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The Bond Market Roars in August

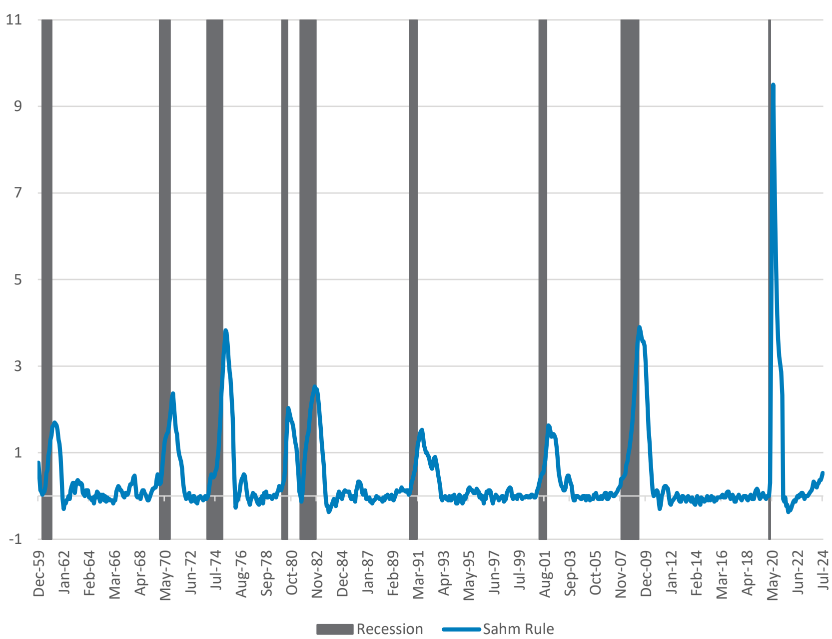
Inflation and employment data provided the last bit of evidence needed by the Federal Reserve to cut policy rates.

What's Driving Markets…

1. **The Kansas City Federal Reserve Bank's annual economic symposium at Jackson Hole** provided the forum for the announcement of a shift in monetary policy. Federal Reserve (Fed) Chair Jerome Powell's highly anticipated speech noted that the Fed was pivoting from its currently restrictive monetary policy. We recommend reading the speech, particularly Powell's comments on the transitory nature of inflation this cycle.

2. **The Sahm Rule recession indicator was triggered** after labor-market conditions further deteriorated. A coincident indicator[1] (**FIGURE 1**), the Sahm Rule signals the start of a recession when the three-month moving average of the unemployment rate rises by 0.50% or more relative to the minimum of the three-month averages from the previous 12 months. While the rule has historically proven accurate in indicating recessions, we think the US economy is relatively healthy and a soft landing can be achieved. The recent increase in the unemployment rate has been driven by an increase in the labor force, especially among prime-age workers, and layoffs thus far remain contained.

FIGURE 1
An Economic Indicator Signals a Downturn as Labor Markets Deteriorate
Sahm Rule Recession Indicator, 1959-2024 (%)



As of 7/31/24. Sources: Federal Reserve Bank of St. Louis, 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

3. **High-yield[2] default rates appear to have peaked**, declining in both the US and Europe over the last few months to 5.2% and 3.6%, respectively, according to Moody's. While we expect default rates to remain around long-term averages (~4-5%) over the next 12 months, we don't see a full-scale default cycle on the horizon given solid issuer fundamentals as well as a lack of near-term maturities. Our optimistic forecast appears to be reflected in spreads, which continue to trade relatively tight vs. history.

4. **Consumer delinquency rates have also leveled off (FIGURE 2), though we expect** consumer-credit fundamentals to weaken modestly going forward as consumers work through overextension of credit by lenders in 2021 and 2022. Further material degradation should be contained because lending standards are tighter this cycle, growth in consumer debt is slowing, and structures are generally more robust. This remains an attractive environment for security selection, as fundamentals are still supportive, while we expect performance across securitized-credit[3] sectors will vary by subsector and borrower type.

