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With lower rates diminishing cash returns, investors should consider high-quality bonds and diversified fixed income strategies for more durable sources of income. (UBS)

Consider diversified fixed income strategies for more durable sources of income

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US Treasuries fell this week ahead of the last key economic data releases before the Federal Reserve's policy decision on 18 December. The yield on the 10-year Treasury rose 7 basis points to 4.22%, as investors await November's consumer price index due today and the producer price index due Thursday.

The annual consumer inflation rate is likely to rise for a second consecutive month to 2.7% from 2.6% in October, according to consensus estimates, partly due to low base effects from the previous year. The month-over-month increase is expected to read 0.3%. Core inflation, however, is forecast to stay largely unchanged at 3.3% year over year and 0.3% month over month.

With fed funds futures now indicating an 86% chance of an interest-rate cut later this month, any sign of sticky price pressures could unsettle markets. However, we maintain the view that investors should lock in currently attractive yields on quality bonds as the Fed easing continues.

Overall US economic conditions should allow the Fed to keep cutting rates. Shelter cost is likely the main thing to watch today, as it is the biggest driver of inflation and has taken longer to slow than markets expected. But we think it should moderate further and help constrain overall inflation over the next 12-18 months. In addition, we do not expect potential tariffs to lead to sustained higher inflation over the medium term. With recent jobs data pointing to a softening

labor market, and rates still in restrictive territory, we believe the US central bank remains on a path to bring monetary policy back to neutral.

Bond yields should fall from currently elevated levels, providing investors with attractive expected returns and the potential for capital gains. The initial yield has historically been a good proxy for longer-term expected returns and return potential. With the current 10-year US Treasury yield at the higher end of its distribution since 2008, we view this as a favorable chance to lock in rates that could offer attractive portfolio returns. While the level of a neutral monetary policy stance is difficult to determine, we expect the 10-year US yield to fall to 4% in the year ahead, supporting capital appreciation for high-quality bond investors.

Bonds outperform cash over the long term and offer diversification benefits. Historically, the probability of bonds outperforming cash rises with longer holding periods—from 65% over 12 months to 82%, 85%, and 90% over five, 10, and 20 years, respectively. This asset class is also appealing from a portfolio risk management perspective, as bonds have typically dampened portfolio volatility, and bond returns could be substantially higher if economic growth slows more quickly and yields decline more rapidly.

So, with lower rates diminishing cash returns, investors should consider high-quality bonds and diversified fixed income strategies for more durable sources of income.

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