

What does Fed policy mean for investors?

UBS House View Briefcase

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Key message

The Federal Reserve delivered a widely expected 25-basis-point rate cut in December, bringing the federal funds rate to 3.50-3.75%. We expect one 25bps reduction in the first quarter of 2026, consistent with the median forecast from top Fed officials in the dot plot for one cut this year. For investors, lower interest rates increase the importance of putting excess cash to work.

01 The Fed cut rates in December.

- The Fed cut policy rates by 25 basis points in December, its third consecutive reduction last year.
- However, the accompanying statement, press conference, and meeting minutes have clouded the outlook for future rate cuts.
- Given the divisions within the FOMC, the Fed's updated "dot plot" showed a wide dispersion of views, with no clear consensus on the path for rates in 2026. The median dot shows one rate cut in 2026.

02 We believe the Fed has scope to continue easing this quarter.

- Our base case is that we will get one further 25-basis-point rate cut by the end of the first quarter. Labor market conditions remain soft.
- US inflation is likely to peak in the second quarter, in our view, before stabilizing toward the Fed's 2% target.
- The DoJ investigation concerning Chair Powell does not materially alter the likely path for Fed rate cuts in 2026, in our view.

03 Lower interest rates strengthen the case for investors to put cash to work.

- Investors should consider phasing excess liquidity into diversified portfolios.
- To achieve alternative sources of portfolio income to cash, we see medium-duration quality bonds and equity income strategies as appealing.

New this week

US President Donald Trump said he has finished interviewing candidates to serve as the next Federal Reserve chair and has someone in mind for the job. Trump's shortlist includes National Economic Council Director Kevin Hassett, BlackRock executive Rick Rieder, current Fed Governor Christopher Waller and a former governor, Kevin Warsh.

One liner

For investors, Fed rate cuts increase the importance of putting excess cash to work.

Did you know?

- The Department of Justice (DoJ) launched a criminal investigation into Chair Powell's June 2025 testimony to Congress regarding the Fed's building renovations. While the investigation adds uncertainty to the timeline of potential leadership changes at the Fed, any adjustments to the policymaking framework are likely to be gradual.
- The Senate plays a key role in confirming the nominations of future governors and the next Fed chair. Senator Thom Tillis (R-NC) said he would oppose the confirmation of any nominees until the DoJ investigation is resolved. This could slow the confirmation of the next Fed chair.
- Cash tends to underperform other assets over time: Stocks have outperformed cash in 86% of all 10-year periods and 100% of all 20-year periods since 1926.

- We also expect lower interest rates, robust corporate earnings, and AI tailwinds to support further gains for equity markets over the coming year.

Investment view

Lower interest rates reduce potential returns on cash. We therefore recommend that investors consider phasing excess liquidity into diversified portfolios. We also like quality bonds, which can offer a more durable source of income. Investors underallocated to equities should consider adding to stocks in CIO's preferred areas, including AI, Power and resources, and Longevity.

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