

An aerial photograph of a multi-lane bridge spanning a body of water. The water is a vibrant turquoise color. Below the bridge, there is a dense forest of green trees. A small white car is visible on the bridge. The overall scene is bright and clear.

2026 Midyear  
Outlook:  
Perspective on  
Markets and  
the Economy

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## The Rally and the Reality

Strong earnings, the AI investment cycle, and higher bond yields are creating opportunities even as inflation, geopolitical risks, and policy uncertainty persist.

### What You Should Know

- **We've raised our view on global equities to overweight.** Despite geopolitical headwinds, companies continue to generate strong earnings, and the global economy remains resilient, with some regional variation. Equity valuations have also adjusted to more reasonable levels over the past few quarters. We expect earnings growth to remain buoyant, though driven largely by demand through the AI supply chain. The market advance has been narrow, although earnings growth is picking up in parts of the market.
- **Among equity markets, we favor emerging markets (EM) over Europe.** We think EM Asia should benefit from the AI theme, given its critical position in the supply chain, but could also benefit from an improvement in prospects for India and China. Earnings per share (EPS)<sup>1</sup> expectations for Europe remain unrealistically high, and we think stagflationary<sup>2</sup> effects are likely to be more acute there.
- **Markets have priced tighter policy across the globe.** We think fears ranging from inflation to stagflation are likely to dominate over the near term, and central banks have moved to a hawkish stance. However, higher real yields present an opportunity to favor government bonds, in our view. We have turned neutral on credit given significant tightening in spreads.
- **We have a moderately overweight view on commodities, expressed in oil,** where the market is already pricing in the resumption of a surplus, even as significant uncertainties remain around exports from the Middle East and demand growth.
- **Downside risks** include high levels of leverage among retail investors and market concentration in the US and EM. The market's ability to digest net issuance from blockbuster IPOs or a big shift in expectations for AI capital expenditures<sup>3</sup> leading to a bust could be concerns; so could a sharp rise in interest rates and the US dollar. **Upside risks** include renewed hopes for central-bank rate cuts enabled by an end to the Middle East conflict and a restoration of oil supply. More broadening in markets beyond technology would be a positive sign for equities.

### Insight From Sub-Adviser Wellington Management



**Supriya Menon**  
Multi-Asset Portfolio Manager



**Josh Riefler**  
Product Reporting Lead

## Our Multi-Asset Views

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

OW = overweight, UW = underweight

Source: Wellington Management Views expressed have a 12-month horizon and are those of the authors and Wellington Solutions. Views are as of June 2026, 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.

## Overview

The macro and market backdrop has surprised us on the upside despite the tug of war with geopolitical risk (**FIGURE 1**). There's been an incremental pickup in maritime traffic through the Strait of Hormuz, but energy supplies remain heavily disrupted, and inflation risks are higher than before the war, with stagflationary pressures elevated in some regions, including Europe.

What explains the economic and market resilience? The AI-driven earnings boom has enabled the market to absorb the geopolitical disruption. In a testament to their adaptability, companies have beaten expectations in the face of extreme uncertainty, and the upshot of strong expectations is that equities have become significantly cheaper. Continued robust AI demand combined with supply constraints (in compute, memory, and power) is expected to extend the AI spending cycle into 2027–2028 and create attractive opportunities as AI bottlenecks drive pricing power.

On the policy front, most central banks have moved quickly to establish credibility on inflation, signaling a degree of willingness to look past any signs of faltering growth in favor of a hawkish stance to address inflation. The European Central Bank was a notable first mover, hiking rates in June, and other central banks may be poised for similar inflation-minded moves.

One factor that kept oil-price shocks from reaching worst-case levels was the extensive use of national reserves; stockpiling by China and other countries also



The AI-driven earnings boom has enabled the market to absorb the geopolitical disruption.

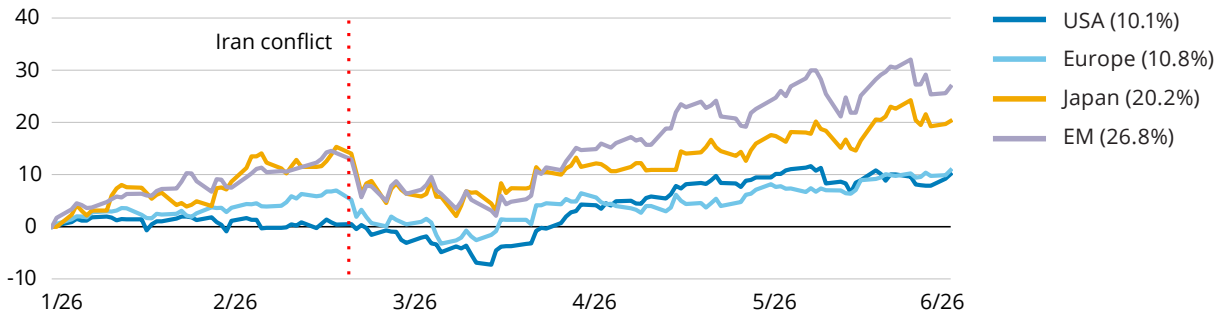
# Asset Allocation Outlook

helped alleviate the pressure. However, a slow normalization of traffic in the Strait of Hormuz would raise upside risks for oil prices given lower inventory levels.

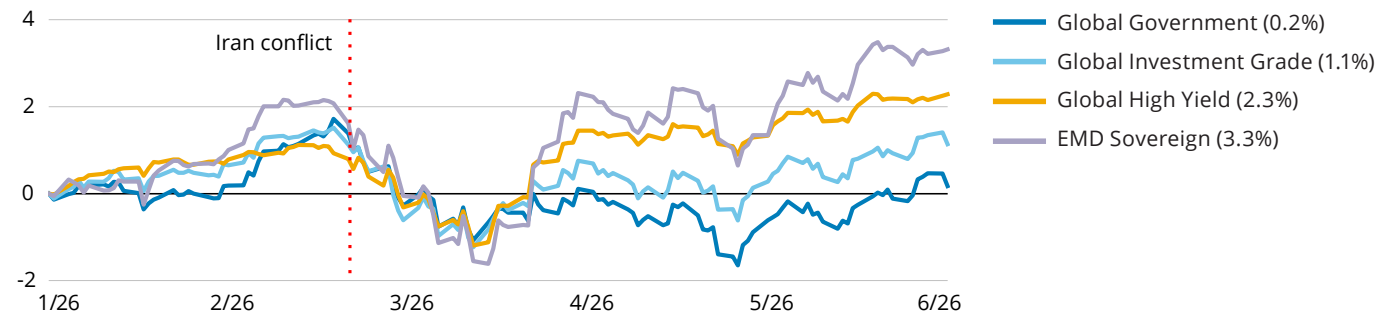
Our expectation of strong earnings growth amid more moderate valuations has led us to increase our equity view to overweight and to express a preference for EM over Europe. We've turned neutral on credit amid a significant tightening in spreads<sup>4</sup> while keeping our moderately overweight view on global duration.<sup>5</sup> Breakeven inflation rates have compressed significantly but we think real yields—particularly in the front end of the yield curve<sup>6</sup>—are too high in many regions.

