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Fixed Income: Back to Normal?

Coming off a challenging backdrop in 2022, the outlook for fixed income looks brighter.

There's no sugarcoating it: Last year was rough sledding for bond investors. High-grade fixed income markets experienced their worst-ever calendar year in 2022,[1] driven by sharply higher sovereign bond yields as global central banks supercharged their rate-hiking cycles in an effort to rein in persistent inflationary pressures (**FIGURE 1**). Credit spreads[2] across most fixed-income sectors widened, significantly in some cases, amid concerns that tighter financial conditions created by less accommodative monetary policy could tip the global economy into recession. High-quality bonds that have traditionally offered investors a measure of protection in challenging market environments instead posted some of last year's most disappointing total returns.

FIGURE 1: Worst-Ever Calendar-Year Return for the Bloomberg US Aggregate Bond Index

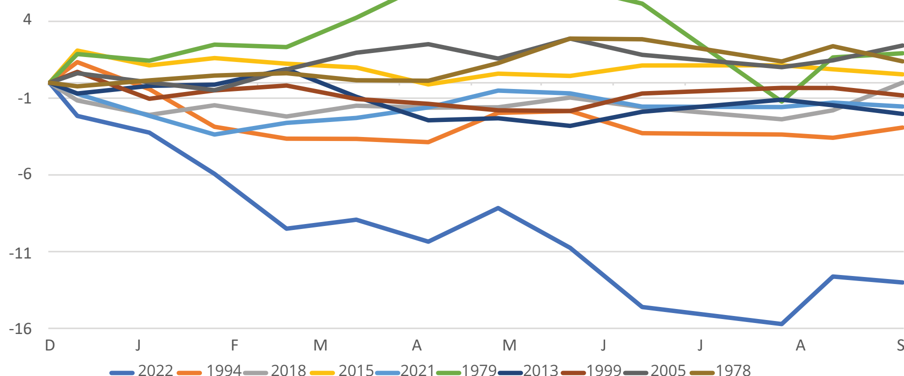


Chart data as of 12/22. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities (MBS) Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index. Source: Bloomberg Index Services Limited.

However, this year is shaping up to be a decidedly different story. We believe last year's interest-rate moves and asset-price declines have spawned a potentially compelling investment opportunity set for risk-conscious fixed-income market participants. The first-quarter market rally notwithstanding, we expect multiple good price entry points (along with some volatility) to show up over the rest of the year.

Now Is Not the Time to Give Up on Fixed Income

Rising stock/bond correlations in 2021 and 2022 seemingly left no place for investors to hide from market volatility. So, are frustrated investors to conclude that fixed income has lost some of its ability to defend their principal and diversify other portfolio risks? We don't think so.

Despite fixed income's prolonged slump through 2022, we remain confident in the power of this cornerstone asset class to act as a portfolio diversifier and help reduce drawdowns in risk-off environments.

Clearly, that was not so last year—a striking anomaly, in our view. Fixed-income exposure in the form of interest-rate duration[4] typically acts as a counterweight to other risks in investor portfolios; bouts of risk aversion that

Insight from sub-adviser Wellington Management

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

Adam Norman
Investment Communications Manager

Key Points

- While the recent sharp increase in yields has been painful in the short term, it could also enhance longer-term income generation and total-return prospects, in our view.
- Despite the challenging start to 2023, we remain confident in the ability of fixed income to once again provide potential diversification and help reduce drawdowns in risk-off environments.
- Investors may want to consider the following strategies: total return in beta[3] recovery as spreads recover, credit returns uncorrelated to market, and risk mitigating and diversifying.

tend to negatively impact risk assets[5] such as equities have historically seen bond prices rise. In 2022, however, aggressive global central-bank monetary-policy tightening pushed yields higher across the yield curve[6] in most developed markets.[7] The result: Bond prices fell along with equity values, with yields across many high-grade fixed-income sectors reaching their highest levels since the early stages of the Global Financial Crisis (GFC) (**FIGURE 2**).

It's important to remember that fixed-income investors may stand to benefit from prevailing higher yields over multiyear time horizons. While the recent sharp increase in bond yields has been painful for many investors in the short term, we believe it may ultimately serve to enhance fixed income's longer-term income generation and total-return prospects.

Today's loftier yields may also offer investors better entry points into some fixed-income assets, along with a potential cushion against further interest-rate volatility in the months ahead.

We believe high-grade fixed income could offer an attractive risk-return profile.

