

Prepare for Inflationary Growth

Positioning for growth as global markets adapt to fiscal tailwinds, innovation, and easing uncertainty.

A Return to More Frequent and Volatile Cycles

From a macro perspective, what matters for asset prices is, first, the interaction between activity and inflation, and second, the associated policy response. That sounds simple in theory and was for a long time in practice because globalization fostered a low-inflation, low-rate environment with extended growth cycles. However, in today's new economic regime, this interaction has become more complex because of:

- **Sticky inflation**, which in many countries remains well above central-bank targets.
- **Conflicting economic shocks** that are jolting the global economy, whether it's loose monetary and fiscal policy vs. tariffs, or the supply boost from AI vs. the drag from protectionism and demographics.
- **Increasingly politicized policy responses**. Against a backdrop of rising wealth inequality and populism, central banks and governments are slower to tighten policy and quicker to stimulate.

We've now returned to traditional cycles in which growth drives future inflation, and the economy can move rapidly across the four quadrants outlined in **FIGURE 1**. This ongoing shift to a more cyclical world has major implications for investors, as different assets and investment strategies will perform differently at each stage of the cycle. Moreover, markets can rapidly and frequently revise the probabilities they assign to different outcomes as we've already seen throughout 2025.

Given this backdrop, we believe the outlook for 2026 will revolve around four scenarios:

1. **Goldilocks**: In the near term, markets are likely to remain priced for noninflationary growth.
2. **Inflationary growth**: Investors may be underestimating the likelihood of an inflationary boom; we think this could be the most probable outcome for 2026.
3. **Recession**: While we view recession as less likely, it can't be entirely ruled out, with AI disappointment and higher private-sector savings in response to ongoing uncertainty being the key potential triggers.
4. **Stagflation**: There's a tail risk that signs of stagflation (i.e., slow growth, inflation, and a weak labor market) could emerge in 2026, potentially exacerbated by inappropriate policy responses.

Below, we explore each scenario and outline the characteristics that can help investors determine which quadrant we are in, and which market reaction to expect.

Insight from sub-adviser Wellington Management



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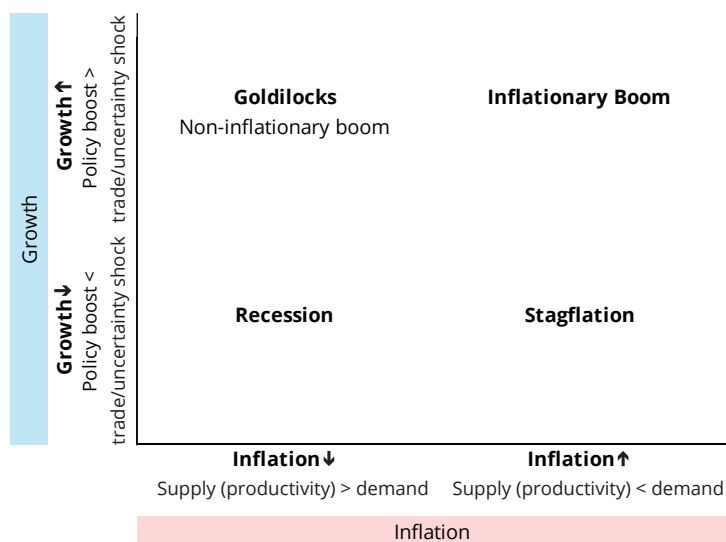


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Key Points

- While markets are currently priced for a Goldilocks scenario in 2026, we think this is the least likely outcome.
- Markets may remain anchored to this benign narrative until we see clear signs of stabilization in labor data.
- Ultimately, the combination of negative global real rates, easing lending standards, and policy loosening at a time of already sticky inflation suggests that inflationary growth may be the most probable outcome.
- Investors may have significant opportunities, provided they're prepared to adapt to very different scenarios, including the limited risk of recession and even stagflation.

