

Fork in the Road: Slowdown or Reacceleration Ahead?

Markets seem to expect a much smoother ride in 2024, but they may be too optimistic.

Key Points

- We raised our view on global equities to neutral. The global economy remains resilient, inflation is falling, and monetary tightening is effectively done. Yet markets are pricing in little risk that growth could disappoint and reignite recession fears, or reaccelerate and put upward pressure on inflation.
- Japan remains our top developed-equity market, as we believe the economy is uniquely positioned for higher inflation and potential profitability. We maintain our neutral view on China due to poor visibility on a property recovery, yet sentiment is already very negative.
- We maintain a neutral duration¹ stance in government bonds. Central banks are warming up to looser policy, but market expectations for rate cuts seem overdone. Japan's real yields stand out as most vulnerable to an adjustment in monetary policy. Spreads² offer little cushion for a rise in defaults, so we maintain our slightly underweight view.
- We believe structural dynamics could keep inflation higher and more volatile than in the post-Great Financial Crisis period. Thus, we remain positive on commodities. While oil prices have declined in response to softer growth expectations, we see upside based on supply/demand fundamentals.
- Downside risks to our views include a deep recession or higher-than-expected inflation and geopolitical risks. Upside risks include a better-than-consensus growth scenario in which the Federal Reserve (Fed) meets market expectations for a rate-cutting cycle amid continued disinflation.

"The recession that wasn't" may be the best way to describe 2023 and the year's strong market performance. The Fed's 550 basis point³ (bps) tightening cycle did wreak havoc in parts of the market, most notably among US regional banks, but strong consumption and artificial-intelligence excitement were underappreciated offsets. While this outcome was a relief, the market dominance of the "Magnificent Seven" stocks left many allocators disappointed with their portfolio results.

Now, the market has set high expectations for rate cuts, exceeding the Fed's projections. We agree that the growth/inflation outlook has improved, and there's better balance in the economy (**FIGURE 1**). But risk assets⁴ have already experienced sharp rallies, and equity volatility has plumbed pre-pandemic lows, which leads us to ask: Has a more benign interest-rate environment already been priced in?

At this juncture, we see several possible scenarios with vastly different investment implications. In one scenario, the lagged effect of higher rates hurts the economy and recession fears reignite. In another, the economy reaccelerates and drives inflation higher, preventing the rate cuts the market expects.

We aren't sure which way the economy and markets will break, but we're skeptical about the smooth ride markets expect in 2024 and have a neutral view on global equities and rates, while focusing more on relative value within asset classes. That said, this is an increase in risk relative to 2023, when we favored global rates over equities.

Insight from sub-adviser Wellington Management



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In credit, we maintain a slight underweight view, as we find spreads tight relative to fundamentals, which we think are deteriorating. Even though bond yields are 100 bps lower since mid-October, this does little to offset the risk for high-yield issuers facing much higher refinancing rates relative to their outstanding coupons. We favor quality in investment-grade corporates.

Our relative-value calls are expressed in regions. Within rates, we favor the US and Europe over Japan, driven by our expectation that the Bank of Japan (BOJ) will pull the trigger on rate hikes sometime this year. Within equities, we maintain our high-conviction view that Japan has more upside than the US and Europe.

Finally, we have stronger conviction in our overweight view on commodities based on our outlook for oil. We see the decline in oil prices as a good entry point to express our view that supply constraints are underappreciated by the markets.

FIGURE 1
Does Better Balance in the Economy Suggest a Sweet Spot for Risk Assets?
Developed Market Purchasing Managers Index

