The January Rally: A Disagreement Between the Fed and the Markets

Most fixed-income sectors outperformed government bonds in response to easing inflation signs in the US and Europe and expectations that major central banks are nearing the end of their rate-hiking cycles. Warmer weather in Europe, lower natural gas prices, and China's reopening added to the optimism.

Insight from sub-adviser Wellington Management

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

While we generally only address events that occurred in the prior month, given that early February had both a Federal Reserve (Fed) meeting and a Treasury Quarterly Refunding, we thought it made sense to briefly touch on both events:

As expected, the Fed hiked rates by 0.25% and remained somewhat hawkishly in line with recent communications. However, markets interpreted Chair Powell's press conference comments as more dovish than the statement, as Powell didn't push back against recently loosened financial conditions and effectively labeled those conditions as already tight.

The Treasury Quarterly Refunding: While the policy statement didn't offer any additional insight into the debt ceiling, it did allude to the fact that the Treasury Department's (TD) bill issuance is likely to become more variable with an increase in cash-management issuance to allow the TD to have maximum flexibility in reaching the "X" date, the date when the US is no longer able to meet its obligations in full and on time. Furthermore, the Treasury Borrowing Advisory Committee also did a deeper dive into buybacks, a tool that will allow the TD to better manage the stability and liquidity of the Treasury market.

What's Driving Markets…

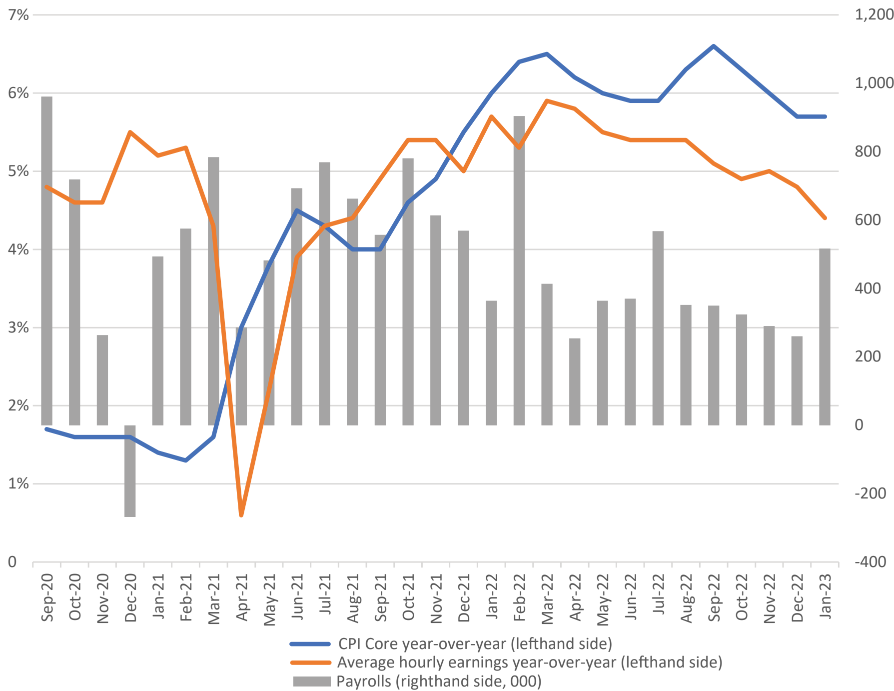
1. **Diverging economic data** pose a challenge for the Fed in pursuit of its dual mandate of 2% inflation and maximum employment. Housing indicators have weakened due to higher mortgage rates, services and manufacturing purchasing-manager indices[1] remain in contractionary territory, and retail sales have declined. Yet labor-market strength persists, highlighted by extremely low jobless claims and a gangbusters January payroll report that showed 517,000 jobs were created with strong upward revisions to prior months. On the inflation front, wages exceeded estimates but have moderated to 4.4% (average hourly earnings), still inconsistent with inflation declining to the Fed's 2% target. Broader measures of inflation continue to trend lower, with the December core Consumer Price Index[2] at the weakest level of the year. The payroll report modestly reset Fed policy-rate expectations higher, but if growth proves to be more robust than anticipated, the Fed may need to increase interest rates more than is currently priced into the market.

[1] Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. A reading above 50 signals economic expansion; below 50 signals contraction.

[2] The CPI in the US is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services." Core CPI excludes volatile food and energy prices.

