In Focus

For professional investors only*

January 2018

The Danish covered bond market and the Danish economy Review 2017 – Outlook 2018

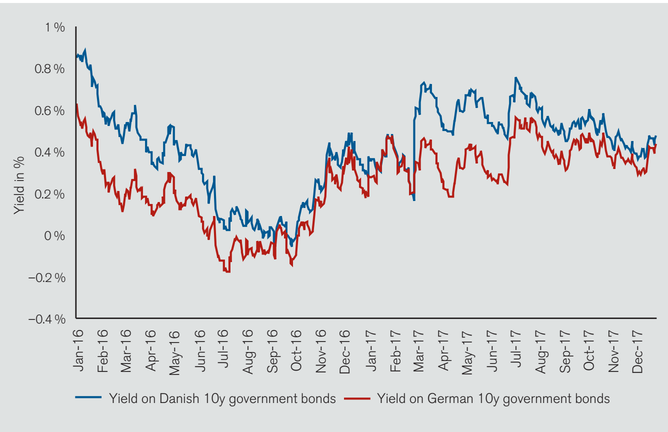
- Strong development of Danish covered bonds in 2017, particularly in the callable segment
- New regulation and initiatives strengthen investor protection and further improve the safety of Danish covered bonds
- The Danish economy continues to recover across all sectors, reinforcing its reputation as a safe haven
- Danish covered bonds continue to offer more attractive returns than their European counterparts and government bonds, which makes them a true alternative in the persisting low yield environment

2017 – Stable interest rates support the performance of callable Danish covered bonds

After a highly volatile 2016, Danish interest rates increasingly stabilized over the course of 2017 and remained range bound throughout almost the entire year. Danish 10-year rates traded in a robust range of 0.35% to 0.75% – as usual, slightly above but broadly in line with German 10-year rates, which traded between 0.2% and 0.55% throughout the year. After widening slightly to 0.3%, the yield differential returned to a consistent 0.10% by mid-year.

Chart 1:

Performance of German 10-year government bond yields (red) vs Danish 10-year government bonds yields (blue)



Source: Nordea Analytics, as at 31.12.2017.

Stable interest rates without significant fluctuations in either direction are particularly beneficial to the performance of callable Danish government bonds. If interest rates fall too much, leading to higher bond prices, an increasing number of borrowers exercise their right to call the bonds at par. If, on the other hand, interest rates climb, leading to falling bond prices, the duration of the bonds increases as the probability of calls declines. This effect is called negative convexity. Both scenarios are disadvantageous for investors in callable bonds since they face either refinancing risk (in the event of falling interest rates) or higher interest rate sensitivity (if interest rates go up). In an environment of stable interest rates, however, investors in callable covered bonds benefit from the additional return generated from the option premium. As we will see later, this fact made Danish callable bonds by far the most attractive segment in the Danish mortgage bond market.

New regulation spells greater investor protection

2017 saw the implementation of some new regulation as well as new initiatives designed to ensure the solvency of debtors and therefore increase investor protection. At present, debtors are only allowed to enter into short-term variable loan contracts to the extent that they would be able to take out a fixed-term 30 year loan at a minimum interest rate of 4% (or, if higher, the benchmark interest rate +1%).

These rules will be further tightened next year. Mortgage financing will become tougher for households whose leverage is equal to or exceeds four times their disposable annual income or who have a loan to value ratio in excess of 60%: they will neither be able to take out variable loans with a maturity of less than 5 years nor will they be allowed to take out loans with an initial interest-only period and no principal repayments if these loans have variable interest rates. These measures have been put in place to ensure a stable housing market while increasing protection against rising interest rates.

* investing for their own account – according to MiFID definition

New initiative for social housing loans

On 23rd November, the Danish government presented a new agreement with the country's mortgage institutions that regulates loan financing for social housing. Financing will come in the form of government-secured mortgage bonds issued by an independent "capital centre". This agreement applies to all government-sponsored social housing loans. The new bonds will be rated AAA and have a regulatory risk weighting of 0%, which puts them on the same level as government bonds from a safety perspective.

