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2024 Outlook: Perspective on Markets and the Economy

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Fork in the Road: Slowdown or Reacceleration Ahead?

Markets seem to expect a much smoother ride in 2024, but they may be too optimistic.

Key Points

We raised our view on global equities to neutral. The global economy remains resilient, inflation is falling, and monetary tightening is effectively done. Yet markets are pricing in little risk that growth could disappoint and reignite recession fears, or reaccelerate and put upward pressure on inflation.

Japan remains our top developed-equity market, as we believe the economy is uniquely positioned for higher inflation and potential profitability. We maintain our neutral view on China due to poor visibility on a property recovery, yet sentiment is already very negative.

We maintain a neutral duration[1] stance in government bonds. Central banks are warming up to looser policy, but market expectations for rate cuts seem overdone. Japan's real yields stand out as most vulnerable to an adjustment in monetary policy. Spreads[2] offer little cushion for a rise in defaults, so we maintain our slightly underweight view.

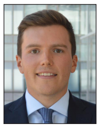
We believe structural dynamics could keep inflation higher and more volatile than in the post-Great Financial Crisis period. Thus, we remain positive on commodities. While oil prices have declined in response to softer growth expectations, we see upside based on supply/demand fundamentals.

Downside risks to our views include a deep recession or higher-than-expected inflation and geopolitical risks. Upside risks include a better-than-consensus growth scenario in which the Federal Reserve (Fed) meets market expectations for a rate-cutting cycle amid continued disinflation.

Insight from sub-adviser Wellington Management

Nanette Abuhoff Jacobson
Managing Director and Multi-Asset Strategist at Wellington Management and Global Investment Strategist for Hartford Funds

Supriya Menon
Multi-Asset Strategist at Wellington Management



Alex King, CFA
Investment Strategy Analyst at Wellington Management

"The recession that wasn't" may be the best way to describe 2023 and the year's strong market performance. The Fed's 550 basis point[3] (bps) tightening cycle did wreak havoc in parts of the market, most notably among US regional banks, but strong consumption and artificial-intelligence excitement were underappreciated offsets. While this outcome was a relief, the market dominance of the "Magnificent Seven" stocks left many allocators disappointed with their portfolio results.

Now, the market has set high expectations for rate cuts, exceeding the Fed's projections. We agree that the growth/inflation outlook has improved, and there's better balance in the economy (**FIGURE 1**). But risk assets[4] have already experienced sharp rallies, and equity volatility has plumbed pre-pandemic lows, which leads us to ask: Has a more benign interest-rate environment already been priced in?

At this juncture, we see several possible scenarios with vastly different investment implications. In one scenario, the lagged effect of higher rates hurts the economy and recession fears reignite. In another, the economy reaccelerates and drives inflation higher, preventing the rate cuts the market expects.

We aren't sure which way the economy and markets will break, but we're skeptical about the smooth ride markets expect in 2024 and have a neutral view on global equities and rates, while focusing more on relative value within asset classes. That said, this is an increase in risk relative to 2023, when we favored global rates over equities.

In credit, we maintain a slight underweight view, as we find spreads tight relative to fundamentals, which we think are deteriorating. Even though bond yields are 100 bps lower since mid-October, this does little to offset the risk for high-yield issuers facing much higher refinancing rates relative to their outstanding coupons. We favor quality in investment-grade corporates.

Our relative-value calls are expressed in regions. Within rates, we favor the US and Europe over Japan, driven by our expectation that the Bank of Japan (BOJ) will pull the trigger on rate hikes sometime this year. Within equities, we maintain our high-conviction view that Japan has more upside than the US and Europe.

Finally, we have stronger conviction in our overweight view on commodities based on our outlook for oil. We see the decline in oil prices as a good entry point to express our view that supply constraints are underappreciated by the markets.

FIGURE 1
Does Better Balance in the Economy Suggest a Sweet Spot for Risk Assets?
Developed Market Purchasing Managers Index

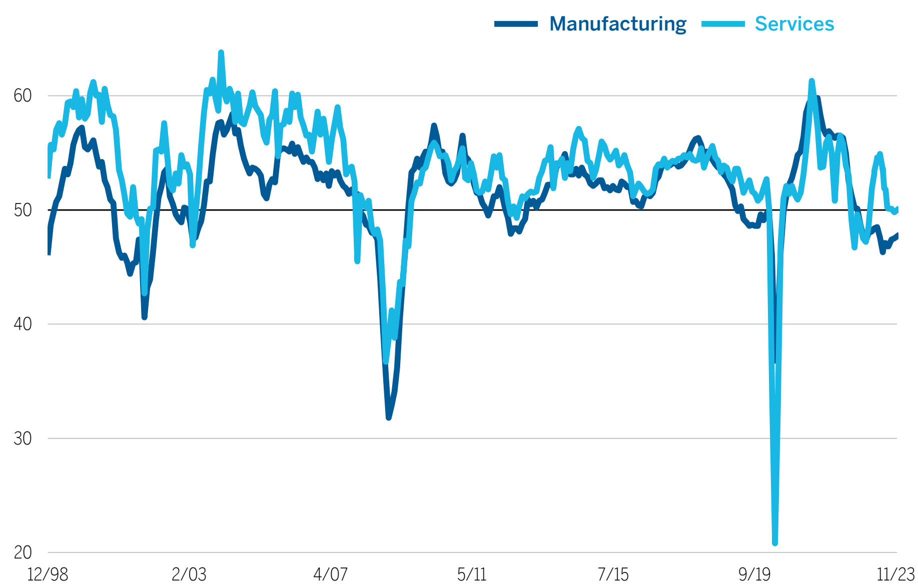


Chart data: Manufacturing: 12/98-11/23; Services: 12/98-11/23. The S&P Global Developed Market Purchasing Managers' Index is an indicator of the economic health of the manufacturing sector. A reading above 50 signals economic expansion; below 50 signals contraction. Source: Bloomberg Finance LP.

Equities May Have More Room to Run, but the Path Isn't Without Hurdles

We've raised our view on global equities from moderately underweight to neutral, given our belief that equities can continue to benefit from a policy "sweet spot" in which a mixed growth picture and disinflation have allowed the liquidity backdrop to dominate. What kept us from moving to an overweight view? We expect central banks to pivot to rate cuts in 2024, but in the absence of a severe recession, there's scope for disappointment—especially in the US, where the market expects five to six rate cuts this year. Meanwhile, it remains to be seen whether core inflation is truly under control, and this will remain a focus for investors until inflation is sustainably at or below central-bank targets.

Markets are also pricing in strong earnings growth of around 10% globally over the next 12 months. While the earnings downside is likely behind us, we think this may be too rosy given our expectation of below-trend growth and potential for further margin compression. The combination of elevated earnings

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Neutral	↑
Defensive fixed income	Neutral	↓
Growth fixed income	Moderately UW	—
Commodities	Overweight	↑
Within asset classes		
Global equities		
US	Moderately UW	—
Europe	Moderately UW	—
Japan	Overweight	↑
China	Neutral	—
EM ex China	Neutral	—
Defensive fixed income		
US government	Moderately OW	—
Europe government	Moderately OW	—
Japan government	Underweight	—
Global investment grade credit	Neutral	—
Growth fixed income		
High Yield	Neutral	—
EM debt	Neutral	—
Bank Loans	Moderately UW	—
Securitized assets	Neutral	—

OW = overweight, UW = underweight

Views have a 6-12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 12/31/23, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

expectations and high valuations, including a tight equity-risk premium[5] against bonds, also prevented us from adopting an overweight view on global equities. In short, our neutral view reflects our belief that we're at a crossroads, and we'll be monitoring central-bank monetary policy, earnings surprises, and signs that the long tail of prior tightening is making its way through the economy as we gauge whether to dial our equity view up or down from here.

It remains to be seen whether core inflation is truly under control.

Turning to our regional views, we see better valuations outside the US. But within the US, we see better valuations outside of megacap stocks. As of mid-December, the S&P 500 Index[6] had a 12-month forward price/earnings ratio[7] of about 17.3 once the megacaps were removed. While gains in the US equity market finally broadened beyond the largest stocks in the last few weeks of 2023, the megacap cohort remains dominant, which has implications for global market structure since this cohort is now larger than any country or region outside the US. For example, megacaps tend to be less sensitive to interest rate and cyclical shifts, and, therefore, their increasing heft can make the overall equity market more resilient. Another factor to consider is the influence of US fiscal policy, which surprised to the upside in 2023 but could shift more negative in 2024. These crosscurrents balance out to a modest underweight view on the US in our analysis.

We continue to see opportunities to take advantage of regional diversification, with economic and monetary-policy cycles remaining less synchronized than in recent years. Most notably, we've increased our overweight view on Japanese equities, where we continue to see a confluence of higher nominal growth and evidence of corporate governance shifts boosting profitability (**FIGURE 2**). While the BOJ shifted its monetary policy stance somewhat, dialing back on yield-curve[8] control, it remains accommodative, and the country's fiscal policy is even more so. The economy remains in cyclical recovery mode, although valuations reflect improving fundamentals to a greater extent than early in 2023. Japan did underperform some other markets in the fourth quarter but given that there was no change in our conviction level, we saw this as an attractive buying opportunity.

FIGURE 2
In Japan, Profits Remain Well Supported
Japan Current Profits-to-Sales Ratio (All Enterprises)

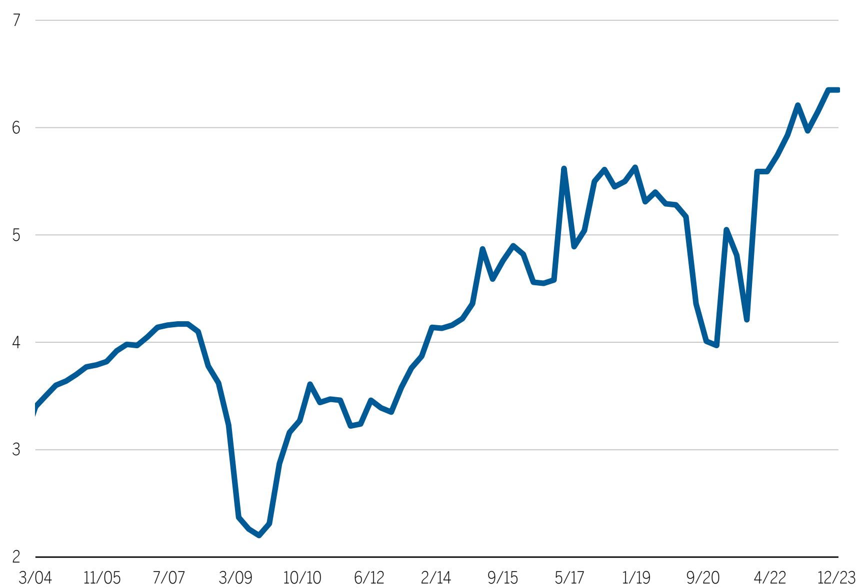


Chart data: 3/24-12/23. Data from the Bank of Japan's Tankan Survey. Data Source: Bloomberg Finance LP.

We maintain our moderately underweight view on European equities. They have the advantage of both negative sentiment and attractive valuations, but we expect the region's macro and earnings downturn will take time to play out.

In China, valuations and sentiment are both at rock bottom, which should cushion against further de-rating. This remains a market in which the dispersion of views is wide, but on balance, we think structural factors such as internal deleveraging and geopolitical uncertainty could suppress the potential for the market to outperform over a 12-month horizon.

At a sector level, we prefer consumer-discretionary stocks, which have the potential to benefit from disinflation and higher disposable income, as well as undervalued utilities. We think the energy sector has strong fundamentals, including high earnings and free cash-flow. We have an underweight view on the telecom, consumer-staples, and healthcare sectors. The consumer-staples sector has a weaker fundamental picture with low free cash flow and negative sentiment. The telecom sector's fundamentals are also weak, as capital expenditures to depreciation look low. Capital needs are high for the sector and may increase its cost of capital. Healthcare is challenged by higher costs and lower utilization at hospitals, as well as continued poor sentiment in biotech.

