

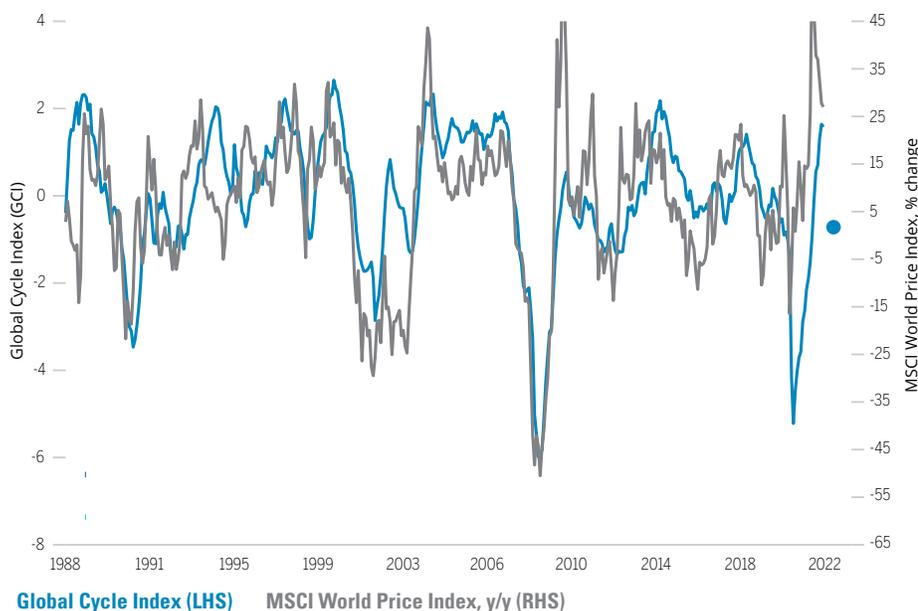
The Global Economic Outlook: Reflation, But Feeling Like Stagflation

We expect the recovery to continue in 2022, despite rising inflation and slowing economic growth causing stagflation fears.

As we look ahead to 2022, should investors fear a return to stagflation—the toxic mix of high inflation and low growth that blighted the global economy during much of the 1970s—or are the sharp price rises and the slowing recovery only temporary? We expect this debate to intensify over the next five-to-six months as high energy prices, supply bottlenecks, and labor shortages take their toll.

There's no doubt the global recovery is already slowing as evidenced by the evolution of our Global Cycle Index (FIGURE 1), which has started to move downward and is likely to go lower over the next three-to-six months (we expect it to move to the level indicated by the blue dot). At the same time, we anticipate that global inflation, as measured by the MSCI World Price Index, will stay high given the rise in energy prices, which could accelerate in the event of a cold winter in the northern hemisphere and persistent supply constraints. Elevated energy prices are also a negative for growth as they erode confidence and squeeze real incomes.

FIGURE 1
Wellington Global Cycle Index Is Likely To Shift Downward in the Next 3–6 Months



Global Cycle Index is Wellington's proprietary global cycle index that combines forward-looking macro variables including measures of monetary policy, policy uncertainty, and corporate activity that we think best captures the cycle pulse and provides a good short to medium-term lead on the economic cycle. MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. Sources: Wellington and Datastream, as of 9/21.

Insight from sub-adviser, Wellington Management



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Key Points

- Rapidly rising global inflation and slowing economic growth are likely to fuel fears of stagflation over the coming months.
- While initially it may feel like we are heading toward a scenario of high inflation and stagnating growth, we expect the recovery to continue in 2022, albeit at a slower pace and with stickier inflation.
- The main risk to our outlook is not so much stagflation, but the potential for a recession triggered by premature central bank tightening, persistent supply constraints, and/or a more serious slowdown in China.

