What does Fed policy mean for investors?

UBS House View Briefcase

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Key message

Despite inflation risk that reduces the likelihood for near-term easing, we believe the Federal Reserve's medium-term policy trajectory still points toward lower rates. As markets continue to overprice the risk that the Fed will not cut interest rates, it presents an opportunity for investors to "lock in rates" by adding to quality bonds, particularly in the short- and medium-maturity segment.

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

- Minutes from the Fed's policy meeting in March showed that a number of officials felt interest rate hikes might be needed to counter inflation, with a "vast majority of participants" judging that the risk of US inflation running persistently above target had increased.
- Fed Chair Jerome Powell also stressed that officials would need to see more progress in moderating inflation in the US to ease further.

02 But we think the Fed's policy easing bias remains intact.

- Price data for March showed that underlying inflation was milder than markets had expected.
- We expect slowing core goods inflation in the US in 2H26, while growth is likely to decrease to a near-trend pace amid higher oil prices.
- Growing signs of labor market vulnerability should also open the door to further Fed easing later this year.

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

- The case for quality bonds as a source of diversification and income is strong, especially those with short to medium maturities as the risk of tighter monetary policy remains overpriced, in our view.
- 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.

New this week

Kevin Warsh reaffirmed his commitment to monetary policy independence last week, emphasizing in his Senate confirmation hearing that operational independence is not threatened simply because elected officials express their views on rates. Warsh made it clear that he had not been asked to commit to any specific rate decisions and would not do so.

One liner

The Fed's policy easing bias remains intact, and investors should "lock in rates" by adding to quality bonds, particularly in the short- and medium-maturity segment.

Did you know?

- Analysis by the Dallas Fed shows that the incremental price pressure due to rises in energy prices tends to fade quickly after a few months, with core inflation little changed.
- 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 growth impact, which could drive interest rate cuts, nor on the potential for de-escalation.
- 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.

Non-Traditional Assets

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

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