Government Bonds: Is the Rate Rally Overdone?

The Federal Open Market Committee's December meeting validated and accelerated the rally we've seen in rate markets since the yield on the 10-year US Treasury hit 5% in mid-October. Markets appear to have latched onto a couple of positive narratives. One narrative is that if inflation continues to fall, then mathematically, real rates rise and become more restrictive. Therefore, the Fed will need to cut rates even if the economy doesn't slow. Another narrative is that inflation's decline has been driven not by a harmful decline in demand, but by supply factors, including increased labor participation and immigration, as well as a continued unwinding of supply-chain distortions.

Our neutral-duration stance is based on our view that slower global growth and lower inflation will bring lower rates but that the rates markets have repriced too much too fast. (As of this writing, fed funds[9] futures imply that the first rate cut will come in March and that we will see 150 bps of cuts by December.) Rates could go lower in a deep-recession scenario, or they could rise if inflation reaccelerates or the term premium[10] expands as it did in the third quarter.

In a global context, we still prefer US and European rates to Japanese rates. Europe is flirting with recession, so the European Central Bank could join or even preempt the Fed in cutting rates. Japan is unique: Amid loose monetary and fiscal policy, inflation is running hotter than target, so the central bank is under some pressure to tighten ultra-loose policy.

Credit: Attentive to the Risks but Also Open to Opportunities

The economy has been resilient, and spreads have been narrowing. Inflation has come down quickly, giving central banks the room to cut rates this year. Against this backdrop, we retain a slight underweight view on spreads, but think there may be opportunities to add risk on any weakness. We believe the risks remain somewhat skewed to the downside, especially with tight spread levels, but we see an environment in which spreads could remain rangebound for some time and where income could dominate returns.

Defaults began picking up in high-yield markets in 2023 but were largely concentrated in a few sectors, including technology, healthcare, and autos. We see some risks around the need to refinance at higher interest rates. High-yield issuers have been able to push out the impact of higher interest rates by delaying refinancing. But many issuers have debt maturing in 2025, meaning they will need to refinance within the next 12 months (**FIGURE 3**). Even with 150 bps of interest-rate cuts priced in, refinancing will be at much higher rates than existing debt and could lead to higher defaults.

Meanwhile, as refinancing has been delayed, corporate balance sheets have been weakening, as issuers have spent cash rather than issuing more debt. We don't think this risk is fully priced in. High-yield spreads are narrow at around the 30th percentile in the US.

Europe is flirting with recession, so the European Central Bank could join or even preempt the Fed in cutting rates.

Having said all this, we don't see an immediate catalyst for wider spreads, and so we remain only marginally negative on the asset class in the near term. The opportunity to add on weakness may be helped by the more positive starting point for yields, which is a strong determinant of long-term returns. We prefer higher-quality credit in this environment, and, therefore, remain more positive on investment-grade credit relative to high yield.

FIGURE 3

High-Yield Companies to Refinance at Higher Rates in 2024

US High Yield – Coupon-to-Yield Ratio

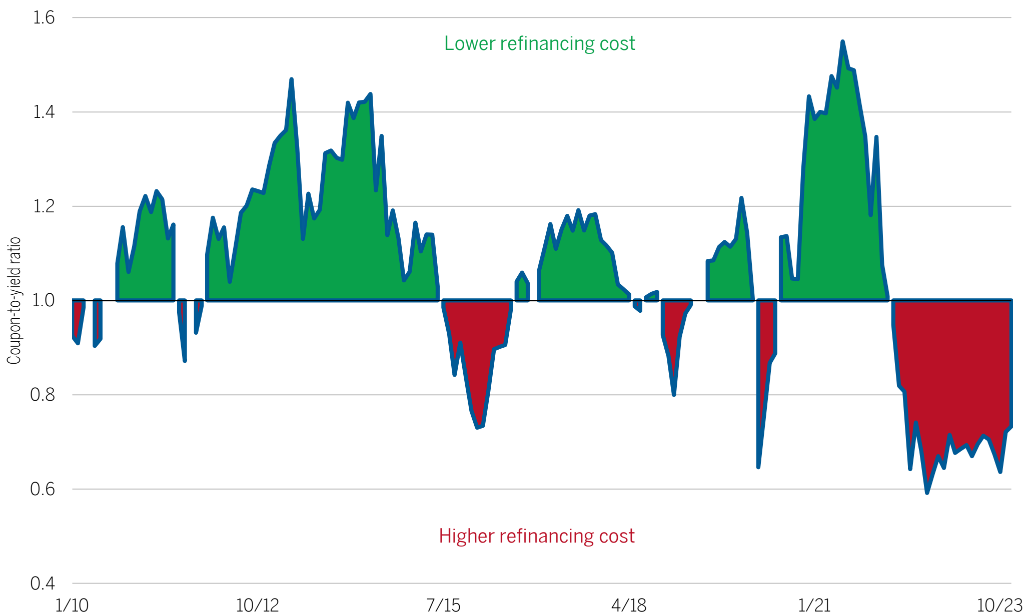


Chart data: 1/10-12/23. **Past performance does not guarantee future results.** Ratio between index coupon and yield to worst of Bloomberg US Corporate High-Yield Bond Index. Yield to worst is the minimum yield that can be received on a bond assuming the issuer doesn't default on any of its payments. 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. Data Sources: Wellington Management and Bloomberg.

Commodities: Stronger Conviction Based on the Outlook for Oil and Inflation

We've increased our conviction in our overweight view on commodities, primarily driven by our more positive outlook for oil, as well as a view that inflation could remain somewhat stickier and more volatile than the market anticipates.

We've raised our view on oil from neutral to moderately overweight, with recent price declines creating what we think is an attractive entry point. We expect supply to remain relatively constrained, driven by both an incentive for OPEC to support prices and the US actively refilling its Strategic Petroleum Reserve, which we think could outweigh the headwind from slower demand in 2024. We're also monitoring the impact that attacks on commercial ships in the Red Sea could have on prices in coming months.

We maintain our moderately overweight view on gold, which has reasserted its status as a potential safe haven and a store of value as demand has picked up around the world. Central banks have been buying gold recently in light of geopolitical issues and the trend of de-dollarization. This buying has been robust, and we expect it to continue.

Copper remains structurally constrained from a supply perspective, and we expect long-term demand to be strong given its role in the green economy. However, we believe there could be downward pressure on prices in the near term, as there may be some supply surplus coming through, and demand may be slightly weaker given our expectation of below-trend growth this year. With these contrasting short- and long-term trends, we moved to a neutral view on copper, preferring to watch for opportunities to add risk in the months ahead.

Risks

Upside risks include a scenario in which the loosening in financial conditions lifts growth above trend without stymying disinflationary momentum. Another positive scenario would be a reacceleration in China's economy, with positive spillover effects on the global economy. We might also see unexpected upside from high cash levels on household balance sheets being reallocated to risk assets.

Downside risks include the potential for core inflation to reaccelerate, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking. There's also the potential for the economy to "break" due to the lagged impact of tighter monetary policy on commercial real estate or parts of the banking sector. Finally, if the Middle East or Russia-Ukraine conflicts broaden, it risks increasing macro uncertainty.

Investment Implications

- **Consider rotating equity exposure to less expensive areas** — We think an improved fundamental backdrop of slowing growth and inflation combined with the prospect of Fed rate cuts warrants at least a neutral exposure to equities. But given relatively expensive valuations in megacaps, we think there are better opportunities in the underpriced utilities and energy sectors. Disinflation could be positive for the consumer-discretionary sector.
- **Look for regional advantages, especially in Japan** — Equities outside the US are less expensive and are at different stages of the cycle. We think Japan still has a long runway for improved profitability, even if monetary policy tightens slightly.
- **Consider maintaining a neutral-duration stance** — The Fed's pivot is positive for rates markets, but we think this has been priced in, and rates could go higher or lower depending on inflation and Treasury supply. Among rates markets, we believe Japan has more downside than the US and Europe given the shift in monetary policy we envision. We lean slightly negative on spreads given rich valuations and heavy refinancing needs at higher rates.
- **Be prepared for disruptions in the market's benign expectations** — The inflation story may not be over. We see upside for oil prices and a case for gold amid heightened geopolitical risk and strong buying from central banks.

Talk to your financial professional about how to position your portfolio for the year ahead.

[1] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

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

[3] A basis point 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 indexes and the yield of a fixed-income security.

[4] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[5] The risk premium is the excess return above the risk-free rate that investors require as compensation for the higher uncertainty associated with risky assets. The five main risks that comprise the risk premium are business risk, financial risk, liquidity risk, exchange-rate risk, and country-specific risk.

[6] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[7] Price/Earnings is the ratio of a stock's price to its earnings per share.

[8] 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.

[9] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[10] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

Important Risks: Investing involves risk, including the possible loss of principal. Security prices fluctuate in value depending on general market and economic conditions and the prospects of individual companies. • Foreign investments may be more volatile and less liquid than U.S. 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 such as China. • Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject the investors to greater volatility than traditional investments. The value of such instruments may be volatile and fluctuate widely based on a variety of factors. • 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. • 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. • 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. • Diversification does not ensure a profit or protect against a loss in a declining market.

2024: A Year of Intensifying Macro Regime Change?

A turbulent forecast: Mild recessions, slow growth, stubborn inflation, and continued volatility.

The nature of economic cycles is changing. We expect domestic output gaps to be far more important in determining inflation in a particular economy than we have seen over the past 20 years of globalization. Markets and central banks may take time to adjust to this new normal, but the result may be shorter and more frequent cycles, accompanied by more volatile and, on average, higher inflation.

- **Global growth is slowing.** And we expect it to keep slowing into 2024. There's a high chance that most countries may experience at least one quarter of contraction and that some may even face a technical recession, meaning two consecutive quarters of negative growth. However, these downturns could be mild, especially as households are supported in aggregate by rising real incomes.[1]
- **Central banks are keen to indicate that rates have now peaked.** As growth slows, unemployment rises modestly, and inflation comes down, central banks may probably see an opportunity to cut rates. In our view, that would be a mistake, because the growth slowdown is unlikely to be sufficient to create the slack required to get inflation sustainably back to target.
- **Fiscal policy and electoral cycles will increasingly dominate outlooks.** A long list of fiscal commitments, ranging from military to climate-transition expenditure, may keep government budgets in deficit, particularly in Europe. As we approach elections, countries may loosen fiscal policy further—the US and UK being prime examples in 2024—even though inflation may still be above target.

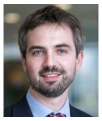
With monetary policy in flux and governments consistently increasing their spending commitments, we expect risk premia[2] to experience a further upward trend in the coming years, driven by a significantly higher shift in the net supply of government debt, which is fast approaching levels not seen for three decades.

Governments are consolidating their deficits slowly while central banks, which acted as the buyers of last resort over the last 10 years, have become net sellers. At the same time, global savings surpluses have shifted toward emerging markets, which seem to be less inclined to recycle the money into developed-market government debt.

- **The resulting structural upward pressure on term premia** is likely to restrict the potential for long-term rates to rally in the event of a downturn. Conversely, they could potentially continue to sell off at the first signs of a reacceleration of inflation in 2024.

Insight from sub-adviser Wellington Management

John Butler,
Macro Strategist



Eoin O'Callaghan
Global Bond Strategist

Key Points

Global growth is slowing. And we expect it to keep slowing into 2024, with some countries facing a possible technical recession.

While central banks may be tempted to cut rates, the slack in global economies won't be sufficient to get inflation sustainably back to target.

A long list of fiscal commitments, ranging from military to climate-transition expenditure, may keep government budgets in deficit, particularly in Europe.

Global savings surpluses have shifted toward emerging markets, which seem to be less inclined to recycle the money into developed-market government debt.

- **Deglobalization means that thinking locally may yield greater value.** Throughout 2024, there is the potential for many interesting themes to play out at a regional and country level. Many small, open economies—from the Scandinavian countries to New Zealand—could follow very different cyclical and policy paths from the US, the euro area, and other large economies whose private-sector balance sheets tend to be in better shape. Some of the countries that have depended on exports for growth—most notably, Germany and China—may need to transition to a new domestic-led growth model or risk deflating. And Japan, for so long a source of deflation and savings for the world, could well raise rates, end yield-curve control,[2] and continue to reflate.

