

# Credit: The Power of Flexibility in An Uncertain World

Uncertainty in credit markets can create opportunities, but investors should strike a balance between flexibility and discipline.

Today's fundamentally different economic era—defined by structurally higher inflation, greater volatility, and more frequent market cycles—can present compelling opportunities for active fixed-income investors. I believe this to be the case not only in spite of heightened unpredictability, but in some instances, because of it. In my view, uncertainty can create opportunity for fixed-income investors, provided they can achieve the right balance between flexibility and discipline.

## How Bond Investors Can Harness Market Ambiguity

We tend to view fixed-income markets as a constantly evolving equation. Simply put, this means there's a good result (outcome A) and a bad result (outcome B). I believe, however, that attempting to predict the right future outcome and position your portfolio accordingly is futile, especially given the inherent unpredictability of the new economic era.

Instead, I find more value in identifying a crowded trade—where the probability of outcome A is perceived to be much higher than the probability of outcome B—and analyzing why outcome B may be more likely than market consensus and pricing imply.

When you apply this way of thinking, uncertainty can create opportunities for bond investors to capitalize on mispricing. The current market environment is marked by wider performance dispersion across regions, sectors, and issuers alongside elevated inflation and increased cyclical, presenting many such opportunities.

## Adapting to Shifting Conditions

How might this approach work in practice? Two examples come to mind:

The first relates to the consumer-finance sector in 2023. Going into 2023, the market was concerned about the impact of interest-rate hikes by the US Federal Reserve, believing that consumer-finance companies would be particularly at risk if recession fears materialized (outcome A).

While we couldn't dismiss the possibility of a recession, we hypothesized about the probability of outcome B, that the US consumer was in a far healthier state than the market realized, interest-rate hikes were having less of an impact on consumers than had been feared, and small businesses weren't as dependent on regional banks as the market seemed to think they were.

By working closely with sector-specific experts and diligently analyzing alternative data, we were able to position portfolios to capitalize on this mispricing and uncertainty.

The shifting dynamics of the Trump administration's policy mix provides a more recent example. In this scenario, outcome A is that the Trump administration's policies boost US growth and extend the economic and credit cycles, and outcome B is that they trigger a negative growth shock and tighter financial conditions. While both scenarios are plausible, I believe the latter may be more likely than the market expects.

## Insight from sub-adviser Wellington Management



**Connor Fitzgerald, CFA**  
Fixed-Income Portfolio Manager

## Key Points

- Today's volatile environment is a timely reminder that while markets are unpredictable, flexible fixed-income allocations may help investors take advantage of periods of volatility.
- While flexibility is important, it should be balanced with discipline to avoid taking on unnecessary risk.
- Investors should be mindful that focusing too much on yield could mean they risk overpaying for income and underestimating the impact of price volatility on returns.

President Donald Trump's re-election seems to be accelerating underlying trends around weaker labor supply and a deteriorating fiscal backdrop. While tariffs may ultimately serve as a negotiating tool, they currently appear to be one of the few identifiable sources of funding within the administration's economic strategy. This could suggest a reliance on tariffs to help support tax-cut extensions or additional stimulus measures. That said, the approach carries the risk of disrupting global trade, which could have unintended consequences.

Tighter immigration policies could also be negative for growth. Immigration hasn't only been a positive catalyst for labor-supply growth but also a stimulant for demand. With fewer people seeking housing, food, goods, and services, will prices adjust downward? The effects could be especially acute in the housing sector, as the US has been aiming to close a structural housing-supply deficit.

## Making Sense of a Complex Environment

So, how can bond investors leverage uncertainty to their advantage? We think the following considerations may help:

