Allocating to Fixed Income in an Age of Austerity

In periods of volatility and uncertainty, bonds have historically offered stability.

Insight from sub-adviser Wellington Management

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Policy and geopolitical risk are rising almost exponentially. Policy communication, still-sticky inflation, and rapidly cooling economic data all have added substantial turmoil to markets. In this environment, it's easy for allocators and end-investors to feel powerless amid the chaos.

One potential solution? Consider adding to fixed-income allocations.

The Problems: Breaking Down the Backdrop

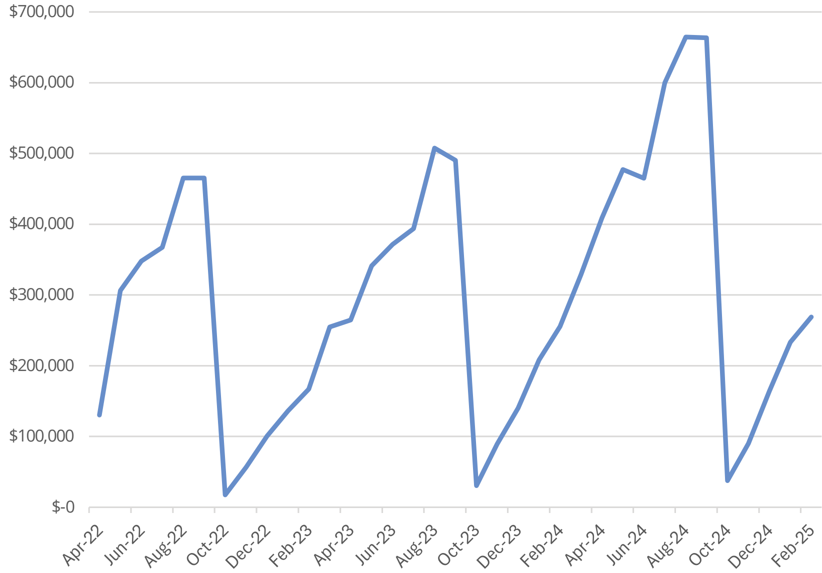
Over the course of early March, fixed-income markets rallied as risk assets sold off. As the new US presidential administration launched the largest tariff increase in nearly a century, markets struggled with which effects—slower growth or higher inflation—would translate into pricing. The answer came as US Treasury yields moved broadly lower, reflecting heavy concerns about slowing growth. To understand these dynamics, it's necessary to break down the political and economic backdrop.

While the stated goal of the second Trump administration is a reduction in government spending, current policy has added a substantial amount of opacity about fiscal outlays. Consumer and business confidence has declined, likely with adverse consequences for spending and capital-expenditure decisions. Indeed, this pushback on animal spirits occurs at a time when government spending is currently running higher than 2024 levels (**FIGURE 1**). Year-to-date spending for the first two months of 2025 was $269 billion, up from $255 billion for the same timeframe in 2024.

Key Points

- US Treasury yields have moved lower due to concerns about slowing growth.
- Portions of the consumer market are weakening, and this could be exacerbated by tariffs.
- Prudent fixed-income investors should consider the potential benefits of being flexible and active, and investing globally.

FIGURE 1
Federal Spending Levels Are Running Higher Than in 2024
Treasury General-Account Total Withdrawals (4/22–2/25)



As of 2/28/25. Data Sources: Department of the Treasury, Wellington Management, and Hartford Funds.

Congress passed a budget resolution that extended current government spending through the US fiscal year that ends September 30. While the resolution averts a government shutdown for the time being, a larger debate still looms as Republicans seek an extension of the 2017 Tax Cuts and Jobs Act, set to expire at the end of this year, along with cuts to several social programs.

The tax cuts themselves, which are an extension of policies already in place, are unlikely to produce additional stimulus. Paring back services to pay for them, which the resolution aims to do through reducing Energy & Commerce Committee spending by more than $800 billion, could have an immediate impact on aggregate demand. This spending is linked to Medicaid, and given the matching state funds that often accompany Medicaid, we're likely to see a fiscal drag on demand.*

On top of these changes and the increased spending so far this year, the labor market is in stasis, and consumer confidence continues to weaken. Labor demand has cooled rapidly so far this year, with layoffs only just beginning and pauses in hiring portending further labor-market deterioration.

