MAY 2024

Fixed Income Observations

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Not Pivoting, As the Federal Reserve Steers a Steady Course

Persistent inflation data and some initially hawkish Fed policy commentary led market participants to price a higher-for-longer policy-rate backdrop.

What's Driving Markets…

1. **The Federal Reserve (Fed) maintained a dovish stance at the Federal Open Market Committee (FOMC)[1] meeting** ending May 1 despite sticky inflation data. The central bank also announced it would slow the pace of its balance-sheet reduction by redeeming no more than $25 billion in Treasury securities per month, down from up to $60 billion per month. This Fed statement coincided with the latest quarterly refunding announcement (QRA)[2] from the US Treasury Department, released earlier in the same day, stating there would be no changes to issuance sizes of longer-maturity coupon bonds and that it would begin its long-awaited buyback program. So, the Fed is reducing issuance needs in the near term while the Treasury is assisting with liquidity in the secondary market. Though modest, these steps represent technical support factors for Treasury securities and could slightly help reduce upward pressure on term premia.[3]

   Market expectations for rate cuts have been scaled back over the course of this year, though they increased following the FOMC meeting to price 1.5 cuts through the end of this year (**FIGURE 1**). This compares with the Fed's last summary of economic projections of three cuts from January, which will next be updated at the June FOMC meeting. While Treasury yields moved higher over April, the dovish bias of the FOMC statement and press conference eased the upward pressure on the Treasury yield curve[4] at month end.

FIGURE 1: Futures Markets Price in Fewer Fed Rate Cuts for the Year

Number of 25-basis-point[5] Fed Rate Hikes or Cuts Predicted by December 2024

As of 5/2/24. Source: Federal Open Market Committee, Bloomberg, Wellington Management, and Hartford Funds

Insight from sub-adviser Wellington Management

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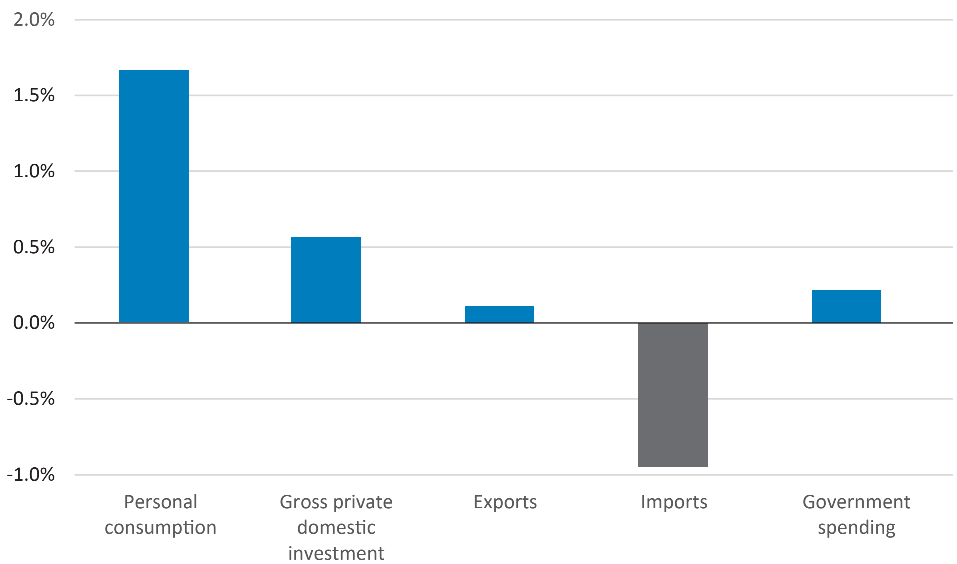
2. **Inflation remained sticky, GDP disappointed, and the consumer showed some cracks despite a healthy labor market.** In terms of inflation, both core CPI and core PCE[6] came in hotter than expected (3.8% and 2.8% year-over-year, respectively). GDP growth slowed to 1.6% in the first quarter, well below the 2.5% consensus forecast. A big jump in imports was the primary reason, though consumer spending also moderated (**FIGURE 2**).