**FIGURE 1**  
**Shake It Off? Markets Have Largely Seen Further Gains Despite Ongoing Conflict**  
 Cumulative Returns (%)

## Equities



## Fixed income



## Commodities

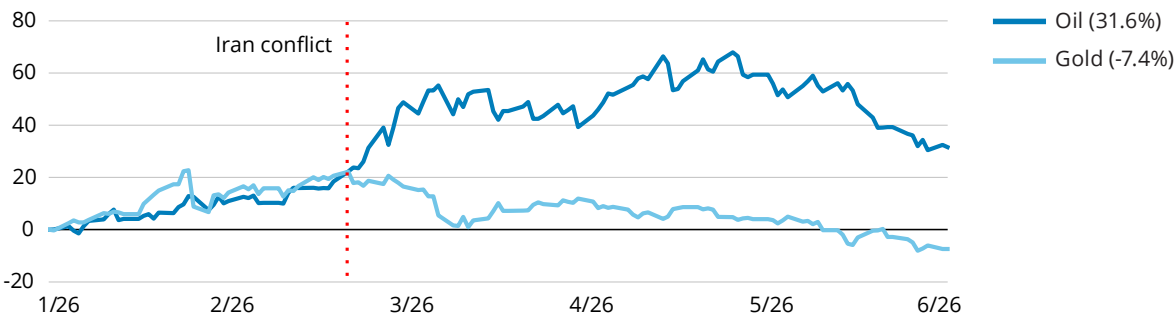


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## Equities

Despite the effects of the Middle East conflict, we think conditions for equities have remained supportive, driven by strong earnings revisions and a resilient manufacturing cycle. The durability of the global earnings and macro cycle is a sign of the profound impact of the technological shift we're witnessing and the capex wave it's fueling.

In nearly every market except Japan, virtually all the year-to-date gains in equities have been driven by EPS growth. Given that returns have been tied to earnings, valuations have de-rated, and we don't expect them to be a headwind.

Looking ahead, we think the market's performance will come down to earnings expectations, which we estimate will be in the low- to mid-double digits for global equities over the coming 12 months, with some room for modest valuation expansion. In our view, high expectations for EPS growth over the short- and mid-term are justified. Beyond earnings, balance sheets are strong, with relatively low debt-to-equity and high operating-cash-flows-to-debt ratios.

There are incipient signs of equity-market broadening. This includes a growing awareness of the layers beneath the big AI names, including the companies supporting the AI-driven build out of infrastructure, chips, energy, and other parts of the economy. Recent outperformance by US small caps over large caps, along with hyperscalers lagging sectors such as industrials and financials, also points to some rotation underway. Amid this rotation, volatility has picked up, and any technical correction driven by these dynamics would, in our view, present a tactical opportunity to add exposure, given solid fundamentals.

We've moved to a neutral view on US equities. Earnings growth remains robust and valuations appear reasonable. We think the spate of Initial Public Offerings (IPOs) will likely drive positive-to-neutral net issuance this year. While we expect the market to absorb this new issuance, we think the growth in net issuance and larger deal sizes could make equity supply something of a headwind for the market over the coming 12 months. We don't see evidence of stretched positioning, in aggregate, across a range of investor groups, but there are signs of exuberance in some areas, such as leveraged ETFs.

In Europe ex-UK and the UK, we think earnings expectations remain too high, and stagflationary concerns are more relevant. France and Germany have been hurt by competition from China, and risks related to political instability in France ahead of the 2027 presidential election could weigh on sentiment. We would stress, however, that we aren't negative on Europe, and there's potential for positive surprises, such as progress on financial-markets reform in the European Union (EU) or quicker-than-expected deployment of fiscal stimulus in Germany.

Relative to Europe, we have a higher-conviction view on EM equities. EM in Asia, in particular, are critical to the AI supply chain. In addition, China's resilience during the Middle East conflict stands out.

We're neutral on Japan. The market continues to benefit from buybacks, high/improving return on equity (ROE),<sup>7</sup> and corporate reforms, but we're concerned about the potential for blowback from rate and currency volatility at a time when valuations are more stretched, based on some metrics, than they have been for some time.



Given that returns have been tied to earnings, valuations have de-rated, and we don't expect them to be a headwind.

## Fixed Income

While yields moved modestly lower after the US and Iran began discussing a peace deal, they remain elevated given continued inflation risks and hawkish central-bank positioning. Global growth has remained largely resilient throughout the crisis, particularly in the US, offering some central banks breathing room to focus on inflation via rate hikes. However, markets may be overestimating future policy tightening. A lasting resolution to the conflict would likely ease energy-driven inflation pressures. In addition, evolving policy frameworks that emphasize any evidence of limited secondary inflation effects or real-economy softening could test central-bank willingness to follow through on hawkish rhetoric.

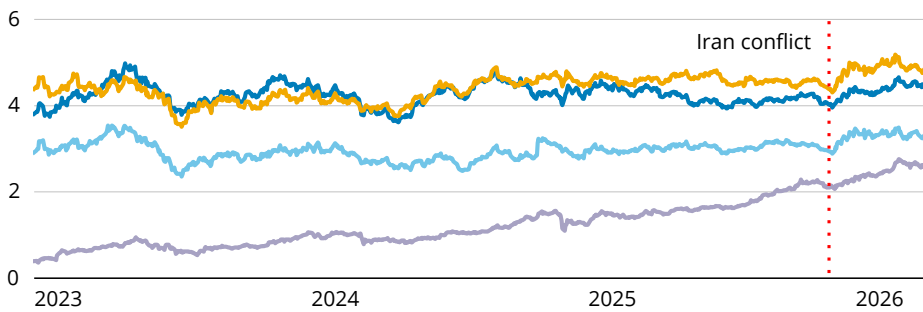
Against this backdrop, government bonds look more compelling to us as both nominal and real yields have reset higher (FIGURE 2). Entry yields are a key driver of long-term total returns, and we think today's elevated levels offer improved carry<sup>8</sup> and return potential. They could also help restore government bonds' role as a potential downside diversifier to equities in a steady inflation/weaker-growth scenario.



