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2025 Outlook: Perspective on Markets and the Economy

Table of Contents

Page

Global Macro

Trump 2.0: Time to Curb Your Enthusiasm? 1

Income, Returns, and Resilience 9

Navigating Uncertain Policy Shifts 13

Equities

Trump's Win Creates a Period of Uncertainty for Emerging Markets 18

Small Caps Offer an Inexpensive Way to Gain Exposure to the Robusy US Economy 21

Fixed Income

Go Your Own Way: Capitalizing on Bond Divergence 27

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Trump 2.0: Time to Curb Your Enthusiasm?

US exceptionalism will remain a focus for markets, but the big question is how long it can last.

Key Points

- **The Republican sweep in the US election turbocharges the already positive direction of US fundamentals.** While there are many policy unknowns with the incoming administration, we're aligned with the recent momentum in equities, despite rich valuations, and continue to favor global equities over bonds.
- **We favor US over European equities and European rates relative to US rates.** We've increased our view on Chinese equities to neutral, given cheap valuations and our belief that recent stimulus, while not entirely adequate, has at least put a floor under the market.
- **We've reduced our credit view to neutral** given record tight spreads[1] and compression between CCC and BB bonds. We think rich valuations on high yield offset the good supply/demand technicals and carry.[2]
- **We remain wary of higher US fiscal deficits** and think US rates and the embedded term premium[3] are the best reflection of the market's view. On the other hand, the Federal Reserve (Fed) remains on an easing path, even if rate cuts might be shallower than expected a few months ago. Thus, we remain neutral on duration.[4]
- **We think gold has upside based on central banks' continued desire to diversify** their foreign-exchange holdings and as a hedge against geopolitical and stagflation[5] risk.
- **Downside risks** to our views include a spike in US interest rates spurred by inflation concerns (from fiscal policy and/or tariffs) and dimming hopes of Fed easing. A flare-up in geopolitical risk could also weaken our base case. **Upside risks** include a jump in US productivity that increases US growth potential without higher inflation and meaningful fiscal stimulus from China that catalyzes a strong rally there as well as in emerging-market (EM) economies linked to China.

Insight from sub-adviser Wellington Management

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Risk markets have been ecstatic over the US election results, with US equities climbing to record levels and credit spreads tightening. US exceptionalism is the running theme based on expectations of deregulation and lower taxes, and that has meant US outperformance over pretty much everything else. The big question is how long it can last.

The crystal ball is pretty cloudy right now. How does an allocator navigate markets when so much about the policy landscape is unknown, and the details, once they emerge, could have major implications for sectors, companies, and regions?

First, focus on what we do know (at least as of this writing in early December). We expect the new administration to act on the four pillars of its campaign: lower taxes, more restrictive trade, deregulation, and less immigration. But changes in trade and regulation may be implemented sooner than tax or immigration policies, which could require congressional approval. We also have deeper knowledge of fundamentals than politics, and we know current valuations.

Second, take a scenario-based approach to what we don't know. For instance, what's the likely impact of different growth/inflation mixes on interest rates? Third, consider using policy uncertainty and associated volatility to increase or decrease exposure when markets' knee-jerk reactions put valuations out of sync with fundamentals.

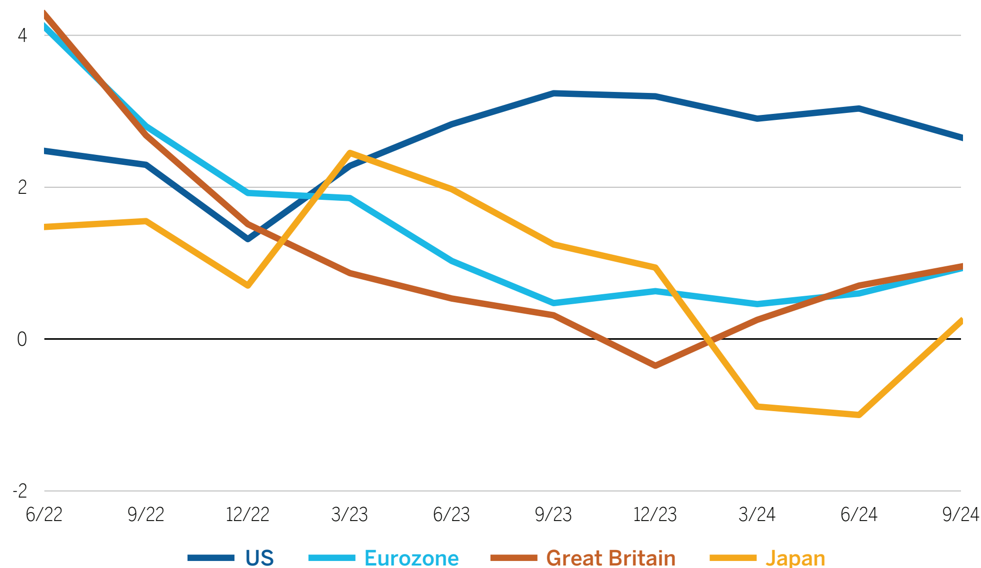
With that in mind, we're leaning into the good fundamental picture in the US—a better growth/inflation balance, stronger earnings than the rest of the world, and supportive Fed policy—with a moderately overweight view on US equities. What keeps us from having a larger overweight view? Valuations are at the rich end of the historical range, though we acknowledge that any reversion could take years, not months.

We expect the Trump administration to put tariffs on European goods, which, in combination with weaker growth, could hurt Europe relative to the US. We express that in our overweight view on US equities and on European duration relative to the US. Japanese equities have had a good run since we initiated our overweight view on the market in late 2022, but we've now moved to a neutral view given that the weak yen and uncertain political situation could offset the positives, including improving corporate governance and supportive valuations.

FIGURE 1

US Exceptionalism Is the Running Theme

Real GDP (Year-Over-Year %)



Quarterly real GDP data from Refinitiv, 6/30/22-9/30/24. Data Sources: Wellington Management and Refinitiv.

In fixed income, we've reduced our high-yield view to neutral. With spreads close to the zero percentile, the risk/reward has shifted negatively—though we recognize that attractive US yields, low default rates, and limited net supply could keep spreads tight for a while. We note that interest-rate volatility has been running higher than equity volatility, creating potential opportunities for allocators to take advantage of pricing anomalies in government bonds.

We remain positive on gold. De-dollarization continues to be a goal for many central banks concerned about US sanctions on US-dollar reserve assets. We see limits to the rise in yields, which hurt gold prices recently, and think the precious metal will again be valued for its hedging role amid geopolitical and inflation risks.

While US political uncertainty will be a feature of the coming year, several guardrails could rein in the tail risks. First, the Senate confirmation process should mean that more extreme picks for key policymaker roles won't be a shoo-in. Second, existing laws and regulations should limit the implementation of more radical policies. Third, the stock and bond markets will be "voting" on the economic implications of new policies. If either market tanks, the president is likely to respond.

Equities: Broadly Bullish but Weighing Regional Pros and Cons

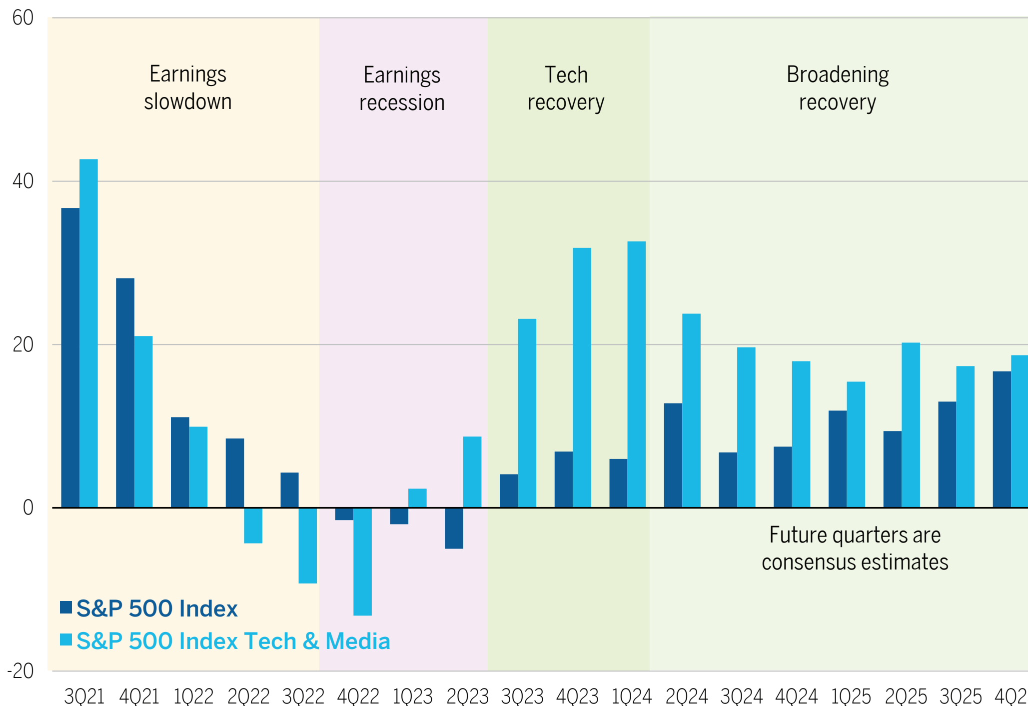
We maintain a modestly positive stance on global equities. Overall, economic growth remains on a steady positive trajectory, and the disinflationary path is intact, although bumpier than before in some regions. Broadly speaking, market sentiment is bullish but not overextended, in our view; however, divergences remain. In the US, we think companies may be well positioned to achieve robust earnings growth, but valuations are a challenge. In other markets, such as Europe and Japan, earnings breadth is a concern, but valuations are supportive. We think the biggest threat to global equities is the potential reemergence of inflationary pressures, which could lead to a disorderly move upward in yields and create valuation headwinds. While these risks aren't our base case, they give us reason to maintain some caution and keep us from moving to a full overweight view on global equities.

Turning to our regional perspectives, we've moved from a neutral to a moderately overweight view on the US. The economy displays continued resilience, with a renewed pickup in macroeconomic leads, such as consumer confidence. Earnings surprised on the upside in the third quarter, and we estimate they could grow by 14% over the next 12 months. The latest earnings show a picture of margin expansion, and a pickup in productivity has supported companies' bottom lines. Evidence of a more balanced advance in earnings thus far is mixed, as tech and related sectors still dominated cyclicals and energy in the third-quarter earnings season. However, the market advance turned more broad-based following the US election. And looking forward, expectations are for earnings growth in companies outside tech and mega-caps to close the gap with the leaders (**FIGURE 2**). When it comes to election impacts, markets face a balancing act between growth-boosting policies, including deregulation and the extension or addition of tax cuts, and the disruptive effects of tariffs and curbs on immigration. Still, we believe that the potential policy mix disproportionately favors the US over other regions.

