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Recession...But with Inflation!

As tariffs shocked world markets, government bond yields were mixed, and credit spreads[1] widened.

What's Driving Markets...

Insight from sub-adviser Wellington Management

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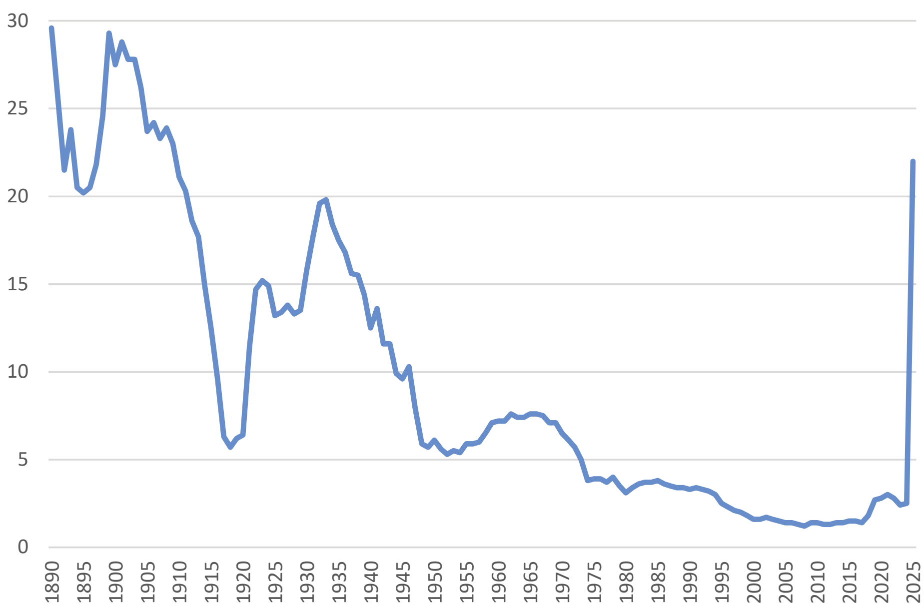
1. **Tariffs:** President Trump announced reciprocal tariffs on April 2—which he declared "Liberation Day"—with a 10% baseline rate and higher rates for other countries. As a result, the US will have imposed its largest tariff-rate increase since the Smoot-Hawley tariffs just prior to the Great Depression (**FIGURE 1**). Dangerously, trade as a portion of GDP is significantly higher today than it was in 1930. The universal 10% tariff on all countries took effect April 5, while additional reciprocal tariffs became effective April 9. Some retaliatory tariffs placed on the US immediately followed. The administration's announced tariff rates exceeded most estimates, leading to lower stock prices, an initial decline in government bond yields, wider credit spreads, and a rise in gold prices.

   Policy on tariffs is constantly shifting, making it difficult to accurately assess the implications for economic growth, international relations, and monetary policy. For example, while the tariffs were deemed reciprocal, it's unclear what calculation was used for each country; the current numbers don't reflect any publicly stated tariffs. Additionally, tariffs were placed on small, sparsely inhabited islands such as Svalbard and Jan Mayen (located near the North Pole). But, if fully implemented, these tariffs will result in a dramatically worse near-term growth/inflation tradeoff and increase the probability of a recession and a spike in short-term inflation. Risk markets are realizing that the chance of a recession has moved sharply upward.

FIGURE 1
US Implements Largest Tariff Hikes Since the 1930 Smoot-Hawley Levies
Average Tariff Rate on All US Imports, 1890-2025 (%)

