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How will Fed rate hikes impact markets?

UBS House View Briefcase

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Key message

Strong US economic data and higher energy costs pushed Treasury yields higher and raised concerns about an extended tightening cycle from the Federal Reserve. We expect rate hikes in December 2026 and March 2027, and believe resilient economic growth and robust corporate earnings should help US equities withstand moderate policy tightening. Higher starting yields are also creating opportunities to add portfolio income.

01 Strong US GDP growth and renewed inflation concerns pushed Treasury yields higher.

- High energy prices and strong US economic data have added to inflation concerns. September consumer price inflation was higher than consensus forecasts. The core rate, which excludes food and energy, rose to 2.6% on an annual basis.
- The 10-year US Treasury yield rose to 5.36% in early October, its highest intraday level since 2002, though it has since moderated to around 4.95%.
- The FOMC kept the federal funds target rate unchanged in October after raising it by 25 basis points in September.

02 But we believe US equity markets can withstand a measured tightening cycle.

- We expect 25-basis-point rate hikes from the Fed in December and March. Recent Fed communication suggests a patient approach.
- Robust activity data this year have increased confidence that the US economy can absorb a longer period of elevated rates.
- US GDP growth was close to 2.5% annualized in the first half of the year and tracked near 3% in the third quarter.

03 So, resilient earnings and higher starting yields continue to offer investment opportunities.

- We forecast S&P 500 earnings growth of 25% in 2026 and 14% in 2027, which should help equities absorb moderately higher yields while US economic growth remains firm.
- We recommend positioning for further equity gains while diversifying across regions, sectors, and return drivers and managing concentrated single-stock exposure.
- We rate fixed income as Attractive and see opportunities to add portfolio income through medium- to long-duration high-quality bonds and medium-maturity credit from stronger investment grade issuers.

New this week

The FOMC kept rates unchanged at its October meeting and upgraded its assessment of US economic activity to "strong." Chair Warsh noted that financial conditions had tightened and inflation expectations were moving in the right direction.

One liner

We do not expect measured Fed tightening to derail the equity rally and think higher yields create opportunities to strengthen portfolio income and diversification.

Did you know?

- The US industrial cycle is improving. The new orders component of the ISM Manufacturing Index has been in expansion territory for nine consecutive months.
- Past US economic downturns generally did not begin until at least two years after the Fed started raising rates, although the timing varied with the scale of the tightening cycle.

Investment view

We expect the Fed to raise rates by 25 basis points in December 2026 and March 2027, and do not believe a measured tightening cycle will derail the US economy or equity rally. Investors should maintain diversified equity exposure and use the rise in yields to add selectively to quality bonds, while remaining cautious on the longest maturities and lower-quality credit.

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