

Positioning Bond Portfolios for Fed Rate Cuts

Executive Summary

After a 9-month pause, the Federal Reserve is expected to start lowering interest rates again as its focus shifts from fighting inflation to supporting a slowing labor market. This report looks at how to position bond portfolios ahead of expected rate cuts. Bonds serve two main roles: generating income and protecting against the risk of stock market sell-offs and economic slowdowns. As the Fed cuts and interest rates fall, yields on shorter-maturity bonds will fall first. Shifting into intermediate-term bonds can offer a balanced combination of steady income and potential price appreciation. Meanwhile, longer-maturity Treasury bonds, which are the most sensitive to interest rate changes, can provide diversification and hedge against the risk that the economy weakens and the Fed cuts more than anticipated.

Five Main Points

1. Market Expects Significant Rate Cuts Through the End of 2026

The market expects the Fed to lower interest rates by about 1.50% by the end of 2026. Three cuts are expected by the end of this year. Another three cuts are forecast in 2026, but the market expects the pace of rate cuts to slow, reflecting a more measured and cautious approach by the Fed. There is still a debate about how much the central bank will lower interest rates, which will ultimately depend on how the economy performs.

2. Intermediate Bonds Offer a Balanced Approach

Bonds with shorter maturities currently offer the highest income with the least interest rate risk, making them attractive on a risk-adjusted basis. However, as the Federal Reserve lowers interest rates, the yields on these bonds could fall quickly. Intermediate-term bonds help offset this challenge by locking in today's higher yields for a longer period. Although they carry slightly more interest rate risk and offer a bit less income upfront, intermediate bonds benefit more from interest rate cuts than bonds with shorter maturities.

3. Short and Intermediate Maturity Bonds Historically Outperform Once the Fed Starts to Cut

Historically, short- and intermediate-term Treasury bonds deliver the strongest returns in the 12 months after the first cut. This is because yields on shorter-maturity bonds fall the most as the Fed cuts, which boosts their prices. Long-term bonds benefit less directly from rate cuts, but they still serve a purpose. In severe economic slowdowns, when the Fed cuts more aggressively than expected, longer-maturity bonds can outperform due to their greater sensitivity to falling interest rates.

4. Economic Outlook Uncertain as the Fed Starts to Cut

This year, the U.S. economy has experienced significant volatility. Economic activity slowed in early Q2 as businesses and consumers responded to tariffs, but as the quarter progressed and trade policy uncertainty declined, activity rebounded. The main question is whether this recent improvement is a temporary bounce or early signs that the economy is reaccelerating. For bond investors, this uncertainty supports the case for holding some longer-maturity Treasury bonds, which historically hedge against slowing economic growth.

5. Long-Term Treasuries Offer More Reliable Protection in Downturns

Longer-maturity Treasury bonds tend to move in the opposite direction of stocks during recessions, making them useful for managing risk. In contrast, longer-maturity corporate bonds carry credit risk, which limits their effectiveness in times of stress. This is because credit spread expansion can weigh on corporate bond prices.

during economic slowdowns, offsetting the benefit of Fed rate cuts and falling interest rates. For investors looking to extend the duration of their portfolios, Treasury bonds provide a more reliable hedge by avoiding the added risk that comes with corporate debt.

Key Takeaways

With rate cuts on the horizon, it's a good time to re-evaluate bond portfolio positioning. A mix of short- and intermediate-term Treasury bonds can form the foundation of a portfolio, offering both income and the potential for price gains as interest rates fall. In addition, a smaller allocation to long-term Treasuries adds protection in case the economy slows more than expected. While corporate bonds still have a role, their sensitivity to credit risk may limit their effectiveness during periods of economic stress.

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