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2025 Midyear Outlook: Perspective on Markets and the Economy

JULY 7, 2025
Asset Allocation Outlook

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Severance: The Split Between the Economy and the Markets

As global markets diverge from economic fundamentals, investors face a landscape shaped by tariffs, policy uncertainty, and shifting regional opportunities.

Key Points

- **Peak tariffs appear to be in the past, but policy uncertainty is still a factor in our view on risk.** We expect lower growth and higher inflation as tariffs eventually weigh on consumers and businesses. While that's not a great environment for risk assets,[1] we see a low risk of recession and think fundamentals continue to support a slight overweight in global equities relative to bonds.
- **We continue to see relative advantages to equity markets outside the US that may benefit from fiscal stimulus**, including Europe and Japan, and from a longer-term trend of declining US exceptionalism. We have a neutral view on European and emerging-market (EM) equities, a moderately overweight view on Japan, and a slight underweight view on the US.
- **We have a neutral view on duration,[2] and a slight overweight view on credit.** The Federal Reserve (Fed) and markets remain in a "wait and see" mode, as they gauge the effect of tariffs on growth and inflation. Thus, we don't see much opportunity in an outright duration view and prefer to take advantage of mispricings in regional bond markets. While spreads[3] have tightened, high yield has earned decent carry[4] with low refinancing risk.
- **We have an underweight view on oil, as we think the market may be in a surplus this year, as OPEC slows production cuts.** Tensions in the Middle East could upend this view by increasing the risk premium[5] for oil. However, we expect the geopolitical flare-up to fade. We maintain our overweight view on gold, given central-bank demand and the metal's potential to protect against stagflation (weak growth and high inflation).
- **Downside risks** include a supply-induced spike in inflation due to tariffs or a sustained rise in oil prices, which could crater global growth; policy uncertainty, which could slow economic activity and raise the risk of a US recession; and an escalation of geopolitical tensions. **Upside risks** include reasonable US trade deals with Europe and Japan; the passage of a US budget deal that reduces taxes and regulation; and a jump in US productivity that increases growth potential without higher inflation.

Insight from sub-adviser Wellington Management

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Since President Donald Trump shook the markets with his Liberation Day tariff announcement in early April, risk markets have climbed the proverbial wall of worry, with stocks bouncing back from double-digit sell-offs. Multiple rounds of tariff threats and walk-backs taught markets that the pattern of threat/détente will probably continue, but the worst-case scenario may be behind us.

Meanwhile, consumers and businesses are hanging in there. Lower-income consumers are under some stress, but higher-income consumers continue to spend. And first-quarter corporate earnings surprised to the upside, especially in technology. The wake-up call from the US administration to other nations to boost spending has resulted in more fiscal stimulus in Europe and Japan. Finally, the inflation bogeyman hasn't come out yet, perhaps because demand is easing.

Against this backdrop, we have a slightly pro-risk stance on equities and credit, assuming a base case of slower growth and sticky inflation. Our caution stems primarily from policy uncertainty, which is weighing on economic activity, but also from the less-discussed impact of immigration restrictions that have shrunk the labor force, a reversal relative to the past few years. We see better value in regional plays in equities and credit and are particularly focused on these relative opportunities. With a nod to the TV series *Severance*, we're on the lookout for markets with "innies and outies"—that is, disconnects between the economy and markets.

For example, recent narrow gains in US equities, on the back of better-than-expected mega-cap tech earnings, have returned valuations to "priced for perfection" levels. As a result, we have an underweight view on the US relative to other regions where we expect the valuation gap to narrow. While Europe has enjoyed the best performance among developed markets (DM) year-to-date, we think it may be Japan's turn to rise, with substantial fiscal stimulus already enacted and more good news on corporate governance. We're also more open to the potential for EM equities to outperform the US, driven partly by improvements in China. Technology innovation and investments in green industries are shifting China's growth engine away from real estate, while fiscal stimulus appears to be boosting consumer spending.

Turning to government bonds, we're most interested in the disparate stances of central banks, as each region's domestic economy is being affected differently by tariffs. We think the market is overly bearish on the UK's fiscal situation, and favor duration there relative to Europe, where the European Central Bank (ECB) has already delivered 175 basis points (bps)[6] of rate cuts over the past year, yet markets expect even more. We prefer a short-duration stance in Japan, where we think the Bank of Japan (BOJ) will finally deliver rate hikes in response to higher inflation, even as more fiscal stimulus could add to inflationary pressure. Despite tight spreads, we maintain our overweight view on high yield, which is supported by continued low default rates, higher-quality names, and limited supply.

