Greg Stock: How falling rates are improving the quality of credit portfolios

By Perpetual Asset Management

2 September 2025

With only two more rate cuts likely over the next six months, it's time for a sensible, solid approach to credit investing, argues Perpetual's Greg Stock

- Lower rates ease pressure on borrowers, increasing credit quality
- A good time to focus on sensible, solid fixed-income returns
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THE Reserve Bank is expected to cut interest rates twice in the next six months, taking the cash rate close to 3 per cent by early next year.

But persistent inflationary pressures and the economy's ongoing productivity challenges mean we're not likely to see further rate cuts below that level for some time, says Perpetual senior portfolio manager Greg Stock.

What does that mean for fixed-income investors, particularly those looking to floating-rate credit for improved returns?

It's true that floating-rate funds tied to the cash rate will naturally deliver lower returns as the RBA eases.

But falling rates also generally mean an increase in quality for credit securities, points out Stock, who heads up credit research at Perpetual and is deputy portfolio manager of Perpetual Pure Credit Alpha Fund.

That's because falling rates reduce financial strain among households and businesses – which means they're less likely to default on loans.

That increases the quality (the likelihood that a borrower will repay a loan) of the assets underpinning credit portfolios.

Against that backdrop, the outlook for credit is improving, argues Stock.

"We often see people being very bullish or very bearish in credit. But often the outlook is just benign – and in those circumstances just being sensible and solid in this asset class actually delivers a better risk-adjusted result for investors.

"Everyone wants to go game fishing – but investing in fixed income is not about that. Riskier asset classes sometimes pay off, but in environments like this it's better to do sensible little things.

"A less-positive return is better than a negative return."

Understand what's driving monetary policy

As rates fall, it's important for investors to pause and consider why the RBA is easing, rather than just reflexively seek out higher-yielding alternatives, cautions Stock.

"Offshore – in New Zealand, America and Great Britain – rates were raised much higher, which induced more unemployment and a deeper downturn, driving inflation lower.

"That led to those economies being forced to be more productive, stretching them and making them more resilient.

"We have not done this to the same extent."

The implication for investors is that Australia faces a more drawn-out recovery, Stock says.

"The outlook is not dire, but it's challenging. There appears to be a slow grinding path ahead."

Productivity challenges, inflation pressures

Proposed policy solutions appear unlikely to drive meaningful productivity changes here in the short term, resulting in sticky inflationary pressures.

"People are talking about four-day work weeks – that might be good for some people, but it's not going to help productivity. It's going to keep costs higher and inflation higher."

Australia's productivity challenge will likely put the brakes on rate cuts around the 3 per cent level.

"There will be pressure to ease the servicing of mortgages and all that, but they won't be able to because inflation will still be high.

“It will be a long work out, we’re going through a genuine economic cycle, and it looks like last in, last out.”

What it means for investors

The upside for fixed-income investors is lower cash rates provide greater support for credit fundamentals and help keep losses contained.

Lower cash rates are already reducing borrower stress associated with cost-of-living pressures, Stock says.

“Easing rates helps improve the asset quality of our underlying investments –mortgagees can pay their home loans more easily and if repayments stay steady, the principal component of the loan is repaid quicker.

“It also helps corporate borrowers with a reduced debt servicing cash outflow.”

That should drive an improving outlook for credit, Stock says.

“Last year’s weak credit outlook has improved somewhat and is now less tepid.

“We think broadly we can collect running yield, and less positive or negative return contribution from spread movements.

“We continue to find quality assets at fair prices, and given that valuations are tight and the subdued outlook, that’s a good risk adjusted outcome for investors.”

About Greg Stock

Greg Stock is a Senior Portfolio Manager and Head of Credit Research with Perpetual’s Credit and Fixed Income team.

Greg has more than 30 years of investing experience, including 20 at Perpetual. He has researched and analysed credit markets on the buy side and sell side for more than a decade, through multiple cycles.

Greg is a senior portfolio manager responsible for Perpetual Active Fixed Income Fund, which offers diversification and risk management via exposure to a hand-picked selection of mainly corporate and government bonds.

He is also portfolio manager for Perpetual Dynamic Fixed Income Fund, an absolute return fund that seeks to provide investors with a regular income and consistent returns.

Greg is also deputy portfolio manager of Perpetual Pure Credit Alpha Fund.

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