FIGURE 2

Earnings Growth Expected to Broaden

% Earnings-Per-Share Growth Year-Over-Year



As of 11/11/24. Data represents year-over-year change in earnings-per-share for S&P 500 Index and the technology and media industries within the S&P 500 Index. Earnings per share is the projected growth rate in earnings per share for the next five years. S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. Indices are unmanaged and not available for direct investment. Data Sources: Wellington Management and Bloomberg.

We maintain a moderately underweight view on Europe, where earnings growth remains muted, and earnings revisions are more negative. Germany's sluggish economy and France's political uncertainty have further clouded the economic outlook. European equities are cheap relative to earnings in both absolute and sector-adjusted terms, but they lack a compelling catalyst for outperformance vs. other regions, particularly in light of potential US tariffs. We'll keep a watchful eye for a change in trend given low valuations.

We've moved from our long-term overweight view on Japan to a neutral view. We think the market faces a few potential stumbling blocks in the coming quarters. As with Europe, we think Japan faces uncertainty about whether potential trade frictions will stymie companies' ability to capitalize on any improvement in the global demand picture. We've noted that earnings expectations are falling, and revisions breadth is weak. Japan also faces some domestic policy uncertainty following its election this past fall, which has yielded an unstable coalition. Volatility in the exchange rate may also cause price-to-earnings[6] compression and lead to margin uncertainty for exporters. We remain constructive on Japan structurally though, as improvements in corporate governance, buybacks,[7] and domestic demand growth continue apace.

We've moved from a small underweight view on China to neutral. While recent fiscal stimulus hasn't sufficiently addressed weak private-sector confidence, we believe it puts a floor under the equity downside. Policymakers may have preserved dry powder for fiscal interventions in case tensions escalate. Looking at company fundamentals, we see room for modest optimism, as buybacks are increasing, and short-term earnings expectations are moving slightly higher. We remain neutral, however, because we expect valuation expansion may continue to be limited by a weak and uncertain long-term earnings growth picture and a lack of visibility on the sequencing of a policy response to serious growth challenges.

Within sectors, we're positive on financials and utilities, given favorable valuations and macro signals, and more negative on consumer staples and telecoms. Utilities appear to be in a good position to capitalize on strong projected electricity demand growth and the resulting pricing power. We think financials could benefit from the steeper yield curve,[8] a recovery in private credit, and deregulation. Small caps in the US seem likely to benefit in relative terms from a deregulatory impulse and a pickup in mergers and acquisitions. They may also benefit from low starting valuations and are less exposed to an expansion in tariffs and supply-chain frictions than many large caps.

Government Bonds: We Expect Divergence Ahead

Most central banks are easing monetary policy, but President-elect Donald Trump's election victory inserts new risks into the outlook that could induce greater divergence between countries' bond markets. Our highest-conviction view is that the combination of fundamentals and politics could drive the gap between US and European yields wider.

On the fundamental side, the difference between US and European growth is stark (**FIGURE 3**). The US has surprised on the upside, with 2.7% GDP growth expected for 2024, and should benefit from the Trump administration's pro-growth agenda. Europe, on the other hand, is struggling with weakness in Germany, political uncertainty there and in France, and the threat of a negative growth shock from US-imposed tariffs. In fact, we think the market may price more rate cuts for the European Central Bank. In our probability-weighted excess-return scenarios, we see the greatest potential upside for European bonds and the greatest potential downside for US bonds.

On the political side, we think inflation is the main risk in the US given Trump's campaign promises to extend tax cuts, impose stiff tariffs, and deport immigrants. Interest-rate volatility, as proxied by the MOVE Index,[9] has been

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	—
Developed market (DM) govt. bonds	Neutral	—
Credit spreads	Neutral	↓
Commodities	Moderately OW	—
Cash	Moderately UW	↑
Within Asset Classes		
Global Equities		
US	Moderately OW	↑
Europe	Moderately UW	—
Japan	Neutral	↓
China	Neutral	↑
EM ex China	Neutral	—
DM Government bonds		
US government	Moderately UW	↓
Europe government	Moderately OW	↑
Japan government	Neutral	—
Credit Spreads		
US high yield	Neutral	—
Europe high yield	Neutral	—
Global investment grade	Neutral	—
EM debt	Neutral	—
Bank loans	Neutral	—
Securitized assets	Moderately OW	—

OW = overweight, UW = underweight

Source: Wellington Management | Views expressed have a 12-month horizon and are those of the authors and the Investment Strategy & Solutions Group. Views are as of November 2024, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This is not to be construed as investment advice or a recommendation to buy or sell any specific security.

running much higher than equity volatility, as proxied by the VIX.[10] The market has cut easing expectations from 200 basis points (bps)[11] in September to around 90 bps today, and 10-year yields are 60 bps higher, driven mostly by real yields.

Of course, the bond market's reaction to higher inflation would depend on whether it was driven by strong growth (deregulation), a supply shock (fewer workers or less trade), or fiscal profligacy (an end to Social Security taxes, for example). The risk is that the term premium spikes in response to "bad" inflation. That said, the policies that are actually implemented may be milder than campaign rhetoric. We expect the feedback between higher US yields and the economy to cap the rise in yields and think allocators can potentially take advantage of high volatility and may want to consider positioning tactically in a range of 3.75% to 5.25% on the 10-year Treasury.

On balance, the combination of winners and losers in an era of deglobalization makes us neutral on overall duration.

The bond market's reaction to higher inflation would depend on its cause, and the policies that will actually be implemented may be milder than campaign rhetoric.

FIGURE 3

European Weakness Suggests Lower Yields Relative to the US

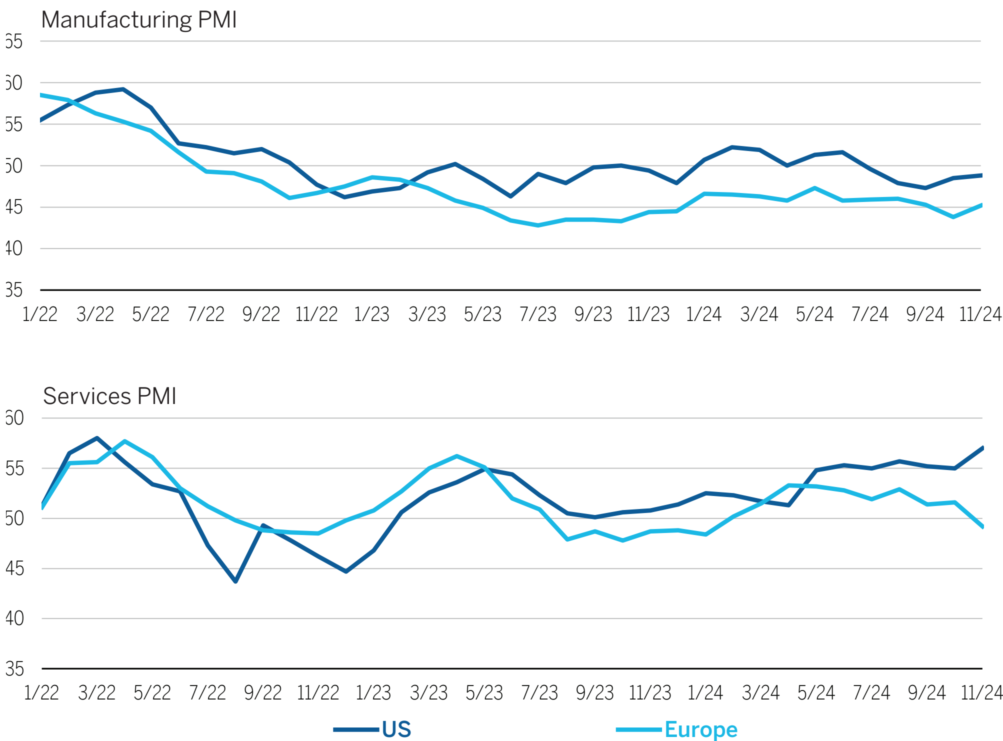


Chart data as of 1/31/22-11/30/24. The Purchasing Managers' Index (PMI) is a monthly indicator of the prevailing direction of economic trends in the manufacturing and service sectors. Data Sources: Wellington Management and Refinitiv.

Credit: Upside Is Limited, but Not Enough for an Underweight View

Having had an overweight view on high-yield credit spreads since the start of 2024, we've now moved to a neutral view. We think the macro and fundamental backdrop remains supportive for credit—central-bank rate cuts are underway, economic growth is strong, earnings and balance sheets are healthy, and high-yield default rates globally continue to trend down. However, the upside for credit is now limited by the fact that spreads are extremely tight relative to history. Last quarter, there was at least some value remaining in the riskiest parts of the credit markets, but that gap has closed, and we see very tight spreads across the entire quality spectrum. This means the upside potential of the asset class, compared to equities, for example, is more limited.

Having said that, we opted for a neutral rather than underweight view because we think spreads could remain at current levels for some time. We don't see any immediate catalysts for widening (especially now that the US election is behind us). Technical support also remains for credit markets, with yield-sensitive buyers continuing to flow into the asset class in search of attractive yields and seemingly agnostic about slim spread levels. We expect this to continue into the new year. Regionally, we remain neutral, seeing limited forward-return differentials between different credit markets.

Gold has had an incredible run in 2024, and we see reasons for it to continue into 2025.

Commodities: As Good as Gold

We maintain our moderately overweight stance on commodities, driven by positive views on gold. Gold has had an incredible run in 2024, and we see reasons for it to continue into 2025. Our base case is that central-bank buying, ETF demand, and interest-rate cuts could be supportive for prices going forward. We've stuck with a moderate rather than full overweight view because there are risks—particularly the possibility that central-bank buying fades or real yields increase with sticky or rising inflation. But for now, the status quo remains supportive for the asset class.

Within oil, we've moved to a neutral view after previously being positive. While we continue to think economic growth will be supportive for prices, there's a growing risk (particularly coming out of the US election) that supply will increase and hurt prices in the new year. A positive roll yield,[12] which reflects the lower cost of longer-dated futures, continues to support the asset class, in our view.

Risks to Our Views

Downside risks include:

- A scenario in which core inflation reaccelerates or spikes, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking
- A jump in fiscal risk that pushes long-term rates higher in a disorderly fashion
- A big reversal in one or more of the mega-cap stocks, which could threaten the market's current sharp upward momentum
- A spike in geopolitical risk that pushes up oil prices and increases macro uncertainty
- Punitive US tariffs on China and/or the rest of the world
- The risk that capital flows to China are constrained by political maneuvers

Upside risks include:

- A breakthrough in US/China relations that results in lower-than-expected tariffs or no tariffs
- More widespread diffusion of growth globally and inflation moving closer to target, giving central banks room to cut more than is currently priced in
- Meaningful fiscal stimulus in China, targeted to the consumer and private-sector companies
- A broad resolution to the Middle East conflict
- Lower oil prices, suppressing inflation fears

Investment Implications

- **Prepare for US exceptionalism to potentially dominate in equities** — We think the optimistic mood in risk assets[13] could continue as pro-growth policies dominate the narrative over the coming months. Rich valuations make the decision to be long equities less straightforward, as does the risk of inflation down the road. To express this balance, we prefer a slight overweight view on global equities and a regional equity view favoring the US over Europe.
- **Expect further broadening in the equity rally** — With better growth prospects, we expect earnings improvement to expand beyond the mega-cap tech sector. We think this could benefit value, small cap, and some cyclicals. Among sectors, we favor financials and utilities and are more negative on consumer staples and telecoms.
- **Consider seeking relative value in fixed income** — We think the positive backdrop for credit, including strong technicals and falling default rates, is fully priced in and that a neutral view on credit is appropriate. We also have a neutral view on duration on the basis of central-bank easing continuing, albeit at a slower pace. We favor securitized credit over other credit sectors and favor European duration over US duration.
- **Consider a small allocation to gold** — Central-bank buying continues to be a positive demand technical for gold as countries look to diversify their currency reserves and avoid the risk of US sanctions. A more muscular approach to foreign policy from the new US administration could insert more geopolitical uncertainty into the landscape.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

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

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

[3] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

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

[5] Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation.

