In Focus

Nordea ASSET MANAGEMENT

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January 2021

The Danish Covered Bond Market and the Danish Economy (2020 Review – 2021 Outlook)

Nordea 1 – Danish Covered Bond Fund

ISIN: LU0076315968 (BP-DKK) / LU0229519045 (BI-DKK)

- **Strong performance**, despite a **challenging move in rates and spread triggered by the pandemic**[1]
- The **Danish economy has proven its resilience**, facing global uncertainties
- Danish covered bonds' **unique features remain key to find returns in a safe investment**

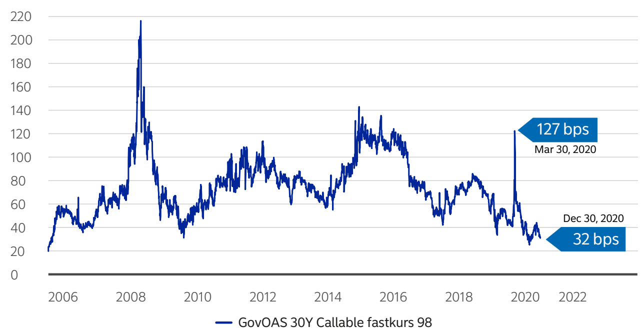
Denmark offers one of the oldest and largest covered bond markets, with a size of around EUR 419 billion[2]. Predominantly AAA-rated, these covered bonds have not experienced a single default in more than 200 years of history. At the core of the mortgage system, the Danish "Balance Principle" ensures the match between the borrowers' interest and capital payments, and the coupons and capital payments owed to the covered bond holders. With both non-callable bonds and callable bonds, this market is a field of opportunities for an active manager to harvest returns in one of the safest assets of the fixed income world.

2020 Review

While the coronavirus outbreak looked like an isolated Chinese problem at the end of 2019, the story drastically changed over the first quarter of 2020: the world entered a global pandemic. Until mid-February, the equity and credit markets seemed resilient. Nevertheless, the financial markets' positive trend was quickly reversed to sharp declines in risky assets' prices, sending yields on safe government bonds lower. While Danish government bond yields tracked their German equivalents in January and February, **yield spreads widened in March, primarily because the Danish central bank hiked its CD (deposit) rate by 15bp to -0.60%.** The Danish kroner had been weak versus the euro and, in March, the need for purchases to support the local currency had become so pronounced that the bank chose to narrow the spread to the Euro zone. Like credit assets, the Danish covered bond market was hit by significant spread widening, and some days market liquidity was sharply reduced. However, **as opposed to many corporate bonds, it was possible to trade Danish covered bonds**! - highlighting the strong liquidity of the asset class.

Over the first quarter, Danish covered bonds underperformed comparable-duration government bonds. This was especially the case of the callable bond market. As illustrated in the graph below, **Danish callable spreads peaked at 127bps in March**, with related drawdowns around 6%. However, this performance behaviour was expected, as **this market segment is particularly sensitive to interest rate volatility**. In comparison to a traditional bond, a callable bond price drops more from high upward moves in interest rates – on the long run, this unique risk is compensated by a higher yield on the bond. A sharp rise in interest rates, combined with up pressure on spreads, triggered therefore a challenging environment for the callable segment. Nevertheless, **the callable covered bonds benefited from a strong and timely recovery: the spread movement was indeed not linked to an increased default risk on those AAA bonds, but rather fuelled by market technical** that eventually normalized.

Danish Callable (OAS) Spreads over Danish Government curve



Source: Nordea Investment Management AB and Nordea Analytics, 31.12.2020.

1) **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, you could lose some or all of your invested money.** 2) Source: ECBC. Date: 31.12.2019.

*investing for their own account - according to MiFID definition

From the very high levels in March, spreads narrowed back - underpinned on top **by solid local and international investor demand along with low issuance from mortgage lenders**. Danish covered bonds yielded then significantly higher than Danish government bonds, regaining more than the ground lost to government bonds from the beginning of the year. Over 2020, callable covered bonds outperformed the government curve on similar duration. Long callable mortgage bonds with low coupons (0.5%–1%) delivered the best performance with an excess return of 2.5–3% versus comparable-duration government bonds[3]. They benefited from their long duration and higher spread risk, as both spread and duration had a positive performance impact over 2020. Once again, it has been crucial for investors to remain calm when short-term volatility hit the callable market: as shown many times over its history, this segment traditionally recovers the fastest.

As active investors, **we benefit from our ability to select issues and bond segments to harvest relative value opportunities**. This is a clear advantage in such volatile markets! Moreover, we combine this dynamic selection with our strong focus on risk management. For example, we keep the portfolio duration around 4–5 years, not to rely on a duration purely derived from the market. In this context, the Nordea 1 – Danish Covered Bond Fund delivered +1.54% on the BP-DKK share class, slightly outperforming net of fees to the general covered bond market (+1.50% as measured by the Iboxx EUR Covered Bond index in DKK terms) despite the unique challenges faced by the callable segment[4]. Positive effects from spread and carry were important drivers, contributing the most to the positive performance of the portfolio. **Being dynamic towards our allocation to callable mortgage bonds proved beneficial too:** in order not only to manage the volatility coming from this segment, but also to capture its strong returns.

