UBS

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Investment Research

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.

- The balance of risks of higher inflation is evolving rather than dissipating. While tariff-related pressures are now improving, energy/geopolitical developments and AI-related demand dynamics remain active sources of pressure on general prices.
- We expect the June meeting to include removal of the easing bias and a shift in the 2026 dot plot toward no cuts, with the start of the easing cycle now pushed back to March 2027.

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

- Waning 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, risks of lower growth could lead to rate cuts.

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

The US consumer price index (CPI) rose 4.2% y/y in May, up from 3.8% in April and marking the highest level in three years. According to data released on 10 June, core inflation, which excludes volatile items like energy and food, accelerated to 2.9%, from 2.8% in April. But core goods prices declined on a monthly basis for the first time since May 2025, suggesting a deceleration in price increases in tariff-sensitive categories.

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.
- 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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