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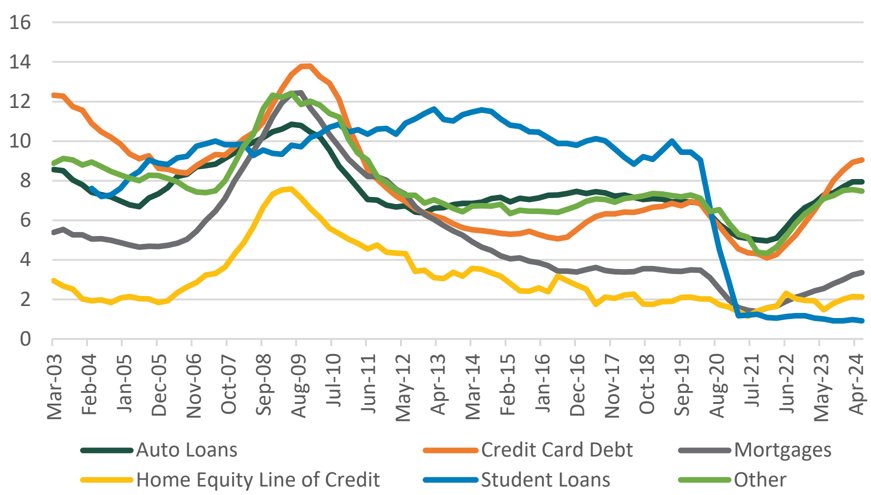
FIGURE 2

Credit Fundamentals Are Expected to Weaken Modestly

Consumer Delinquency Rates by Loan Type, 2023-2024 (%)



As of 6/30/24. Sources: New York Fed Consumer Credit Panel/Equifax, Wellington Management, and Hartford Funds.

What's Keeping Us Up at Night...

1. **Iranian retaliation against Israel for the deaths of senior leadership in Hezbollah and Hamas** took place in August with hundreds of rockets fired by Hezbollah at targets in Israel. Israeli forces retaliated, striking targets in southern Lebanon. In early September, six of the Israeli hostages abducted during the October 7 attack were found dead. The situation remains highly volatile and continued escalation is possible.

