Do lower interest rates mean more opportunities?

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While both the ECB and the Federal Reserve have just started to normalise their monetary policies, the pace and scale of this movement remain uncertain given the economic fundamentals. How should we deal with this new climate? Emmanuel Petit and Philippe Lomné, managers of R-co Conviction Credit Euro, explain.

How should we interpret the latest cuts in base rates?

Recent decisions by central banks have clearly marked the start of a rate-cutting cycle. The ECB has already made two cuts of 25 basis points, in June and September, while the Federal Reserve has just approved its first direct cut of 50 basis points, the first since 2020. These decisions were made in the aftermath of healthy headline inflation figures of 2.2% in Europe[1] and 2.5% in the United States[2], close to the 2% target. However, core inflation[3] remains stable at around 2.8% in Europe[1] and 3.2% in the United States[2], supported by a service sector that is particularly susceptible to wage pressures.

Does this decision mark a change in assessment by the central banks?

Despite this change of direction, central banks continue to insist that they are and will remain ‘data dependent’[4]. Until now, they have used inflation as their compass, but now employment data is being closely monitored. The decision to ease their monetary policies indicates, however, that both are expecting a rise in the unemployment rate in the months to come.

How is the job market performing in these two areas?

In Europe, unemployment is at an all-time low and wage growth remains strong at almost 4%[1], with no productivity gains. Companies may therefore be tempted to raise their prices to maintain their margins. In the United States, the unemployment rate has admittedly risen by 0.8% since its low point in May 2023[2] but, as the latest publications show, unemployment registrations have been falling, and the trend has also been down over the last few months. With retail sales remaining buoyant, these figures tell us that we are still a long way from a recession.

What can we expect in the coming months?

For the time being, we can assume that the central banks are reducing their restrictive monetary policy in line with the economic slowdown. The latter would have to fall sharply over the next few months for central banks to feel fully comfortable with the idea of continuing to slash rates. When we look at the leading indicators, they are already showing an economic slowdown. Nevertheless, the valuation of risky assets does not factor in the possibility of a recession at all. An alternative scenario to a recession and soft landing[5] is based on the idea that central banks are starting to loosen the monetary vice too soon, before inflation has returned to target. By boosting the economy through interest rate cuts, the risk is that inflation will take off again, and rates will have to be raised later, which would have a very negative impact on the economy. Central banks are therefore taking a real gamble on controlling inflation.

How did the markets react to these decisions?

Over the next year, interest rate markets are now expecting eight cuts in the United States and up to seven in Europe, resulting in a total of ten and nine respectively, including those that have already taken place. This estimate corresponds to the average number of cuts observed in recent recessions, including financial crises. This may seem high given the current situation. Central banks could work at a slower pace in order to still have room for manoeuvre, as Philip Lane, the ECB's chief economist, pointed out.

Where are interest rates currently?

Yield curves steepened again over the summer. The slope of the US curve has even reentered positive territory between the 2nd and 10th years, after hitting a low of -110 basis points in July 2023[6]. Nevertheless, we do believe it's worth taking a little perspective. European rates peaked in October 2023 at almost 3%[6]. They now stand at 2.15%, even though the curves began to steepen again in July 2023[6]. So this motion started more than a year ago. For a credit index, this represents a return of almost 10%[7].

What is your approach in this climate?

The difficulty currently lies in how to position ourselves in relation to one-year interest rate expectations. We believe we should be more cautious during this period for two reasons, with a bias towards the steepening of the curve. The first concerns the valuation of yield curves, which already incorporate a recession scenario, notably via inflation expectations of 1.60% on the German curve[6], whereas the central banks' target is 2%. On the other hand, if the markets are too optimistic about the pace and scale of rate cuts, and if the economy remains buoyant, we can expect a rise in volatility that we will need to be able to understand. This volatility will certainly be seen in interest rates, but also in credit, where spreads[8] have narrowed considerably. Also, this asset class would react particularly badly if investors were caught on the wrong side of the rates curve. This is a situation which, in this instance, will precede a more severe cyclical downturn. In view of these factors, we consider this strategy to be the most convex at present.

How can a fund like R-co Conviction Credit Euro stand out in this climate?

Our management flexibility gives us the room we need to weather the different credit cycles, particularly in pivotal periods such as the one we are currently experiencing. More generally, our investment ethos is based on strong convictions, which sometimes lead us to deviate somewhat from our benchmark index, both in terms of duration and credit risk. Our portfolio consists mainly of Investment Grade[9] corporate bonds, but we diversify our exposure with tactically selected high-yield and non-rated securities. Our responsiveness is also an asset. We pay close attention to market motions to seize opportunities as soon as they arise, because timing is often key in the bond markets.

Learn more about the fund(s)

R-co Conviction Credit Euro

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(1) Source: Eurostat, September 2024.
(2) Source: U.S. Bureau of Labor Statistics, September 2024.
(3) Excluding food and energy.
(4) Data-dependent.
(5) Soft landing: scenario in which monetary policy succeeds in bringing inflation down without triggering a recession.
(6) Source: Bloomberg, 08/17/2024.
(7) Source: Bloomberg, Rothschild & Co Asset Management, 08/17/2024.
(8) Yield differential between a bond and a loan of equivalent maturity considered “risk-free”.
(9) Debt security issued by companies or governments rated between AAA and BBB- by Standard & Poor's.

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R-co Conviction Credit Euro

We have classified this product as risk class 2 out of 7, which is a low riskclass and mainly reflects its positioning on private debt products while having a sensitivity between 0 and +8. In other words, the potential losses associated with the future performance of the product are at a low level and, should market conditions deteriorate, it is very unlikely that our ability to pay you would be affected. The risk indicator assumes that you hold the product for 3 years, otherwise the actual risk may be very differentand you may get less in return.

Main risks: Discretionary management risk, interest rate risk, credit risk, counterparty risk, performance risk, risk of capital loss, risk related to the use of derivatives, risk related to temporary acquisitions and sales of securities, specific risk related to the use of complex subordinated bonds (bonds with a maturity of less than one year) of securities, specific risk related to the use of complex subordinated bonds (contingent convertible bonds, so-called «CoCs»)

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