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How will Fed rate hikes impact markets?

UBS House View Briefcase

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Key message

The Federal Reserve is likely to raise interest rates in the coming months as it seeks to bring down inflation. We expect rate hikes in December 2026 and March 2027, although the risk of consecutive hikes has grown. However, we believe resilient economic growth and robust corporate earnings should help US equities withstand moderate policy tightening. Elevated starting yields also create opportunities to add portfolio income via exposure to high-quality bonds.

01 The Fed is likely to raise interest rates as it seeks to curb inflation.

- US inflation came in stronger than expected in October, reinforcing the case for Federal Reserve tightening.
- Headline consumer prices rose 0.4% month over month, while core prices increased 0.3%.
- 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 continue to expect 25-basis-point Fed rate increases in December and March, although the risk of consecutive moves has grown.
- 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 3.4% 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 short- to medium-duration high-quality bonds.

New this week

Several Fed officials struck a more hawkish tone over the past week. Dallas Fed President Lorie Logan suggested the pace of tightening might need to accelerate, while Governor Christopher Waller raised the possibility of a 50-basis-point rate increase in December.

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 ISM Manufacturing Purchasing Managers' Index has been in expansion territory for ten 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.
- 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 5.13%.

Investment view

We expect the Fed to raise rates by 25 basis points in December 2026 and March 2027, though the risk of consecutive hikes has increased. Nevertheless, we do not believe a measured tightening cycle will derail the US economy or the 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.

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