FIGURE 2: A Big Jump in Imports Helped Slow Down GDP Growth

Economic Factors Impacting Changes in First-Quarter 2024 Real GDP



As of 4/30/24. Source: Bureau of Economic Analysis, Wellington Management, and Hartford Funds.

3. **Japanese authorities likely intervened in foreign-currency markets** to prop up the yen, which has been depreciating vs. the US dollar as the Fed has maintained elevated policy rates (**FIGURE 3**). The Bank of Japan (BOJ) kept policy rates unchanged at 0% during its last meeting despite having provided an upward revision of its inflation expectations. Japan's Ministry of Finance (MOF) is widely believed to have sold currency reserves in order to support a key 160 level on the yen, a necessary step to prop up a currency that continues to weaken amid the measured pace of BOJ policy normalization (i.e., reluctance to hike rates).[7] The intervention, on which the government of Japan is remaining quiet, was likely calculated to cause significant pain to short sellers.[8] While this is likely to be a temporary measure, the MOF's goal is to make currency changes gradual, rather than rapid and disorderly.

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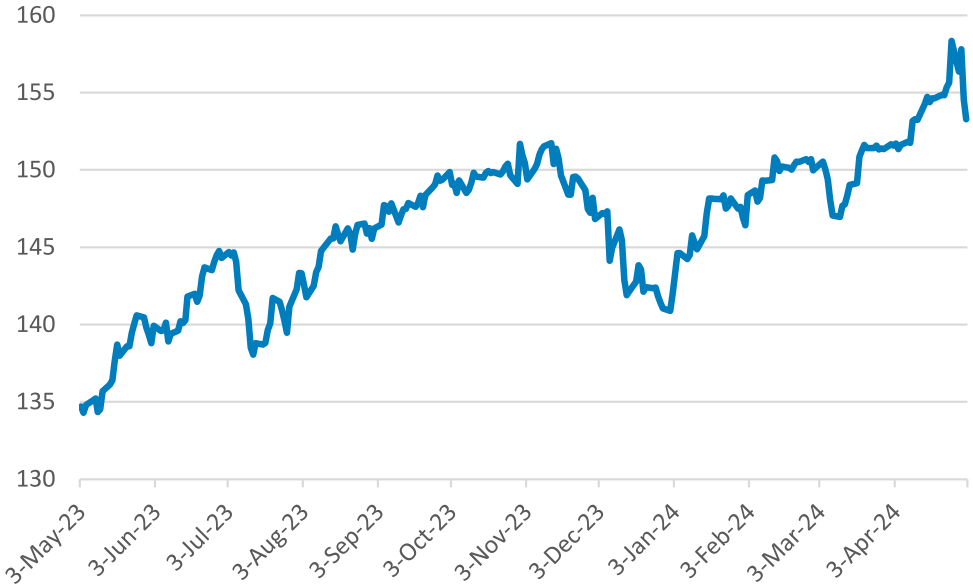
FIGURE 3: Japan Likely Propped Up the Yen in a Bid to Stem Its Weakening
Japanese Yen/US Dollar Spot Exchange Rates (May 2023-May 2024)

