Nordea ASSET MANAGEMENT

Fund Update

May 2018

Nordea 1 – US High Yield Bond Fund

ISIN: LU0278531610 (BP-USD)

Market commentary

After an initial spike in ten-year US Treasury yields, the yield curve flattened with long-dated yields closing lower than at the beginning of the period; volatility in global markets contributed to this safe haven bid. The prospect of a coalition government in Italy formed by the far-right 'League' and the anti-establishment 'Five Star Movement' raised the specter that Italy might leave the euro and revert to a 'pre-Maastricht setting'. Despite their political differences, both parties are considered to be euroskeptic. The yields on Italian sovereign and corporate debt rose dramatically although local markets settled down somewhat after a successful auction of Italian government debt near month-end.

The Bureau of Labor Statistics reported that US unemployment hit an 18-year low of 3.8%, and the FOMC is widely expected to hike at its June meeting. Although Eurostat reported an uptick in Eurozone inflation, largely due to the rise in oil prices, developments in Italy and otherwise benign macro data point to a dovish ECB. Oil prices rallied for much of the month but receded after Russia and Saudi Arabia discussed relaxing production caps. West Texas Intermediate Crude Oil reached a high near USD72 but gave back some gains to close around USD68 a barrel. President Trump's withdrawal from the Iran nuclear accord and the reintroduction of sanctions were one source of the initial increase in oil prices. The White House also added to market angst by ramping up trade friction with China, Mexico, Canada, and our European allies.

Fund commentary

In May, the fund returned -0.47% and underperformed its benchmark, the Merrill Lynch US High Yield Master II – Total Return Index, by -0.45%[1].

From the broadest view both US and Global high yield (HY) returns were negative during the period. However, CCCs and lower once again outperformed higher rated categories and posted significant positive returns. According to JP Morgan, US HY bond issuance was much lower than usual and came in at USD16.5 billion with refinancing representing USD6.3 billion of the new volume. Only one company defaulted during the month. The default of USD375 million of Gibson Brands (the maker of famous guitars) brought JP Morgan's par-weighted HY bond default rate, including distressed exchanges, to 2.34%. The last twelve month (LTM) recovery rate for HY bonds was 46.5% which exceeds the 25 year historical average of 41.5%. Preliminary estimates indicate that US HY bond mutual funds and ETFs experienced outflows of USD843 million.

We believe that tighter spreads in the non-investment grade market require greater vigilance in security selection and in allocations to any higher beta sector, in general. Although the credit fundamentals of the non-investment grade market are broadly sound, we are concerned that low return on capital, an uptick in leverage, technological disruption, and rising idiosyncratic risk have led to an increase in uncompensated risk.

In general our longer spread duration posture hurt performance. This posture is intended to offset the reduction in beta associated with our avoidance of names vulnerable to disruption and idiosyncratic risk along with an underweight to the lower rated tiers of the US HY market, and the strong rally in the lowest quality cohorts of the market hurt relative performance during the period.

The US economic backdrop remains supportive, but competing forces from accommodative fiscal stimulus and tighter monetary conditions, coupled with a populist US trade agenda has ushered in a new era of uncertainty. Furthermore, geopolitical risks surrounding territorial disputes in the South China Sea, the abandonment of the Iran nuclear deal by the US, Russian intervention into political elections, and rapprochement between North Korean leader Kim Jong-Un and President Donald Trump provide further backdrop for caution.

As investors, we believe corporate fundamentals and central bank policies should be the dominant drivers of market sentiment over the near-term. Rising interest rates, helped by a hawkish Fed, have led to a flatter yield curve. This is very typical during the late stages of an economic cycle. While we do not foresee a recession on the immediate horizon, we are mindful of a few factors that usually lead to the peak of a cycle. First, historical data shows that the effective Fed Funds rate

1) Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 30.04.2018 – 31.05.2018. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 31.05.2018. Initial and exit charges could affect the value of the performance. **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 cannot be ensured.**

typically reaches its apex two quarters before a recession, on average. Second, the spread differential between the two-year and ten-year US Treasury rate will turn negative (an inverted curve) about four quarters prior to a recession. Lastly, the unemployment rate typically also reaches its floor about four quarters before a recession. It is important to keep in mind that historical correlations are not causations, and therefore we view them as additional observations, or data points that factor into our own macroeconomic discussions.

As we have observed throughout this economic expansion, there are always a variety of risks factors – some of which are transient in nature, and others that can lead to fundamental impairment. We acknowledge that investor compensation is still relatively limited today, and therefore chasing yield indiscriminately is not an appropriate strategy. Instead, we reaffirm our less aggressive targeted risk profile across portfolio styles. Downside protection remains paramount in an environment of elevated idiosyncratic risk and disruptive forces at play.