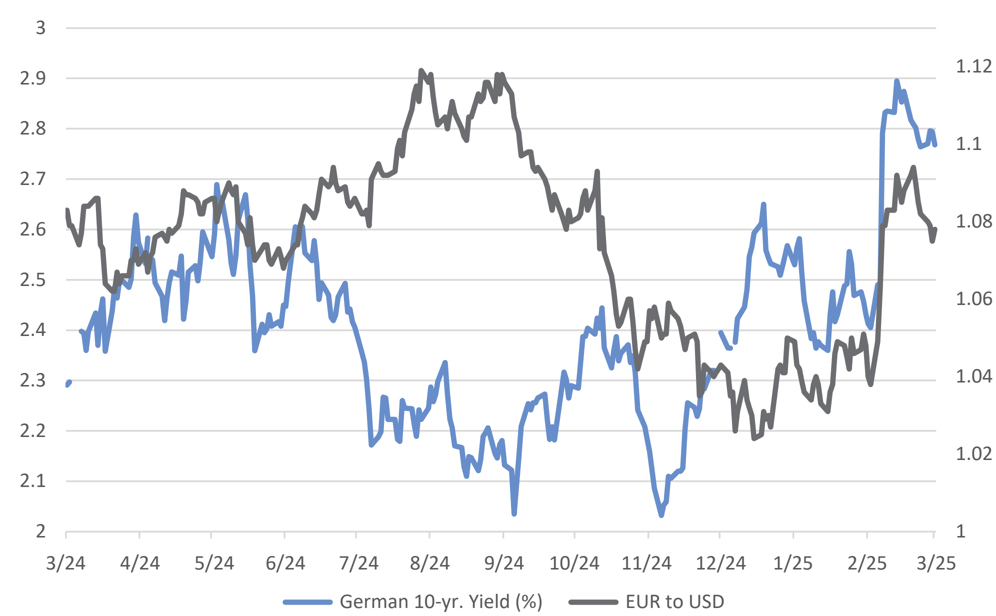


As of 3/31/25. Historical rates from 1890-2023, Projected rate for 2024, estimated rate for 2025 under Trump's announced tariffs. Data Sources: Tax Foundation, Wellington Management, and Hartford Funds.

2. **German fiscal transformation:** Germany's incoming coalition government, led by Chancellor-in-waiting Friedrich Merz, announced a sweeping fiscal overhaul, marking a notable pivot from the country's long devotion to fiscal conservatism. The prospective fiscal plan includes:
    - €400 billion military funding top-up
    - €500 billion public investment fund to be spent over 10 years

    Importantly, instead of a one-off military fund top-up, all expenses in the defense budget above 1% of GDP will be exempted from the debt brake.[2] The parties will also seek to reform the debt-brake rules in the new parliament to further encourage investment. German bund yields and the euro rose sharply higher following the announcement (**FIGURE 2**), given likely implications of stronger growth, higher inflation, and less accommodative European Central Bank policy, though some of that move later pulled back.

FIGURE 2
A Sweeping Fiscal Overhaul in Germany Helps Boost Yields
Bund Yields (%) and the Euro-vs.-Dollar (3/27/24–3/27/25)



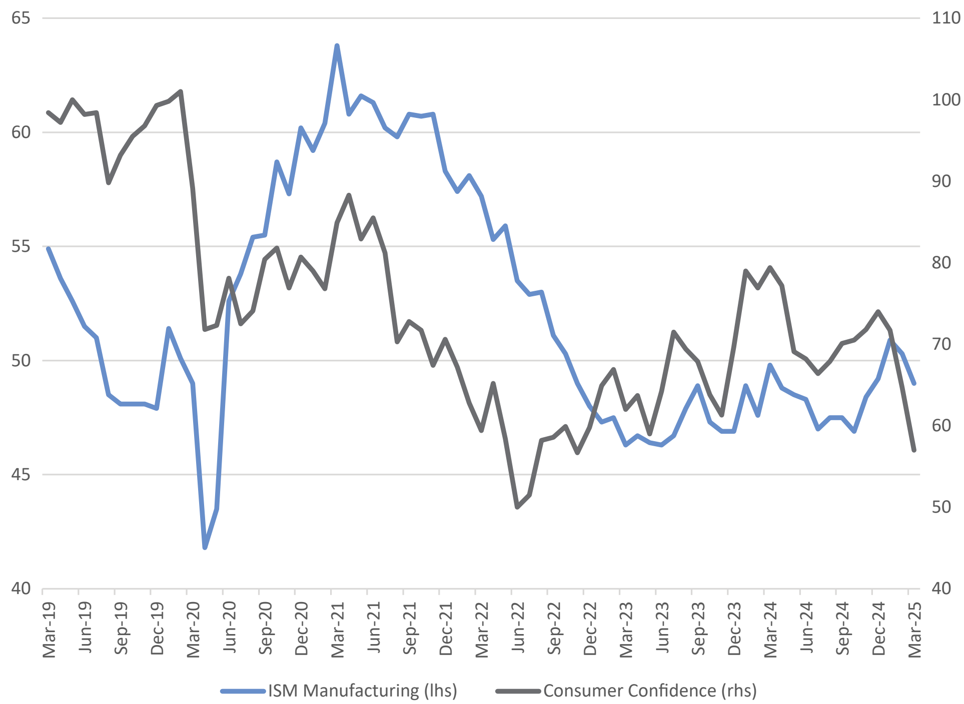
As of 3/27/25. Sources: Bloomberg, Wellington Management, and Hartford Funds.

