

Daily: How to position in fixed income as Fed hikes rates

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Thought of the day

Short-dated US Treasuries sold off on Wednesday after the Federal Reserve delivered a hawkish 25-basis-point interest rate hike, lifting the fed funds target range to 3.75-4%. The 2-year yield rose 6 basis points to 4.72%, while the 10-year yield edged up 1 basis point to 5%. The 30-year Treasury yield, meanwhile, fell 2 basis points to 5.34%.

Fed Chair Kevin Warsh described the move as removing “a dose of accommodation,” adding that broad financial conditions could not be characterized as restrictive. The latest Summary of Economic Projections showed that policymakers now expect stickier inflation and stronger growth than they did previously. The “dot plot” put the median policy rate projection at 4.1% for 2026, suggesting another hike this year, while eight participants projected a third hike in 2027.

The hawkish tone from Warsh, together with broad support among policymakers for two or more rate increases, prompted investors to price in three further hikes by mid-2027.

We maintain our expectation for another hike in December, and view current market pricing as excessive, although we acknowledge that risks are skewed to the upside. The median policy rate projection suggests a hold throughout 2027, and we expect steady disinflation over the next six months. Favorable base effects in the first half of next year should also weaken the case for a long sequence of hikes.

Against this backdrop, we discuss how investors should position in fixed income.

Bonds continue to play an important role in portfolios. We maintain an Attractive view on fixed income. Higher starting yields reinforce bonds' role as a key source of portfolio income, while high-quality bonds can provide valuable diversification if economic growth slows. We see select opportunities across regions and market segments, and believe investors should calibrate both credit risk and duration to their objectives and investment horizons.

Consider adding duration selectively in high-quality bonds. More income-focused investors may prefer shorter-maturity bonds to reduce duration risk, but the recent sharp rise in yields has created tactical opportunities in medium- to long-duration high-quality bonds. Alongside attractive income, these securities have scope for price gains if tighter monetary policy slows growth or reduces longer-term inflation expectations, leading yields to decline. In credit, we believe stronger investment grade issuers offer attractive carry across medium tenors. For higher-risk credit (such as high yield and emerging market bonds), we prefer short-dated exposure.

Avoid the longest maturities. We remain cautious on the longest-dated bonds despite compelling valuations over a lack of catalysts for a sharp drop in long-end yields. Fiscal sustainability concerns, growing AI-related debt issuance, and a shift toward more price-sensitive buyers could keep term premiums elevated, in our view.

So, we think a measured approach that balances income, diversification, and sensitivity to interest rates can help investors strengthen their portfolios as they navigate further tightening ahead. For those in lower-rate jurisdictions (such as Switzerland), retaining diversified income strategies remains important.

Source: <https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-17092026.html>