What does Fed policy mean for investors?

UBS House View Briefcase

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Key message

Despite inflation risk in the US reducing the likelihood of near-term easing, we believe the bar for a Federal Reserve interest rate hike is high. As markets continue to overprice the risk of Fed tightening, we see an opportunity for investors to "lock in rates" by adding to quality bonds, particularly in the short- and medium-maturity segments.

01 The Fed is likely to hold rates steady in the near term.

- Some of the weakness in the US Treasury market may reflect nervous anticipation over what new Fed Chair Kevin Warsh could say at his first meeting on 17 June.
- While hawkish risks have risen, we think the Warsh-led Fed will remain inclined to look through tariff- or oil-induced one-off supply-shock inflation.
- Ongoing evidence of loosening in the labor market should also help keep the Fed in a wait-and-see mode.

02 And we think the bar for a Fed hike is high.

- We forecast oil prices below current levels by late 2026 while oil-related growth headwinds are likely to return GDP growth to trend, reinforcing disinflation in the second half.
- Financial conditions have also tightened, particularly given long-end rates are now close to multi-decade highs, which are key borrowing rates for both households and corporations.
- In a scenario where the Strait of Hormuz remains blocked for a prolonged period, downside risks to growth could lead to rate cuts. We expect the Fed to cut rates in December this year and March 2027.

03 Lower interest rates strengthen the case for investors to lock in yields.

- We think market hawkishness on global rates right now is a chance to lock in high yields, especially in quality bonds with short to medium maturities.
- An allocation to emerging market bonds can enhance yields and offer an alternative to developed market fiscal challenges. Investors can also consider equity income and yield-generating strategies for a diversified income portfolio.
- We believe Fed policy overall will remain supportive for US equities, and we favor a balanced and diversified approach to the asset class.

New this week

US jobs data out last week showed the US economy created 172,000 net new jobs in May, roughly twice the consensus forecast, while the unemployment rate held steady at 4.3%. That followed data earlier in the week showing job openings at a two-year high.

One liner

The bar for a Fed hike is high, in our view. Investors should "lock in rates" by adding to quality bonds, particularly in the short- and medium-maturity segments.

Did you know?

- We think bond markets are currently too focused on the short-term inflationary impact of higher energy prices, and not enough on the potential medium-term negative economic growth impact, which could drive interest rate cuts, nor on the potential for de-escalation.
- US wage growth continues to trend lower, labor force participation rates are falling, and sentiment surveys imply the market remains in a low firing, low hiring environment. In fact, real wage growth has recently turned negative and personal savings rates are close to historical lows, limiting the buffers for economic activity
- 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.

Investment view

We believe markets continue to overprice the risk of a tighter Fed policy, presenting an opportunity for investors to "lock in rates." We like short- and medium-maturity quality bonds, and see value in select exposure to higher-beta segments such as emerging markets, high yield, or subordinated debt. We also expect Fed policy to remain supportive for equities.

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