FIGURE 2: Yields Across High-Grade Bond Sectors Were the Highest They've Been Since the GFC (%)

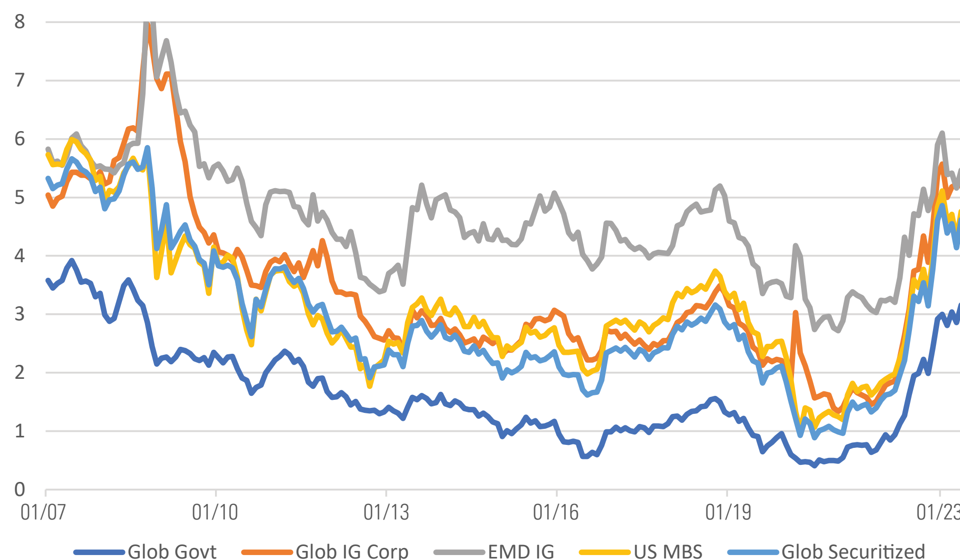


Chart data: 1/31/07-3/31/23. Past performance does not guarantee future results. Investors cannot directly invest in indices. Please see page 5 for representative index definitions. Sources: Bloomberg Index Services Limited, JP Morgan.

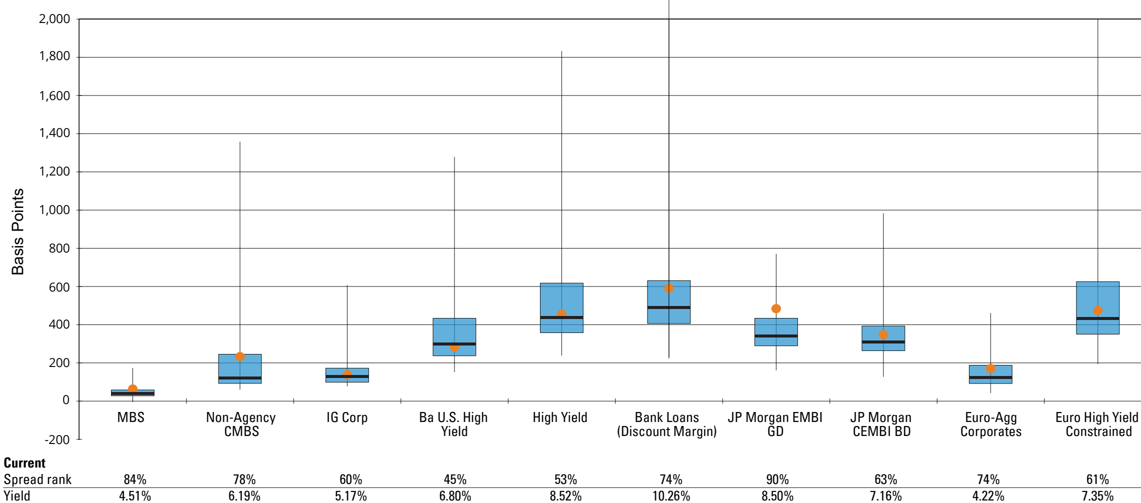
Consider High-Grade Fixed Income Amid Recession Risks

We believe high-grade fixed income, in particular, features an appealing risk-return profile these days: all-in yields were recently perched at relatively attractive thresholds, including credit spreads wider than their long-term historical medians (**FIGURE 3**). High-grade bonds also have a lower probability of permanent credit impairment than their lower-quality counterparts. In addition, high-grade fixed income typically performs well in difficult economic settings—worth noting with the threat of a global recession looming over the investment landscape this year.

Looking more broadly across credit markets, forward-looking returns appear promising in some sectors, with the core tenets of fixed income/credit (yield, pull-to-par,[8] etc.) potentially working to investors' advantage given where interest rates and credit spreads currently sit. However, the path of future returns could be quite volatile, with bouts of spread-widening likely. As such, we recommend that investors judiciously allocate to credit assets based on their individual risk appetites and other circumstances.