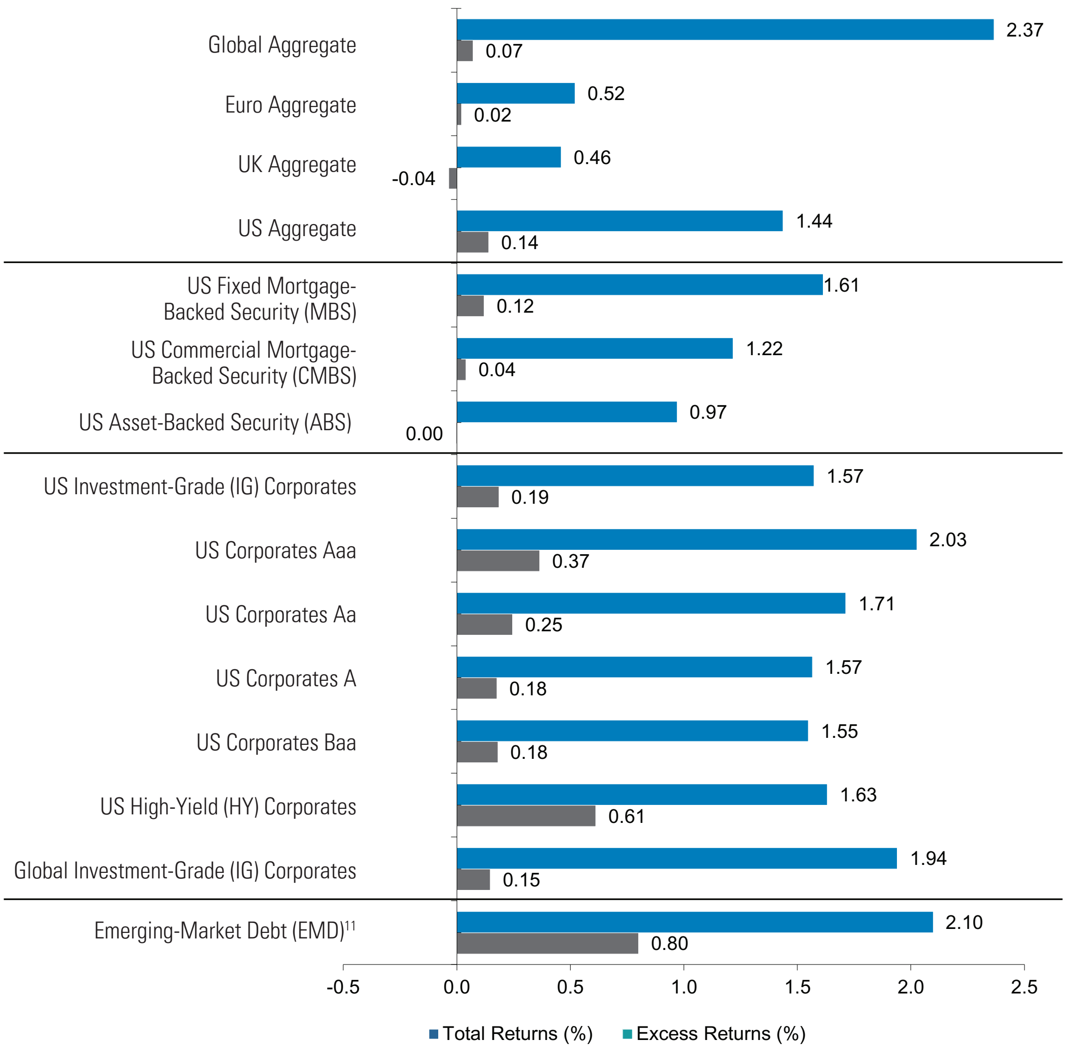
2. **The first monkeypox case outside of Africa was identified in Sweden.** Increasing monkeypox cases and deaths in the Congo prompted the World Health Organization to declare a public health emergency of global concern. Unlike COVID-19 or bird flu, transmission of monkeypox occurs primarily via prolonged skin contact, so it can likely be contained through public-health measures that lead to changes in behavior in conjunction with vaccination of individuals that are more likely to contract the disease.

3. **US election uncertainty could contribute to bouts of market volatility over the next several weeks,** as specific details on policy agendas are codified and betting odds shift between Harris and Trump. Congressional races are also important since the balance of power will determine whether certain proposals become law. Investors may be able to capitalize on any market dislocations that push spreads across fixed-income sectors and issuers to levels wide of perceived fundamental value.

Investment Implications for Consideration

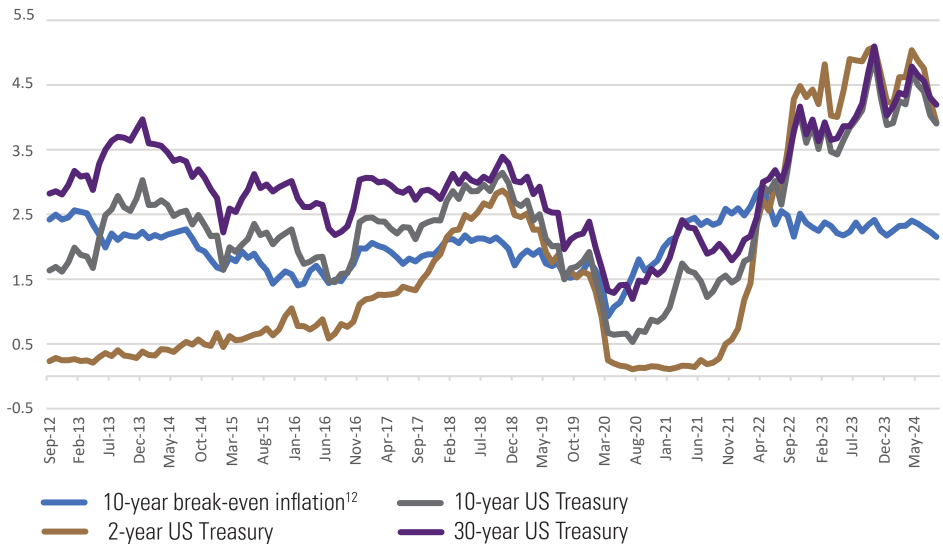
- Given how drawn out and uncertain the rate cycle has been, we still favor total-return strategies that are less constrained by benchmarks. These could include global sovereign and currency strategies that potentially shine during these periods, or "go-anywhere"[4] strategies that may be able to navigate 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[5] 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[6] 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 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. For clients looking for higher expected returns, we favor select CLO equity,[7] which allows locked-in, non-recourse, term financing for an actively managed pool of bank loans.
- High yield 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[8] may make high yield a good equity substitute. In particular, we favor senior bank loans[9] and convertible debt[10] with a bias toward "up-in-quality" issuers.