Equities: It's All Relative

We retain our slight overweight view on global equities. We still expect positive earnings growth across all major regions and believe downward earnings revisions may have bottomed out, but we're cautious on valuations. The current tight equity risk premium suggests excessive optimism, in our view, and implies that tail risks are underpriced. While there are reasons for optimism, as noted earlier, the market seems to assume that tariffs and other policies will avoid causing any economic damage, and it's incorporating little geopolitical risk premium.

We maintain an overweight view on Japan relative to the US, thanks in part to the valuation gap between the two. Governance reforms in Japan are gaining momentum, boosting both return on equity (ROE) and corporate balance sheets. Japan has historically lagged in ROE compared to global peers, but this is changing and strengthening the argument for higher price-to-earnings multiples (**FIGURE 1**). Along with Europe, Japan has one of the highest levels of cash return to shareholders, through both dividends and buybacks. Policy—and specifically the potential for yen strength—could be a headwind, however, preventing us from taking a larger overweight stance against the US.

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	—
DM government bonds	Neutral	—
Credit Spreads	Moderately OW	—
Commodities	Neutral	—
Cash	Moderately UW	—
Within Asset Classes		
Global Equities		
US	Moderately UW	↓
Europe	Neutral	—
Asian DMs	Moderately OW	↑
EMs	Neutral	—
DM Government Bonds		
US government	Neutral	—
Eurozone government	Moderately UW	↓
UK government	Moderately OW	↑
Japan government	Moderately UW	↓
Credit Spreads		
Global investment grade credit	Neutral	—
Global high yield	Moderately OW	—
EM debt	Neutral	—

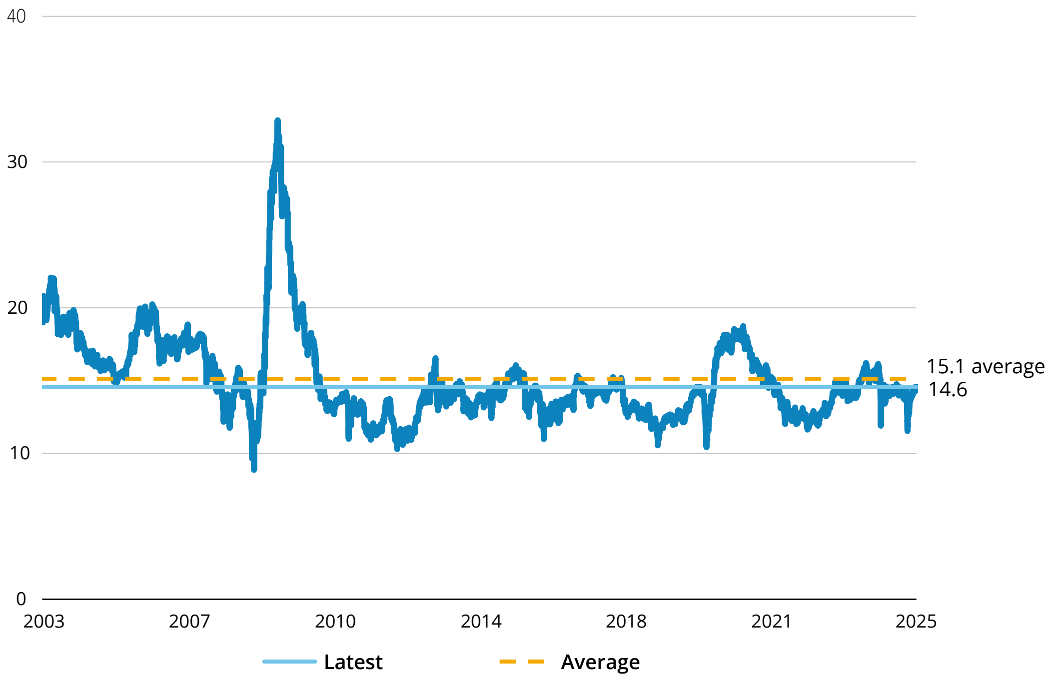
OW = overweight, UW = underweight

Views have a 6–12-month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 6/30/25, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This is not to be construed as investment advice or a recommendation to buy or sell any specific security.

FIGURE 1

Japan Is Building a Case for Higher Earnings and Multiples

12-Month Forward Price/Earnings



Daily Data: 6/30/03-6/27/25. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Index used: IBES MSCI Japan, which is a free-float adjusted market-capitalization index designed to measure large- and mid-cap Japanese equity market performance. The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock. Data Sources: Wellington Management, MSCI, and Refinitiv.

