

January 2022

The Danish Covered Bond Market and the Danish Economy (2021 Review – 2022 Outlook)

Nordea 1 – Danish Covered Bond Fund

LU0173779223 (BP-EUR) / LU0772917414 (BI-EUR) / LU0076315968 (BP-DKK) / LU0229519045 (BI-DKK)

- **Rising yields triggered convexity risk that weighed on the callable covered bond performance**
- **High interest rate volatility provided for further headwind**
- **Net of recent market movements, Danish callable bonds trade close to significantly lower rated assets in spread terms providing for attractive valuations**

Denmark offers one of the oldest and largest covered bond markets, with a size of around EUR 438 billion¹. 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.

2021 Review

While inflation per se has dominated most of the market action in 2021, market participants were called to judge on a complex mix of factors this year, including the strong recovery putting strain on the economic tissue as supply struggled to trail demand, multiple Covid-19 waves across the globe, the potential reactions of central banks to current inflationary trends in term of tapering measures and more recently the surge of the new highly mutated Corona virus variant Omicron.

The year has also brought significant volatility in terms of rates oscillations, particularly in February and then after late summer despite a temporary range bound movement in most of the second quarter. Rising yields posed an overall challenge for the broad covered bond asset class, and even more so for the

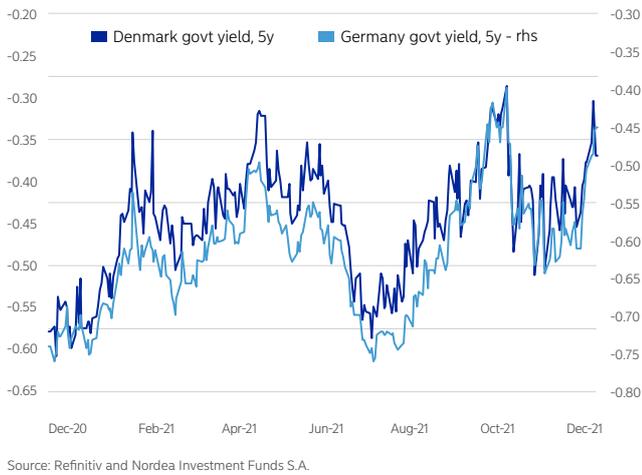
Danish callable segment as negative convexity further weighed on performance along with increasing rates volatility. In addition, also the spreads of callable covered bonds were under pressure as negative convexity implied an extension of duration to the highest level this segment has seen in over 6 years, triggering divestments from those investors that were seeking to rebalance the sensitivity of their portfolio to interest rates. To put things in perspective, the spread had more than doubled in the first half of the year alone. Interest rates seemed to stabilize around mid-year, however high inflation figures released for Europe in late summer spurred a second rising yield wave that resulted in the continuation of underperformance for Danish callable covered bonds, similarly to what happened in the previous part of the year.

It is important to stress that the above mentioned dynamic was not related to credit concerns on Danish fixed income in general. It was in fact only the callable segment taking a significant dip, whereas non-callable covered bonds and Danish government bonds posted a significantly smaller loss, highlighting the dominant role of the negative convexity feature to explain the underperformance. The underperformance of the callable segment was the largest since the Global Financial Crisis.

Rising rates were of course not only affecting Denmark: the economic condition all over the world has shown strong signs of recovery, and inflation expectations have risen towards levels that prompted the Fed reaction in the US for example. In Europe, the ECB has followed a similar path, yet a bit behind the curve and with softer communication strategy implemented throughout the year. In Denmark the local monetary policy remained focused on a somewhat tight peg to the EUR currency, with no quantitative easing program in place but two deposit rate cuts delivered throughout 2021 as the Scandinavian country was one of the best in Europe in terms of resilience to corona crisis. All in all, in 2021 Danish government bonds yield moved roughly in tandem with German Bunds, with both countries boasting AAA credit quality.

¹) Source: ECBC. Date: 31.12.2020.

Govt yield: Denmark vs Germany



In this context, the Nordea 1 – Danish Covered Bond Fund delivered -4.13% on the BP-EUR share class, as negative convexity impacted our allocation to Danish callable covered bond in the rising yield environment². The positive effects from carry were not enough to compensate for the losses due to price changes, bringing the portfolio into negative territory for the year.

