AUGUST 2024

Fixed Income Observations

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Japan Makes a Splash in US Markets as the Fed Keeps Investors Waiting a Bit Longer

As the Federal Reserve readies a September cut, Japan's rate moves cause a currency stir.

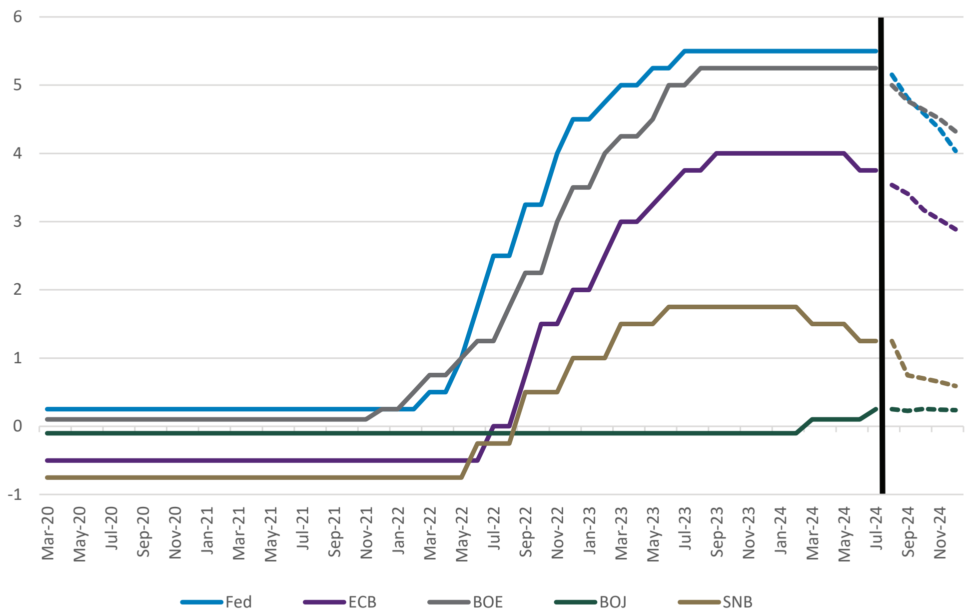
What's Driving Markets…

1. **Global central banks continue to chart diverging policy paths as they move toward normalization.** The Federal Reserve (Fed) kept policy rates unchanged but set the stage for a September cut. The Bank of England cut rates on August 1, joining the European Central Bank (ECB) and Swiss National Bank (SNB), who initiated their easing cycles earlier this year. The Bank of Japan (BOJ) hiked rates as it moved further away from its negative-rates policy, having grappled with decades of low/negative inflation. While bond yields have already moved materially lower, they should have a tailwind from the persistent easing cycle (dotted lines in **FIGURE 1**). The increasingly unique economic, inflationary, and policy dynamics should continue to provide ample opportunities for active duration[1] management.

FIGURE 1

Most Central Banks Have Cut Policy Rates as the Fed Follows Its Own Timetable

Major Central-Bank Policy Rates, 2019-2024 (%)



As of 8/5/24. Sources: Bloomberg, Wellington Management, and Hartford Funds.

Insight from sub-adviser Wellington Management

Amar Reganti
Managing Director at Wellington Management LLP and Fixed-Income Strategist for Hartford Funds

2. **The labor market has shown some signs of softening in recent months** as wage pressures have moderated and the unemployment rate has already risen above the Fed's end-of-year forecast. This has been fueled in part by an immigration-driven increase in labor-force participation. However, the Fed's preferred inflation gauge—core personal consumption expenditures (PCE[2])—still hovered around 2.6% year-over-year as of June. While some base effects (low comparisons from last year) will likely put upward pressure on inflation in the coming months, this will be offset by further weakening in the shelter component, the decline of which accelerated last month. The Federal Reserve Bank of Cleveland publishes a new tenant-rent series, which tends to lead owner's equivalent rent[3] (a component of the Consumer Price Index[4]) by 3-6 months, and it has come well off its peak (**FIGURE 2**).

