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Riding the Volatility Wave

Fixed-income markets generated positive total returns to start the year as participants scrambled to assess tariff implications. Treasury yields rose initially, but DeepSeek news helped spark a reversal.

What's Driving Markets...

1. **Tariffs:** President Trump imposed 25% tariffs on Canada and Mexico, along with 10% tariffs on China. Both Canada and Mexico announced tariffs on US goods in retaliation, and China followed suit with tariffs on US$14 billion of US goods. While there's a range of estimates, it's thought the tariffs will increase US inflation between 0.5% to 0.7% and reduce real GDP by 1% to 1.2%. We expect the following market reactions if these measures are fully implemented (and particularly if additional tariffs are placed):
   - Wider breakevens[1] from additional inflationary pressures and a flatter nominal curve with lower real rates.
   - Lower equity prices as global trade absorbs these new tariffs.
   - Wider credit spreads[2] as part of the broader risk-off[3] move.
   - Higher oil prices, particularly if Canadian oil imports into the US become more costly.
   - A stronger dollar, though this may not always move in sync with tariffs.

   Additionally, the implementation of tariffs (and retaliatory tariffs) will likely complicate the Federal Reserve's (Fed) ability to cut interest rates. It remains to be seen whether the tariffs change broader inflation expectations. As we write this, there is breaking news that the Mexican tariffs will be delayed one month and that the Trump Administration is in additional talks with the Canadian government. Nevertheless, markets are now highly attuned to additional tariff action—which was not, despite rhetoric, priced in prior to this weekend.

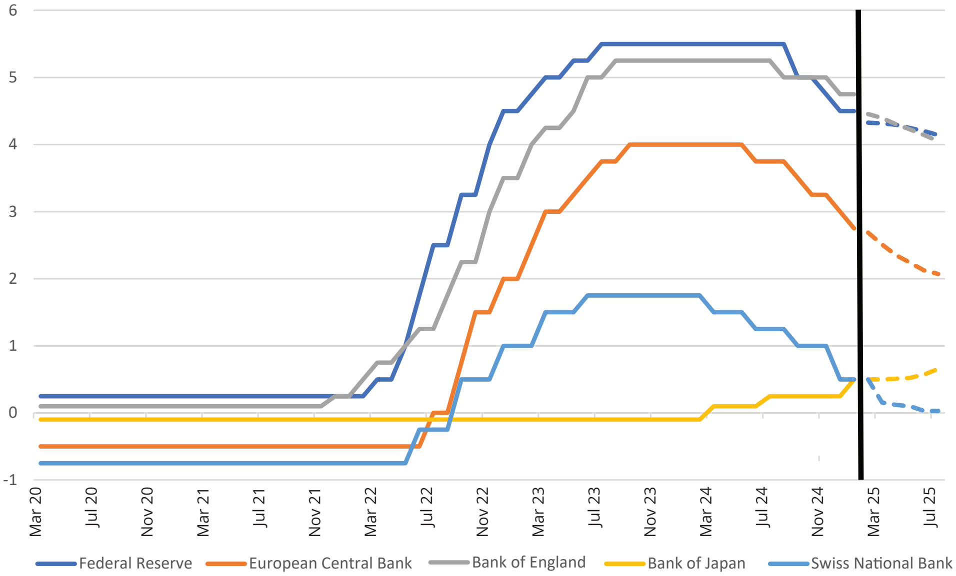
2. **Monetary policy divergence:** The Fed paused its rate-cutting campaign and communicated a balanced assessment of risks. However, there are many potential policy changes from the Trump administration that could alter the inflation outlook—namely, around trade, immigration, and regulation. In his press conference, Fed Chair Jerome Powell reiterated the Fed's independence and the importance of the 2% inflation target. Inflation-expectations data will be crucial for the market going forward.

   The European Central Bank (ECB) continued to ease policy with another 25-basis-point (bps)[4] rate cut while maintaining a dovish tone despite some recent inflationary pressures, electing to prioritize risks of weaker growth. An outlier among developed-market central banks, the Bank of Japan (BOJ) hiked rates by 25 bps and suggested further hikes as it grapples with higher inflation levels than the US and Europe.