Talk to your financial professional to learn how you can prepare your portfolio for greater volatility.

[1] Real income is how much money an individual or entity makes after accounting for inflation and is sometimes called real wage when referring to an individual's income.

[2] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

[3] Yield-curve control (YCC) refers to efforts by a central bank to maintain a target yield level on government bonds by buying and selling the securities. In the summer of 2023, the Bank of Japan announced the start of a gradual phaseout of YCC policy so that long-term rates could gradually rise within certain limits.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than U.S. 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.

The US Economy: A Tale of Transition

My base case for the US economy in 2024 is slower nominal growth and policy normalization.

Insight from sub-adviser Wellington Management

Juhi Dhawan, PhD
Macro Strategist

Key Points

- I expect consumer spending to decline as disposable income growth slows.
- Conversely, I anticipate growth in investment spending if companies feel that the economic outlook is improving.
- With 2024 being an election year in the US, all eyes will be on the economic agendas of the presidential candidates, especially with former President Trump's tax cuts set to expire by the end of 2025.

In the upcoming year, there are a variety of risks to watch for, including monetary policy taking a bite out of growth, a maturing business cycle leading to credit deterioration, and geopolitical turmoil driving heightened economic uncertainty. In this context, efforts by corporate America to cut costs and boost productivity could be important offsets. In the coming year, the Federal Reserve (Fed) will slowly reward an improving core inflation backdrop, and US elections will merit attention given the large prevailing fiscal deficits.

Shifting Trends in Spending

In 2023, US consumers benefited from lower inflation, strong jobs growth, and termed-out debt on private-sector balance sheets—all of which helped to shield consumers from the impact of higher interest rates, for a time at least. But in 2024, I expect consumer spending to slow as the resumption of student-debt payments, weaker jobs growth, rising energy bills, and fading fiscal support curb household disposable income growth.

Service areas such as travel, leisure, and entertainment all benefited this past year from the unleashing of pent-up consumer demand, but I think that catch-up spending has largely played out. I also expect government spending to slow, as some of the surplus funds that state and local governments received from the federal government during the pandemic have been used up.

On the other hand, investment spending, an area with room to grow, could see some gains if clarity on the economic outlook improves enough to motivate companies that have been holding back. The tight labor market, a long-term economic challenge, will incentivize companies to invest in automation technology and other tools that can help reduce labor costs. One notable area of focus is, of course, generative artificial intelligence (AI). While it's unclear how quickly companies will reap the benefits of the technology, the breadth of industries that could leverage AI brings hope for a more productive future in the medium term.

Investment spending should also benefit from an end to the destocking cycle that occupied many industries in the ailing goods economy after they found themselves working off post-pandemic excess inventories. In addition, US industrial policy, including provisions of the Inflation Reduction Act, the CHIPS Act, and the Infrastructure bill, have helped spark a dramatic increase in construction spending, including new plants for semiconductor production and for electric vehicle batteries and other manufacturing associated with the energy transition. While construction spending will likely slow meaningfully as this ramp-up fades, the output from these factories could boost investment spending.

Worries Over the Global Economy and Profit Margins

Global developments in 2023 didn't make things any easier for the US economy. China's reopening failed to ignite global growth as the real-estate sector dragged down domestic spending and the global destocking cycle in goods dampened prices. Sticky wage inflation kept the European Central Bank in tightening mode even as growth disappointed in parts of Europe. The war in Israel and Gaza impacted thousands of lives and brought the threat of a broader Middle East conflict. Energy prices rose sharply in recent months as the world grappled with tight supplies and two wars, clouding prospects for the global economy and prolonging the central-bank fight against inflation.

Weaker economies overseas, where manufacturing plays a bigger role in the aggregate economy, held back US export growth. That said, we may be nearing the bottom of the global manufacturing slump, which should mean stronger US exports.

In the meantime, while tight labor markets are a feature across much of the developed world, a somewhat better balance between labor demand and supply has emerged in the US as immigrants have regained share in the US workforce, reducing upward pressure on wages. That, coupled with improving supply-chain bottlenecks, means that companies have seen profit margins stabilize even as revenues have slowed, given that costs decelerate faster. However, given my expectation that nominal growth will slow further in 2024, companies will likely find the environment more challenging on the margin front. It is plausible that after robust gains in the job market, the coming year will see a rise in the unemployment rate. Companies that commit to cutting costs and gaining efficiency in their businesses should be relative winners.

A Big Year for Policy and Politics

Monetary policy is now restrictive, and its impact has been felt in the slump in housing activity, in rising delinquencies in consumer credit, and in the tightening of bank-lending standards, especially following the failure of Silicon Valley Bank. Fiscal policy will lose steam as some of the cost-of-living-adjustment payouts made to consumers in 2023 normalize in the next year. This means that in 2024, the Fed should get to a place where it can slowly reward progress on core inflation and work to aid growth and employment rather than being so singularly focused on its inflation target.

With 2024 being an election year in the US, all eyes will be on the economic agendas of the presidential candidates. This election takes on additional significance since former President Trump's tax cuts are set to expire by the end of 2025. Will the US show the willingness to conduct fiscal consolidation, especially if the economy is weakening? This question will be of utmost importance in financial markets as bond vigilantes focus on the prevailing large US fiscal deficits. US/China relations will also stay in the spotlight and be a key geopolitical risk for market participants to navigate.

Talk to your financial professional to prepare your portfolio for slower growth and more uncertainty.

Macro Implications of the AI Revolution: Is the Market Right?

The market is already anticipating the impact of AI, but many questions still remain unclear.

Insight from sub-adviser Wellington Management

John Butler,
Macro Strategist

In my view, advances in artificial intelligence (AI) could alter the macro environment meaningfully by raising both expectations and growth trends of long-term real interest rates, but by how much and when is less clear. Below I set out an initial framework to help answer those questions within the context of deglobalization and demographic change.

How Could AI Transform the Macro Backdrop?

Generative AI technologies offer the promise of human-like output, with high usability thanks to natural language and a wide range of potential applications.

If successfully implemented, AI-driven automation could boost productivity growth by improving efficiency and freeing up resources for more productive tasks. Such an outcome would be welcome in a world where one of the most prevalent market themes over the past decade has been the fear of secular stagnation, where trend growth and R* (the real interest rate[1] that is neither expansionary nor contractionary when the economy is at full employment) are so low that interest rates cannot fall far enough to stimulate investment.

How Big Could the Macro Impact Be?

The lack of data makes it difficult to predict the likely macro impact of AI. Some academic studies (**FIGURE 1**) have attempted to do so based on a bottom-up breakdown of automation potential by sector and the speed of adoption of past technological advances. Understandably, the range of estimates about the potential boost to productivity are large and depend on assumptions about the level of task automation, associated structural worker displacement, and timeline of adoption.

In summary, these studies estimate that productivity growth could be raised by anywhere between 0.2% and 3%, with obviously very different implications. If we take the average across the six studies, the estimated boost to productivity is as much as 1.5%, while potential trend growth—inferred from the share of labor in production—could increase between 0.1% and 2%, with an average of 1%. Those estimates are very large.

FIGURE 1
Potential Boost to Productivity Growth From Generative AI: Estimates From Different Studies

Study	Annual % Boost	Range
McKinsey	0.5	0.3-1.5
Briggs et al	1.5	0.3-2.9
Bessen et al	1.7	-
Acemoglu et al	1.9	-
Behrens et al	2.5	0.5-4.0
Czarnitzki et al	2.6	-
Alederucci et al	6.8	-

As of 10/23. Source: Wellington.

Key Points

- AI-driven automation could boost productivity growth by improving efficiency— a welcome outcome in a world where one of the most prevalent market themes over the past decade has been the fear of secular stagnation.
- We still have little clarity on the speed of transition, the degree of automation possible, and the proportion of jobs that are likely to be displaced.
- The potential of AI should be assessed in the context of deglobalization and demographics since both are likely to constrain trend growth and long-term real rates.

What Does This Mean for Bond Yields?

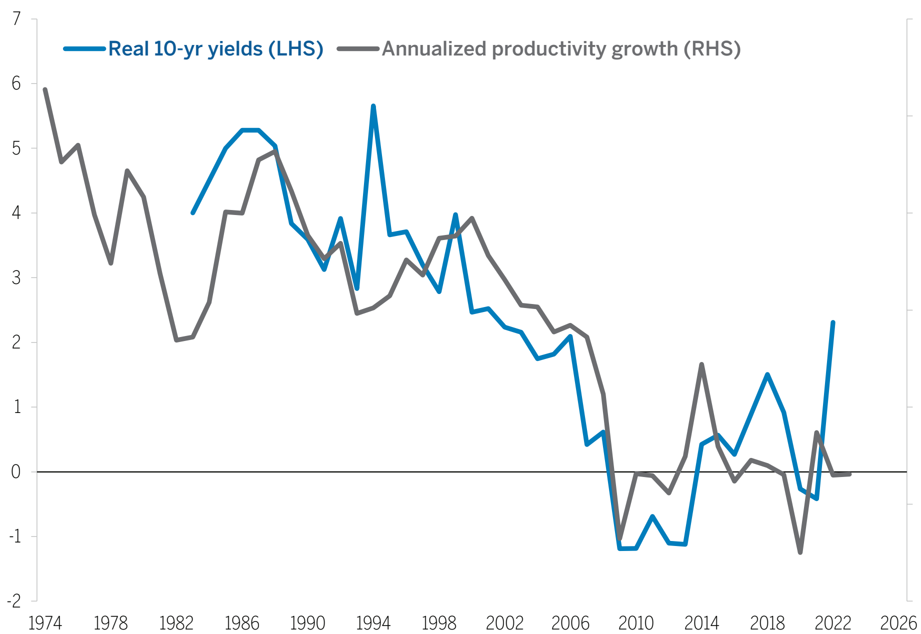
Since the Global Financial Crisis (GFC), we've seen a steep decline in real bond yields, mostly because of two forces:

- **A big squeeze in risk premia,**[2] which dropped from an average range of +100 to +200 basis points (bps)[3] before 2008 to -100 to 0 bps for most the ensuing period.
- **A sharp fall in estimates of R*** from 200 bps before 2008 to between -100 and +100 bps afterwards.

R* over time is highly correlated with the trend in productivity and real GDP growth (**FIGURE 2**), so it's not surprising that the drop in estimates of R* coincided with the steep decrease in productivity post-GFC. Investors believed that R* in developed economies had fallen to zero because of the faltering supply-and-demand picture driven by factors such as a lack of innovation, aging populations, falling education standards, and unequal income distribution. As a result, central banks struggled to get interest rates down far enough to stimulate spending and investment, which prompted discussions about removing the lower bound on rates and, in some instances, rate cuts into negative territory.

If AI could reverse downward trends in productivity, previous levels of interest rates that would have been enough to slow the economy may no longer be sufficient.

FIGURE 2
G7 Productivity and Yields Over Time (%)



As of 10/23. Sources: OECD, Wellington, and select data provided and copyrighted by Refinitiv.

If AI could reverse this downward trend in productivity, the level of interest rates that would have been enough to slow the economy over the past 15 years may no longer be sufficient. Higher rates may go hand-in-hand with increased valuations of risks assets[4] as these rate rises mostly reflect higher estimates for long-term return on capital. There's tentative evidence that markets may have started to price in some expectations that AI will raise productivity and trend growth.

What Is the Counternarrative?