Of all government sponsored loans (which have a current total value of EUR 24 billion), only bonds totalling about EUR 14 billion, approximately 4% of the entire Danish mortgage bond market, will be affected by this agreement. The effects of this new initiative on the market should therefore be only moderate.

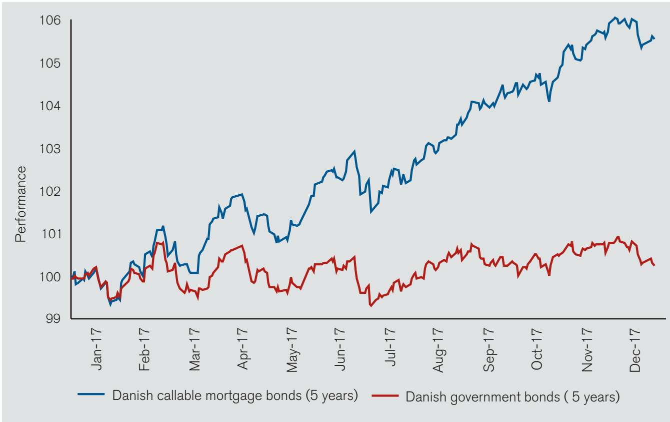
Strong development of Danish covered bonds – also thanks to foreign investors

In their search for yield in today's low interest rate environment and the negative or low yields of high quality government bonds, investors are inevitably drawn to Danish covered bonds with their outstanding credit qualities: over 95% carry the top AAA rating.

The fact that the Danish covered bond market also remains one of the most liquid bond markets globally is another reason why investors focus on this market. The Danish mortgage system is based on the so-called "balancing principle" that has been in existence since 1850 and ensures that interest and principal repayments of debtors are matched to at least 99% of the payments to the mortgage bond holders. This unique transparency is a key characteristic of the Danish mortgage bond market and is one of the reasons Denmark overtook Germany as Europe' biggest covered bond market in 2016. Particularly in times of crisis as, for instance, during the property crisis, the liquidity of individual segments of the Danish covered bond market even exceeded that of Danish government bonds.

These are some of the reasons the percentage of foreign investors reached a record high of around 30% in 2017. They invested predominantly in callable Danish mortgage bonds, helping to drive strong outperformance from this segment 2017. It outperformed government bonds with similar maturities by about 4.5% as the following chart illustrates.

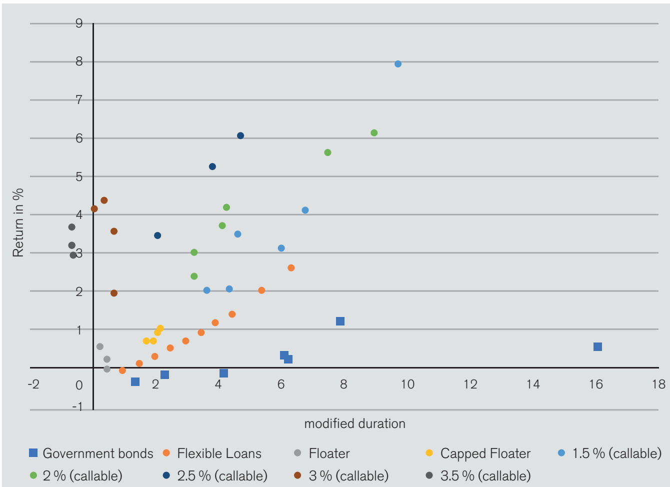
Chart 2:
Performance of callable Danish 5-year mortgage bonds (blue) vs. 5-year Danish government bonds (red)



Source: Nordea Analytics, as at 31.12.2017; Period under consideration: 01.01.2017 – 31.12.2017. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. There can be no warranty that an investment objective, targeted returns and results of an investment structure is achieved. Comparison with other financial products or benchmarks is only meant for indicative purposes.**

Over the course of the year, all segments of the Danish mortgage bond market significantly outperformed Danish government bonds with comparable durations. This is especially true for the callable segment given the growing interest of foreign investors combined with the above-mentioned stable interest rate environment. Within this segment, callable bonds with low coupons outperformed their high-coupon counterparts in response to the above-mentioned initiative for social housing loans. Overall, the excess yield of Danish callable bonds versus Danish government bonds of comparable duration peaked at 6% and on average has been around 4% as illustrated in the chart below.