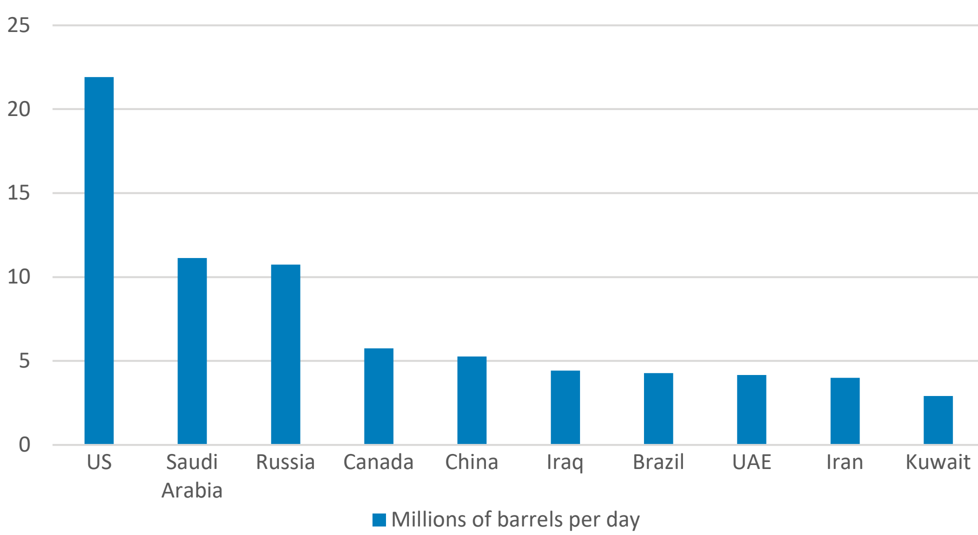


As of 5/2/24. Source: Bloomberg, Wellington Management, and Hartford Funds.

4. **In a reversal of the détente that was taking place between the US and the Maduro regime** in Venezuela, a variety of sanctions on Venezuela's energy industry will be reimposed by the US. Nearly two years ago—during the first year of the war in Ukraine—the US eased those sanctions in exchange for a roadmap to more-robust election commitments. At the time, the US was seeking additional energy producers following the sanctioning of Russian energy, while Venezuela was looking to broaden its energy-export market. However, despite lack of forward progress, it's important to note that this isn't the 1970s: There's been a reshuffling of energy production, with the US emerging as the world's largest producer (**FIGURE 4**).

There's been a reshuffling of energy production since the 1970s, with the US emerging as the world's largest producer.

FIGURE 4: The US Is Now the World's Largest Energy Producer
Leading Global Oil Producers in 2024, by Millions of Barrels Per Day



As of 4/30/24. Source: US Energy Information Administration, Wellington Management, and Hartford Funds.

What's Keeping Us Up at Night…

1. **Geopolitical flareups continued as Iran launched a direct attack on Israel**. While the vast majority of missiles were shot down, rapid escalation to a full-scale conflict seemed possible over the course of several days. US commitment to the region has acted as a significant deterrent, though we cannot downplay the tragic loss of life already suffered and still to come.

