

# The Case for Lower Rates: Sector Sensitivity and Credit Implications

*Elizabeth Henderson, CFA | Head of Fixed Income, Director of  
Corporate Credit & Principal*

*Leah Savageau, CFA | Senior Fixed Income Credit Analyst & Principal*

## Sector Outlook and Rate Sensitivity

The direction of interest rates may arguably be the single most important variable influencing sector performance across fixed income and credit markets. While many sectors have demonstrated resilience, the risk profile could change dramatically if rates remain elevated. In this report, AAM shares its perspectives on the most interest rate-sensitive sectors and explains why lower rates are critical for their near- and intermediate-term performance.

## Housing and Construction

Weakness in the U.S. housing market is viewed as a key driver of the current slowdown in manufacturing activity. Because housing turnover and new construction are highly sensitive to interest rates, a meaningful rebound in manufacturing is unlikely without a decline in long-term borrowing costs. Persistently high rates continue to suppress housing demand, which in turn weighs on related sectors such as construction and building materials. Recent industry surveys reinforce this view, with contractors reporting disappointing sales and a sharp drop in demand for core residential products in recent months<sup>1</sup>.

<sup>1</sup> Wells Fargo Securities, Equity Research, October 2025

## Commercial Real Estate

A lower rate environment would benefit all stakeholders in commercial real estate (CRE), borrowers, lenders, and investors, by reducing stress and uncertainty in both loan extensions and workouts. Banks, particularly those with significant CRE exposure, stand to gain from lower rates through improved net interest margins and asset quality. If rates remain elevated, CRE stress is likely to persist, with new lending and issuance staying subdued. While large banks are currently stable, their outlook could deteriorate if rates do not fall, as both credit quality and investment banking activity are highly rate-sensitive.

As more CRE loans approach balloon repayments, especially in markets like CMBS, the prevailing rate environment becomes the key driver of outcomes. Lower rates would directly improve refinancing options, reduce the risk of foreclosure, and support higher recoveries in liquidation scenarios. In short, easing rates would help stabilize the CRE sector and mitigate risks for all participants.

## REITs (Real Estate Investment Trusts)

REITs, particularly those focused on office, are highly sensitive to rates. Lower rates would support valuations and fundamentals, especially for premier office space and regions digesting oversupply. If rates remain high, questions about workspace demand and supply overhang in certain regions will continue to weigh on performance.

## Business Development Companies (BDCs)

After rebounding to their tightest levels since January, bond valuations in the BDC sector have come under renewed pressure. Major indices such as the VanEck BDC Income ETF (BIZD) and the S&P BDC Index have experienced sharp price declines, with many BDC equities hitting 52-week lows. This weakness has been mirrored in the bond market, where wider bid-ask spreads and a surplus of sellers over buyers signal deteriorating sentiment.

The recent BDC equity sell-off appears to be driven primarily by interest rate dynamics rather than funding pressures. As policy rate cuts begin, portfolio yields are expected to decline more rapidly than funding costs, compressing net investment income and earnings power. While high dividend yields have supported BDC valuations, the reset in forward earnings expectations has led investors to anticipate potential payout reductions and to reassess fair value multiples.

On the bond side, underperformance is also linked to renewed credit quality concerns, with some losses tied to isolated bankruptcies. More importantly, the rise of private and perpetual BDC structures—often less transparent than their listed counterparts—has increased uncertainty, particularly as macroeconomic sentiment turns cautious and labor-market data weakens. Although fundamentals remain stable for most large BDCs, an economic downturn or persistently high rates would pose a significant headwind for the sector and for financials more broadly.

## Technology

Tech has been a standout, driven by AI-related capex and robust earnings growth. While less directly rate-sensitive, a persistently high-rate environment could eventually weigh on valuations and slow the M&A cycle that has supported the sector. Notably, rising equity valuations in tech have increased the sector's vulnerability to any shift in macro conditions or investor sentiment. Elevated valuations can amplify volatility and leave tech stocks more exposed to corrections if growth expectations are not met or if capital flows reverse. However, current tech equipment spend as a share of GDP remains below prior innovation cycles, suggesting room for continued growth even if rates do not fall sharply.

## Consumer Sectors

Consumer products and retail are more exposed to macro conditions and margin pressures than to rates directly. If rates remain high, slower growth and continued pressure on margins are likely, especially for sectors exposed to lower-income consumers. Pricing power will be critical, and B2B companies are better positioned than B2C to pass through cost increases. The auto sector, in particular, is highly sensitive to both macro trends and interest rates, as most vehicle purchases rely on financing. While auto sales have been resilient this year, there are concerns of weaker sales going forward as tariffs continue to put upward pressure on vehicle pricing. Affordability has become a more prominent concern, particularly among mass-market and lower-income buyers. Lower rates provide a tailwind in support of an auto industry increasingly concerned about a weakening consumer.

## Small Businesses and Private Credit

Recent headlines around First Brands and Tricolor have brought renewed attention to the vulnerabilities in the small business segment of the private credit market. Morgan Stanley's Private Credit Tracker<sup>2</sup> highlights the growing importance—and fragility—of small businesses in the current rate environment. Private credit has grown to approximately \$1.2 trillion in the U.S., now representing nearly 30% of the leveraged finance market. It is the fastest-growing segment, driven by demand from lower middle market borrowers and small businesses that increasingly rely on non-bank financing.

However, these borrowers face mounting challenges. Leverage ratios have risen to 5–7x, coverage ratios have declined to 1–2x, and many issuers now operate with negative free cash flow—a stark contrast to prior years. While private credit yields and returns remain higher than public loans, the volatility and capital losses are also more pronounced, especially among the smallest borrowers and BDCs with less than \$500 million in assets.

Default rates in private credit are mixed but trending higher for smaller borrowers. The maturity wall is more front-loaded in private credit than in public markets, raising refinancing risk if rates remain elevated. This dynamic poses a significant threat to small businesses, which are more exposed to credit deterioration and refinancing stress despite their historical resilience. A decline in rates would alleviate pressure on interest coverage ratios and support refinancing activity, improving credit quality across the private lending landscape.

In summary, while private credit continues to expand, the underlying fragility of small business borrowers makes the case for lower rates even more compelling. Without rate relief, refinancing risks and default pressures could escalate, undermining the stability of this critical segment of the economy.

2 Morgan Stanley US Credit Strategy Private Credit Tracker, 2Q25

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