

Markets Are Underestimating the Persistence of Inflation

Inflation risks are rising, and markets may be underpricing the impact on interest rates and bond yields.

What You Should Know

- Markets continue to price a relatively benign inflation outlook despite signs that price pressures may prove more persistent than expected.
- The combination of accommodative fiscal policy, resilient growth, and elevated inflation expectations could keep interest rates and bond yields higher than investors anticipate.
- Policymakers face an increasingly difficult balance between supporting economic growth and maintaining inflation credibility.
- Diverging economic and policy conditions across countries may create greater dispersion in investment outcomes.
- Government bond yields may remain under upward pressure as investors demand greater compensation for inflation and fiscal risks.
- Investors should pay close attention to the interaction between inflation, policy decisions, and long-term government debt dynamics.

Insight From Sub-Adviser Wellington Management



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In our 2026 outlook, we highlighted that the conditions were in place for nominal growth to accelerate given supportive policy settings. We also argued that markets were underestimating the risk that inflation would remain above central-bank targets. While recent geopolitical developments have contributed to market volatility, we believe the more important investment question is whether inflation ultimately proves more persistent than investors currently expect.

Inflation Risks Remain Underappreciated

The first part of the year generally supported our constructive outlook on nominal growth. Economic activity remained resilient in many regions, while measures of inflation began showing signs of renewed firmness. Yet financial markets have largely continued to assume that inflation will moderate steadily toward central-bank targets.

We believe that assumption may underestimate several important risks. Accommodative fiscal policies, resilient demand, rising inflation expectations, and the potential for supply-side disruptions could all contribute to a more persistent inflation backdrop. If inflation proves stickier than expected, interest rates and bond yields may need to remain higher for longer.

Markets May Still Be Pricing a Best-Case Outcome

Current market pricing appears consistent with the view that inflation will gradually normalize without significantly undermining growth. If that outcome materializes, investors could once again focus on the themes that dominated discussions at the start of the year, including the impact of AI on productivity, the outlook for global growth, and the evolving flow of capital across regions.

In such a scenario, many central banks could maintain broadly supportive policy settings while growth continues at a reasonable pace. Risk assets¹ would likely benefit from a combination of stable inflation expectations and continued economic expansion.

The Risk Is That Inflation Remains More Persistent

We believe the risks are skewed toward a more prolonged period of inflationary pressure. Commodity markets remain a potential source of volatility, while disruptions to energy markets, global trade, or supply chains could contribute to renewed price pressures even if near-term market concerns fade.

At the same time, policy settings remain broadly supportive. In many developed markets, fiscal policy continues to provide stimulus, while monetary policy is no longer as restrictive as it was during the peak of the inflation-fighting cycle. Together, these factors may create conditions in which inflation remains above target for longer than markets currently anticipate.

A Growing Source of Regional and Country Divergence

The impact of persistent inflation is unlikely to be evenly distributed. Countries with different energy profiles, fiscal positions, labor-market dynamics, and monetary-policy frameworks may experience markedly different economic outcomes. As a result, investors may increasingly need to evaluate opportunities and risks on a country-by-country basis rather than relying on broad global trends.

Some economies may prove more resilient because of favorable structural characteristics, while others may face greater challenges as higher inflation interacts with already stretched fiscal positions.

Policy Credibility Matters More Than Ever

Since the pandemic, governments and central banks have generally maintained supportive policies designed to cushion economies from a series of shocks. While these policies helped sustain growth, they've also contributed to concerns about inflation persistence and long-term fiscal sustainability.

Many governments continue to run sizeable fiscal deficits, even in periods of economic expansion. Investors have increasingly demanded additional compensation for lending to governments with less favorable fiscal trajectories, contributing to higher term premia² and steeper yield curves³ in some markets.



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Meanwhile, inflation expectations in several developed economies remain above central-bank targets. Until policymakers demonstrate greater success in restoring confidence that inflation will remain sustainably under control, yields may remain structurally elevated.

Sustained Inflation Could Further Test Credibility

The challenge for policymakers is balancing growth and inflation objectives. Efforts to support economic activity may help reduce near-term economic pain but could also risk reinforcing inflationary pressures if implemented too aggressively.

This tension makes policy credibility an increasingly important factor for investors. Markets are likely to differentiate more aggressively between countries perceived as maintaining disciplined fiscal and monetary frameworks and those seen as falling behind the curve.

Growing Market Sensitivity

We believe investors are increasingly incorporating inflation and fiscal risks into asset prices. Countries experiencing the greatest divergence between inflation expectations and policy objectives have often seen larger moves in long-term yields and currencies.

The relationship between fiscal sustainability, inflation expectations, and yield-curve behavior may become an even more important driver of returns in the years ahead.

Tangible Investment Implications

For investors, government and central-bank credibility is emerging as both a source of risk and a source of opportunity. Countries with challenging fiscal and inflation dynamics may experience greater volatility across bonds, currencies, and risk assets, while those with stronger policy frameworks may be better positioned to attract capital.

Japan, the UK, France, and the US remain important markets to watch given the interaction between inflation trends, government debt levels, and policy responses.

History suggests that periods of elevated inflation can have significantly different outcomes depending on how policymakers respond. While stronger nominal growth can support asset prices under moderate inflation conditions, persistently high inflation has often been associated with rising bond yields, currency weakness, and lower real returns.

Looking Ahead

While today's environment differs meaningfully from the inflationary episodes of the 1970s, investors shouldn't dismiss the possibility that inflation remains more persistent than expected. If policymakers struggle to balance growth and price stability, government-bond yields, currencies, and risk assets may continue to reflect growing concerns about inflation and fiscal sustainability.

In our view, inflation, policy credibility, and long-term debt dynamics remain among the most important macroeconomic themes for investors to monitor over the coming years.



Persistently high inflation has been associated with rising bond yields, currency weakness, and lower real returns.

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

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

²Term premia is the compensation that investors require for bearing the risk of longer maturities, which are more sensitive to changes in interest rates.

³The 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.

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