Chart 3:
Return of Danish government bonds (blue squares) versus returns of the individual segments of the Danish mortgage bond market across various maturities in 2017



Source: Nordea Investment Management, Analytics. As at 31.12.2017. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested.**

Development of the Danish economy

The Danish economy not only continued its upwards trend in 2017, it also demonstrated for the first time in 10 years that it has fully recovered from the last crisis. Employment is on the rise, consumption is growing consistently, companies benefit from the global economic recovery, and property prices are trending upwards, not just in Copenhagen but also increasingly in rural areas. We therefore currently expect GDP growth for 2017 to come in at 2.2 % – the highest level since 2006. Growth also is expected to continue in the years ahead, although higher interest rates and labour shortage may have some impact.

Consumers in buying frenzy

The continued increase in consumption is without doubt the main driver of the recovery. We expect private consumption spending to grow by 2.5 % in 2017 – the biggest increase in more than ten years. This "buying frenzy" seems even more important as households are also reducing their debt-to-income ratio, which means that this increase in consumption, far from being a nine day's wonder, could actually evolve into a sustainable trend.

Companies take the cue

In the first half of 2017, manufacturing companies – particularly in the drug, metals and food sectors – reported record production levels. Confidence indicators suggest that this trend will continue in the years ahead particularly since investment volumes and the demand for company borrowing are on the increase.

Exports benefit from global growth

Danish exports have likely risen by approximately 4% in 2017 on the back of global growth, making last year the best for exporters since 2011 and the export sector a major contributor to Denmark's GDP even though imports also edged higher.

Unsurprisingly, this has immediate positive effects on the current account surplus, which looks likely to reach a record of approximately 9 % of GDP in 2017. The year ahead should therefore be uneventful for the Danish kroner which, though currently trading rather strong compared to the USD, does not require weakening thanks to these record numbers. As a result, interest rates will remain low in Denmark in order to keep the currency within its trading range to the EUR.

Labour market a spoilsport?

Of course, improved economic conditions also lead to an increasingly frantic search for qualified labour in the corporate sector. While the number of foreign employees has grown consistently since the beginning of the recovery to now 8 % of the working population, the number of companies suffering from staff shortage has now risen to its highest level in 10 years.

Property prices continue to rise

As borrowing rates have reached historic lows and discretionary household incomes increase, more and more families have entered the property market, pushing prices of single-family houses up by about 4 % on average while prices for condominiums grew by about 10 %. In contrast to previous years, this trend towards higher prices has now moved beyond large cities such as Copenhagen to more rural areas. In fact, prices rose most in Bornholm and Zeeland.

Could this trend grow into a full-blown property bubble? We do not think so because many metrics show a different picture. For one, property prices are still moderate compared to the other Nordic countries. As noted, the property boom is mainly a consequence of the low interest rates in our opinion. The overall burden households have to shoulder for purchasing property, which amounted to 50 % of income and more in 2007/2008, has fallen to 25 % of income over the last year. The reduced household burden of property purchase is illustrated by the fact that late payments on existing mortgage loans have been falling consistently to a multi-year low of 0.20 %. Needless to say, higher property prices also result in lower loan to value ratios, creating an additional safety buffer in the unlikely event of a market correction. We believe that the development of property prices is in line with a more optimistic economic outlook.

Overall, nothing seems likely to stop a sustainable, multi-year growth in Denmark. We cannot identify any domestic headwinds: threats to this optimistic scenario would be slower global growth or unpredictable political or economic risks.

