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Hartford Schroders Tax-Aware Bond Fund Symbols: I: STWTX A: STWVX C: HFKCX F: HFKFX SDR: HFKVX Y: HFKYX

Can't Hardly W(AIT): The Fed's New Inflation Target

The Federal Reserve now seeks to achieve inflation that "averages 2% over time," effectively allowing inflation to run above 2% to make up for periods when it's below 2%.

Insight from sub-adviser Schroders Investment Management

Jonathan Mackay
Head of Sales, Wealth Management Solutions

Lisa Hornby
Portfolio Manager, Hartford Schroders Tax-Aware Bond Fund

Key Points

- The Federal Reserve's new policy means they won't raise rates in anticipation of rising inflation, instead allowing inflation to rise first.
- We may be entering a new cycle in which it wouldn't be unusual for rates to rise; this could harm traditional fixed income and benchmark-constrained strategies.
- Rising inflation could lead to a weaker dollar, which could be beneficial for international stocks.

RECENTLY, JEROME POWELL WAS THE HEADLINE PRESENTER AT THE US FEDERAL RESERVE'S (FED) ANNUAL JACKSON HOLE ECONOMIC POLICY SYMPOSIUM. He unveiled the Fed's new framework of Average Inflation Targeting (AIT). The Fed now "seeks to achieve inflation that averages 2% over time," effectively allowing inflation to run above 2% (for how long and how high remains unclear) to make up for periods in which inflation is below 2%. This change was anticipated by the markets and we are seeing a bear steepening move in the yield curve, as well as a rise in inflation breakevens given the move in longer maturity nominal yields[1] over the last month. Higher long-end rates is something that we believe most markets are not priced for, but the odds of a further steepening of the yield curve due to a continued rise in long rates seem quite high.

We believe a combination of the following four factors may result in a structural steepening bias in the yield curve: 1) record Treasury issuance (that could be more skewed to the long end); 2) a demand gap between the supply coming and the investor base (the Fed can't buy it all); 3) the Fed's new policy of inflation targeting (which means they won't raise rates in anticipation of inflation but will wait until it happens), and 4) the fact that the Fed will not implement yield-curve[2] control except as a last resort.

Whether we ultimately get above 2% inflation remains to be seen. But, at the very least, we think we are in the early stages of a new cycle, and a rise in long-end rates is normal at the start of a new cycle. The 10-year Treasury has averaged a yield of about 2.2% for the past 10 years. Therefore, just getting back to average would be a massive move given where we are today (the 10-year is about 0.75%) and could wreak havoc on portfolios that are overweight long duration[3] both on the fixed-income and equity side.

So how will this impact investors? Obviously, rising rates could be a headwind for traditional fixed income, especially long duration, and we think benchmark-hugging managers may also suffer.

To manage changing environments, the Hartford Tax-Aware Bond Fund seeks to shift between sectors, depending on market conditions, and adjust duration to manage interest-rate risk. When we see opportunities, we will allocate to other sectors. This opportunistic approach allows us to be flexible in responding to changing market conditions and valuations across sectors. We manage interest-rate risk through an approach that seeks to account for a rising-rate environment using our 1- and 3-year "stress test" scenarios. In essence, we look for value opportunities across fixed-income sectors (taxable and tax-exempt munis, credit, securitized, and Treasuries) with yields that can help potentially offset any steady rise in rates (which would hurt bond prices). We have maintained sufficient "dry powder" for months, so we are comfortable with our positioning. Finally, short-duration (or select floating-rate) strategies can also serve as a defensive bond allocation in such an environment.

Rising inflation may also impact equities as it could lead to a weaker dollar, and, therefore, we think international stocks may generally benefit from this trend. Rising rates could also be a tailwind for bank and financial stocks. Also, we think high multiple growth stocks and defensive equities could be hurt the most.

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[1] Nominal yields are the fixed interest rates (coupon) a bond issuer agrees to pay the bond purchaser.

[2] The yield curve is a plotted line showing the interest rates (yields) of bonds of the same credit quality but different maturity dates.

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

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