[6] The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock.

[7] A buyback is a company's purchase of its outstanding stock shares. Buybacks reduce the number of shares available on the open market.

[8] 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.

[9] The MOVE Index, short for the Merrill Lynch Option Volatility Estimate Index, is a measure of expected volatility in the U.S. Treasury bond market. It is a gauge the level of uncertainty or risk in the bond market, which can sometimes signal potential volatility in the broader financial market.

[10] VIX, commonly referred to as the "Fear Index," is the ticker symbol for the Chicago Board Options Exchange (Cboe) Volatility Index and measures the market's expectation of 30-day volatility. VIX levels below 20 reflect complacency, while levels of 40 or higher reflect extremely high levels of volatility.

[11] 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.

[12] Roll yield is the amount of return generated in the futures market after an investor rolls a short-term contract into a longer-term contract and profits from the convergence of the futures price toward a higher spot or cash price.

[13] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than U.S. 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 such as China. • Small-cap securities can have greater risks, including liquidity risk, and volatility than large-cap securities.• Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject the investors to greater volatility than traditional investments. The value of such instruments may be volatile and fluctuate widely based on a variety of factors. • 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. • Different investment styles may go in and out of favor, which may cause underperformance to the broader stock market.

Diversification does not ensure a profit or protect against a loss in a declining market.

The views expressed here are those of the authors and Wellington Management's Investment Strategy Team. They should not be construed as investment advice. They are based on available information and are subject to change without notice. Portfolio positioning is at the discretion of the individual portfolio management teams; individual portfolio management teams and different fund sub-advisers may hold different views, and may make different investment decisions for different clients or portfolios. This material and/or its contents are current as of the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management or Hartford Funds.

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Income, Returns, and Resilience

The economic backdrop is still conducive for returns, but diversification will be essential for building resilient portfolios.

Insight from sub-adviser Schroders Investment Management

Johanna Kyrklund
Group Chief Investment Officer

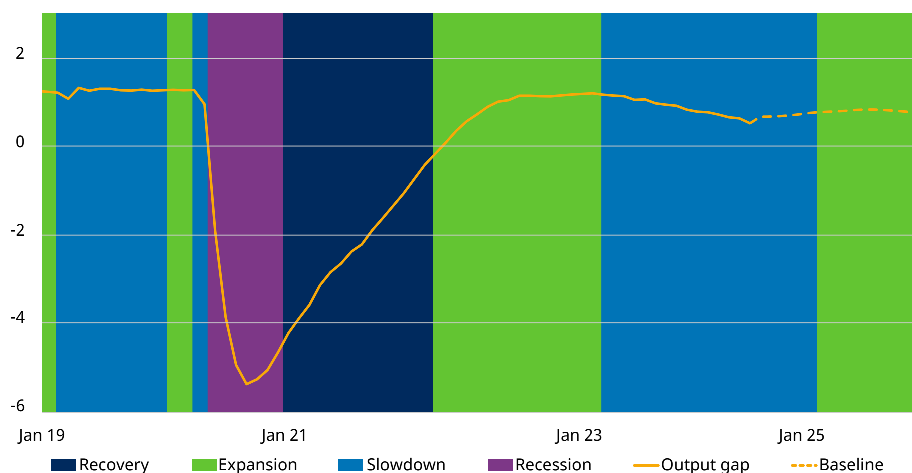
News of Donald Trump's conclusive US election win has led to endless speculation about what his policies might be. In this environment, it's always useful to step back and focus on the bigger picture.

We've written before about the changing investment regime: a shift to a multipolar world, more proactive fiscal policies, and higher interest rates compared to the last decade. The post-Global Financial Crisis (GFC) environment of tight fiscal policy, zero interest rates, and liberalized global trade was not working for the average person in the West, leading to support for more populist policies.

In this context, Trump is more of a symptom than a cause of the political environment. His second term will represent an intensification of trends that were already in place: loose fiscal policy and an ongoing reaction against globalization in the form of higher tariffs (note that President Biden did not reverse the tariffs imposed by Trump in his previous term).

What does this mean for markets in 2025? Leaving aside political risks, the economic backdrop remains benign. Inflation has moved in the right direction and interest rates are falling in the US and Europe. We expect a soft landing, and our expectation is that growth will reaccelerate as we move through 2025.

FIGURE 1
Our Expectation: A Soft Landing for the Economy in 2025
Gross Domestic Product, January 2019-January 2025 (%)



As of 11/11/24. The Schroders Output Gap model assesses the extent to which an economy is operating below its full potential, without generating inflationary pressure. In the slowdown phase the output gap is positive and falling, and in the expansion phase, the output gap is positive and rising as the economy reaccelerates. Sources: LSEG DataStream, Schroders Economics Group.

Key Points

- We think there's potential for markets to broaden out further in the US, particularly given the Trump team's focus on deregulation and corporate tax cuts.
- The old-fashioned reason for owning bonds—seeking to generate income—is back, and we continue to argue for their inclusion in portfolios.
- We believe conditions are favorable for good returns in 2025, but there likely will be challenges. A diversified approach across regions and asset classes can contribute to making portfolios more resilient.

Look Beyond Recent Winners for Return Opportunities

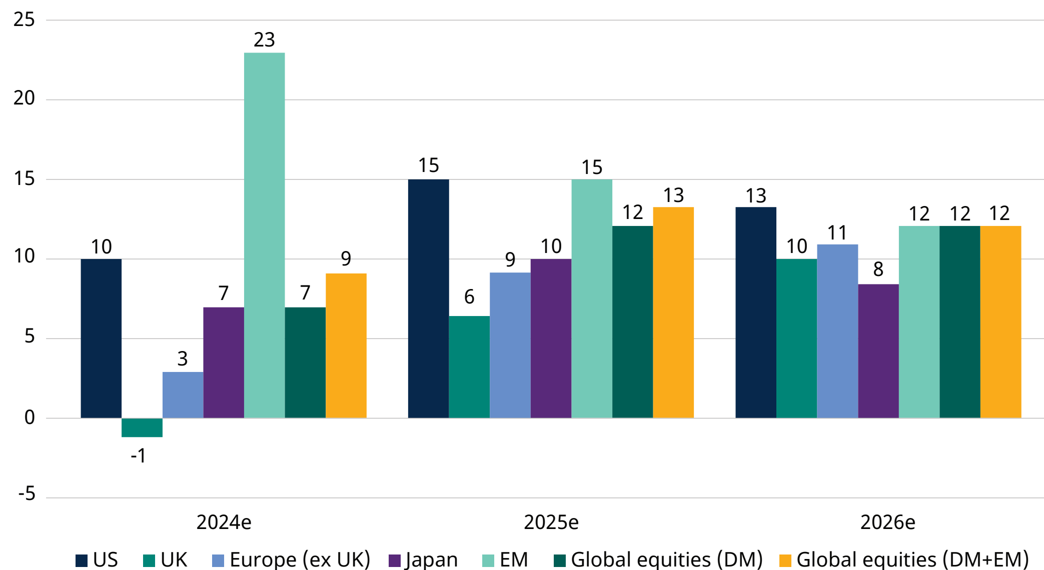
Turning to equities in more detail, the S&P 500 Index[1] is looking expensive, but valuations away from the mega caps and outside of the US appear more reasonable. Equity investors have grown accustomed to a small number of large companies powering the stock market's gains; however, this pattern is already changing.

We think there's potential for markets to broaden out further in the US, particularly given Trump's focus on deregulation and corporate tax cuts.

FIGURE 2

Consensus Expectations: Improving Earnings Growth in Most Regions in 2025

Year-on-Year Corporate Earnings per Share (EPS) Growth Forecasts (%) (e=estimate)



As of 10/31/24. **Past performance does not guarantee future results.** Japan EPS represents a 4-quarter sum of the next calendar year through 6/30/25, e.g. 2024 = 3/31/24–3/31/25. DM: developed markets, EM: emerging markets. Sources: LSEG DataStream and Schroders Strategic Research Unit.

Beyond the US, trade will be an important area of focus if Trump fully implements the tariffs he announced during the campaign. In practice, such widespread tariffs might be hard to implement into law, but the uncertainty will encourage US companies to reshore in any case. This could boost US growth at the expense of its neighbors, but we would also expect more monetary stimulus outside of the US to offset this.

So, all in all, we see scope for positive returns from equities in 2025, but investors may need to look beyond the recent winners.

We also need to recognize that the risks are increasing as positive expectations get baked into market valuations. In particular, given an approximate 4.5% to 5% yield on the US 10-year Treasury bond, we'd judge that comparisons with bond valuations would pose a speed limit to equity returns (this arises because higher bond yields can draw money away from the stock market, as well as increasing borrowing costs for corporates).

As mentioned previously, we remain positioned for a soft landing, which is a benign outcome. But, as we consider the risks around this scenario, our bias is still to worry that the US growth environment might be "too hot" rather than "too cold." Curbs on immigration and policies to boost the corporate sector could increase the risk of domestic inflation, curbing the Federal Reserve's (Fed) abilities to deliver rate cuts.

We think there's potential for markets to broaden out further in the US, particularly given Trump's focus on deregulation and corporate tax cuts.

Bonds Can Offer Attractive Income

Which brings us to bonds. As I've outlined previously, we believe that we're in an environment that's very different from the deflationary, zero-rate regime of the 2010s. As a consequence, bonds don't offer the same negative-correlation benefits that they did in the last decade.

However, the old-fashioned reason for owning bonds—seeking to generate income—is back, and we continue to argue for their inclusion in portfolios. Divergent fiscal and monetary policies around the world will also provide cross-market opportunities in fixed income and currency. Strong corporate balance sheets support the yields offered by credit markets.

To the extent that investors are seeking diversifiers, we continue to like gold as it can provide a hedge against recession risks such as bonds. It's also a good store of value in the event of more stagflationary outcomes and geopolitical events.

> Bonds don't offer the same negative-correlation benefits that they did in the last decade.

