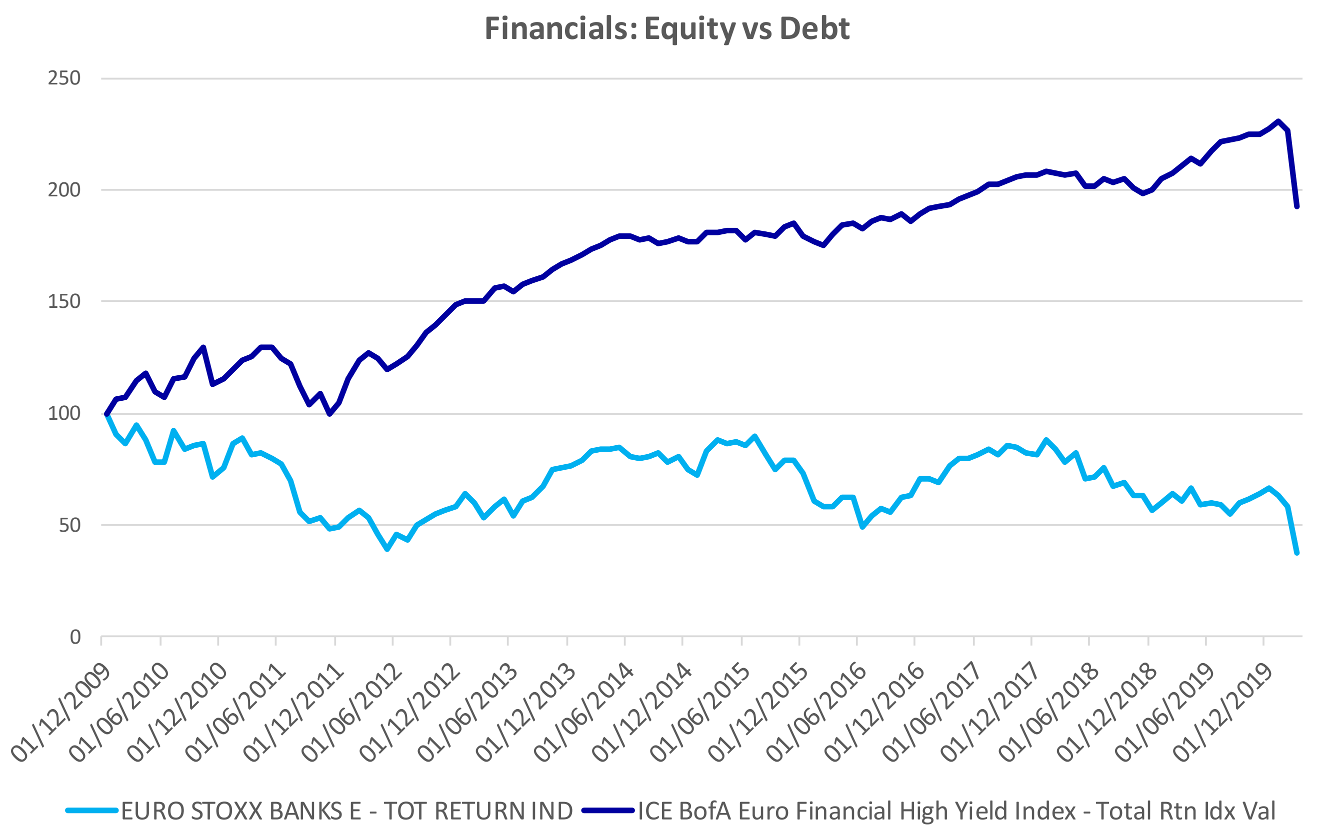
# European financial debt, longer and shorter term considerations

Nordea ASSET MANAGEMENT

## The longer term perspective

Following the Global Financial Crisis, the European financial sector has continuously undergone a deep and radical transformation. The weaknesses of many financial institutions back then have urged regulators to have a closer look at banks and insurance companies, resulting in a strong regulatory trend which still persists today.The regulation of the financial sector is certainly not an easy topic, countless rules are enforced every year, as well as the technical nature of the regulation itself makes it hard to focus on the financial credit landscape with clarity.

Nevertheless, if we look for the common denominator in all regulatory actions, we will always find an underlying intention, namely de-risking and/or de-leveraging. This is per se a congenial tailwind for creditors: investors lend money to financial institutions and regulators force them to reduce their risk. The same is not necessarily true for equity investors, that de-facto are sustaining the costs of derisking via lower margins and lower payout ratios and/or lower equity distributions. It is not by chance that over the last 10+ years European financial credit, especially within high yield, has massively outperformed European financial equity, while proving a strong investment.