We still have little clarity on the speed of transition, the degree of automation possible, and the proportion of jobs that are likely to be displaced. In my view, the two most critical questions that still need answering are:

1. **Where is the investment?**
   Higher productivity growth is usually correlated with higher capital expenditure[5] (CapEx). Yet, since the global economy reopened after the COVID-19 lockdowns, global CapEx has been disappointing in aggregate, particularly outside of the US, with global capex intentions even starting to trend down recently.
2. **How will governments respond?**
   AI could bring significant job displacement—a Goldman Sachs report estimated that 300 million full-time jobs could be displaced worldwide over a 10-year period.[6] Historically, innovation has always created new sectors and new jobs. For instance, a significant proportion of the jobs that exist today didn't exist 50 years ago. However, the accompanying uncertainty represents a major challenge for governments. The correct response from a macro point of view is to focus government policy primarily on reskilling workers to allow them to adapt rapidly and shift to more productive outputs. But given the potential for a significant political backlash, the government response may focus mostly on improving safety nets and reducing the associated cost of unemployment, which would reduce the positive impact on R* and potentially lead to much higher inflation.

AI development could displace 300 million full-time jobs worldwide over the next 10 years.

What About the Wider Context?

Another important consideration is that AI isn't happening in isolation. In some ways, the incentive to adopt these new technologies is higher because several other structural forces, most notably demographic changes and deglobalization in high-income countries, are raising the cost of labor and lowering productivity.

- **Demographics** – AI could help offset the negative implications of the expected drop in available workers in high-income countries, but the extent to which it will do so is unclear.
- **Deglobalization** – Our research suggests that we're likely to see deglobalization intensify, which could work in the opposite direction to AI by lowering productivity. Alternatively, the incentive to adopt AI may increase because deglobalization has made labor more expensive. In turn, successful adoption of AI may encourage countries to accelerate the process of deglobalization even further as it lessens the need for access to foreign workers and supply chains. At this stage, it's impossible to tell which trend will prevail.

Bottom Line

We think that AI has the potential to alter the macro landscape and counteract the secular stagnation theme, and we see tentative evidence that markets have started to anticipate this potential recently.

While markets need to anticipate and price the future, it's still early given the lack of investment to date and the lack of clarity on governments' response to potential job displacement, which could entail more inflation on the journey to AI implementation.

Moreover, the speed of implementation, scope of applications, and level of usage are important factors to consider. The potential of AI should also be assessed in the context of deglobalization and demographics as both are likely to constrain trend growth and long-term real rates.

On balance, I think investors should prepare for meaningful adjustments in rates and asset prices as market participants seek to gauge the extent to which AI can lift productivity and trend growth.

To learn more about the potential impacts of AI, talk to your financial professional.

[1] A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. Once adjusted, it reflects the real cost of funds to a borrower and the real yield to a lender or to an investor.

[2] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

[3] A basis point 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 indexes and the yield of a fixed-income security.

[4] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[5] Capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment

[6] S. Briggs and D. Kodnani, "The potentially large effects of artificial intelligence on economic growth", Goldman Sachs, March 2023.

The Intersection of Geopolitics and Deglobalization

A fracturing of the global order will create risks and opportunities for investors.

Insight from sub-adviser Wellington Management

Thomas Mucha,
Geopolitical Strategist

As the devastating conflict and humanitarian catastrophe in the Middle East once again underscores, we find ourselves in the most complex, dangerous, and unpredictable geopolitical environment in decades. What do investors need to know while navigating the investment landscape?

These geopolitical challenges are likely to continue throughout 2024 and, indeed, for years to come as the Ukraine/Russia war, US/China great-power tensions, growing climate stresses, and other national-security issues further impact the global investment, policy, and macro backdrops.

Meanwhile, elevated geopolitical risk around the world is also raising new and important questions about the pace and direction of deglobalization.

In my conversations with global policymakers, it's clear these jarring geopolitical events are fracturing the global order and, importantly, strengthening a focus around national security—sometimes at the expense of economic efficiency.

As a result, I expect strategic decoupling (or "de-risking" in the current parlance) to be a key investment theme in 2024, particularly in industries critical to deepening great-power competition between the US and China.

To be sure, this doesn't mean globalization is dead.

But it does mean policymakers in Washington, Beijing, and elsewhere around the world may seek to protect and promote a growing number of strategic sectors central to establishing economic and military power in coming years and decades.

These "dual-use" civilian-military applications include semiconductors, next-generation communications, critical minerals, and a variety of other renewable energy inputs, biotech, space-related technologies, robotics and automation, as well as artificial intelligence and quantum computing, among others.

In the US, the CHIPS and Science Act, which is designed to boost US semiconductor manufacturing, is particularly instructive as are stringent export controls and proposed outbound investment restrictions on advanced semiconductors.

That's because these policy actions can be seen as a potential "blueprint" for how current and future US administrations and the US Congress will address great-power competition across strategic industries—working, wherever possible, with US allies globally to broaden the economic and geopolitical impacts of these measures.

This emerging industrial policy is a long way from the heady days of globalization, when policymakers were keen to take a more hands-off approach and allow markets and companies to more freely allocate capital.

But given the national security imperatives of great-power competition—and the myriad supply-chain disruptions the COVID-19 global pandemic revealed—I believe policymakers around the world will remain committed to reducing dependencies in these critical sectors in 2024 and, indeed, beyond.

Specific Geopolitical Risks to Watch in 2024

Given the focus on national security, I expect the global-policy environment and markets to be impacted by a number of geopolitical risks in 2024, including:

Key Points

- Jarring geopolitical events are fracturing the global order and placing a greater focus on national security.
- Globalization isn't dead but nations may grow and protect civilian-military applications such as semiconductors, AI, and quantum computing.
- Higher macro and market differentiation across the world may benefit actively managed strategies.

- The escalatory potential of the Israel-Gaza conflict, especially the significant energy, inflation, and monetary-policy implications a wider regional war could trigger
- Structural stresses in the US-China relationship, particularly around the outcome of Taiwan's presidential election in January and the US presidential election in November
- The escalatory potential of the Ukraine/Russia war, which shows few signs of ending soon
- The growing national-security challenges of climate change, as this accelerating trend further stresses "hot zone" regions across the equator and the tropics where many of the world's most intractable geopolitical problems currently reside

Other Geopolitical Risks Are Also Easy to Imagine in 2024:

- An increasing probability of global terrorism if the war in the Middle East escalates
- The risk of a major cyber-attack on US critical infrastructure amid new conflicts and rising great-power tensions
- An increasing probability of US domestic political violence in a contested US presidential election
- Rising information warfare and disinformation campaigns such as "deep fake" videos and other AI-enabled technologies taking root

Implications for Investors

Several key investment considerations come to light amid these ongoing shifts in the geopolitical and policy environments.

First, actively managed strategies have the potential to benefit from the higher macro and market differentiation that these disruptive policy developments may produce.

Properly marrying the right "bottom-up" analysis with these top-down geopolitical and policy trends may uncover numerous alpha[1] opportunities—at the regional, country, industry, company, and asset-class levels.

Second, several "great-power competition" investment themes may create additional alpha opportunities in 2024, including traditional defense contractors, defense innovation, climate resilience, and decarbonization.

These investment themes and others may enjoy government spending support for years to come. So, in general, consider whether getting more exposure to relevant thematic approaches should be a bigger part of the investment toolbox as these deepening structural shifts accelerate in 2024.

Finally, supply-chain and other policy disruptions in coming years may contribute to structurally higher inflation over time and lower global growth than we experienced in previous "goldilocks" eras.

Investors should consider how the macro implications of geopolitical risk, policy risk, and accelerating deglobalization could affect their investment strategy.

Talk to your financial professional for help with managing your portfolio in light of geopolitical risks.

[1] Alpha is the measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio to some benchmark. The alpha is the excess return of the portfolio over the benchmark.

Equities in the Age of the 3D Reset

The mega-themes reshaping the world economy may provide opportunities and risks for investors in equities.

Beneath the surface of some respectable returns for global equities in 2023, with the MSCI World Index[1] so far up 22.15% through mid-December in US dollar (USD) terms, the picture is anything but benign.

A confluence of factors, associated with what we've called the 3D reset, is driving a regime shift of major proportions. Structural challenges that were already apparent before the pandemic are becoming acute.

In 2024, uncertainties may persist and equity markets may remain volatile. As always, however, the old adage that "there is always a bull market somewhere" may prove accurate. In fact, we think there are a number of areas that may prove highly profitable for global equity investors in 2024.

The 3D Reset and the End of the Free Money Era

Perhaps the most striking feature of financial markets in the last decade was the steady decline in the cost of risk. With post-Global Financial Crisis (GFC) central-bank policy driving interest rates down to zero, the effect on asset prices was dramatic; they went up a lot. Then came the pandemic, closely followed by the war in Ukraine—events which served to crystallize pressures that had been building for some time.

There are many different factors at play, but we think they can be usefully grouped into three categories, namely 1) demographic constraints; 2) decarbonization imperatives; and 3) deglobalization initiatives. Together, they form what we call the 3D reset.

Combined with high sovereign debt levels, these factors have created supply bottlenecks, driven up wage costs, boosted general price inflation, and underpinned populist politics. Central banks have been forced to act decisively. Interest rates have risen dramatically and look set to stay elevated for some time. No wonder financial markets are jittery.

Time To Consider Doing the Opposite?

Hindsight is always 20/20. Looking back over the 10-year period ending in 2021, there were only a few things that investors needed to have done: buy equities; invest in growth (especially technology); invest mainly in the US; not worry about valuations; and lever up (finance with debt).

Anyone following this approach would have done superbly well, and many investors did.

But the 3D reset is now ongoing, and the implications for investors could be substantial across most asset classes. Most obviously, cash is no longer trash: Money in the bank can get you respectable returns.

Equity investors many need to change their mindset. This involves considering the following strategies:

- Diversification across regions (less US, more of the rest of the world),
- Focus on the implications of structural change, and
- Renewed attention to valuation, quality, and risk.

Insight from sub-adviser Schroders Investment Management

Alex Tedder,
Head of Global &
Thematic Equities

Key Points

- A confluence of factors, associated with what we've called the 3D reset, is driving a regime shift of major proportions.
- Automation is a long-standing trend that has rapidly expanded from narrow industrial processes to whole swathes of the service sector. Generative AI raises the stakes materially.
- Whereas the last decade was all about growth, the next decade may be more about finding companies that offer genuine value.

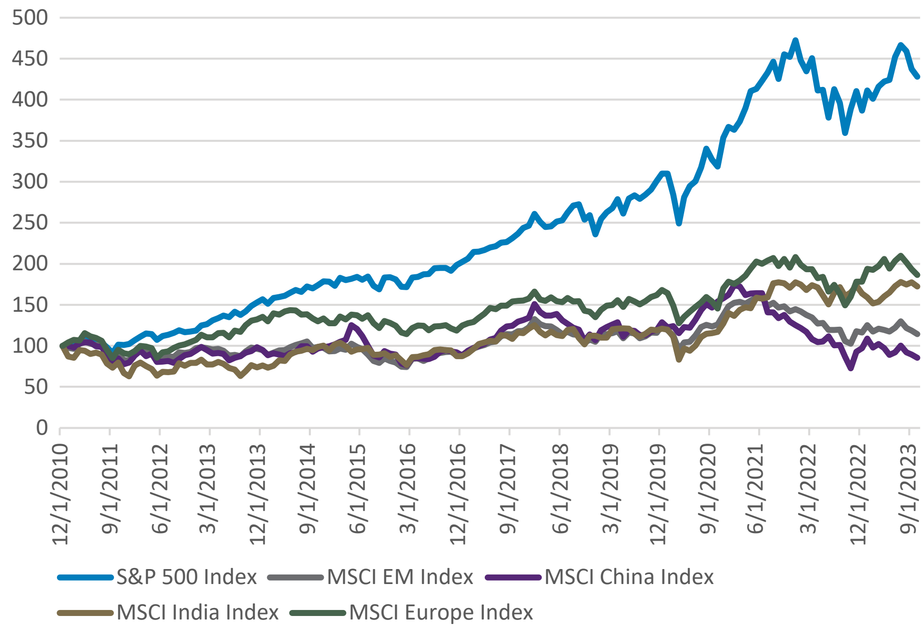
Consider Looking Beyond the US, Particularly to Unloved Markets Such as Japan and the UK

As Warren Buffett regularly reminds us, it's tough to bet against the S&P 500 Index.[2] Since the end of 2010 the S&P 500 Index has delivered, in USD terms, a cumulative return of 340% compared to 95% for European equities and just 20% from emerging markets. China has delivered a negative return over that period.