Diversification Holds Key to Portfolio Resilience

And that brings us to the importance of portfolio resilience. While the economic backdrop generally looks favorable for returns, we can't gloss over the fact that there are many risks to markets. We're facing disruption on an unprecedented scale and it's taking various forms.

We've already mentioned the potential disruption from tariffs and trade wars. There are also the ongoing conflicts in the Middle East and Ukraine, where the risks of political miscalculations can't be ignored.

The transmission mechanism of geopolitical events to markets is typically through commodities. As an asset class, commodities have been out of favor due to global-growth worries, but they have an important role to play in offering diversification and creating resilient portfolios. Energy is one way to play this, while gold is still the ultimate safe-haven asset.

Private markets can also help provide resilience via exposure to different types of assets that are typically more insulated from geopolitical events than listed equities or bonds. Examples include real estate and infrastructure assets that offer resilient long-term cash flows, as well as assets such as insurance-linked securities, where weather is the key risk factor.

Overall, we think conditions are favorable for good return potential in 2025, but there will likely be challenges to navigate. A diversified approach, looking across regions and asset classes, can contribute to making portfolios more resilient, no matter what the year ahead brings. Keep in mind that diversification does not ensure a profit or protect against a loss in a declining market.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] **S&P 100 Index**, a sub-set of the S&P 500®, measures the performance of large cap companies in the United States. The Index comprises 100 major, blue chip companies across multiple industry groups. Indices are unmanaged and not available for direct investment.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than U.S. 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 such as China. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • U.S. Treasury securities are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. • Investments in the commodities market may increase liquidity risk, volatility, and risk of loss if adverse developments occur. Investments linked to prices of commodities may be considered speculative.

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Navigating Uncertain Policy Shifts

Donald Trump's second administration is expected to bring significant policy changes, with concurrent impacts on inflation, trade, and economic growth.

Insight from sub-adviser, Wellington Management

Juhi Dhawan
Macro Strategist

The decisive victories of President-elect Donald Trump and the Republican Party appear to be a mandate for meaningful change that will influence the US economic outlook in 2025 and beyond. While the GOP's ambitious agenda is expected to increase US inflation, its impact on economic growth should be more mixed, depending on the scale and sequence of policy measures enacted.

The incoming administration expects to reset trade relations with the threat of tariffs, tighten immigration laws and deport undocumented immigrants, broaden industry deregulation, and consider new ideas for increasing US government efficiency. A Republican-controlled Congress will focus on maintaining personal income tax rates passed under the Tax Cuts and Jobs Act (TCJA) of 2017, which are set to expire at the end of 2025, and possibly cutting some corporate taxes further.

All this change implies heightened volatility for US companies, consumers, trading partners, and financial markets. The Federal Reserve (Fed) is already shifting its thinking on monetary policy recalibration, with two negative supply shocks possible in 2025: a constricting labor supply and higher tariffs.

Key Points

- Consumer spending should moderate, with housing affordability remaining a challenge due to high home prices and interest rates.
- Investment spending will likely be positive, with artificial intelligence spending alongside equipment investments boosting growth.
- The US Federal Reserve (Fed), with its dual mandate of full employment and price stability, will maintain a vigilant stance on monetary policy, balancing inflationary pressures from potential labor supply constraints and tariffs.

President Trump Inherits a Solid, Though Uneven, Economic Expansion

The administration's starting point is a relatively good economy that has made tremendous progress on disinflation and established better balance in the labor market. Still, the economic expansion has been uneven, with high costs of living and recently high interest rates weighing on corporate and consumer sentiment. Consumer incomes normalized meaningfully in 2024, as inflation receded and as wage growth and employment gains slowed. While spending on goods remained lackluster, services spending by high-income consumers, seeking experiences such as travel, was a hallmark of the year. 2025 should bring moderate consumer spending and better balance between goods and services spending.

Housing remains a weak spot in the US economy. The 50% gain in home prices since the pandemic, compared with a smaller 25% increase in household incomes, has undermined housing affordability. If mortgage rates remain elevated, it's plausible that the benefits of renting over owning a home may persist a while longer. Compounding the problem are the low turnover of existing homes and the still-insufficient supply of new homes being built. After declining for the better part of two years, this stagnation means that the sector has been recovering in fits and starts and remains hostage to the interest-rate environment.

Investment spending, in aggregate, was tepid in 2024, dragged down by a correction in commercial-property construction along with the broad-based decline in goods spending that has occurred post the COVID boom. Despite overall weakness, however, the Inflation Reduction Act (IRA), CHIPS Act, and artificial intelligence boosted investment spending in certain pockets of the economy. Some measures in the IRA, including spending on electric vehicles (EVs) and renewable energy, as well as part of the CHIPS Act, will be under increased scrutiny as Congress aims to pass a fiscal budget. Still, Washington's focus on US industrial policy suggests that new incentives for domestic manufacturing could be established.

Areas of Focus for the New Administration

Trade: The correction in the goods economy worldwide has slowed global trade appreciably over the last few years. Tariffs are a renewed threat for many US companies with overseas exposure, as well as for those US trading partners whose exports are a substantial contributor to their economies' growth. Some companies may try to increase imports in the near term to circumvent or precede tariffs; however, the generally diversified base of operations for most multinationals should allow for better overall trade management if targeted tariffs emerge.

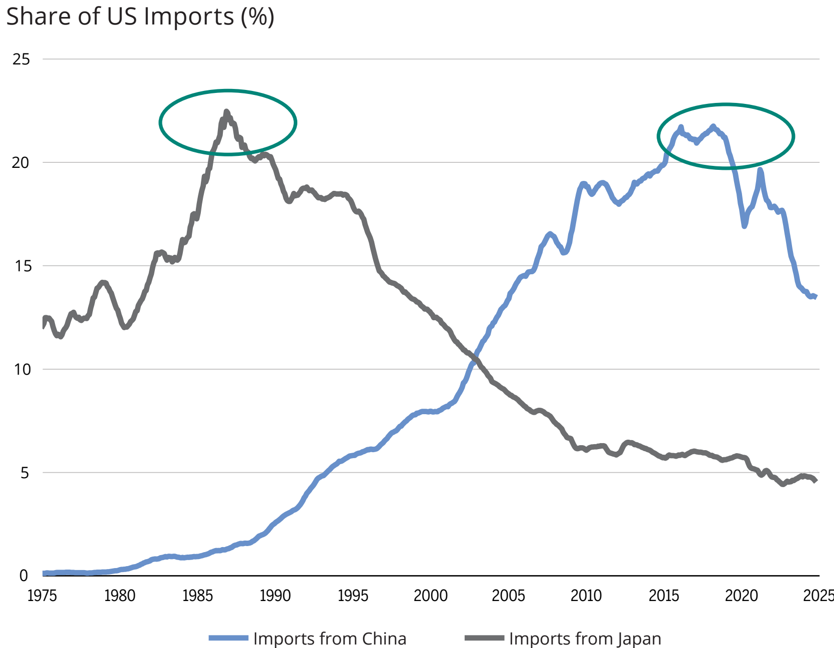
Overshadowing the trade discussion is the ongoing economic decoupling from China, which remains a priority for policymakers, just it was with Japan 40 years ago (**FIGURE 1**). While China is the priority, bilateral trade deficits with Germany and even Mexico (the US's second-largest trading partner) will be on the radar. Broad-based tariffs would likely dampen economic growth and be a major challenge for companies, denting both profitability and margins, especially if countries choose to retaliate against US measures. Trump's overarching theme of protectionism will continue to reverberate in shifting trade dynamics across the global economy.

> Broad-based tariffs would likely dampen economic growth and be a major challenge for companies, denting both profitability and margins.

FIGURE 1

Decoupling From China Is a Policy Focus, Analogous to Japan 40 Years Ago

Share of US Imports (%)



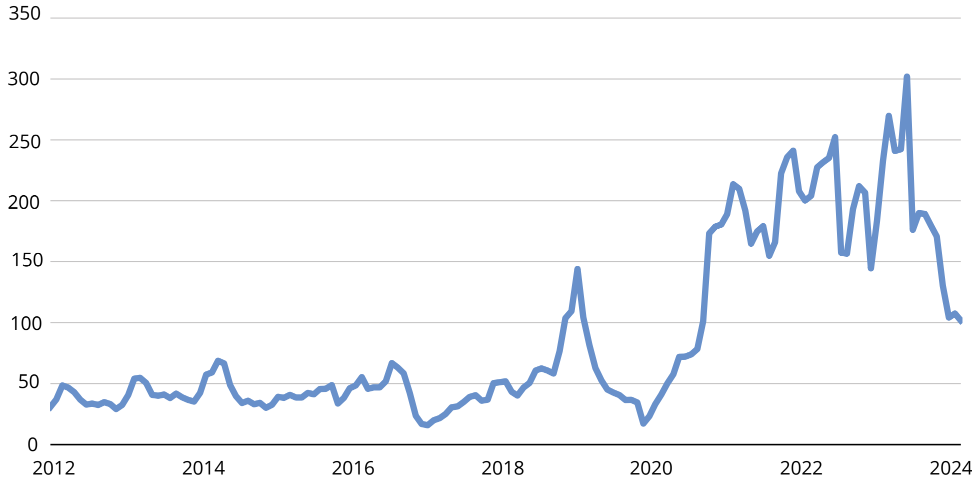
As of 9/30/24. Source: US Census Bureau.

Immigration: Next year, the Fed faces the challenge of understanding what the underlying labor supply looks like. Tougher restrictions at the southwestern US border put in place by the Biden administration in 2024 have resulted in a sharp slowing in the influx of illegal immigrants (**FIGURE 2**). Additionally, more than 11 million undocumented workers already in the US are going to be under scrutiny of the new government (**FIGURE 3**). How effective will deportations be, and at what pace will they occur? Answers to these questions will be critical in determining wage growth—a key input for inflation—especially in industries such as food processing and construction where undocumented immigrant workers account for a substantial share of labor. The theme of relative labor scarcity in the post-COVID economy due to aging demographics bolsters the argument that inflation could reignite under a possible negative labor supply shock, particularly if coupled with higher tariffs.

FIGURE 2

Influx of Illegal Immigrants Has Slowed Sharply ...

US Southwest Border Encounters[1] (Thousands)

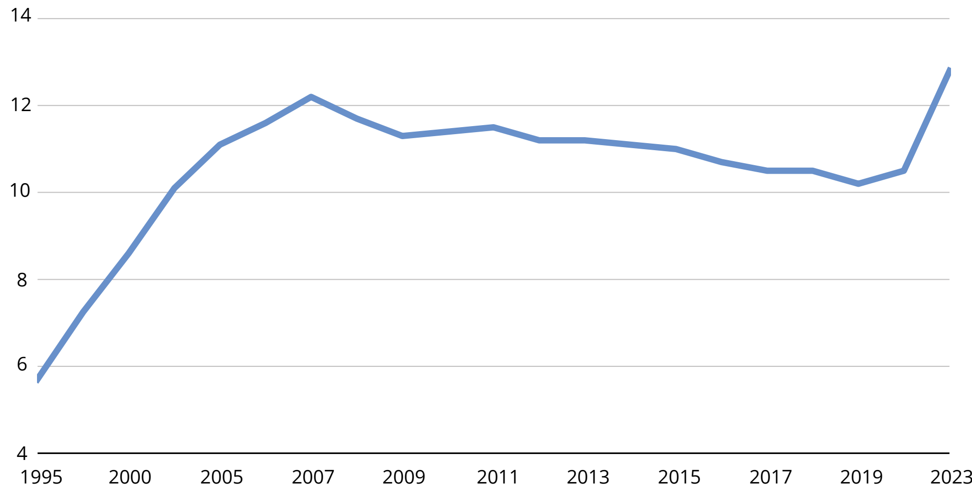


As of 9/30/24. [1]Refers to land border apprehensions, inadmissables, and expulsions. Source: US Customs and Border Protection.

