

What does the Fed's dovish tilt mean for markets?

UBS House View Briefcase

Kurt Reiman, Head of Fixed Income, Americas, UBS Financial Services Inc. (UBS FS); **Christopher Swann**, Strategist, UBS Switzerland AG; **Daisy Tseng**, Strategist, UBS AG Singapore Branch

Key message

Federal Reserve Chair Jerome Powell paved the way to a resumption of rate cuts at the annual Jackson Hole summit. Changes to the composition of the FOMC also point to a more dovish tilt to policy. A cooling labor market gives room for the Fed to ease, despite lingering inflation concerns. We expect a further 100bps of rate cuts starting in September and, with policy rates set to fall, advise investors to put cash to work.

House view

01 Policymaker comments and FOMC composition point toward a resumption of rate cuts.

- Fed Chair Powell has signaled that a rate cut may be warranted as policy remains restrictive.
- With the upcoming rotation of regional Fed presidents, the existing governor lineup, and Governor Kugler's departure in August, the FOMC is set to move toward a more dovish, rate-reducing bias.
- The latest Fed meeting minutes suggest officials expect the jobless rate to rise above their estimate of the natural rate by year-end and stay elevated through 2027.

02 A softening labor market and economy give the Fed scope to resume easing.

- August nonfarm payrolls showed the labor market cooling, and we believe downside risks to employment are likely to outweigh lingering inflation concerns in the Fed's decision-making.
- Economic growth risks are becoming an increasingly important consideration for the Fed. US GDP growth remains subdued, with the economy expanding just 1.2% in the first half of the year and activity likely to remain soft.
- Given the Fed's dual mandate, we expect rates to come down by 100 basis points by January 2026, especially following the weak jobs data for August.

03 With policy rates set to fall, investors should put cash to work now.

- To achieve alternative sources of portfolio income to cash, we see quality bonds such as high grade and investment grade as appealing.
- We believe investors should focus on medium-duration bonds, as longer-duration bonds may face risks from fiscal policy, concerns around the Fed's independence, and upcoming inflation prints.
- We also expect further upside for US equities over the next 6-12 months based on Fed easing and strong capex momentum.

New this week

Futures markets priced in more extensive Fed rate cuts after nonfarm payrolls data for August showed the US economy added just 22,000 jobs in August, below expectations for a 75,000 addition. Revisions added 6,000 new jobs for a total of 79,000 in July, but led to a final 13,000 decline in jobs in June, the first month of falls since December 2020.

One liner

We expect the Fed to resume its rate-cutting cycle in September and deliver 100bps of further cuts by January 2026.

Did you know?

- Soft landing rate cuts have historically been positive for stocks, and the Fed's shift from restrictive to more neutral policy should help extend the bull market.
- 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, with cumulative returns more than 200 times higher than cash over the long term.
- The probability of bonds outperforming cash rises with time—65% over 12 months, 82% over 5 years, 85% over 10 years, and 90% over 20 years.

Investment view

High grade and investment grade bonds offer an attractive risk-reward proposition, in our view. With rate cuts likely to resume, we believe quality fixed income offers a way to lock in attractive yields. Investors underallocated to equities should consider phasing in and using market dips to add exposure to preferred areas, including AI, power and resources, and longevity.

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