High US valuations and the post-Liberation Day performance reversal reflect a skew to the most positive scenarios and contribute to our underweight view. Moreover, US market gains continue to be driven by the outperformance of a narrow group of the largest companies. We would prefer to see broader earnings growth and more widespread price trends. However, expectations for that broadening have been delayed. Companies are increasingly unable to pass through all the tariffs and may be forced to absorb some of the higher costs, which could dent profit margins.

We have a neutral view on European equities. We're positive on prospects for economic multipliers from the fiscal expansion underway in Germany, which provides some support for European equity valuations. However, earnings-per-share growth[7] may take time to materialize, particularly with currency strength weighing on foreign earnings. Key uncertainties also remain, including progress in trade negotiations.

We also have a neutral view on EMs. The US dollar remains soft, which typically supports EM assets. The likely peak of US-China trade headwinds, coupled with additional Chinese stimulus, provides upside. Inflation is largely under control in many EM economies, giving central banks room to ease policy and cut rates. However, we'd want to gain more conviction on global growth developments, tariffs, and geopolitical developments before we turn positive here.

Within sectors, we have an overweight view on utilities, financials, industrials, and consumer discretionary, against underweight views on information technology, materials, and energy. Utilities and financials are our highest-conviction overweight views, driven by fundamental tailwinds such as infrastructure spending and a more favorable regulatory environment for banks. On the other hand, macro headwinds to materials and energy equities persist, with our energy sector underweight view complementing our new underweight view on oil.

> Inflation is largely under control in many EM economies, giving central banks room to ease policy and cut rates.

Government Bonds: Central Banks Go Their Own Way

Pity the central bankers who must figure out how fiscal and trade policy moves will impact their economies! The consensus appears to be that tariffs will drive growth lower and inflation higher in the coming months. While we await definitive evidence of these outcomes, we don't see a big opportunity in being long or short overall duration. Fed Chair Jerome Powell has articulated a similar case for patience on interest rates. He argues that as long as the US economy is solid, the right thing to do is stick with the current policy stance and learn more over the summer. Signs of labor-market weakness are surfacing, and we think the Fed may be more likely to tilt in favor of its employment mandate and cut rates sometime this year, trusting that above-target inflation will ease. This expectation is priced in by markets.

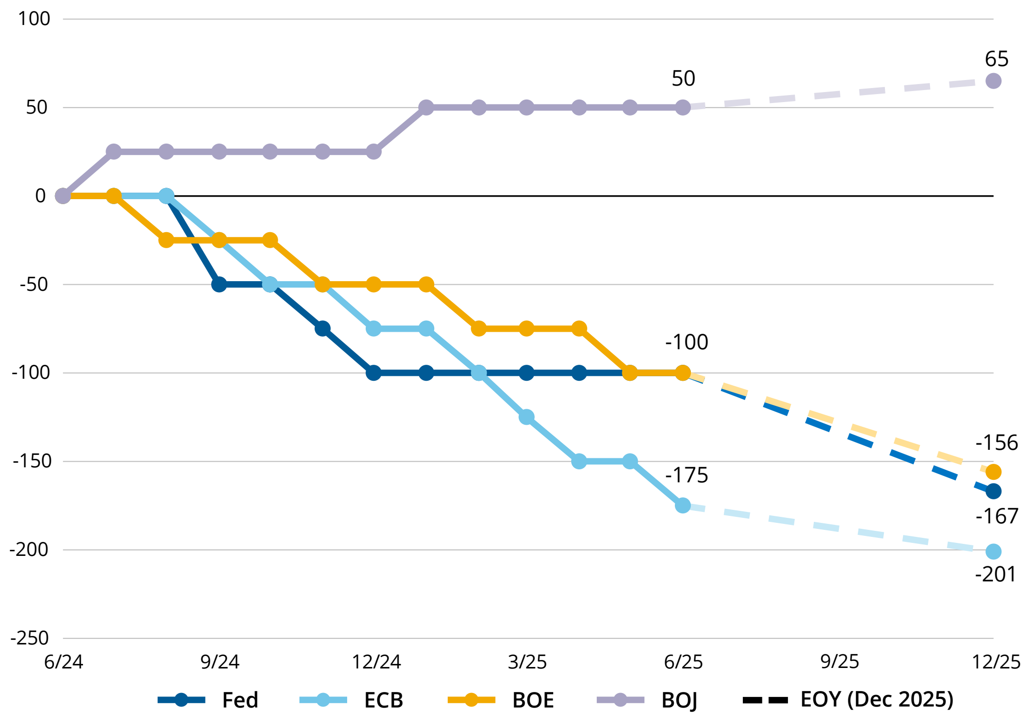
That said, central banks around the world are dealing with varied regional dynamics that require different policies (**FIGURE 2**), so "severance" between economies and markets abounds. In the euro area, as noted, markets expect the ECB to cut rates beyond the 175 bps already delivered. We see upside risks to longer-term yields, including tentative signs that euro-area demand is picking up from looser financial conditions and fiscal policy, and that inflation assumptions are too low. The details of a US-European trade deal will be important as well. We think the risk skew favors a hawkish scenario in which growth and inflation pick up, and 10-year yields rise.

