

# All-Time Highs and CPIs: What Comes Next?

Central-bank policy and geopolitical risks remain top-of-mind in the second half of the year.

## Key Points

- We think global fundamentals look favorable from a growth, inflation, and monetary-policy standpoint and support a risk-on tilt despite lofty valuations and political uncertainty. Whether inflation settles lower remains an open question, but central banks are in cutting mode.
- We maintain a moderately overweight view on global equities and would turn more positive on signs that equity-market gains are broadening out beyond mega caps. We expect earnings growth to broaden across regions, as reflected in our neutral regional stance.
- We've moved to a moderately overweight view on duration<sup>1</sup> given signs of growth, moderating inflation, the Federal Reserve's (Fed) tilt toward policy easing, and the market alignment with fewer anticipated rate cuts. We see tight spreads<sup>2</sup> persisting and express this in high yield.
- We have a slight overweight view on commodities, expressed in oil where the supply/demand dynamics and carry<sup>3</sup> are favorable.
- Downside risks to our views include a resurgence of inflation, US or European political turmoil, and a broader conflict in the Middle East. Upside risks include a resumption of disinflation that drives more aggressive rate cutting, stronger-than-expected earnings outside of mega-cap tech, and a resolution to the war in Gaza.

While economic fundamentals have been a source of relative calm for markets, political noise is rising in this important election year. Whether that will have a sustained impact on markets is another matter. We're loath to predict political outcomes. We have more conviction in our view that the fundamental backdrop of decent growth, moderating inflation, and credible monetary policy has staying power and is bullish for risk assets<sup>4</sup> despite high valuations. In the US, we see signs that growth is slowing and there's a bit more slack in labor markets. Service inflation remains sticky, specifically shelter, but the path is pointing downward. That leaves the Fed in a position to ease eventually, which could support equities and bonds.

Of course, politics can't be ignored. The success of France's right wing in the European Union (EU) elections and President Emmanuel Macron's announcement of a snap election spooked bond markets last month. Populist-driven spending proposals by the National Rally party on top of a French budget deficit of 5.5% of GDP drove the spread between French and German 10-year bond yields to its widest level since early 2017, when French fiscal concerns also arose.

However, we don't see this growing into a systemic issue for a couple of reasons. First, we don't see an EU breakup as a risk, although its fiscal rules and institutional setup face challenges. Second, as we saw in the UK in 2022, France in 2017, and Greece in 2015, markets can impose discipline on politicians when fiscal policies are deemed profligate. Even if a crisis were to ensue, the

## Insight from sub-adviser Wellington Management



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European Central Bank (ECB) would likely be a buyer of last resort at some level of risk-premia spike. We'll be watching for politically induced market disruptions elsewhere, too, but we don't think they'll be sustained enough to influence our 12-month view. Ultimately, a divided US Congress could curb spending, while the UK election will likely have little impact on markets and may even yield a better outlook.

Confident in the positive fundamental backdrop, we've maintained our moderately overweight view on global equities but no longer have a regional preference. We've raised our view on emerging-market (EM) equities to neutral: valuations are relatively inexpensive but politics and the delay in Fed rate cuts are weighing on the macro outlook. Within risk assets, we also favor high-yield credit, given the macro backdrop and the role that lower US yields have played in improving access to liquidity. We have a slight preference for European high yield given wider spreads in reaction to French political concerns. Within commodities, we have a moderately overweight view on oil given OPEC's desire to keep the market tight and oil futures' positive carry.

Turning to government bonds, slowing growth, declining inflation, and eventual central-bank easing underpin our moderately long-duration stance across developed-market (DM) regions. This view is challenged somewhat in Japan, where the Bank of Japan (BOJ) seems out of sync with inflation data, especially as the yen sinks to new lows, but we think the central bank could remain patient given weaker growth data.

## Equities: Still Positive, But Broader Would Be Better

We maintain a moderately overweight view on global equities. While economic growth momentum has slowed in the US, global activity continues to improve, and the rate outlook in major markets is more realistic. Meanwhile, global earnings revisions continue to inflect positively, and we expect earnings growth, rather than valuation expansion, to drive returns over the next 12 months. We also expect earnings growth to be more broad-based than it has been in the narrow market driven by mega-cap tech stocks.

On the negative side, the resumption of mega-cap outperformance and the narrowing market advance in the latter half of the second quarter is a source of concern. The recent softness in growth data in the US and the flare-up in eurozone political risk have probably compounded market concentration dynamics. We would likely turn more positive on global equities if we saw signs that the equity rally was broadening out or if valuations cheapened in response to political flare ups or weaker economic data.