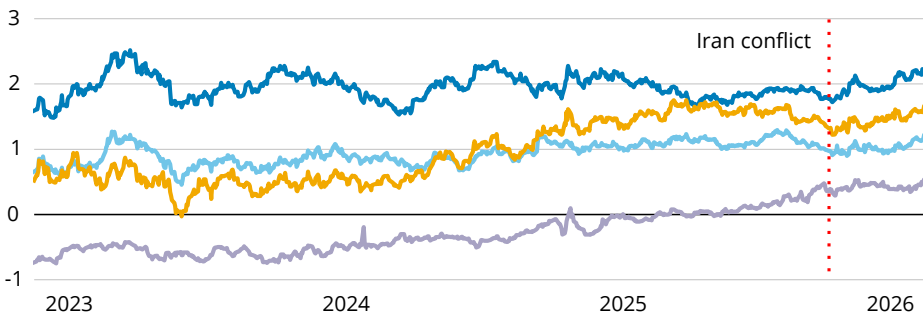
Entry yields are a key driver of long-term total returns, and we think today's elevated levels offer improved carry and return potential.

FIGURE 2  
**Are Rising Yields a Warning Sign or an Opportunity?**

Nominal 10-Year Yields (%)



Real 10-Year Yields (%)



— USA — EZN — GBR — JPN

Chart Data: 6/30/23-6/30/26. **Past performance does not guarantee future results.** Select data provided and copyrighted by Refinitiv. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. Refinitiv is not liable for any errors or delays in Refinitiv content, or for any actions taken in reliance on such content. Refinitiv's logo is a trademark of Refinitiv and its affiliated companies. Sources: Wellington Management and Refinitiv.

We've moved from a moderate underweight view on Japanese government bonds (JGBs) to a neutral view. Inflation risks have risen, partly because the Bank of Japan remains behind the curve in tightening rates. However, this has been priced in to a great extent, making a separate position in the 10-year JGB—where paying carry is the most expensive among regions—less attractive, in our view.

Globally, differentials in how fiscal risks are priced can lead to interesting relative-value opportunities. We're watching France, in particular, where domestic political uncertainty is growing against a backdrop of fiscal slippage vs. EU targets. In other countries, additional defense spending could reinforce the fiscal-activism narrative, weakening confidence in long-term demand even as this spending fuels more supply.

In credit, we've moved to a neutral stance. While we think all-in yields are attractive, spreads have once again tightened significantly and offer limited compensation for downside risks. We've downgraded our overweight view on credit as a result, although we continue to prefer European credit due to stronger fundamentals. Increased issuance, including AI-related capex and financing activity, could weigh on technicals, though it may also create greater dispersion across sectors and issuers, supporting more selective opportunities. Overall, we think the risk/reward profile appears balanced, warranting a neutral view.

## Commodities

We've moved to a small overweight view on oil given the sharp decline in prices. The market is transitioning from a short-term deficit to a medium-term surplus. However, the market is already pricing in much of that future surplus today despite lingering uncertainties about the resumption of exports from the Middle East, demand growth, and the supply response (e.g., the development of new pipelines to bypass the Strait of Hormuz).

On the cyclical demand side, many countries, including the US, will need to replenish their reserves given the large drawdowns during the conflict. However, structural demand also carries uncertainties, particularly from China given its focus on renewables.

On the supply side, the urge by OPEC member nations to flout OPEC agreements or even consider exiting the organization, as the United Arab Emirates did in May, could be limited by breakeven oil prices, which are much higher than the cost of production in many Middle Eastern countries.

The near-term setup for oil is, therefore, finely balanced, and we think our modest overweight view is warranted based on fundamental upside. While there could be an additional relief rally, the outlook appears asymmetric from here, in our view, particularly as prospects for an enduring resolution to the Middle East conflict and a fuller resumption of flows in the Strait of Hormuz remain in flux.

On gold, we've moved from our small overweight view to a neutral view. Our conviction has fallen materially, as the thesis has weakened from a two-engine demand story (central-bank and ETF demand) to a single propeller (central-bank demand). To reiterate a point we've made previously, we don't view gold as an inflation hedge, as correlations<sup>9</sup> are weak or nonexistent. The primary long-term relationships are negative correlations to the US dollar and real yields. We don't see significant upside emerging in either, but a fundamental reengagement with a bull case in the dollar is a risk.



In credit, tight spreads offer limited compensation for downside risks.

## Investment Implications

**Look for opportunities to diversify** — Returns may diverge across regions and sectors based on energy vulnerabilities, creating the opportunity for active positioning to add value over passive beta.<sup>10</sup> (Diversification doesn't ensure a profit or protect against a loss in declining market.)

**Don't give up on the AI boom as a driver of the macro and earnings cycles** — We still see a positive trajectory for US and EM earnings—the US because the AI innovation theme is intact, and EM because EM Asia is a lifeline for AI infrastructure. The theme can evolve and efficiencies in model usage will likely drive higher AI adoption.

**Consider capturing the spike in government bond yields** — Rising oil prices have shifted central-bank rate expectations from easing to tightening. We think the move puts global yields at attractive valuations, with the repricing overdone, in our view, particularly given the potential for high oil prices to derail growth. Look for opportunities created by regional divergences in yields.

**Opportunities may be limited in credit, which should be well-supported but has tightened** — Spreads have narrowed significantly, and we find little value at current levels. We think European credit has better fundamentals than the US in terms of debt service and leverage, and it's more insulated from US private credit issues. EM debt has tightened to pre-war levels; investors may want to consider adding there opportunistically.

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

### Indices used in FIGURE 1:

MSCI USA Index is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid cap segments of the US market.

MSCI Europe Index is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

MSCI Japan Index is a free-float adjusted market-capitalization index designed to measure large- and mid-cap Japanese equity market performance.