Insight from sub-adviser Wellington Management

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

FIGURE 1
Futures Markets Expect Global Monetary-Policy Divergence
Past and Future Central Bank Policy Rates, March 2020-July 2025 (%)

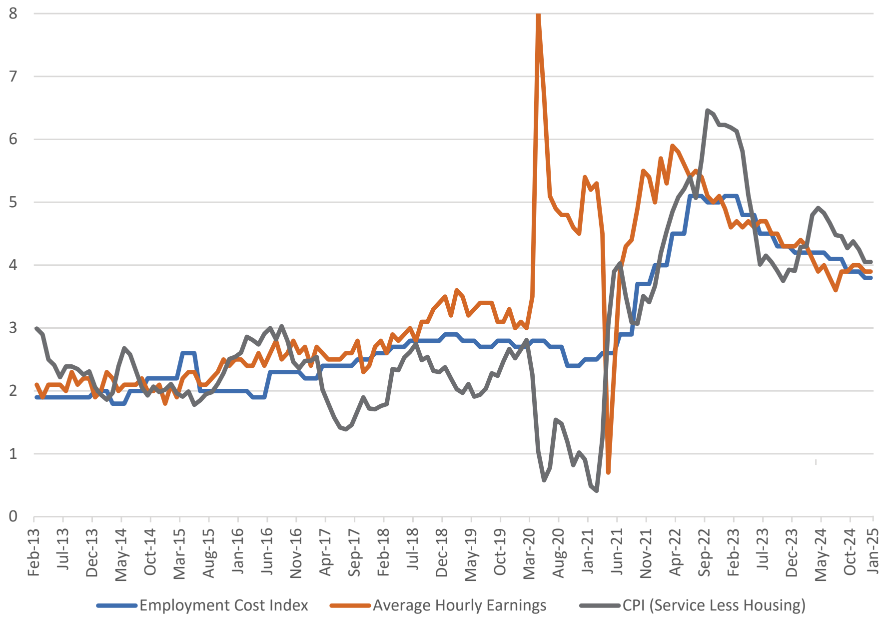


As of 2/3/25. Sources: Bloomberg, Wellington Management, and Hartford Funds.

3. **Fiscal policy:** There's a current tug of war in the new US administration regarding fiscal policy. Following an executive order, the Office of Management and Budget issued a memo essentially stopping all non-Medicare and Social Security payments. While the memo was rescinded, and a federal judge halted its implementation, two issues should raise the awareness of market participants: 1) A sudden halt to fiscal payments of that size and scale, as initially described in the memo, would likely induce a recession given the size and speed in the halt of federal payments; 2) This is an opening salvo in overturning the Impoundments Act of 1974 and re-interpreting Congress's Article I powers. These actions, in conjunction with tax reform and tariffs, make fiscal policy likely to be very volatile in the coming months.

4. **Economic data:** The US economy grew at a robust 2.3% during the fourth quarter of 2024, with strong underlying details. Consumption accelerated along with private sales to domestic purchasers, more than offsetting temporary detractors that included weather-impacted capex activity and inventory reductions. Wage pressure appears to be stabilizing at elevated levels while slowing immigration and deportations are also impacting the labor force, suggesting sticky non-rent services inflation over the next 6 to 12 months (**FIGURE 2**).

FIGURE 2
Wage Pressures Appear to be Stabilizing at Elevated Levels
Employment Costs, Hourly Earnings, and Service Prices (%, Year-Over-Year)



As of 1/31/25. Sources: Bloomberg, Wellington Management, and Hartford Funds.

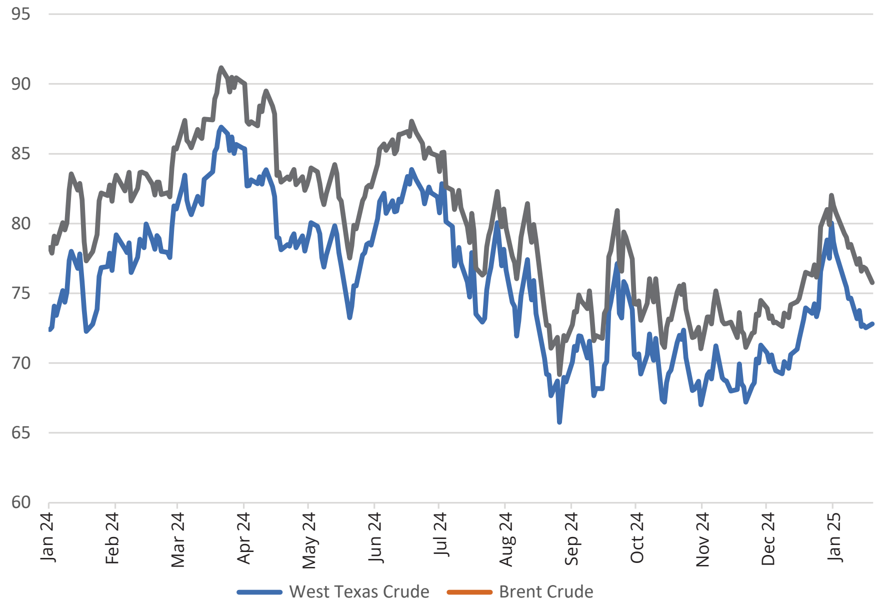
> AI-related technology stocks suffered a rout after Chinese startup DeepSeek claimed to offer an AI model with competitive performance at a fraction of the cost.