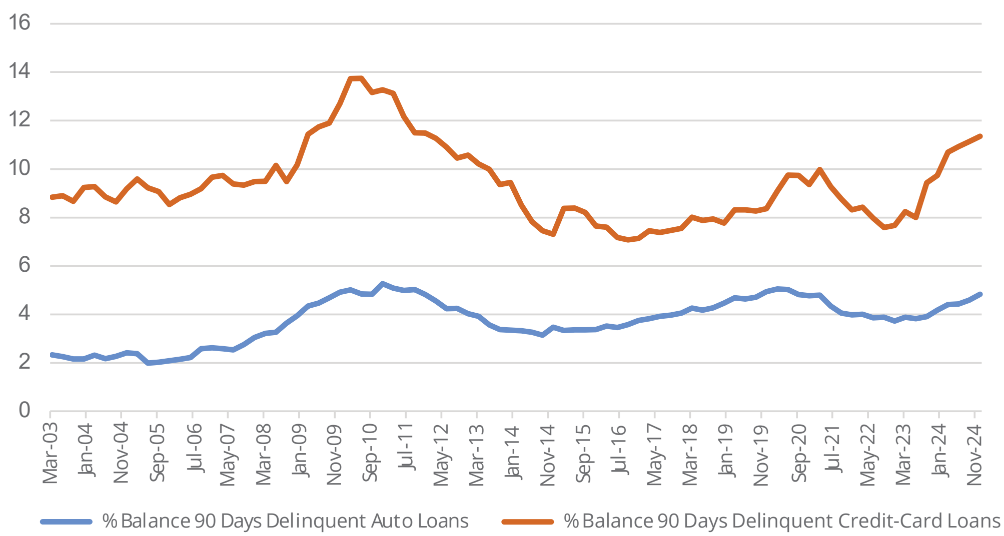
Initial job losses will be reflected among federal employees and contractors. While these represent a small portion of total payrolls, the sheer size and speed of federal layoffs will likely have spillover effects in labor sentiment. This comes at a time when portions of the consumer market are weakening, with 90-day delinquencies in auto loans and credit-card balances having risen to multi-decade highs (**FIGURE 2**). Importantly, tariffs could weaken consumer demand while the labor market is cooling.

> 90-day delinquencies on auto loans and credit-card balances have risen to multi-decade highs.

FIGURE 2

Auto-Loan and Credit-Card Delinquencies Are Rising

Consumer-Loan Default Rates (3/31/03-12/31/24)



As of 12/31/24. Data Sources: Federal Reserve Bank of New York, Bloomberg, Wellington Management, and Hartford Funds.

* The final draft of the bill may include additional tax stimulus either in increasing the SALT (state and local tax) cap or having no taxes on tips. The SALT deduction permits taxpayers who itemize when filing federal taxes to deduct certain taxes paid to state and local governments. The Tax Cut and Jobs Act capped it at $10,000 per year, consisting of property taxes plus state income or sales taxes, but not both.

The Potential Solution: Implementing Fixed Income

Against this backdrop, we argue that while a fixed-income allocation is always a compelling component of a diversified portfolio, it's more important now than it's been in recent memory. But, of course, there's more than one way to allocate to fixed income. In our view, prudent investors may wish to do the following:

- **Be active, be flexible:** We think adhering to pure benchmarks during a time of volatility and uncertainty is likely to diminish returns rather than enhance them. While growth could slow, inflation could remain sticky, presenting a stagflationary[1] impact. If this is the case, dynamic fixed-income strategies will likely fare better than rigid, benchmarked strategies.
- **Go global:** Bond markets abroad have come alive. Often, when hedged back to US dollars, international fixed income can potentially offer a more attractive return with additional diversification.
- **Remember, not all fixed income is created equal:** We expect credit markets to continue to perform, but be mindful of issuer and sector selection. This will be critical for risk management.
- **Consider yield:** Yields are still attractive from a historical perspective and may offer substantial carry[2] and cushion to total return.

The political and economic narrative is likely to seesaw back and forth as policies are announced, withdrawn, and rescheduled, but the net effect is potential market volatility. While we believe the underlying US economy remains in good shape (without the strategic imbalances that were endemic in the era leading up to the 2008 Global Financial Crisis), headwinds exist, and investor vigilance is necessary. We believe that as these new paradigms take root, fixed income could be an attractive option in a volatile and uncertain environment.

To learn more about the benefits of investing in fixed income, talk to your financial professional.

[1] Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation.

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

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. • Foreign investments may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. • Diversification does not ensure a profit or protect against a loss in a declining market.