We've reduced our view on Japan to neutral. We first moved to an overweight view on the country in November 2022, based on strong evidence of a macro regime shift and improvements in corporate governance. The push for better corporate governance, returns to activism, and rising margins have been helpful, and our view is that Japanese equities could continue to re-rate over the medium term and reduce the margin/return-on-equity gap vs. other markets.

However, we're less bullish on macro conditions in the short term. Our outlook on inflation and rates is above consensus, and we believe the BOJ is behind the curve on policy settings and risks losing credibility. While the BOJ has (seemingly) intervened as yen depreciation has intensified, this has provided only temporary support, and more monetary-policy action will likely be needed to stabilize the currency. All of this raises the potential for higher macro volatility or uncertainty in the short term, which means the overall risk/reward skew is less positive than a few months ago. The caveat to this view is that Japanese equities' relative performance has become less tied to moves in the yen as companies have increasingly diversified their production abroad through subsidiaries.

## Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	—
DM govt. bonds	Moderately OW	↑
Credit spreads	Moderately OW	—
Commodities	Moderately OW	↑
Cash	Underweight	↓
<b>Within Asset Classes</b>		
<b>Global Equities</b>		
US	Neutral	↓
Europe	Neutral	—
Japan	Neutral	↓
China	Neutral	↑
EMs ex China	Neutral	↑
<b>DM Government Bonds</b>		
US government	Neutral	↑
Europe government	Neutral	↓
Japan government	Neutral	—
<b>Credit Spreads</b>		
US high yield	Neutral	↑
Europe high yield	Moderately OW	—
Global IG	Neutral	↓
EMD	Moderately UW	↓
Bank loans	Neutral	—
Securitized assets	Moderately OW	↑

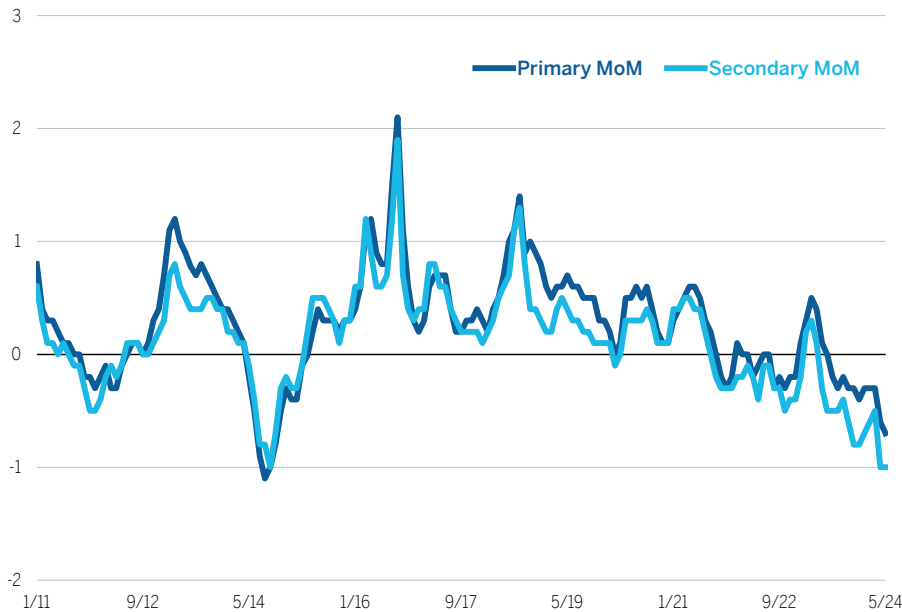
OW = overweight, UW = underweight

Views have a 6-12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 6/30/24, 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.

We've raised our view on China and EMs broadly to neutral, thanks in part to the beginning of a rate-cutting cycle, albeit one that's likely to be shallow. We're also less willing to maintain an underweight view on China given cheap valuations, which recently drove a sharp rally. At the same time, structural headwinds and the lack of policy traction (FIGURE 1) keep us on the sidelines and reluctant to engage positively.