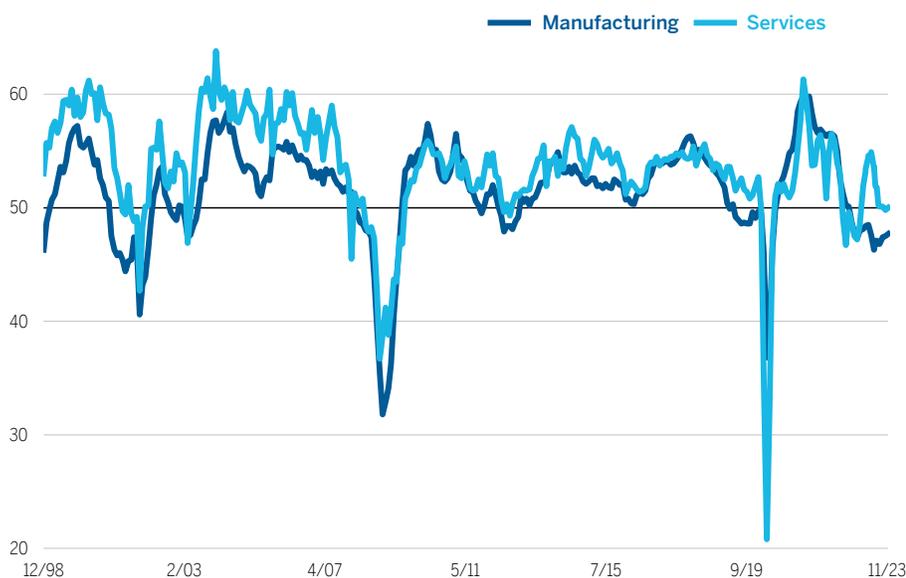


Chart data: Manufacturing: 12/98-11/23; Services: 12/98-11/23. The S&P Global Developed Market Purchasing Managers' Index is an indicator of the economic health of the manufacturing sector. A reading above 50 signals economic expansion; below 50 signals contraction. Source: Bloomberg Finance LP.

Equities May Have More Room to Run, but the Path Isn't Without Hurdles

We've raised our view on global equities from moderately underweight to neutral, given our belief that equities can continue to benefit from a policy "sweet spot" in which a mixed growth picture and disinflation have allowed the liquidity backdrop to dominate. What kept us from moving to an overweight view? We expect central banks to pivot to rate cuts in 2024, but in the absence of a severe recession, there's scope for disappointment—especially in the US, where the market expects five to six rate cuts this year. Meanwhile, it remains to be seen whether core inflation is truly under control, and this will remain a focus for investors until inflation is sustainably at or below central-bank targets.

Markets are also pricing in strong earnings growth of around 10% globally over the next 12 months. While the earnings downside is likely behind us, we think this may be too rosy given our expectation of below-trend growth and potential for further margin compression. The combination of elevated earnings

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Neutral	↑
Defensive fixed income	Neutral	↓
Growth fixed income	Moderately UW	—
Commodities	Overweight	↑
<i>Within asset classes</i>		
Global equities		
US	Moderately UW	—
Europe	Moderately UW	—
Japan	Overweight	↑
China	Neutral	—
EM ex China	Neutral	—
Defensive fixed income		
US government	Moderately OW	—
Europe government	Moderately OW	—
Japan government	Underweight	—
Global investment grade credit	Neutral	—
Growth fixed income		
High Yield	Neutral	—
EM debt	Neutral	—
Bank Loans	Moderately UW	—
Securitized assets	Neutral	—

OW = overweight, UW = underweight

Views have a 6-12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 12/31/23, 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 material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

expectations and high valuations, including a tight equity-risk premium⁵ against bonds, also prevented us from adopting an overweight view on global equities. In short, our neutral view reflects our belief that we're at a crossroads, and we'll be monitoring central-bank monetary policy, earnings surprises, and signs that the long tail of prior tightening is making its way through the economy as we gauge whether to dial our equity view up or down from here.

Turning to our regional views, we see better valuations outside the US. But within the US, we see better valuations outside of megacap stocks. As of mid-December, the S&P 500 Index⁶ had a 12-month forward price/earnings ratio⁷ of about 17.3 once the megacaps were removed. While gains in the US equity market finally broadened beyond the largest stocks in the last few weeks of 2023, the megacap cohort remains dominant, which has implications for global market structure since this cohort is now larger than any country or region outside the US. For example, megacaps tend to be less sensitive to interest rate and cyclical shifts, and, therefore, their increasing heft can make the overall equity market more resilient. Another factor to consider is the influence of US fiscal policy, which surprised to the upside in 2023 but could shift more negative in 2024. These crosscurrents balance out to a modest underweight view on the US in our analysis.

We continue to see opportunities to take advantage of regional diversification, with economic and monetary-policy cycles remaining less synchronized than in recent years. Most notably, we've increased our overweight view on Japanese equities, where we continue to see a confluence of higher nominal growth and evidence of corporate governance shifts boosting profitability (FIGURE 2). While the BOJ shifted its monetary policy stance somewhat, dialing back on yield-curve⁸ control, it remains accommodative, and the country's fiscal policy is even more so. The economy remains in cyclical recovery mode, although valuations reflect improving fundamentals to a greater extent than early in 2023. Japan did underperform some other markets in the fourth quarter but given that there was no change in our conviction level, we saw this as an attractive buying opportunity.

FIGURE 2
In Japan, Profits Remain Well Supported

Japan Current Profits-to-Sales Ratio (All Enterprises)



Chart data: 3/24-12/23. Data from the Bank of Japan's Tankan Survey. Data Source: Bloomberg Finance LP.

We maintain our moderately underweight view on European equities. They have the advantage of both negative sentiment and attractive valuations, but we expect the region's macro and earnings downturn will take time to play out.

It remains to be seen whether core inflation is truly under control.

In China, valuations and sentiment are both at rock bottom, which should cushion against further de-rating. This remains a market in which the dispersion of views is wide, but on balance, we think structural factors such as internal deleveraging and geopolitical uncertainty could suppress the potential for the market to outperform over a 12-month horizon.

