

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 spreads¹ tend to rise and fall together, meaning duration² 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 credit³ 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



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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 bonds⁴ 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,"⁵ 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.



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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) securities⁶—now largely short-maturity, stable instruments with limited capital appreciation—toward US non-agency mortgage-backed securities,⁷ where the market fears a repeat of 2022, wrongly in our view. Non-agency underwriting has been strong: Loan-to-value ratios⁸ 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.⁹

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

¹ 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.

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

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

⁴ 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.

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

⁶ 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.

⁷ 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.

⁸ 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.

⁹ 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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