5. **AI-related technology stocks suffered a rout** after Chinese startup DeepSeek claimed to offer an AI model with competitive performance at a fraction of the cost. This overturned conventional thinking on the costs of AI as well as the inherent US competitive advantage in the space. So, why should fixed-income investors care? Treasuries rallied on the wider risk-off move following the announcements. More granularly, there's been huge growth in data centers, which fund themselves in the asset-backed securities (ABS)[5] market.

What's Keeping Us Up at Night...

1. **Geopolitical uncertainty.** Israel and Hamas agreed to a temporary ceasefire and hostage-release deal in Gaza. While geopolitical uncertainty has moderated in the Middle East recently with this ceasefire, a new president in Lebanon, and the fall of the Assad regime, the conflict remains far from resolved. Domestic politics in Israel and Iran remain potential concerns and could still cause flare-ups in the months ahead. Oil prices have retreated since the ceasefire was announced (**FIGURE 3**) though they remain vulnerable to tariff developments.

FIGURE 3
Crude Oil Prices Have Retreated Since the Gaza Ceasefire Was Announced
Oil Prices (Year-Over-Year, US$/Barrel)



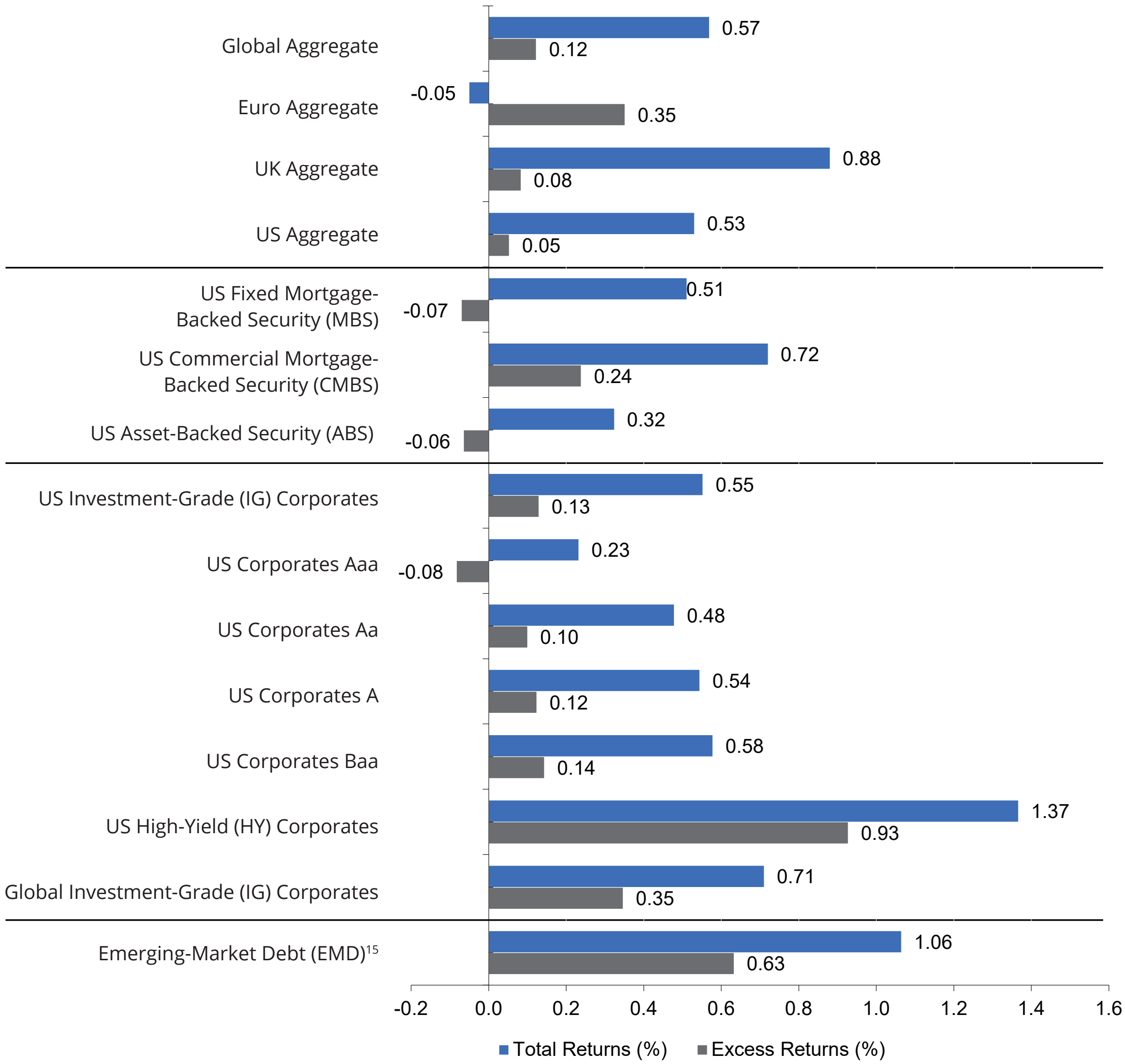
As of 2/3/25. Sources: Bloomberg, Wellington Management, and Hartford Funds.

