

The Fed delivers a rate cut with a caveat

The U.S. Federal Reserve cut rates by 25 basis points for the third consecutive meeting. As the economy remains resilient while the labor market softens and inflation eases, we see opportunities across fixed income sectors, small cap equities and real estate-linked assets as the Fed continues its easing cycle.

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KEY TAKEAWAYS

- The Fed cut interest rates by 25 basis points, with the target policy rate range now at 3.50%-3.75%.
- The policy statement leaned hawkish, adding a qualifier about “the extent” of future changes in rates and boosting the GDP growth outlook. It also dropped a reference to “low” unemployment.
- The updated Summary of Economic Projections showed one rate cut expected next year, the same as the previous edition.
- Chair Powell struck a neutral tone in his press conference, downplaying the near-term outlook for rate cuts but continuing to signal that risks are skewed to the downside.
- We favor asset classes that may benefit from Fed rate cuts, including shorter-duration segments in fixed income, small cap equities and global real estate.

WHAT HAPPENED?

The Federal Reserve cut interest rates for the third consecutive meeting, reducing the fed funds rate by 25 basis points (bps) to a new target range of 3.50%-3.75%. The market anticipated this move, which aligns with the Fed’s previously published dot plot.

The policy statement leaned hawkish compared to the prior edition. Instead of simply referencing “additional adjustments to the target range for the federal funds rate,” the statement now references “the extent and timing” of adjustments. That subtle shift suggests less confidence about cutting rates again soon.

Chair Powell said that “the fed funds rate is now within a broad range of estimates of its neutral value” and that the FOMC is “well positioned to wait and see how the economy evolves.” Both comments indicate less urgency to cut rates again.

Nevertheless, Powell also repeated previous rhetoric about “significant downside risks” to the labor market. He said, “I don’t think a rate hike is anybody’s base case,” indicating that, notwithstanding a near-term pause, the next move is still likely to be a rate cut.

We now expect two additional rate cuts totaling 50 bps during 2026 – 25 bps more than previously forecast. This revision reflects softer labor market data and increasing odds of a more dovish nominee to replace Chair Powell.

ECONOMIC OUTLOOK REMAINS POSITIVE DESPITE LABOR MARKET SLOWING

The economic outlook remains positive through 2025 and into next year. Since the last FOMC meeting, the federal government shutdown has ended and economic data reports have resumed, albeit with delays. The data show robust growth but continued labor market loosening.

September's jobs report showed a strong rebound with 119,000 net jobs added – the best month since April. However, the unemployment rate rose to 4.4%. While partially driven by increased participation (a positive signal), workers are finding it harder to secure jobs. The falling private quits rate suggests workers are less eager to test the market.

The looser labor market is easing inflationary pressures. Core PCE inflation rose 2.8% year-over-year through September, but housing inflation is at its lowest level since pre-pandemic. Wage inflation, at 4.2% year-over-year, remains elevated but is at its lowest since early 2022.

We expect continued labor market loosening and inflation to move higher. We've revised our year-end core inflation forecast down to 3.0%, reflecting slower-than-expected tariff passthrough. We still expect unemployment to reach 4.5% and stabilize in 2026, when headline growth should rebound to around 1.8%.

WHAT DOES THIS MEAN FOR INVESTORS?

As the Fed continues cutting rates amid economic strength, we suggest caution on duration while positioning for income.

Short-term yields (including the 2-year Treasury, already down 64 bps this year) should decline further as the Fed eases, while longer-term yields like the 10-year will likely hold near current levels.

This steepening yield curve should provide better future entry points for adding duration. For now, we favor sectors with duration below the Bloomberg U.S. Aggregate Bond Index's 6.0 years.

Securitized assets comprise roughly 26% of the Agg's market value, including asset-backed, mortgage-backed and commercial mortgage-backed securities. But many ABS and CMBS issues are excluded due to their small size. Expanding beyond the index offers opportunities for additional yield and return potential.

Plus fixed income sectors, including **preferred securities**, also sit outside the Agg. We favor \$1,000 par preferreds, which have returned around 8.0% year-to-date while spreads have marginally widened – unlike other fixed income areas.

While rate cuts may cause modest yield erosion, **senior loans** currently yield about 7.9%, near 15-year highs. Rate cuts may improve fundamentals by reducing issuers' interest expense. Other corporate fundamentals for leveraged finance borrowers remain broadly healthy. Among lower-rated (B and CCC) issuers, selectivity is essential, as deterioration will likely concentrate in weaker issuers with limited cash flow and stretched balance sheets.

In equities, we see value in **small caps**. Though megacap technology companies have dominated recent performance on AI tailwinds, dynamics may shift. We think forward earnings growth, valuations and interest rate expectations make U.S. small caps attractive now.

Corporate earnings growth generally drives stock prices over the long run, especially as inflation and rates normalize. Smaller companies may have an earnings growth advantage ahead after lagging large caps from late 2022 through 2024 amid rising rates and recession fears.

With recession odds now lower given economic resilience, improved productivity and the Fed's pivot toward supporting employment, cyclical areas like small caps may benefit. Analysts expect faster earnings growth for smaller companies in 2026.

U.S. small cap valuations are in line with their 25-year average in absolute terms. But after trailing large caps by nearly 13 percentage points in 2024 and over four points through Q3 2025, the Russell 2000 Index's P/E relative to the Russell 1000 Index hovers near long-term lows. With large caps expensive, valuations favor small caps.

Historically, small caps have outperformed during Fed easing cycles because smaller companies benefit from easier financial conditions, rely more on short-term variable debt and pay higher interest rates. When the Fed cuts, their cost of capital declines, enabling cheaper refinancing and expansion that may boost stock prices. While history may not repeat, the current cutting cycle could catalyze small cap outperformance.

Finally, we continue favoring **real estate-linked assets**. After two years of declines, global private real estate has posted positive returns for five consecutive quarters. Rebounding prices, rising transaction volumes and sharply reduced construction activity have helped.

We think real estate debt remains attractive given high base rates, reset asset values and wider-than-normal spreads – rare among current credit asset classes. But we're finding increasingly attractive deals in real estate equity as deployment opportunities grow.

Our favored property sectors include health care and neighborhood retail. Within health care, outpatient medical buildings benefit from all-time-low vacancies, falling for four years as demand outpaces supply. Senior housing is another preferred area – the 75+ population is expected to grow 3.7% annually over the next decade, supporting strong fundamentals amid limited supply. Neighborhood retail also shows vacancies well below historical averages, with construction starts at a 20-year low. Grocery-anchored retail centers have outperformed, and we expect their resilience to continue.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, December 2025.

Bloomberg, L.P and S&P Markit.

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