

Daily: What matters from today's Fed decision?

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Thought of the day

The US Federal Open Market Committee votes on interest rates Wednesday and is widely expected to raise the federal funds rate by 25 basis points to 3.75-4.00%. The decision represents a major policy test for Federal Reserve Chair Kevin Warsh, including his ability to build consensus and manage market expectations around the degree of guidance provided on the interest rate path ahead.

The meeting comes at a complicated moment. Renewed strength in crude oil prices amid supply concerns linked to the US-Iran conflict is adding to near-term price pressure and a shift in the Fed's attention toward the inflation side of its dual mandate. On the other side of the equation, resilient economic activity, robust earnings, and continued AI-related investment suggest the economy can withstand efforts to address above-target inflation. Meanwhile, long-dated Treasury yields have climbed to multi-decade highs, in spite of the US Treasury's surprise expansion of buybacks to support market liquidity.

But with markets pricing an aggressive rate path ahead, the bar looks high for the Fed to deliver a further hawkish surprise:

Much of the tightening is already priced. With a quarter-point increase widely expected, investor attention will instead likely center on the voting split and updated economic projections. Policymakers may also provide greater clarity on their assessment of the longer-run neutral rate. A divided vote could suggest that support for further tightening is less robust than the headline decision implies. With money markets already pricing nearly four additional rate increases in this cycle, versus our forecast for two, we would not expect a material further increase in Treasury yields or the US dollar unless policymakers signal a substantially longer rate-hiking period.

Economic strength makes tightening more manageable. Rate increases driven by resilient activity are generally easier for risk assets to absorb than tightening accompanied by a sharp deterioration in growth. Consumer spending, business investment, and employment growth should give the economy room to withstand a measured rise in rates. Continued AI investment provides additional support, and we think recent talk of pacing advanced-model development should not curb capital spending. We forecast AI industry capital spending to increase by around one-third, from USD 900bn in 2026 to USD 1.2tr in 2027.

Strong earnings can counter higher yields. Higher bond yields can weigh on equity valuations by increasing the discount rate applied to future profits. But our analysis of the relationship between 10-year Treasury yields and the S&P 500 forward price-to-earnings ratio suggests that much of this pressure is already reflected in valuations. Earnings growth, continued investment, and orderly credit markets can provide a further offset. We forecast S&P 500 earnings per share of USD 350 in 2026 and USD 400 in 2027, representing growth of 25% and 14%, respectively. A more difficult environment would require not just higher yields, but also weaker earnings expectations and wider credit spreads.

So, as the Fed begins what we expect to be a relatively shallow tightening cycle, we believe investors should remain positioned for further equity gains while preparing for near-term volatility. If tightening remains measured, credit spreads stay stable, and profits continue to grow, the rally should have scope to broaden across sectors and regions. We anticipate the S&P 500 will trade around 8,100 by December 2026 and 8,400 by June 2027. We continue to recommend diversified equity exposure while avoiding excessive concentration in areas more sensitive to interest rates or where returns rely on a single driver.

We view fixed income as Attractive, and we see select opportunities across regions and market segments. The recent sharp rise in yields has created tactical opportunities to add some duration in high-quality bonds. We believe medium- to long-duration, high-quality bonds have scope for price gains and can provide valuable diversification in an economic downturn. In credit, stronger investment grade issuers offer attractive carry across medium tenors, while exposure to higher-risk credit should remain relatively short dated. We remain more cautious on the longest-dated bonds, given fiscal sustainability concerns and the growing extent of AI-related debt issuance. Investors should calibrate both credit risk and duration to their objectives and investment horizons—for example, more income-focused investors may prefer shorter maturities to reduce duration risk.

Broader commodities can add strategic diversification and exposure to structural growth drivers, while an actively managed approach could help limit the impact of outsized volatility in any single commodity.

Source: <https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-16092026.html>