Nordea ASSET MANAGEMENT

CORPORATE CREDIT – QUARTERLY NEWSLETTER

Third quarter 2018

Market Review and Outlook
Volatility is here to stay

Main highlights

- **EU:** European stability, once again, came under pressure due to political developments in Italy. As a result, peripheral bonds underperformed, in particular financial issuers. The ECB announced that they will phase out the bond purchasing program by the end of the year.
- **US:** The Fed maintained the hiking path with the seventh rate hike since 2015, causing the US Treasury yield curve to flatten further. CCC and Distressed credit rallied as investors sought returns in industries and credits that continue to be subject to a high level of disruption.
- **EM:** An increase in market volatility and concerns about the effects of protectionist trade policy from the US dampened investor appetite to allocate to EM. Fundamentally, EM corporates are in a good shape though as default rates are at cyclical lows.

Europe

Investment Grade by Nordea

The quarter started with some relief during April due to more solid economic growth indicators as the Eurozone outlook showed some signs of bettering and stabilisation.

The more positive note at the beginning of the quarter soon came to a halt and credit spreads started to drift wider for the rest of the quarter. The change in investor sentiment caused higher beta names in terms of lower rated bonds and financials bonds to widen the most. Over the full course of the quarter non-financial investment grade corporate bonds widened by 22 bps (to 115 bps) while the full investment grade universe widened by 25 bps (to 122 bps). Although all rating classes posted negative absolute returns the negative spread performance was somewhat offset by dropping government yields. The German sovereign curve flattened as 2y yields dropped by 10 bps and 5y by 23 bps.

Trade war rhetoric and rising political risk in Europe were the main drivers behind risk aversion and subsequent higher market volatility during the last two months of the quarter. The political situation in Italy led to tensions in the market as a populist government was formed, which yet again raised concerns over Italian budget deficits and not least the stability of the Euro. The negative impact was broad based but most pronounced for bonds from financial issuers. The Italian government leader focused to dampen the worries and communicated Italian support to the Euro. Trade war tensions escalated and triggered concerns about the dampening effect on global economic growth.

The ECB announced that they will half the bond purchasing program during Q4 2018 and eventually phase it out by the end of the year. This will supposedly have a negative effect on bonds eligible for ECB acquisitions.

The covered bond market delivered positive returns in Q2, +0.23% as measured by the iBoxx EUR Covered Bond Index. April was the calmest of the three months, with only a small decrease in yields and a tiny widening of covered bond spreads. In May, the formation of the new Italian government had made the market in general very nervous and the iBoxx EUR covered index widened by 4 bps. Italy was the worst performing country and the IBOXX Italy widened 32 bps. Also, Spain and Portugal widened more than average 12 bps. Germany, France and Scandinavia in general outperformed and their respective bonds traded unchanged in May. This movement in credit spreads however was more than offset by the yield movement with the EUR 5Y swap yield decreasing by 11 bps. This pattern continued in June, but at a much lower pace and less extreme movement in the widening of spreads and the tightening of yields.

Q2 issuance in covered bonds has been supported by the general risk off sentiment in the market that makes it difficult for banks to issue bonds further down in the credit structure. Overall, covered bonds managed the current turmoil in the financial markets very well and proofed once again to be one of the most resilient fixed income asset classes in volatile market environments.

*investing for their own account – according to MiFID definition

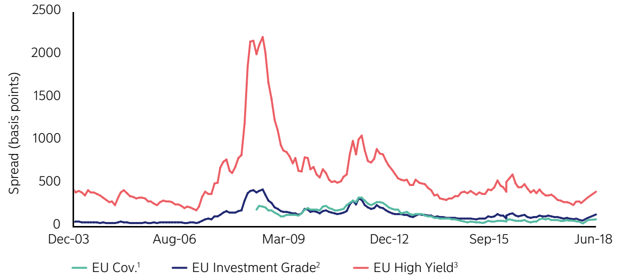
High Yield by Capital Four Asset Management A/S

European High Yield spreads widened by 68bps to 400bps during Q2 leading to a –1.01% market return with the major source of volatility being concerns regarding political developments in Italy and the potential impact on the economy. Worries regarding (dis)integration and the stability of the Eurozone was not the only theme as another source of volatility was the increasing concerns regarding escalating protectionism.

