CIO's base case remains that the Federal Reserve will start easing policy, most likely starting at its September policy meeting, creating a favorable backdrop for quality bonds. (UBS)

The backdrop remains favorable for quality bonds

09 May 2024, 1:55 pm CEST, written by UBS Editorial Team

Further volatility looks likely in the near term as markets respond to central bank policy meetings and economic data. Central banks in Europe have been moving ahead of the Federal Reserve in cutting rates, with the easing cycle kicked off by the Swiss and Swedish central banks.

But, our base case remains that the Federal Reserve will also start easing policy, most likely starting at its September policy meeting, creating a favorable backdrop for quality bonds.

We expect a renewed fall in US inflation in the coming months. Many investors are expecting April's Consumer Price Index (CPI) to show that the trend toward slowing inflation—which was interrupted in the first quarter of the year—is resuming. Our view is that inflation will start heading back to the Fed's 2% target in the coming months. We see this being driven by several forces. Data points to a moderation of housing costs, which feeds through into the official figures only with a lag. We also expect consumer spending growth to moderate as wage growth slows and households increase their savings rates from the current historically low levels. We are also seeing other signs of activity cooling, including a weaker ISM survey of the services sector, which pointed to the first contraction since December 2022, ending a period of 15 consecutive months of growth.

The disinflation trend remains intact in most other advanced economies. Sweden’s central bank on Wednesday cut its benchmark interest rate for the first time since 2016 amid subsiding inflation, with Governor Erik Thedeen saying two more cuts could be expected during the second half of the year. The move made the Riksbank the second central bank from a major developed-market nation to cut rates in this cycle, after the Swiss National Bank eased policy in March. The European Central Bank remains on track to cut 75–100 basis points this year starting in June, in our view.

A data-dependent Fed is not a hawkish Fed. Boston Fed President Susan Collins on Wednesday became the latest top official to argue that rates would need to stay higher for longer "until we have greater confidence that inflation is moving sustainably toward 2%." However, comments from officials have also underlined that rate cuts have likely been delayed, rather than canceled. Fed Chair Jerome Powell has said the current policy is sufficiently restrictive, and noted that interest-rate-sensitive sectors of the economy were slowing amid more balanced demand for workers. We continue to believe that more favorable data over the coming months will allow the Fed to start easing later this year.

So, we keep a preference for quality bonds, and recommend investors use currently attractive yields to gain exposure. We also see value in a more active and diversified approach to fixed income investing.

Main contributors - Solita Marcelli, Mark Haefele, Daisy Tseng, Jon Gordon, Jennifer Stahmer

Original report - **The backdrop remains favorable for quality bonds, 9 May 2024.**