Nonetheless, deleveraging a financial institution is a very complex topic which in turn generates a lot of complexity along the regulatory way. CoCo bonds are a good example of this complexity: they are in essence hybrid capital that can absorb losses (just like equity), without necessarily diluting existing shareholders (unlike equity). This intricacy embedded in the financial debt asset class creates the perfect ground for active management, in a context where dedicated expertise and focus can turn complexity into appealing investment opportunities.

Summing up, we see European financial debt as an asset class where a long term regulatory tailwind provides for an interesting backdrop to a perfect arena where complexity leave space to opportunities based on bottom-up and dedicated financial expertise.



Source: Datastream, Nordea Investment Funds S.A. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of your investment can go up and down, and you could lose some or all of your invested money.**

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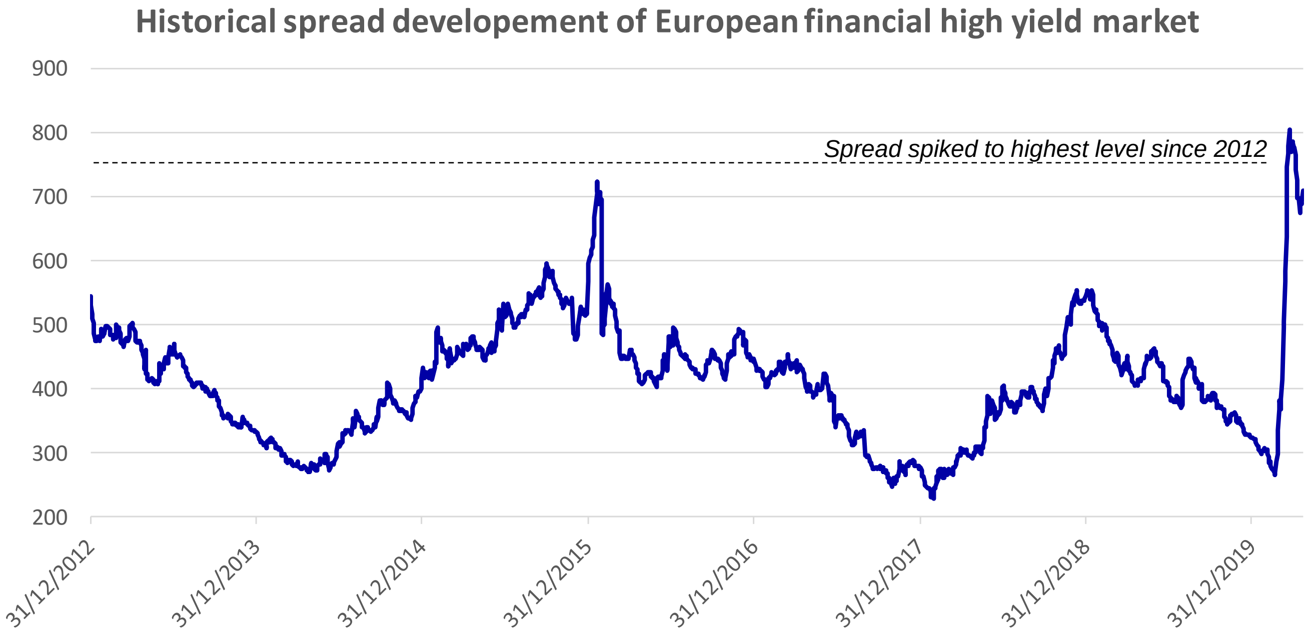
## How financial credit fared along the recent Covid-19 selloff and where do we stand?

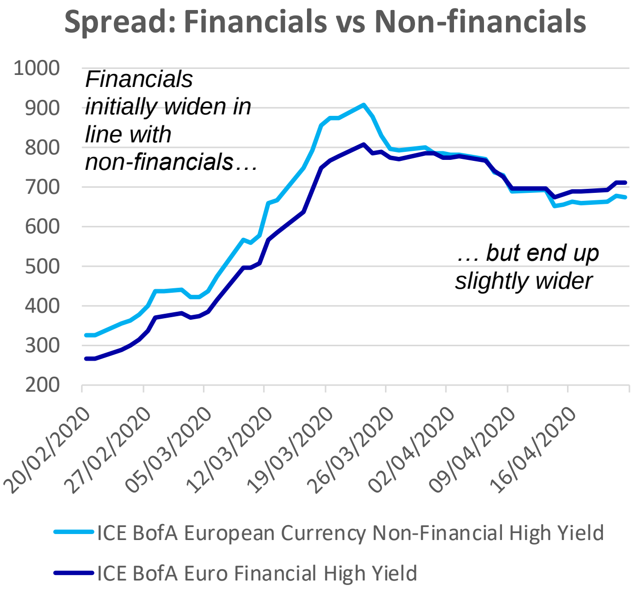
Worldwide markets have been hit hard by the global Covid-19 outbreak this year, which did not spare financial credits in Europe as **spreads reached levels not seen since 2012**. While March selloff came to an halt as central banks and local governments joined forces to establish and roll out **monetary and fiscal support**, the crisis is still ongoing and markets are called to judge on the economic implications of virus containment measures such as social distancing and lockdowns.