MSCI Emerging Markets Index a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

ICE BofA Global Government Index is a market value-weighted benchmark designed to track the performance of investment-grade sovereign debt publicly issued and denominated in the issuer's domestic market.

ICE BofA US Corporate Index tracks the performance of U.S. dollar-denominated, investment-grade-rated corporate debt publicly issued in the U.S. domestic market.

ICE BofA Global High Yield Index tracks the performance of below-investment-grade corporate bonds denominated in US dollars, euros, British pounds, and Canadian dollars and issued in major global markets.

JPMorgan Emerging Markets Sovereign Index (EMBI Global Core) tracks total returns for traded external debt instruments in the emerging markets. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding.

Dow Jones Commodity Index – Crude Oil tracks the performance of the crude oil commodities market by measuring the returns of WTI (West Texas Intermediate) crude oil futures contracts.

Dow Jones Commodity Index – Gold tracks the performance of the gold market using futures contracts.

**Indices used in FIGURE 2:** Nominal: US generic 10-year Treasury yield, Eurozone 10-year yield (Wellington composite of Germany [bund], France [OAT], and Italy [BTP]), UK generic 10-year government bond (gilt) yield, Japan generic 10-year government bond (JGB) yield; Real: US 10-year inflation-linked Treasury (TIPS) real yield (constant maturity), Eurozone 10-year real yield (Wellington composite of inflation-linked bonds from Germany, France, and Italy), UK 10-year inflation-linked gilt real yield, Japan 10-year inflation linked government bond real yield.

<sup>1</sup> Earnings per share measures how much profit a company makes per share of common stock.

<sup>2</sup> Stagflation is an economic cycle characterized by slow growth, inflation, and signs of labor market weakness.

<sup>3</sup> Capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. They are often used to undertake new projects or investments by a company.

<sup>4</sup> Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

<sup>5</sup> Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

<sup>6</sup> 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.

<sup>7</sup> Return on Equity is the average amount of net income returned as a percentage of shareholder's equity over the past five years.

<sup>8</sup> Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

<sup>9</sup> 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.

<sup>10</sup> 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. • 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. • Investments in the technology sectors may go in and out of favor, which may cause underperformance.

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# 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 premia<sup>1</sup> 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



**Martin Harvey, CFA**  
Fixed-Income Portfolio Manager



**Marco Giordano**  
Investment Director

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)

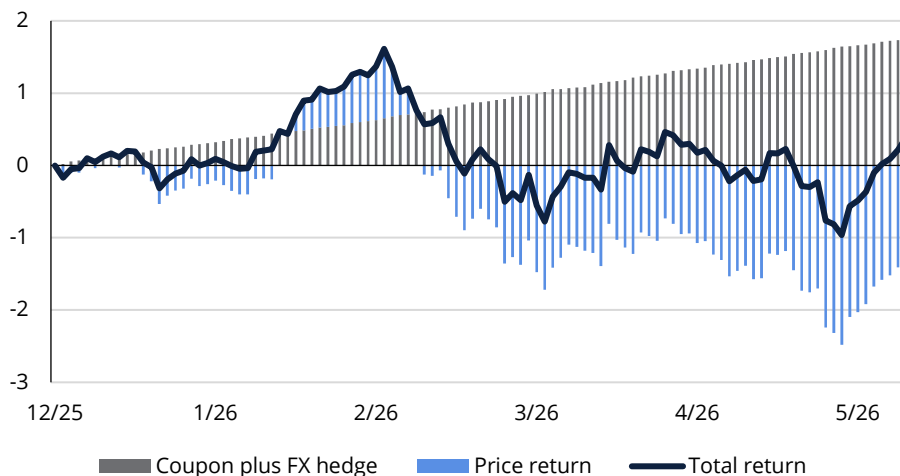


Chart data as of 5/29/26. Past performance does not guarantee future returns. Indices are unmanaged and not available for direct investment. “FX hedge” refers to foreign-exchange hedging strategies (e.g., currency options, futures, or spot contracts) designed to act as a shield against unfavorable currency-exchange movements. Return breakdown of the **Bloomberg Global Treasury Index<sup>2</sup>** 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 duration<sup>3</sup> 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,<sup>4</sup> 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,



Even allowing for a potential reduction in geopolitical risks, the exogenous shock of the US-Iran war will have long-term ramifications.

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.<sup>5</sup> 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

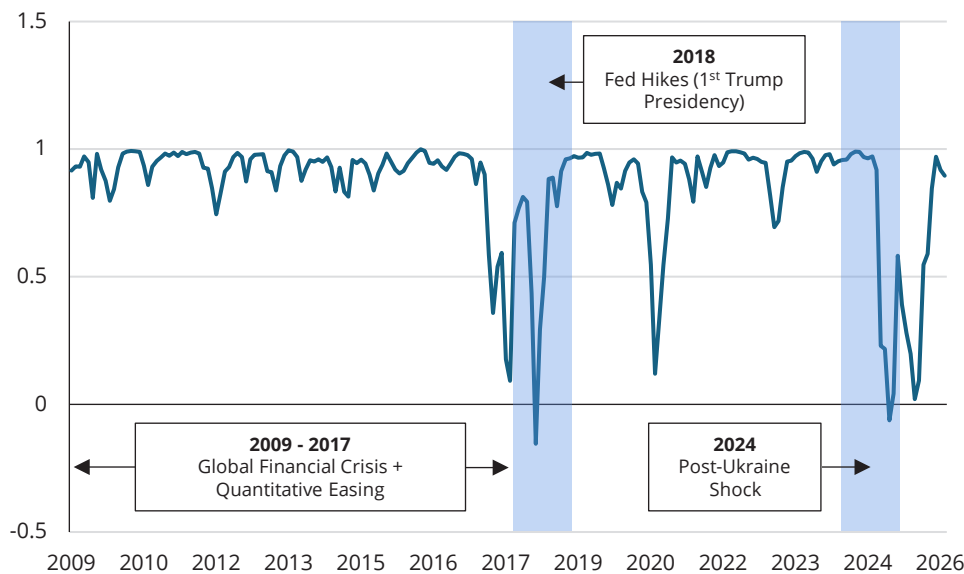


Chart data as of June 2026. Correlation between US 10-year Treasury yield and average of G10 sovereign bond yields. G10 for this comparison includes Australia, Canada, Germany, Japan, Mexico, New Zealand, Norway, South Korea, Sweden, and the UK. Correlation is a statistical measure of how two investments 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.