The market capitalization of the Magnificent 7 is now greater than that of the UK, France, China, and Japan combined.

FIGURE 1

Is it Time to Think About Non-US Markets Again?



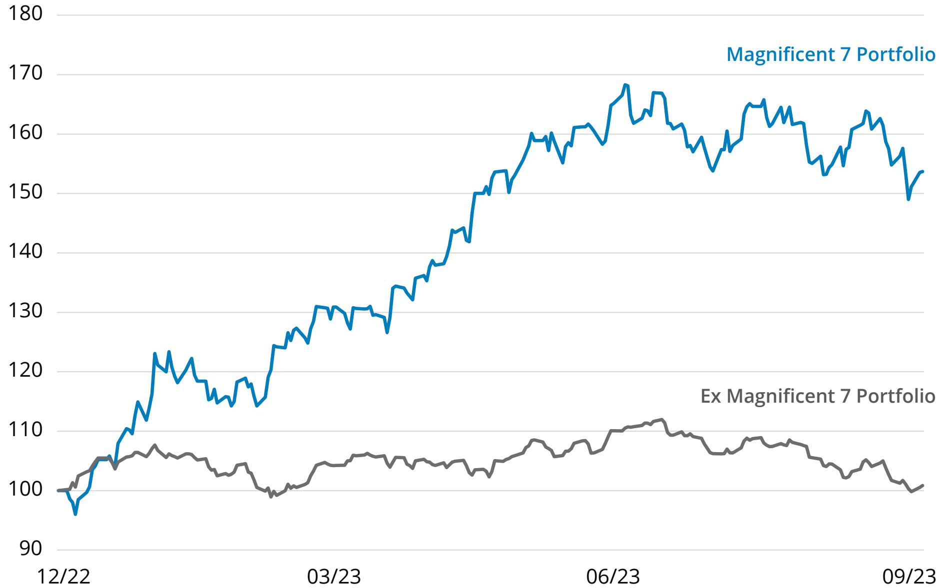
As of 10/31/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Please see index definitions on page 23. Data source: Schroders and EIKON.

The US corporate sector remains, in aggregate, better managed and more innovative than nearly any other. It has a unique composition. High-growth areas such as technology, communications, or healthcare account for a far higher proportion of the Index than in other regions. The IT sector, for example, now accounts for 28% of the S&P 500 Index compared to just 6% in Europe.

In light of these facts, the S&P 500 Index could continue to trade at a premium to other markets. However, it's notable that the valuation gap between the US and the rest of the world is now at extreme levels. To put this into context, the market capitalization[3] of the Magnificent 7 (responsible for most of the return from global equities this year) is now greater than that of the UK, France, China, and Japan combined. While such polarization has often persisted for long periods, the gap has eventually closed in the past.

FIGURE 2

The Magnificent 7 Are Up Over 50% This Year, the Rest of the World Is Flat



As of 10/31/23. **Past performance does not guarantee future results**. The Magnificent 7 portfolio consists of Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla, and Meta (Facebook). Ex Magnificent-7 is a portfolio of the remaining constituents of the MSCI ACWI Index. MSCI ACWI is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax. Data Sources: LSEG DataStream and Schroders.

To be clear, we aren't negative on the US market. If you were to strip out the Magnificent 7 and other high-growth names, the S&P 500 Index is trading only slightly above its long-term average. Indeed, small- and mid-cap US stocks look compellingly valued in many cases.

And in the case of the Magnificent 7, although they may not have as far to run as before, they remain unique franchises with powerful and highly profitable business models. They aren't going away anytime soon.

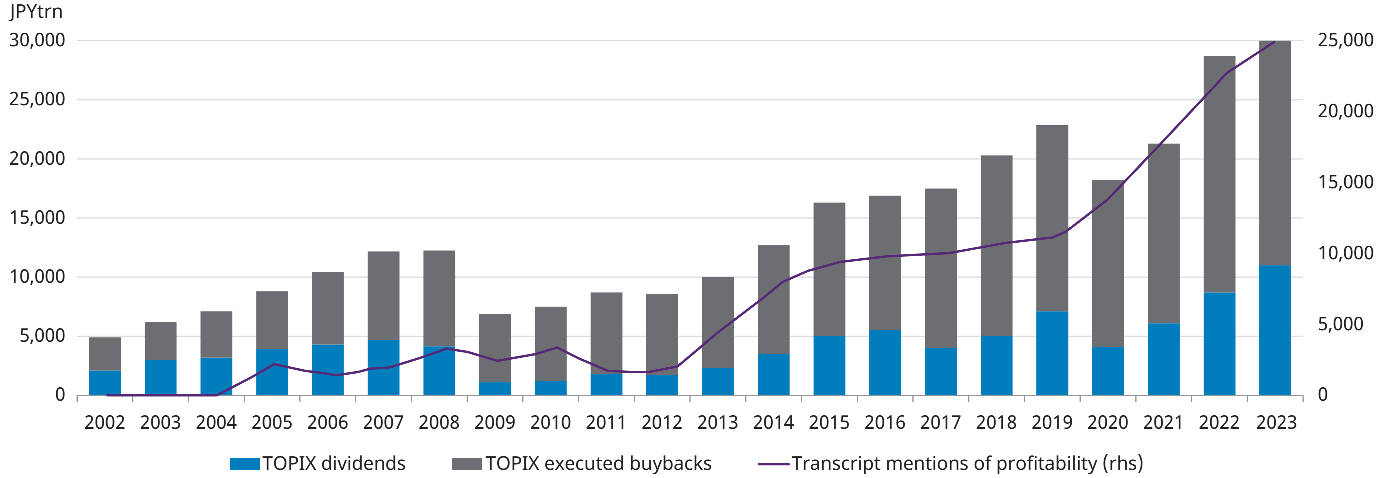
Incrementally though, after years of disappointing returns, now is probably a good time to look at unloved markets such as Japan and the UK.

Japan's market has been a laggard since its asset price bubble burst in 1992 with catastrophic consequences for the economy. After two decades without inflation and a currency that has depreciated 50% against the USD, the Japanese economy is now highly competitive. What's more, authorities there have woken up to the fact that more than half of companies on the stock market trade on less than the value of their assets (that is, have a book value[4] of less than 1), as of the end of May 2023.

In late 2022, a directive was issued to encourage Japanese companies to return cash to shareholders, either via buybacks or higher dividend pay-outs. There has already been a startlingly strong response from the corporate sector, and we expect this to continue.

Although the Magnificent 7 may not have as far to run as before, they remain unique franchises with powerful and highly profitable business models.

FIGURE 3
A Resurgence of Profitability and Productivity in Japan



As of 5/24/23. 2023 data has been annualized. The Tokyo Price Index, known as TOPIX, is a Japanese stock market index that tracks domestic companies in the exchange's first section, which represents Japan's largest firms by market capitalization. Data Sources: TSE, Nikkei NEEDS, AlphaSense, and Morgan Stanley Research.

Long perceived as a "legacy" stock market due to the relatively high concentration of traditional industries such as energy, mining, consumer staples, and banking, the UK has steadily under-performed the MSCI World Index over the last 20 years. Regulation, government apathy, and Brexit haven't helped. Yet scratch the surface and the UK may have much to offer.

Governance and accounting transparency are generally best-in-class. Companies in the Financial Times Stock Exchange Group (FTSE) are mostly global businesses with broad exposure to growth markets. And there around 1,800 other listed companies, many of which are over looked and under-researched. Most significantly, the UK market trades at a material discount, both to the rest of the world and to its own history. With the FTSE All-Share Index[5] valued at just 10 times next year's earnings and with a dividend yield[6] over 4%, the market looks compelling.[7]

> Technology is key to addressing many of the structural challenges we currently face.

Think About Long-Term, Structural Themes

It's striking that so far in 2023 the MSCI Global Alternative Energy Index[8] is down 40%.[9] Investor sentiment has been hit by a combination of poor results (not helped by extended valuations in some cases) and a political backlash against environmental initiatives.

And yet, even the most hardened eco-skeptic would struggle to deny that extreme climate effects are becoming ever more apparent. The case for decarbonization is overwhelming. Given that many post-pandemic cost pressures and over-capacity in parts of the renewable energy space have now been worked through, now would seem to be an excellent time for investors to consider the energy transition theme.

It seems clear that technology is key to addressing many of the structural challenges we currently face. For example, solar and carbon capture are central to the energy transition theme. In a similar vein, the challenge of demographics is one that could largely be met by medical discovery, automation, and artificial intelligence (AI).

AI has captured the imagination of investors and, of course, there's a substantial risk of it getting over-hyped. Nevertheless, the logic behind the market's excitement is irrefutable. Automation is a long-standing trend that has rapidly expanded from narrow industrial processes to whole swathes of the service sector. Generative AI, based on language models, raises the stakes materially.

Globally, there are more than one billion knowledge workers—workers applying theoretical or analytical knowledge to specific tasks. Augmenting, enhancing, and perhaps replacing a portion of this work could result in immense changes and may create significant opportunities for investors not just in the technology sector but in almost every part of the economy. PwC put the potential economic value of AI at $17 trillion annually by 2030. Compared to current global GDP of around $110 trillion, that's an extraordinary sum and the opportunities in the automation space could prove immense.

AI advancement could result in immense changes and may create significant opportunities for investors in almost every part of the economy.

Price Is What You Pay, Value Is What You Get

In a higher interest-rate environment, valuations matter much more than when interest rates are close to zero. Equities have been wonderful long-term investments, with the S&P 500 Index delivering a real return (after inflation) of more than 7% per annum over the last 150 years, compared to just 2% from US Treasuries. And yet equities are also highly volatile. There have been drawdowns of more than 10% in 29 of the past 50 years. Equity markets are fickle and can be quite unforgiving.

All the more reason, in our view, to focus on valuations. Or more precisely, on value for money. Whereas the last decade was all about growth (especially revenue growth), the next decade may be more about finding companies that offer genuine value.

By this we don't simply mean companies that are cheap. Cheap stocks are usually cheap for a reason. Companies in traditional sectors such as energy, financials, or industrials are not only highly cyclical, but also face major disruption from the transition to new technologies. In contrast, a company that trades expensively based on current metrics may turn out to be attractive, but only if it delivers sustained growth and cashflows in the future.

We think investors could benefit from focusing on the longer term, identifying areas with structural, under-appreciated growth, and committing strongly to those companies with sustained competitive advantages. Like anything, the price you pay for a security is the price you pay. Value is what you get. We think there's plenty of value in global equity markets, especially for the patient investor.

Talk to your financial professional to learn more about positioning your equity portfolio.

[1] MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

[2] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[3] Market capitalization refers to the total dollar market value of a company's outstanding shares of stock.

[4] Book value is the sum of the amounts of all the line items in the shareholders' equity section on a company's balance sheet.

[5] The FTSE All-Share Index represents the performance of all eligible companies listed on the London Stock Exchange's main market, which pass screening for size and liquidity. The index captures 98% of the UK's market capitalization.

[6] The dividend yield, expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

[7] As of 10/23. Data source: Bloomberg.

[8] The MSCI Global Alternative Energy Index includes developed and emerging market large, mid and small cap companies that derive 50% or more of their revenues from products and services in Alternative energy.

[9] As of 10/31/23. Data source: Bloomberg.

MSCI China Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in China.

MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

MSCI Europe Index is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

MSCI India Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in India.

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3D Reset and Emerging Markets: Risks and Opportunities

While emerging markets have faced a tough decade, the 3D reset may now be paving the way for new opportunities.

Emerging markets (EM) enjoyed a turbocharged period of growth during the 2000s, led by China. It was a decade of globalization, urbanization, the commodity "super cycle," and a rising middle class. Manufacturing, commodities, and consumption all benefited strongly.