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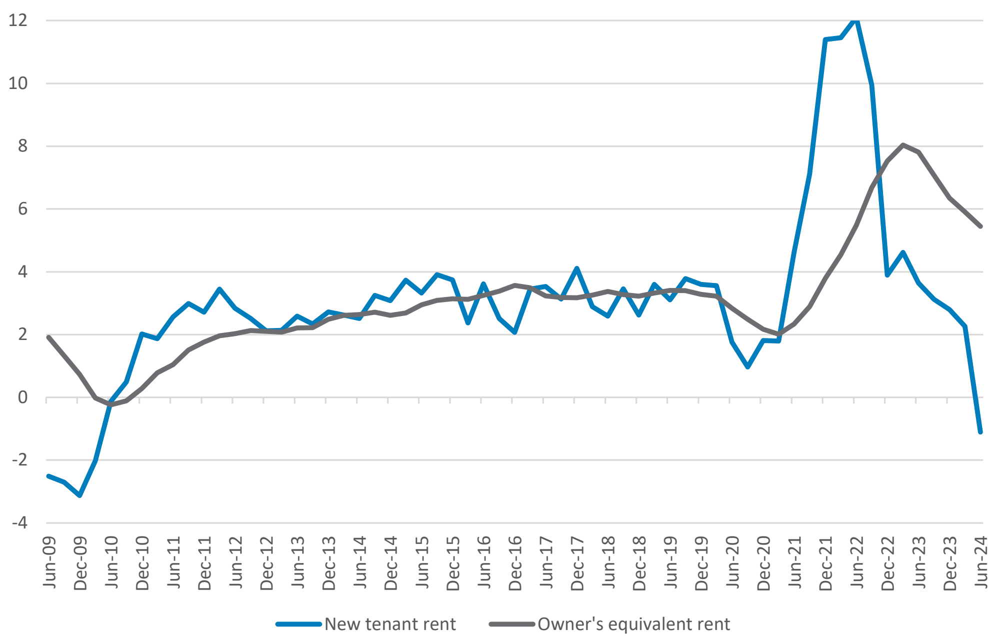
FIGURE 2
Rents Moved Sharply Lower During the Previous Month
New-Tenant Rents and Owner's Equivalent Rents, 2009-2024 (%, Year-Over-Year)



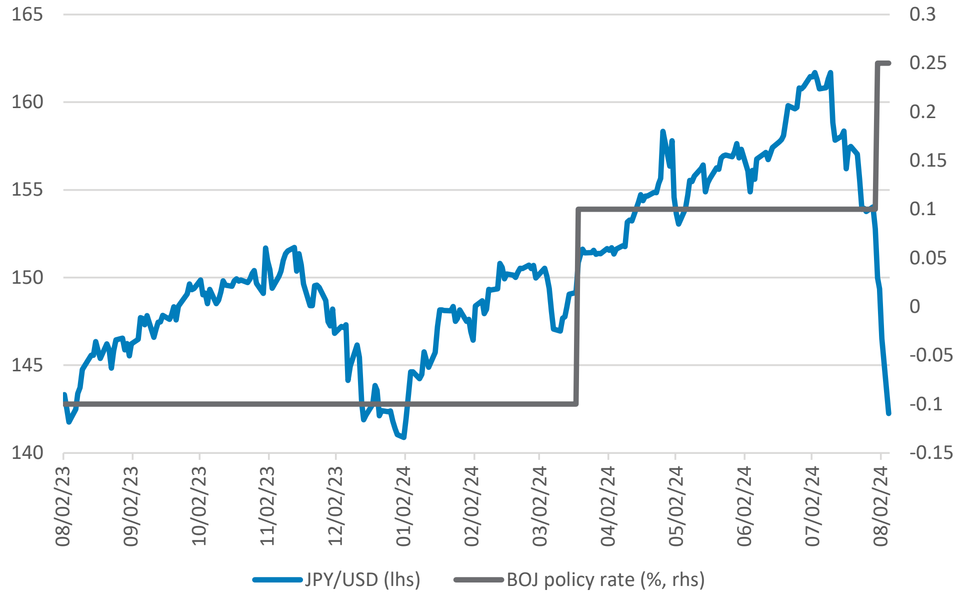
As of 6/30/24. Sources: Bloomberg, Federal Reserve Bank of Cleveland, Wellington Management, and Hartford Funds.