Outlook 2018: A strong alternative in the low interest rate environment

Investors find it increasingly hard to generate positive returns in the fixed income space without compromising on credit quality, particularly in today's low interest rate environment. Last year's interest by foreign investors indicates that evermore players are zeroing in on Danish mortgage bonds, a thoroughly solid, liquid asset class with outstanding credit quality. This momentum is further supported by the excellent economic outlook, stability and characteristics of the Danish mortgage bond market and the increasing investor protection from stricter borrower requirements. In addition, Danish mortgage bonds continue to offer attractive returns compared to their European counterparts and government bonds.

The expected return of the Nordea 1 – Danish Mortgage Bond Fund for the next 12 months, for instance, amounts to 1.44 %[1] gross of fees as at 31 December 2017 based on stable interest rates and spread levels.

1) Source: Nordea Investment Management AB, Nordea Analytics, 31.12.2017. The data shown are option adjusted and as estimated by Nordea Investment Management AB. They are based on assumptions and information obtained from a third-party model at the time of writing. No guarantee can be given as to the accuracy of this information nor can there be any guarantee that the estimates will materialise in the future. The performance represented is indicative only and not a reliable prediction of future events. As at: 31.12.2017. **There can be no guarantee that targets, targeted returns or the returns of an investment structure will be achieved.**

At the same time, risks are minimal. The Danish mortgage bond market is far from overheating and develops in line with improving economic conditions.

It also seems excessive to consider the heightened interest of foreign investors in Danish mortgage bonds a risk. True, selling foreign holdings is almost a knee-jerk reaction in a crisis and a massive sell-off would certainly put Danish mortgage bonds under price pressure but the Danish mortgage bond market is still dominated by domestic investors.

One of the biggest risks for Danish mortgage bonds would come from a large rise in interest rates over a short period of time. The instruments' negative convexity means that investors in callable Danish mortgage bonds would lose significantly more money than investors in government bonds or non-callable mortgage bonds in this event. However the ECB's policy appears predictable at the moment and major hikes are very unlikely during the remainder of Mario Draghi's term (until 2019), which makes this risk modest as well.

The greatest risk for investors resides arguably in the current spread levels of callable bonds since the heightened interest and the very strong performance of callable bonds it triggered led to massive spread tightening in 2017 as is illustrated in the chart below:

Chart 4:
Development of spread levels of callable Danish mortgage bonds

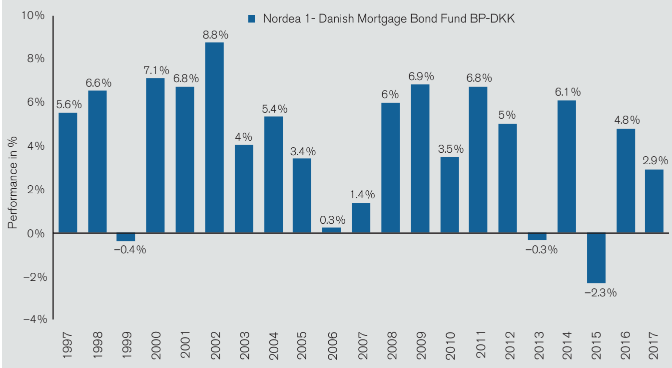
Source: Nordea Analytics, as at 31.12.2017.

The chart shows that the current spread level is slightly below its long-term average, however it is still significantly above the lows of the last decade. As such, the asset class compares well to many high yield markets where spreads reached multi-year lows in 2017, since the market for callable Danish mortgage bonds could still absorb some additional spread tightening. Spread widening risks seem small.

Still, the performance in 2017 particularly in the callable segment has shown that bonds with low and high coupons can yield rather different results. And despite the current high focus on the callable segment, investors should also carefully analyse the advantages of non-callable bonds and short-term floaters. Expertise and flexible asset allocation will become a key success factor in 2018.