> "Powell argues that as long as the US economy is solid, the right thing to do is stick with the current policy stance and learn more over the summer.

FIGURE 2

Divergent Central-Bank Policy

Current Cumulative Policy Rate Changes vs. End-of-Year Expectations



Monthly Data: 6/24-6/25. Policy rate changes from major central banks: the Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BOE), and Bank of Japan (BOJ), along with end-of-year (EOY) expectations for December 2025. Regional Overnight Index Swap (OIS) models used for rate expectations in Europe, Great Britain, and Japan; Fed funds rate model used for rate expectations in the US. The OIS is a financial derivative that reflects the average overnight interest rate over a set period and is used to estimate market expectations of future interest rates. The federal funds rate is the target interest rate set by the Federal Open Market Committee at which commercial banks lend and borrow excess reserves from each other overnight. Data Sources: Wellington Management and Bloomberg.

In Japan, inflation is becoming a problem. First-quarter nominal GDP was running above 5% year-over-year—10 times the policy rate of 0.5%. Business conditions are strong, especially among domestically oriented sectors, while labor markets are tight, and inflation expectations are accelerating. The BOJ should be hiking rates, but tariffs, which could cut into GDP and reduce confidence, remain a concern. Election uncertainty is also muddying the picture: Upper House elections happen on July 20, and the candidates are effectively competing on who can loosen fiscal policy more. Poor demographics are always pulling real yields in the other direction, yet we think the combination of inflation and fiscal risks will bias longer-term yields higher.

Where do we see opportunities relative to these concerns about Europe and Japan? We think yields could decline in the UK, where worries about fiscal slippage caused a spike in the term premium[8] that we believe is overdone, while the employment picture appears to be weakening.

Credit: Tight Spreads Okay in a No-Recession Scenario

Credit spreads roundtripped the widening we saw in early April and are back to historically tight levels. Given that our base case is no recession, balance sheets are healthy, and supply/demand technicals are still solid. We retain our slight overweight view on credit spreads. This is expressed in US high yield, which provided an all-in yield of 6%–7% as of June 24 that we think will continue to attract carry-seeking allocators. We also continue to highlight the secular improvement in the quality of the US high-yield market, as well as the alternative financing options available to issuers via the private credit markets, which have kept the default rate low. While spreads are tight, we also know that spreads can stay tight for a long time.

What could go wrong? The risk is that the combination of tariffs and an oil shock could increase the odds of a recession and weigh on risk assets in general. However, as long as inflation doesn't spike, we don't think a slower growth outlook would be problematic for spreads.

Commodities: Weighing Geopolitical Opportunities and Concerns

We maintain our neutral view on commodities. Structural tailwinds remain favorable for gold, including the geopolitical environment and flows from EM central banks and retail investors. The prospect of an acceleration in central-bank efforts to diversify their reserves may provide an additional kicker. That said, we see a case for pausing to wait for a more favorable entry point for a long position in gold. This comes within what we acknowledge is a strong uptrend (albeit with some volatility). A recent geopolitical premium has provided what we believe is a short-term boost to prices, and structural tailwinds remain, but valuations are extreme (the highest since 1980).

We moved to a small underweight view on oil following the recent spike in geopolitical concerns. While the situation in the Middle East is fluid, there's already a significant geopolitical risk premium in the oil market, even though prices have come down since the US strikes on Iran. Given that we see a low probability of a significant supply disruption, we think higher prices could give producers the opportunity to hedge 2026 production. This could reverse the trend of capital expenditures[9] and production discipline. We agree with the consensus view that there could be oversupply by the end of the year, creating a potentially attractive entry point for shorting crude, with the primary risk being the substantial negative carry drag.

"While the situation in the Middle East is fluid, there's already a significant geopolitical risk premium in the oil market.