FIGURE 1
The Four Quadrants of the Economic Cycle



For illustrative purposes only. Source: Wellington.

Four Potential Scenarios for 2026

1. Continued Goldilocks Market Narrative (For a While)

Looking across different asset classes, global markets still appear priced for a continuation of the noninflationary growth scenario that characterized the global economy prior to 2018. That's how you reconcile:

- Elevated equity valuations and strong earnings-per-share (EPS)¹ growth expectations, particularly in AI-related areas;
- Tight credit spreads;²
- Long-term bond prices reflecting low inflation expectations (breakeven rates) despite pricing in further central-bank rate cuts to neutral or slightly below neutral.

This scenario largely depends on the success of AI. If productivity gains from AI outweigh the negative impact of tariffs and rising protectionism, demand in the economy could remain strong without fueling inflation.

What Would This Mean for Asset Prices?

In this environment, we think equities would continue to rally, credit spreads would remain tight, and government bond yields would rise modestly to reflect better trend growth. Yes, unemployment rates may temporarily rise due to AI-driven displacement, but policymakers could respond with looser policy as productivity keeps inflation subdued.

We think this market theme is likely to persist in the near term, given our expectations for a weaker labor market and lower (but still elevated) inflation. However, our analysis suggests this is unlikely to be the dominant outcome for 2026.

2. Higher Growth With Inflation—the Most Likely Outcome, in Our View

Nominal global growth remains strong, but inflation continues to exceed the 2% target in most developed economies. Despite this, policymakers remain firmly accommodative as evidenced by:

- Global liquidity near all-time highs, which, if deployed, could further support nominal growth.



If AI productivity gains outweigh the negative impact of tariffs and protectionism, demand in the economy could remain strong without fueling inflation.

- Government initiatives to stimulate lending, including banking deregulation, even as private-sector credit conditions are already easing across many countries.
- Real global interest rates³ at zero and could turn negative again.
- Forthcoming fiscal expansion, with developed-market economies set to embark on the sharpest fiscal easing since 2010 (excluding the COVID-19 years).

This policy stimulus is occurring at a time when the world economy is being hit by several inflationary supply shocks:

- The imposition of US tariffs and the growing protectionist response from the rest of the world represent a significant negative global supply shock. Just as globalization reduced inflation in global goods by allowing capital to flow to the lowest-cost producers, protectionism and a rising focus on security of supply is likely to raise it.
- China's increasing attempts to remove capacity in many sectors rather than continuing to add to it also has the potential to be a material source of sticky inflation.

If AI-driven productivity growth fails to materialize, conditions could be ripe for an inflationary boom in 2026, with policy stoking stronger demand amid weaker supply. While this theme may not yet dominate, signs of labor market stabilization could prompt a market shift if it becomes clear there won't be enough slack in the economy to bring down inflation.

What Would This Mean for Asset Prices?

The policy response is key. An inflationary boom can still benefit risk assets:⁴ Strong nominal growth⁵ could lift equities and contain credit spreads. It also increases the likelihood of structurally higher yields in developed markets. The rally in risk assets may persist until policymakers stop prioritizing growth and start trying to rein in inflation through tighter policy, or if the bond market penalizes the "inappropriate" policy response and forces a tightening via higher term premiums.⁶ Bond investors will, at a minimum, need to see data that exposes the inappropriateness of loose policy at this stage of the economic cycle, such as clear signs of labor-market recovery, and that may still take some time.

In our view, the near-term risks to the labor market globally are skewed to the downside, particularly in the US. But the longer it takes for signs of stabilization to materialize, the more policymakers risk generating the conditions for a boom and subsequent bust.

3. A Lower-Probability Risk of Recession

We can't completely discount the risk of a recession in 2026. The trigger could take many forms, but some would be more disruptive for risk assets than others. For example, tariffs and inflation already moving through the economy might have a harsher impact than current models predict. However, this scenario aligns more with a temporary slowdown, given loosening policy and low private-sector leverage.

