

Daily: Higher inflation need not derail US assets

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Thought of the day

US equities fell on Wednesday after September inflation came in higher than expected, increasing expectations for further Federal Reserve rate hikes. Headline inflation accelerated to 0.6% month over month from 0.4% in August, driven largely by a 9.1% rise in gasoline prices. More importantly, core inflation rose 0.3%, above the 0.2% increase consensus forecast for a second consecutive month, while the annual rate rose to 2.6% from 2.4%.

Price pressures also extended beyond energy, with increases in shelter, airfares, vehicles, apparel, and technology-related goods. Markets raised the probability of an October hike to around 40% from about 20% before the release.

The breadth of the increase makes the latest inflation strength hard for the Fed to dismiss. We now expect the Fed to raise rates in December and March, following its September move. We have also raised our end-December forecast for the 10-year Treasury yield to 4.9%, from 4.6% previously.

But this remains below Wednesday's closing level of 5.19%, and we do not expect the revised rate and yield outlook to undermine the positive outlook for US assets.

The economic strength driving the Fed to raise rates is also supportive for equities. US GDP growth was close to 2.5% annualized in the first half of the year and likely near 3% in the third quarter, underpinned by a healthy labor market. While September payroll growth slowed to 29,000, the three-month average of 51,000 remained broadly in line with estimates of the pace needed to keep unemployment stable. Initial unemployment claims also recently reached a 10-week low, with no broad increase in layoffs, while the ISM manufacturing index remained firmly in expansion at 54.5 in September. This combination gives policymakers greater scope to focus on inflation without creating a high near-term risk of recession. For investors, the same resilience should support household income, consumer spending, and company profits, helping equities absorb moderately higher rates.

Markets are pricing a more aggressive rate path than we expect. Investors are pricing roughly 3.5 further hikes, in addition to the one in September, while we expect just two more increases. Recent Fed communication also supports a more measured path: New York Fed President John Williams has said there is “no need for urgency,” although back-to-back higher-than-expected core inflation readings make October a closer call. We expect hikes in December and March, and then for rates to remain on hold until late 2027. The gap between market pricing and our forecast leaves scope for Treasury yields to decline if the Fed waits in October and subsequent data indicate that inflation pressures are stabilizing.

Another strong earnings season should help equities withstand moderately higher rates. We forecast S&P 500 earnings per share growth of 28% for the September quarter, supported by AI demand, improvement in cyclical industries, and resilient consumer spending. We expect AI-related capex to rise 84% this year to USD 900bn, while semiconductor profits are expected to account for about half of the

S&P 500 earnings growth in the third quarter. The earnings contribution should also extend beyond technology: The new-orders component of the ISM manufacturing index has remained in expansion for nine consecutive months, supporting the outlook for industrial profits. Notably, equities have historically performed well after the start of Fed tightening cycles. Across the 16 Fed hiking cycles since 1954, the S&P 500 gained an average of 10.8% in the year following the first increase, although past performance is no guarantee of future returns.

So, we remain positioned for further equity gains while emphasizing broad diversification across sectors and regions. Strong economic growth and earnings should help equities withstand moderately higher rates. We also continue to see value in fixed income: Higher starting yields provide attractive portfolio income, while our expectation for the 10-year Treasury yield to decline to 4.9% by the end of December leaves scope for capital gains. We continue to favor a combination of cyclical and secular equity exposure alongside quality fixed income.

Source: <https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-15102026.html>