

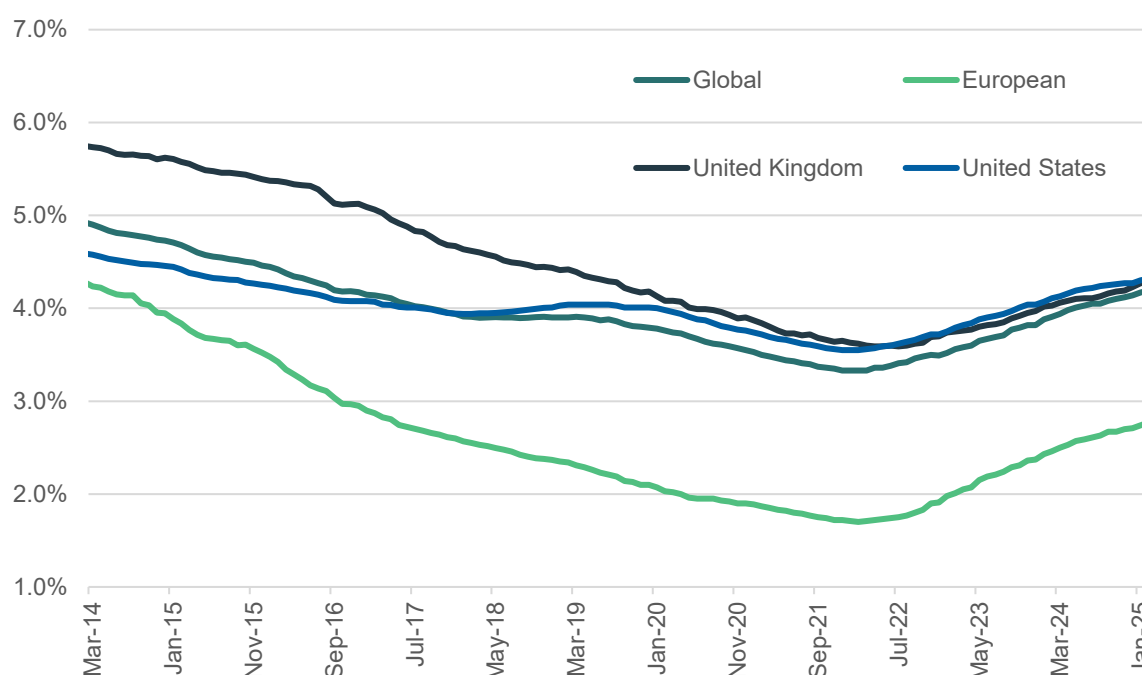
The Evolving Landscape of Fixed Income Investing

April 2025

The Corporate Bond Market: A Shifting Paradigm

A key investment theme in recent years has been strong demand for corporate bonds. In particular, investors have favoured high-quality investment-grade assets, while demand for sub-investment-grade (high-yield) debt and private credit has also been strong. This trend is unsurprising given that developed market interest rates, having peaked in 2023, have now begun to fall, presenting investors with the potential for near-term capital gains. Meanwhile, the average coupon for corporate bonds is at its highest level since March 2016.