The Covid-19 outbreak is a **multi-faceted** black swan. It is first and foremost an **health crisis**, as people fear for their lives above their money. It is also an **energy crisis** as travel bans, lockdowns and mobility restrictions are putting enormous pressure on energy consumption, dragging oil prices to levels which are not sustainable for a large share of companies operating in the sector. It is hence also an **economic crisis** which slashes both supply and demand across most industries, resulting in distressed environments for firms that face a major slowdown in cash inflows which can hardly be met by a proportional reduction in costs, posing employment at risk in the recessionary context that lies ahead.

But **this crisis is not a financial crisis**. Banks and insurance companies are all but immune from a recession as they do participate in the broader economic activity, however, unlike during the Global Financial Crisis, the problem **does not originate in the financial sector**. On the contrary, banks play a crucial role in the transmission of liquidity and monetary support from central banks to real economies and it is in the **best interest of all European countries** that their banks continue operating efficiently and without disruptions. At the same time, the insurance sector is arguably less exposed to the current crisis given the **strong solvency positions** as well as the more limited expected impact on their financial positions.

Along the turmoil, the European financial high yield market has widened broadly in line with the other sectors, or even slightly less, yet it did not ride the rebound to the extent non-financial sectors did: spreads on financials are currently **higher by some 30-40 bps vs non-financials**.

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## European banking snapshot

Support measures in the banking space have been plenty, from an easing of pro-cyclical accounting requirements to State-Aid burden-sharing exemption. On the other side, the downturn will have large implications for the banks' capital structures. This makes more junior financial debt (AT1s, CoCos) a pocket of concern, whereas we are more constructive on tier 2 subordinated bonds.

The Nordea 1 – European Financial Debt Fund has consistently maintained a **low exposure to AT1s and CoCos**, with the few positions we maintain concentrated in national champions with large capital buffers and balance sheets that we see more resilient to a downturn.

The bottom line is, we are confident banks can be part of the solution to the crisis rather than the opposite, however a sharp bottom-up focus shall be at the forefront, especially when tipping toes in higher risk segments within financial credit.

We believe recent events further underline how a dedicated risk framework is paramount to consider and manage properly the risk embedded in such segment.

## European insurance snapshot

As opposed to many bank, insurance companies went into the current crisis with a **significantly higher capitalisation** above minimum requirements on average. To put things in perspective, in 2019 many insurers were more than adequately reserved for solvency capital requirements (SCR) with a coverage of roughly **2 times** the regulatory threshold. As a matter of fact, despite the dramatic market movements, **many insurers remain at more than comfortable regulatory levels**.

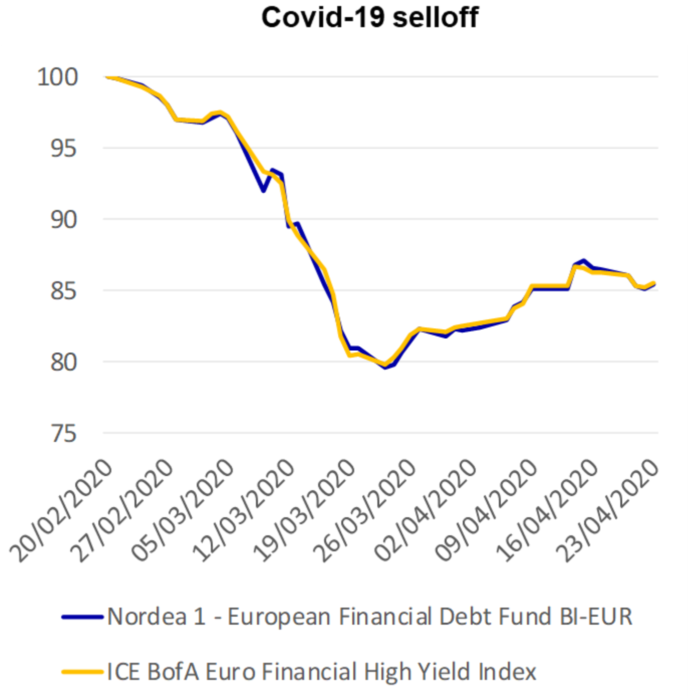
This doesn't mean the sector is immune to the crisis of course. On the contrary, future economic impacts on the wider economy will translate into concrete financial difficulties for companies, which could lead to rating downgrades, thus increasing capital requirement, as well as potential defaults. However, the good news is that most insurers are mainly exposed to high quality corporate bonds, with usually less than 30% exposure to BBB and below.

We are only exposed to the risk through **globally diversified insurers** and we do not currently foresee large solvency impacts on the insurers we are exposed to. A number of Tier 2 bonds within the sector actually show interesting valuations.