3. **Economic data:** While much of the "hard" economic data has proven resilient, we have seen more downside surprises in "soft" data releases that are based on surveys (**FIGURE 3**) and could portend weaker growth ahead. Consumer spending continues to buoy the US economy, which expanded at a healthy 2.4% during the 4th quarter. Increased anxiety and uncertainty about tariffs might cause consumers and businesses to tighten their purse strings and increase cautionary savings or delay capex[3] spending, which could quickly translate into deteriorating hard data, particularly if financial conditions tighten further.

FIGURE 3

Downside Surprises in Recent Soft Survey Data May Portend Weak Growth

Business and Consumer Sentiment Indicators (3/31/19–3/31/25)



As of 3/31/25. Data Sources: Bloomberg, Institute of Supply Management, University of Michigan, Wellington Management, and Hartford Funds.

4. **Monetary policy:** The Federal Reserve (Fed) maintained policy rates, recognizing a weaker growth outlook alongside a higher inflation forecast for the coming year. The Fed has reduced its quantitative tightening (QT)[4] from $25 billion to $5 billion per month in US Treasuries starting April 1, which we view positively for liquidity conditions. More than $2 trillion has been lopped off the Fed's balance sheet since QT commenced in June 2022. While acknowledging rising inflation expectations, the Fed emphasized that medium-term measures remain well-anchored. While tariff announcements may shift market focus toward demand implications rather than inflation, we expect the Fed to remain on hold absent a negative growth shock.

What's Keeping Us Up at Night...

1. **Capital flight:** The technology sector sell-off that has taken place in the equity market highlights a risk that could surface for fixed-income investors. The administration's America First Investment Policy Memo, aimed at China, proposes measures to accelerate decoupling in trade, production, and investment, including tighter investment restrictions, increased audits, and potentially banning Chinese ADRs[5] on US exchanges.

   While it could raise revenue and ease the US fiscal burden, these measures could erode the US reserve-currency status, as previous reserve currencies lost their status due to debt, debasement, and war. Risks to US institutional integrity have been building, and the implementation of these policies could accelerate capital flight out of the US, impacting the US dollar (USD) and term premia[6] in the medium term. However, we note that the US Treasury market remains the world's deepest and most liquid segment of the fixed-income market, and we've written previously about factors that mitigate the threats to the USD reserve-currency status. If tariffs seek to reduce the trade deficit, they will, by definition, decrease the capital-account surplus the US currently enjoys. Overall, that means fewer buyers of US financial assets.