FIGURE 1

Payrolls Are Up and Inflation Is Persistent, but Wages Have Moderated



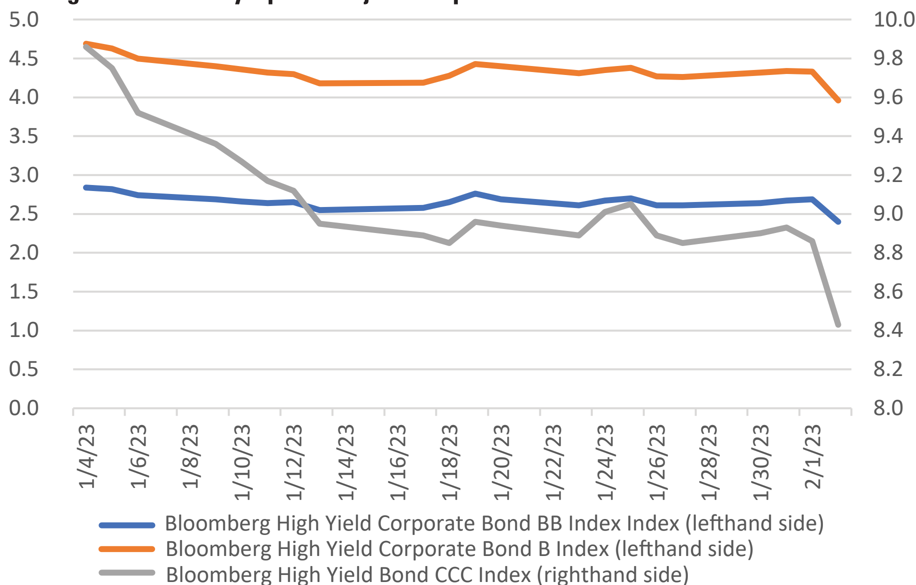
As of 1/31/23. Source: Bloomberg.

Markets rallied in January, partly driven by the view that the Fed won't move to further tighten financial conditions.

2. **January witnessed a substantial risk-asset[3] rally.** The rally was partly driven by the view that the Fed won't move to further tighten financial conditions, and indeed, will be unable to maintain a higher-for-longer posture in rates. Over the month, we saw the lowest-rated credits benefit the most from the risk-on dynamic, as CCC-graded (one of the lowest ratings) bond spreads[4] collapsed tighter by more than 1% (**FIGURE 2**). Moreover, in early January, dealer balance sheets were still quite light following year-end and tepid new issuance in high yield, allowing marginal bids to drive and tighten pricing. Chair Powell's comments during his press conference added additional tailwinds to the rally.

FIGURE 2

US High-Yield Quality Option-Adjusted Spreads[5]



As of 2/2/23. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Source: Bloomberg,

[3] Risk assets (such as equities, commodities, high-yield bonds, real estate, and currencies) have a significant degree of price volatility.

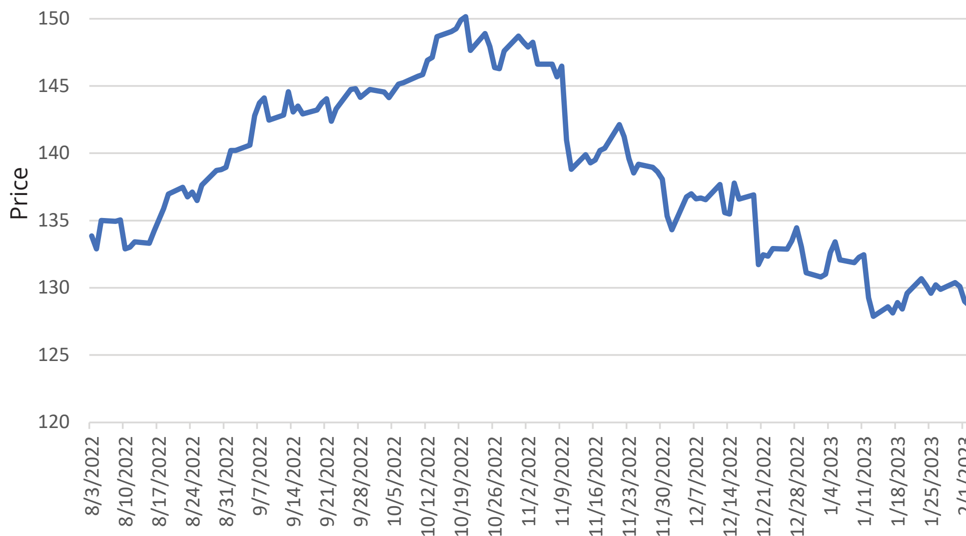
[4] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[5] Option-adjusted spreads are a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options.