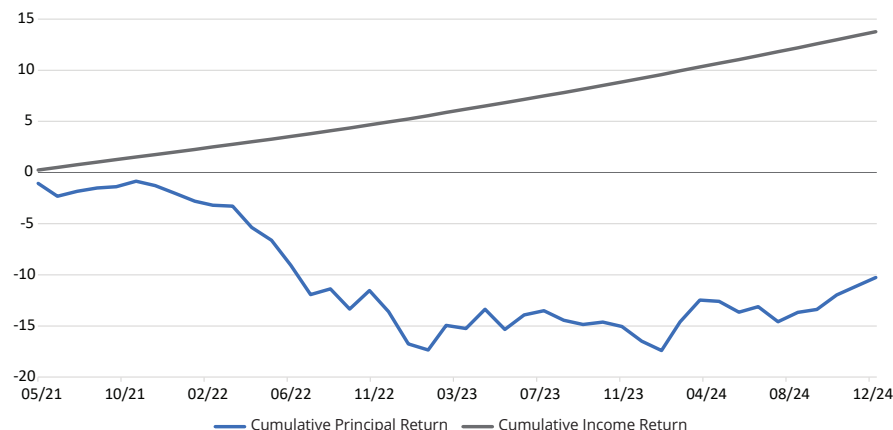
1. **Embrace flexibility to seize dislocations** – Bond allocations should be flexible enough to take advantage of dislocations as they occur. An unconstrained approach has a greater ability to capitalize on opportunities than a benchmark-oriented approach does.
2. **Balance flexibility with discipline** – An unconstrained approach can capitalize on opportunities, but it can also leave investors exposed to unnecessary risk. Employing a resilient and consistent framework to continually assess the upside and downside risks of every decision and possible price outcome can help investors seeking to achieve an “all-weather” total return experience.
3. **Focus not only on income but also on total returns** – Investors who focus too much on yield risk overpaying for income and underestimating the impact of price volatility on returns. Comparing a bond's cumulative return from income vs. its rolling price change over time serves as a good illustration of the importance of paying attention to total returns (**FIGURE 1**).

An income-focused investor who ignores total returns may experience drawdowns on certain bonds in their portfolio. In contrast, a more flexible investor who prioritizes total return may be able to better adapt to shifting market conditions. This approach may help them avoid much of the initial drawdown and instead benefit from a potential rally.

**FIGURE 1**

### Price Volatility Can Erode Fixed-Income Gains

Bloomberg US Intermediate Corporate Index: Cumulative Principal and Income Returns (%)



“

A more flexible investor who prioritizes total return may be able to better adapt to shifting market conditions.

Chart data: 5/31/21-12/31/24.

**Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Rolling monthly price change for cumulative principal and income returns for Bloomberg US Intermediate Corporate Index, which tracks investment-grade, fixed-rate, USD-denominated corporate bonds from industrial, utility, and financial issuers with at least \$300 million outstanding. For illustrative purposes only. Data Source: Bloomberg.

4. **Consider multiple perspectives** – As fixed-income investors, we naturally scrutinize central-bank movements, inflation levels, and macroeconomic indicators. But bond investors have much to gain from perspectives that might not immediately come to mind, such as looking at issuers with an equity investor's lens or assessing the potential impacts of geopolitical shifts.
5. **Liquidity as a tool for opportunity** – Keeping some liquidity on hand—even when markets appear stable—may help investors act quickly when opportunities arise. Rather than waiting for a downturn, having some “dry powder” on hand during tighter spread<sup>1</sup> environments may make it easier to step in when valuations become more attractive.

## Bright Spots Exist, If You Can Capture Them

Today's more volatile backdrop is a timely reminder that markets are inherently unpredictable. Yet, rather than being a hindrance, volatility can serve as a performance driver for those who are willing to think critically about shifting probabilities in fixed-income markets and adapt their portfolios to perform across different phases of the market cycle.

**To learn more about fixed-income strategies in volatile markets, please talk to your financial professional.**

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

“Bloomberg®” and any Bloomberg Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the indices (collectively, “Bloomberg”) and have been licensed for use for certain purposes by Hartford Funds. Bloomberg is not affiliated with Hartford Funds, and Bloomberg does not approve, endorse, review, or recommend any Hartford Funds product. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to Hartford Funds products.

**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.

The views expressed herein are those of Wellington Management, are for informational purposes only, and are subject to change based on prevailing market, economic, and other conditions. The views expressed may not reflect the opinions of Hartford Funds or any other sub-adviser to our funds. They should not be construed as research or investment advice nor should they be considered an offer or solicitation to buy or sell any security. This information is current at the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management or Hartford Funds.

Mutual funds are distributed by Hartford Funds Distributors, LLC (HFD), Member FINRA. Certain funds are sub-advised by Wellington Management Company LLP. Wellington Management is an SEC registered investment adviser. HFD is not affiliated with any sub-adviser.