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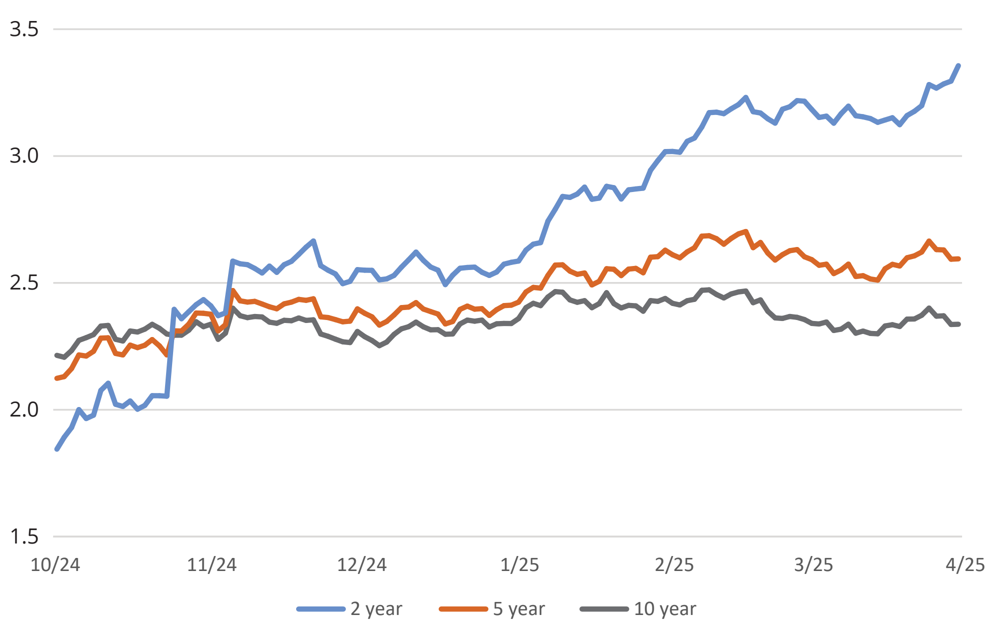
In the near term, higher rates abroad in Europe and Japan have somewhat blunted the traditional demand one would see in USD fixed-income markets. If this trend continues, some sectors that have traditionally had robust international support may weaken—not because of fundamental reasons but rather driven by relative-value technical flows.

2. **Geopolitical uncertainty:** China's People's Liberation Navy enacted large-scale live-fire drills relatively close to Taiwan following US Defense Secretary Pete Hegseth's trip to the Asia-Pacific region. The US has moved additional assets to the Middle East, including a second carrier, as well as planes to the island of Diego Garcia as tensions with Iran continue.
3. **Fed independence:** The Trump administration has fired the two Democratic commissioners of the Federal Trade Commission (FTC). Traditionally, both Republicans and Democrats serve on the commission, and no more than three FTC members can be from the same party. Additionally, the Federal Trade Commission Act, enacted in 1914, prevents the removal of commissioners without cause, usually cited as inefficiency, neglect of duty, or malfeasance. It's likely the case will go the Supreme Court and will involve the 1935 *Humphrey's Executor* decision. In that case, President Franklin Roosevelt attempted to remove a Republican commissioner for opposing New Deal policies. The Supreme Court unanimously rejected the Roosevelt administration's firing of the commissioner without cause. If, however, the current Supreme Court decides to allow the firings and overturn *Humphrey's*, it could lay the legal groundwork for firings/dismissals of Federal Open Market Committee governors and impair or destroy the independence of the Fed.
4. **Stagflation** is not off the table. While we think the growth effect dominates, inflation is likely to accelerate in the near term, challenging the Fed's ability to execute an easing strategy. The inversion of the inflation break-even[7] curve (shorter-dated breakevens at higher levels than longer-dated breakevens) was exacerbated by the tariff announcement.

FIGURE 4
Inflation May Accelerate in the Near Term, Challenging Fed Strategy
US Break-even Inflation Rates, 10/2/24–4/2/25 (%)



As of 4/2/25. Data Sources: Bloomberg, Institute of Supply Management, University of Michigan, Wellington Management, and Hartford Funds.