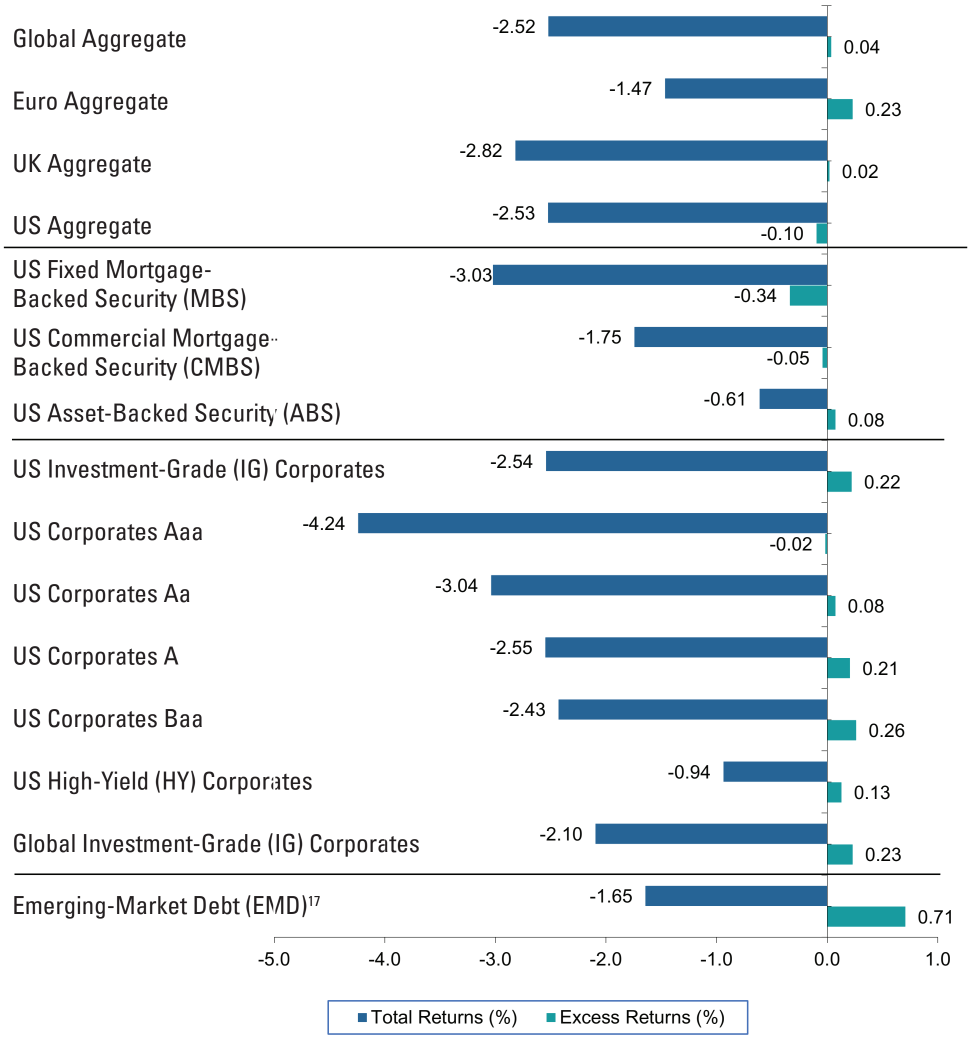
2. **Stagflation[9] is undoubtedly one of the ugliest words in finance and one we don't use lightly**. But, because inflation is still running relatively hot while growth slowed more than expected last quarter, it's worth debating whether the US economy could soon find itself in such a precarious position. Fed Chair Jerome Powell was asked about this potential scenario and responded by saying that he sees neither "stag" nor "flation." While we're encouraged by evidence of more-balanced labor markets, we'll still closely monitor the trend, which might indicate that the Fed demonstrated insufficient resolve in its inflation fight—which would require difficult policy decisions down the road.

3. **H5N1, or avian bird flu, has been discovered among cattle in the US dairy industry.** While current pasteurization methods appear to be adequate in treating milk, a key concern for US agricultural and public-health officials is whether the virus will mutate and spread—as it has from birds to cows—to other species. The current situation bears watching as a tail risk.

Investment Implications for Consideration

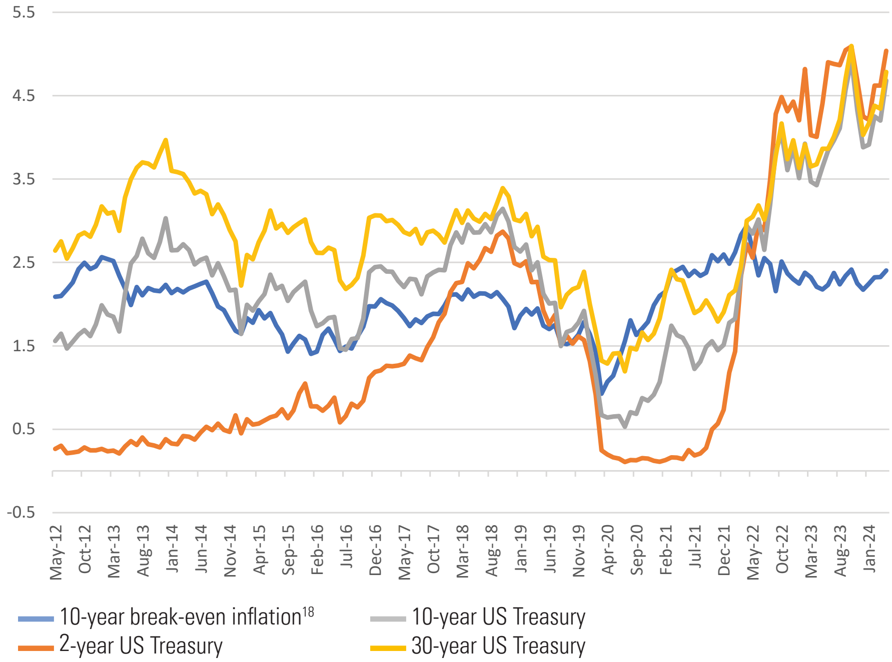
- Given how drawn out and uncertain the rate cycle has been, we still favor total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods, or "go-anywhere"[10] strategies that may be able to navigate the late cycle, or nimble strategies that can toggle between government securities and credit.
- We acknowledge the tumult of rate markets this year. But, given where spread levels are in many sectors, core-bond and core-bond-plus[11] positions could make sense as we approach an easing cycle. The gradual cooling of inflation and slowing of the economy makes higher-quality fixed income potentially attractive from a recessionary perspective, as well as for positive convexity.[12]
- Securitized credit[13] could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns negative faster than expected.
- High yield[14] warrants a cautious approach given how late in the cycle we are and the normalizing of default rates relative to current spreads. However, the robust carry[15] may make high yield a good equity substitute. In particular, we favor senior bank loans[16] with a bias toward "up-in-quality" issuers.