## FIGURE 1: No Clear Signs of China Property Bottoming

China House Price Growth (%) Month-Over-Month (MoM)



**Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Based on the NBS 70 City House Price Indices, which tracks residential property prices in 70 medium and large-sized cities in China. Primary: Includes major metropolitan areas with most developed economies, highest urbanization. Secondary: Smaller, typically more regional cities that have been rapidly growing. For illustrative purposes only. Data Sources: Refinitiv, National Bureau of Statistics China (NBS), and Wellington Management

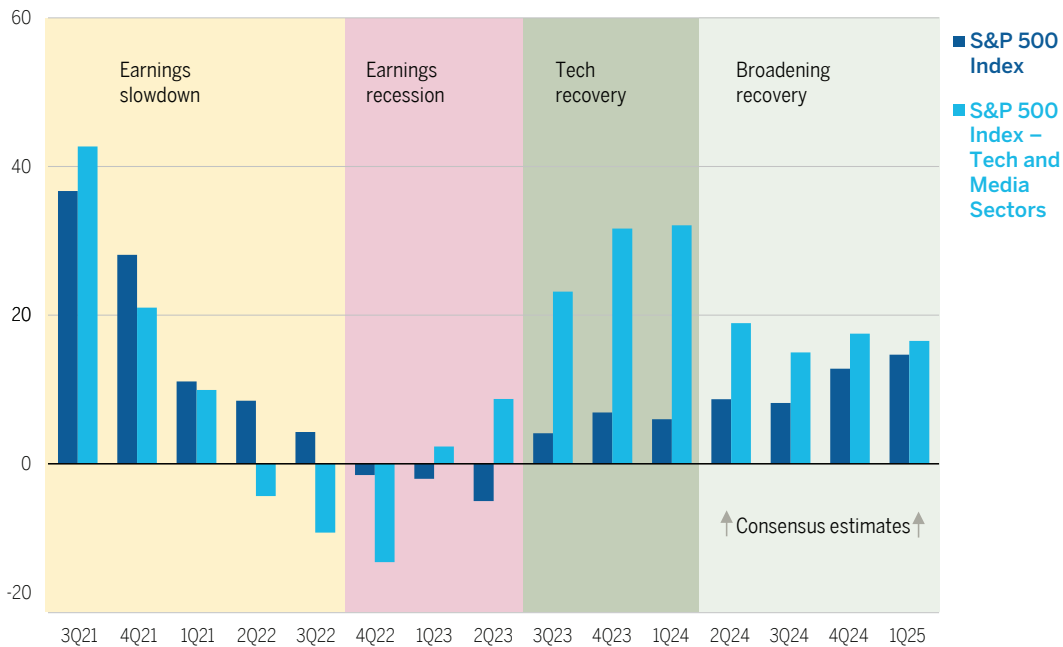
We were turning more positive on Europe given evidence of improvement in earnings and market breadth, but the resumption of political uncertainty has given us pause, so we're maintaining our neutral regional view. Still, valuations are compressed relative to global equities, and the discount is even more pronounced in the UK, where underperformance has been driven by weakness in both relative earnings and sentiment.

In the US, we've also turned neutral. We think earnings will likely broaden out with little or no expected valuation expansion, and with large-cap tech likely to normalize as other sectors catch up (FIGURE 2).

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**FIGURE 2: Earnings Growth Is Broadening in the US Equity Market**

% Earnings-Per-Share Projected Growth Year-Over-Year



As of 6/20/24. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Data represents year-over-year change in earnings per share for S&P 500 Index and the technology and media industries within S&P 500 Index. Earnings per share is a measure of a company's profitability that indicates how much profit each outstanding share of common stock has earned (\$/share). S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. Data after 1Q24 is consensus estimates. For illustrative purposes only. Data Sources: Wellington Management and Bloomberg.

Within sectors, we have an overweight view on financials, utilities, and consumer discretionary, and an underweight view on materials, staples, and communications. We maintain our neutral view on information technology.

## Government Bonds: Multiple Themes Acting on Rates

Disparate factors popped up over the second quarter to drive moves in government bonds in DMs. In the US and Germany, central-bank easing is on the horizon and bond yields have rallied. The government-bond markets in each of these countries got a boost from their safe-haven status relative to France, where the spread to Germany rose in response to the political shift to the far right. Other "weak links" in southern Europe also saw spreads rise. In Japan, yields moved higher as the BOJ's measured policy appeared out of sync with rising inflation and a weak yen.

We've moved from a neutral view to a moderately overweight view on duration because we have higher conviction that central-bank easing will be the primary driver of rates over our 12-month horizon. In the US, we've seen more evidence that growth is softening (albeit from strong levels), including in manufacturing, consumption, and employment, and that inflation is decelerating. We think this may be paving the path for the Fed to cut rates at least once this year following the ECB's first rate cut in June. We also think the BOJ could remain patient given the recent negative GDP print, and we note that the high carry makes shorting Japan duration expensive.

