

A Credit Investor's Perspective on Inflation, Fiscal Policy, and AI

Perspective on where opportunities and risks are emerging across fixed income and what it means for investors in an uncertain environment.

What You Should Know

- Inflation has cooled from its 2022 highs, but rising energy prices tied to geopolitical uncertainty could keep near-term pressure on prices and leave the direction of interest rates uncertain.
- The US economy remains resilient but uneven, with AI-related investment supporting growth while cumulative price increases and a softer labor market weigh on lower-income consumers.
- Cooling housing costs and slower population growth should help pull inflation lower over time, though they may also create headwinds for broader economic growth.
- AI is likely to boost productivity and support corporate margins over the medium term, but it may also limit hiring and contribute to a more cautious labor market.
- Bonds now offer more attractive income than they have in years.
- A coming wave of long-dated bonds from AI infrastructure spending could pressure parts of the investment-grade market, making selectivity especially important.
- Private credit remains a viable asset class, but looser lending standards suggest investors should temper expectations relative to recent history.

Insight From Sub-Adviser Wellington Management



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Heading into this year, inflation had been gradually cooling while the job market showed signs of stabilizing. Then the situation with Iran pushed oil prices higher, putting inflation back in the spotlight.

The good news? Today's inflation levels are nowhere near the 4% – 6% we experienced in 2022. We still believe the broader forces in the economy are pulling inflation lower over time, but higher energy prices are creating a near-term headwind. For the US Federal Reserve, this likely means staying on hold for now and waiting for more clarity before making any moves on interest rates. Markets are already pricing in much of this uncertainty.

How Strong Is the US Economy Right Now?

We see what we would describe as a two-speed economy. On one side, the AI buildout is powering a remarkable wave of investment that should support growth for some time. On the other side, years of cumulative price increases and a softer job market are weighing on everyday consumers, particularly those in lower-income brackets.

The bottom line: Growth should remain solid for now, in our view, supported by AI-related spending and the tail end of government stimulus. But the picture is uneven, and that unevenness matters.

Government Spending Has Been a Big Topic. Where Do Things Stand?

Government spending has been an unusually powerful driver of economic growth over the past few years, even at a time when the economy was already running near full capacity. We believe this fiscal boost has been the key factor pushing both growth and inflation above their longer-term trends.

That boost is peaking right now. We think the maximum impact is being felt in the first half of this year, then it will turn neutral in the second half and potentially become a drag on growth early next year, unless new spending measures are passed. Given the current political landscape, passing additional stimulus could prove difficult. History offers a useful parallel: After the 2010 midterms, a shift in Congressional power significantly curtailed government spending, and the deficit shrank quickly.

We aren't predicting any specific political outcome, but the direction of fiscal policy is something every investor should be watching closely.

What About Housing and Population Trends?

Put simply, housing is unaffordable for many. Home prices are still rising at the top end of the market, but for most buyers, prices are starting to soften. Rents are following a similar path.

Why does this matter? Housing-related costs make up roughly a third of the Consumer Price Index,¹ the main measure of inflation. If rent- and home-price growth continue trending toward zero, that alone could reduce inflation by up to 1%, a meaningful shift.

On the demographic front, population growth has slowed sharply, from its fastest pace in 25 years to one of its slowest. Since economic growth is essentially population growth plus productivity growth, this is a headwind for the economy and a further force pulling inflation lower. We expect this dynamic to persist for at least the next two years, which should also help bring housing supply and demand into better balance over time.

Everyone Is Talking About AI. How Is It Really Affecting the Economy?

This is one of the most fascinating debates we're having at Wellington. Economists point out that technological revolutions have historically created more jobs than they have destroyed. But when we speak directly with large companies, the message is remarkably consistent: They want to grow profits by 30% – 40% over the next five years while keeping their workforce the same size.

That's a telling statement. It suggests that even in a good economy, companies are unlikely to hire aggressively, and if conditions worsen, reducing headcount will be their first move.

Over the medium term, we believe AI will be a powerful source of productivity gains, enabling businesses to do more with less. While the current buildout phase carries some inflationary elements, with all of the physical infrastructure being built, we believe the longer-term effect should be disinflationary. The pace of change continues to surprise even the most optimistic forecasters, and we expect that to continue.



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With All of This in Mind, How Should Investors Think About Bonds vs. Equities?

The story we've laid out is, in many ways, supportive for equities. A better productivity outlook translates into healthier profit margins for large companies.

But here's what's changed: The income available in bonds is meaningfully higher than it was for most of the past decade. Investors can now build a portfolio yielding 4% – 6% with a sensible level of risk, something that simply wasn't possible during the era of ultralow interest rates.

We still believe strongly that government bonds can help minimize drawdowns in portfolios during a downturn, provided growth and inflation move below trend. Rather than reducing equity exposure, our view is that investors should consider shifting some cash into intermediate-duration² bonds to add both potential income and resilience. Think of it as building a more balanced portfolio, not choosing one over the other.

There's Been Massive Borrowing by Big Tech Companies. What Does That Mean for Bond Markets?

The scale is significant. We expect the large technology companies, often called hyperscalers, to raise anywhere from half a trillion to a trillion dollars in the bond market to fund their AI infrastructure. Most of this borrowing will be in longer-dated bonds.

For the past few years, the investment-grade bond market has seen very little new borrowing, which has been one reason credit spreads,³ the extra yield investors earn above government bonds, have stayed tight. This is now changing. We don't expect a dramatic blowout in spreads, but we do anticipate that excess returns (returns from a security or portfolio that exceed a benchmark or index with a similar level of risk) on longer-dated bonds will be eroded as the market absorbs this wave of supply.

This is the largest corporate investment cycle we have seen in our careers. For investors, it means being thoughtful about where you take credit risk and potentially favoring shorter-duration positions while the market adjusts.

What's Your View On Private Credit?

Private credit has grown enormously over the past decade, stepping in as the primary lender to small- and mid-sized businesses as traditional banks pulled back after the Global Financial Crisis. It's become a significant part of the lending landscape.

However, the sheer volume of capital flowing into the space has compressed returns and, in our view, modestly lowered lending standards. We don't see private credit as a systemic risk; the structure of these funds doesn't lend itself to the kind of sudden withdrawals that can destabilize banks. But we do think returns going forward may not be as attractive relative to public bonds as they have been over the past five to 10 years.

In short, private credit remains a sound asset class, but investors should temper their return expectations and weigh the trade-offs carefully.



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To learn more about today's opportunities in fixed income, talk to your financial professional.

¹ The CPI in the United States is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."

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

³ Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

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. • Private equity investments involve a high degree of business and financial risk that can result in substantial losses.

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