Investing in a falling interest rate environment

May 2025

Craig Inches, Head of Rates & Cash
at Royal London Asset Management

The current investment environment is unique for many reasons. There is obvious geopolitical and economic uncertainty that we see in the headlines every day. Looking at the UK, there are concerns about long-term growth and unprecedented levels of government borrowing. There is also a throwback issue: after a period of high inflation which led to a series of interest rate cuts, inflation is returning to normal levels and the Bank of England (BoE) is cutting interest rates accordingly. While this is basic economic normalcy, it is also something we arguably haven't seen in this country for around 30 years – when inflation came down from 7-8% through 1991 and into 1992, returning towards 2% by the start of 1993, creating a backdrop for a series of rate cuts.

It is a liquidity fund truism that if you know rates are going to fall, you should extend duration. The reasoning is simple: if interest rates today are 4.50%, and you expect them to be at 4% in a year, then you should do everything you can to lock in that higher rate for as long as possible. Lock in a one-year money market instrument paying 4.5% and when rates will be 4% by next summer, you are achieving an attractive 50 basis point yield premium.

Go long, go high?

The idea of buying longer maturity instruments may seem obvious. However, the caveat is that this only works if you are confident that rates are going to fall, and that the market is not pricing those rate cuts. If the market agrees with you, then one-year instruments will already reflect this. This is the situation today.

In our view, picking the right course of action has two key factors to consider: first, your view of interest rates vs the market expectation and second, your risk appetite to exploit that view. Short term money market funds launched under EU Money Market Fund Regulations and/or short term money market funds wanting a AAAm rating are limited to a weighted average maturity of 60 days and weighted average life of 120 days, limiting capacity to add longer maturities such as one-year paper. For short term fixed income funds – those with a little more flexibility –one year paper becomes more attractive if we believe the market has priced fewer rate cuts when compared to our view. We prefer to take a more nuanced view: looking for the best value – getting an attractive yield but with the right amount of risk.

Cover the bases

Using the flexibility that is available to strategies in this space broadens the options for ways to add value. An example is covered bonds. These are regulated, prime residential mortgage-backed securities that offer so-called dual recourse: investors have a claim against both the issuer and the underlying pool of assets. In addition, these bonds are regulated by the Bank of England and have certain parameters – such as low loan-to-value ratios – that must be met.

We therefore see regulated covered bonds as high quality instruments. These tend to be longer dated than traditional money market instruments, typically three-to-five years. More importantly, they are usually floating rate, essentially removing interest rate risk.

Another area where we can create value is in secured overnight lending, where we lend cash to banks on an overnight secured basis, but generally receive government bonds as collateral (Reverse Repurchase transactions). So if a bank collapses or defaults , we can sell the collateral (government bonds) to recoup our money lent to them. In this scenario, we may not have boosted yield, but we are reducing risk by securing the cash lent with government securities as collateral.

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Even in our most flexible strategy, where we can add short-dated bonds, we take the same approach targeting value over yield. For example, if we buy bank bonds, we typically prefer senior to subordinated, and we can target the same banks as we like in the money market space, thus leveraging our bottom-up fundamental research. In addition, adding corporate bonds can help reduce overall portfolio risk, as it provides scope to invest outside the bank sector. Money market instruments are exclusively issued by banks, so by adding corporate bonds from other sectors, we can increase sector diversification.

Value drive, not yield driven

While the direction of interest rates has a significant bearing on a liquidity investor's decision-making process, we believe that all other considerations are equally important when constructing a portfolio. Ultimately, while liquidity investors are looking for short-term homes for cash, they still prefer an approach that can be used over the long term, and through a variety of market conditions. So while yield is always a consideration, we see controlling the various risks taken to achieve that – including interest rate risk, credit risk, and liquidity risk – as perhaps of overriding importance.

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Contact us

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Royal London Asset Management
80 Fenchurch Street,
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

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