Investment Implications

Here are four things investors may want to consider:

- **Maintaining a slight pro-risk stance** — We believe we're past peak uncertainty, but trade-policy uncertainty remains relatively high. Given our base case of no recession, we see a case for maintaining some risk in both global equities and credit. Within global equities, we favor utilities and financials. We have underweight views on materials and energy, with the latter reflecting our expectation that oil supply could lead to lower prices.
- **Positioning for equities outside the US to potentially outperform** — With the recent rebound, US equities remain narrowly concentrated in mega-cap tech stocks. We've seen comparable earnings growth outside the US at lower valuations, and we also expect continued foreign flows away from the US into other regions. We think allocators may want to consider shifting some of their US equity exposure to other developed markets and EMs.
- **Watching for fixed-income opportunities resulting from divergent policies** — While we don't currently have a strong overweight/underweight view on global duration, we see regional duration opportunities that can potentially add alpha[10] to portfolios. In particular, yields in the euro area and Japan look expensive relative to the UK given our expectation that fiscal stimulus, improving growth, and rising inflation expectations could push yields higher in the former markets.
- **Staying steady in spreads** — Given a no-recession base case, we maintain our slight overweight view on credit spreads, specifically in US high yield. Fundamentals and technicals continue to be supportive, and we think the all-in yield of 6%–7% is still attractive.

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

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

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

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

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

[5] A risk premium is the investment return an asset is expected to yield in excess of the risk-free rate of return.

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

[7] Earnings-per-share growth is the projected growth rate in earnings per share for the next five years.

[8] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

[9] Capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. Capital expenditures are often used to undertake new projects or investments by a company.

[10] The measure of the performance of a portfolio after adjusting for risk. Alpha is the excess return of a portfolio over its benchmark.

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 or if focused in a particular geographic region or country. • 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. • Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Diversification does not ensure a profit or protect against a loss in a declining market.

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.

Insight from sub-adviser Wellington Management

John Butler
Head of Emerging-Market Equities

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.

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.

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.

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

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.

The Rates Perspective: Can Bonds Provide Shelter for Stormy Weather Ahead?

Can bonds still act as defensive assets amid growing concerns over government-debt sustainability?

Insight from sub-adviser, Wellington Management

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

Marco Giordano
Investment Director

We started the year expecting rates to remain elevated and increased divergence across bond markets, as investors and policymakers reacted to increasingly local growth/inflation dynamics. Markets have pondered the possibility of rates staying higher for longer on several occasions since the inflation shock of 2021–2022, only to look for signals of any easing to prompt market rallies, such as in the last quarter of 2023 and last summer. The question, then, is this: Will this time prove to be any different? And what can a bond allocation offer in a broader portfolio?

Vigilantes Are Back, Capital Flows Could Follow

There has been no shortage of exogenous shocks in the first half of this year. The Trump administration's approach to tariffs escalated progressively. Further escalation ensued after the April 2 announcement, upending decades of trade policy, until a temporary reprieve was announced. In this context, longer-dated bonds, rather than equity markets, acted as the disciplinarian, forcing the administration to rethink its approach. This could mark the return of the so-called bond vigilantes—buyers who use their buying and selling power to influence policies—with fixed-income markets imposing a degree of restraint on governments whose fiscal outlook is increasingly deteriorating. Even if some of the tariffs are walked back through trade deals, there's an increased probability of more economic nationalism and repatriation of capital. We could start to see capital outflows from US financial assets into global fixed income, which should imply higher risk premia[1] and higher long-term bond yields for the US. In the rest of the world, this could be a strong technical factor to support non-US financial assets, with European, Japanese, and Chinese fixed income potentially benefiting from US outflows.

Storing Up Trouble

We continue to expect heightened volatility in rates markets around longer-dated maturities. Yield curves[2] across developed markets have now normalized, but could see further steepening due to persistent inflation and high government spending. Growing concerns about debt sustainability could lead to higher term premia[3] across developed markets, especially the US—a dynamic illustrated by **FIGURE 1**, which shows that, at the time of writing, the average term premium across developed markets had risen above 1.0% for the first time in 11 years.

Key Points

- Local factors are driving bond markets; inflation and fiscal issues are impacting markets, especially in the US, Europe, and Japan.
- Bond vigilantes have returned, pressuring governments and potentially prompting potential capital shifts from US to global bonds.
- US bonds may still maintain their defensive status, but investors are diversifying beyond US Treasuries amid rising volatility.

FIGURE 1

Term Premia Are Starting to Rise Across Developed Markets (%)

As of 5/22/25. Data Sources: Morgan Stanley and Wellington Management.