FIGURE 3

... and Millions of Undocumented Workers Face the Risk of Deportation

Number of Undocumented Immigrants (Millions)



Sources: Pew Research Center, 2023 estimate based on Center for Immigration Studies, December 2023 study.

Taxes, spending, and fiscal deficits: One of Washington's first orders of business next year will be to pass the federal debt ceiling to ensure that the government continues to function normally. Congress will then devote itself to the path forward on tax and spending policy. We're watching the potential lifting of the State and Local Tax (SALT) credit as well as the child tax credit, both of which increasingly receive bipartisan support in Congress.

The ultimate size of a US budget package matters a great deal to bond markets, given the high US fiscal deficit and debt level (**FIGURE 4**). Any plan that either limits the extension of tax relief or considers budget offsets, such as slashing Inflation Reduction Act spending, will be important to watch. The potential for further reduction of the tax rate for manufacturing companies, a reinstatement of the research and development (R&D) tax credit, and possible shift in business-interest tax deductibility by using

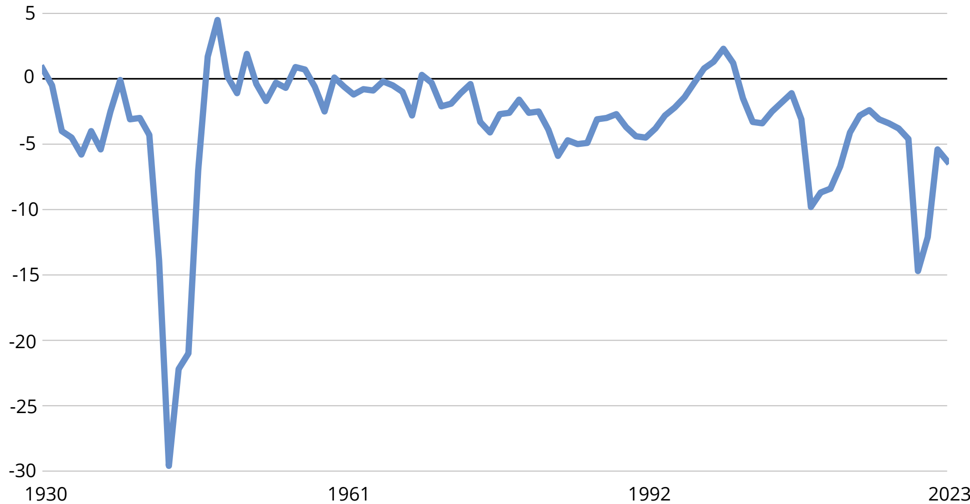
The ultimate size of a US budget package matters a great deal to bond markets, given the high US fiscal deficit and debt level.

EBITDA (earnings before interest, taxes, depreciation, and amortization) rather than EBIT are also on the table. Given the slim congressional majorities for the Republican Party, quick agreement on all elements of the fiscal bill so quickly seems unlikely; rather, the beneficial effects of tax cuts should be apparent in 2026.

FIGURE 4

Markets Will Focus on the Budget Deficit as Tax Policy Is Negotiated

Fiscal Deficit as a Share of GDP by Fiscal Year (%)



Data as of 12/31/23. Source: Office of Management and Budget.

At the state and local level, government spending has been especially strong over the past couple of years. Officials spent down some excess savings that had accrued via federal grants, even as local revenues flatlined. While states' nest eggs have stayed ample, budget plans suggest a marked slowdown in 2025 spending—closer to the recent flatlining revenue projections. This deceleration should translate into weaker job gains in most states as well.

While the proposed Department of Government Efficiency may recommend radical federal budget cuts, it's unclear how quickly those could be implemented.

Deregulation and cost cutting: Finally, while the proposed Department of Government Efficiency may recommend radical federal budget cuts, it's unclear how quickly those could be implemented, given the hurdle of legislative approval needed to execute some plans. In the meantime, the administration's deregulatory drive could ease onerous bank capital requirements, lessen the burden of Environmental Protection Agency (EPA) restrictions, and lower the cost of doing business for companies across the economy.

Keeping an Eye on Inflation and the Fed

Inflation: A long-drawn battle plan against inflation finally gained ground in 2024 as both the rate and breadth of inflation approached historically normal levels. Much of the improvement came on the more volatile goods side, with sticky services-price inflation lingering somewhat above normal throughout the year. Structural factors, such as elevated homeowners' insurance rates based on climate shifts, are reminders that policymakers and investors should remain vigilant on inflation. The slow deceleration in shelter inflation, given long lags in lease adjustments across the economy, means that it should still help into 2025.

Federal Reserve: The low unemployment rate and sticky inflation suggest that the Fed will remain vigilant and keep monetary policy moderately restrictive, adjusting upward its previous guidance on the ultimate resting point of short-term interest rates. The degree and duration of the Fed's patience will partly depend on the government's approach to tariffs, immigration, and fiscal prudence, as the central bank will seek to counterbalance the inflationary impact of negative supply shocks.

Next year is also likely to bring new guidance from the Fed on the end of quantitative tightening and reinvestment plans for maturing securities. Specifically, the central bank may choose to limit its investments to shorter-term Treasuries, gradually relieving the downward pressure of outstanding stock of Treasury holdings on longer-term interest rates. All told, medium-term upward pressure on longer-term interest rates seems likely.

Closing Thoughts

The breadth of change proposed by the President-elect suggests that 2025 could be a choppy year, as businesses, consumers, and the central bank calibrate expectations about the new direction in Washington, DC. Financial markets have had an exceptionally strong 2024. Given current high valuations for US equities, there's little room for disappointment, and markets could face a more difficult path should policy uncertainty linger. Investors may need to exercise patience next year in order to find potential relative winners in both the US and global markets. The Fed and Congress will both play key roles in determining the level of bond yields, with higher yields posing a potential risk to future growth prospects for the US economy and return potential of the US equity market.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

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Trump's Win Creates a Period of Uncertainty for Emerging Markets

Valuations in many markets are broadly cheap, and since a great deal of uncertainty is already priced in, there may be opportunities to consider adding to exposures in the coming months.

Insight from sub-adviser Schroders Investment Management

Tom Wilson
Head of Emerging Market Equities

The outlook for emerging-market (EM) equities is colored by uncertainty relating to the impact of a Trump administration. Valuations, excluding India and Taiwan, are broadly cheap, but markets are facing a period of uncertainty. Key drivers include tariff risk, a strong US dollar, a higher US yield curve (higher US bond yields), Chinese policy action, India, and technology trends.

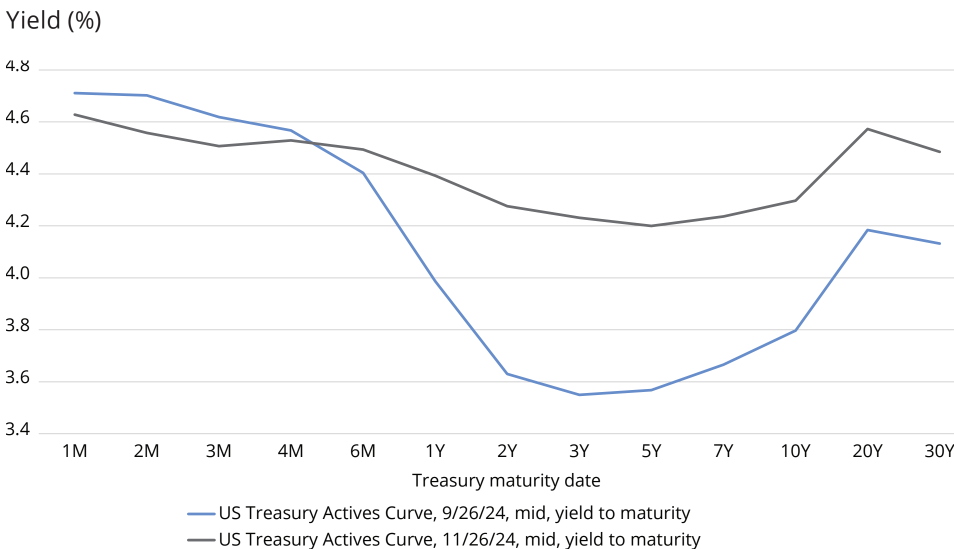
President-elect Trump's proposed policies are expected to put upward pressure on US inflation, which would lift the US yield curve and support the US dollar. This would tighten financial conditions in EM and acts as a headwind to market performance.

However, we've already seen a significant move in the US dollar, which is pressuring EM currencies, many of which screen as cheap. Meanwhile, US bond yields and rate expectations have also adjusted markedly, and EM real interest rates (adjusted for inflation) are elevated.

Key Points

- The outlook for emerging-market equities is uncertain due to potential tariff risks, a strong US dollar, and higher US bond yields.
- China has visibly made a more coordinated attempt at policy support, but the follow through on fiscal policy has disappointed markets so far.
- India's market is richly valued, but recent slower nominal growth and tighter fiscal and monetary conditions may present investment opportunities.

FIGURE 1
US Yield Curve Has Moved Higher in Response to Trump's Proposed Policies
Yield (%)



As of 11/26/24. Past performance does not guarantee future results. 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. Sources: Bloomberg, Schroders.

Trump also brings tariff risk, both in relation to broad-based tariff application (on all imports into the US) and a significant increase in tariffs specific to China (an increase to 60% was raised in campaign rhetoric). If tariffs are implemented rapidly and in line with campaign rhetoric, part of the impact would be absorbed via EM currency depreciation, but there would likely be a substantial impact on US inflation. This would disproportionately affect lower income households, a key element of Trump's support base. Consequently, we'd expect a more nuanced approach to tariff application than suggested by campaign rhetoric.

In relation to China specifically, Trump's cabinet appointments look to be broadly politically hawkish toward the country. So we'd expect asymmetric tariffs to be applied. Depending on scale, this could impact China's trade volumes and may lead to a significant renminbi (China's currency) devaluation, though it may also drive an acceleration in Chinese stimulus to defend growth.

A significant renminbi devaluation may pressure competing EM currencies, although on a medium-term basis, competing EM manufacturing economies may benefit from ongoing supply-chain diversification away from China.

