Payden&Rygel

Fed Hike Strengthens the Case for the Front End of the U.S. Yield Curve

LOS ANGELES, September 24, 2026 – The Federal Reserve's first interest-rate increase since 2023 confirmed that the inflation battle is not yet over. The decision, alongside updated economic projections, reinforced a picture of an economy that remains resilient even as inflation continues to run above the Fed's target, according to Payden & Rygel.

The Fed raised its target range by 25 basis points to 3.75-4.00% at its September meeting, citing resilient economic activity, strong productivity, and robust capital investment. The decision was unanimous.

The accompanying forecasts reinforced the message. Fed officials raised their median forecast for 2026 economic growth to 2.3%, lowered their unemployment forecast to 4.1% and increased their projection for headline PCE inflation to 3.7%. The median projection for the federal funds rate at year-end also increased to 4.1% from 3.8% in June.

For investors, however, the question is no longer simply whether the Fed will hike. It is how much additional tightening is already reflected in bond prices.

Markets are currently pricing just under two additional hikes by year-end and around three through June 2027. That is broadly consistent with our own expectations and, if anything, slightly more tightening than we anticipate.

That creates what we believe is an increasingly attractive risk-reward proposition at the front end of the U.S. yield curve, where two- to three-year Treasuries currently offer yields of approximately 4.75%, around 75 basis points above cash and three-month Treasury bills. That starting yield provides a meaningful cushion against further increases in rates, allowing yields to rise further without necessarily producing a negative total return. With considerable additional Fed tightening already reflected in market pricing, we believe that creates an attractive asymmetry, particularly if the economic outlook weakens.

In previous cycles, investors often relied upon long-duration government bonds as a natural hedge against a growth shock. We believe the starting point today is different.

The U.S. is running a fiscal deficit of roughly 6 per cent of GDP despite an economy that remains relatively strong, creating substantial ongoing Treasury financing needs. Against that backdrop, the long end of the yield curve may not provide the same degree of protection it has in previous cycles, when fiscal deficits and government borrowing needs were considerably smaller.

An already-elevated deficit could also constrain the scope for counter-cyclical fiscal policy in a downturn, while additional spending or tax cuts would add further to government financing needs. The front end, by contrast, may offer a cleaner hedge against weaker growth, whereby the Fed would likely become less hawkish and could eventually reverse course, with changes in the expected path of monetary policy reflected most directly in shorter-term yields.

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At the same time, competition for capital is increasing.

Government borrowing requirements are already elevated, while the private sector is entering a more capital-intensive phase. The artificial-intelligence investment cycle is an important part of that story.

Until recently, much of the investment in AI infrastructure was financed through the substantial cash flows and equity valuations of the largest technology companies. As investment requirements continue to expand, corporations are increasingly turning to debt markets.

The hyperscalers have already become meaningful issuers of longer-dated investment-grade bonds, and we expect financing to broaden further across corporate bonds, loans, and securitized credit.

This investment is supportive of economic growth, but for bond investors it also means the public and private sectors are increasingly competing for the same capital. Against an already-heavy backdrop of Treasury issuance, that competition could continue to put upward pressure on longer-term yields.

For investors, the implication is that where you take duration risk increasingly matters.

We remain constructive on fixed income and credit spread risk, but within U.S. interest rate exposure our preference has increasingly shifted toward the front end of the yield curve. Attractive starting yields, substantial tightening already reflected in prices, and greater sensitivity to any eventual change in Fed policy create a compelling combination.

The Fed may not be finished raising rates. But at today's yields, investors need not wait for the Fed to finish raising rates to find value at the front end of the yield curve.

About Payden & Rygel

Payden & Rygel is one of the largest privately-owned global investment advisers, managing approximately $164 billion in assets. Founded in 1983, the firm specializes in the active management of fixed income and equity portfolios, serving a diverse range of institutional clients worldwide. With clients that include central banks, pension funds, foundations, and corporations, Payden & Rygel offers a comprehensive suite of investment strategies through separately managed accounts, US mutual funds, and Irish domiciled funds (subject to investor eligibility). Headquartered in Los Angeles, the firm also maintains offices in Boston, London, and Milan. To learn more, visit www.payden.com.

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