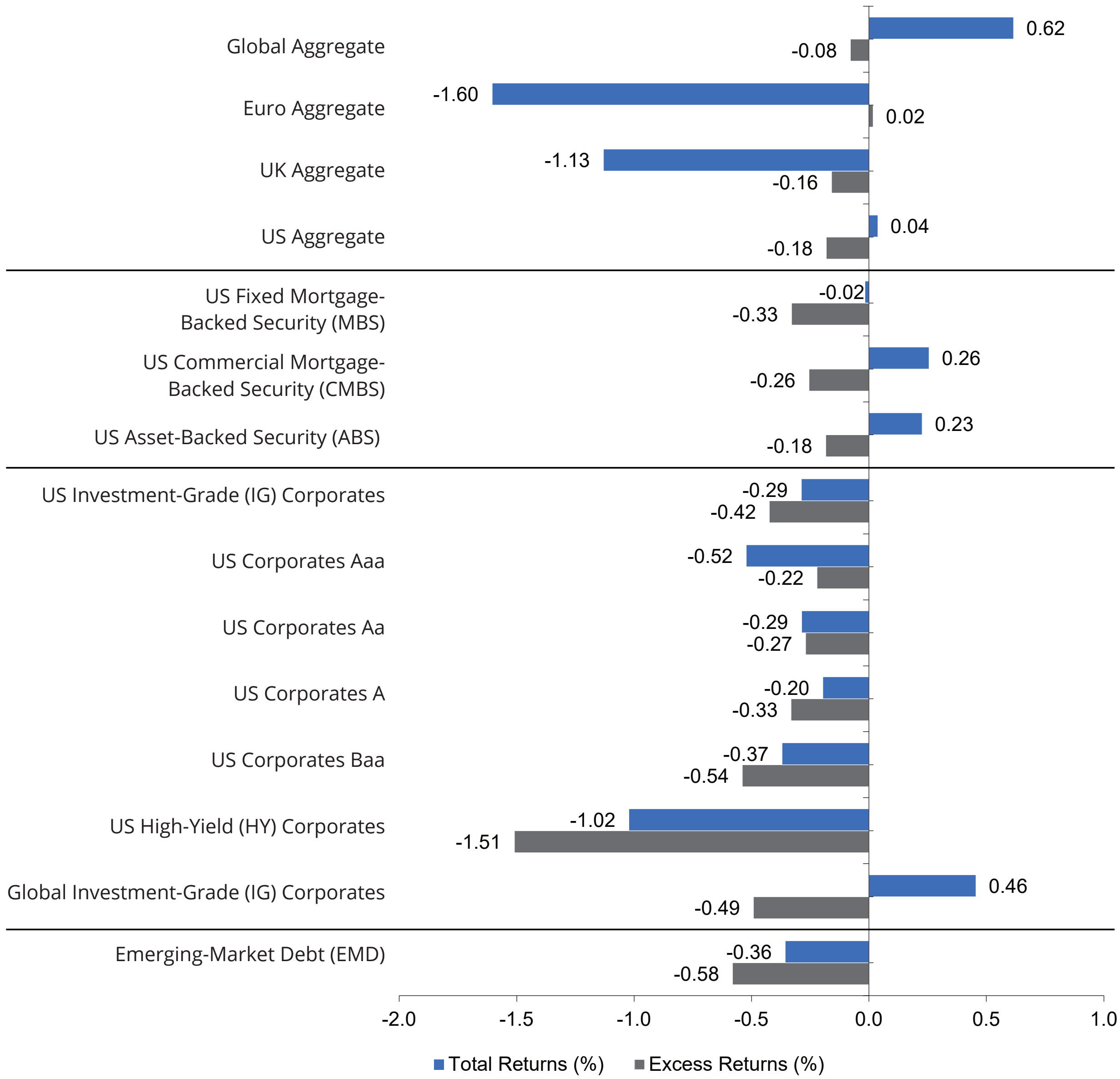
Investment Implications for Consideration

While the below positions have been static for some time, it's a reflection on how drawn out the current cycle has been due to the underlying strength of the economy.