Despite the volatility, the fundamentals of the European High Yield market remain sound with very low default rates (<1%) and a favourable rating upgrade/downgrade dynamic. In Q2, the returns of the different rating categories were: BB –1.2%, B –0.4% and the CCC-rated bonds returned –1.5%, as measured by the Merrill Lynch European Currency High Yield Constrained Index. The best performing sectors within the benchmark were Media, Technology & Electronics and Healthcare while the worst performing sectors were Insurance, Transportation and Energy.

Fundamentals within European High Yield continue to look healthy with high interest rate coverage ratios and leverage remaining at overall healthy levels.

EU Covered vs. Investment Grade vs. High Yield market



As of 30.06.2018	EU Cov.[1]	EU IG[2]	EU HY[3]
Q2 2018 performance in %	**0.23**	**–0.22**	**–1.01**
Credit spreads (bps)	81	121	393
Yield to worst in %	0.53	0.99	3.81
Duration in years	4.78	5.17	3.93

1) iBoxx EUR Covered Bond Index. Source: Analytics. Date: 30.06.2018. 2) Merrill Lynch EMU Corporate Bonds Index. Source: Bloomberg (ER00 ticker). Date: 30.06.2018. 3) Merrill Lynch European Currency High Yield Constrained – Total Return Index (100% EUR Hedged). Source: Bloomberg (HPC0 ticker). Date: 30.06.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

US

Investment Grade & High Yield by MacKay Shields LLC

As expected, the Federal Reserve raised the fed funds target rate by 25 bps in June to 1.75 – 2.00%. The Fed maintained its hawkish stance by signalling for two more rate hikes during the back half of the year and potentially three more in 2019. Although the US economy grew at a slightly slower rate in the first quarter than previously estimated (2% vs 2.2%), second quarter growth is expected to be considerably stronger.

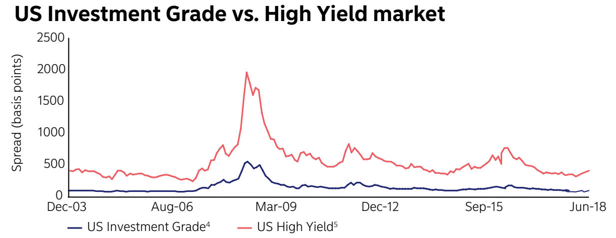
The US Treasury yield curve flattened further during the quarter as the difference between the 2–year and 10–year rates narrowed to 33 bps. The potential for an inverted curve remains a near-term risk as this indicator has typically signalled an impending recession.

US Investment Grade corporate spreads widened 14 bps to 123 bps during the quarter, according to Bloomberg Barclays index data. Lower quality BBB rated credits widened further than higher quality credits, while the long-end of the curve underperformed shorter and intermediate maturities. At an industry level, financials fared a little better during the quarter but still lag industrials for the year. It is also worth noting that Investment Grade corporate net issuance fell about 26% during the first half of the year, based on data published by Barclays. Some of this can be attributed to the recent tax reform, which incentivized issuers to repatriate overseas cash.

US High Yield spreads tightened by 1 bps during the Q2 to 371 bps, according to ICE BofA Merrill Lynch. While spreads were little changed for the market as a whole, performance by rating category diverged dramatically as BB spreads widened by 16 bps while CCC and Distressed credit saw dramatic spread tightening. Consequently, the lowest quality part of the market dramatically outperformed during the second quarter. Longer duration bonds lagged once again during the quarter, but the underperformance was much less pronounced than during the first quarter. The rally in the more challenged parts of the market continued during the second quarter as investors sought returns in industries and credits that continue to be subject to a high level of disruption such as telecom (especially satellites), energy and retail. The banking sector was weaker as bonds issued by foreign banks were under pressure in part due to political developments in Europe. High yield issuance slowed during the second quarter and at $53.5 billion was the lowest new issue quarter since 4Q 2016, according to JP Morgan. Market volatility continued to keep many companies on the sideline and investors were also requiring greater new issue concessions as the 2017 vintage of new issue bonds has generally underperformed during the first half of 2018.

