

Daily: Quality bonds for income and diversification

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Thought of the day

US bond and equity markets have remained volatile over the past 24 hours as investors weigh mixed signals on the outlook for AI alongside further evidence of persistent US inflation. Chipmaker TSMC offered a more cautious outlook, while the producer price index in the US rose 1.3% in September, its largest monthly increase in four and a half years and well above the 0.5% consensus forecast. Although energy accounted for much of the rise, prices also increased across a broader range of goods and services, adding to concerns that inflation pressures remain in the pipeline. The data followed a higher-than-expected consumer price index print in the US earlier in the week.

But US Treasury yields declined, with the 10-year yield trading at around 5.09% and close to its lowest level in three weeks. Equity market volatility increased risk aversion and supported demand for high-quality bonds. While further yield volatility cannot be ruled out amid elevated inflation, heavy debt supply, and persistent fiscal concerns, we continue to rate fixed income as Attractive.

Current market pricing of Federal Reserve tightening remains too hawkish. We now expect the Fed to raise interest rates by another 50 basis points over the next 12 months, but this remains more dovish than the current market pricing of nearly 90 basis points more. Recent comments from several Fed officials support a more gradual tightening, with Vice Chair Philip Jefferson stating there is no immediate urgency to hike again, and New York Fed President John Williams saying he sees no need for further rate increases in 2027. San Francisco Fed President Mary Daly has also signaled little urgency in adjusting policy rates. This suggests to us that Treasury yields should decline from their current levels as markets scale back their expectations, leaving scope for capital gains in bonds.

Elevated starting yields offer an attractive income cushion. Elevated starting yields provide a stronger income base and have historically been a good indication of subsequent total returns. This income can also cushion portfolios against further increases in yields. Our analysis indicates that 2-, 5-, and 10-year US Treasury yields would need to rise by around 257, 113, and 65 basis points, respectively, for capital losses to offset the income earned. We therefore believe investors can benefit from attractive portfolio income even if yields remain volatile.

Quality bonds offer diversification and stability in a portfolio. The latest Treasury rally underscores how high-quality bonds can help stabilize portfolios by providing diversification when risk assets come under pressure. Our analysis of US stock and bond portfolios found that a conventional 60/40 portfolio had a maximum recovery period of 4.2 years from bear market drawdowns since 1945, compared with 6.2 years for an all-equity portfolio. Medium- to long-duration quality bonds may also appreciate if tighter monetary policy slows growth or reduces longer-term inflation expectations, helping to offset weakness elsewhere in a portfolio. This combination of income, potential price appreciation, and diversification can help smooth overall portfolio returns across different market environments.

So, fixed income should remain a key component in a well-diversified portfolio, and we see opportunities

across regions and market segments. Investors should calibrate both credit risk and duration to their objective and investment horizons. More income-focused investors may turn to short-maturity bonds to reduce duration risk, while those who are willing to tolerate volatility may consider select tactical opportunities in medium- to long-duration high-quality bonds. We remain cautious on the longest maturities given fiscal concerns and rising AI-related issuance.

Source: <https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-16102026.html>