HARTFORDFUNDS
Our benchmark is the investor.®

Could the Global Policy Response Misfire?

Valuations in many markets are broadly cheap, and since a great deal of uncertainty is already priced in, there may be opportunities to consider adding to exposures in the coming months.

Turbocharging of Two Critical Themes

Two critical themes have underpinned our team's macro research over the last few years:

1. **The global economy is becoming less integrated**, with higher hurdles for cross-border labor and capital flows, and growing pressure on supply chains.
2. **Policymakers seem increasingly unwilling to inflict the pain needed** to pull inflation sustainably back to target.

In combination, these trends are reshaping the macroeconomic backdrop, leading to higher and more volatile inflation, shorter and less stable cycles, and structurally higher risk premia[1] and yields.

Ripping Up the Post-War Playbook

These two themes are now being turbocharged by the US's disengagement from leading the post-war monetary and economic order it shaped as it seeks to implement the Trump administration's America First agenda. In the process, this shift away from the principles of free movement of goods and capital is creating economic, policy, and geopolitical uncertainty.

Whatever the result of the ongoing trade negotiations, the world's largest consumer is likely to end up with the highest effective tariff rate since the 1930s on imports from its trade partners. In our view, this will:

- accelerate deglobalization as the ratio of trade-to-goods production is likely to continue declining, reversing the trend of the past 30 years;
- represent a structural headwind to growth, particularly in the US. A 10%–15% US effective trade rate would be a bigger hit to US growth than the rest of the world because it is, in effect, a tax on US consumers;
- over time, entail a negative supply shock for all because supply chains may become less productive and more costly; and
- longer term, disrupt the flow of global savings invested in US financial markets, with a growing reallocation of capital to other markets.

Policy Reaction With Unintended Consequences

Policymakers' response to these developments is further adding to structural upward pressures on inflation.

First, governments are further loosening fiscal policy. Perhaps the most important macro data point over the past five years has been the unwillingness of almost all governments, particularly in the developed world, to reduce their fiscal deficits, despite strong nominal growth and record low unemployment. Low unemployment rates (and high nominal growth) normally coincide with shrinking fiscal deficits as tax revenues improve. But countries have failed to allow that to materialize in recent years. Instead, governments everywhere have spent the cyclical gains.

Insight from sub-adviser Wellington Management

John Butler
Head of Emerging-Market Equities

Key Points

- Rising US protectionism is turbocharging many of the defining features of the new economic era by accelerating deglobalization, worsening the inflation/growth trade-off, and increasing risk premia and global yields. Over time, we think the America First agenda should drive a structural reallocation of global capital flows away from the US.
- Policymakers' response to these developments is further adding to structural upward pressures on inflation. We began the year with remarkably supportive macro conditions. Since then, policymakers' response to the tariffs shock has been to add more stimulus.
- If trade uncertainty eases, this would remove a negative tail risk and drive a significant reacceleration in global inflation. That would be positive for nominal growth in the near term but could mean central banks risk being caught offside with policies that are too loose. Such a scenario would embed structurally higher inflation further and, ultimately, heighten the probability of a boom-and-bust cycle.
- If, on the other hand, today's uncertainty triggers a sustained increase in savings by consumers, we could be heading for a global recession and increased scrutiny over the sustainability of sovereign debt.

Now, governments are once again responding to a “negative” supply and geopolitical shock by further fiscal loosening, which is projected to result in the most significant fiscal relaxation since 2010, with the obvious exception of the COVID-19 pandemic. On a positive note, we think the stimulus in countries such as Germany, Japan, and China should drive up domestic demand and help narrow global imbalances, but it could come at the price of structurally higher inflation. Unlike in 2010, when there was significant slack in the global economy and obvious pain (a high unemployment rate), today’s fiscal loosening is happening with global unemployment close to 40-year lows and core inflation globally well above target.

> Today’s fiscal loosening is happening with low global unemployment and global inflation well above target.

Second, global monetary policy is being loosened, too. While the Federal Reserve appears reluctant to cut rates given the potential impact of tariffs on inflation and a stimulative America First agenda, the rest of the world has reacted by cutting rates, while Japan has put the brakes on its hiking cycle, meaning global policy rates are now substantially below the global nominal GDP growth rate. Despite central-bank assertions to the contrary, it wasn’t clear ahead of the tariff shock that global policy was tight; that’s even less clear now.

Savings Behavior Is Key in Understanding Potential Outcomes

This policy response is further sowing the seeds for higher structural inflation.

How quickly we engage with that will depend on the scale of the US trade and uncertainty shock. Has the Trump administration undermined confidence to the extent that the private sector will run higher precautionary savings going forward? Or will the momentum toward some trade deals and lower tariff rates restore confidence sufficiently to unblock halted spending? We see two potential outcomes ahead:

1. If consumers and companies respond by saving more, any additional fiscal and monetary loosening will probably be ineffective. The private sector may just save if it thinks a global recession is the most likely outcome. In such a scenario, we expect investors to ask increasingly awkward questions about the creditworthiness of highly indebted sovereigns.
2. However, if, instead, uncertainty starts to lift over the next few months, we think policy stimulus and its consequences will be the development to watch.

On balance, the second outcome appears more likely to us at this stage, meaning that as uncertainty fades, the world is left with more expensive and inefficient supply chains, but a policy stance designed to boost demand. In this scenario, we would expect to see nominal growth reaccelerate and inflation move back up from already high levels, with central banks caught significantly offside with policies that are too loose. The interest-rate debate later this year could then turn to when central banks start reversing recent cuts.

Stimulative policy and surprisingly high nominal growth may feel good. However, we believe it’s ultimately taking us to a much less stable macro environment with more compressed boom-and-bust cycles, so current policies would need to be reversed. Politically, that’s unlikely to come from the fiscal side. It would, therefore, fall to central banks to step in. We think failure to do so would lead to ingrained inflation, higher long-term rates and, ultimately, a much more unstable cycle.

Developments over the next six months or so may give us a greater sense of the direction of travel. Meanwhile, we believe it’s important for investors to keep an open mind and to consider pivoting in either direction while seeking to reduce uncertainty.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

Important Risks: Investing involves risk, including the possible loss of principal. • 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. These risks may be greater, and include additional risks, for investments in emerging markets such as China.

The views expressed here 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.