Divergence, rather than synchronization, is likely to become the main theme across markets.

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 gilts<sup>6</sup> move at a higher beta<sup>7</sup> 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.



A proactive and flexible approach can help manage ongoing volatility and may enhance the total return potential of core fixed-income allocations.

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

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

<sup>2</sup> 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.

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

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

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

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

<sup>7</sup> 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

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. • Diversification does not ensure a profit or protect against a loss in a declining market.

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## In Credit Markets, Expect Tighter Spreads, Wider Dispersion

Supply shocks from AI and the Middle East may create unique credit-selection opportunities.

### What You Should Know

- This year, credit markets are having to contend with two significant shocks: the Middle East conflict and AI. Both are supply rather than demand shocks, which require a distinct approach to portfolio positioning.
- In a supply-shock world, growth and inflation move in opposite directions, while interest rates and credit spreads<sup>1</sup> tend to rise and fall together, meaning duration<sup>2</sup> no longer offsets credit risk to the same degree—suggesting investors may need to hold moderately lower duration.
- Supply shocks hit sectors and issuers unevenly, and that unevenness is showing up as the widest sector dispersion we've seen in years, creating additional opportunities for credit selection.
- High yield, emerging markets (EM), convertible bonds, and securitized credit<sup>3</sup> are the sectors that we consider to be most appealing as we move into the second half of 2026.

### Insight From Sub-Adviser Wellington Management



**Campe Goodman, CFA**  
Fixed-Income Portfolio  
Manager



**Rob Burn, CFA**  
Fixed-Income Portfolio  
Manager

Markets opened 2026 focused on the disruptive impact of AI. Was there a future for companies selling subscription software? Or, in a few years, would we all be “vibe coding” our own applications? Yields fell, and credit spreads gyrated as markets wrestled with the idea that AI-driven change could raise productivity, lower prices, and perhaps cause widespread unemployment.

In late February, before markets could resolve those questions, the US attacked Iran. The prolonged closure of the Strait of Hormuz led to higher prices not just for oil and gas, but for critical goods such as fertilizer, aluminum, helium, and various other industrial chemicals. The result was a market trying to price two very different forces at the same time.

Government bond yields rose, and credit spreads widened substantially. By the end of March, the conflict cooled, but the strait remained largely shut. Markets realized the war mattered more for prices (much higher) than for growth (stable to slightly weaker), profits held up, and credit spreads recovered quickly even as yields continued to move higher.

## Supply Shocks, Not Demand Shocks

This year's defining forces are supply shocks, not demand shocks. The war in the Middle East is the acute supply shock: immediate, inflationary, and reminiscent of the 1970s oil crises. AI is the structural supply shock: slower-moving and potentially disinflationary, with the ability to raise productivity and push prices down. AI will matter enormously, but it'll take years to show up in the macro data. For now, the acute shock dominates. The Strait has begun to reopen, but only partially. Supply shocks leave a long tail, and the inflationary impulse will be felt for months, even once the Strait is fully open.

That distinction drives how we think about positioning for the remainder of 2026. In a supply-shock world, growth and inflation move in opposite directions, while interest rates and credit spreads tend to rise and fall together. When rates and spreads move together, duration no longer offsets credit risk. That's why we believe in holding modestly less duration compared to a year ago, not as a forecast that rates must rise, but because the diversification investors expect from duration is less pronounced in this regime.

## A Better Environment for Selection

The same regime that weakens duration as a hedge is good for sector and security selection. Supply shocks hit sectors and issuers unevenly, and that unevenness is showing up as the widest sector dispersion we have seen in years. Average spreads have returned to historically tight levels, implying the need for adopting a more defensive risk posture and keeping dry powder for dislocations. But the average hides the opportunity. Beneath tight index spreads, the gap between winners and losers has widened—and that's where we're finding value. AI is creating uncertainty around long-term winners and losers; higher rates are exposing differences in business quality hidden during the era of near-zero rates; and investors have grown selective toward sectors facing cyclical pressure, such as software, housing, and parts of commercial real estate. Average valuations look expensive, but individual securities can still offer compelling value.

High-yield corporates, emerging markets, securitized credit, and convertible bonds<sup>4</sup> are the sectors that we consider to be most appealing as we move into the second half of 2026. But we think the defining shift this year is balance: Rising dispersion has created value across many credit sectors, which, in our view, calls for considering rotating some risk into developed-market (DM) high yield and bank loans, and for being highly diversified.

## Global High Yield

In the spread-tightening environment that followed "Liberation Day,"<sup>5</sup> high yield offered the fewest opportunities we've ever seen in our careers. That has changed. Market concern over software companies—whose business models may be challenged by AI-enhanced coding—has given investors the chance to identify companies that stand to be AI winners, or at least those whose models won't be easily replaced. Building materials is another sector where weak housing has created opportunities to buy issuers that can withstand a soft market and benefit from a home-remodeling upturn. Key, in our opinion, is to focus on those select issuers where the balance sheet may look challenged today, but where careful credit analysis can reveal a credible path to improvement.



AI will matter enormously, but it'll take years to show up in the macro data.

## Emerging Markets

High-yielding EM corporate bonds have been one of our favorite sectors for several years, and to some extent that's still true: Telecoms and utilities with solid balance sheets trade at discounts to their DM counterparts. However, given more opportunities elsewhere, we see value in selectively reducing EM corporate exposure. In our view, investment-grade EM sovereign debt remains unappealing.

## Securitized Credit

Within securitized credit, we see value in shifting away from credit risk transfer (CRT) securities<sup>6</sup>—now largely short-maturity, stable instruments with limited capital appreciation—toward US non-agency mortgage-backed securities,<sup>7</sup> where the market fears a repeat of 2022, wrongly in our view. Non-agency underwriting has been strong: Loan-to-value ratios<sup>8</sup> are typically below 70%, and borrowers have solid credit scores. We also like commercial mortgage-backed securities (CMBS) linked to trophy office properties, where many issues still price in too much distress despite a marked rise in commuting and return-to-office mandates. We think it appropriate to trim allocations to collateralized loan obligations (CLOs) and recalibrate remaining exposures toward investment-grade tranches.<sup>9</sup>

## Bank Loans

Bank loans have moved from relatively unattractive to more compelling. Underwriting standards remain weaker than before, but spreads have widened enough to compensate, and dispersion has increased as investors have grown more selective. We see potential for adding exposure, particularly in software and technology issuers caught up in the same AI fears that are creating opportunities in high yield.