3. The world continues to watch the Bank of Japan (BOJ). While most central banks are in some form of hiking—Fed, European Central Bank (ECB), and Bank of England—markets are now actively predicting that hiking is coming to an end in many of those developed markets. The BOJ, on the other hand, refrained from tightening policy or allowing a further rise in Japanese government bond rates via relaxation of its yield-curve control. While the BOJ's actions were dovish, the perceived light at the end of the tunnel from other central banks has allowed the yen to have a substantial rally from its low in October 2022. Our global bond team notes that pressures continue to grow on the BOJ with ongoing wage negotiations in Japan expected to add upward pressure on Japanese wage inflation.

Markets are now actively predicting that hiking is coming to an end in many developed markets.

FIGURE 3
Japanese Yen vs. US Dollar



Source: Bloomberg

4. **Our Syndicate Team notes new issuance has surged** as issuers take advantage of lower yields relative to 2022 to tap the market. January 2023 quickly outpaced January 2022 as issuers roared back into the market. However, new primary-market issuance has been skewed toward investment-grade corporates, collateralized-loan obligations, and hard currency emerging-market (EM) sovereign issuance. High-yield bonds, bank loans, and EM corporate issuance is down substantially relative to the same period a year ago.
5. **The European Central Bank (ECB) remains a bit more hawkish than the Fed**, hiking by 0.50% this month to 2.50% and signaling another 0.50% hike in March "in view of underlying inflation pressures." However, there are some hints the ECB is laying the groundwork for a slower pace thereafter, and we now expect a 3.50% terminal (or peak) rate, consistent with market expectations. There were no significant surprises to its asset-purchase program, which will be reduced going forward and "greener by focusing more on firms with a better climate performance." At the press conference, President Christine Lagarde downgraded concerns around inflation from "primarily on the upside" in the previous meeting to "more balanced," indicating the ECB may have some room to slow the pace of hikes in Q2.
6. **China's reopening:** The country ditched quarantine requirements for incoming travelers, in a major and final reversal of its zero-COVID-19 policy, ahead of Lunar New Year, a time that's typically very busy for domestic and international travel. The Chinese economy grew 3% over 2022, marginally beating economists' forecast. With the notable exception of 2020, this was the worst year for growth in China since

the 1970s. Most of the drag came from the services sector, as China was able to perfect closed-loop manufacturing during the pandemic, meaning it was able to keep exporting goods to the rest of the world. The reversal of the highly restrictive zero-COVID-19 policies should result in pent-up demand being spent both domestically and internationally, but it could be a bumpy ride. Passenger numbers around the Lunar New Year were still only 50% of 2019 levels, with private vehicles the preferred mode of transport at the expense of air and rail travel. If China continues its reopening, this could have a positive effect on global growth and push global inflation upward.

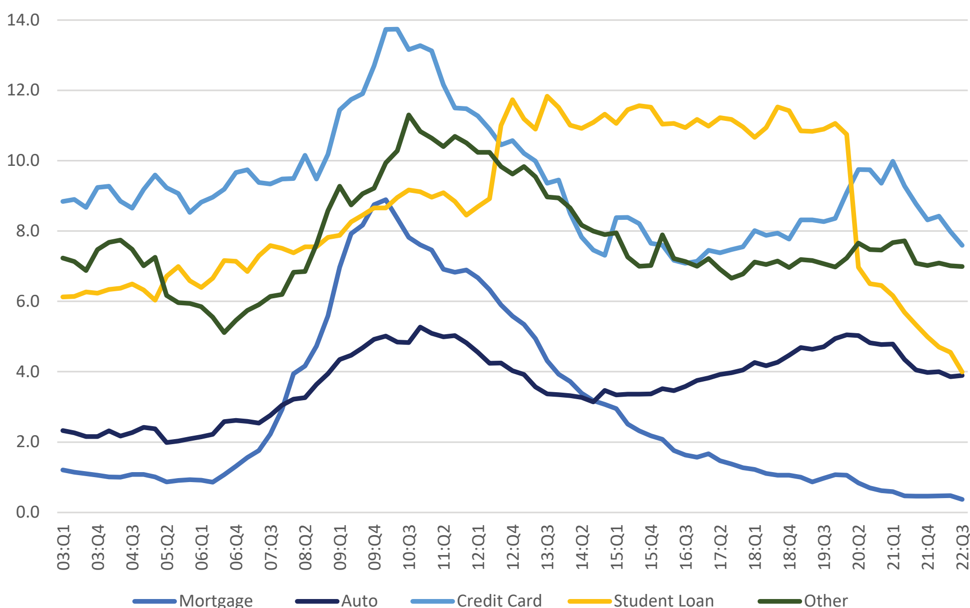
> Savings rates are declining and delinquencies are picking up for subprime consumers.