3. **As I noted earlier, the Bank of Japan (BOJ) tightened policy further during the month,** remaining an outlier among developed-market central banks, by raising the policy rate by 15 basis points (bps[5]) to 0.25%. There remains a very large gap in interest-rate differentials between the US and Japan, which had fueled a depreciation of the Japanese yen since the start of the year—a depreciation that has now reversed (**FIGURE 3**). The policy moves likely accelerated the sell-off in risk assets in Japanese asset markets in early August and may prompt a further unwinding of the popular yen carry trade.[6]

FIGURE 3

As the BOJ Began Hiking Rates, the Yen Steadily Lost Value—Until It Didn't

Bank of Japan Policy Rate (right) vs. Yen/Dollar Value (left)



As of 8/5/24 Sources: Bloomberg, Wellington Management, and Hartford Funds.

The disputed election result in Venezuela complicates the country's efforts to restructure its defaulted debt.

4. **Nicolas Maduro maintained power in Venezuela's presidential election,** in what is widely viewed as a fraudulent outcome. Since 2005, Venezuela has been subject to a number of US sanctions for human-rights abuses and corruption by the Maduro government, which came to power in 2013. The disputed election result complicates the country's efforts to restructure its defaulted debt. Additionally, it makes it unlikely that the Treasury Department's Office of Foreign Asset Control will issue a new general license to transact with Venezuela's oil and gas industry.

What's Keeping Us Up at Night…

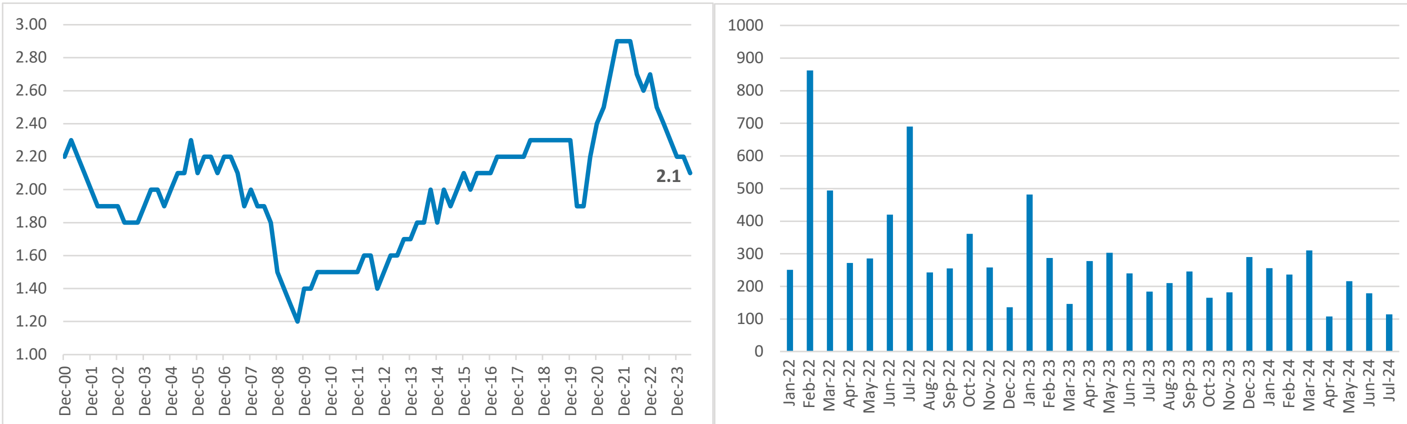
1. **Regional war: Ismail Haniyeh, the senior Hamas official involved in the ceasefire negotiations for the Gaza conflict**, was killed while in Tehran. The location of the attack in the capital city of Iran increases the chance of retaliation. Around the same time, Fuad Shukur, the leader of Hezbollah's military wing, was killed in Beirut. The targeted killings likely raise the chances of a broader regional conflict. Financial markets continue to await Tehran's response to the attacks. The current conflict has already driven shipping costs to nearly half of the peak seen in 2022 following the Russian invasion of Ukraine.

