

Interview with Portfolio Manager Henrik Stille Nordea 1 – European Covered Bond Fund

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Please note that the conference call occurred on the 12th of August 2020. All market commentary and information refers to the period before then

Key takeaways

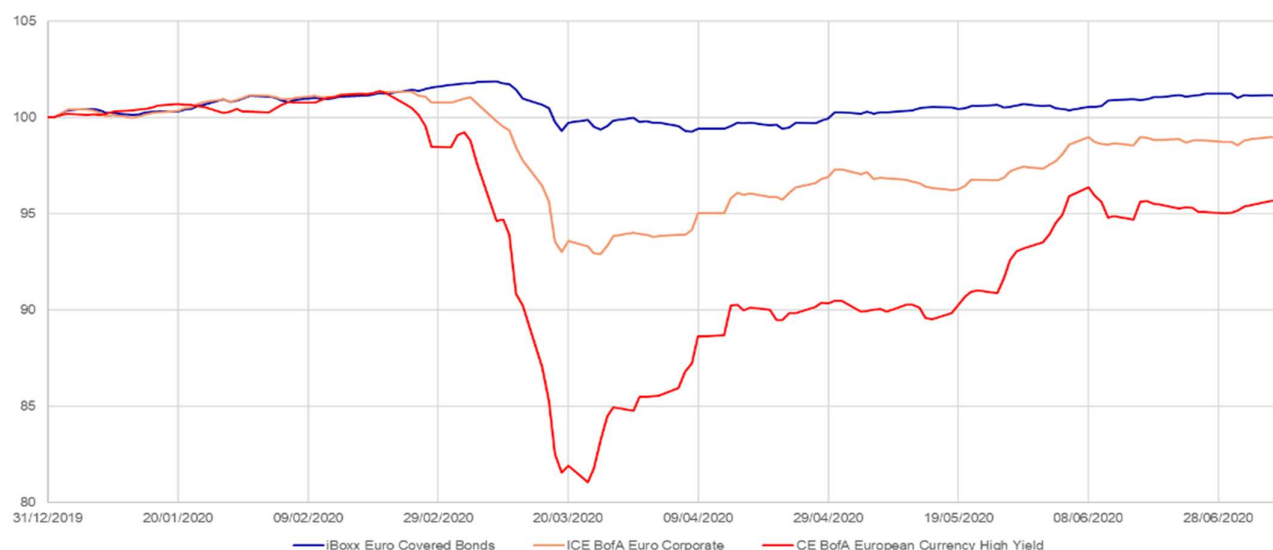
- With a double recourse and no default in more than 200 years of history, covered bonds have again proven resilient during the COVID-19 sell off.
- The ECB stepped in with unprecedented Quantitative Easing, supporting liquidity and demand in the covered bond market.
- The diversity and complexities of the asset class offer a wide range of attractive opportunities for truly active managers.
- From the Nordics to wider European markets and now beyond, Nordea's unique expertise dares to go off the beaten track to identify compelling opportunities

Compared to other areas of credit markets, covered bonds have held up well this year. Why is this?

The strong features of the covered bond asset class are very visible in a year like we are currently experiencing. Firstly, this crisis is far different to the one we saw in 2008. This crisis had its roots in the financial industry and had a much larger impact on banks – which are the issuers of covered bonds. In addition, the volatility of covered bonds is lower than that of sovereigns or corporates, with reduced spread widening in the covered bond space.

It became quite clear early in the Covid-19 crisis that the default rate probability would not change for covered bonds. However, the default probability for many other asset classes has dramatically increased due to the global slowdown.

Year-to-date resilience of covered bonds



Source: Nordea Investment Funds S.A. and Datastream. Date: 08.07.2020. Period under consideration: 31.12.2019 – 08.07.2020

What has been the regulatory response to the Covid-19 crisis?

The European Central Bank (ECB) stepped up its purchases of covered bonds very early in this crisis, and is now buying about twice as many covered bonds as it did at the beginning of the year. While the ECB is also buying corporate and sovereign bonds, there are some important differences to covered bonds. No matter how many corporate bonds the ECB buys, the default probability is still there. As for the sovereign side, there is still a significant amount of issuance, which is not the case for covered bonds, where issuance is far more muted.