The US economy remains entrenched in one of its longest recoveries on record. Unemployment is low, core inflation is below the Federal Reserve's 2% target and both monetary and fiscal policies remain relatively stimulative. The recent tax cuts have supported earnings growth in 2018. While credit conditions are tightening slowly, it's important to keep in mind that Federal Reserve policy is to provide guidance rather than gospel. Data dependency will remain paramount and the central bank has a watchful eye on the inflation data. Historically, inflation has risen when the unemployment fell below 5% – a threshold crossed nearly two years ago. A shifting demographic landscape has likely contributed to the lack of meaningful wage pressures.

US Investment Grade vs. High Yield market



As of 30.06.2018	US IG[4]	US HY[5]
Q2 2018 performance in %	**–0.88**	**1.00**
Credit spreads (bps)	116	361
Yield to worst in %	3.94	6.39
Duration in years	7.01	4.14

4) Bloomberg Barclays Capital US Credit Index. Source: © 2018 Barclays Bank PLC. All rights reserved. Member SIPC. Date 30.06.2018. 5) Merrill Lynch US High Yield Master II – Total Return Index. Source: Bloomberg (H0A0 ticker). Date: 30.06.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

Emerging Markets

Emerging Corporates by T. Rowe Price

Emerging markets corporate debt produced negative total returns of –1.77% in Q2, as measured by the J.P. Morgan CEMBI Broad Diversified Index. Underlying corporate and macro fundamentals remained supportive. Market technicals were roughly balanced, though skewed negatively, throughout the quarter, with periods of outflows being met with reduced new supply.

Corporate credit spreads continued to widen from the tightest levels since the end of the global financial crisis. An increase in market volatility and concerns about the effects of protectionist trade policy from the US dampened investor risk appetite. On average, investment-grade issues outperformed high yield securities, though both were negative. All corporate sectors were negative for the quarter, led by losses in real estate and metals and mining sectors. Emerging European and Latin American corporates produced the weakest returns, with all regions declining.

Emerging markets corporate bond gross issuance for the quarter was around $94 billion. Asian issuers accounted for the majority of new quarterly supply. New issues from Investment Grade companies continue to outpace those from High Yield.

In its World Economic Outlook, the IMF maintained its global growth forecasts for 2018 and 2019. The Chinese central bank cut its reserve requirement ratio to encourage bank lending in an effort to support economic growth that is expected to moderate. China reported first-quarter GDP growth of 6.8%, the same rate as the previous two quarters.

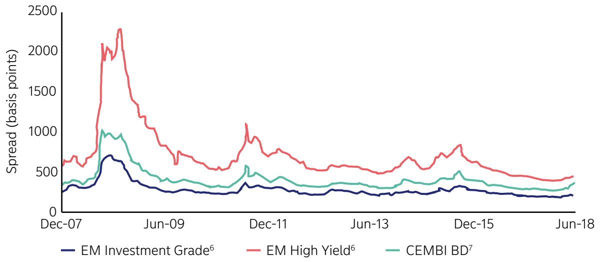
Turkish assets were under pressure as President Erdogan vowed to take greater control of monetary policy. The lira plunged to an all-time low. The central bank defied Erdogan's wishes for lower rates by hiking rates twice during the quarter as it responded to rising inflation and a weaker lira. The central bank also simplified the country's complex rate framework.

Argentina's central bank hiked rates several times to 40%, the world's highest rate, in an attempt to halt a precipitous drop in the peso. The country reached an agreement with the IMF for a larger-than-expected USD50 billion standby arrangement to cover external financing needs.

Other elections in emerging markets countries went as expected: Venezuela re-elected Nicolas Maduro in an election that was widely viewed as fraudulent. The US introduced new sanctions. Colombia elected market-friendly Ivan Duque as president as expected.

The long-term outlook for emerging markets corporate debt is supported by secular tailwinds that include strong underlying economic growth, rising middle class wealth, improved corporate governance, reduced external vulnerabilities, political reforms in key markets, and reduced contingent liabilities in the private sector. Also, the emerging market corporate default rate is at its cyclical low as the broad commodity complex is supportive and companies have been able to extend bond maturities and buffer balance sheets.

