(UBS)

Borrowing in a falling rate environment

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Borrowing became a less attractive part of a wealth strategy as central banks raised rates to the highest level since the 2007 global financial crisis in an effort to curb inflation. But with the rate cutting cycle now getting underway, more investors are asking what role borrowing can play in their plans and whether floating or fixed rates make more sense.

Borrowing is viewed by many investors as a last resort, for emergencies only. After all, debt comes at a price, as creditors demand to be compensated, and there can be significant risks if one is unable to repay on time. In addition, central banks' recent efforts to tame inflation have lifted borrowing costs to their highest levels since the global financial crisis of 2007 and 2008. That reduced the appeal of debt as part of a financial plan.

However, while the costs and risks of borrowing are well known, the benefits are often overlooked. When implemented carefully, borrowing can be a vital tool to help families meet their goals and address financial risks. Meanwhile, central bank rates have already started to fall in developed nations. Europe has been leading the way, with rate cuts by the Swiss National Bank and Sweden's Riksbank, while the European Central Bank looks set to follow at its June policy meeting. While economic growth has been stronger in the US, we still expect the Federal Reserve to start cutting rates this year.

So, what roles can borrowing play in a prudent financial strategy? What are the risks? And how should investors evaluate whether to lock in borrowing costs?

We see several key ways in which borrowing has the potential to boost wealth.

- **Providing a bridge loan or liquidity.** Families may need funds temporarily, so don't want to sell assets that offer the potential for strong returns. Borrowing can help avoid realizing taxable capital gains and transaction costs, while providing the means to fund business ventures, or improve portfolio returns as long as expected returns outweigh borrowing costs. The ability to borrow can increase an investor's freedom to buy assets (or avoid selling assets) at distressed prices, but these opportunities can only be fully exploited if the investor manages liabilities proactively to ensure there's borrowing capacity when it's needed.

- **Improving diversification.** Investors may have overly concentrated net worth—perhaps even holding just a single asset. This is often the case for entrepreneurs or high-level executives, whose wealth can be highly focused prior to selling a business or tied up in restricted company stock. In this situation, business owners or executives may want to consider borrowing against concentrated illiquid assets to fund a diversified portfolio.
- **Increasing returns.** Investors may consider borrowing as a means to boost the growth rate of their net worth, for example by tapping borrowing capacity for spending instead of setting aside cash and bonds in the Liquidity* strategy. Returns on long-term investments in the Longevity and Legacy strategies can often exceed the cost of borrowing. However, such strategies also involve the risk that investment returns undershoot expectations, or that the investor faces liquidity needs that reduce their ability to ride out bear markets.

But borrowing also involves potential pitfalls. To evaluate the tradeoffs, investors should start by considering two key metrics: cost and robustness.

Cost is the first consideration. In particular, it is important to evaluate the difference between the estimated interest rate on any loan versus the expected return of the asset in which loan proceeds are invested, or the asset which no longer needs to be sold due to the influx of liquidity. Robustness is a crucial second component. Borrowing that results in an investor being forced to sell assets to make a loan repayment is not a good idea. There are usually two main culprits that can lead to this scenario materializing: market risk and spending plans.

Market risk arises if the value of a loan's collateral falls, breaching agreed loan-to-value ratios, and a borrower lacks alternative funds, they may be forced to sell assets to meet a margin call or repay debt. Spending plans are equally important. If a family or investor expects to tap a portfolio for large expenditures, such as university tuition for children or a home purchase, it is important to consider how long the portfolio could take to recover (the “time underwater”) and the impact that spending might have on a projected loan-to-value ratio.

So what does this mean at present? The global rate cycle has already turned. We expect a series of rate cuts into 2025 across most of the developed world, except Japan where policy is set to tighten modestly. As a result, strategies that involve borrowing have started to become more viable once again—a trend that looks likely to continue.

But investors will also face the choice of whether to lock in borrowing costs or opt for floating rates. In general, this will depend on investors' level of risk aversion and confidence in their ability to refinance debt. A fixed rate confers greater peace of mind for risk-averse investors, while other investors will be less worried by fluctuations in debt servicing costs. Equally, some investors will run into trouble if borrowing costs rise even modestly, while others will have the flexibility to pay higher rates if needed.

Investors can also consider whether the falling borrowing costs will make it more cost-effective to opt for floating over fixed rate. The dynamic here will depend on the currency and the central bank outlook.

US rates and the Federal Reserve: Expectations on the outlook for the timing and scale of Fed rate cuts have fluctuated considerably over the past few months. But since the start of 2024, markets have gone from pricing as much as 160 basis points of easing at the peak in January, to about 33 basis points at the time of writing. In our view, market have become too cautious on the ability of the Fed to ease policy, and we expect 50 basis points of easing this year, with further cuts through 2025. The April consumer price index reading reinforced our view that the trend toward slowing inflation is resuming, having stalled during the first quarter of the year. Against this backdrop, a decision to fix rates would need to be justified by a desire to moderate risk or a concern over refinancing risk.

The European Central Bank: The ECB is expected to cut rates for the first time this cycle at its meeting on 6 June. Our base case is for three or four quarter point cuts over the course of the year, in June, September, October, and December, with a high risk that policymakers skip October. From the current 4%, we expect rates to fall to 2% by June 2025. As with the US, our trajectory for rate cuts from the ECB is steeper than market pricing.

**Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.*

Swiss rates: In March, the Swiss National Bank became the first G10 central bank to cut rates since the aftermath of the COVID-19 pandemic. Most economists had expected the SNB to wait for clearer guidance that the ECB and the Fed were poised to ease policy. We expect the SNB to lower its policy rate by 25 basis points in both June and September, to 1.00% from the current 1.50%. This forecast assumes inflation will stay comfortably within the target range, with economic growth remaining below trend. At the time of writing, the two rate cuts we project have been priced by the market.

This article is based on research by Christopher Swann, Leslie Falconio, Marianna Mamou, Matthew Carter, Justin Waring, Brian Rose, and Frederick Mellors.

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