However, the decade following has been a disappointment. Persistent US dollar appreciation has dragged on EM financial conditions and nominal growth. Globalization leveled off as the loss of manufacturing jobs in developed markets (DM) added to populist pressure. Chinese property, infrastructure, and debt have become increasingly developed and, more recently, geopolitical tensions have intensified with both economic and market implications.

So where now for EM? How are the 3Ds of demographics, deglobalization, and decarbonization causing risks and opportunities? Let's begin with the structural, starting with China—which currently accounts for 30% of the MSCI Emerging Market[1] Index benchmark.

Don't Write Off China

China faces slower growth in the coming decade, and its economy may need to transition away from an investment-led growth model. The investment share of GDP is unsustainably high: Infrastructure is considerably built out, but a years-long real-estate boom has led to oversupply in many parts of the country and debt levels remain high. Demographic trends are also acting as an increasing drag as China faces a shrinking working-age population, a marked fall in its birth rate, and a rapid increase in its dependency ratio as the population ages.

What's more, China is facing the "middle-income trap." As wage costs have risen, China has become less competitive in low-end manufacturing and needs to continue to move up the value chain.

In addition, geopolitical tension with the US is adding to economic headwinds. This tension contributes to supply-chain diversification, hinders access to advanced technology and knowledge transfer, has triggered aggressive US industrial policy, and impedes foreign direct investment (FDI). Despite these obstacles, China remains an $18 trillion economy, with a very large domestic market and the scale to support its own industrial policy. Since China is highly integrated and highly competitive, the impact on supply-chain diversification could take years to play out.

The country is innovative and is a major potential beneficiary of decarbonization. It manufactures 80% of the world's solar panels, sold two-thirds of the world's electric vehicles in 2022, controls 75% of the world's battery-cell production capacity, and dominates large parts of the renewables supply chain. It has a high savings rate and a controlled capital account so it isn't reliant on external capital for growth. Together with its control of the financial system, this gives China significant policy flexibility. Finally, in such a broad and deep market, we see opportunities at the company level.

Insight from sub-adviser Schroders Investment Management

Tom Wilson,
Head of Emerging Market Equities

Key Points

- While slower growth and economic headwinds present challenges for China, the country remains competitve, integrated, and flexible.
- Supply-chain diversification and the energy transition could create opportunities in Latin America, Central Europe, and Southeast Asia.
- A slowing economy in the US could lead to a softening US dollar, which in turn, may benefit EMs.

Demographics Among Drivers of India's Inexorable Rise

India is the counterpoint to China in many ways. Having been outstripped by China over the past 40 years, it may be India's turn in the sun.

India is coming off a low base: Urbanization is low and represents a significant medium-term productivity opportunity. Returns from infrastructure investment are high, demographics are supportive, and labor is abundant and cheap. Government policies to improve fiscal efficiency, increase infrastructure investment, reduce friction for trade between Indian states, and drive import substitution have improved the prospects for growth. Meanwhile, digitization and smartphone penetration create opportunity to improve economic formalization and improve financial intermediation, education, and price discovery.

However, caveats are required: Issues of infrastructure; bureaucracy; protectionism; labor skills; and labor code persist, and, despite its scale, India isn't necessarily the first choice for export manufacturing FDI. But India's prospects for the next decade look promising.

Decarbonization and Deglobalization Beneficiaries

As the world becomes increasingly digitized, our structural view on technology is positive, and both Korean and Taiwanese markets enjoy exposure to trade and technology. As of October 2023, technology comprises 70% of Taiwan's benchmark, while in Korea it accounts for 50%. Meanwhile, Korea also has strong battery companies with excellent long-term growth prospects from decarbonization.

There are other countries in EM that are beneficiaries of supply-chain diversification. While India might not be a first-choice destination for export manufacturing FDI yet, a mix of infrastructure, skilled labor, and geographic proximity supports the prospects for Mexico, Central Europe, and the Association of Southeast Asian Nations.

Manufacturing in DMs can be very expensive both to build and operate. For example, reshoring chip and battery production to the US requires enormous fiscal support. Hence, deglobalization may be more about near-shoring and friend-shoring than it is about reshoring. It's also more about de-risking supply chains.

The impact of commodities in EM has diminished markedly. But the investment requirements of the energy transition will strongly support certain commodities to the benefit of some markets (primarily in Latin America).

Finally, even though the Middle East will face challenges from the energy transition due to its economic dependence on oil production, interesting opportunities derive from a strong government focus on economic diversification, with significant fiscal support and reform in Saudi Arabia and the United Arab Emirates.

Cyclical Opportunities: China, Brazil, and Technology

Despite the structural opportunities that abound in EM, investing in this universe is as much about the cyclical as the structural. This is one of the reasons why we believe style-agnostic active management is so important. India represents a compelling medium-term structural growth opportunity, but valuations in that market are currently very high and we see stronger opportunities elsewhere—including China.

Sentiment in China is currently very negative. The structural and geopolitical headwinds are much discussed, while weak economic momentum adds to shorter-term concerns. However, this is now reflected in cheap valuations and positioning has adjusted markedly. The government has the policy flexibility to support growth, while there's a visible push to stabilize US-China relations. Although the market is not without risk, we think there may be excessive pessimism at this time.

Despite the structural opportunities that abound in EM, investing in this universe is as much about the cyclical as the structural.

We also see potential opportunities in the trade cycle, particularly in technology where we have a material overweight. The inventory cycle is inflecting as inventories run down and production and capacity expansion are constrained. While soft DM demand in 2024 may mute the upcycle, we have positions in companies and markets that trade at attractive valuations and could benefit from the upcycle while also having good medium-term prospects.

Monetary cycles may provide opportunity as well. Central banks in EMs are generally obliged to be orthodox. In some countries, there's now room for significant monetary easing following aggressive rate hikes and disinflation. For example, in Brazil, interest rates are currently 12.25%, while inflation in 2024 is expected to be below 4%. The central bank is expected to continue to cut rates, benefiting a market in which equities are broadly cheap and the yield curve[2] is elevated.

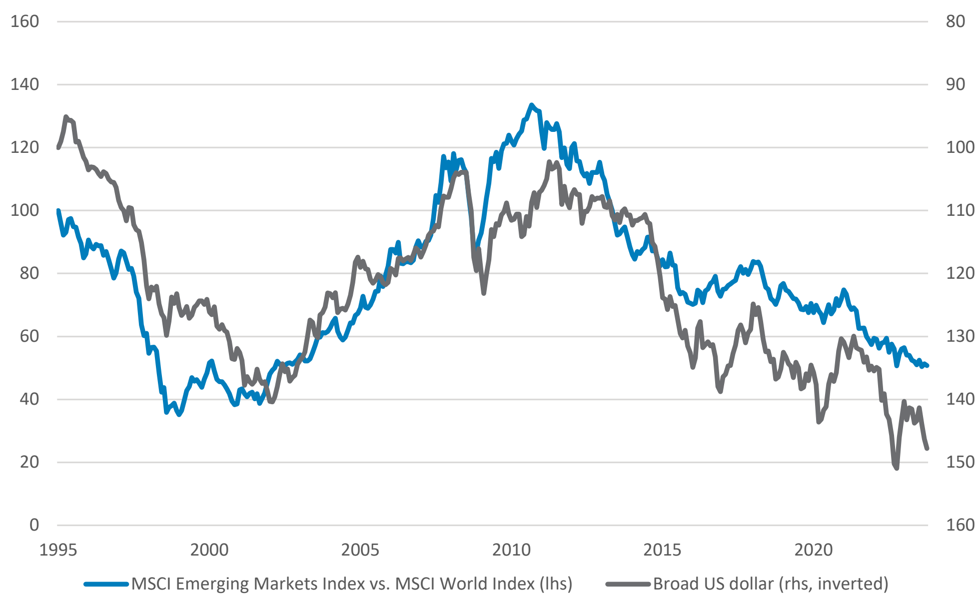
The Fourth D: The US Dollar

Finally, we can't speak of global EMs without referring to the fourth D—the US dollar. A decade of dollar appreciation has been a headwind for EMs, and this remains the case in the near term.

A decade of dollar appreciation has been a headwind for EMs, and this remains the case in the near term.

However, the dollar now looks richly valued, while the US carries significant fiscal and current-account deficits. A slowing economy, which triggered monetary easing and relaxed the yield curve, could potentially soften the dollar, which would improve financial conditions in emerging countries. In combination with valuations that are broadly attractive, this could be very supportive of EM equity returns.

FIGURE 1
The Importance of the US Dollar in EM Equity Performance



As of 10/31/23. **Past performance does not guarantee future results**. MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. Data Sources: LSEG DataStream, MSCI, and Schroders Strategic Research Unit.

Talk to your financial professional to learn more about positioning your portfolio for a changing investment landscape.

[1] MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

[2] 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.

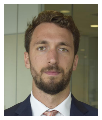
Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject investors to greater volatility than traditional investments. Diversification does not ensure a profit or protect against a loss in a declining market.

Rates: Tracking the Trade-Off Between Inflation and Growth

While an economic soft landing now seems likely, inflation and recession risks still remain.

Insight from sub-adviser Wellington Management

Amar Reganti
Managing Director



Marco Giordano
Investment Director

Inflation appears to be cooling globally, with the multi-decade-high reads of 2022 now firmly in the rearview mirror. While there could, of course, be upside surprises such as commodities shocks, idiosyncratic events, or prolonged consumer resilience, we believe global inflation is trending firmly downward. Based on current pricing, we think a soft landing is the most likely outcome. That said, a sudden reacceleration in the economic data or increasing inflation that could surprise market participants cannot be excluded altogether, given strong corporate and consumer balance sheets as well as remarkably tight labor markets.

The more likely scenario, however, is that markets are correctly pricing in rate cuts. With inflation moving lower and real interest rates much higher compared to a year ago despite the recent rally, central banks have room to maneuver and will want to avoid monetary policy becoming too restrictive. The return of the trade-off between inflation and growth has caused policymakers to worry about the downside risks for the economic cycle, arguably at least as much as they do about the risk that inflation does not return to target.

US and Europe Potentially Diverging

Given this growing concern about avoiding a deep recession, we believe central banks may take weak economic growth (or a recession, no matter how shallow) as a cue to cut rates, particularly as monetary policy appears to be achieving its objective of bringing inflation sustainably down toward 2%. While the first half of the year may see the US Federal Reserve (Fed) setting the trend for cuts among global central banks, we could witness growing divergence between countries later in the year.

The Fed has likely already reached its terminal policy rate and may begin rate cuts in the first quarter of 2024 as economic data likely weakens further and before the presidential election cycle gets in full swing. With inflation likely to remain above the Fed's 2% target during that period, consumers will by then feel the pain—with elevated inflation having eroded real wages further and precautionary savings largely spent—amid rising unemployment and tighter credit conditions. The Fed will therefore likely demonstrate a tolerance for above-target inflation, since failing to do so (and increasing policy rates further) would risk tipping the economy into a more severe recession.

Europe has experienced a persistent drop in inflation over the course of 2023, albeit to a lesser degree in the UK. Growth has flatlined and some countries—most notably Germany—are flirting with a technical recession. Consumer spending has not kept pace with the US over the last few years and COVID-19 savings are unlikely to suddenly be spent. However, core inflation is likely to stay above target, thanks to a very resilient jobs market and only a slight uptick in unemployment. Despite significant rate hikes, the last mile in getting inflation back to 2% is going to be harder than the path trodden so far, as the manufacturing cycle appears to have troughed, and services could pick up. In this context, while markets are pricing in

Key Points

- The trade-off between inflation and growth has prompted concerns about the downside risks for the economic cycle as well the persistence of high prices.
- While the first haf of 2024 may see the Federal Reserve setting the rate-cutting trend among central banks, a growing divergence among countries may occur later on.
- Japan remains the notable exception to inflation-cooling efforts as officials pursue their own path away from the accommodative rate policies of other leading central banks.
- The last year has shown that economies can withstand higher interest rates for longer and may continue to see positive growth, even if skewed toward nominal, rather than real, growth.[1]

rate cuts, we could, in fact, see the European Central Bank keep rates where they are unless there's significant deterioration in labor markets. The Bank of England may also be forced to pause after a few cuts. Maintaining rates at these higher levels would be a sign that:

- Economies appear able to withstand higher rates without entering a significant recession
- Cycles across countries can remain unsynchronized; and
- Barring exogenous shocks, the years of zero-lower-bound rates are behind us

We expect a continuation of the yield-steepening trend, either through rallies at the front end of the yield curve[2] or through upward movement in long-term yields as economies withstand more persistent inflation in the long term.

