

Bonds: Finding Durable Value Amid Shifting Currents

We expect global yields to edge higher in 2026 as nimble investors weigh opportunities and risks.

Our expectation going into 2025 was that bond yields would stay higher for longer, central banks would look to cut policy rates, and governments would pursue increasingly activist fiscal policies. While these themes played out, we've also witnessed remarkable stability in bond markets. Except for the short-lived period of acute market stress following President Donald Trump's "Liberation Day" tariff announcement, bond investors have, to date, been relatively sanguine. Measures of bond volatility have edged lower and reached levels not seen since just before the inflation shock roiled markets in 2022. Credit spreads¹ have compressed to 15-year tightens and global government bond yields have remained remarkably rangebound, despite increasing divergence across countries. Where do we go from here, and what are the key developments to watch as we move into 2026?

Central-Bank Independence Questioned

Over the last few years, it's become clear to investors that central banks are much more sensitive to protecting against potential economic shocks than to targeting inflation in the long or even short term. This focus on avoiding economic pain becomes especially relevant in a context in which fiscal policy continues to be expansionary and inflation remains well above central-bank targets in most developed economies—a scenario that puts monetary and fiscal policy at odds with each other. This policy disconnect is likely to be exacerbated by governments preferring, or potentially even pressuring, central banks to deliver decisions that support their expansionary budget deficits.

No central bank is more likely to see its independence implicitly or explicitly challenged than the US Federal Reserve (Fed). With Fed Chair Jerome Powell's term ending in May 2026, the combination of a new incoming Fed chair and a potentially altered composition of the rate-setting Federal Open Market Committee will provide markets with a clearer understanding of the extent to which monetary policy may further enable fiscal policy decisions. Eventually, this potential reduction in independence risks entrenching inflation and eroding cooperation across policymakers globally.

Risks to the Upside, but Yields Remain Attractive

Our base case is for global yields to edge higher throughout 2026, as expansionary fiscal policies and resilient economies could result in higher risk premia² across bond markets (despite some weakening in labor markets). Productivity gains could offset some of this upward pressure. But there is, of course, substantial timing uncertainty, particularly in relation to AI's ability to neutralize the negative impact of growing trade restrictions and deteriorating demographics. If business and consumer balance sheets remain resilient, we see little chance of a broad-based recession—barring a major exogenous shock. On the contrary, the economic cycle may be supported by significant capex³ and fiscal stimulus. As the world adjusts to less-efficient supply chains and persistent trade-policy uncertainty, governments are signaling they'll continue to protect consumers from external shocks, implying further record bond issuance.

Insight from sub-adviser, Wellington Management



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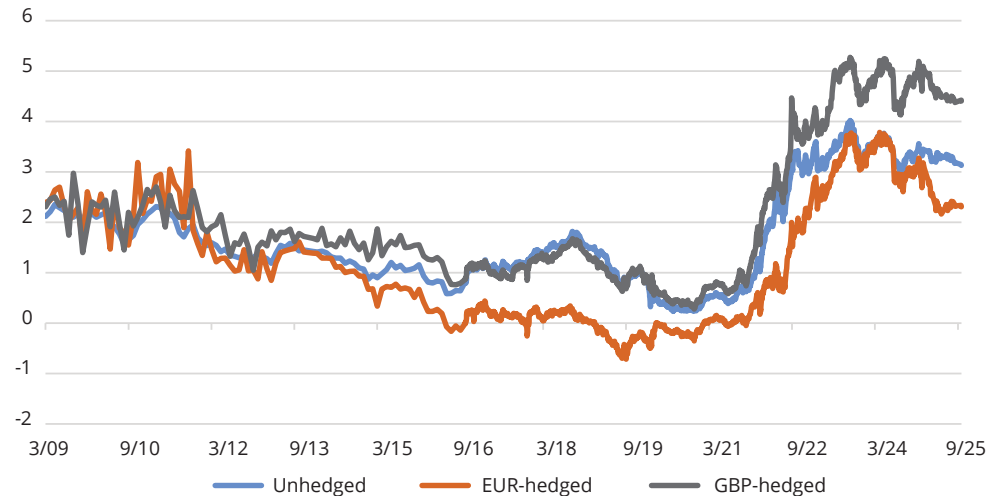
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Key Points

