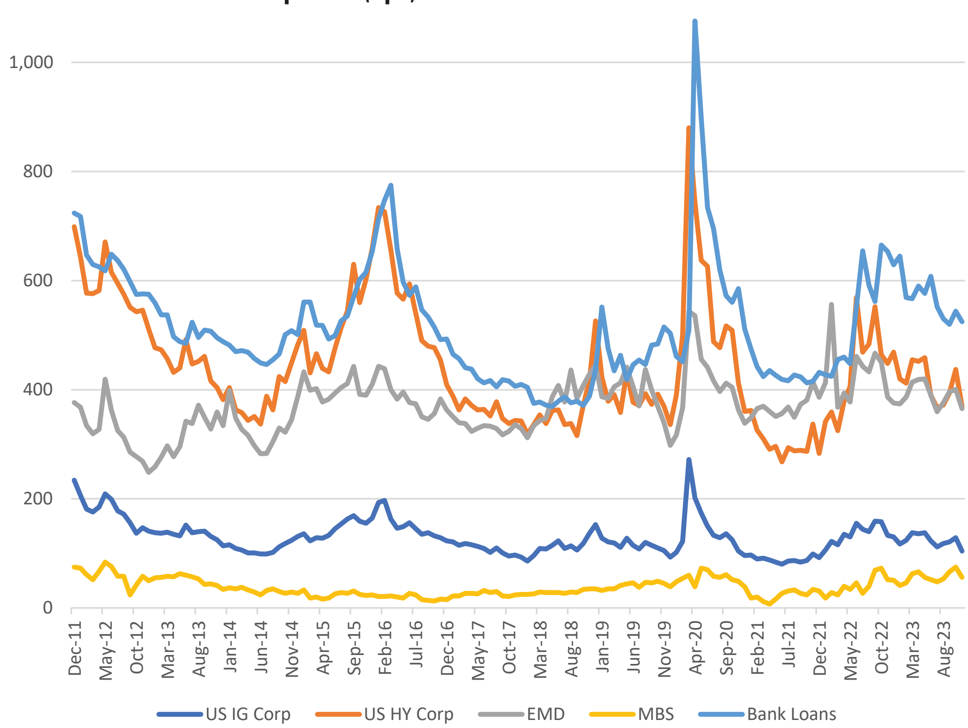
As of 11/30/23. **Past performance does not guarantee future results**. Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, and Wellington Management.

FIGURE 5: US Yields (%)



As of 11/30/23. SourceS: Bloomberg, Wellington Management.

FIGURE 6: Fixed-Income Spreads (bps)



As of 11/30/23. US IG[20] Corp is represented by the Bloomberg US Corporate Bond Index; US HY[21] Corp is represented by the Bloomberg US Corporate High Yield Index; EMD[22] is represented by the JP Morgan EMBI Plus Index; Bank Loans are represented by the Morningstar LSTA US Leveraged Loan Index; MBS is represented by the Bloomberg US MBS Index. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA, Wellington Management.

[1] Every quarter, the Office of Debt Management at the United States Department of the Treasury announces its funding needs for the next two quarters. The announcement details which securities will be offered and the dates of their announcement, auction, and settlement. This is mostly of interest to bond traders who will be looking at the amount of debt that is to be issued so that they can gauge the supply of debt in the market.

[2] 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.

[3] The CPI in the US is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

[4] ISM manufacturing index stands for the Institute for Supply Management Manufacturing Index. Also known as the Purchasing Managers' Index (PMI), it's a monthly indicator of US economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.

[5] Short covering refers to buying back borrowed securities in order to close out an open short position at a profit or loss. It requires purchasing the same security that was initially sold short, and handing back the shares initially borrowed for the short sale. Short selling a security is when a trader borrows shares from a broker and immediately sells them with the expectation that the share price will fall shortly after. If it does, the trader can buy the shares back at the lower price, return them to the broker, and keep the difference, minus loan interest, as profit.

[6] Long bonds offer a maturity date far out on the investment horizon. For the U.S. Treasury market, this includes the 30-year Treasury which has the longest maturity of all offerings. Corporate bonds, however, can issue maturities in different variations. Corporate bonds may offer maturities of 15, 20, or 25 years.

[7] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[8] On-the-run Treasuries are the most recently issued US Treasury bonds or notes of a particular maturity.

[9] 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.

[10] The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

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

[12] An investment-grade rating is a rating that signifies whether a municipal or corporate bond presents a relatively low risk of default. Bond-rating firms such as Standard & Poor's (S&P), Moody's, and Fitch use different designations, consisting of the upper- and lower-case letters "A" and "B," to identify a bond's credit quality rating. "AAA" and "AA" (high credit quality) and "A" and "BBB" (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ("BB," "B," "CCC," etc.) are considered low credit quality and are commonly referred to as junk bonds.

[13] The option-adjusted spread is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to account for an embedded option (defined as provisions included with some fixed-income securities that allow the investor or the issuer to take specific actions, such as calling back the issue).

[14] A corridor-like system for energy prices refers to a system of managing the US Strategic Petroleum Reserve in a manner designed to maintain an unofficial floor and ceiling to US oil prices. If oil prices rise too high, the US government releases oil from the reserve to increase supply. If prices drop too low, the government refills the reserve via purchases.

[15] Go-anywhere strategies are typically benchmark-agnostic and not bound by limits on exposure by sector, quality, currency, or country. While 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 that are rated below-investment-grade, domiciled outside the US, non-US-dollar-denominated, or classified within a particular sector (e.g., emerging markets).

[16] 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.

[17] Convexity is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. If a bond's duration rises and yields fall, the bond is said to have positive convexity.

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

[19] 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.

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

[21] See footnote 19.

[22] 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.

Global Aggregate is represented by the Bloomberg Global Aggregate Index, a broad-based measure of the global investment-grade fixed-rate debt markets. **Euro Aggregate** is represented by the Bloomberg Global Aggregate Index - European Euro, which includes fixed-rate, investment-grade Euro denominated bonds. **UK Aggregate:** Bloomberg Global Aggregate Index - United Kingdom which includes fixed-rate, investment-grade sterling-denominated bonds. **US Aggregate:** 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. **US Fixed MBS:** Bloomberg Agency Fixed-Rate MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **US CMBS:** Bloomberg CMBS ERISA Eligible Index, which 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. **US ABS:** Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, which has three subsectors: credit and charge cards, autos, and utility. **US IG Corporates:** Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt. **US Corporates Aaa:** Bloomberg Aaa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa; **US Corporates Aa:** Bloomberg Aa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; **US Corporates A:** Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of A; **US Corporates Baa:** Bloomberg Baa Corporate Index; designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa; **US High-Yield Corporates:** Bloomberg US Corporate High Yield 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. **Global IG Corporates:** 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. **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bank Loans**: LSTA Leveraged Loan Index, which 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. **JP Morgan Emerging Markets Bond Index Global Index** is a broad-based, unmanaged index which tracks total return for external currency denominated debt (Brady bonds, loans, Eurobonds and US dollar-denominated local market instruments) in emerging markets. **Bloomberg US MBS Index** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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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