A closer look at the Danish economy

Compared to many countries, Denmark was able to **weather the coronavirus pandemic and its economic consequences pretty well**. The relative resilience of the Danish economy can be first explained by the spread of the virus locally, as Denmark has kept it largely under control. On the other hand, the large pharmaceutical industry could still support exports, when global demand was tumbling. A drop of 4.5% in Danish GDP is estimated for the year, a clear consequence of the historical setback from the first half of 2020.

Since then, the economic **recovery has been largely driven by rising household consumption**. Benefiting from a relatively limited spread of the virus, local consumption has been sustained as well by a surprisingly strong housing market. In June, the Danish parliament voted in addition a recovery package: a welcomed boost to households' purchasing power, paving the way for a positive trend in consumption over the next years.

Despite the resilience of the pharmaceutical industry, **Danish exports were severely hit**: the total value of exports declined by appx. 7% in the first half of the year (compared to the same period one year earlier). Yet, recent data suggests that industrial companies are becoming more optimistic. This should bode well for a good rebound next year, especially if combined with a solid recovery of key export markets.

Denmark: Macroeconomic indicators

	2018	2019	2020E	2021E	2022E
Real GDP, % y/y	2.4	2.3	-4.5	3.0	2.5
Consumer prices, % y/y	0.8	0.8	0.6	0.9	1.2
Unemployment rate, %	3.8	3.7	5.1	4.9	4.1
Current acccount balance, % of GDP	7.0	7.8	8.3	7.0	6.6
General gov. budget balance, % of GDP	0.5	3.8	-4.5	-2.6	-0.4
General gov. gross debt, % of GDP	33.9	33.3	45.0	43.5	42.0
Monetary policy rate, desposit (end of period)	-0.65	-0.75	-0.60	-0.60	-0.60
USD/DKK (end of period)	6.53	6.66	6.33	5.92	5.74

Source: Nordea Markets, Nordea Bank Abp. As of September 2000. Monetary policy rate refers to the certificate of deposit rate.

Up until now, **the Danish housing market is coming out of this crisis in far better shape than expected**. Since mid-spring, the amount of houses sold has been higher than in previous years, contributing to boost prices. This positive trend has been supported by declining financing costs. In parallel, more and more homeowners have refinanced their mortgage into fixed-rate loans to take advantage of the decline in long-term yields. As of end of September 2020, expectations for the Danish economic activity to return to pre-crisis levels are set for mid-2022. Looking forward, **a major factor to consider is the evolution of the spread of the coronavirus**. This is indeed key for both local and global demand, as Denmark's export markets should not be ignored. Positive developments regarding vaccine's availability and distribution would have a substantial effect in lifting the economic activity. On the contrary, any further virus outbreaks, or additional restrictions, have the potential to delay the economic recovery.

2021 Outlook

Investors looking at safe allocation nowadays face the continuous challenge of low yields: absolute positive returns are not getting any easier to find. When some want to turn to lower credit quality investments, we remain true to our belief that portfolio risk should not be deteriorated for the sake of chasing short-term investment gains. **Danish covered bonds represent a sound, liquid investment with first-class creditworthiness.** The Danish economy offers the resilience to face global uncertainties and remains one of the safest economies in Europe.

As many safe assets, the Danish covered bond market is of course also challenged by lower yield levels. However, one cannot only look at this market with an absolute lens: **Danish covered bonds continue to offer attractive yields in comparison to**

3) Source: Nordea Investment Funds S.A. 4) Source: Nordea Investment Funds S.A. and Bloomberg. 30.12.2019-31.12.2020. **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, you could lose some or all of your invested money.**

their European counterparts and to government bonds. As shown in the following table, and considering the duration risk associated to those investments, Danish covered bonds offer a potential for higher returns, especially looking at the callable bond segment.

	12-Month Horizon Return(%)	Duration
DKK Covered Bonds (Callables)[5]	0.65	3.19
DKK Covered Bonds (Non-Callables)[6]	−0.32	2.02
EUR Covered Bonds[7]	−0.32	5.08
German Government Bonds[8]	−1.03	4.80

Source: Nordea Investment Management AB, 31.12.2020. The mentioned data are option-adjusted and estimates of Nordea Investment Management AB. They are based on assumptions and information currently available, on the basis of an external model. There can be no guarantee of the accuracy of this information, and there is also no assurance that the estimates will occur in the future. The development is merely indicative and is not an accurate prediction of future results. 5) Nordea DK Callable Mortgage Bond Index. Horizon return on callable bonds is more uncertain due to unknown future calls. 6) Nordea Non-callable CM3. 7) Iboxx EUR Covered Bond index. 8) DE 0% Oct. 2025.