FIGURE 3: Monthly Fixed-Income Sector Total and Excess Returns



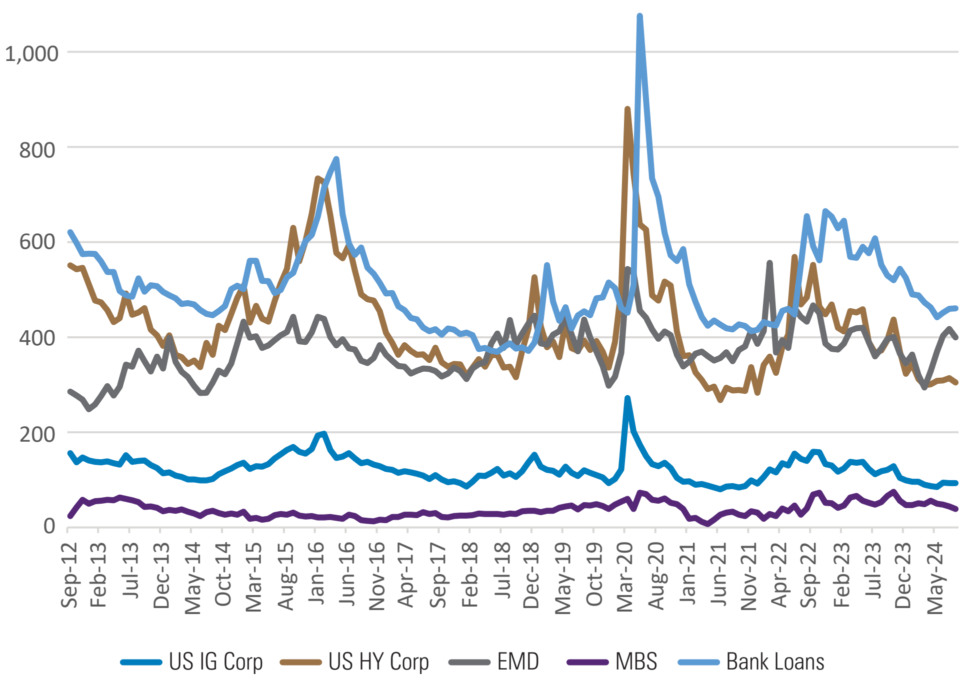
Monthly data as of 8/31/24. **Past performance does not guarantee future results**. Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg and Wellington Management.

FIGURE 4: US Yields (%)



As of 8/31/24. Sources: Bloomberg, Wellington Management.

FIGURE 5: Fixed-Income Spreads (basis points)



As of 8/31/24. 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] Coincident indicators are data points that usually change simultaneously with general economic conditions and, as a result, are viewed as reflecting the present economy. While leading indicators look ahead and lagging indicators look behind, coincident indicators reflect the present, or very recent past.

[2] 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.

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

[4] 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).

[5] 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.

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

[7] 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.

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

[9] 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.

[10] 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.

[11] 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.

[12] 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 3:
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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