FIGURE 5: Fixed-Income Sector Excess Returns



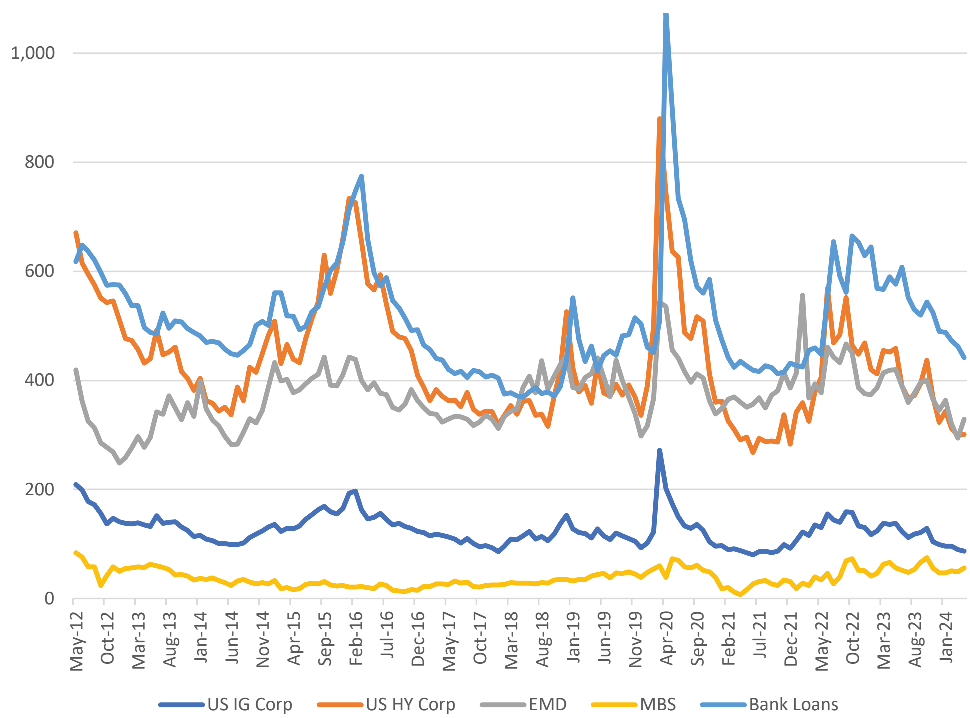
Monthly data as of 4/30/24. **Past performance does not guarantee future results.** Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg and Wellington Management.

FIGURE 6: US Yields (%)



As of 4/30/24. Sources: Bloomberg, Wellington Management.