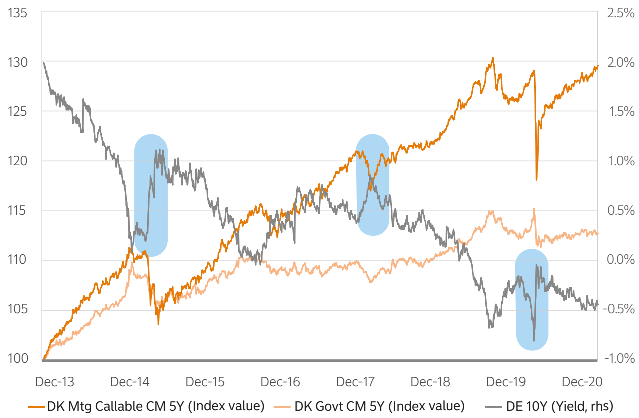
Danish government bonds continue to trade at a higher spread than comparable German government bonds, mainly due to a lack of Quantitative Easing in Denmark. This interest rate differential has already narrowed since March, and Nordea expects a further narrowing for 2021 – generally in favour of Danish bonds.

Regarding the callable bond market, investors traditionally get additional compensation for the convexity risk, which affects the asset class in environment of sharp interest rates moves. Today, **the pickup offered by the callable covered bond market is around 32bps**, as measured by the option adjusted spread on the 30y callable segment versus Danish government debt. In addition, the overall interest rate level would have to drop sharply before the current benchmark covered bond (i.e. 1% 2050/53) can be called and refinanced. This comforts the contribution from the present excess return of these bonds to the market's return. Finally, **the best scenario for callable bonds would be a stable yield development**, as we've experienced throughout 2017 and 2018. They are now many signs that the ECB will seek to keep the European yield curve stable, which is supportive for the asset class.

An active allocation to the Danish covered bond market, with a deep understanding and management of its complexities, is a compelling investment opportunity. By way of illustration, as of 31 December 2020, the expected return on the Nordea 1 – Danish Covered Bond Fund for the coming 12 months was 0.33%[9] before fees, based on unchanged interest rates and spreads, with an effective duration of 3.83. At year end, our portfolio has an appx. 70% allocation to the callable bond market.

On a more general note, **the convexity premium is a very interesting pick up to harvest (especially by stable yield development). Convexity risk - being quite unique - can be thought within a portfolio context, i.e. a diversification mindset**. Historically, and as we experienced in 2020, periods of underperformance of callable covered bonds have been short-lived. We've witnessed solid recovery features, as the convexity risk materializing is not related to worsened credit. Danish callable bonds display thus a strong track looking at the big picture!

Historical track of the Danish callable bond market
DKK Callable Bonds CM5 vs DK Government Bonds CM5 (5Y Duration; Total Return)



Source: Nordea Investment Management AB and Nordea Analytics. As of 31.12.2020

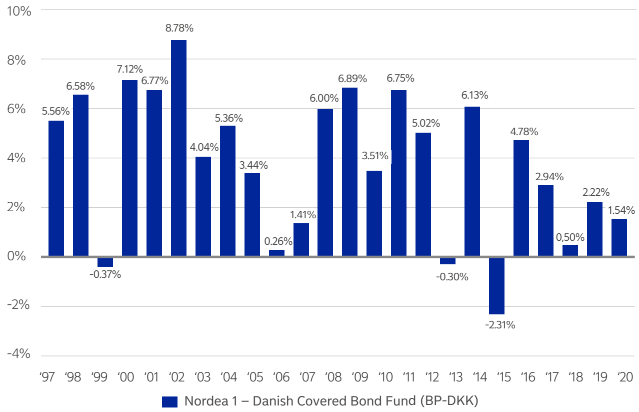
9) Source: Nordea Investment Management AB. As of 31.12.2020. **Estimated yield over the next twelve months, based on current model portfolio and market conditions, assuming no change in portfolio holdings and no movement in interest rates and spreads.** The presented figures are estimations of Nordea Investment Management AB and are based on assumptions and on information currently available. **No guarantee can be given for the accuracy of the data and these estimations might not be met in the future.**

Nordea 1 – Danish Covered Bond Fund

AAA covered bonds & the convexity premium for a yield pick up

With around EUR 45bn of AuM[9], the Danish Fixed Income & Euro Covered Bond Team offers the winning formula behind the fund: its investment philosophy. **It is based on in-house research expertise for selecting individual Danish covered bonds with adequate premiums and emphasizes active risk management** that focuses predominantly on tracking error and on identifying all sources of risk.

Active management and expertise are at the core of the incredible track of our Danish covered bond allocation: **an opportunity to improve one's portfolio quality, diversification… and therefore risk-return profile!**



Annualised Performance (BP-DKK) in %	
2020	1.54
Since launch	3.83
Base currency	DKK
Fund size in millions	EUR 1096
ISIN codes	LU0076315968 (BP-DKK) LU0255620204 (AP-DKK) LU0229519045 (BI-DKK) LU0476538607 (AI-DKK)
Annual Man. Fee	0.60 % (BP-DKK / AP-DKK) 0.30 % (BI-DKK / AI-DKK)
Launch date	21.02.97

Source Nordea Investment Funds S.A., Period under consideration: 1997 - 2020. **TThe 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, you could lose some or all of your invested money.**9) Source: Nordea Investment Management AB. As of 31.12.2020.