- We believe global government bond yields continue to be attractive. But risks remain, underscoring the need for nimble positioning.
- Debt sustainability concerns are translating into heightened volatility and growing divergence between countries, as well as upward pressure on longer-term yields that active investors can exploit.
- Eroding central-bank independence is an area that warrants close monitoring.

Despite risks to the upside for yields as investors start to react to persistently higher debt—particularly at the longer end of the yield curve⁴—we think the total-return potential for rates remains very attractive. As **FIGURE 1** illustrates, yields on government bonds remain significantly above the levels seen between the Global Financial Crisis and 2022.

FIGURE 1
Global Government Bond Yields Remain Attractive
10-year Global Government Bond Yields (9/30/08–10/22/25)



As of 10/22/25. Data Sources: Bloomberg, Wellington Management, 12/25.

When Does Debt Become Unsustainable?

The game is up (or certainly becomes more difficult) for countries that lose the confidence of the market. Policymakers across major economies have increasingly turned to fiscal stimulus, delivering the most significant fiscal easing since 2010, if we exclude the extraordinary measures surrounding the COVID-19 pandemic. The key takeaway is that less economic integration and more activist fiscal policy may not only put structural upward pressure on long-term bond yields but may also lead to more compressed and more volatile cycles. We expect the theme of divergence across countries and regions to become even more pronounced heading into 2026.

US

The Trump administration's trade-policy agenda will likely remain a considerable source of uncertainty for global investors, especially as we approach the mid-term elections later in the year. The front end of the US curve will probably reflect an ongoing dovish policy tilt as the Fed will be under renewed pressure to continue its rate-cutting cycle, despite further fiscal expansion through the One Big Beautiful Bill Act. While labor demand has clearly softened, the administration's immigration policy has reduced supply, leading us to think that the labor market is weaker but will likely hold up in 2026. We note warning signs in some pockets of the credit markets but, absent a major exogenous shock, we don't anticipate a recession, meaning inflation pressures may remain elevated, especially if productivity gains don't materialize. In this scenario, yields could trend higher, particularly at the back end of the yield curve.

Europe

We expect continued differentiation across countries. Persistent political turbulence in France has not only cost the country its AA rating but also made it vulnerable



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to global investors' concerns over fiscal sustainability and political fragmentation. Without credible fiscal consolidation or a surge in productivity growth, countries that combine high debt levels, large deficits, and elevated interest costs relative to trend growth with heavy reliance on foreign financing are increasingly susceptible to a sudden loss of market confidence. This is likely to drive elevated term premia⁵ and nominal yields. It also translates into curve steepening and widening spreads relative to countries deemed fiscally responsible. Among the key beneficiaries of the increased emphasis on fiscal rectitude is the Netherlands, which is emerging as a new risk-free benchmark for the euro area as Germany shifts toward more expansionary fiscal policy. Formerly crisis-stricken Greece, Spain, and Portugal are also enjoying increased investor confidence in their fiscal trajectories.

UK

The UK has long been identified as a bellwether for global investors' tolerance of countries with high debt levels and an unclear path toward debt consolidation. It also faces a particular challenge from persistent inflation, with a wide distribution of possible outcomes, including renewed economic growth on the one hand and the tail risk of stagflation on the other. Unless inflation is brought down by tighter demand- or supply-side policies, we expect UK rates to remain persistently higher than those of its European counterparts.

Japan

While the domestic inflation dynamics and strong nominal growth should imply the Bank of Japan has the go-ahead to keep hiking policy rates, it will likely remain on hold until it has more visibility on fiscal policy. Our structural view is for higher front-end yields and a stronger yen, but this theme will only play out if uncertainty clears.