At a sector level, we prefer consumer-discretionary stocks, which have the potential to benefit from disinflation and higher disposable income, as well as undervalued utilities. We think the energy sector has strong fundamentals, including high earnings and free cash-flow. We have an underweight view on the telecom, consumer-staples, and healthcare sectors. The consumer-staples sector has a weaker fundamental picture with low free cash flow and negative sentiment. The telecom sector's fundamentals are also weak, as capital expenditures to depreciation look low. Capital needs are high for the sector and may increase its cost of capital. Healthcare is challenged by higher costs and lower utilization at hospitals, as well as continued poor sentiment in biotech.

Government Bonds: Is the Rate Rally Overdone?

The Federal Open Market Committee's December meeting validated and accelerated the rally we've seen in rate markets since the yield on the 10-year US Treasury hit 5% in mid-October. Markets appear to have latched onto a couple of positive narratives. One narrative is that if inflation continues to fall, then mathematically, real rates rise and become more restrictive. Therefore, the Fed will need to cut rates even if the economy doesn't slow. Another narrative is that inflation's decline has been driven not by a harmful decline in demand, but by supply factors, including increased labor participation and immigration, as well as a continued unwinding of supply-chain distortions.

Our neutral-duration stance is based on our view that slower global growth and lower inflation will bring lower rates but that the rates markets have repriced too much too fast. (As of this writing, fed funds⁹ futures imply that the first rate cut will come in March and that we will see 150 bps of cuts by December.) Rates could go lower in a deep-recession scenario, or they could rise if inflation reaccelerates or the term premium¹⁰ expands as it did in the third quarter.

In a global context, we still prefer US and European rates to Japanese rates. Europe is flirting with recession, so the European Central Bank could join or even preempt the Fed in cutting rates. Japan is unique: Amid loose monetary and fiscal policy, inflation is running hotter than target, so the central bank is under some pressure to tighten ultra-loose policy.

Credit: Attentive to the Risks but Also Open to Opportunities

The economy has been resilient, and spreads have been narrowing. Inflation has come down quickly, giving central banks the room to cut rates this year. Against this backdrop, we retain a slight underweight view on spreads, but think there may be opportunities to add risk on any weakness. We believe the risks remain somewhat skewed to the downside, especially with tight spread levels, but we see an environment in which spreads could remain rangebound for some time and where income could dominate returns.

Defaults began picking up in high-yield markets in 2023 but were largely concentrated in a few sectors, including technology, healthcare, and autos. We see some risks around the need to refinance at higher interest rates. High-yield issuers have been able to push out the impact of higher interest rates by delaying refinancing. But many issuers have debt maturing in 2025, meaning they will need to refinance within the next 12 months (FIGURE 3). Even with 150 bps of interest-rate cuts priced in, refinancing will be at much higher rates than existing debt and could lead to higher defaults.

Meanwhile, as refinancing has been delayed, corporate balance sheets have been weakening, as issuers have spent cash rather than issuing more debt. We don't think this risk is fully priced in. High-yield spreads are narrow at around the 30th percentile in the US.

Europe is flirting with recession, so the European Central Bank could join or even preempt the Fed in cutting rates.

Having said all this, we don't see an immediate catalyst for wider spreads, and so we remain only marginally negative on the asset class in the near term. The opportunity to add on weakness may be helped by the more positive starting point for yields, which is a strong determinant of long-term returns. We prefer higher-quality credit in this environment, and, therefore, remain more positive on investment-grade credit relative to high yield.