- The risks of a recession have increased, yet tariffs are also likely to add to the current inflationary impulse. Given these dual risks, we still favor higher-quality 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[8] that may be able to navigate the late cycle.
- Core-bond and core-bond-plus[9] positions continue to make sense for all-in yields, and we think recession/growth risks will likely outweigh inflation risks over the medium term. Intermediate government/credit may be useful as a more risk-balanced way of adding a high-quality ballast into asset allocations. Moreover, recent slowing of economic data highlights a cooling of economic conditions.
- Securitized credit[10] could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, may offer attractive carry[11] with substantial subordination[12] in case the cycle turns negative faster than expected. While these sectors may face headwinds from non-US buyers finding more attractive opportunities in home markets, we think the hedge against rate volatility that subordination can provide will remain important in volatile markets. For clients looking for higher expected returns, we favor select CLO[13] equity, which allows locked-in, non-recourse, term financing for an actively managed pool of bank loans.

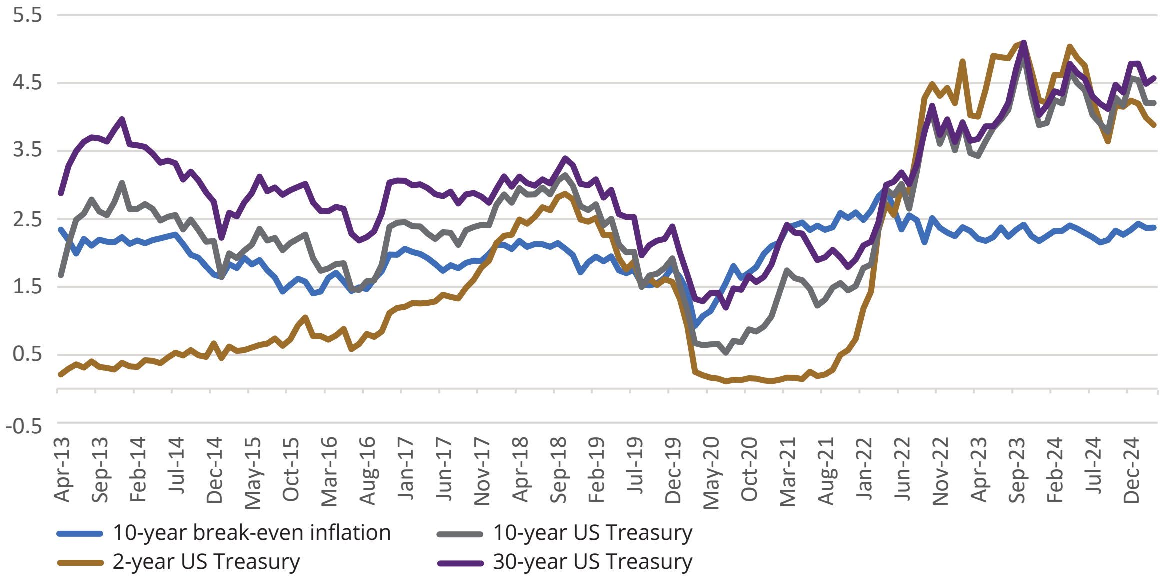
To learn more about opportunities in fixed income, please talk to your financial professional.