Nordea Asset Management, the leading manager of fixed income investing in the Nordic region, has a highly experienced and multiple award winning line-up in its Danish Fixed Income & Euro Covered Bond team, which has particular expertise in the Danish mortgage bond market. The Nordea 1 – Danish Mortgage Bond Fund, which has been in existence since 1997, offers investors the opportunity to participate in the performance of Danish mortgage bonds. The fund seeks to protect investor capital and to consistently outperform the average interest rate level in Denmark.

Performance per calendar year since inception:



Source: Nordea Investment Funds S.A. Period under consideration: 15.02.1997 – 31.12.2017. 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 31.12.2017. 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.** 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.

Nordea 1 – Danish Mortgage Bond Fund	
Fund manager	Danish Fixed Income & Euro Covered Bond Team
Fund domicile	Luxembourg
ISIN-codes	LU0076315968 (BP-DKK)/LU0229519045 (BI-DKK) LU0255620204 (AP-DKK)/LU0476538607 (AI-DKK)
Annual management fees	0.60 % (BP-DKK / AP-DKK) 0.30 % (BI-DKK / AI-DKK)
Base currency	DKK
Fund size in millions	5,764.06
Number of positions	90
Launch dates	21.02.1997 (BP-DKK) / 02.11.2005 (BI-DKK) 01.07.2006 (AP-DKK) / 14.01.2010 (AI-DKK)

Source: Nordea Investment Funds S.A., as at 31.12.2017.

The big picture – the European covered bond market

- Strong development of European covered bonds in 2017 on the back of the ECB's purchasing programme
- Attractive return potential in the current low yield environment
- Diversification offers a new solution to a turn-around in interest rates

Review of 2017

After a broad-based widening of European covered bond spreads towards the end of 2016, many investors took advantage of these attractive levels to increase their exposure at the beginning of 2017. Combined with the ECB's buying programme, this resulted in stronger demand for European covered bonds. The supply side is also to some degree influenced by the ECB at the moment because the central bank continues to engage in targeted longer-term refinancing operations, which enables banks to refinance themselves at low costs via the ECB rather than having to issue bonds in the market. In summary, demand exceeded supply the past year, which meant that 2017 was a strong year for European covered bonds. The Iboxx EUR Covered Bond index, for instance, increased by 0.59 % over the course of the year.

Any attempt to explain this fact exclusively via the supply/demand dynamics would, however, overlook the attractiveness of this asset class. Particularly in today's low interest rate environment, investors increasingly recognise that the European covered bond market continues to offer positive returns beyond those achievable with government bonds – while not necessitating them to compromise on their risk profiles.

This supportive market environment has not gone unnoticed by previous participants in the covered bond market in 2017: after years of abstinence, Greece and Portugal again issued covered bonds.

Outlook 2018 – still attractive in relative terms

Needless to say, the attractiveness of the covered bond market is not without drawbacks. One is spread tightening on the back of heightened investor interest. However, a comparison with senior corporate bonds reveals that both instruments trade at fairly similar spread levels in many countries (taking Australia as a recent example).

The lack of distinction between the spread of mortgage bonds and senior corporate bonds indicates that investors see little difference between the risk levels of the two bonds. The additional safety provided by the covered bonds' cover pool, which represents a second collateral level, is completely "overlooked". From this relative point of view therefore, covered bonds still look very attractive.

In addition, supply and demand will remain an important factor for the development of European mortgage bonds in 2018, as they have been in the past.

On the supply side, banks will likely resort to corporate bonds as their preferred refinancing instrument due to their low spread levels. This and regulatory requirements for banks will likely lead to more subdued issuance in the European mortgage bond market which we anticipate to come in at approximately EUR 115 billion. This roughly corresponds to the value of bonds maturing this year.

Demand will remain dominated by the ECB's repurchase program under which the central bank will only buy EUR 30 billion per month from January instead of the current EUR 60 billion. Recently many investors were worried about the tapering of the buying programme. However this reduction will not directly affect the European covered bond market since the ECB has already cut back its repurchase volume in this market from the original EUR 12 billion per month to now only EUR 3-4 billion per month. This sum corresponds in large parts to the ECB's refinancing needs from maturing instruments. The ECB will remain a predictable player as long as it continues to roll over maturing securities and keeps the overall volume on its books constant.