The euro area is a good example of this tension. The European Central Bank appears biased to continue its rate-cutting cycle, while the sustained increase in defense spending—especially in Germany—and deteriorating fiscal outlooks in some countries (notably France) could push long-term bond yields higher. Equally, the Japanese yield curve has steepened significantly in the last year with 30-year bonds reaching yield levels not seen this century, even if monetary policy remains stubbornly loose. Contrary to other markets, we expect to see a flattening of the Japanese curve should the Bank of Japan opt to hike policy rates, in response to a potential trade deal with the US and persistent, domestically generated inflation.

Finding the Right Defensive Asset

In times of macroeconomic turbulence, rates should act as an anchor that rallies as riskier assets depreciate. Investors have been skeptical of bonds' total return and their correlation to equities since the annus horribilis of 2022. Recent market turmoil suggests that bonds have generally regained their historical role, providing portfolios with income and downside mitigation. However, identifying where this anchor can be found could be changing. Over the course of April, global investors implicitly challenged the notion of the US Treasury market as the main diversifier asset in times of exogenous shocks. Moody's recent downgrade to the US credit rating (due to concerns about growing national debt) may further cement the view that alternative assets, such as European, Australian and Japanese government debt (as well as select currencies) can deliver the required diversification within a broader portfolio. Diversification does not ensure a profit or protect against a loss in a declining market.

In summary, bonds are demonstrating once again that they can be a defensive asset during heightened volatility, but an active approach may be warranted as local conditions increasingly trump the global cycle in driving market returns.

“Bonds are demonstrating once again that they can be a defensive asset during heightened volatility, but an active approach may be warranted.

Talk to your financial professional to learn more about fixed-income opportunities.

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

[2] The 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.

[3] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

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. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest. • 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.

JULY 8, 2025

Fixed Income Outlook

HARTFORDFUNDS

Our benchmark is the investor.®

The Credit Perspective: How to Navigate the Rapids in a Year of Market Crosscurrents

As conditions rapidly change, investors need to move with agility and purpose.

Did the first half of 2025 feel like a whitewater rafting trip you didn't sign up for? If so, you're not alone. What looked like a calm river paddle has turned into a wild ride that could've easily capsized markets and submerged the global economy. Yet the US economy has stayed afloat: Unemployment is historically low and consumers are still paddling. Corporate fundamentals in the US and beyond remain solid, with healthy cash flows, limited new debt issuance, and muted merger activity.

That said, we're not floating through calm waters. The US Federal Reserve (Fed) hasn't eased much, so monetary policy remains tight in the US while most other central banks have started to loosen the lines. Spreads[1] are wider than they were in January but still not what I'd call generous. In this environment, I'm staying cautious on risk while watching for better entry points downstream.

Looking Beyond the US

I don't expect a sharp loss of confidence in US markets, but I do think investors may start shifting their focus away from the US into other markets with more attractive potential. I'm leaning more heavily into non-US credit—specifically global high yield and emerging-markets corporates—seeking to build a more resilient portfolio in today's choppy waters.

Where Are We Spotting More Favorable Conditions?

- **European financials:** Well-capitalized and largely insulated from US trade dynamics, European banks look sturdy in turbulent waters. They may also be poised to benefit from German fiscal spending.
- **Emerging-market corporates:** Companies with limited US exposure, especially in sectors such as utilities and telecoms, can offer steady cash flows and low leverage. We're finding solid ground here.
- **Convertible bonds:** With tighter high-yield spreads, converts offer asymmetric upside. Their bond floors may help to provide protection in risk-off environments, while their equity linkage gives them strong potential in bullish scenarios. They also add exposure to tech and life sciences, sectors underrepresented in most fixed-income portfolios.

Where Are We Cautious (for Now)?

- **Long-dated investment-grade corporates:** Spreads are tight, and rising term premia[2] due to increased Treasury issuance could weigh on returns. With additional potential margin pressures from tariffs, we're cautious here.
- **Emerging-market sovereigns:** Fundamentals are solid, but the upside seems limited. We're focused on a select group of high-conviction improving credits.
- **Commercial mortgage-backed securities (CMBS):** The waters are choppy in CMBS. We're avoiding known hazards—lower-grade offices and regional malls—but in a few well-positioned areas, such as high-end New York office buildings and hotels, we see a clear opportunity.

Insight from sub-adviser, Wellington Management

Campe Goodman, CFA
Fixed-Income Portfolio Manager

Key Points

- The US economy has remained resilient, with strong employment and solid corporate fundamentals, despite tight monetary policy.
- Investors are shifting their focus globally and favoring non-US credit such as European banks, emerging-market corporates, and convertible bonds.
- With rising risks and tight spreads, caution remains key. This is especially true in long-dated investment-grade bonds, emerging-market sovereigns, and commercial mortgage-backed securities.