Investment Grade Corporate Bond Coupons

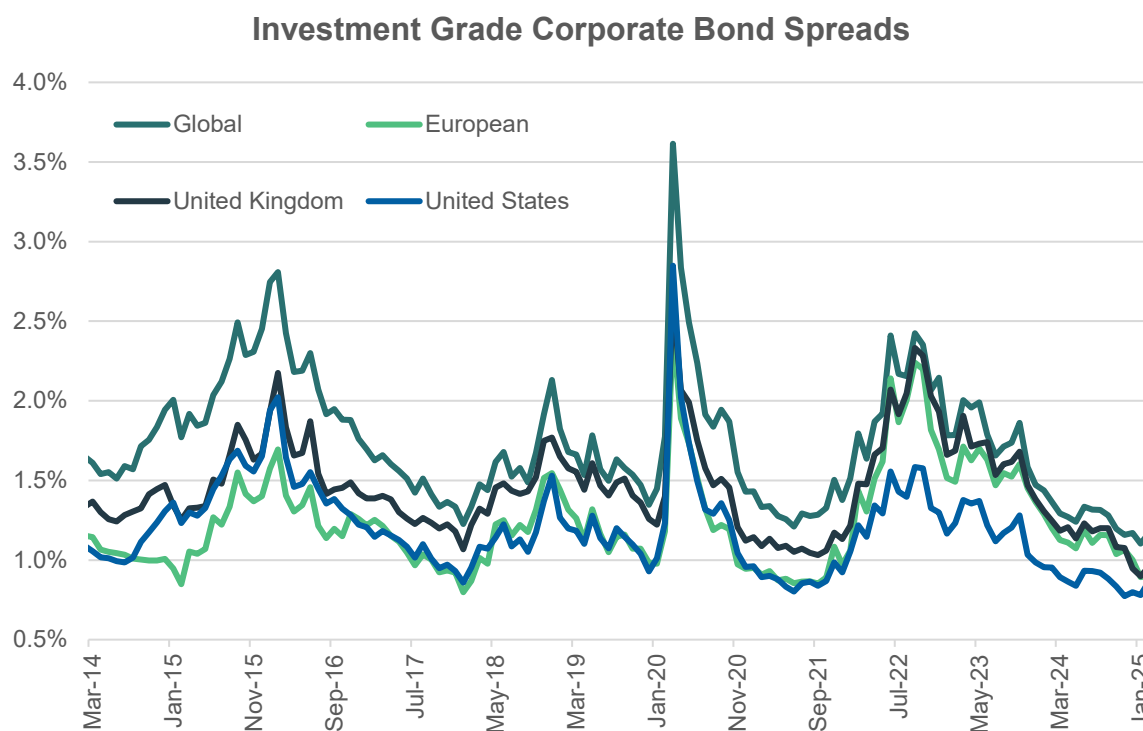


Source: Bloomberg, 2025

Furthermore, while recent trade disputes have deflated expectations for global economic growth, very few market commentators forecast a severe downturn (i.e. a recession) and inflation appears under control despite remaining stubbornly above central bank targets. As such, if one subscribes to the view that the global economy will slow but not crash, corporate credit makes logical sense as an allocation. High-quality issuers should be well-positioned to endure a mild slowdown, and further rate cuts will support bond valuations.

Risks and Considerations in Corporate Credit

Despite these positive factors, risks remain. Corporate bond spreads are near multi-year lows, meaning the compensation for taking credit risk is limited. Moreover, while default rates remain modest, refinancing risk is emerging as a key concern. Many issuers took advantage of the low-rate environment to lock-in cheap funding, but as these bonds mature, refinancing at current levels could be a challenge, despite interest rates falling from their recent peak. This is particularly true in the high-yield segment, where maturity profiles are shorter.



Source: Bloomberg, 2025

Geopolitical uncertainty also presents a significant risk. According to the Peace Research Institute of Oslo, 2023 saw the highest number of state-based conflicts since 1946. Escalating tensions in the Middle East and Ukraine could disrupt financial markets. Additionally, political uncertainty is rising, with centrist parties losing ground to far-left and far-right movements, while the Trump administration's aggressive use of tariffs has the potential to shift global trade dynamics. Rising government debt and increased fiscal spending to court voters could also have broader macroeconomic implications.

At the time of writing, the German government had just agreed to a €500 billion infrastructure fund and changes to the infamous debt brake that would allow for higher defence spending and more fiscal space for state governments. How the market digests what is widely expected to be a significant increase in government bond issuance remains to be seen.

The Liquidity Conundrum: Private Credit and Market Dynamics

Private credit has emerged as an institutional favourite, offering floating-rate coupons, flexible structures, and (in theory) a low correlation with traditional fixed income. However, liquidity remains a key drawback. In a crisis, private credit markets may freeze, eliminating any perceived diversification benefits. This highlights the importance of maintaining liquidity in a fixed-income portfolio, particularly during periods of market stress.

The Role of Relative Value Strategies in a Fixed Income Portfolio

Given these considerations, investors seeking to enhance portfolio resilience should complement their corporate bond exposure with strategies that offer downside protection and diversification – risk mitigation. Traditional fixed-income portfolios are typically dominated by two risk factors: duration and credit. However, a third lever, relative value, can provide a distinct and uncorrelated source of return.

Why Relative Value?

Reduced Sensitivity to Market Direction: Unlike traditional bond strategies, pure relative value investing is not dependent on the direction of interest rates or credit spreads. Instead, it seeks to exploit pricing inefficiencies within the fixed income market.

Effective Portfolio Diversification: One of the biggest shocks to investors in recent years has been the high correlation between government bonds and equities, traditionally considered diversifiers. Relative value strategies are designed to be uncorrelated with both asset classes, providing a true source of diversification.

Defensive Characteristics: Pure relative value strategies can be structured to deliver positive returns in both risk-on and risk-off environments. This makes them a compelling complement to traditional corporate bond allocations, especially when credit risk compensation is low.

Relative Value vs. Corporate Bonds

Empirical studies highlight that corporate bonds, particularly investment-grade securities, are often positively correlated with equities during periods of market stress. This reduces their effectiveness as a defensive allocation. Research from Norges Bank (2017) and AQR (2017) underscores that much of the outperformance in actively managed fixed-income portfolios is derived from persistent overweight exposure to credit beta, rather than genuine alpha generation.

Relative value strategies, by contrast, seek to remove directional credit and duration risk. Instead, they focus on extracting returns from mispricings in government and government-related bond markets. This can enhance portfolio resilience during market downturns.

Implementing a Balanced Approach

We believe investors increasing their corporate bond exposure or with a large existing exposure should consider incorporating downside protection. A useful analogy is motorsport, when increasing the power of an engine, it is prudent to install a roll cage and larger brakes. Similarly, allocating to a relative value strategy alongside corporate credit enhances portfolio robustness.

Conclusion

While corporate credit remains an attractive asset class, investors must be cognisant of emerging risks. Tight spreads, refinancing challenges, geopolitical uncertainty, and liquidity constraints in private credit all warrant caution. By complementing traditional fixed income allocations with relative value strategies, investors can improve portfolio diversification, mitigate downside risk, and access an additional return lever beyond duration and credit. This approach ensures a more resilient fixed income portfolio in an increasingly complex investment landscape.

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