Source: Datastream, Nordea Investment Funds S.A.

## Putting it all together: longer and shorter term performance

The selloff has been very pronounced and quick. **Dislocation was massive** along the drawdown, further exacerbated by panic and forced selling. On one side, this has made it relatively hard to outperform along the worst days of the downturn, however dislocation may open up to **attractive investment opportunities** in a complex asset class like financial credit.

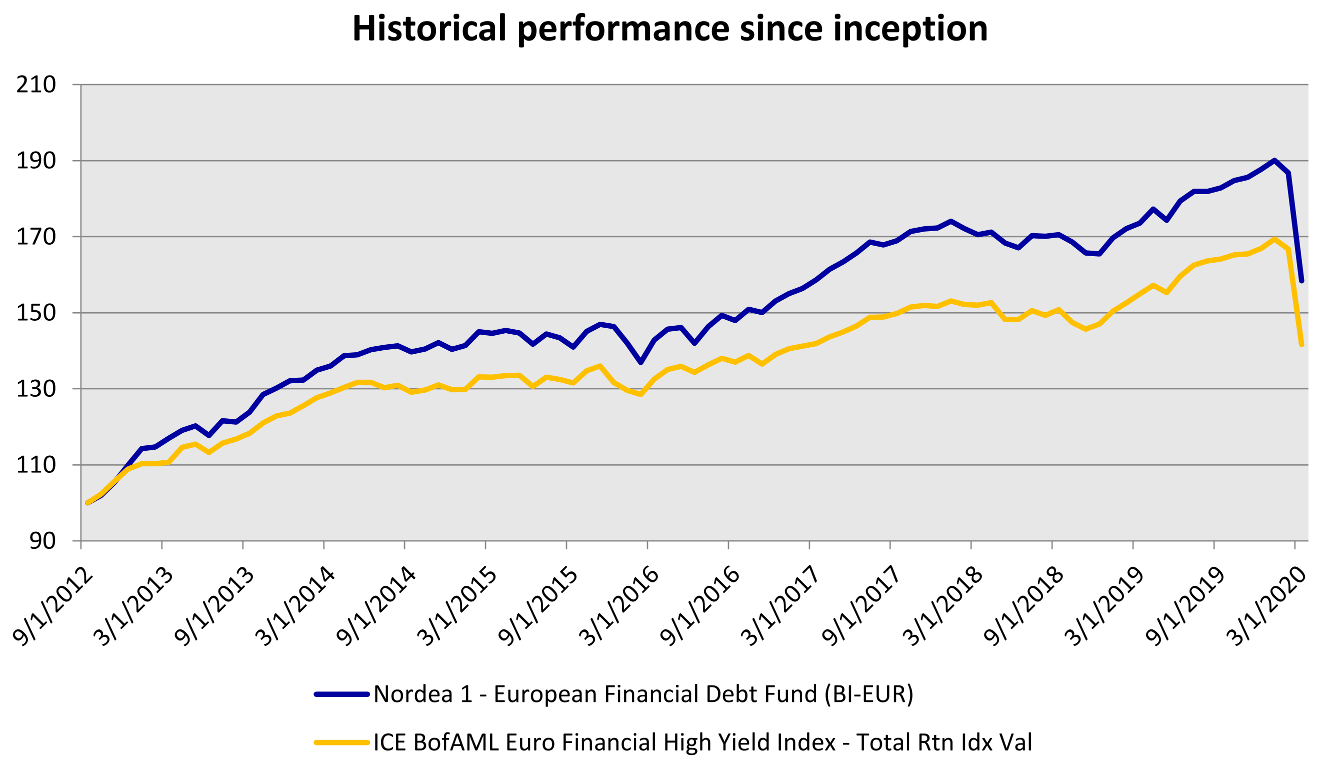



We are proud to highlight that along the selloff we **stayed true to our views and remained calm**, keeping our cash position and investments to our liking, ensuring that our views on optimal investments have remained reflected in the fund in an orderly manner. Net of fees (BI-EUR), the fund has managed to trade in line with the broader European high yield financial market.

As of Q1 2020 end, we have slowly increased our exposure to insurance subordinated bonds, while decreasing our exposure to selected banks, in line with our above mentioned considerations.

We keep our focus on bottom-up credit selection and credit quality, which results in a portfolio meant to deliver **high yield type of returns**, in line with our risk target, despite more than 30% of the allocation being in investment grade issues and more than 70% of the exposure being in investment grade issuers.

While our strategy has no official benchmark, and despite a substantial allocation to investment grade bonds ranging from 30% to 50%, we have historically outperformed both on a risk adjusted and on an absolute basis the broader European financial high yield market as a result of our bottom-up focus and ability to turn complexity into opportunities in a robust regulatory tailwind environment.

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