What's Keeping Us Up at Night…

1. **The spring offensive:** There is a high likelihood of a large-scale spring offensive in Ukraine, with Russia utilizing newly mobilized troops to push forward into the country. This offensive, along with the additional supplies of tanks from NATO allies to Ukraine, makes it likely the war heats up again in the coming months. As always, there are substantial risks of miscalculation and escalation.

2. **The subprime consumer** is starting to show some cracks: Savings rates are declining, and delinquencies are picking up within deals issued during 2022 (before issuers began to tighten their lending standards—this isn't showing up yet in the data in **FIGURE 4**). We acknowledge that subprime consumers will likely continue to struggle as recession risks mount; however, the combination of subsiding inflation, wage gains, and tightened credit standards from lenders should lead to differences in performance by vintage across asset-backed securities (ABS). We are now observing material changes to underwriting standards and see select opportunities to be liquidity providers in certain auto and credit-card ABS. But further deterioration in consumer fundamentals will vary widely across geography, income, and asset type. Because of this, security selection will be key to outperformance.

FIGURE 4
90+ Days Delinquency (%)



As of 9/30/22. Source: New York Fed Consumer Credit Panel/Equifax

3. **The US government has once again reached its debt limit,** though by employing extraordinary measures, it's not expected to exhaust spending for at least a few more months (depending in large part on April tax receipts). The debt ceiling "X" date is already being reflected in parts of the curve and in individual Treasury securities. Many Republicans are seeking spending and/or tax cuts in exchange for raising the

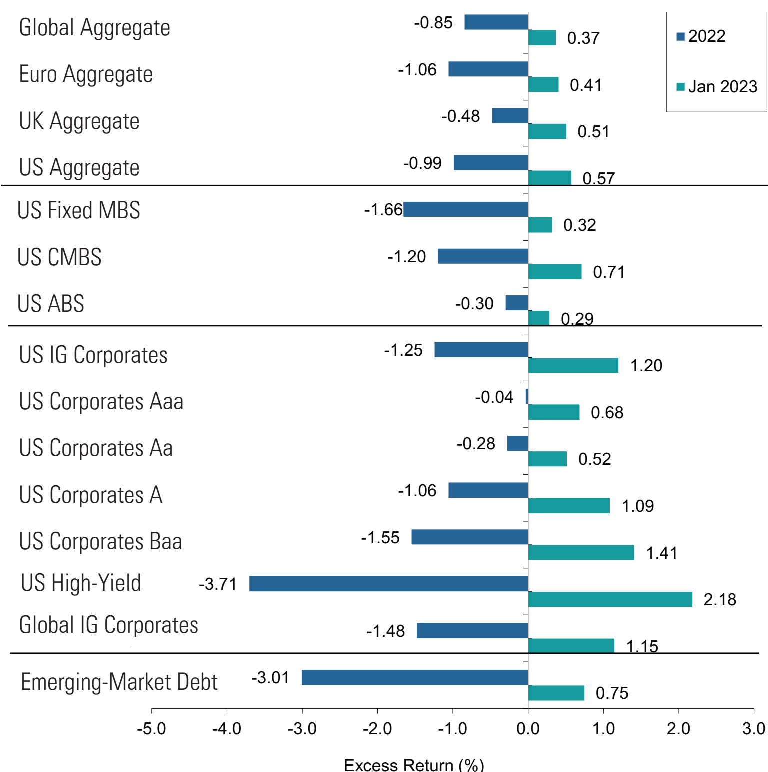
debt ceiling, while many Democrats view the debt ceiling as a separate issue that should be raised with no strings attached. Our base case is that the process to raise the debt ceiling will once again prove contentious and come down to the wire. The worst-case scenario is for a technical default, though most market participants don't question the ability of the US government to meet its debt obligations. Still, failure to raise the debt ceiling will likely contribute to significant market volatility, similar to 2011 when S&P downgraded the US rating below AAA.

