(UBS)

Quality bonds can help smooth portfolio volatility

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Treasury yields dipped from recent highs as Middle East tensions eased, making short- and medium-duration quality bonds an attractive option for income and portfolio stability amid ongoing market volatility.

With inflation concerns unlikely to ease meaningfully until a clearer path toward ending the Middle East conflict emerges, we expect yield volatility to persist in the near term. In fact, given the less liquid nature of the long end of the curve, even incremental news headlines can trigger outsized market moves.

But we maintain the view that the risk-reward outlook for short- and medium-duration quality bonds is appealing.

A shift in focus to growth risks could lead markets to price in interest rate cuts. Minutes from the Federal Reserve's April meeting showed that "many" officials called for the central bank to signal that its next move could be an interest rate increase, with "the vast majority" of participants noting an increased risk that inflation would take longer to return to the 2% target. Fed funds futures now indicate a more than 50% probability that the Fed will raise interest rates by the end of this year. But while we acknowledge higher inflation concerns, we also expect growth risks to come into focus if oil prices stay elevated for a prolonged period. If this were the case, this could lead to interest rate cuts as central banks look to shore up the economy, benefiting quality bonds.

Starting yield has been a strong predictor of subsequent returns for quality bonds. The current elevated level of yields offers investors an attractive entry point to lock in portfolio income, as initial yield has historically been a good proxy for longer-term expected returns. Our analysis indicates that investors entering at these elevated yields can expect robust income-driven returns, even if market volatility persists, as coupon payments provide a reliable foundation for total return.

Quality bonds can help smooth portfolio volatility. Beyond return generation, quality bonds play a crucial role in dampening portfolio volatility as they have historically exhibited low correlation with equities. This provides a stabilizing effect during periods of market stress, reducing overall drawdowns and smoothing performance. This defensive characteristic is particularly valuable for investors seeking resilience in the current environment.

So, we continue to see an opportunity to add to short- and medium-duration quality bonds, as they offer an appealing combination of income and the potential to perform well in the event of slowing economic activity and rate cuts. Holding select exposure to higher-beta segments such as emerging markets, high yield, or select subordinated debt can also help build a diversified income strategy.

Original report – **Yield volatility creates an opportunity in quality bonds, 21st May 2026**

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