

The Fed cuts rates: What to do next?

UBS House View - CIO Alert

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What happened?

The Federal Reserve has cut US interest rates by 25 basis points, and policymakers' projections point to the prospect of further reductions at the next two meetings.

Compared with the last FOMC meeting in July, when the Fed stated that "labor market conditions remain solid," the committee now "judges that downside risks to employment have risen." So, even though inflation has "moved up and remains somewhat elevated," the fed funds effective range was lowered to 4.00-4.25%. The reduction was the first of the year, after the central bank cut rates by 100bps in 2024. There was one dissent from Stephen Miran, the new appointee, who favored a larger 50bps cut.

Policymakers' median projection for the fed funds rate at the end of the year (the dot plot) now indicates two additional cuts are expected this year.

Because the rate cut was widely expected, the immediate market reaction was muted. The S&P 500 dipped briefly during the post-FOMC conference when Chair Jerome Powell noted that a "good number" of officials see no more rate cuts this year but recovered to close roughly flat on the day. US 10-year Treasury yields finished 6bps higher at 4.08%. Gold traded modestly lower, down 0.8% at USD 3,665/oz, while the dollar index rose 0.4%.

What do we expect?

In our base case, we estimate that the Fed will cut interest rates by a further 75bps between now and 1Q26, as we believe the central bank will continue to prioritize labor market weakness over what is still likely to be a temporary increase in inflation.

At the press conference Chair Powell said that "labor demand has softened and the recent pace of job creation appears to be running below the break-even rate needed to hold the unemployment rate constant." Indeed, nonfarm payrolls growth has averaged just 27k per month since May, and the Bureau of Labor Statistics announced an estimated -911k revision to total nonfarm payrolls. Meanwhile, continuing jobless claims have reached their highest level since late 2021.

The Fed will aim to balance labor market concerns with inflation trends. Core inflation remained above the Fed's target in August at 3.1% y/y and leading indicators of inflation like the ISM services prices paid index are elevated. The Fed will also be mindful that some tariff-related price increases could prove sticky even if the Supreme Court rules that some

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tariffs should be reversed.

However, the price passthrough from tariffs has proven slower than expected in the Fed's opinion, and Chair Powell reiterated he is expecting an only one-off price increase from tariffs. FOMC economic projections show inflation near the target in 2027, and Chair Powell noted that both market and survey measures of longer-run inflation expectations are "rock solid" in showing inflation at levels consistent with the Fed's 2% target.

How do we invest?

While a 25bps rate cut may not have a major impact on the outlook on its own, it does serve as a reminder to investors that interest rates can move lower. In a downside scenario, if labor market weakness proves to be more severe or durable, we believe the Fed could cut rates by 200-300bps, which could bring rates as low as 1.0-1.5%.

In this context, we believe now is an opportune time for investors to review cash allocations. The imperative to put cash to work is increasing.

1) Develop a cash management strategy

We recommend that investors limit liquidity holdings to those needed for near-term expected portfolio withdrawals, and manage their liquidity strategy to optimize returns:

- *Everyday cash*, for spending needs up to one year, should be readily available and take little to no interest rate, credit, or market risk. Deposit programs, money market funds, or certificates of deposit offer relative stability in exchange for modest yields.
- *Core liquidity*, covering known expenses or emergencies over a one- to three-year horizon, should balance flexibility and yield. A bond ladder—a portfolio of individual bonds or fixed maturity bond funds with staggered maturities—can provide predictable cash flows and manage interest rate risk. Structured strategies with capital preservation features may also be considered here, aiming to capture market gains while curtailing losses so the original capital is returned at maturity.
- *Investment cash*, earmarked for needs up to five years out, with a focus on optimizing returns while accepting some price fluctuation and lower liquidity. We believe that medium-term government or investment grade bonds, as well as diversified multi-sector bond investment approaches can play a key role in this part of the portfolio. Historically, global high-quality bonds (Bloomberg Global Aggregate) outperformed US dollar cash (one- to three-month T-bills) in the 12- to 24-month period after the peak in rates by between 2.7% and 4.1%.