EM IG, HY and CEMBI



As of 30.06.2018	JPM CEMBI[7]
Q2 2018 performance in %	**–1.77**
Credit spreads (bps)	325
Yield to worst in %	5.79
Duration in years	5.30

6) Source: J.P. Morgan. Date: 30.06.2018. 7) JPM Corporate Emerging Markets Bond Index Broad Diversified in USD. Date: 30.06.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

In Focus

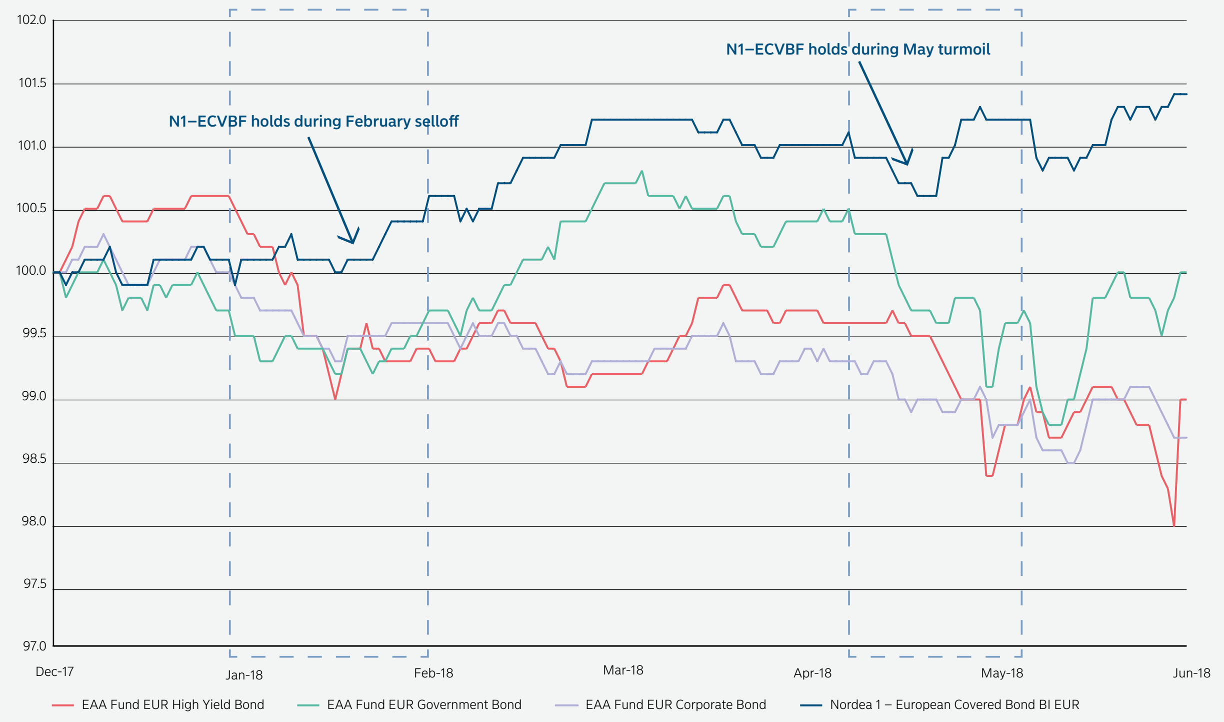
Nordea 1 – European Covered Bond Fund
Nordea 1 – Low Duration European Covered Bond Fund

The turbulences we've experienced since the beginning of 2018 has convinced many that volatility has returned in the European bond markets. After the first challenging weeks of January and February driven by rising interest rates (negative duration impact), European bond markets have been shaken again by the political turmoil in Italy, primarily in May (negative credit impact). Many investors think there has been no place to hide and indeed most European bond categories suffered from both events and across all risk profiles, they are trading in negative territory YTD.

All of them? No, as once more one of the safest European bond markets, **European covered bonds,** showed particular resilience and is one of the few Fixed Income asset classes with positive performance YTD.