2. **Trade wars.** The chances of a trade war have grown substantially. In addition to the announced (but not yet fully implemented) tariffs on Canada, Mexico, and China, there's also a high likelihood of tariffs on the EU. In short, this would be a significant change in the tariff structure vis-a-vis the largest US trading partners. There will also be retaliatory tariffs, possibly exacerbating inflation and currency volatility if negotiations are not forthcoming over time. We do expect *some* tariffs because it appears that tariff revenue may be a key revenue tool in congressional negotiations to offset the cost of extending the prior Trump administration's tax cuts.

Investment Implications for Consideration

- Given how drawn out and uncertain the rate cycle has been, and which is now compounded by geopolitical risks, 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" strategies[6] that may be able to navigate the late cycle. With US election results creating uncertainty around economic policy, our conviction in less-constrained fixed-income strategies only increases.
- Despite rate volatility earlier in the month, core-bond and core-bond-plus[7] positions continue to make sense for all-in yields.
- Securitized credit[8] 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,[9] which allows locked-in, non-recourse, term financing for an actively managed pool of bank loans.
- High yield[10] warrants a cautious approach given the robust rally in spreads, including CCCs.[11] We view bank loans[12] (despite expected lower reference rates), convertibles,[13] and capital securities[14] as alternative places to deploy capital.

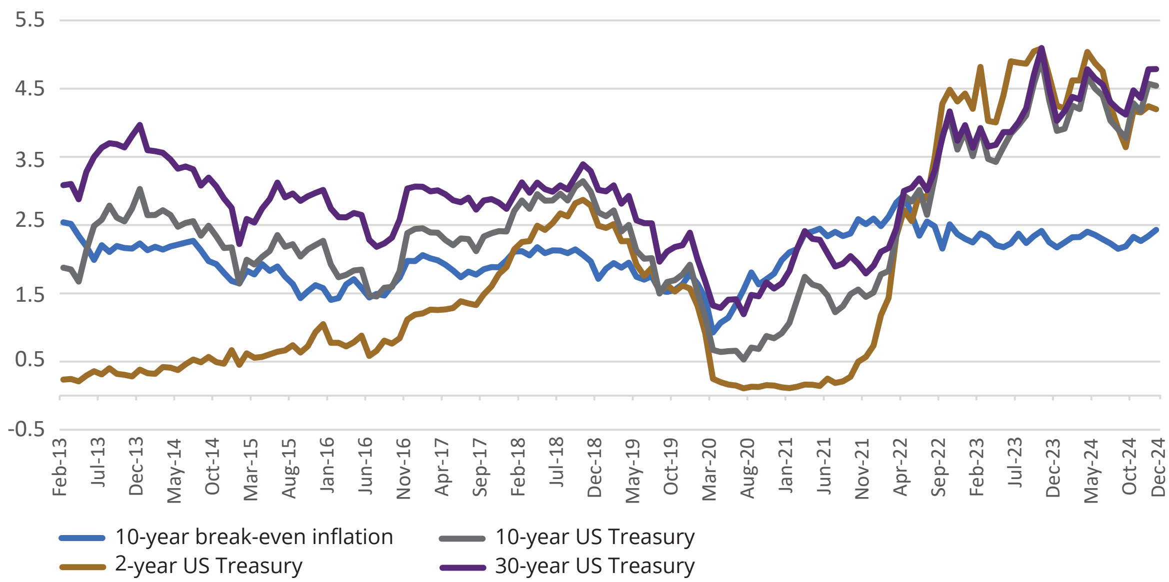
FIGURE 4: Monthly Fixed-Income Sector Total and Excess Returns