Finally, as far as Trump's impact on geopolitics, there are both potential risks and opportunities. As noted, Trump's team looks hawkish on China, and a decoupling process is expected to continue, which may not always be smooth. In Ukraine, if a peace deal is accompanied by sufficiently strong security guarantees, this and significant reconstruction spend could benefit emerging European economies and risk premia.[1]

China's Economy and Market May Remain Sensitive to Policy Announcements

In China, there was a visible move toward more coordinated and determined policy support in September. However, monetary policy settings remain tight, and the follow through on fiscal policy has disappointed markets. The trade cycle is expected to soften through 2025, and China now faces tariff risk from a Trump administration. However, the domestic economy is at a low base, and there are some signs of stabilization in real-estate markets in the largest "tier 1" cities, the most developed cities in the country.

We believe there's now a stronger policy backstop to China's economy and market. Policy announcements can drive the market, and positioning remains relatively supportive (foreign investors remain underweight the market, and domestic cash balances are high).

As far as Trump's impact on geopolitics, there are both potential risks and opportunities.

There May Be an Opportunity to Consider Adding to India in Coming Months

In India, the market is richly valued vs. history, profit margins and earnings expectations are elevated, and escalating equity supply has increasingly offset strong domestic fund flows. Most recently, nominal growth (i.e. growth unadjusted for inflation) has slowed, led by tighter fiscal and monetary conditions, and the market has softened as earnings expectations are challenged. This may present an opportunity.

The rainy season was good in 2024, which typically leads to an improvement in rural incomes, while there is some scope for monetary easing. India is also geopolitically neutral, less exposed to tariffs vs. other EM, and has an interesting structural growth opportunity.

Finally, foreign investors have low allocations to the market. We'll be monitoring the market in the coming months, looking for a sufficient reset in valuations and earnings expectations to lift our exposure.

Will the Technology Cycle Continue Into 2025?

We've been moving through the technology cycle, led by AI. The valuations of technology companies are higher, and there's uncertainty regarding the sustainability of AI-related capital expenditure, given the lag on monetization.

We see momentum sustaining in the near term given the potential in the technology and the reluctance of any "hyperscaler" (the big US providers of AI infrastructure) to lag its peers.

Other areas of the technology sector remain soft and in an extended downcycle. Here, we may see an improvement off a low base in the sector through 2025, supported in certain cases by improving product cycles.

Valuations Are Broadly Supportive, But Uncertainty Reigns in the Near Term

In the near term, there are three key areas of uncertainty: the impact of a Trump administration, AI momentum, and Chinese policy support. But valuations in many markets are broadly cheap, as are EM currencies. Much is priced in, and a stressed or uncertain environment may provide opportunities to consider adding to exposures in the coming months.

Talk to your financial professional about the opportunity in emerging-market equities.

[1] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

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Small Caps Can Be an Inexpensive Way to Gain Exposure to the US Economy

Multiple favorable trends may explain why Wall Street expects to see the strongest earnings gains come from small caps in 2025.

Insight from sub-adviser Schroders Investment Management

Bob Kaynor, CFA
Head of US Small & Midcap Equities

The US economy emerged from the pandemic with greater strength than most other economies around the globe. That rebound was fueled, in part, by the fiscal stimulus the Biden administration promoted with two major pieces of legislation—the CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act and the Inflation Reduction Act. The US consumer, however, has once again demonstrated a propensity to drive the economy. With a strong labor market and likely policies from the upcoming Trump administration that may support domestic growth, indications suggest investing in the US economy could remain beneficial. However, US equities are expensive, and investors could assume the market has already priced in this growth. The latter point may be true of large-cap US equities, but not most other US companies.

We remain confident that US exceptionalism will continue to reign in 2025, and, for investors, we believe US small- and mid-cap stocks could offer a relatively inexpensive way to participate in the US economy.

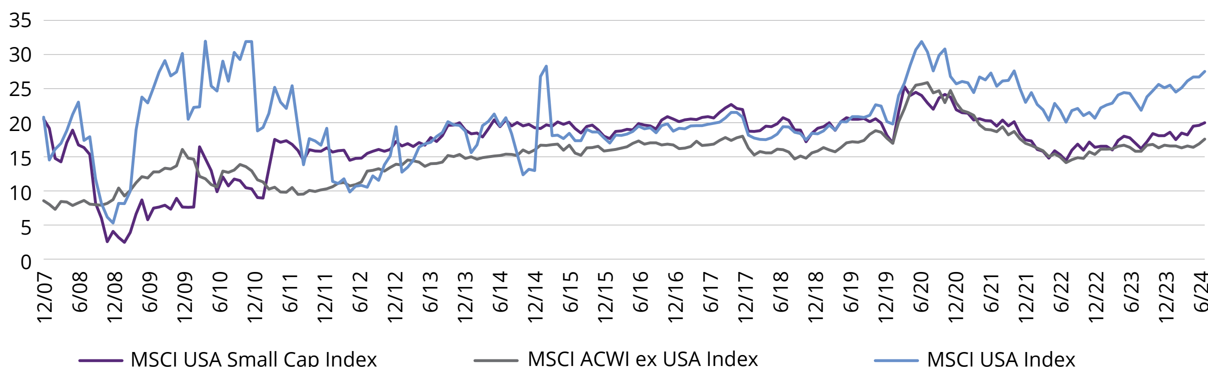
Key Points

- Small- and mid-cap stocks may continue to benefit from strong consumer spending and supportive fiscal policies.
- Key trends such as a rebound in mergers and acquisition activity, favorable inflation rates, and increased capital expenditures may create a favorable environment.
- Wall Street forecasts a significant rebound in small-cap earnings starting in the final quarter of 2024, driven by stabilizing interest rates and improving economic conditions.

An Inexpensive Way to Gain Exposure to US Economic Strength

Many US large-cap companies compete on the global stage, and their revenues are, therefore, more dependent on the global economy. Small- and mid-cap companies are more likely to have customer bases that are either exclusively or predominantly in the US. For that reason, small- and mid-cap stocks can provide investors with more direct exposure to the US economy. Given how expensive large caps are today, small- and mid-cap stocks can also provide a less expensive way to gain that exposure. As **FIGURE 1** shows, the price differential between small and large caps demonstrates that gaining or increasing exposure to the strong US economy doesn't have to come with a hefty price tag.

FIGURE 1
Small and Mid Caps Remain Cheap Relative to Large Caps
Price-to-Earnings



As of 8/31/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock. See page 26 for index definitions. Data Sources: Schroders and FactSet.

Key Trends Could Benefit Small- and Mid-Cap Stocks

It's true that small- and mid-cap valuations have been at a discount to large caps for several years. So, what's changing as we head into 2025? Beyond the ongoing strength of the US economy and the pricing considerations, a number of key trends could also work together to create a highly favorable environment for small- and mid-cap stocks.

1. The recovery in M&A activity and IPOs could continue in 2025.

In 2022 and 2023, concerns about a recession, high company valuations, and soaring inflation significantly slowed mergers and acquisitions (M&A) activity and initial public offerings (IPOs). Globally, 2023 was the second-worst year for M&As in a decade.[1] A strong comeback, fostered by less expensive valuations, began in 2024. M&A activity in North America through the first three quarters of 2024, for example, almost surpassed the deal value for all of 2023, and it's on pace to stage a 30% rebound for the year.[2] Stabilizing interest rates and improving economic conditions could fuel an even stronger rebound for M&As and IPOs in 2025.

The pickup in M&A activity and IPOs benefits small-cap stocks in multiple ways. Attractive small caps often become acquisition targets, and high-quality companies garnering headlines as they go public increases interest in the small-cap space. Overall, the pick-up in animal spirits demonstrated by greater M&A activity and IPOs delivers the optimism that increases risk appetites, and the confidence investors may need to pursue the potentially stronger growth small caps may deliver.

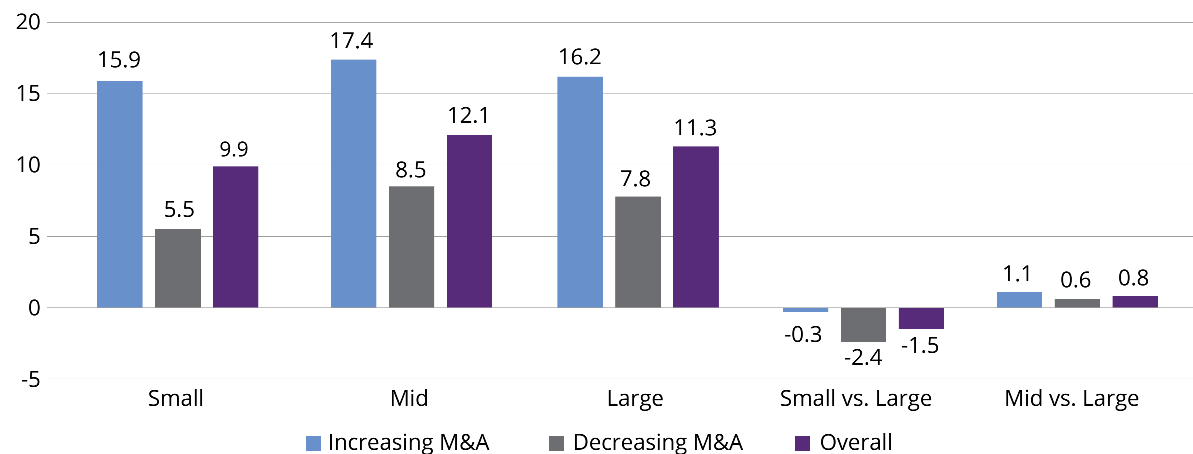
While a rise in IPOs increases the number of small-cap companies, active managers still must be selective. With newly public companies, in particular, careful consideration is required by those managers who participate in IPOs. While IPOs are renowned for historically delivering initial outperformance, selectivity is still needed to find the companies that can deliver on that promise.

History demonstrates that periods of increasing M&A activity have delivered strong performance for stocks across the capitalization spectrum (**FIGURE 2**). The gains registered by small caps during these periods have been on pace with the returns generated by large caps, and mid caps have outpaced both.

> “Stabilizing interest rates and improving economic conditions could fuel an even stronger rebound for M&As and IPOs in 2025.

FIGURE 2

Periods of Rising M&A Activity Have Historically Delivered Strong Equity Returns



Past performance does not guarantee future results. Investors cannot directly invest in indices. Small caps are represented by the Russell 2000 Index. Mid caps are represented by the Russell Midcap Index. Large caps are represented by the Russell 1000 Index. See page 26 for index definitions. Data Source: Schroders.

2. **Inflation is now in a range that has been favorable for small caps.**
While small caps have historically outperformed their large-cap brethren in periods when annual inflation has exceeded 1%, the higher interest rates that come when central banks try to reduce high inflation can be challenging for small companies. Much of their debt is financed with shorter-term and floating-rate instruments.[3] As a result, financing became much more expensive for the small caps when the Federal Reserve (Fed) began hiking rates in early 2022.

