November Starts With a Bang
Global sovereign yields were mixed in October. Spreads\(^1\) widened across most fixed-income sectors amid geopolitical concerns and resilient economic data. Federal Reserve and Treasury reports sparked a rally.

What’s Driving Markets…
1. Ending the weeks-long stalemate in the US House of Representatives, a new Speaker was elected to the House after multiple rounds of voting. Rep. Mike Johnson’s ascent as 56th Speaker of the House gave congressional leadership only two weeks to pass a continuing resolution to fund the government and avoid an immediate shutdown. A stopgap bill to fund government operations until January 2024 passed both the House and Senate and was signed by President Biden in mid-November. Had the effort failed, a government shutdown, depending on length, could have had an adverse impact on growth.

The Treasury Quarterly Refunding\(^2\) provided a welcome relief to Treasury markets. On November 1, the Treasury Department released its quarterly refunding statement that lays out the US government’s issuance strategy. In the statement, Treasury stated it would continue expansion of its coupon program, but would do so gradually and in modest increments, allowing markets time to digest the additional duration.\(^3\) This softened language (vs. the August communications on Treasury coupon supply) led to a sharp rally in rates that extended following that day’s dovish Federal Open Market Committee (FOMC) meeting (see FIGURE 1) and weaker economic data releases.

FIGURE 1
Softened Language at Treasury and the Federal Reserve Sparks a Rate Rally
10-Year Treasury Yields (8/1/23-11/2/23)

Past performance does not guarantee future results. Sources: Bloomberg, Wellington Management, and Hartford Funds.

2. The Federal Reserve (Fed) held rates steady at the FOMC meeting that concluded on November 1. Despite the action having met expectations, US Treasuries rallied sharply, erasing some of their October losses. The statement included a reference to the recent tightening of financial conditions, further detailed during Powell’s post-meeting press conference. The Fed conveyed a greater degree of confidence that: (a) inflation will eventually return to target; (b) policy tightening to date is sufficient; and (c) the lagged impact of financial conditions will work to slow the economy.
3. The Bank of Japan (BOJ) made a further “marginal” but important tweak to its yield-curve control (YCC) policy, in which the central bank purchases bonds to control the yield on Japanese government bonds (JGBs) up to the 10-year point. The most recent announcement represents a further step toward de-facto YCC removal and, therefore, policy normalization. The BOJ tweaked the YCC structure further, with the 1% cap on 10-year JGBs now a “reference,” allowing yields to rise above 1%. We anticipate more tweaks to come in 1Q24 as the reflation theme has been underscored, likely anchoring growth.

FIGURE 2
Yield-Curve Control by the Bank of Japan Has Been Gradually Loosening
Yields on 10-Year Japanese Government Bonds (11/1/22-11/1/23)


4. On October 18, the US announced a relaxation of sanctions on Venezuela, which include the oil and gas sector and some secondary trading in Venezuelan securities. Particularly on the energy side, there was some inkling that the US was going to move in this direction. A new rapprochement between the Maduro regime and the opposition allowed the US to take additional steps following the Q4 Treasury announcement. This now means that, over time, there will be an additional large energy producer in the Western Hemisphere that isn't under sanctions.

5. Corporate-bond spreads widened during the month, likely driven by a combination of concerns over the impact of higher-for-longer policy rates on earnings, geopolitical angst, and some earnings misses. Corporate fundamentals may deteriorate, albeit from strong starting points, as softer demand, higher financing costs, and sticky cost pressures conspire to impact profit margins. Despite the widening, spread levels trade around median levels vs. history and still likely reflect the optimistic soft-landing scenario coveted by Fed officials.

**What’s Keeping Us Up at Night…**

1. **Geopolitical risk has grown.** While the Ukraine/Russia conflict continues to rage, the conflict in Israel and Gaza is, or should be, of great concern to markets. The conflict could easily spread around the region, adding to global instability and the already costly human toll. Thus far, energy markets do not appear to reflect this enhanced risk into pricing. Higher energy prices are a challenge, as has been repeatedly demonstrated, to central banking. While the Fed can’t control energy supply and typically excludes such measurements from its inflation measurements, it’s well aware that energy prices can have one of the strongest impacts on inflation expectations.

**FIGURE 4**

**Geopolitical Risk Is Often Reflected in Crude-Oil Price Volatility**

WTI and Brent Crude Price-per-Barrel Trends ($)
2. A policy mistake by the Federal Reserve (or another central bank) remains top-of-mind. While the Fed should be welcoming cooling inflation and a gradually loosening labor market, Chair Jerome Powell indicated that the central bank is still prepared to raise rates if the data justify the move. On the other hand, because the Fed remains cautious about cutting rates and easing financial conditions, it may keep rates too high for too long and thus erase the possibility of that miracle of economic management: the soft landing. This is all complicated by the fact that monetary policy works in long and variable lags (how long and how variable is still unclear). We sympathize with the FOMC’s challenges, but the economic backdrop makes it extremely difficult to achieve its policy objectives.