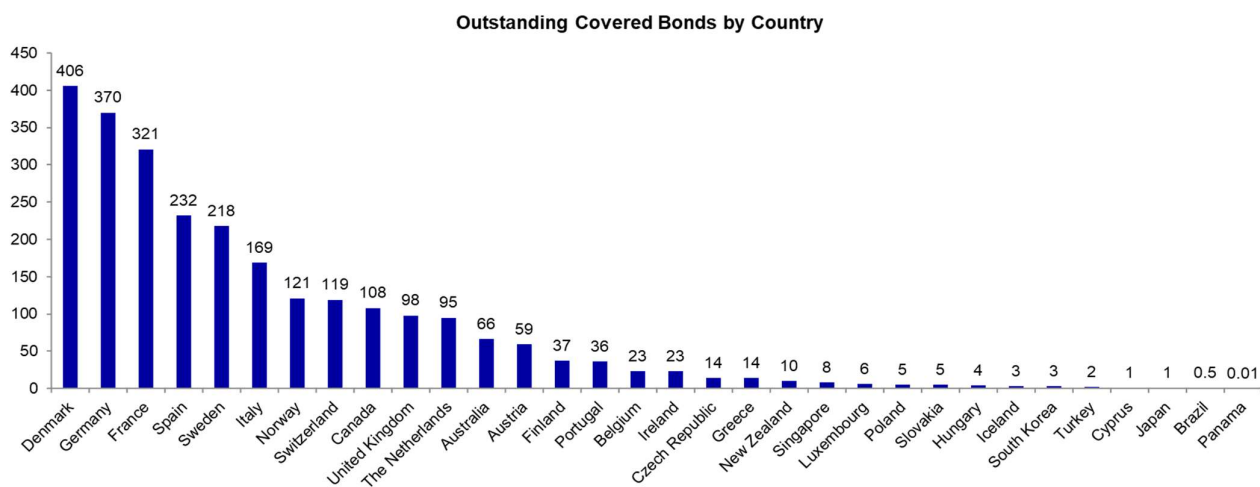
We expect the ECB to buy a little more than €100bn of covered bonds this year, which is the most since 2015. Next year's expected level of €80bn is also higher than the one of any other year between 2016 and 2019. So the ECB is committed to supporting the covered bond market for the foreseeable future. At the same time, the issuance of covered bonds is falling – roughly 30% below the levels at the same time in 2019. It is a different story on the sovereign side, with a widespread increase in issuances mostly as a result of the various Covid-19 response programmes.

Central banks have learned from the crisis in 2008. It is better to react fast, as the longer you wait, the larger the programme needs to be. The ECB moved faster than many other central banks in the world. For example, the National Bank of Canada waited longer to implement these facilities. As a consequence the spreads on Canadian covered bonds widened more than their European equivalents.

You mention Canada, which is one example of the growing global covered bond opportunity set. What have been the recent developments in this space?

The rapid growth of the global covered bond market is quite exciting. When we started to invest in covered bonds back in 2008, it was essentially the Scandinavian countries, as well as France, Germany and Spain, issuing covered bonds. Today, we are witnessing covered bond legislations in pretty much every European country, as well as others globally. Alongside more country entrants, we are also seeing new issuers joining the market from existing jurisdictions.

In addition to this, the asset class is growing into new currencies. For example, there has been quite a lot of domestic covered bond issuance in the UK – as well as issuances in US, Australian and Canadian dollars. Exploiting opportunities in all three areas – countries, issuers and currencies – is how we generate alpha in the covered bond market.



Source: EMF-ECBC, data from end of 2018.

How does your team look to capitalise on opportunities?

Stability is a strong feature of any investment team. Our covered bond team has been working together for more than 10 years now. In fact, our 10 members-strong dedicated team managing Danish and European covered bonds has an average of 21 years of experience and manages more than €40bn. We are also able to draw on Nordea's wider expertise, such as the five bank analysts we have in our credit team. They assist us when we are undertaking credit analysis of individual institutions. Our risk management team also provides us with risk data on a daily basis.

Besides this we are able to utilise Nordea Asset Management's renowned ESG capability. Our Responsible Investments team, consisting of 18 members, undertakes ESG analysis on all the issues we invest in. ESG analysis is integrated into our investment process and the ESG score is one input we utilise when determining the issuers we invest in.

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