While markets are pricing in rate cuts, we could see the European Central Bank keep rates where they are unless there's significant deterioration in labor markets.

Japan Remains the Exception

The notable exception to cooling inflation in developed countries is Japan, which is seeing significant reflation as the Bank of Japan (BOJ) has been unfazed in shifting away from accommodative policies at its own pace instead of joining global central banks in their hiking cycles. While yield-curve control[3] has been significantly adjusted, we'll still start 2024 with negative BOJ rates and markets unable thus far to put pressure on policymakers. While the direction of travel is clear—abandonment of yield-curve control and exit from negative rates—the question remains as to how and when policy normalization may occur. The move higher in Japanese rates may have a significant impact on financial markets globally.

Emerging Markets in a More Comfortable Position

In emerging markets (EM), central banks have been successful in front-loading hikes during this cycle, putting them in an enviable position (from other policymakers' perspective) where they can gradually bring down rates without the risk of entrenching inflation in the system. In this context, EM currencies could struggle, not only because of reductions in interest rates, but also because end-of-cycle dynamics generally favor the greenback, Swiss franc, and Japanese yen, which markets perceive as safe-haven assets. However, the carry trade[4] could continue for some time, making emerging markets a potentially attractive space for positive returns.

China's Systemic Challenge

Chinese policymakers were slow to respond to a disappointing reopening in the first half of 2023 but are now more engaged in combatting the domestic slowdown as they seek to shift the economic model toward consumption and manufacturing of higher-value-add goods for export. The slowdown observed so far is multifaceted, as issues in the property market have combined with deteriorating balance sheets and a surprisingly high unemployment rate among younger cohorts. The People's Bank of China has taken a number of steps so far to address liquidity concerns, but monetary policy alone will not suffice to resolve these more systemic challenges.

Summary: Continued Normalization, but Beware of Potential Surprises

In summary, 2023 has shown that economies can withstand higher interest rates for longer, and may continue to see positive growth, even if this is skewed toward nominal, rather than real, growth.[4] Yield curves may steepen further, especially if inflation shows any signs of reaccelerating, while we note an increased potential for policy errors as central banks and markets navigate a treacherous trade-off between inflation and growth. Tracking these potential developments closely will be crucial for portfolio positioning in 2024.

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

[1] Nominal growth, as measured by GDP, reflects the raw numbers in current dollars unadjusted for inflation. Real GDP adjusts the numbers by fixing the currency value, thus eliminating any distortion caused by inflation or deflation.

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

[3] Yield-curve control (YCC) refers to efforts by a central bank to maintain a target yield level on government bonds by buying and selling the securities. In the summer of 2023, the BOJ announced the start of a gradual phaseout of YCC policy so that long-term rates could gradually rise within certain limits.

[4] A carry trade is a trading strategy that involves borrowing at a low-interest rate and investing in an asset that provides a higher rate of return. A carry trade is typically based on borrowing in a low-interest rate currency and converting the borrowed amount into another currency.

2024: Fixed Income in the Age of the 3D Reset

After the bear market in bonds, investors could be forgiven for giving up on the asset class. That could be a mistake.

No investors have felt the economic regime shift of the past three years more keenly than those in fixed-income markets.

Returns have been sobering: US Treasuries have posted their worst loss since the US ratified its constitution in 1787. However, such performance has also created opportunity. Despite inflation being more elevated than during the previous decade, yields—both real and nominal[1]—on higher-quality bonds now stand at their highest levels in 15 years. This not only makes them look cheap in absolute terms but also in relative terms compared to other asset classes, particularly equities.

Additionally, with growth and inflation slowing, and most developed central banks at or near the end of their hiking cycles, this has historically been the moment when investing in bonds has been the most rewarding.

The unprecedented bond-market declines seen over the last three years can be attributed to three key factors. First, the low starting point in yields provided minimal income to offset capital losses. Secondly, major central banks began their most aggressive hiking cycle on record. Finally, the fallout from the pandemic resulted in the highest inflation in 40 years.

Challenges undoubtedly remain amid what we've labelled the "3D Reset," with global trends related to the Ds of *demographics, deglobalization,* and *decarbonization* reshaping the investment landscape. Fiscal dynamics in the US and other developed markets remain problematic while high inflation may be set to linger, and geopolitical tensions could add another layer of uncertainty. But the disappointing returns of the last three years are now in the history books. As we start a new chapter, we must shift our focus toward the potential opportunities that lie ahead.

In terms of valuations, both in an absolute sense and relative to other asset classes, bonds screen[2] as cheaply as they have in the last decade and in the top quartile in terms of their attractiveness over the last 20 years.

That doesn't mean a rally is necessarily imminent. But the higher yields may offer a significant cushion in terms of income to offset any further price declines.

Insight from sub-adviser Schroders Investment Management

Julien Houdain,
Head of Global Unconstrained Fixed Income

Lisa Hornby,
Head of US Multi-Sector Fixed Income

Abdallah Guezour,
Head of Emerging-Market Debt and Commodities

Key Points

Three major global trends—demographics, deglobalization, and decarbonization—are likely to lead to increasing deficits, debt, and defaults, with major consequences for bond investing.

We currently assign a high probability to an economic soft landing, but it's difficult to ignore the warning signs around a potential hard landing as tighter financial conditions bite.

We're starting to see signs of stress from the previously bulletproof consumer. With pandemic savings close to exhausted, consumers are increasingly relying on debt.

Emerging-market inflation has come under control. The already attractive expected returns in EM fixed income may be boosted further should the US dollar complete its overextended bull cycle.

Global: 3D Reset Will Lead to Deficits, Debt, and Defaults

***Julien Houdain,** Head of Global Unconstrained Fixed Income*

The market has fully embraced the higher-for-longer narrative as inflation challenges persist. But with interest rates now peaking, what's going to drive markets in 2024?

We think the 3Ds of demographics, deglobalization and decarbonization are likely to lead to three more Ds with major consequences for fixed-income investing: deficits, debt, and defaults.

Although this doesn't sound particularly positive for the bond markets, we see some compelling investment opportunities ahead.

Deficits: Elephant in the Room?

"I'm not worried about the deficit. It's big enough to take care of itself." — Ronald Reagan

As bond investors, we—unlike Ronald Reagan—do worry about the size of government budget deficits, which are large for this stage of the economic cycle. And the market is beginning to take notice. Nowhere does this have greater significance than in the US, where the deficit has grown in size beyond anything seen in the pre-pandemic era.

Worryingly, there are apparently few signs of deficit reduction any time soon. While pandemic-support measures have now all but ended, longer-term "green" subsidies, including those offered by the Inflation Reduction Act, (which is helping to fund the decarbonization effort) have now taken up the fiscal baton.

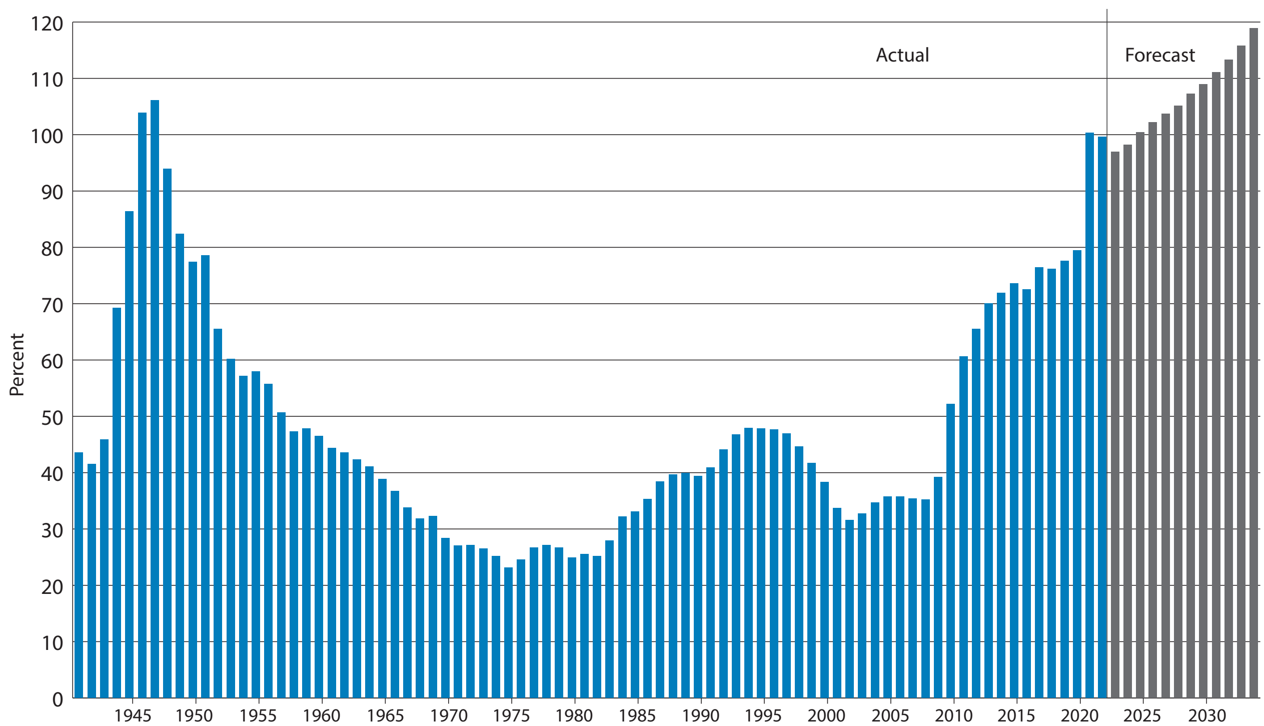
Meanwhile, reshoring in the form of the CHIPS Act—motivated by a desire to protect national interests (part of a broader deglobalization trend) and the requirement to support an aging demographic—are adding fuel to the fiscal fire. The problem: Financing this level of debt is getting significantly more expensive.

In the US, the deficit has grown in size beyond anything seen in the pre-pandemic era. There are apparently few signs of deficit reduction any time soon.

FIGURE 1

US Debt Is Mounting at a Time of Higher Financing Costs

Congressional Budget Office 10-Year Budget Projections: Public Debt* (% of GDP)



As of 11/30/23. *Public debt refers to all federal debt held by individuals, corporations, state or local governments, Federal Reserve Banks, foreign governments, and other entities outside the US government less Federal Financing Bank securities. Data Sources: Macrobond and Schroders.

All these factors point to structurally higher bond yields, but also to a greater level of market divergence as regional fiscal trends differ. This presents interesting cross-market opportunities. Let's take the eurozone, for example. Unlike in the US, the eurozone fiscal narrative is one of consolidation, which warrants a preference for European bond exposure over the US.

Creditors Have Better Memories Than Debtors

Fiscal management is intrinsically linked to our second 'D': debt dynamics. Transitioning to a new era, in which financing costs are higher, is likely to perpetuate a vicious cycle, adding to the stock of debt in the years to come.

After years of price-insensitive buyers (i.e., central banks) dominating demand for debt, they're retreating because of quantitative tightening. This means greater reliance upon price-sensitive buyers of debt, who expect greater compensation for holding a bond over a longer period (i.e., higher "term premia").

This should lead to a steepening of yield curves,[3] meaning a growing difference between long-term and short-term bond yields. Indeed, we see value in strategies that benefit from yield-curve steepening across a number of markets.

More broadly, the higher coupons generated can potentially provide not only a cushion against capital losses, but also a genuine alternative to other income-generating asset classes (including equities) for the first time in many years.