The big question is on term premia<sup>5</sup> and the extent to which France's deficit concerns could ensnare a wider set of countries with similar issues. As of this writing, prior to the French Parliament elections, we think a French/German premium will persist but could widen further with a far-left majority and their even more ambitious spending

In the US, softening growth and decelerating inflation could pave the path for the Fed to cut rates at least once this year.

plans. The US could face its own debt problems, of course, given that both presidential candidates share a predilection to spend beyond their means. However, the US dollar's reserve status could tip flows toward US Treasuries in a eurozone-crisis scenario. Our view is that the environment is ripe for disruption but that markets could force politicians away from extreme policies. Either way, we expect higher rate volatility to persist and think investors need to be quite tactical to capture opportunities.

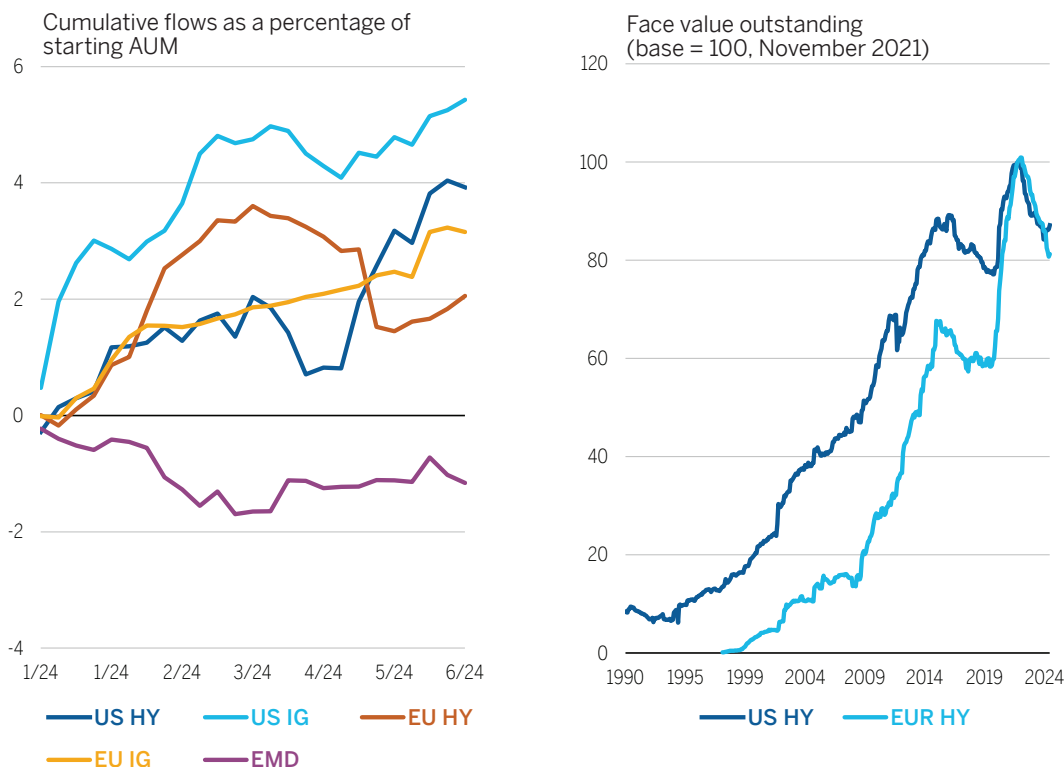
## Credit: Still Attractive Despite Tight Spreads

With economic growth remaining solid, inflation receding, interest-rate cuts around the corner, default rates declining, and all-in yields twice as high as they were in 2021, credit looks attractive, and we maintain our moderately overweight view. Tight credit spreads give us pause, but with strong demand for bonds and weak supply, we believe credit could be an attractive place to generate income with limited potential for spread widening.

We're still observing moderate distress in issuers at the lower end of the quality spectrum, which indicates that the higher-for-longer rate regime is creating headwinds for some companies. But with rate cuts already arriving in some regions and imminent in others, we believe relief may be provided to some of the riskiest names.

Technical supply-and-demand dynamics could be a positive driver of price support. Demand for corporate bonds has been very strong, as investors seek to lock in attractive yields ahead of a rate-cutting cycle. But the size of the high-yield market (the supply of bonds available to and held by investors) has been shrinking as many companies graduate back to investment grade (IG) after being downgraded in recent years. Strong company balance sheets, robust refinancing year to date, and a limited mergers-and-acquisitions pipeline suggest supply may continue to be overwhelmed by demand going forward (FIGURE 3).