## Convertible Bonds

Convertibles remain attractive, particularly in technology and biotech—combining equity participation with risk mitigation in a sector that remains overlooked by traditional mandates. Convertibles performed strongly in 2025 as biotech recovered, but with valuations looking less compelling than a year ago, we see a case for trimming. However, we still believe that the structural merits of the asset class haven't changed.

## Putting It All Together

Credit spreads have largely retraced their earlier widening, leaving broad market valuations relatively expensive on a spread basis—even as relatively high yields still point to attractive total-return potential. In our view, that argues for a more defensive credit-risk posture and enough liquidity to take advantage of dislocations.

But tight index spreads don't mean a lack of opportunity. Dispersion across sectors and issuers has increased materially, and the average is hiding a more interesting market beneath the surface. In our view, this is an environment that favors selective risk-taking. Investors are not being paid much to own the average credit, but there's no need to focus on averages. The best opportunities could be in credits where fear has moved further than fundamentals.

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Investors are not being paid much to own the average credit, but there's no need to focus on averages.

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

<sup>1</sup> A credit spread is the difference between the yields of two bonds that mature at the same time but are rated at different credit qualities. This spread can have a significant impact on investment returns. Credit spreads are measured in basis points, where one basis point equals 0.01%. For example, a 1% difference in yield is equal to a spread of 100 basis points.

<sup>2</sup> Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

<sup>3</sup> Securitization transforms non-liquid assets into tradeable securities, providing investors with principal and interest returns from diverse assets like mortgage loans and consumer debt.

<sup>4</sup> A convertible bond is a hybrid security that offers interest payments while providing the option for conversion into a set number of the issuing company's common stock shares, which can benefit investors if the stock price rises.

<sup>5</sup> The "Liberation Day" tariffs refer to the sweeping import taxes announced by President Donald Trump on April 2, 2025 (declared "Liberation Day").

<sup>6</sup> CRTs allow banks to transfer credit risk to third parties while maintaining their lending relationships. This innovative approach helps banks reduce credit risk, lower regulatory capital requirements, and potentially increase return on equity.

<sup>7</sup> Non-agency mortgage-backed securities (MBS) are pools of mortgages packaged by private institutions rather than government-sponsored enterprises like Fannie Mae or Freddie Mac. Because they lack federal guarantees, they carry higher credit risk but offer potentially higher yields.

<sup>8</sup> A loan-to-value (LTV) ratio typically represents the amount of a mortgage compared to the property's value. It measures how much risk a prospective homebuyer represents based on the mortgage amount and the appraised value of the property.

<sup>9</sup> Investment grade (IG) CLO tranches are fixed-income securities rated AAA down to BBB, backed by a pool of below-investment-grade leveraged loans. They offer floating-rate yields that outpace traditional corporate bonds and maintain exceptionally low historical default rates due to strict credit protections and cash flow subordination.

**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. • Investments in high-yield ("junk") bonds are considered speculative, involve heightened credit risk and greater risk of price volatility, illiquidity, and default than investment grade bonds. • The risks associated with mortgage-related and asset-backed securities as well as collateralized loan obligations (CLOs) include credit, interest-rate, prepayment, liquidity, default and extension risk. There are additional risks associated with credit risk transfer securities. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • 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 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. • Diversification does not ensure a profit or protect against a loss in a declining market.

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## Preparing for a Shift in US Exceptionalism

While US leadership remains largely intact, it may be wise to prepare now for a time in which it wanes, creating more opportunities for diversification and attractive returns outside the US.

### What You Should Know

- US exceptionalism remains intact, but its advantages may be narrowing.
- Global markets are becoming less synchronized, creating more diversification opportunities.
- Elevated US valuations may make future outperformance harder to sustain.
- AI growth opportunities extend beyond US mega-cap technology companies, particularly in Asia.
- Earnings growth is broadening across sectors, company sizes, and regions.
- The US dollar may no longer provide the same tailwind it has in the past.
- Europe and Japan are becoming more self-reliant, creating new investment opportunities.
- Investors may benefit from maintaining US exposure while increasing allocations to non-US markets.

### Insight From Sub-Adviser Wellington Management



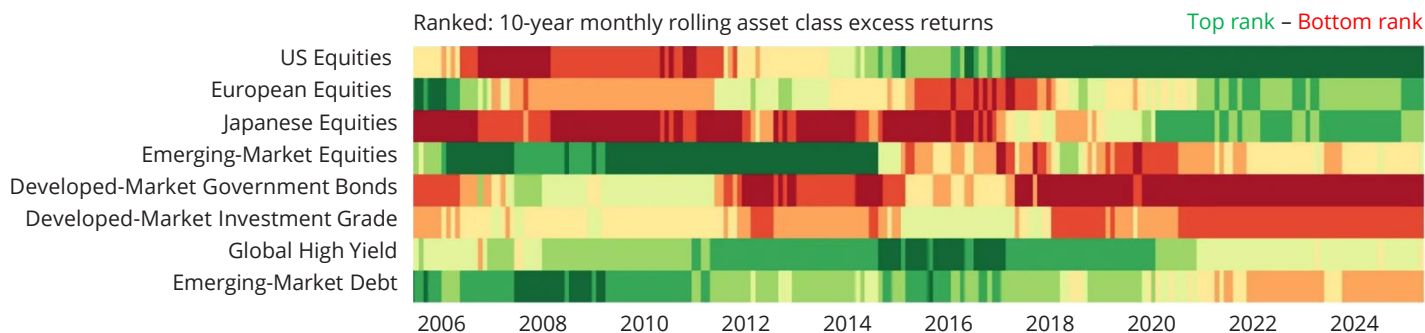
**Andrew Heiskell**  
Equity Strategist



**Nicolas Wylenzek**  
Macro Strategist

Over the last 15 years, US public companies have achieved superior performance and faster growth than the rest of the world, while also almost always exceeding absolute-return expectations. Coupled with favorable starting valuations, these tailwinds have delivered a prolonged period of exceptional returns for US equities, well ahead of other asset classes and markets (**FIGURE 1**). For non-US investors, these returns were further enhanced by a consistently strengthening US dollar. Now, with valuations at much higher levels and growing doubts about US global leadership, investors have started to ask if this US exceptionalism can persist.