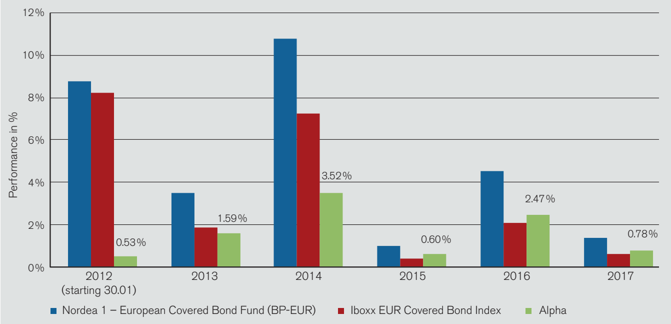
Overall, we expect a slight demand overhang that should support the development of European mortgage bonds.

The Nordea 1 – European Covered Bond Fund in the context of the market

In short: nothing has changed for the Nordea 1 – European Covered Bond Fund. In 2017, the portfolio management team again succeeded in significantly outperforming the Iboxx Eur Covered Bond index (in the BP-EUR share class)[2]. The team has generated strong alpha each year since the inception of the fund six years ago - a fact that becomes increasingly important particularly in today's low interest rate environment and proves that active management is of crucial importance in this market. Expertise makes all the difference!

2) Source: Nordea Investment Funds S.A. Period under consideration: 01.01.2017 – 31.12.2017. 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 31.12.2017. 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.** 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.

Performance per calendar year since inception:



Source: Nordea Investment Funds S.A. Period under consideration: 30.01.2012 – 31.12.2017. 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 31.12.2017. 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.** 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.

Nordea 1 - European Covered Bond Fund	
Fund manager	Danish Fixed Income & Euro Covered Bond Team
Fund domicile	Luxembourg
ISIN-codes	LU0076315455 (BP-EUR) / LU0539144625 (BI-EUR) LU0733666746 (AP-EUR) / LU0733665771 (AI-EUR)
Annual management fees	0.60 % (BP-EUR / AP-EUR) 0.30 % (BI-EUR / AI-EUR)
Base currency	EUR
Fund size in millions	886.68
Number of positions	77

Source: Nordea Investment Funds S.A., as at 31.12.2017.

A new fund to prepare for the upcoming interest rate trend reversal

We have developed a new fund, launched in October 2017, for investors who fear that interest rates will trend upwards and would like to reduce the duration risk in their portfolio in response. This new addition to our fund range, the **Nordea 1 – Low Duration European Covered Bond Fund,** combines the attractive alpha opportunities of our existing investment solution with significantly lower interest rate risk.

Clients investing in this innovative investment solution benefit from:

- **An asset class that meets highest safety standards**

  > No defaults for more than 200 years; dual safety and preferred treatment under EU regulation

- **A dedicated and experienced investment team**

  > Responsible for EUR 39 billion in assets under management (as at 30/09/2017) and with more than 18 years of experience, on average, in the covered bond segment

- **A strong alpha generation track record**

  > Excellent track record proves that the team can generate alpha consistently without increasing portfolio risk

- **Only limited interest-rate risk**

  > Duration is lowered to about one year

Since its inception several months ago, the Nordea 1 – Low Duration European Covered Bond Fund has already raised **EUR 246 million in investor money** (as at: 31/12/2017). This reflects the **need of investors for alternatives in low-risk asset classes:**

Please do not hesitate to contact us and learn more about this interesting solution.

Nordea 1 - Low Duration European Covered Bond Fund	
Fund manager	Danish Fixed Income & European Covered Bond Team
Fund domicile	Luxembourg
ISIN-codes	LU1694212348 (BP-EUR) LU1694214633 (BI-EUR)
Annual management fees	0.50 % (BP-EUR) 0.25 % (BI-EUR)
Base currency	EUR
Fund size in millions	246

Source: Nordea Investment Funds S.A., as at 31.12.2017.