

Interview with Karsten Bierre, Head of Fixed Income Allocation within Nordea's Multi Assets Team Flexible Fixed Income and Balanced Strategies

Please note the conference call occurred on the 7th of October 2020. All market commentary and information refer to the period before then.

Key takeaways

- Unprecedented fiscal and monetary easing has powered the recent market rebound.
- Government transfers, paired with falling household outlay, have led to all-time highs in private savings.
- This excess cash is partly flowing into financial markets, pushing bond yields to historic lows, credit spreads tighter and stock prices higher.
- Harvesting returns while containing risks has become a real challenge for investors.
- A flexible and balanced investment approach is key to obtaining returns with a low level of risk.
- Nordea's Multi Assets Team offers multiple solutions for traditional fixed income investors, with different risk-return profiles.

As a macroeconomist, what is your take on the global economic environment today?

We are witnessing the mother of all bailouts, with monetary and fiscal policy easing almost without precedent. It is remarkable just how much intervention has taken place since Covid-19 hit the economy and markets, which has led to an explosion in public debt and deficit levels not seen since World War II. This is a global phenomenon, with all central banks hitting the accelerator in terms of supporting the fiscal expansions we are seeing.

This support is working its way through to the household sector, as disposable incomes have actually increased during the current recession. This is probably the first recession ever where disposable income has risen.

What are the implications of these interventions?

Governments, both in the US and Europe, have now effectively absorbed drops in national income. Typically, the private sector takes the bulk of the burden in a recession, but this time it is the government sector. This has dampened the usual second round effects of a downturn – such as credit distress, asset price declines and household bankruptcies. You would normally see a credit contraction during a recession, but there is actually a credit expansion this time.

How are you overcoming the challenges evident in fixed income markets right now?

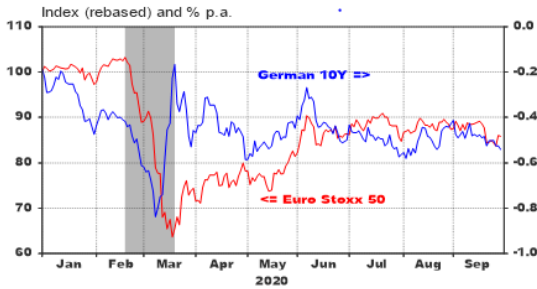
The normal ability of government bonds to protect in a recessionary scenario is no longer present. This was evident in the recent volatility, as there was no negative correlation between high-quality government bonds and risk assets like equities or credit. Our team has developed different tools to deal with the challenge of finding sources of downside protection.

Firstly, we have a flexible approach when it comes to strategic asset allocation. This essentially means we have the ability to seek out segments of the high-quality bond space offering superior return-risk characteristics than, for instance, traditional German bunds. An increased degree of tactical adjustment is also used to provide flexibility and protection. Obviously with low bond yields and low credit spreads, you cannot rely to the same extent on strategic diversification between duration risk and credit risk. So, a higher degree of tactical adjustments can increase the robustness of the portfolio.

In addition, we look for defensive strategies offering an alternative to duration. For example, during the sharp Covid-19 sell-off, defensive currencies provided superior downside protection to many traditional bond sources. Indeed, whenever there are jitters in the financial system and risk aversion rises, cash and liquidity become king. Our alternative strategies, such as our bond substituting FX strategies, are all based on very liquid instruments that can be traded in high volumes and at low cost.

Defensive Currencies worked better than Bonds (duration) during the COVID-19 sell-off

Europe: Euro Stoxx 50 and German 10Y yield



FFIF: Long JPY to diversify HY



Global equities and defensive currencies



FFIF: FX valuation to diversify EMD



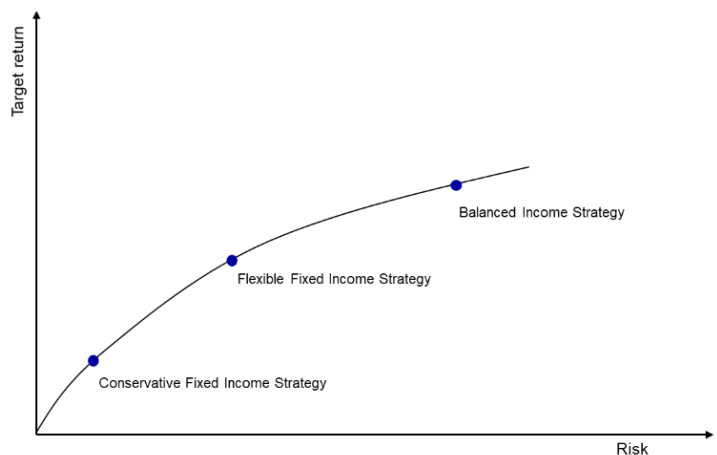
Source: Datastream, Multi Asset Team - Nordea Investment Management AB **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of your investment can go up and down, and you could lose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

You manage a full range of fixed income-oriented products, does each strategy have the same investment philosophy?

Yes. We follow the same investment risk balancing approach and philosophy – which looks to combine defensive and aggressive return drivers with reliable negative correlation. Our range of strategies then seeks to meet the differing needs of our clients.

In today's negative cash environment, some of our clients seek a highly liquid solution able to serve as an alternative to cash. This is our Conservative Fixed Income strategy, which targets a cash plus 100 basis points return.¹ We also have a slightly higher risk version, our Flexible Fixed Income strategy. It has the same focus on limiting downside and a high degree of liquidity, but with a target of cash plus 200 basis points.¹

Finally, we have our Balanced Income strategy, which uses some equity exposure on top of the more traditional fixed income instruments in the Flexible Fixed Income strategy. This enhanced risk profile enables us to target cash plus 300 basis points.¹



With low yields on offer in government bond markets, can investors be confident of generating robust returns in the years ahead?

This is a good question. We expect central banks to be accommodative for the next two to three years – with interest rates to remain near zero, or even below zero, for quite a long time. This means expected returns for safer elements of the fixed income

¹ There can be no warranty that an investment objective, targeted returns and results of an investment structure is achieved. The value of your investment can go up and down, and you could lose some or all of your invested money.

universe are low. At the same time, we do not believe there is scope to stimulate much further, as tools are somewhat exhausted on the monetary policy side. Looking ahead, there are risks to fixed income in terms of rising yields, which is driving the current muted return expectations for high-quality government bonds.

Despite this, as mentioned earlier, our differentiated risk balancing approach – where we employ alternative strategies to protect downside – will allow us to access additional sources of return without increasing volatility.

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