2. **Policy mistake at the Federal Reserve: US labor-market conditions continue to weaken as noted above.** Given the path of recent inflation data, and the weakness in labor markets, there's a substantial chance the Federal Reserve may be behind the curve in terms of beginning its cutting cycle. If so, it would jeopardize the desired outcome of a soft landing. With the recent weakness in job quits rates (**FIGURE 4**) and non-farm payrolls (**FIGURE 5**), employment conditions appear to be less tight than expected. This may mean the Fed has to cut either harder (in 50-bps increments) or in a faster cutting sequence in order to deliver the soft landing.

FIGURE 4 AND 5

Labor-Market Conditions Have Been Deteriorating

Job Quits Rate[7] (Year-Over-Year, left) and Non-Farm Payrolls (in Thousands, right)



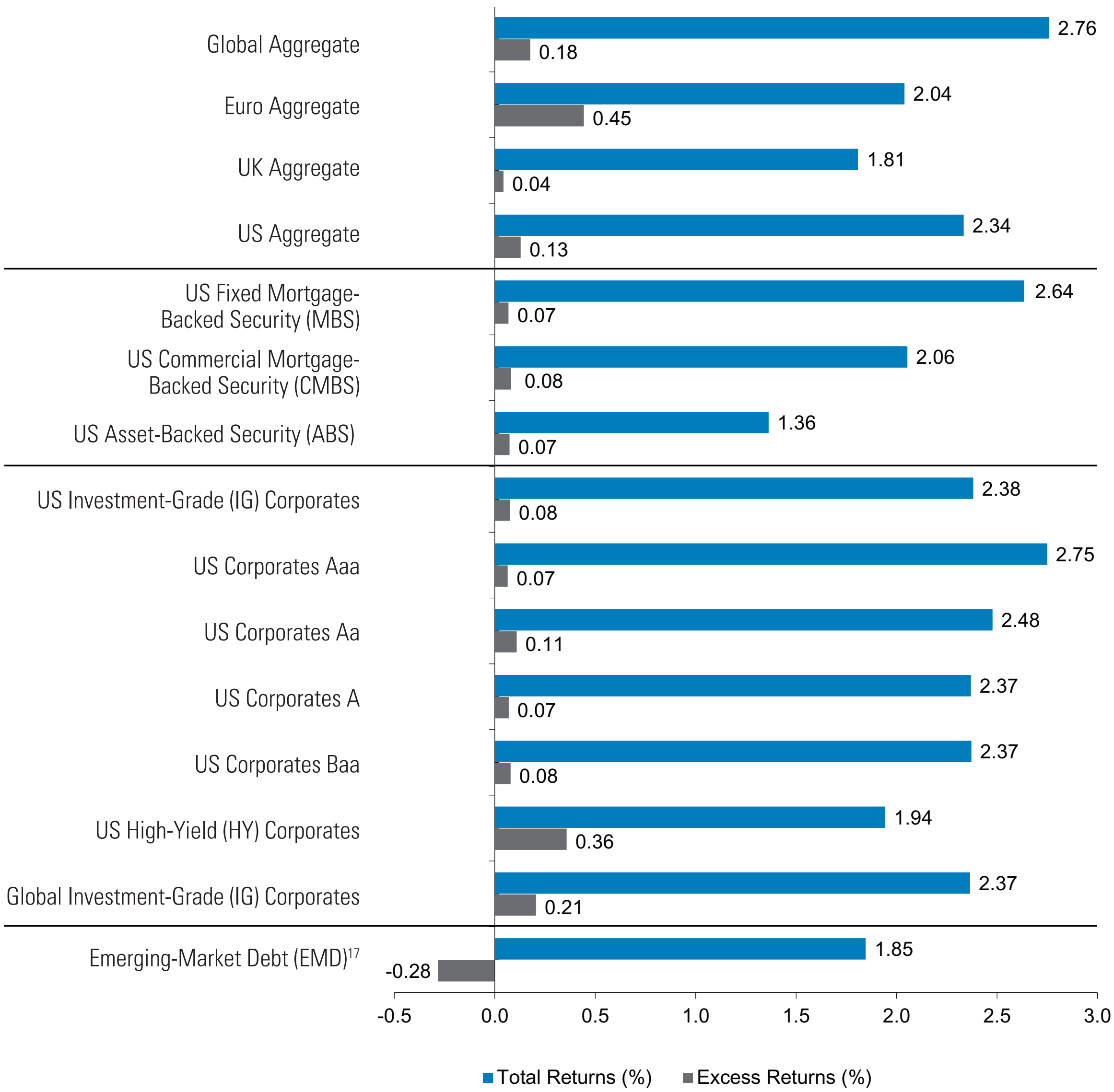
Job quits-rate data as of 6/30/24. Non-farm payroll data as of 7/24/24. Sources: Bloomberg, Wellington Management, and Hartford Funds.