**FIGURE 3: Positive Supply/Demand Technicals in High Yield Could Continue**



Left chart data: 1/3/24-6/19/24. Right chart data: 3/1/90-6/1/24. Data Source: EPFR

We've initiated a preference for high-yield credit over IG credit by moving our view on the latter from moderately overweight to neutral. We had previously seen IG credit as a good place to generate carry, with some potential for spread tightening. Much of this spread tightening played out in the first two months of the second quarter, which caused us to moderate our view. Since then, we've seen significant volatility in the European IG market, which has a large proportion of banks—potential targets of tax-raising measures that could be enacted by a newly elected government in France. We view this elevated political uncertainty as another reason to focus on higher-yielding parts of the credit markets.

Regionally, we have a slight preference for European high yield, funded from EM high yield. On valuation, Europe is where there's still a bit of a premium left and potential for some tightening in spreads. We're also turning more constructive on the European macro outlook, where momentum is improving and the central bank has already delivered a rate cut. We continue to monitor political developments in France (20% of the European high-yield market), which have caused spread widening in recent weeks, but we see this as an opportunity to add risk. In EMs, growth remains weak while many lower-rated idiosyncratic stories have played out, sometimes resulting in their spreads over-tightening relative to their fundamentals. Flows also remain lackluster.

## Commodities: A Stronger View Fueled by Oil

We've moved from a neutral view on commodities to a moderately overweight view, driven by an upgrade to oil. We think oil looks fairly valued, with prices in the mid US \$80s. However, we think a positive roll yield,<sup>6</sup> which reflects the lower cost of longer-dated futures, warrants a more constructive stance.

We believe geopolitical risk in the Middle East limits downside to the price of oil, and with supportive growth dynamics globally and a tight supply, the price could remain range-bound at current levels. As a result, we believe that carry will primarily drive returns this year with some potential for capital gains if demand is stronger than expected or OPEC+ pricing power comes back into play.

Gold has been a strong performer in recent months, and we see limited further price appreciation from here as well as a negative outlook for carry, leaving us on the sidelines. Investors and central banks have been building gold allocations this year after weak sentiment in 2023, but with heightened geopolitical risks largely priced in, we think a lot of the positive case may have already played out. We're waiting to see whether surging demand from retail investors in China will continue and whether central-bank buying can further support prices.

## Risks

Downside risks to our views include a reacceleration or spike in core inflation, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking. In addition, our expectation of more broad-based gains in equities could be undermined by sharp upward momentum in one or more mega-cap stocks. Finally, geopolitical issues will bear watching, including the potential for election-year turmoil in the US and Europe and a broader conflict in the Middle East.

Upside risks to our views include a scenario in which growth is more widespread globally and disinflation resumes, allowing central banks—and particularly the Fed—to cut rates faster than currently priced in by markets. We could also see a second-quarter earnings surprise on the upside, with a better earnings impulse outside of mega-cap tech stocks, and/or positive rotation in the market and better breadth than we expect. Additional upside risks include a resolution to the Middle East conflict and a balanced coalition emerging from the French election.

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## Investment Implications

- **Consider sticking with global equity exposure** — Growth and inflation are moderating from strong levels, and we think central banks will eventually cut rates. We think allocators may want to keep a risk-on tilt despite expensive valuations and political noise, as we expect positive fundamentals to support earnings.
- **Anticipate broadening in the equity rally** — We no longer have a regional-equity bias and think gains could accrue to DMs and EMs. We also see the earnings trajectory improving for areas outside of the mega-cap tech stocks, which could benefit some that have lagged, including value and small caps. Among sectors, we favor financials, utilities, and consumer discretionary over materials, staples, and communications, and we have a neutral view on information technology.
- **Consider overweighting duration and credit** — Most central banks have pivoted to rate-cutting mode, so we see scope for lower yields across regions. We continue to like credit spreads for the carry, strong supply/demand technicals, and declining default rate. We favor high yield over IG given the positive macro backdrop and superior carry.
- **Benign expectations could be disrupted** — While our risk-on tilt is supported by fundamentals, we're wary of volatility stemming from politics in Europe and the US, in particular. Depending on developments, we're biased toward using cheaper valuations as an opportunity to add risk in equities given the positive earnings backdrop and more reliable mean reversion in credit spreads.

**Talk to your financial professional about how to position your portfolio amid a changing economic landscape.**

<sup>1</sup> Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

<sup>2</sup> Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

<sup>3</sup> Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

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

<sup>5</sup> Term premia is the compensation that investors require for bearing the risk of longer maturities, which are more sensitive to changes in interest rates.

<sup>6</sup> Roll yield the return from adjusting a futures position from one futures contract to a longer-dated contract.

**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. • 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.

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