**Investment Implications for Consideration**

- Given how drawn out and uncertain the rate cycle has been year-to-date, we favor higher-quality total-return strategies that are less constrained by benchmarks. This could include global-sovereign and currency strategies that potentially shine during these periods, or “go-anywhere” strategies that may be able to navigate the late cycle.

- We acknowledge the tumult of rate markets this year. But, given where spread levels are in many sectors, core-bond and core-bond-plus positions may make sense as we (gradually) approach the end of the tightening cycle. The gradual cooling of inflation and slowing of the economy makes higher-quality fixed income potentially attractive from a recessionary perspective, as well as for positive convexity. Carry on such strategies has only grown more attractive, providing additional buffers to rate volatility. We adhere to this view, but we know that near-term volatility abounds until there’s continued evidence of a slowing economy.

- Securitized credit could be a potential hedge against rate volatility since it generally offers attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.

- Shorter-duration credit has historically paid well in periods of volatility and uncertainty in markets. For low-risk appetite thresholds, the opportunity cost of this approach has diminished substantially over the last several months and the “higher-for-longer” approach could be indicative of robust carry.

- High yield, despite its excellent performance year-to-date, warrants a cautious approach given how late in the cycle we are and the normalizing of default rates relative to current spreads. However, we acknowledge there’s a substantial rate cushion that could provide some potential total-return risk mitigation in the event of a risk-off environment. Given the robust carry, this may be a good equity substitute.
FIGURE 5: FIXED-INCOME SECTOR EXCESS RETURNS:

Global Aggregate
-0.13
Euro Aggregate
-0.04
UK Aggregate
-0.09
US Aggregate
-0.27
US Fixed Mortgage-Backed Security (MBS)
-0.57
US Commercial Mortgage-Backed Security (CMBS)
-0.33
US Asset-Backed Security (ABS)
-0.21
US Investment-Grade (IG) Corporates
-0.34
US Corporates Aaa
-0.09
US Corporates Aa
-0.12
US Corporates A
-0.35
US Corporates Baa
-0.37
US High-Yield (HY) Corporates
-0.92
Global Investment-Grade (IG) Corporates
-0.29
Emerging-Market (EM) Debt
-0.14

As of 10/31/23. Past performance does not guarantee future results. Excess returns are defined as investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk. Indices are unmanaged and not available for direct investment. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, and Wellington Management.

FIGURE 6: US Yields (%)

As of 10/31/23. US IG Corp is represented by the Bloomberg US Corporate Bond Index; US HY Corp is represented by the Bloomberg US Corporate High Yield Index; EMD is represented by the JP Morgan EMBI Plus Index; Bank Loans are represented by the LSTA Leveraged Loan Index; MBS is represented by the Bloomberg US MBS Index. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA, and Wellington Management.

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

2 Every quarter, the Office of Debt Management at the United States Department of the Treasury announces its funding needs for the next two quarters. The announcement details which securities will be offered and the dates of their announcement, auction, and settlement. This is mostly of interest to bond traders who will be looking at the amount of debt that is to be issued so that they can gauge the supply of debt in the market.

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

4 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.

5 The option-adjusted spread is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to account for an embedded option (defined as provisions included with some fixed-income securities that allow the investor or the issuer to do specific actions, such as calling back the issue).

6 Go-anywhere strategies are typically benchmark-agnostic and not bound by limits on exposure by sector, quality, currency, or country. Whereas traditional core-bond-plus strategies generally have flexibility to invest across the fixed-income landscape, they generally have upper limits on the amount that can be invested in securities rated below-investment-grade, domiciled outside the US, non-US-dollar-denominated, or reside in a particular sector (e.g., emerging markets).

7 Core/core plus typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core-plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

8 Convexity is the relationship between bond prices and bond yields.

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

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

11 High-yield (HY) securities, or “junk bonds,” are rated below-investment-grade because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities.

12 A basis point (bps) 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.

13 Investment-grade (IG) securities are fixed-income securities that are rated at “BBB” or higher by Standard & Poor’s or Moody’s.

14 See footnote 11.

15 Emerging-market bonds (EMD) are debt instruments issued by developing countries. These bonds tend to offer higher yields than Treasuries or corporate bonds in the US. Emerging-market issues tend to carry higher risks than domestic debt instruments.
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 pass-through 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 designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; 

US Corporates A: Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of A; 

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. 


Bank Loans: LSTA Leveraged Loan Index, which is a market-value-weighted index that is designed to measure the performance of the US leveraged loan market based upon market weightings, spreads, and interest payments. 

JP Morgan Emerging Markets Bond Index Global Index is a broad-based, unmanaged index which tracks total return for external currency denominated debt (Brady bonds, loans, Eurobonds and US dollar-denominated local market instruments) in emerging markets. 

Bloomberg US MBS Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). 

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**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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