Running the Rapids Ahead

This year calls for the skills of a seasoned raft guide—adjusting as soon as conditions change, reading the currents, and ready to strike when the right course appears to emerge. A flexible, global approach can help navigate the waves while turning uncertainty into an edge. By staying nimble and broadening their horizon, investors can aim not just to stay afloat, but also to move ahead with agility and purpose in the second half of 2025.

Talk to your financial professional to learn more about fixed-income opportunities.

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

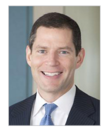
[2] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

JULY 7, 2025
Equity Outlook

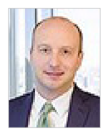
Beyond US Exceptionalism: Where Now for Equities?

Economic "regime change" has been underway for nearly a decade. Going forward, the global shift presents risks and opportunities for stock investors.

Insight from sub-adviser Wellington Management



Andrew Heiskell
Equity Strategist



Nicolas Wylenzek
Macro Strategist

Is the era of US exceptionalism coming to an end? It's an unsettling proposition for equity investors, who have long benefited from a seemingly unstoppable wave of US equity market returns and the strength of the US dollar. What could this mean for equity investors in 2025?

What US exceptionalism is depends on who you're asking. To most people, the term captures a sense of unassailable US leadership across multiple interlinked dimensions, such as geopolitics, military might, economic growth, fiscal spending, rule of law, technology and AI, and equity returns. As equity investors, we see US exceptionalism as the consistent outperformance of US equity markets relative to global counterparts. A shift in any of the dimensions that constitute US exceptionalism is likely to challenge many of the assumptions that have supported the US dollar's dominance, creating implications for not only currency considerations and Treasuries, but also US equities.

Key Points

- A "Goldilocks" era of synchronized global growth ended in 2015-2016, ushering in a zero-sum world of capital flights, populist movements, and fiscal drama. The Liberation Day tariffs were a symptom of changes already long underway.
- The long-term implications of regime change are yet to be fully understood, but a weaker US dollar could have direct implications for exposures to US equities, especially for non-US investors concerned about net returns and currency hedging.
- European equities, which sharply outperformed in the first half of the year, remain attractively valued in absolute and relative terms. Japanese equities may also benefit from increasing domestic investment, wage growth, and automation.

Liberation Day Marked a Turning Point, but Regime Change Was Already Underway

It might feel like this narrative has only been questioned in recent months—particularly in the wake of Liberation Day—but we see Trump's tariff announcements as the clearest signal yet of a shift that has already been underway for nearly a decade. The prior economic regime of expanding globalization was characterized by synchronized global growth, low dispersion,[1] low inflation, and falling interest rates—an era that began with the fall of the Berlin Wall, accelerated with NAFTA in 1994, and arguably peaked with the formation of the euro in 2000 and China's entry into the World Trade Organization in 2001. In a highly synchronized environment, investors were incentivized to reduce diversification and concentrate exposure into whichever asset class was delivering the best growth. Throughout this period, and especially since the Global Financial Crisis (GFC), growth leadership was consistently led by the US, particularly its large-cap tech sector—a perception only bolstered by a consistently strengthening US dollar (USD).

But the first cracks in this "Goldilocks" regime began to appear as early as 2015–2016. We saw a growth scare and capital flight out of China in the second half of 2015, Brexit in June 2016, a rise in populism, including the election of US President Donald Trump in November 2016, and the onset of US-China tariffs in 2018.

While the disruption caused by the pandemic obscured this picture, each of these events signaled a shift from globalization as a rising tide that lifted all boats to a more zero-sum, domestically reoriented world. We've seen this shift in elections across the US, UK, Germany, France, and Poland, where establishment parties have lost ground to anti-establishment movements representing, or claiming to represent, those that feel left behind by globalization. We've also seen the policy response increasingly shift from monetary to fiscal in an attempt to try and address these concerns.

A US recession was priced in, then out, of markets, leaving investor confidence fragile. In the wake of the Trump adminkstraion's tariffs, the market seems to be gripped by two opposing forces: short-term panic and long-term optimism. A key concern now is that the market overreacts to immediate risks while underplaying the potential for deeper long-term challenges.

What Does This Mean for US Equities?