For us, the bigger recession risks stem from:

1. **The market downgrading its views on AI**, from either a timing or future earnings perspective, which could trigger a sharp equity correction, hitting households' wealth perceptions.
2. **Today's rolling uncertainty and lack of fiscal discipline** prompting an increase in private-sector savings, as already seen in large parts of Europe. If sustained, such a response would be highly deflationary, reminiscent of Japan in the 1990s.



If AI-driven productivity fails to materialize, conditions could be ripe for an inflationary boom.

What Would This Mean for Asset Prices?

We view the risk of a noninflationary recession in 2026 as still relatively low, albeit rising. If realized, equities may likely sell off while bonds (at least initially) may rally, and credit spreads may widen sharply. If the recession is triggered by an AI-driven correction, it could also mean a substantially weaker dollar.

4. Stagflation: Also a Tail Risk to Monitor

Though currently a tail risk, some economies, most notably the UK, have exhibited signs of stagflation, which could be aggravated by escalating protectionism. The telltale sign would be inflation rising despite weakening employment. This risk matters because:

1. It would be very negative for risk markets.
2. Policymakers may repeat past mistakes, accommodating rather than countering inflation, similar to what occurred in the early 1970s.

What Would This Mean for Asset Prices?

Stagflation, especially if prolonged, would be most damaging for equities and credit spreads, but would also imply higher bond yields driven by breakevens and term premia.

As summarized in **FIGURE 2**, we believe an inflationary upturn is the most likely scenario for 2026. For now, markets may cling to the Goldilocks scenario, before adjusting to the new reality of high nominal growth. While much less likely, we can't rule out the risk of a recession and even stagflation.



If a recession is triggered by an AI-driven correction, it would likely mean a substantially weaker dollar.

FIGURE 2

Where We're Heading in the Cycle, What To Look for, and the Market Implications

	Probability	Productivity	Signs For Each Cycle			How Markets Could Trade		
			Unempl. Leads	Inflation Leads	Inflation Expectations	Equities	Credit Spreads	Yield Curves
Goldilocks - Noninflationary upturn	20%	↗	↘	→/↘	Anchored at 2%	↑	↓	Not clear cut
Inflationary Upturn	50%	→/↘	↘	↗	↗	↑ initially	↓ initially	Steeper initially
Recession	15%	→/↗	↗	↘	↘/Anchored at 2%	↓	↑	Steeper
Stagflation	15%	→/↘	↗	↗	↗	↓↓	↑↑	Steeper

Note: Arrows indicate both direction (unchanged, down, upwards or combination thereof) and level of intensity (from single to double arrows). 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. For illustrative purposes only. Source: Wellington.

Each scenario comes with very different implications for asset prices and portfolios. The most likely scenario—inflationary growth—generally supports risk assets, though policymakers may eventually tighten policy or, if they don't, markets could demand higher risk premiums.⁷

In this fast-changing environment, we think investors need to be vigilant: look for tell-tale signs of shifts in the cycle and consider actively adjust asset allocations to make the most of the significant opportunities that 2026 is likely to offer while mitigating the increased downside risks.

Talk to your financial professional about how to position your portfolio for a changing global landscape.

¹Earnings per share is the projected growth rate in earnings per share for the next five years.

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

³Real interest rates represent the true cost of borrowing or the real return on savings after adjusting for inflation.

⁴Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

⁵Nominal growth refers to economic growth measured in current prices, without adjusting for inflation.

⁶Term premium is the compensation that investors require for bearing the risk of longer maturities, which are more sensitive to changes in interest rates.

⁷Risk premium 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. • 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. • There are risks of focusing investments

in securities of companies in the utilities and industrials sectors which may cause performance to be sensitive to developments in those sectors. • The value of the underlying real estate of real estate related securities may go down due to various factors, including but not limited to, strength of the economy, amount of new construction, laws and regulations, costs of real estate, availability of mortgages and changes in interest rates.

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