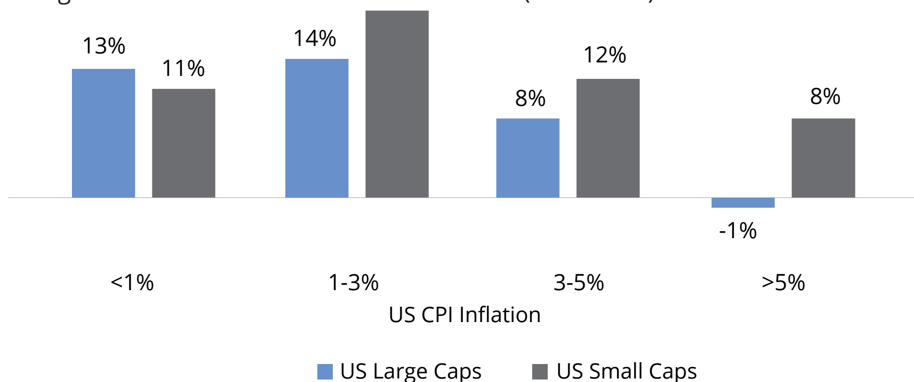
With the declining rate environment that began in the fall of 2024 and is expected to continue through 2025, conditions may now be more favorable. The small-cap companies' debt may become less expensive. Further, the macroeconomic conditions that enabled the Fed to reduce rates—slowing inflation and below-trend growth—have historically been a climate in which small caps can outperform other asset classes, including large-cap stocks, bonds and commodities. With a century of history as evidence, the range that inflation seems to have now settled into (1% to 3%) is one that has historically enabled small caps to deliver exceptional returns (**FIGURE 3**).

> With the declining rate environment that is expected to continue through 2025, conditions may now be more favorable for small caps.

FIGURE 3

Average Small-Cap Returns Have Been Particularly Strong When Inflation Has Been 1%-3%

Average 12-Month Return in Excess of Inflation (1926-2023)



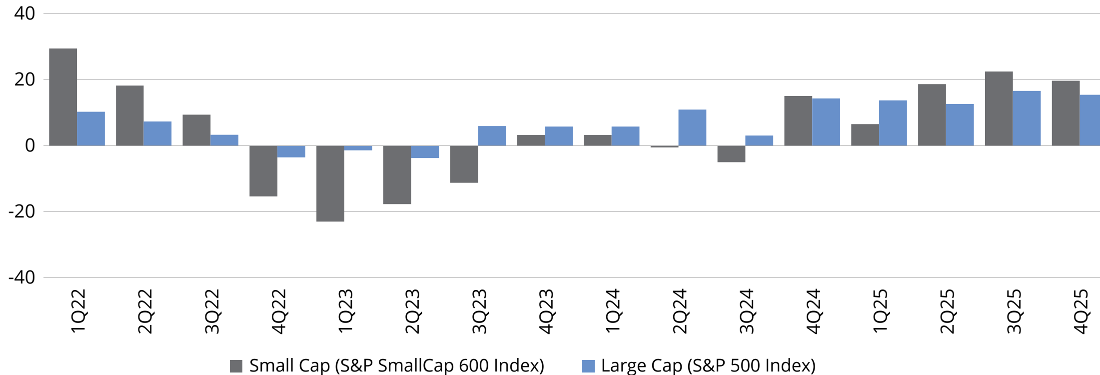
As of 12/31/23. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. Based on rolling 12-month periods. The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics. US large caps is represented by Ibbotson SBBI US Large-Cap Stocks Index, which tracks the performance of large-cap stocks in the US market. US small caps is represented by Ibbotson SBBI US Small-Cap Stocks Index, which tracks the performance of small-cap stocks in the US market.
Data Sources: Schroders.

3. **Wall Street is forecasting a bigger rebound in small-cap earnings, starting in Q4 2024 and through much of 2025.**
The developments that made 2023 such a difficult year for small caps (i.e., rate hikes and the ripple effects of the collapse of Silicon Valley Bank) may now be in the rearview mirror. The favorable conditions noted here may explain why a consensus of Wall Street analysts believe that in the fourth quarter of 2024 and for every quarter of 2025 except the first, the rebound in earnings for small caps will exceed the bounce experienced by large caps (**FIGURE 4**).

FIGURE 4

Wall Street Forecasts a Bigger Increase in Earnings for Small Caps

Year-Over-Year Earnings-Per-Share Growth Estimates



FactSet research through 12/31/24; custom earnings-per-share from Q1 2024 forward. Earnings-per-share growth is the projected growth rate in earnings per share for the next five years. See page 26 for index definitions. For illustrative purposes only. Data Sources: FactSet and Schroders.

4. **While the megacap tech stocks have been dominating the AI headlines, we believe many small-cap companies could help propel the AI revolution.**
   Artificial intelligence (AI) needs much more than the sophisticated chips provided by companies like NVIDIA. For example, thermal management solutions are critical to manage the extreme heat generated by those AI chips. Optical communications will provide the high bandwidth, low latency, and large data capabilities that are necessary to support the massive data-processing demands of AI applications. Data storage and management, software development, and cybersecurity are all equally critical. Small-cap companies are often key, and even leading, players in these industries that will both shape and benefit from the growth that the AI revolution generates.

5. **The continued growth of the service sector helps small and mid caps, which operate predominately in this space.**
   While US manufacturing has experienced a rebirth in recent years, helped by federal legislation, the US is primarily a service-oriented economy. In the second-quarter of 2024, private services-producing industries represented 72% of the US GDP.[4] The decades-long shift that started to take a dramatic turn in 1977—when services still accounted for only 54.7% of US GDP—continues to reshape the US economy.[5] While large-cap companies dominate the manufacturing and consumer goods sectors, small-cap companies are often key players in service sectors, so they are among the beneficiaries of this shift.

6. **Reshoring enables more small- and mid-cap companies to step in as reliable suppliers.**
   COVID-19 and the lockdowns at Chinese manufacturers and other suppliers led many companies to reconsider their supply chains. The move to onshoring benefits many small US companies that are replacing global competitors as the suppliers to large US firms.

7. **Small- and mid-cap companies may be prime beneficiaries of the increases in capital expenditures.**
   Capital expenditures (capex) have been increasing for a number of reasons, including the shift to automation, as companies look to lower costs and stay competitive, and the financial support the government is providing key sectors like the semiconductor industry and renewable energy sector through the CHIPS Act and the Inflation Reduction Act. Historically, capex has been highly correlated with small caps' revenue, and the increases may portend growth.

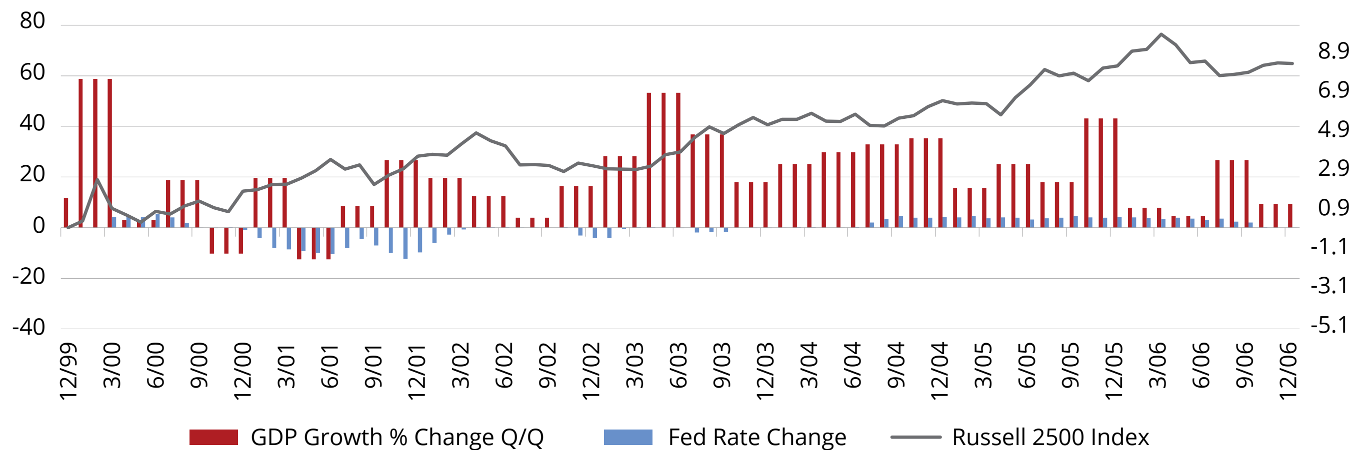
Small-cap companies are often key, and even leading, players in these industries that will both shape and benefit from the growth that the AI revolution generates.

The Market Does Rotate Eventually

Large caps have been on such an extended run since the end of the Global Financial Crisis that it can be easy to forget that the market does rotate. Small caps registered their own run of outperformance from 2000 to 2006, a period that demonstrated their ability to deliver exceptional returns through changing GDP conditions and federal funds regimes, as **FIGURE 5** illustrates. It's a worthwhile reminder that an extended run of outperformance has never represented a permanent change of conditions.

FIGURE 5

Small Caps Have Demonstrated Their Ability to Outperform in a Variety of Growth and Rate Regimes (1999-2006)



Past performance does not guarantee future results. Russell 2500 Index is used to represent small- and mid-cap stocks, and represents total return relative to the S&P 500 Index. See page 26 for index definitions. Indices are unmanaged and not available for direct investment. Data Sources: Schroders.

Favorable Conditions for Small Caps Amid Signs That the Market Is Already Broadening

The large vs. small caps debate that has played out recently has been complicated by the fact that it was really just the Magnificent Seven[6] stocks propelling the market to greater heights in the aftermath of the pandemic. Signs that the market was broadening beyond the Magnificent Seven appeared in 2024. That broadening benefits not only the other constituents of the S&P 500 Index, but also small- and mid-cap stocks. Without the benefits of a crystal ball that might reveal when the inevitable market rotation from large- to small-cap stocks might begin, there are still plenty of signs that suggest small- and mid-cap stocks may warrant investors to consider a reasonable allocation in investors' portfolios in 2025 and beyond.

To learn more about opportunities in small and mid caps, talk to your financial professional.

MSCI ACWI ex USA Index is a broad-based, unmanaged, market capitalization weighted, total return index that measures the performance of both developed and emerging stock markets, excluding the U.S. MSCI index performance is shown net of dividend withholding tax.

MSCI USA Index is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid-cap segments of the US market.

MSCI USA Small Cap Index is designed to measure the performance of the small-cap segment of the US equity market.

Russell 1000 Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

Russell 2000 Index measures the performance of the small-cap segment of the US equity universe.

Russell 2500 Index measures the performance of the small to mid-cap segment of the US equity universe, commonly referred to as "smid" cap.

Russell MidCap Index measures the performance of the mid-cap segment of the US equity universe.

S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

S&P 600 Index is a market capitalization-weighted price index that tracks the performance of small-cap stocks in the US. It includes companies with market capitalizations ranging from approximately $850 million to $3.7 billion.