3. **The Central Committee of the Chinese Communist Party concluded its Third Plenum.** While the aim of the meeting is to address longer-term economic goals, markets were still hoping for more specificity in terms of near-term fiscal stimulus, as well as addressing the ongoing weakness in the real-estate market and local government finances. It's likely that growth in China, as planned, will continue to be driven by a large export impulse rather than a consumption-oriented one. However, in light of the current turmoil in real-estate markets, it may be challenging to jump-start consumer spending.

Investment Implications for Consideration

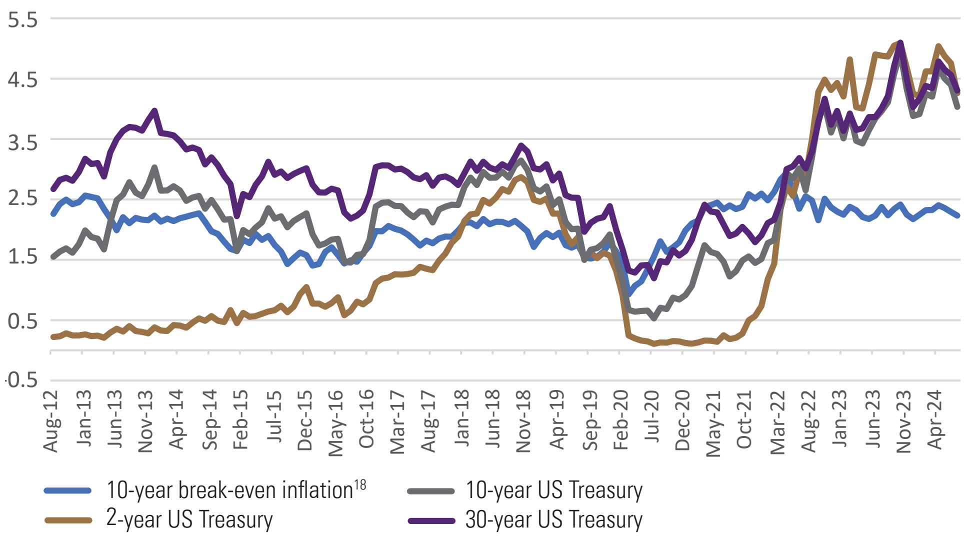
- Given how drawn out and uncertain the rate cycle has been, we still favor total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods, or "go-anywhere"[8] strategies that may be able to navigate the late cycle. With the US election heating up and creating uncertainty around economic policy, our conviction in less-constrained fixed-income strategies only increases.
- The tide has turned on the hiking cycle and our patience with core-bond and core-bond-plus positions[9] continues to make sense. The gradual cooling of inflation and slowing of the economy makes higher-quality fixed income potentially attractive from a positive convexity[10] perspective. Moreover, labor-market trends are showing additional softening, increasing the risk of a Fed policy error during the higher-for-longer era.
- Securitized credit[11] could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected. For clients looking for higher expected returns, we favor select CLO equity,[12] which allows locked-in, non-recourse term financing for an actively managed pool of bank loans.
- High yield[13] 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[14] may make high yield a good equity substitute. In particular, we favor senior bank loans[15] and convertible debt[16] with a bias toward "up-in-quality" issuers.

