

Inflation vs. Growth Risks: A Challenge for Investors

Volatility notwithstanding, core fixed income remains attractive for the rest of 2026.

What You Should Know

- Structurally higher yields inform our continued positive outlook for the remainder of 2026, despite ongoing volatility.
- Markets have reached a crossroads, with investors having to decide whether to focus more on a potential growth hit or the higher inflation impact of the US-Iran war.
- Our base case is that, even if tensions ease, oil prices will remain structurally higher than their pre-conflict levels, at a time when inflation is stubbornly stuck above target and risk premia¹ continue to rise.
- This fragile equilibrium represents an extraordinarily complex challenge for policymakers.
- Against this backdrop, we would advocate a flexible approach to global government-bond (rates)* exposure.
- Over time, we anticipate greater policy divergence, which flexible, active investors may be able to exploit.

Insight From Sub-Adviser Wellington Management



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The first half of this year has reinforced the key message from our original 2026 rates outlook that generationally high yields make core fixed income attractive, but that a flexible approach is required given ongoing risks. This point is illustrated by the year-to-date performance of developed-market government bonds, which ended May with nearly flat returns (**FIGURE 1**). This outcome highlights the benefit of higher starting yields, as the income component has smoothed an otherwise tumultuous journey of price volatility—a very different scenario from what occurred in 2022, when low starting yields and price volatility led to heavily negative total returns. These dynamics underline our view that the total-return outlook for rates remains attractive, even with heightened volatility.

* A global bond is an international financial instrument issued and traded outside the home country of the currency in which it's denominated. They can be issued in one currency but traded worldwide.

FIGURE 1
Developed-Market Bonds: Near-Flat Returns Amid the Energy Shock
 Bloomberg Global Treasury Index (Hedged to USD)

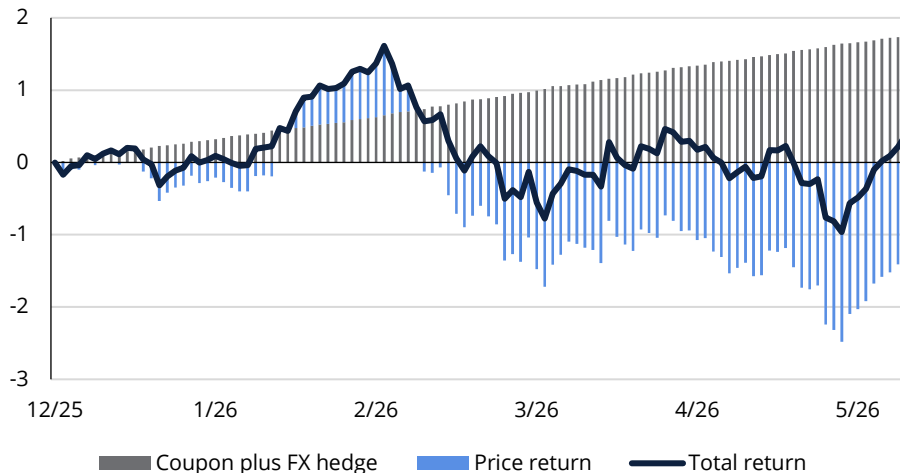


Chart data as of 5/29/26. Past performance does not guarantee future returns. Indices are unmanaged and not available for direct investment. “FX hedge” refers to foreign-exchange hedging strategies (e.g., currency options, futures, or spot contracts) designed to act as a shield against unfavorable currency-exchange movements. Return breakdown of the **Bloomberg Global Treasury Index²** is USD-hedged. Sources: Bloomberg Finance LLP, Wellington Management, and Hartford Funds, 6/26.

Markets at a Crossroads

Following a period of strong, AI-led returns in early 2026, the conflict in the Middle East caused a sharp and synchronized rise in yields. This reaction reflects a combination of geopolitical uncertainty, higher energy prices, and, increasingly, a renewed investor focus on the persistence of inflation. Even allowing for a potential reduction in geopolitical risks, the exogenous shock of the US-Iran war will have long-term ramifications. In an environment in which commodity prices will continue to drive yields, investors find themselves at a crossroads heading into the second half of 2026: Should they brace for a potential growth hit or seek to hedge against higher inflation?

Following the spike in rates, increasing duration³ exposure can be an attractive proposition, as long-end yields (particularly in markets such as the UK) present a compelling entry point. We have already noted the benefit of high starting yields to the total-return equation via the income component. This attractive starting point provides a cushion against a further rise in yields as central banks contemplate tighter monetary policy. Conversely, if geopolitical tensions ease and oil prices fall back, or if the market’s focus shifts to the negative growth implications of the energy-supply shock, there’s the potential for yields to decline. Such a shift would provide additional price return at a time when risk assets are likely to face a tougher outlook.

Our base case is that oil prices will remain structurally higher than their pre-conflict levels, even if tensions ease, as global supply chains will need to adjust to a more fractured trading environment. Moreover, inflation was above policy targets for five years before the current crisis, and mounting questions over public debt have already contributed to a structural rise in term premia,⁴ which has pushed yields higher in recent years.

This crisis will do nothing to help maintain this fragile equilibrium, leaving policymakers with an extraordinarily complex challenge: monetary and fiscal policies will have to address potentially conflicting inflationary and growth trends,



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while limiting a further deterioration in public finances. How well the major central banks deal with this conundrum will likely determine the direction of yields and where we fall between the two scenarios outlined above.