Global Inflation Trends Are Changing

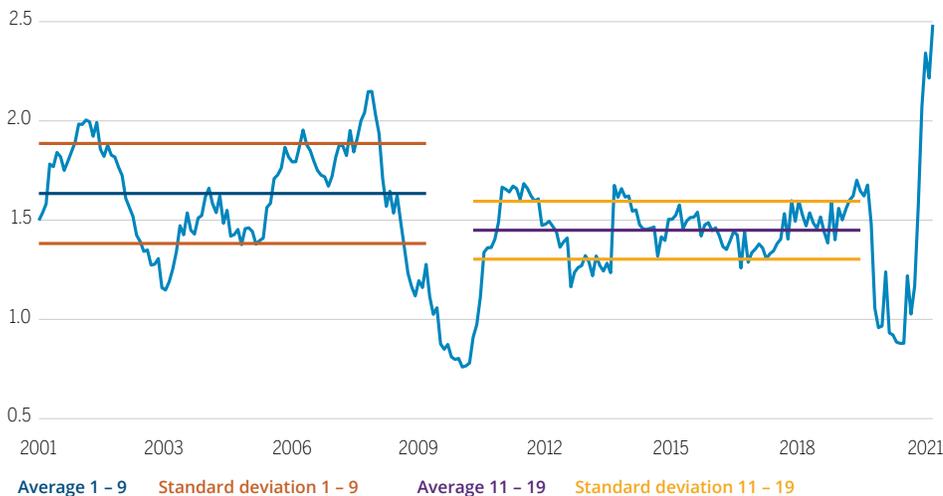
Crucially, across both developed and emerging markets, we are now seeing a significant rise in core inflation—the inflation metric that excludes the more volatile food and energy sectors. **FIGURE 2** shows how core inflation across developed markets has broken out of the low ranges of the last 10 to 20 years.

Today's inflation also appears to be more volatile compared to the last 10 years. Following the global financial crisis (GFC), core inflation across developed markets was, on average, only slightly lower (0.15%) than the 10 years prior to 2007, despite the weakness in GDP, but it was much less volatile, reflecting the protracted nature of the post-GFC recovery.

The current spike in global consumer price indices is primarily linked to supply-chain disruption and is, therefore, likely to be temporary. However, we think we're also about to witness a shift to a structurally higher inflation rate as a number of the key drivers that dampened inflation over the past 30 years, such as globalization, supportive demographics, and reduced price sensitivity to labor and energy costs, have gone in reverse. This means that inflation may once again become more responsive to cyclical factors and may, therefore, turn more volatile.

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FIGURE 2
Higher and More Volatile: Core CPI In Developed Markets



Core CPI, or the consumer price index, 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 excluding food and energy prices. Standard deviation measures the spread of the data about the mean value. Sources: Wellington and Datastream, as of 9/15/21.

Too Early To Write Off Growth

However, looking through these negative headlines, we observe a steady decline in unemployment rates across developed economies, and it's likely that unemployment will continue to decline as growth recovers in 2022.

In fact, our best guess is that, by next year, most developed economies will be back to pre-COVID trend levels from both a GDP growth and employment perspective, with core inflation at or above target. Supply is constrained, but demand, particularly labor demand, is likely to remain firm. And although investors are now focused on rate rises, the reality is that central banks are still expanding their balance sheets, while governments debate how to loosen fiscal policy further. Nevertheless, higher and more volatile inflation could become a more permanent feature for the reasons outlined above, particularly if continued labor demand translates into higher wage growth.

Longer-Term Implications For Markets

If this higher and more volatile inflation trend were to persist, central banks may find it harder to use extraordinary policy measures to counteract the threat of a new recession, in effect halting the paradigm that has existed since the GFC, in which weaker growth was paradoxically good for risk assets as it forced central banks to provide additional liquidity, which then needed to find a home in asset markets.

In fact, we're likely heading into a six-month window where growth slows but the liquidity injections are ending as the US Federal Reserve and other central banks taper. Markets will have to adjust to this more cycle-sensitive environment, but much will depend on the way central banks respond to stickier inflation. If they tighten too soon and too much, the cycle could turn over as consumers' purchasing power is squeezed. Central banks would then have to intervene again, increasing the potential for negative rates. However, this is not our base-case scenario.

On Balance, Still Positive, But Be Mindful Of The Risks

In summary, we still expect a continued recovery of the global economy from the pandemic shock, facilitated by ongoing monetary and fiscal support, despite what is likely to be a rocky growth patch over the next six months. At times, it may feel that we're sliding toward stagflation. However, the main risk to our economic outlook is not so much stagflation, but moreso the potential for a recession triggered by premature central-bank tightening, persistent supply constraints, and/or a more serious slowdown in China. While these risks have increased, it hasn't changed our underlying view that growth will continue to recover in 2022 as households run down the savings they accumulated during the pandemic, companies invest, and policy—particularly fiscal policy—remains supportive.

The main risk to our economic outlook is not so much stagflation, but moreso the potential for a recession.

**For more information on inflation and economic growth,
talk to your financial professional.**

Important Risks: Investing involves risk, including the possible loss of principal.

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