With rate cuts delayed, rather than canceled, CIO still expects the yield on the 10-year US Treasury to end the year around 3.85%, down from around 4.66% at present. (UBS)

Yields on quality bonds look attractive, still room for capital gains

17 April 2024, 3:29 pm CEST, written by UBS Editorial Team

US Federal Reserve Chair Jerome Powell warned on Tuesday that interest rates may need to stay higher for longer, following a series of stronger-than-expected inflation reports.

Chair Powell backed away from providing guidance on when interest rates may be cut, saying that “it’s likely to take longer than expected” to achieve the confidence required for policymakers. “Right now, given the strength of the labor market and progress on inflation so far, it’s appropriate to allow restrictive policy further time to work and let the data and the evolving outlook guide us,” he said.

His comments caused investors to further dial back the likely pace of rate cuts, with markets now implying just 40 basis points of easing during 2024. That is down from a peak of around 150 basis points in January.

While we have recently lowered our expectations on the timing and magnitude of Fed rate cuts, we believe the US central bank remains on track to cut rates twice this year, most likely starting at its September meeting. This means the return outlook for quality bonds remains positive and attractive, and that recent losses in fixed income are likely to be temporary.

The Fed remains biased toward policy easing. As Powell suggested, the US central bank believes the current rates are in restrictive territory, and they continue to transmit into the economy and put downward pressure on demand, despite taking longer than expected. If the Fed should raise rates from here, which is not our base case, that would compromise its objective of achieving full employment and stable inflation. Up until this point, the Fed has managed to achieve a delicate balance in seeing inflation trending lower without generating a recession. A restart of rate hikes would put this in jeopardy and potentially stoke financial stress across the corporate and household sector, in our view. In addition, we believe the downward trend in inflation will resume as restrictive monetary policy helps cool consumer spending and the labor market.

Yields on quality bonds look attractive and there's still room for capital gains. With rate cuts delayed, rather than canceled, in our view, we still expect the yield on the 10-year US Treasury to end the year around 3.85%, down from around 4.66% at present. As a result, we continue to see the potential for capital gains. Once the Fed begins cutting rates this year, the bond market will likely continue to price a sequence of further cuts into 2025 and beyond. Currently, the market's longer-term policy rate expectations suggest the Fed will end the rate-cutting cycle at an equilibrium level of just under 4%, which equates to around 150 basis points of easing overall.

So, we believe investing in quality bonds remains a viable option, and retain a most preferred rating on the asset class in our global portfolios. We like those with 1–10-year duration, as well as sustainable bonds. We also think investors should consider an active exposure to fixed income to improve diversification.

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Original report - **Powell adds to rate-cut caution, 17 April 2024.**