Nordea Asset Management has considerable expertise in the covered bonds space, managing around €39bn of assets, with a dedicated investment team focused on alpha generation. Nordea firmly believes skill, experience and active management are required to navigate the intricacies of this inefficient market. Our investment strategy has well proven itself: the Nordea 1 – European Covered Bond Fund has not only offered an impressive performance so far in 2018, but has also been delivering a convincing track of alpha generation since its inception.

Resilient performance of the Nordea 1 – European Covered Bond Fund (N1–ECVBF)



Source: © 2018 Morningstar, Inc. All Rights Reserved as at: 30.06.2018. European Open End Funds database. Period under consideration: 31.12.2017 – 30.06.2018. **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 shares can greatly fluctuate as a result of the sub-fund's investment policy and is not guaranteed. Comparison with other financial products or benchmarks is only meant for indicative purposes.** In the prospectus dated 30 January 2012 the Nordea 1 – Euro Bond Fund was renamed to Nordea 1 - European Covered Bond Fund, the investment policy of the sub-fund was modified and the NAV history prior to this date is not used for performance measurement.

For investors who do not want a significant duration exposure, Nordea's value offering has been extended to the Nordea 1 – Low Duration European Covered Bond Fund in October 2017. The fund captures the compelling characteristics of the covered bond asset class, benefitting from the expertise and alpha capabilities of the investment team, with a lower interest rate risk, as the portfolio hedges the duration to ≈ 1 year.

Nordea Fixed Income offering

The overview of our corporate credit offering ranked by performance

Nordea 1, SICAV	ISIN	Share class	Average weighted rating	Performance in Q2 2018 (in %)	Modified duration (years)	YTM (in %)
North American High Yield Bond Fund	LU0826399429	BP-USD	B+	0.62	4.60	6.88
International High Yield Bond Fund – USD Hedged	LU0826393653	BP-USD	BB–	0.35	4.67	6.64
Low Duration US High Yield Bond Fund	LU0602537069	BP-USD	BB	0.34	1.75[B]	4.77
European Covered Bond Fund	LU0076315455	BP-EUR	A+	0.16	5.43[A]	1.04
US High Yield Bond Fund	LU0278531610	BP-USD	BB–	0.16	4.40[B]	6.07
Unconstrained Bond Fund – USD Hedged	LU0975281527	BP-USD	BBB	–0.29	1.13[B]	4.07
European Corporate Bond Fund Plus	LU0533593298	BI-EUR	A–	–0.35	5.10[C]	1.45
Flexible Fixed Income Fund	LU0915365364	BP-EUR	A+[I]	–0.94	3.71[I]	1.87
US Corporate Bond Fund	LU0458979746	BP-USD	BBB+	–1.00	6.73[B]	4.20
European High Yield Bond Fund	LU0141799501	BP-EUR	BB–	–1.12	3.42[A]	4.64
European Cross Credit Fund	LU0733673288	BP-EUR	BB+	–1.18	3.56[D]	3.16
Global High Yield Bond Fund	LU0476539324	BP-USD	BB–	–1.59	4.54[B]	5.74
European Financial Debt Fund	LU0772944145	BP-EUR	BBB–	–2.15	2.86[A]	2.86
Emerging Market Corporate Bond Fund	LU0634509870	BP-USD	BB+	–2.42	5.65	6.32
Renminbi High Yield Bond Fund	LU1221952010	BP-CNH	BB–[E]	–2.62	2.70[F]	8.30[G]
Low Duration European Covered Bond Fund	LU1694212348	BP-EUR	A+	–[H]	1.89[A]	0.68[J]

A) Effective Duration. B) Effective Duration. Source: MacKay Shields LLC. C) Modified Duration to Worst. D) Duration to Worst. E) Source: Income Partners F) Effective Duration. Source: Income Partners. G) Yield to Worst. Source: Income Partners. H) Due to local regulatory restrictions, we are not allowed to show performance on share classes less than 1 year old. I) Source: Multi Asset Team. J) Source: Nordea Investment Management AB. Estimated yield over the next 12 months, based on current model portfolio and market conditions, assuming no change in portfolio holdings and no movement in interest rates and spreads.