Regime change and the actions of Trump 2.0 start to prompt questions around the durability of aspects of US exceptionalism, especially those related to geopolitics, fiscal spending, rule of law, and the treatment of foreign capital. The implications of this are yet to be fully understood, but the most obvious consequence of reduced US exceptionalism is likely to be a weaker USD, with implications for all USD assets, but more significant ones for currency and bond yields than equities. That said, a weaker dollar does have direct implications for exposures to US equities and certainly for how non-US investors think about their net returns and currency hedging.

The simple fact that we're transitioning away from an era of high synchronization and tight correlations[2] has significant implications for investors in terms of both opportunity set and risk management. Keeping all one's eggs in a US basket seems imprudent given the broader context. Many portfolios remain heavily concentrated in US equities and dollar-denominated assets, a reflection of capital finding its way to wherever it has historically been treated best. However, investors must now ask: How is that capital being treated now, and how might it be treated in the future?

None of this necessarily means that US large-cap tech companies are any less exceptional, but a shift toward lower correlations and heightened volatility means that diversification starts to matter again (diversification does not ensure a profit or protect against a loss in a declining market). Over the past decade, if you were heavily invested in US equities, diversification—and hedging the US dollar—would have been net detractors. That's no longer likely to be the case, given that country correlations are now at a multi-decade low.[3]

It could also provide greater scope for active managers to add value—a difficult feat when US large-cap equities just went up for 15 years. If the prior regime were all about high beta and low alpha,[4] the future regime could see the reverse: lower correlation and higher dispersion, creating more opportunities for active managers to add value.

> "Regime change and the actions of Trump 2.0 start to prompt questions around the durability of aspects of US exceptionalism.

Where Else Might Be Worth Looking?

European equities are in the middle of a regime change, which has recently started to accelerate, potentially driving the biggest rotation since the GFC and creating a major opportunity.

While European equities look tactically extended given their sharp outperformance in the first half of the year, they remain attractively valued in absolute and relative terms. This creates appealing potential opportunities for diversification as Europe's domestic outlook appears to have structurally improved.

This regime change is unlikely to be straightforward, but we believe the key winners will be parts of the value space such as European banks and telecoms, defense stocks, European small caps, and those enablers of the energy transition that are protected by high barriers to entry, such as grid operators. The likely losers are beneficiaries of globalization and lower interest rates.

Japanese equities may also benefit from a number of supportive dynamics, such as increasing domestic investment, shareholder activism, wage growth, and a push toward automation and efficiency. Higher dividends and buybacks, as well as structurally higher inflation, are also contributing to a more positive environment.

This is translating to an increasingly attractive opportunity set for Japanese equities, but it's worth noting that Japanese governance reforms and economic policy measures are most impactful on domestic small- and mid-cap stocks.

The new regime's reorientation toward domestic priorities has been a positive for smaller companies, reflected in the renewed outperformance of small-cap equities in most countries—other than the US. As the disruptive impacts of tariffs on inflation and growth begin to moderate, US small caps could also benefit from these same forces, especially if we see growth broaden out. This is where deep research can come into its own, given the fact that disparity, dispersion, and less sell-side coverage can help drive positive outcomes for active managers.

In a more volatile and slower-growth world, we also believe that quality "stable compounders"—companies that exhibit consistent growth, resilience, and strong balance sheets, whether growth or value—may become increasingly appealing to investors looking for reliable returns.

What Now?

Ultimately, focusing on whether or not we're seeing the end of US exceptionalism could mean investors risk missing the very real regime changes that are already underway, and that already have implications for portfolios. We're moving away from a period characterized by high synchronization and tight correlations, which has important consequences for investors regarding both the range of opportunities and risk management. A weaker USD could impact USD assets, emphasizing the need for diversification. Meanwhile, European and Japanese equities may present attractive opportunities. Above all, investors should assess whether equity allocations are evolving alongside a changing investment landscape.

> We believe the key winners will be parts of the European value space such as banks and telecoms, defense stocks, European small caps, and those enablers of the energy transition that are protected by high barriers to entry, such as grid operators.

Talk to your financial professional to stay informed about the evolving opportunities within equities.

[1] Dispersion refers to the range of potential outcomes of investments based on historical volatility or returns. Generally speaking, the higher the dispersion, the riskier an investment is, and vice versa.

[2] Correlation is a statistical measure of how two investments move in relation to each other. A correlation of 1.0 indicates the investments have historically moved in the same direction; a correlation of -1.0 means the investments have historically moved in opposite directions; and a correlation of 0 indicates no historical relationship in the movement of the investments.

[3] Based on Wellington's calculations using Bloomberg data.

[4] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index. Alpha is the excess return of a portfolio over its benchmark.

For implementation ideas based on these outlooks, please talk to your financial professional.