Against this backdrop, we would advocate a more cautious and flexible approach to increasing duration risk.

Local Opportunities

Looking further ahead, we believe the global growth-inflation trade-off will become more visible at the local level, giving investors opportunities to generate returns across and within markets. While the initial inflation shock was global and synchronized, the next phase is likely to be more uneven, as energy prices remain a key driver, but local factors become more prominent.

The extent to which commodities are imported and exported, the resilience of labor markets, and the flexibility of economies to adjust to the shock will determine the path for rates in respective countries. Divergence, rather than synchronization, is therefore likely to become the main theme across markets.

This trend would echo what we saw following the 2022 energy price shock. In the early months after energy prices spiked, yields moved higher in lockstep as central banks faced down the immediate threat of stagflation.⁵ As we progressed through 2023 and into 2024, the second-order impact of the shock and the subsequent policy responses led to divergence and, with that, a lower yield correlation across countries, as illustrated in **FIGURE 2**. In early 2026, the global nature of the energy shock caused correlations to move higher again. Once we move beyond the acute phase of this crisis, we expect lower correlation across global rates markets to return. Such a shift would, in our view, create meaningful opportunities for flexible global investors.

FIGURE 2

Sovereign Bond Markets Tend to Diverge in the Aftermath of a Crisis

Lower Yield Correlation Across Countries after the 2018 and 2024 Economic Shocks

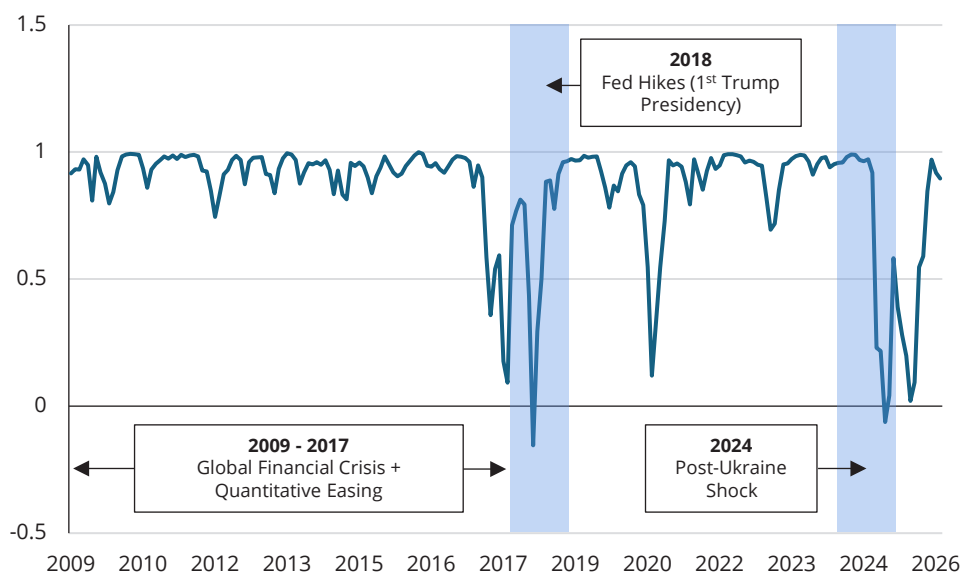


Chart data as of June 2026. Correlation between US 10-year Treasury yield and average of G10 sovereign bond yields. G10 for this comparison includes Australia, Canada, Germany, Japan, Mexico, New Zealand, Norway, South Korea, Sweden, and the UK. Correlation is a statistical measure of how two investments 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. Sources: Bloomberg Finance LLP, Wellington Management, and Hartford Funds, 6/26.



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Fixed-Income Outlook

Recent developments suggest that differentiation across cycles and policy responses is already taking hold:

- In the US, despite the energy shock, growth remains above trend, with strong fiscal accommodation, persistent consumer growth and accelerating inflation. We expect AI to continue to fuel (at least nominal) growth, while the midterm elections will start to drive market pricing over the summer.
- In the UK, a persistent political and fiscal risk premium means gilts⁶ move at a higher beta⁷ to global markets. If we see some political stabilization, the recent, aggressive sell-off in long-end yields may provide an attractive entry point.
- Growth prospects for the euro area remain more mixed. Much depends on whether the industrial cycle is sufficiently robust to maintain positive momentum despite the inflation shock.
- Japan continues to operate monetary policy that is inconsistent with domestic inflation. A long-awaited policy adjustment could have global implications for both currency and rates markets.

In Essence

We believe that the opportunity set for global government bonds (rates) remains compelling. Yields across developed markets are elevated, providing both attractive income and an even stronger potential cushion against downside risks, as already evidenced this year. The combination of these features may strengthen fixed income's potential role as both a provider of diversification and liquidity, but also a return generator, moving us further away from the low-yield environment that characterized much of the previous cycle. A proactive and flexible approach can help manage ongoing volatility and may enhance the total return potential of core fixed-income allocations.



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

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

² The **Bloomberg Global Treasury Index** tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index.

³ Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

⁴ Term premia is the compensation that investors require for bearing the risk of longer maturities, which are more sensitive to changes in interest rates.

⁵ Stagflation is an economic condition defined by the simultaneous occurrence of three factors: high inflation (rising prices), slow economic growth, and high unemployment.

⁶ Gilts are government bonds issued in the U.K., India, and Commonwealth countries and are similar to U.S. Treasury securities.

⁷ Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index.

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 U.S. investments and are subject to the

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