[1] PitchBook, "2023 Annual Global M&A Report," 1/23/24.

[2] PitchBook, "Q3 2024 Global M&A Report," 10/23/24.

[3] A floating rate instrument is a debt instrument that has a variable interest rate that is based on a benchmark rate

[4] Federal Reserve Bank of St. Louis, reporting data from the US Bureau of Economic Analysis, "Value added by Industry: Private Services-Producing Industries as a Percentage of GDP," 9/26/24.

[5] Bureau of Economic Analysis, Gross Domestic Product by Industry for 1947-1986: New Estimates Based on the North American Industry Classification System," December 2005.

[6] The Magnificent Seven stocks are a group of high-performing and influential companies in the US stock market: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

Important Risks: Investing involves risk, including the possible loss of principal. • Small- and mid-cap securities can have greater risks and volatility than large-cap securities.

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Go Your Own Way: Capitalizing on Bond Divergence

We identify key fixed-income themes to watch in 2025, with an emphasis on how active investors can make the most of greater dispersion.

Insight from sub-adviser, Wellington Management

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

Marco Giordano
Investment Director

Will Prentis
Investment Specialist

Since the inflation shock first started rattling interest-rate markets around the start of 2022, we've focused on trying to understand the drivers of inflation and the policy reactions to this price phenomenon. Our expectation going into 2024 was that disinflation would dominate market narratives, paving the way for rate cuts across the globe. While we were proven right in that regard, with policy easing in most parts of the world, we believe caution is now warranted in the face of changing policies and the potential for volatile markets.

We believe this caution sets the tone for 2025, where the income earned from government bonds can help offset potential rate volatility for investors. The starting point of nominally high global growth should cushion against the impact of a potential global economic slowdown. At this stage, we don't anticipate a recession and the associated rise in downgrades and defaults. We also believe that current high yields adequately compensate investors for the heightened volatility. The notable exception to this view is the back end of the yield curve,[1] where long-dated bonds face challenges due to supply dynamics, inflation expectations, and higher nominal growth.

As geopolitical tensions heighten a sense of uncertainty in markets, policymakers' reaction functions will be tested—and our belief is that governments will continue, and indeed be forced, to respond to exogenous shocks by loosening the purse strings. In the wake of the US election, with Germany heading to the polls in early 2025 and China looking to revive its struggling economy, we can't clearly see where policies (and tariffs) are headed. However, thematically, we expect higher barriers to trade, via tariffs, and increased fiscal spending, particularly in relation to European defense. While we expect rates to be range-bound, there's a risk to the upside, as global markets become increasingly tense and react to local dynamics.

Key Points

- Expect greater interest-rate volatility and divergence ahead.
- Sectors such as European autos, materials, and consumer cyclicals are likely to bear the brunt of future US tariffs and the likely ensuing slowdown in Europe.
- The reemergence of animal spirits may reward investors able to identify winners and losers through careful research.

Testing Central Banks' Reaction Functions

The return of the growth/inflation trade-off globally has not only been an important stress test for market participants, who have had to navigate significant exogenous shocks over the last year, but it's also offered us some evidence about policymakers' reaction functions. What we've learned is that governments are eager to protect consumers from upticks in unemployment, while central banks are keen to bring policy rates back down from their current "tight" levels, even if the combination of these actions means stickier inflation.

The New Fiscal Normal: Spend, Spend, Spend

Trump's reelection will likely accelerate underlying trends around weaker labor supply and a deteriorating fiscal backdrop. While the US Federal Reserve (Fed) may slow its cutting cycle sooner than expected, we anticipate volatility in how markets price the pace of future cuts, meaning high yields in government bonds are likely here to stay, and may move even higher for long-dated bonds. Globally, we expect governments to continue tapping into bond markets for an ever-increasing laundry list of fiscal commitments, ranging from higher defense

spending to capital investments and improving climate resilience. The first 20 years of this century were dominated by secular trends that proved to be disinflationary and are now being (partially) reversed through deglobalization and aging demographics.

- *In the US*, the start of the second Trump administration should give us greater clarity on how much of his proposed policy mix of tariffs, taxes, and curbing immigration will be delivered. In the meantime, we're watching the appointments list in key areas such as the National Economic Council (NEC), the Treasury Department, the Commerce Department, and the Office of the US Trade Representative. While the Fed will likely continue cutting rates, as the US has perhaps made the most headway in tackling inflation, there's a real risk that reflationary policies will slow progress, necessitating rates staying higher for longer.
- *In the euro area*, after a brief period of remarkable unity and urgency around the twin challenges of the COVID-19 pandemic and the energy shock, we expect the policy response to immediate exogenous shocks (such as tariffs) to return to a familiar pattern of lengthy decision-making and compromises. With the reintroduction of the European Commission's fiscal rules, we expect there to be limited scope for euro-area and other European Union (EU) countries to meaningfully counter incoming tariffs with significant government spending or a cohesive response across the currency bloc. This comes at a time of perceived fragility for some of the larger countries in the EU. Contrary to the US, we see downward pressure on European yields, where the European Central Bank may need to intervene and cut rates at a faster pace than markets are pricing in.
- *In the UK*, persistent inflation and an expansionary budget deficit have already caused markets to reduce rate-cut expectations. Should the cycle continue to demonstrate resilience through a strong labor market, sticky core inflation, and renewed housing activity, there's a real risk that UK government bonds (or gilts) could de-anchor and move higher than their European peers.
- *In Japan*, we expect front-end yields to climb steadily toward the Bank of Japan's target of 1% by the summer, as deflation risks have now firmly given way to a reflation story driven by positive wage growth, imported inflation, and changes in consumer behavior.
- *In China*, a market that's continued to diverge from the rest of the world, policymakers haven't yet decisively addressed a significant balance-sheet recession, so we expect rates to remain low. The focus, thus far, has been on deleveraging local-government balance sheets, making housing less of a speculative asset, and focusing on growth driven by exports. China could be a potentially global deflationary force.

> While the Federal Reserve may slow its cutting cycle sooner than expected, we anticipate volatility in how markets price the pace of future cuts.

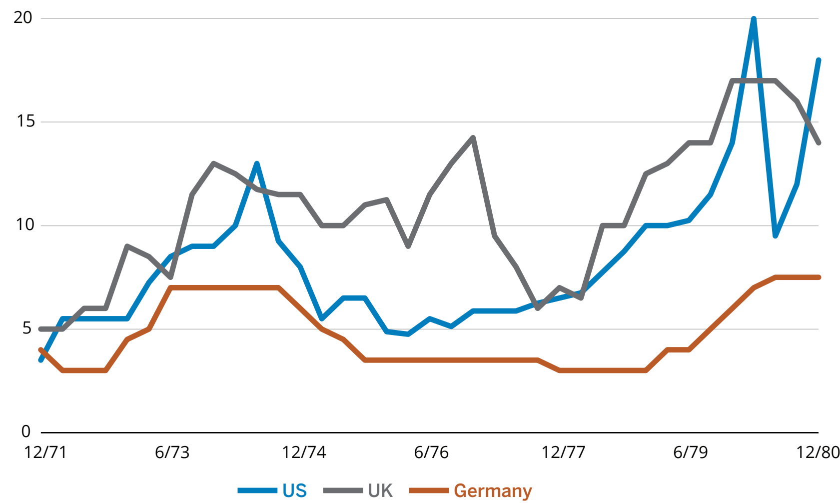
Divergence: Implications for Investors

Amid increased volatility, the theme of divergence could become entrenched in policymaking too. While this hasn't been the case for decades, there's a precedent (the 1970s) for extended periods of time when central banks didn't set rates in sync with one another (**FIGURE 1**). As the growth/inflation trade-off acquires increasingly local dimensions, rate markets may become increasingly sensitive to national cycles rather than the global cycle. We don't think investors have yet priced this in.

FIGURE 1

A Lesson from the Past: Policy Convergence Is Not a Given

Central Bank Policy Rates (1972-1980) (%)



Source: Bloomberg Finance L.P.

Investment-grade corporate earnings growth remains stable, labor markets are still tight, and consumers continue to show signs of strength.

An Extended Cycle—What Next?

In our view, the current environment also remains supportive from a credit-investor perspective. Companies and consumers have proven resilient to higher interest rates, driven by a private sector that's been reducing leverage since the Global Financial Crisis. Investment-grade corporate earnings growth remains stable, labor markets are still tight, and consumers continue to show signs of strength. Although we consider corporate-bond valuations relatively elevated on a spread[2] basis, they remain attractive from a yield perspective. Historically attractive yields have enticed a resurgence of yield-motivated buyers to the market, providing strong technical support for the asset class. Taken in aggregate, we're constructive on the cycle and see benefits for credit investors in an environment in which we expect rates to remain range-bound. Looking ahead, we see value in a nimble approach and have identified three potential areas of opportunity for investment-grade investors in 2025.

1. **Elevated interest-rate volatility**
   As highlighted above, expect greater interest-rate volatility and divergence ahead. In our view, the rate of change in government bond yields is likely to be a key driver in risk-asset valuations. Investors who are able to dynamically adjust the credit exposure of their portfolios over the cycle should be well-positioned to weather volatility and take advantage of the potential opportunities that sudden market adjustments tend to create.

2. **Divergence across developed markets**
   Given likely continued divergence in growth and inflation across developed markets, we think credit investors should be selective about where they take risk. For instance, sectors such as European autos, materials, and consumer cyclicals are likely to bear the brunt of the tariffs that the Trump administration may impose and the likely ensuing slowdown in Europe. On the other hand, the US may benefit from increased fiscal easing, domestic demand, and deregulation, which could continue to support US corporate fundamentals. We see this divergence as a meaningful opportunity for those investors who can combine local macro expertise with deep, bottom-up, fundamental sector and issuer research.

3. **The return of animal spirits**
   Years of extreme accommodative monetary policy suppressed volatility and dispersion among credit sectors and individual credit issuers. Dispersion is returning and is likely to increase as global growth steadies and companies become more willing to explore avenues for expansion beyond organic growth, including debt-financed mergers and acquisitions. This will likely lead to increased issuance, credit-rating changes, and, as a result, higher credit-spread volatility. The reemergence of animal spirits may reward investors for identifying winners and losers through careful bottom-up research.

Overall Focus on Resilience and Security Selection

We believe that the current credit cycle remains robust, supported by strong fundamentals, technicals, and attractive all-in yields. As a result, we think investors can benefit from a pro-credit tilt while exploiting potentially compelling bottom-up sector and security-selection opportunities. However, we recognize the potential for bouts of credit-spread volatility. We believe this warrants a focus on resilience and ensuring that exposures to more cyclical sectors continue to offer adequate compensation. We anticipate that credit-spread volatility may present further opportunities in 2025 to rotate portfolio exposures and add risk at attractive valuations. Against this backdrop, we believe a dynamic, research-driven approach to credit management remains key.

Talk to your financial professional to learn more about fixed-income opportunities.

[1] 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.

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

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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For implementation ideas based on these outlooks, please talk to your financial professional.

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