FIGURE 5: Monthly Fixed-Income Sector Total and Excess Returns



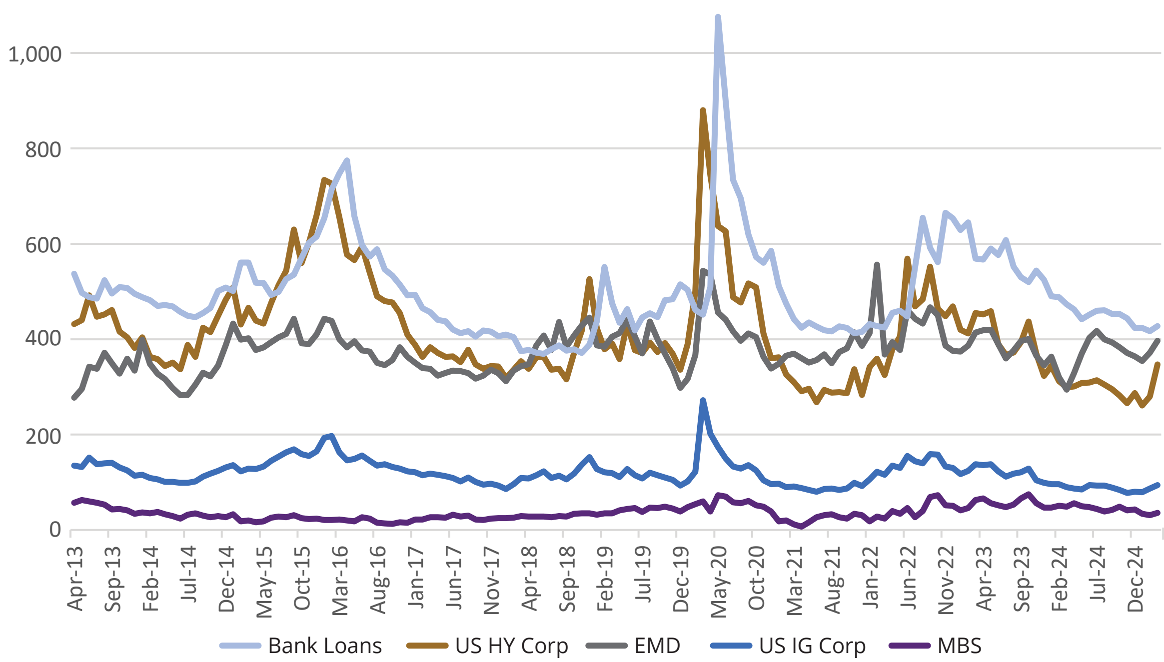
Monthly data as of 3/31/25. **Past performance does not guarantee future results.** Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg and Wellington Management.

FIGURE 6: US Yields (%)



As of 3/31/25. Sources: Bloomberg, Wellington Management.

FIGURE 7: Fixed-Income Spreads (basis points[14])



As of 3/31/25. **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.

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

[2] German debt brake refers to the part of Germany's constitution designed to restrict structural budget deficits at the federal level and limit the issuance of government debt. The rule restricts annual structural deficits to 0.35% of GDP. The federal government and the 16 states are obliged to balance their books and are practically prohibited from taking out extra loans.

[3] Capex stands for "capital expenditures" and refers to the investments a company makes to acquire, improve or maintain long-term assets such as buildings, land, machinery or equipment.

[4] Quantitative tightening (QT) is a contractionary monetary policy where a central bank reduces the amount of liquidity or money supply in the economy, typically by selling assets or allowing them to mature without reinvestment, which is the opposite of quantitative easing (QE).

[5] ADR stands for American Depositary Receipt, which are negotiable securities issued by a US bank representing ownership of shares in a foreign company, allowing US investors to trade in foreign stocks on US exchanges.

[6] A "term premium" refers to the extra yield investors demand for holding longer-term bonds compared to shorter-term ones, reflecting the compensation for bearing the risk that interest rates might change during the bond's lifespan.

[7] 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.

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

[11] "Carry" generally refers to the return or cost associated with holding an asset, often used in the context of currency or asset trades, where investors borrow in a low-interest currency and invest in a higher-yielding one.

[12] Subordination refers to a lower priority level of debt or securities. Subordinated debt ranks below senior debt in terms of claims on assets and earnings. This means that in the event of a default or liquidation, subordinated debt holders are paid after senior debt holders. Subordinated debt is often considered riskier because it has a lower claim on assets, but it typically offers higher interest rates to compensate for this increased risk.

[13] 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.

[14] 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.

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 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.