FIGURE 6: Monthly Fixed-Income Sector Total and Excess Returns



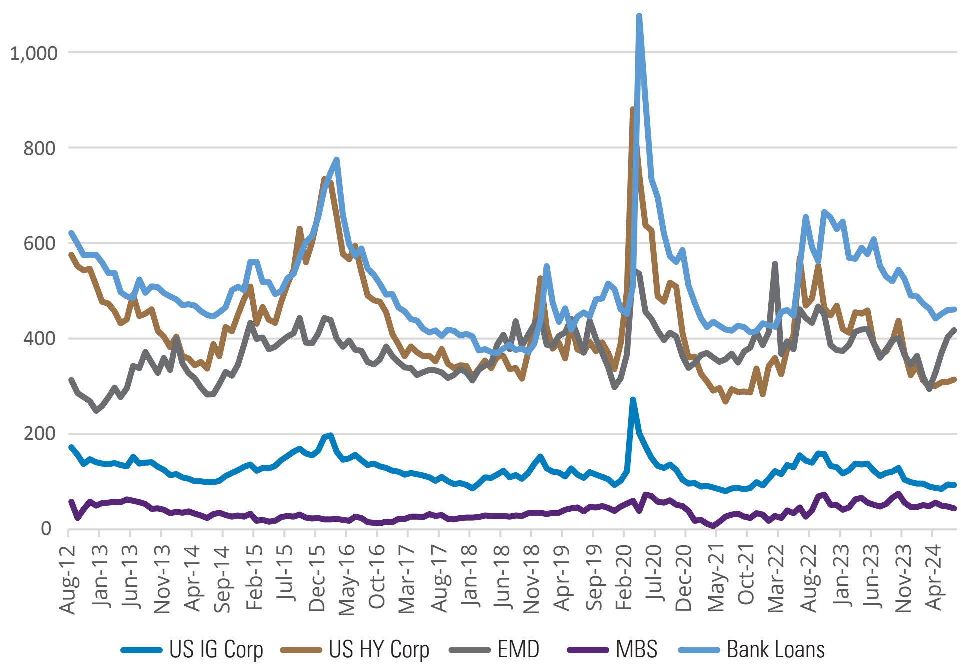
Monthly data as of 7/31/24. **Past performance does not guarantee future results**. Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg and Wellington Management.

FIGURE 7: US Yields (%)



As of 7/31/24. Sources: Bloomberg, Wellington Management.

FIGURE 8: Fixed-Income Spreads (basis points)



As of 7/31/24. 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.

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

2 The Personal Consumption Expenditures (PCE) price index is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

3 Owners' equivalent rent measures how much money a property owner would have to pay in rent to be equivalent to their cost of ownership.

4 The Consumer Price Index (CPI) in the United States is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."

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 A "carry trade" involves borrowing funds in a currency of a country where interest rates are low and then investing them in assets and/or a currency that offers higher interest rates or perceived rates of return.

7 The job quits rate is the percentage of total employment that voluntarily leaves their jobs during a given month. It's calculated by dividing the number of quits by the number of employees who worked or were paid during the pay period that includes the 12th of the month, and then multiplying that number by 100. The quits rate is a measure of how willing or able workers are to leave their jobs.

8 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).

9 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.

10 Convexity is the relationship between bond prices and bond yields.

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

12 A Collateralized Loan Obligation (CLO) is a type of security that allows investors to purchase an interest in a diversified portfolio of company loans. There are two types of CLO tranches: debt tranches and equity tranches. Debt tranches are treated like bonds and have credit ratings and coupon payments. These debt tranches come first in terms of repayment, and there is also a pecking order within the debt tranches. Equity tranches do not have credit ratings and are paid out after all debt tranches. Equity tranches are rarely paid a cash flow but do offer ownership in the CLO itself in the event of a sale. Because equity tranche investors usually face higher risks, they often receive higher returns than debt tranche investors.

13 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.

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

15 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.

16 With convertible debt, a business borrows money from a lender or investor where both parties enter the agreement with the intent (from the outset) to repay all (or part) of the loan by converting it into a certain number of its preferred or common shares at some point in the future. The agreement specifies the repayment and conversion terms which include the timeframe and the price per share for the conversion as well as the interest rate that will be paid until either conversion or maturity.

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 6:
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.

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