FIGURE 3: Credit Spreads Were Recently Wider Than Their Historical Medians Across Most Spread Sectors

Historical spreads (option-adjusted spread,[9] basis points[10])



Current	MBS	Non-Agency CMBS	IG Corp	Ba U.S. High Yield	High Yield	Bank Loans (Discount Margin)	JP Morgan EMBI GD	JP Morgan CEMBI BD	Euro-Agg Corporates	Euro High Yield Constrained
Spread rank	84%	78%	60%	45%	53%	74%	90%	63%	74%	61%
Yield	4.51%	6.19%	5.17%	6.80%	8.52%	10.26%	8.50%	7.16%	4.22%	7.35%

Past performance does not guarantee future results. Investors cannot directly invest in indices. Please see page 5 for representative index definitions. Historical spread analysis based on trailing 20 years (unless otherwise noted) of month-end option adjusted spreads as of 3/31/23. Current yield is represented by yield to maturity[11] for bank loans as of 3/31/23. Sources: JPMorgan, Barclays, Morningstar LSTA LLI, 4/23.

But Wait … What About Fixed-Rate Deposits?

The recent inversion of many global-sovereign yield curves and higher bond yields at the front end may have tempted some investors to allocate to fixed-rate deposits to attempt to capture higher yields while limiting duration and credit risks. While this approach has its merits, we would caution that fixed deposits entail taking on reinvestment risk for at least several years, relative to the opportunity, in order to effectively lock in attractive yields. The increasing likelihood of a global recession in 2023 could also supply a catalyst for less restrictive monetary policies and lower longer-term bond yields under a flight-to-quality scenario.

Against today's structurally higher inflation backdrop, we believe global central bankers will be somewhat hamstrung from cutting their policy rates to levels reminiscent of the post-GFC/pre-COVID years. That said, recent inflation data across a number of developed economies suggest that inflation may have peaked, which would enable central banks to pause or slow the pace of their rate-hiking cycles. Market pricing of policy rates has shifted in recent months, but most are expected to remain elevated, with some chance of rate cuts later in 2023 (**FIGURE 4**).

Bottom line: Investors should be aware of the implicit reinvestment risks they would be assuming with an allocation to fixed-rate deposits vs. investing in fixed-income assets instead.

FIGURE 4: Global Central-Bank Policy Rates

Based on futures pricing (%)

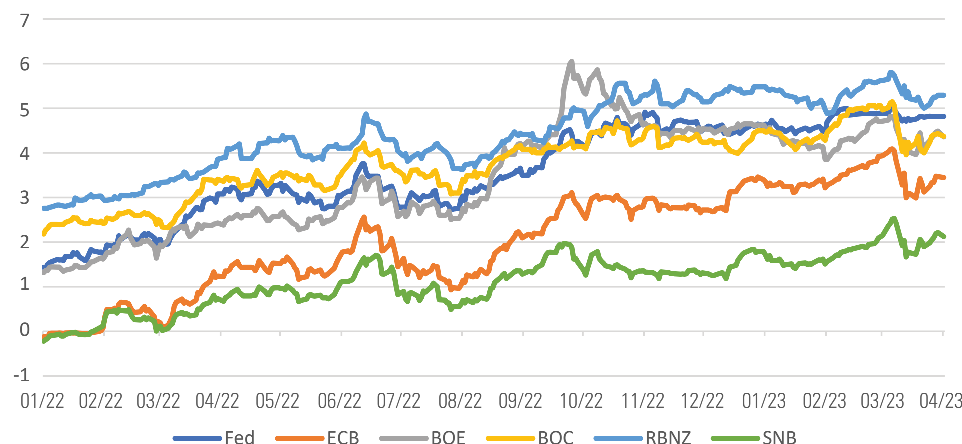


Chart data 1/3/22-4/3/23. Source: Bloomberg, Federal Reserve, European Central Bank, Bank of England, Bank of Canada, Reserve Bank of New Zealand, and Swiss National Bank.

Portfolio Implementation Ideas to Consider

We expect continued volatility in both the interest-rate and credit markets, with potential for meaningfully greater dispersions among:

- **Countries/regions** — Global governments may make very different decisions, depending on many factors, not the least of which will be where the country is in its economic and electoral cycles.
- **Credit sectors** — Amid continued uncertainty and volatility, some credit sectors could sell off to varying degrees, presenting opportunities for investors to rotate across the global fixed-income spectrum.
- **Individual issuers** — Companies that can swiftly identify and adjust to change, control their costs, and wield pricing power may be well-positioned to outperform those that cannot.