**FIGURE 1**  
**US Equities Have Enjoyed Years of Exceptional Returns**



As of 12/31/25. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Total excess returns (over US 3-month cash) ranked on a 10-year monthly rolling basis; green indicates top rank, red indicates bottom rank. Representative Indices: US Equities - S&P 500 Index, European Equities - MSCI Europe Index, Japanese Equities - MSCI Japan Index, Emerging-Market Equities - MSCI Emerging Markets Index, Developed-Market Government Bonds - FTSE World Government Bond Index, Developed-Market Investment Grade Bonds - ICE BofA Global Corporate Index, Global High Yield - Bloomberg Global High Yield Index, and Emerging-Market Debt - JPM EMBI Global Diversified Index. See last page for representative index definitions. Sources: Wellington Management and Refinitiv.

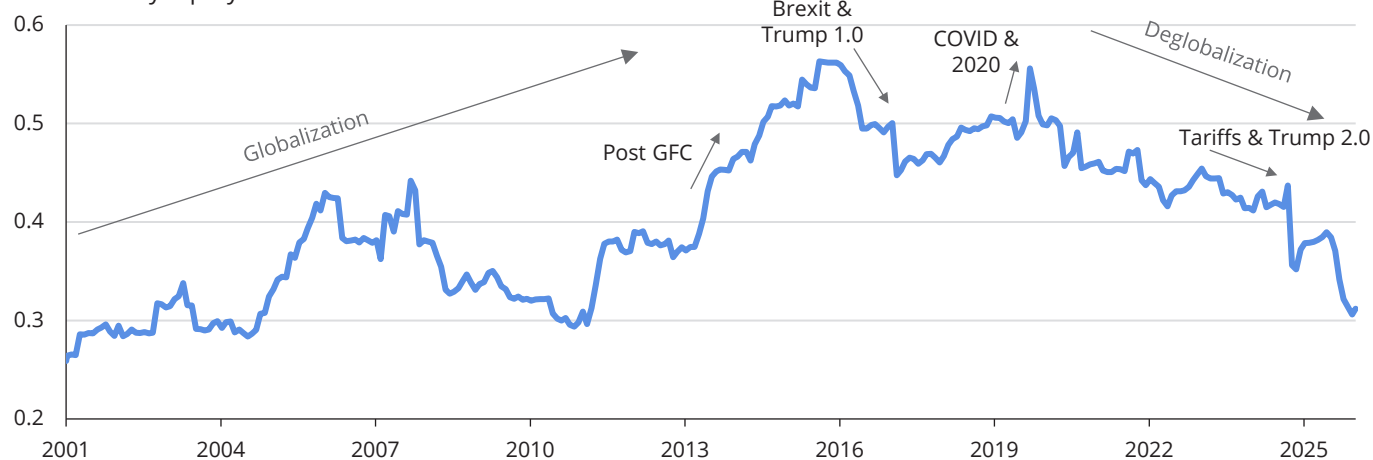
Yet, as we look to the second half of 2026, perhaps the more accurate question to ask is not whether, but how US exceptionalism might evolve? And what can investors do to prepare? The first half of the year offers us some indication. Here we share a few observations.

## With The World Shifting from Multilateralism to Unilateralism, Dispersion Has Returned

The prior economic regime of expanding globalization was characterized by synchronized global growth, high correlations<sup>1</sup> in economic cycles and equity markets, low dispersion,<sup>2</sup> low inflation, and falling interest rates. In a highly synchronized environment, investors were incentivized to reduce diversification and concentrate exposure into whichever asset class (or market) was delivering the best growth. Diversification does not ensure a profit or protect against a loss in declining market. During this period, anything an investor did to hedge or diversify away from the US equity market or the US dollar generally increased volatility and lowered returns. But as **FIGURE 2** illustrates, global markets are no longer moving together in the same way. The correlation of global equity markets rose steadily from 2000 to hit a peak in 2016—a period that in retrospect has come to signal the beginning of the fracturing of globalization. The desynchronization of the global cycle has now driven country correlations close to a multi-decade low.

**FIGURE 2**  
**Desynchronization of the Global Cycle Has Driven Country Correlations Close to a Multi-Decade Low**

Cross-Country Equity Correlations



As of 3/11/26. **Past performance does not guarantee future results.** Monthly rolling 5-year correlation of the S&P 500 Index, MSCI Canada Index, MSCI China Index, MSCI UK Index, MSCI Japan Index, MSCI Germany Index, MSCI India Index, MSCI France Index, MSCI Mexico Index, and MSCI Sweden Index. Source: Bloomberg Finance L.P.

## The Starting Point For Valuations Does Matter

The US equity market today is very different than it was 50 years ago. Then, capital-intensive manufacturing and industrial sectors were the beating heart of the American equity market. When the capital-light tech sector took off, the runway for growth increased exponentially, helping to fuel US exceptionalism. But now, the rapid growth in AI-related capital expenditure is drawing into question the future returns on this invested capital.

Moreover, US equities have historically earned their higher valuations through consistently delivering faster growth and outcomes that beat expectations. Now, valuations imply a bigger hurdle for future beats at a time when the positioning of the US relative to the rest of the world may be changing, while, overall, US earnings expectations remain at a multiyear high.

## The US Is Increasingly Not the Only AI Game in Town

Exceptional US companies may continue to excel, but in this nascent stage of AI, we see plenty of room for new competitors—in the US and elsewhere—to grow, succeed, and even displace incumbents. Prudent investors will look for opportunities among new and established companies alike, both in historically dominant markets like the US, and in others, like Asia, where innovative, new AI-focused companies have long runways to thrive.

It's worth underscoring that while US mega-cap technology companies dominate the application and platform layer of AI, Asia plays a critical role in enabling the infrastructure behind it, and the region's role in the semiconductor ecosystem serves as a good example. The region holds leading positions in materials, memory, and advanced manufacturing capabilities that we think are difficult to replicate at scale. Japan owns a significant proportion of the critical materials and tools, Korea leads memory, and Taiwan still sets the bar in advanced fabrication and packaging.

## Earnings Growth Continues to Broaden, Even Outside of AI-Driven Growth

While for the most part today's US market leaders are still expected to deliver superior growth, especially in the broader tech space, there are reasons to look elsewhere, both in the US and beyond. Against a backdrop of stronger-than-anticipated economic growth and ongoing fiscal support, we continue to see signs of a broadening in earnings growth across sectors, market cap, and regions. This points to the potential for a wider set of beneficiaries, suggesting that investors may wish to position for more diversified sources of growth.

