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INVESTMENT MANAGEMENT

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# Higher rates change the equation


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Interest rates have moved markedly higher this year. It is never possible to say with certainty why interest rates rise or fall over a particular period, and rates are notoriously difficult to predict. Nevertheless, we believe four developments have played an important role in the recent move higher:

- **The inflationary impact of higher energy prices,** largely related to the war with Iran.
- **Enormous capital requirements from hyperscalers,** which tend to be relatively insensitive to the cost of funding and may therefore crowd out other borrowers.
- **Reduced demand for US Treasuries from traditional overseas buyers,** including China, Japan and Europe, while China has continued to increase its gold holdings. This matters because global bond markets are highly interconnected with US Treasuries effectively providing the anchor for global interest rates.
- **Growing investor concerns about public finances, particularly in the US,** France and the UK. Large and persistent budget deficits require substantial amounts of new government debt to be absorbed by the market, increasingly at higher yields.

**The combined effect of these developments has already put one major market under pressure: France.**

## The pressure point: France

French government bond yields have risen sharply, while the spread over German Bunds has widened to levels last seen during the 2011–2012 eurozone crisis. France continues to run a sizeable budget deficit of more than 5% of GDP and, for now, there appears to be limited political scope to address it decisively. The political backdrop adds another layer of uncertainty, with both parliamentary and presidential elections due next year.

French issuers account for almost 20% of the euro IG credit market, making the outcome of the 2027 election highly relevant for credit investors. Regardless of who wins, the bond market is clear on what needs to be achieved: a credible plan to reduce the fiscal deficit. In our view, this will be difficult to accomplish without meaningful pension reform.

> "Ultimately, France requires a discussion about pension reform, and more broadly, a discussion of the size of what the government can provide."
>
> - Rodrigo Valdes, Head of the International Monetary Fund's fiscal affairs department

As long as meaningful change remains out of sight, markets are likely to remain on edge, with continued pressure on French rates acting as a catalyst for policy change. Ultimately, we expect French society to come to terms with the pension challenge, but the path towards that point is likely to be volatile.

## From pressure to opportunity

This is not the first time French issuers have experienced spread widening over concerns about France's fiscal position. We saw a similar episode in 2024. Against this backdrop, we have for some time required additional spread compensation for the risks associated with French issuers.

Euro credit markets remained relatively buoyant through August this year, with spreads generally at tight levels. In our view, this left the spreads offered by many French issuers relatively unattractive, particularly given the underlying fiscal and political risks.

> We therefore entered the spread widening in September and October with a sizeable underweight position in France.

We used the September and October sell-off as an opportunity to reduce this underweight by approximately half in market value terms, focusing particularly on French corporates with diversified international businesses and relatively limited exposure to the domestic economy.

By contrast, we only moderately reduced our underweight positions in French banks, utilities, telecoms and infrastructure. These sectors tend to have greater exposure to the domestic economy and could therefore be more negatively affected by weaker economic growth, fiscal tightening and potentially higher taxation than internationally diversified French corporates.

The situation stabilised towards the end of October, and credit spreads subsequently began to tighten again. Should French spreads return to relatively tight levels versus comparable non-French issuers, we would look to reduce our exposure again. This reflects our view that meaningful fiscal and pension reforms in France are unlikely to materialise without sustained pressure from the bond market.

## The broader credit picture

Despite these risks, we remain cautiously positive on credit. Valuations remain reasonable, all-in yields are attractive, economic growth is holding up and corporate fundamentals remain solid, while the technical backdrop is broadly balanced. At the same time, greater volatility can create mispricing and, with it, opportunities for active credit investors.

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