FIGURE 3
High-Yield Companies to Refinance at Higher Rates in 2024

US High Yield – Coupon-to-Yield Ratio

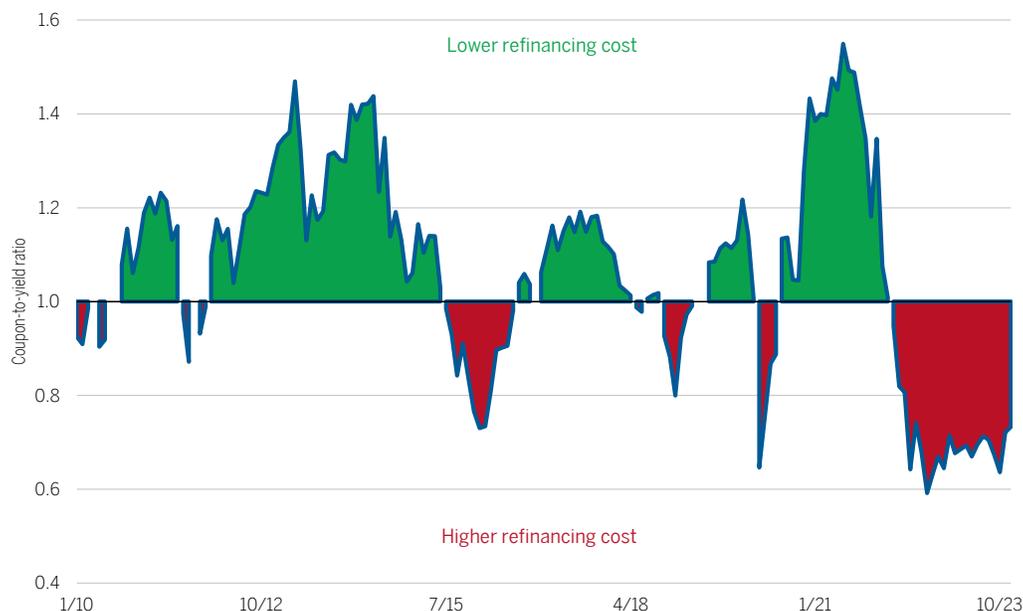


Chart data: 1/10-12/23. **Past performance does not guarantee future results.** Ratio between index coupon and yield to worst of Bloomberg US Corporate High-Yield Bond Index. Yield to worst is the minimum yield that can be received on a bond assuming the issuer doesn't default on any of its payments. 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. Data Sources: Wellington Management and Bloomberg.

Commodities: Stronger Conviction Based on the Outlook for Oil and Inflation

We've increased our conviction in our overweight view on commodities, primarily driven by our more positive outlook for oil, as well as a view that inflation could remain somewhat stickier and more volatile than the market anticipates.

We've raised our view on oil from neutral to moderately overweight, with recent price declines creating what we think is an attractive entry point. We expect supply to remain relatively constrained, driven by both an incentive for OPEC to support prices and the US actively refilling its Strategic Petroleum Reserve, which we think could outweigh the headwind from slower demand in 2024. We're also monitoring the impact that attacks on commercial ships in the Red Sea could have on prices in coming months.

We maintain our moderately overweight view on gold, which has reasserted its status as a potential safe haven and a store of value as demand has picked up around the world. Central banks have been buying gold recently in light of geopolitical issues and the trend of de-dollarization. This buying has been robust, and we expect it to continue.

Copper remains structurally constrained from a supply perspective, and we expect long-term demand to be strong given its role in the green economy. However, we believe there could be downward pressure on prices in the near term, as there may be some supply surplus coming through, and demand may be slightly weaker given our

expectation of below-trend growth this year. With these contrasting short- and long-term trends, we moved to a neutral view on copper, preferring to watch for opportunities to add risk in the months ahead.

Risks

Upside risks include a scenario in which the loosening in financial conditions lifts growth above trend without stymying disinflationary momentum. Another positive scenario would be a reacceleration in China's economy, with positive spillover effects on the global economy. We might also see unexpected upside from high cash levels on household balance sheets being reallocated to risk assets.

Downside risks include the potential for core inflation to reaccelerate, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking. There's also the potential for the economy to "break" due to the lagged impact of tighter monetary policy on commercial real estate or parts of the banking sector. Finally, if the Middle East or Russia-Ukraine conflicts broaden, it risks increasing macro uncertainty.

Investment Implications

- **Consider rotating equity exposure to less expensive areas** — We think an improved fundamental backdrop of slowing growth and inflation combined with the prospect of Fed rate cuts warrants at least a neutral exposure to equities. But given relatively expensive valuations in megacaps, we think there are better opportunities in the underpriced utilities and energy sectors. Disinflation could be positive for the consumer-discretionary sector.
- **Look for regional advantages, especially in Japan** — Equities outside the US are less expensive and are at different stages of the cycle. We think Japan still has a long runway for improved profitability, even if monetary policy tightens slightly.
- **Consider maintaining a neutral-duration stance** — The Fed's pivot is positive for rates markets, but we think this has been priced in, and rates could go higher or lower depending on inflation and Treasury supply. Among rates markets, we believe Japan has more downside than the US and Europe given the shift in monetary policy we envision. We lean slightly negative on spreads given rich valuations and heavy refinancing needs at higher rates.
- **Be prepared for disruptions in the market's benign expectations** — The inflation story may not be over. We see upside for oil prices and a case for gold amid heightened geopolitical risk and strong buying from central banks.

Talk to your financial professional about how to position your portfolio for the year ahead.

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

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

³ 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.

⁴ Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

⁵ The risk premium is the excess return above the risk-free rate that investors require as compensation for the higher uncertainty associated with risky assets. The five main risks that comprise the risk premium are business risk, financial risk, liquidity risk, exchange-rate risk, and country-specific risk.

⁶ S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

⁷ Price/Earnings is the ratio of a stock's price to its earnings per share.

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 federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

¹⁰ 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.

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