From a currency perspective we expect the US dollar to resume its downward trend in the months ahead. With the Fed likely to cut interest rates more quickly than in other regions, a high outstanding volume of unhedged overseas investment in the US, and a still-significant twin current and fiscal deficit, we believe the path of least resistance for the US dollar is lower. Tactically, we prefer the euro, Australian dollar, and Norwegian krone. Investors should review their currency allocations to ensure they match future liabilities and spending needs.

2) Phase excess liquidity into diversified portfolios

Over the long term, history shows it is likely that financial assets will outperform cash. Since 1945, cash has underperformed a strategy of

phasing into diversified portfolio of stocks and bonds on around 74% of one-year horizons, and around 83% of five-year horizons. With interest rates moving lower, we believe it is time for investors to deploy excess cash holdings, and beyond balanced portfolios, we currently see a number of specific opportunities to put excess liquidity to work in financial markets:

- *Buy on dips in equities.* We believe lower interest rates, robust earnings growth, and AI tailwinds will support further upside for global equities over the next year. Investors under-allocated to equities and looking to manage timing risks should consider phasing in and using market dips to add exposure to preferred areas.
- We would expect investors focused on our AI, power and resources, and longevity *transformational innovation opportunities* to outperform broader markets over the longer-term. From a tactical perspective, we also favor US tech, health care, utilities, and financials. In Europe, we like Swiss high-quality dividends, European quality stocks, European industrials, and our “Six ways to invest in Europe” theme. In Asia, we prefer China’s tech sector, Singapore, and India. We also see opportunities in Brazil.
- *Go for gold.* Even after a strong year-to-date rally, gold remains an effective portfolio diversifier and hedge against political and economic risks, in our view. We expect gold to benefit from a weaker dollar, robust central bank demand, lower real interest rates, and investor concerns about rising government debt levels, the potential for financial repression, and ongoing geopolitical risks.
- *Diversify with alternatives* Adding an allocation to alternatives may help improve diversification, growth potential, and downside protection. Investors should be aware of the various risks and drawbacks when investing in alternatives, including illiquidity, limited transparency, and the use of leverage.

3) Consider “income replacement”

Investors who have relied on regular income from cash and are seeking income replacement in light of lower cash interest rates may consider equity income strategies or yield-generating structured strategies. Such approaches can deliver comparable or even higher returns than some cash and fixed income strategies, albeit with higher associated risk.

- *Equity income strategies* In the US, while dividend yields are generally relatively low, for dividend-seekers within US equities we do see select opportunities in stocks with attractive dividend yields. For details, see our “Yield & Income” publication. In Asia, attractive yields in ASEAN markets stand out for investors focused on income and portfolio resilience, with ASEAN markets offering an average dividend yield of 4.6% this year. We also see Swiss dividend-paying equities are attractive, with an average dividend yield around 3.0%. Robust balance sheets and profitability suggest that market-wide distributions are sustainable.
- *Yield-generating structured strategies*, including reverse convertibles, may grow in appeal as interest rates fall. By monetizing market volatility, they can deliver a return stream which can be less correlated with traditional investments. Steady coupon payments provide predictability, while features like barriers and autocalls can tailor risk and reward. Structured strategies carry specific risks, including market, credit,

liquidity, and complexity risks, and understanding these features is essential before considering an allocation.

- *Financial planning considerations* Investors can also find ways to improve portfolio income and reduce reliance on holding excess cash by considering options within the context of a broader financial plan. For example, annuities can secure a reliable stream of income that can last for the rest of an investor's life. Meanwhile, opening up borrowing capacity could reduce the need to for investors hold excess cash for unlikely events.

Global asset class preferences definitions

The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid, commonly known stock indexes, House View scenarios, and analyst convictions over the next 12 months. Note that the tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.

Most attractive – We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.

Attractive – We consider this asset class to be attractive. Consider opportunities in this asset class.

Neutral – We do not expect outsized returns or losses. Hold longer-term exposure.

Unattractive – We consider this asset class to be unattractive. Consider alternative opportunities.

Least attractive – We consider this asset class to be among the least attractive. Seek more favorable alternative opportunities.

Note: For equities, we have collapsed “Most Attractive” with “Attractive” and “Least Attractive” with “Unattractive” from the five-tier rating system that is found in the Equity Compass into three tiers.

Appendix

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