UBS

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Chief Investment Office GWM
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# 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.

- The Fed held rates steady in April at 3.50-3.75%, matching expectations. However, one official dissented for a cut, while three opposed language suggesting the next move would likely be lower.
- Outgoing Chair Powell said the bar for easing was now higher, and that the center of the committee is shifting to a more neutral stance. He also revealed he will remain as governor “for a period of time to be determined.”

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

- Sequential core goods inflation is likely to keep softening in 2Q and 3Q, since tariff rates have mostly remained stable or declined recently.
- 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.
- The balance of risks around timing has become more skewed toward a later start, and we now expect one rate cut this year and another in 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

Money markets on 18 May priced a near 45% chance the Fed will hike rates by at least 25 basis points by year-end, according to the CME FedWatch tool, up from around a 15% probability one week prior.

## 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. We also expect Fed policy to remain supportive for equities.

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