Investment Implications

- We continue to think that this is the environment for global sovereign and currency strategies to shine: from a total-return perspective, a risk-diversifier approach, and a soundness perspective. This is another, more diversified approach to monetize the ongoing and expected volatility of global capital markets. This can be implemented either via some liquid global rates strategies with relative-value capabilities or through macro-oriented alternatives. The growing drumbeat of macroeconomic instability and volatility makes this type of allocation even more critical.
- Given the overall slowdown in some sectors of the economy it may also start to make sense to consider **CORE/ CORE+ positions**[6] as we move later in the tightening cycle. The sell-off in dollar rates, a slowing pace of inflation, rising geopolitical risk, and a slowing economy makes higher-quality fixed income attractive from a recessionary perspective, as well as for a positive relationship between bond prices and bond yields.
- **Shorter-duration**[7] **credit** has paid well given the ongoing volatility and uncertainty in markets. For low-risk appetite thresholds, the opportunity cost of this approach has diminished substantially over the last several months.
- **Securitized credit** may be able to mitigate some rate volatility because it currently has good risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.

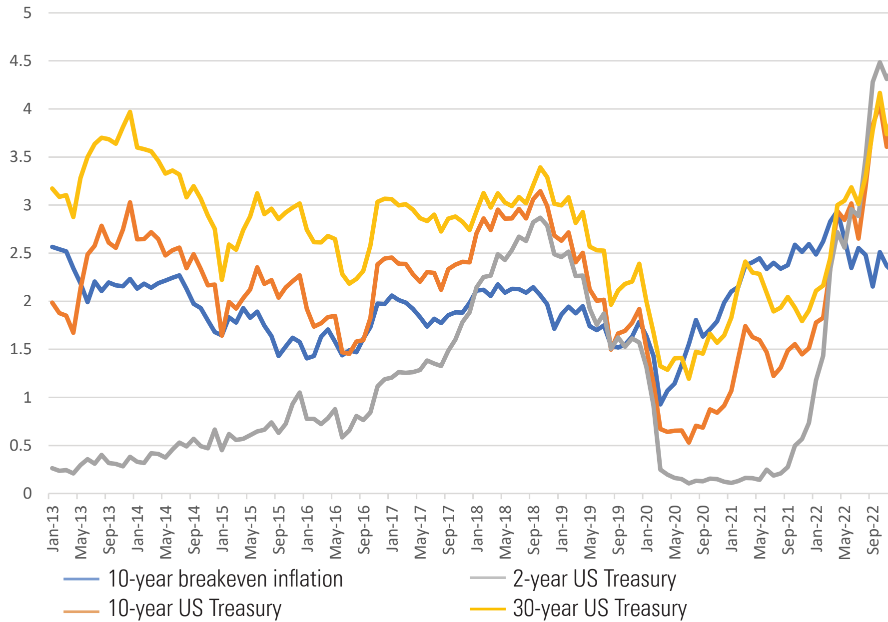
[6] Core funds typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.
[7] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

FIGURE 5
Fixed-Income Sector Excess Returns:



