

Daily: Why higher rates can favor hedge funds

UBS CIO · 2026-09-29 · English original

Thought of the day

Global government bond yields continue to rise as the stalemate in the Middle East pushes Brent crude oil prices higher to around USD 107/bbl. The messages from global central banks in recent weeks have also been clear: Interest rates are likely to stay elevated in the near term as inflation remains sticky while growth is resilient.

Historically, such a global policy environment has been favorable for hedge funds. They generated positive cumulative returns during every Federal Reserve tightening cycle since 1994 and generally outperformed global bonds. In the most recent cycle, global bonds fell by around 12%, while hedge funds ended the period with positive returns.

We continue to rate fixed income as Attractive in the current environment. Higher rates do not guarantee strong hedge fund performance. But when the cost of capital increases, company fundamentals, policy differences, and relative valuations tend to matter more. We expect these conditions to sustain opportunities for alpha generation into 2027.

Higher financing costs are rewarding stock selection. When interest rates were close to zero, easy financing reduced the distinction between stronger and weaker companies. Now, leverage, refinancing needs, balance-sheet quality, and the ability to fund growth internally have become more important. The average S&P 500 constituent is carrying implied volatility of around 2.5 times index volatility, compared with a more typical 1.8 times. Meanwhile, the average pairwise stock correlation is around 0.08, versus a median of 0.23 since 2002. This combination means individual stocks are moving more on their own fundamentals and less as one market, supporting our positive view on equity market neutral strategies.

Central bank divergence is expanding the macro opportunity set. The case for discretionary macro managers does not depend on a single directional view on interest rates. Instead, elevated rates and less predictable policy are creating a wider range of potential outcomes for growth, inflation, currencies, commodities, and yield curves. As central banks respond differently to domestic conditions, relationships among markets can become less synchronized. Discretionary managers can express views across countries and asset classes, then adjust exposures as the balance among inflation, growth, and policy changes. We therefore also see opportunities in discretionary macro funds.

Uneven repricing is creating relative value opportunities. Interest rate changes rarely affect every maturity or security in the same way. Over the past year, the 2-year US Treasury yield has risen by around 130 basis points, compared with increases of 110 basis points for the 10-year yield and 85 basis points for the 30-year yield. These differing moves changed the shape of the yield curve and the pricing relationships among related instruments. This can create opportunities for fixed income relative value managers that seek to profit from discrepancies rather than relying primarily on a broad directional call on yields. We think the strategy offers attractive opportunities, while recognizing that historically high leverage makes manager and vehicle selection particularly important.

So, we believe higher rates strengthen the case for diversified exposure to select hedge fund strategies.

Equity market neutral, discretionary macro, and fixed income relative value managers are positioned to draw on different sources of return as the market environment becomes more selective. Multi-strategy funds can also dynamically reallocate capital among these opportunities as conditions change. Investors should nevertheless account for risks like the potential use of leverage, limited transparency, volatility, higher fees, illiquidity, and longer lockup periods, and align allocations with their objectives, investment horizon, and liquidity needs.

Source: <https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-29092026.html>