FIGURE 7: Fixed-Income Spreads (basis points)



As of 4/30/24. **Past performance does not guarantee future results.** US IG Corp is represented by the **Bloomberg US Corporate Bond Index**; US HY Corp is represented by the **Bloomberg US Corporate High Yield Bond Index**; EMD is represented by the **J.P. Morgan EMBI Global Diversified Index**; MBS is represented by the **Bloomberg US MBS Index**; Bank Loans are represented by the **Morningstar/LSTA US Leveraged Loan Index**. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA, and Wellington Management.

Fixed Income Observations

[1] The Federal Open Market Committee (FOMC) is the division of the Federal Reserve that sets monetary policy by managing open-market operations. By doing this, the Fed influences the fed funds rate, which impacts other interest rates.

[2] The US Treasury Department sells a lot of bonds to keep up with the federal government's borrowing needs. To prepare investors, the Treasury has for decades published a "quarterly refunding" statement that spells out its near-term plans for note and bond sales. These reports have been attracting greater attention as the US debt has grown. In August 2023, for example, the Treasury said it would have to ramp up sales for the first time in 2 1/2 years and predicted further increases. But then a few months later it unexpectedly tempered the pace of its increases in sales of longer-term Treasuries, spurring a rally in those securities. Although the Treasury pushed through one more increase in February and suggested that no more boosts were likely in 2024, these quarterly announcements remain important to bond investors.

[3] The term premium is the excess return that an investor obtains in equilibrium from committing to hold a long-term bond instead of a series of shorter-term bonds.

[4] 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.

[5] 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.

[6] The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics. Personal consumption expenditures (PCE) is a measure of the spending on goods and services by people in the US as determined by the US Bureau of Economic Analysis.

[7] Instead of outright sales, it's possible that the Ministry of Finance's intervention took place utilizing the Foreign and International Monetary Authorities (FIMA) Repo Facility at the Fed (where official sector institutions can post Treasuries for cash rather than have to outright sell their securities).

[8] Short selling involves borrowing a security whose price you think is going to fall and then selling it on the open market. You then buy the same stock back later, hopefully for a lower price than you initially sold it for, return the borrowed stock to your broker, and pocket the difference.

[9] Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation. Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.

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

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

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

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

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

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

[16] A senior bank loan is a debt financing obligation issued to a company by a bank or similar financial institution and then repackaged and sold to investors. The repackaged debt obligation consists of multiple loans. Senior bank loans hold legal claim to the borrower's assets above all other debt obligations.

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

[18] The break-even inflation rate is a measurement that aims to predict the effects of inflation on certain investments, by analyzing known market inflation rates from recent years. It can be calculated by comparing the yield of an inflation-based bond (such as Treasury Inflation-Protected Securities, or TIPS) with a nominal bond of the same maturity period. The difference represents the break-even inflation rate, or the rate that inflation would have to be for an investor to "break even"—or earn the same return—between purchasing TIPS or nominal Treasuries.

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

Representative Indices from Figure 5:
Global Aggregate: Bloomberg Global Aggregate Bond Index; **Euro Aggregate:** Bloomberg Global Aggregate Bond Index - European Euro; **UK Aggregate:** Bloomberg Global Aggregate Bond Index - United Kingdom; **US Aggregate:** Bloomberg US Aggregate Bond Index; **US Fixed MBS;** Bloomberg US MBS Index; **US CMBS:** Bloomberg CMBS ERISA Eligible Index; **US ABS:** Bloomberg Asset-Backed Securities Index; **US IG Corporates:** Bloomberg US Corporate Bond Index; **US Corporates Aaa:** Bloomberg Aaa Corporate Bond Index; **US Corporates Aa:** Bloomberg Aa Corporate Bond Index; **US Corporates A:** Bloomberg A Corporate Index; **US Corporates Baa:** Bloomberg Baa Corporate Bond Index; **US High-Yield Corporates:** Bloomberg US Corporate High Yield Bond Index; **Global IG Corporates:** Bloomberg Global Credit - Corporate Bond Index; **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Bond Index.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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