A closer look at the Danish economy: 2022 outlook

The Danish economy went into 2021 with a strong stance relative to our countries that were more affected by the pandemic outbreak in 2020. As a reminder, Denmark marked a contraction close to 2.1% in 2020, which stands out compared to the 6% average for the rest of Europe. As of today, activity has reached and surpassed pre-Covid levels.

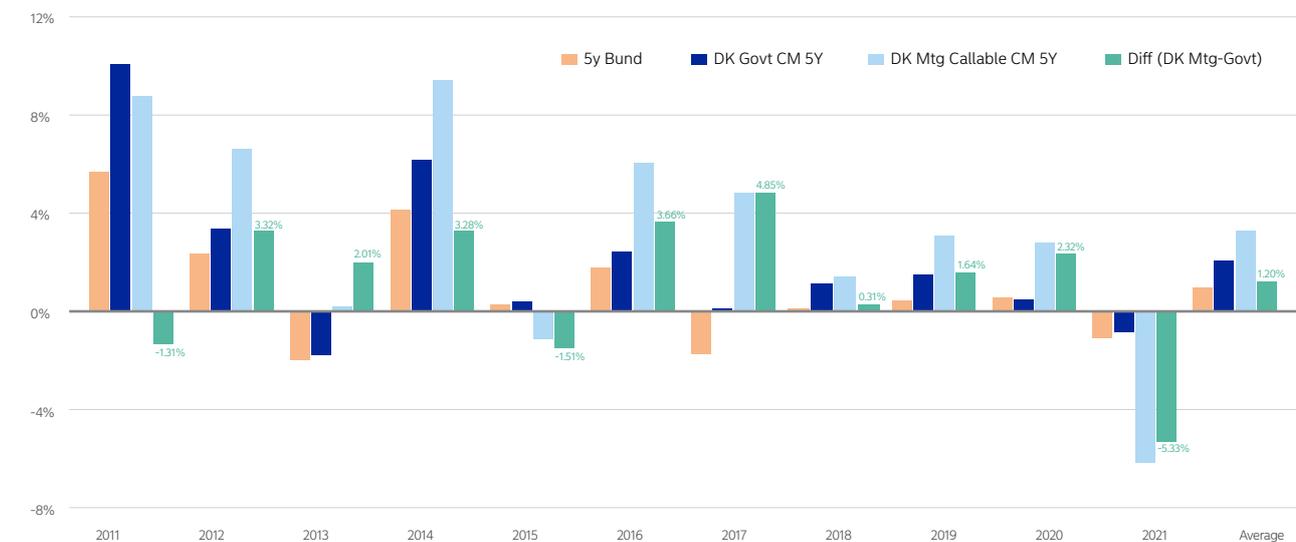
The local housing market recently registered one of the fastest increase in price, supported by an exceptionally low supply in conjunction with strong demand. This has overall contributed positively to household wealth. More recently, supply has picked up and the number of houses on sale has risen visibly, which suggests that a gradual cooling is ongoing in line with rising financing costs.

The Danish Central Bank might operate a rate cut in 2022 to avoid the DKK to strengthen even further against EUR, anchoring in this scenario the short term end of the curve. Longer end maturities will still oscillate freely, potentially rising similarly to what is observed in the rest of Europe as the old continent moves forward towards a post-pandemic recovery. In this sense the Danish economic tissue shall translate into a healthy real GDP growth with unemployment rates down to pre-pandemic levels, yet with inflation sitting at historically high readings, in contrast to the past many years.

When it comes to Danish covered bonds, especially the callable segment, the selloff was significant this year, and current valuations may appear attractive. It is particularly impressive to put the current pricing of Danish AAA rated mortgage bonds in a more international perspective: AAA rated Danish callable covered bonds trade close to significantly lower rated assets in spread terms.