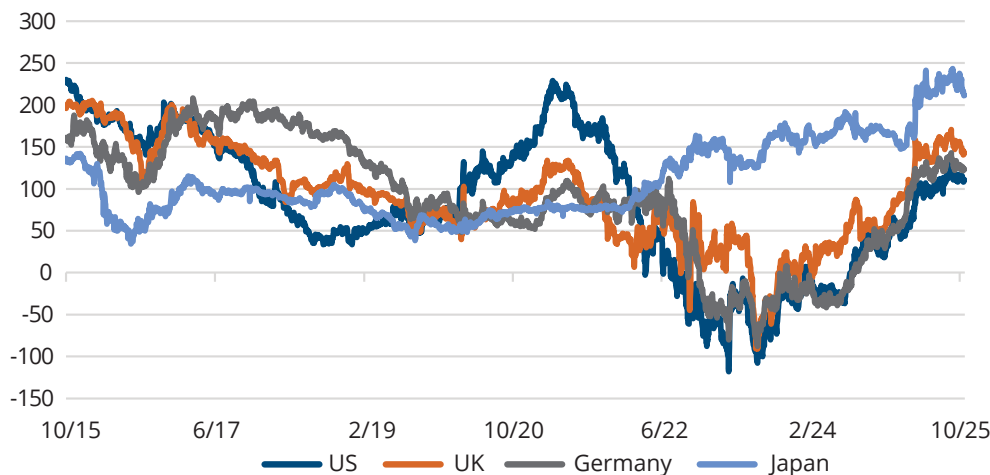
The Shifting Shapes of Yield Curves

Since the lows of 2023, term premia have increased across multiple markets as yield curves normalize and investors demand more compensation for holding longer-dated bonds, as illustrated in FIGURE 2.

FIGURE 2

Investors Demand More Compensation for Holding Long-Term Debt

Evolution of Spreads Between 2-year and 30-year Government Bonds (basis points)



As of 10/27/25. Spreads shown are Bloomberg-calculated spreads that replicate selling current 2-year US Treasuries, gilts, Bunds, and Japanese government bonds, and buying respective 30-year government bonds. Data Sources: Bloomberg, Wellington Management, 12/25.



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2026 Outlook Fixed Income

Periods of heightened volatility, while challenging, tend also to offer compelling opportunities for active investors—and this time is no different. As markets increasingly price in local growth/inflation dynamics, we see significant potential for alpha⁶ generation through:

- Tactically adjusting portfolio duration⁷ and yield-curve positioning
- Leveraging mispricing across regions and maturities
- Aligning exposures with differentiated macroeconomic views and policy-rate expectations, as markets increasingly price in local growth/inflation dynamics.

Conclusion

While we don't expect smooth sailing in the year ahead, we remain confident that bonds can play their role in generating income, providing diversification, and dampening volatility within a broader portfolio. Persistently high global yields should help government bonds to deliver positive total returns. However, we think careful country selection and curve positioning will make the difference, with investors needing to adjust their asset allocation to increasingly local growth/inflation dynamics and inevitable bouts of volatility.

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 A risk premium compensates investors for the higher risk of investments, providing returns above the risk-free rate. Investors typically receive higher premiums for riskier investments, as they accept a greater chance of potential loss.

³ Capex refers to capital expenditures.

⁴ 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.

⁵ The term premium is the extra yield investors demand for holding long-term bonds compared to rolling over a series of short-term bonds. This compensation is for the increased risks of tying up money for a longer period, such as the risk of changing interest rates

⁶ Alpha is an investing term that measures an investment strategy's ability to outperform the market, often called its "edge." It represents the excess or abnormal return of an investment compared to a benchmark index, adjusted for risk. A positive alpha indicates the investment beat the benchmark, while a negative alpha means it underperformed.

⁷ Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

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