We see value in strategies that benefit from yield-curve steepening across a number of markets.

The Big 'D': Default

Default is the ultimate risk to bond investors. For cyclical assets, the macro environment is likely to have the most relevance. We currently assign a high probability to an economic soft landing, but it's difficult to ignore the warning signs around a potential hard landing as tighter financial conditions bite.

With central banks all but finished raising interest rates, the start of a rate-cutting cycle in 2024 would be a real support for bonds. Corporate default rates may rise, although, with balance sheets relatively robust, we're not expecting them to spike significantly.

Nevertheless, the transition to higher funding costs may be much faster in some economies compared to others. The pass-through from higher interest rates is felt much more quickly in Europe, where bank lending is far more prevalent than capital-market funding, which is favored in the US.

As a result, we expect greater market dispersion, not just on a regional basis, but at an issuer level, too, as investors will want to be compensated for allocating to more-levered[4] corporates. This creates opportunities to generate outperformance from careful bond selection.

Although the higher income offered by certain cyclical assets can provide a cushion against losses, we prefer to play it relatively safe given the risks of a potentially sharper slowdown. Our high-quality, lower-beta[4] preference for adding yield to a portfolio: a focus on investment grade (IG) over high yield with an allocation to covered bonds,[5] government-related, and securitized debt.

US: Putting the Income Back in Fixed Income

Lisa Hornby, *Head of US Multi-Sector Fixed Income*

The US economy has shown remarkable resilience over the last 18 months despite a number of headwinds. In the face of the most aggressive rate-hiking cycle witnessed in a generation, markets have grappled with a regional banking crisis, soaring energy costs, a persistently strong dollar, and geopolitical uncertainty.

This economic resilience can be attributed to two primary factors. First, the drawdown of consumer excess savings accumulated during the COVID-19 crisis, which has rapidly diminished from its peak of $2 trillion. And secondly, the implementation in 2022 of federal investment programs, namely the CHIPS and Science Act (approximately $280 billion) and the somewhat ironically named Inflation Reduction Act ($781 billion).

The economic tailwinds provided by these factors over the past 18 months are unlikely to be replicated in the coming quarters. What's more, the full effect of the long and variable lags associated with monetary policy, as acknowledged by the Federal Reserve (Fed), has yet to be fully felt. With more than 500 basis points[6] in rate hikes since the beginning of 2022, bond yields have more than tripled. In a highly indebted economy, it would be rather optimistic to assume there will be no unintended consequences.

We've begun to see some of the consequences of higher interest rates. Financing costs for businesses have continued to move higher in response to the increasing federal funds rate.[7] We're also starting to see signs of stress from the previously bulletproof consumer. With pandemic savings close to exhausted and the savings rate now back below 4% (the bottom decile since 1960), consumers are increasingly relying on debt. Credit-card balances have recently reached an all-time high, above $1 trillion dollars, and delinquencies, while low, are rising. The labor markets remain strong but are showing signs of decelerating. There are indications that investor concerns may shift away from higher rates and toward deteriorating fundamentals and credit risk in 2024.

In terms of allocating across the fixed-income universe, we recommend considering a more selective and opportunistic approach, considering the current yield levels in different sectors.

FIGURE 2
After Record-Low Returns, Bonds May Offer Compelling Value

Index	Yield 10/31/2023	Yield Percentile (Over the last 10 years) 100th (most attractive) 1st (least attractive)	Yield Percentile (Over the last 20 years) 100th (most attractive) 1st (least attractive)
US Aggregate	5.65%	100th	98th
US Treasury	5.03%	100th	99th
US Long Treasury	5.22%	100th	98th
US Securitized	5.96%	100th	98th
US Municipal	4.49%	100th	98th
US Corporate	6.35%	100th	95th
US Short Corporate	6.16%	100th	97th
US Long Corporate	6.54%	100th	90th
US High Yield	9.49%	99th	89th

As of 10/31/23. **Past performance does not guarantee future results.** Indices are not available for direct investment. Indices used: Bloomberg US Aggregate Index, Bloomberg US Long Treasury Index, Bloomberg Securitized Index, Bloomberg Municipal Index, Bloomberg US Corporate Index, ICE BofA US Corporate 1-3 Year Index, Bloomberg US Long Corporate Index, and Bloomberg US High Yield Index. Please see page 36 for index definitions. Data Sources, Bloomberg, ICE BoA.

Our focus remains on building liquidity in high-quality sectors such as Treasuries and agency mortgage-backed securities (MBS) as well as short and intermediate-dated corporates.

We believe there may be better occasions to add risk in the coming quarters as higher rates affect the economy and slower growth begins to weigh more heavily on corporate earnings. Once markets dislocate, there may be a significant opportunity to rotate out of liquid sectors and into higher-risk assets.

We believe there will be better occasions to add risk in the coming quarters as higher rates affect the economy and slower growth begins to weigh more heavily on corporate earnings.

Emerging-Market (EM) Debt: End of the Exodus?

***Abdallah Guezour,** Head of Emerging-Market Debt and Commodities*

The exodus of investors from EM debt in 2022 continued in 2023. Record outflows and depressed net new issuance have made the asset class severely under-represented in global investors' portfolios.

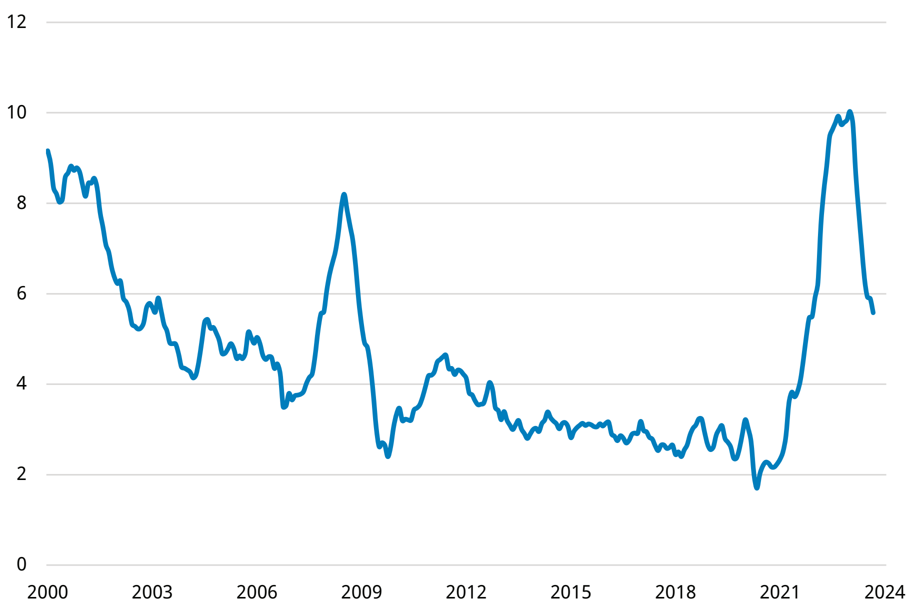
Despite this challenging flow backdrop, EM bonds and currencies have started to perform reasonably well. Tightening global financial liquidity, US-induced fixed-income volatility, broad US dollar strength, China's disappointing growth trajectory, and recent geopolitical dislocations have all been absorbed well by various EM fixed-income sectors recently.

Spreads[8] in dollar-denominated IG debt barely moved, while both EM dollar high-yield and local-currency debt generated positive total returns in 2023. We expect this recovery in performance may gain traction in 2024. This is because several dollar and local currency-denominated debt markets remain supported by not only their attractive levels of yields, but also disciplined monetary-policy frameworks that have brought inflation under control, improved balance of payments, and led to lower reliance on short-term foreign capital. These macroeconomic adjustments may lead to EM economies outperforming their developed counterparts in terms of growth.

Several EM debt markets remain supported by attractive yield levels and disciplined monetary-policy frameworks that have brought inflation under control.

Following a proactive hiking cycle that has taken the average real policy rate as high as 7%, several EM central banks are now regaining the right to ease (**FIGURE 3**). We expect these rate cuts to be moderate in most EM countries given the risks associated with diverging too much from the US Federal Reserve, which still appears committed to a relatively tighter monetary stance.

FIGURE 3
EM Inflation* Has Come Under Control



As of 10/31/23. *17 major equal-weighted emerging markets. Data Sources: Schroders Economics Group, LSEG Data & Analytics.

Such cautious monetary easing by key EM central banks is likely to reinforce credibility, sustain the recent stabilization of currencies that are equally supported by improving trade balances, and lead to a return of capital to local-government bond markets.

Ten-year local-government bond yields of Brazil (11.5%), Mexico (9.7%), Colombia (11%), South Africa, (12%) and Indonesia (6.8%) may be particularly well-positioned to generate high returns in 2024.

EM dollar debt also may offer appealing pockets of value, especially in sovereign high yield. Spreads remain at historically high levels, but a cautious and selective approach is warranted toward this sub-sector. Some high-yield sovereign issuers, such as Nigeria, are experiencing strong reform momentum, a benign maturity profile, and current-account surpluses while offering dollar bond yields in excess of 11%. Although the levels of spreads in EM dollar IG debt indices appear less appealing as they are extremely tight relative to history, it's important to consider that highly rated "AA" and "A" Gulf countries now represent about 20% of the EM IG universe.

The already attractive expected returns in EM fixed income may be boosted further should the US dollar complete its overextended bull cycle. The dollar is extremely overvalued as unsustainable US twin deficits are now starting to act as a major headwind for the greenback.

We think the post-pandemic long-term bull cycle in commodities is still in place and is also a potential tailwind for several EM bonds and currencies. After a period of strong gains, the commodities complex saw a correction from the highs seen in 2022, as investors turned more cautious on the outlook for global demand.

Looking ahead, we're entering the age of the 3D Reset with increasing risks of further waves of inflation and deepening geopolitical conflicts. Resilient commodity demand and constrained supply should also drive prices higher in the long run, especially in commodities leveraged to the energy-transition investment boom. Such a backdrop may support an active allocation to the commodities complex as a strategic hedge for investors' portfolios.

Index Definitions

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.

The Bloomberg US Long Treasury Index measures the performance of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with a maturity greater than 10 years.

The Bloomberg U.S. Securitized Index is a subset of the Bloomberg U.S. Aggregate Bond Index and only includes the securities that are classified under BCLASS Level 1 "Securitized" group. This group includes MBS Pass-through, ABS, CMBS and covered assets.

Bloomberg Municipal Bond Index is designed to cover the USD-denominated long-term tax exempt bond market.

Bloomberg US Corporate Index is a market-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

The ICE BofA US Corporate 1-3 Year Index includes publicly issued U.S. Treasury debt, U.S. government agency debt, taxable debt issued by U.S. states and territories and their political subdivisions, debt issued by U.S. and non-U.S. corporations, non-U.S. government debt and supranational debt.

The Bloomberg US Long Corporate Index is designed to measure the performance of U.S. corporate bonds that have a maturity of greater than or equal to 10 years.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

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

[1] Nominal interest rates refer to interest rates that are unadjusted for inflation. Real interest rates factor inflation into the equation to give investors a more accurate measure of their potential buying power.

[2] Typical factors to consider when screening bonds for investment include: the bond's maturity and redemption features; credit quality (rating by Moody's or Standard and Poor's); interest rate; price/yield ratio; tax status.

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

[4] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index.

[5] Covered bonds are debt securities issued by a bank or mortgage institution and collateralized against a pool of assets that, in case of failure of the issuer, can cover claims at any point in time.

[6] 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.

[7] The federal funds rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight.

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

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. • Investments in the commodities market may increase liquidity risk, volatility, and risk of loss of adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject investors to greater volatility than traditional investments. • 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. • Obligations of US Government agencies are supported by varying degrees of credit but are generally not backed by the full faith and credit of the US Government. • Municipal securities may be adversely impacted by state/local, political, economic, or market conditions. Although municipal securities that are exempt from federal income taxes, investors may be subject to the federal Alternative Minimum Tax as well as state and local income taxes. Capital gains, if any, are taxable.

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For implementation ideas based on these outlooks, please talk to your financial professional.