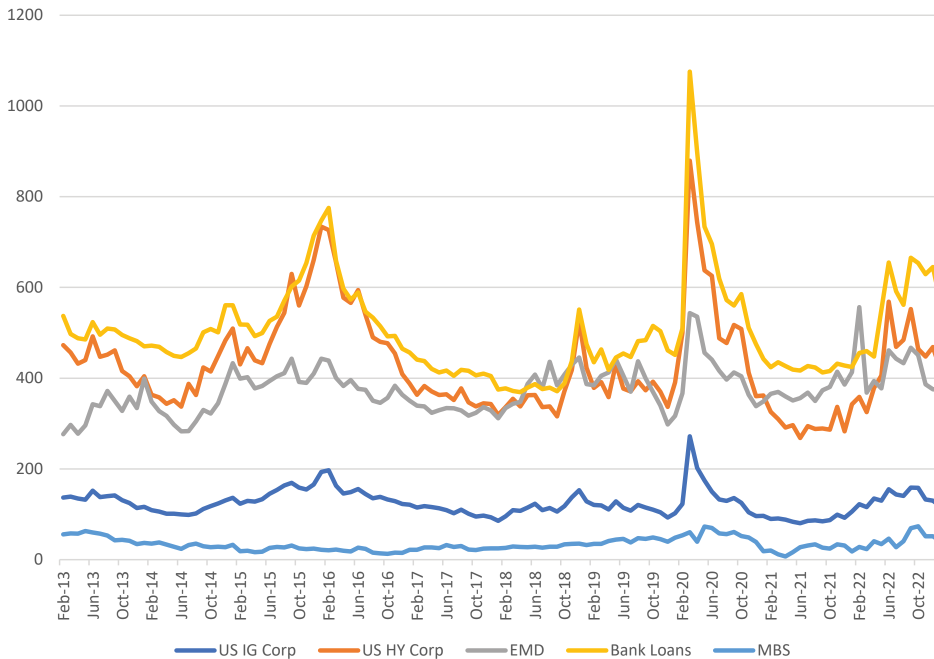
As of 1/31/23. **Past performance does not guarantee future results.** See last page for representative indices. Sources: Bloomberg, JPMorgan, Wellington Management.

FIGURE 6
US Yields (%)



As of 1/31/23. **Past performance does not guarantee future results.** Source: Bloomberg

FIGURE 7
Fixed-Income Spreads (Basis Points)



As of 1/31/23. 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 indices and the yield of a fixed-income security. See last page for representative index definitions. Source: Bloomberg, JP Morgan, Morningstar LSTA

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

Bloomberg High Yield Corporate BB Index is designed to measure the performance of bonds that have a credit rating of BB; **Bloomberg High Yield Corporate B Index** is designed to measure the performance of bonds that have a credit rating of B; **Bloomberg High Yield Corporate CCC Index** is designed to measure the performance of bonds that have a credit rating of CCC. **Bank Loans** are represented by the LSTA Leveraged Loan Index, which is a market-value-weighted index that is designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments. **Global Aggregate** is represented by the Bloomberg Global Aggregate Index, a broad-based measure of the global investment-grade fixed-rate debt markets. **Euro Aggregate** is represented by the Bloomberg Global Aggregate Index - European Euro, which includes fixed-rate, investment-grade Euro denominated bonds. **UK Aggregate**: Bloomberg Global Aggregate Index - United Kingdom which includes fixed-rate, investment-grade sterling-denominated bonds. **US Aggregate:** Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index. **US Fixed MBS**: Bloomberg Agency Fixed-Rate MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **US CMBS**: Bloomberg CMBS ERISA Eligible Index, which measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974. **US ABS:** Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, which has three subsectors: credit and charge cards, autos, and utility. **US IG Corporates:** Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt. **US Corporates Aaa:** Bloomberg Aaa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa; **US Corporates Aa:** Bloomberg Aa Corporate Index; **US Corporates A:** Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; **US Corporates Baa:** Bloomberg Baa Corporate Index; designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa; **US High-Yield Corporates:** Bloomberg US Corporate High Yield 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. **Global IG Corporates:** Bloomberg Global Credit - Corporate Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets. **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

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

The views expressed herein are those of Wellington Management, are for informational purposes only, and are subject to change based on prevailing market, economic, and other conditions. The views expressed may not reflect the opinions of Hartford Funds or any other sub-adviser to our funds. They should not be construed as research or investment advice nor should they be considered an offer or solicitation to buy or sell any security. This information is current at 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.

"Bloomberg®" and any Bloomberg Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the indices (collectively, "Bloomberg") and have been licensed for use for certain purposes by Hartford Funds.Bloomberg is not affiliated with Hartford Funds, and Bloomberg does not approve, endorse, review, or recommend any Hartford Funds product. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to Hartford Fund products.

Mutual funds are distributed by Hartford Funds Distributors, LLC (HFD), Member FINRA. Advisory services are provided by Hartford Funds Management Company, LLC (HFMC). Certain funds are sub-advised by Wellington Management Company LLP. HFMC and Wellington Management are SEC registered investment advisers. HFD and HFMC are not affiliated with any sub-adviser.