Monthly data as of 1/31/25. **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.

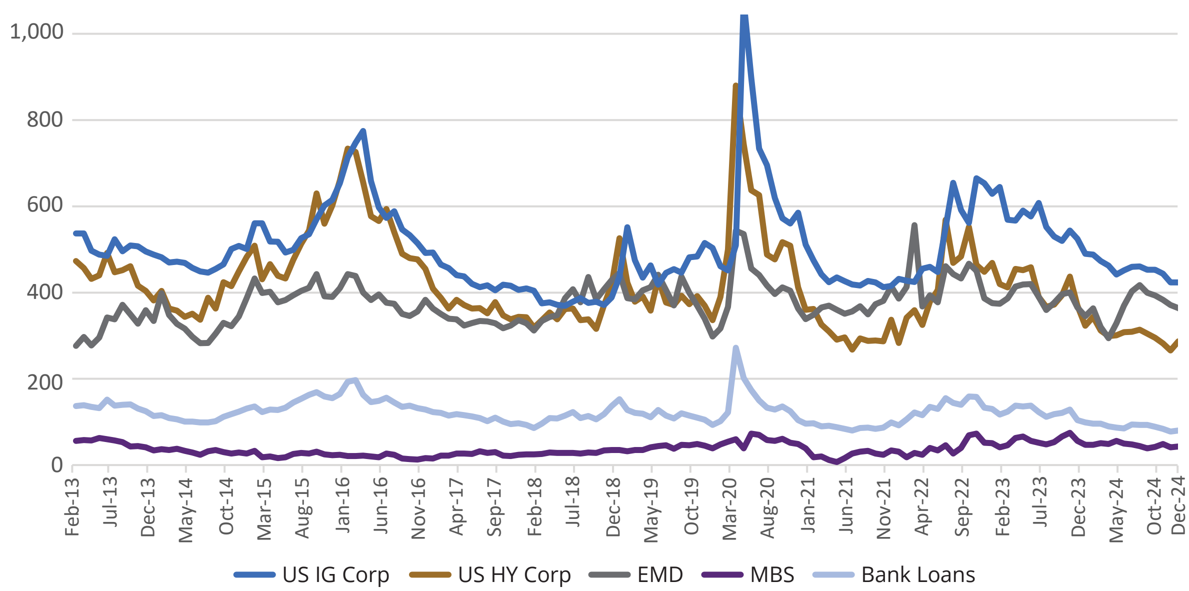
Fixed-Income Observations

FIGURE 5: US Yields (%)



As of 1/31/25. Sources: Bloomberg, Wellington Management.

FIGURE 6: Fixed-Income Spreads (basis points)



As of 1/31/25. **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.

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

[1] 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.

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

[3] When stocks are selling off, and investors run for shelter to bonds or gold, the environment is said to be risk-off. Risk-off environments can be caused by widespread corporate earnings downgrades, contracting or slowing economic data, and uncertain central bank policy.

[4] 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.

[5] Asset-backed securities (ABS) is a type of financial investment that is collateralized by an underlying pool of assets—usually ones that generate a cash flow from debt, such as loans, leases, credit card balances, or receivables.

[6] 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).

[7] 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.

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

[9] 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.

[10] 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.

[11] A CCC credit rating is a speculative or junk grade rating that indicates a high risk of defaulting on debt obligations. It's often given to companies that are experiencing financial difficulties or have a high level of debt.

[12] 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.

[13] 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.

[14] Capital securities are financial instruments that represent a person's ownership in a company or other entity. Capital securities may include shares (a corporation's capital stock, including common and preferred shares), interests (a person's partnership, membership, or limited liability company interests), warrants (options to purchase shares or other securities), or convertible securities (securities that can be converted into other securities).

[15] 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.

Representative Indices from Figure 4:
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 Bond 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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