## The US Dollar Remains in a Tenuous Position

One of the major factors supporting US exceptionalism has been a consistently strengthening currency, delivering not just enhanced returns but also "risk off" diversification benefits. This trend of persistent dollar strength has now come to an end as evidenced by the significant weakening we saw prior to the US-Iran conflict. Since then, the dollar has rallied somewhat but, longer term, we think it remains vulnerable to growing uncertainty about the US's long-term fiscal position and the role of the dollar as the world's reserve currency. The attractiveness of the dollar may be further undermined if investors start to view it as a source of risk amplification rather than risk mitigation.



Valuations imply a bigger hurdle for future beats at a time when the positioning of the US relative to the rest of the world may be changing.

## US Policy Actions Continue to Drive “Reflexive” Responses from The Rest of the World

Political drivers and objectives are now shaping economic decisions. This means investors increasingly need to look at the direction policymakers are headed in order to understand risks and opportunities.

As US policies shift away from the prior global order, other countries may have reflexive responses that could encourage their own domestic resilience and economic strength. Over time, this could narrow the gap for US growth expectations relative to the rest of the world.

## Europe and Japan: Going Their Own Way

Europe and Japan, in particular, appear to be stepping up efforts to insulate their economies from external shocks. After decades of relying on external demand, imported energy, and US-provided security, these regions are now reassessing the sustainability of that model. First, both are net energy importers and are likely to accelerate efforts to reduce reliance on fossil fuel imports. Second, Europe and Japan have historically relied not only on the US security umbrella but also on US defense technology. With future US support less certain, domestic defense capabilities are likely to become a greater priority. And finally, as major beneficiaries of globalization, both regions have long depended on exports. However, with China exporting excess capacity and the US raising trade barriers, we’re likely to see an increased focus on boosting domestic demand and protecting local industries to offset external headwinds.

In our view, these regime shifts in both Europe and Japan could create winners and losers, potentially expanding the opportunity set for active managers. Moreover, European and Japanese equities are likely to offer improved diversification as their drivers increasingly decouple from the US cycle.

## Putting This All Together: Two Truths—US Exceptionalism Is Intact, But Also Waning

The problem equity investors face now is how to deal with a world in which US exceptionalism appears to be both intact and waning. An 80-year history of US economic, geopolitical, and military dominance—one that’s driven dollar primacy, powered US financial markets and, for the most part, supported global stability—is being challenged. While most of these dynamics still hold, it’s also true that the world and the US face growing turbulence in many forms: expanding regional conflicts, economic instability, and diminishing policy cohesion. The effects of this emerging dichotomy on capital markets are beginning to take shape, and asset allocators need to understand what the two truths of US exceptionalism may mean for them.

Because we believe US exceptionalism remains largely intact, investors should consider staying invested in US equities but potentially look to broaden their exposure. However, we think that they should also be prepared to accept lower risk-adjusted returns relative to what they’ve grown accustomed to in the last 15 years, but also compared to the rest of the world, especially given high starting valuations. And because US exceptionalism is simultaneously waning, we also believe investors should consider balancing investment in the US with increased allocations to non-US markets, both to effectively diversify US exposure and add to the potential for higher risk-adjusted returns.



The problem equity investors face now is how to deal with a world in which US exceptionalism appears to be both intact and waning.

## To learn more about opportunities in equities, please talk to your financial professional.

<sup>1</sup> Correlation is a statistical measure of how two investments move in relation to each other, 1.0 indicates the investments have historically moved in the same direction; -1.0 means the investments have historically moved in opposite directions; and 0 indicates no historical relationship in the movement of the investments.

<sup>2</sup> Dispersion is a statistical measure of how much individual asset returns deviate from a broader market index or average. It indicates the range of potential investment outcomes.

### Representative Index Definitions:

**Bloomberg Global High Yield Index** represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices.

**FTSE World Government Bond Index** is a market-capitalization-weighted index consisting of government bond markets. Country eligibility is determined based on market capitalization and investability criteria. All issues have a remaining maturity of at least one year.

**ICE BofA Global Corporate Index** tracks the performance of investment-grade-rated corporate debt publicly issued across major domestic and Eurobond markets.

**JPM EMBI Global Diversified Index** tracks total returns for traded external debt instruments in the emerging markets. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding.

**MSCI Canada Index** is designed to measure the performance of the large- and mid-cap segments of the Canada market. The index covers approximately 85% of the free float-adjusted market capitalization in Canada.

**MSCI China Index** MSCI China Index is a free-float adjusted market-capitalization index that is designed to measure equity market performance in China.

**MSCI Emerging Markets Index** is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets. MSCI index performance is shown net of dividend withholding tax.

**MSCI Europe Index** is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

**MSCI France Index** is designed to measure the performance of the large- and mid-cap segments of the French market. The index covers about 85% of the equity universe in France.

**MSCI Germany Index** is designed to measure the performance of the large- and mid-cap segments of the German market. The index covers about 85% of

the equity universe in Germany.

**MSCI India Index** is designed to measure the performance of the large- and mid-cap segments of the Indian market. The index covers approximately 85% of the Indian equity universe.

**MSCI Japan Index** is a free-float adjusted market-capitalization index designed to measure large- and mid-cap Japanese equity market performance.

**MSCI Mexico Index** is designed to measure the performance of the large- and mid-cap segments of the Mexican market. The index covers approximately 85% of the free float-adjusted market capitalization in Mexico.

**MSCI Sweden Index** is designed to measure the performance of the large- and mid-cap segments of the Swedish market. The index covers about 85% of the equity universe in Sweden.

**MSCI UK Index** is designed to measure the performance of the large and mid cap segments of the UK market.

**S&P 500 Index** is a market capitalization-weighted price index composed of 500 widely held common stocks.

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# 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



**Eoin O'Callaghan**  
Macro Strategist



**Michael Medeiros, CFA**  
Macro Strategist

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 assets<sup>1</sup> 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 premia<sup>2</sup> and steeper yield curves<sup>3</sup> in some markets.



If inflation proves stickier than expected, interest rates and bond yields may need to remain higher for longer.

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.



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

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

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

<sup>3</sup>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.

**Important Risks:** Investing involves risk, including the possible loss of principal. • 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 such as China. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur.

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