As the Danish economy offers the resilience to face global uncertainties and remains one of the safest economies in Europe, the local covered bond market along with its peculiar negative convexity risk currently offers unparalleled yield for AAA credit quality. It is also important to highlight that if the general interest rate level continues to rise, then a special feature of Danish covered bonds can come into play - namely

Calendar year performance



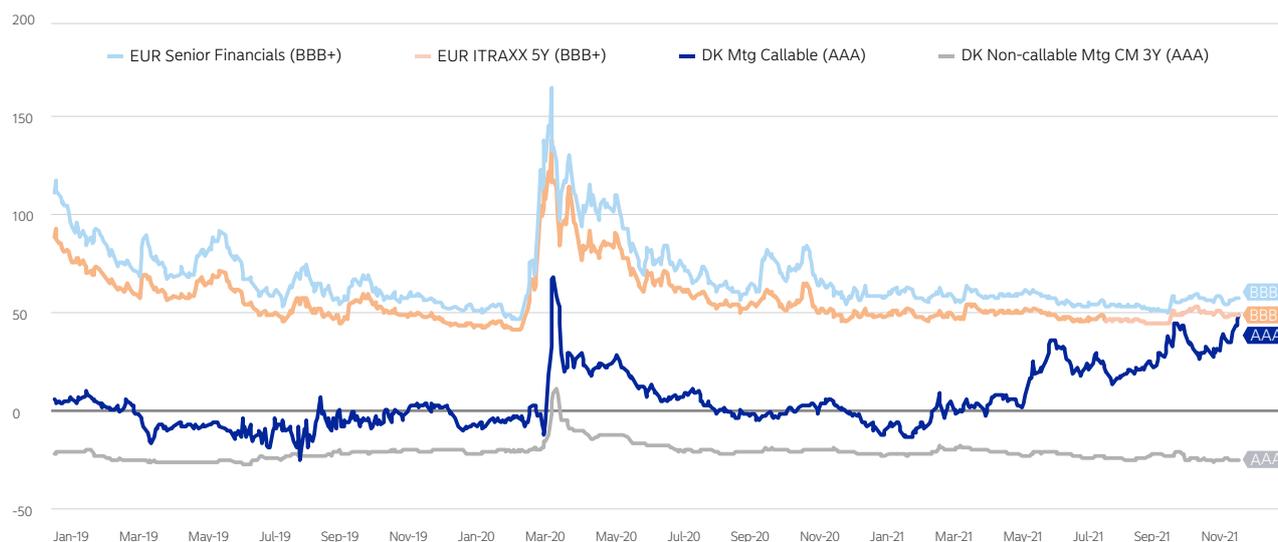
Source: Nordea Markets, Nordea Bank Abp, Nordea Investment Funds S.A. and Bloomberg. 30.12.2011 – 19.11.2021. The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of your investment can go up and down, and you could lose some or all of your invested money.

²⁾ 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.

the borrower's right to buy back the bonds that reflect their own loan in the capital market. Exercising this right means that these bonds are bought at market price by the mortgage lender. This enables the borrower to reduce their remaining debt (the price is lower than the initial loan at issuance) and to benefit on top from tax advantages on this operation. In order to finance the repurchase and the reduced residual debt, the

borrower must take out a loan with a higher coupon. If the activity of borrowers increases, the issuers will buy back the bonds that have fallen the most in price, i.e. the bonds with the highest modified duration. This implies that this move should also take some duration out of the overall market, along with providing a demand support to prices.

AAA rated Danish callables trade close to BBB rated funds



Source: Nordea Markets, Nordea Bank Abp, Nordea Investment Funds S.A. and Bloomberg. 30.12.2011 – 19.11.2021. 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.

Nordea 1 – Danish Covered Bond Fund

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

With around EUR 45bn of AuM², 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-EUR) in %	
2021	-4.13
Since launch	2.80
Base currency	DKK
Fund size in millions	EUR 1,110
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)
Reference Index	75% Nordea DK Govt CM 5Y and 25% Nordea DK Govt CM 3Y
Launch date	15.09.2003

Source Nordea Investment Funds S.A., Period under consideration: 2003 – 2021. 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: Nordea Investment Management AB. As of 31.12.2021.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 15.09.2003–31.12.2021. 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 31.12.2021. 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,** you could lose some or all of your invested money. If the currency of the respective share class differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations.

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