Against this global backdrop, there are a few fixed-income strategies that we believe can help meet a range of investor needs and objectives (**FIGURE 5**):

FIGURE 5: Strategies to Consider for Different Objectives

Total return in beta recovery	Credit-like returns uncorrelated to broader market	Risk mitigating and diversifying
Multi-Sector Credit Fixed Income High Yield	Credit Total Return Securitized Opportunities Core Bond Plus	Global Total Return Opportunistic Core Bond

For illustrative purposes only. Source: Wellington Management.

1. **Risk-mitigating and diversifying strategies:** Many investors allocate to high-quality fixed income through a core-bond strategy that includes government and high-rated corporate bonds. For added portfolio diversification, we believe many could also benefit from having allocations to flexible, nimble approaches that aim to capitalize on country-specific characteristics and elevated market volatility (including strategies that seek positive absolute returns regardless of market direction).
2. **Core-plus/total return in beta recovery:** A somewhat more risk- tolerant investor, and/or one looking to de-risk from equities, may opt for a "core-plus" bond strategy that invests in higher-risk assets such as emerging-markets debt and high-yield debt. Others may prefer a more dynamic rotational approach, complementing their core allocations with strategies that target fixed-income sectors with higher yields and/or potentially more attractive relative value.
3. **Credit-like returns uncorrelated to the broader market:** A third option is pairing a core bond portfolio with a credit strategy that seeks to deliver consistent excess returns (over its benchmark) across a variety of market environments, with low correlation to traditional fixed-income market betas.

For more fixed-income ideas, please contact your Hartford Funds representative.

[1] Based on calendar-year total returns for both the Bloomberg US Aggregate Bond Index and the Bloomberg Global Aggregate Bond Hedged USD Index. The Bloomberg Global Aggregate Bond Hedged USD Index represents the global investment-grade fixed-income markets.

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

[3] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index.

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

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

[6] 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.

[7] Stock/bond correlations tend to be positive based on a central bank/inflation-driven catalyst and negative based on an aggregate demand-driven catalyst. Much of 2022 was characterized by Fed-/inflation-driven catalysts, resulting in more positive stock/bond correlations that dampened fixed income's typical diversification benefits.

[8] Pull-to-par is the movement of a bond's price toward its face value as it approaches its maturity date.

[9] An option-adjusted spread is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options.

[10] 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. A basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[11] The term yield to maturity (YTM) refers to the total return anticipated on a bond if the bond is held until it matures.

Ba US high yield is represented by the Bloomberg US High Yield Corporate Bond Index, which 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. **Bank loans** are represented the Morningstar 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. **Emerging-market debt** is represented by the JP Morgan EMBI Global Diversified Index, which tracks total returns for traded external debt instruments in the emerging markets. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. **Euro high yield constrained** is represented by the ICE BofAML European Currency High Yield Constrained Index, which tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the Eurobond, sterling domestic, or euro domestic markets. **Euro-agg corporates** is represented by the Bloomberg Euro Aggregate Corporate Total Return Index, which is a benchmark that measures the investment grade, euro-denominated, fixed-rate bond market, including treasuries, government-related, corporate and securitized issues. **Global government** is represented by the Bloomberg Global Treasury Index, which tracks fixed-rate, local-currency government debt of investment-grade countries, including both developed and emerging markets. **Global investment-grade corporates** are represented by the Bloomberg Global Investment Grade Corporate Bond Index, which is a rules-based market-value-weighted index engineered to measure the investment-grade, fixed rate, global corporate bond market. **Global securitized** is represented by the Bloomberg Global Aggregate Securitized Bond Index, which is a subset of the Bloomberg Global Aggregate Bond Index that tracks securitized bonds. **High yield** is represented by the Bloomberg US High Yield Index, which covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds of issuers in non-EMG countries are included. **IG corporate** is represented by the Bloomberg US Corporate Investment Grade Bond Index covers all publicly issued, fixed rate, nonconvertible, investment grade debt. **JP Morgan CEMBI BD** is represented by the JP Morgan Corporate Emerging Markets Bond Index (CEMBI), which is a global, liquid corporate emerging-markets benchmark that tracks US-denominated corporate bonds issued by emerging-markets entities. **JP Morgan EMBI GD** is represented by JP Morgan EMBI Global Diversified Index, which tracks total returns for traded external debt instruments in the emerging markets. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. **MBS** is represented by hard currency only. In April 2020, May 2021, and January 2022, MBS index spreads were impacted by updates to Bloomberg's prepayment model. **Non-agency CMBS** is represented by the Bloomberg US CMBS Investment Grade Index, which measures the market of US Agency and US Non-Agency conduit and fusion CMBS. **US MBS** is represented by the Bloomberg US Mortgage-Backed Securities Index, which tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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. • 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.

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