In Focus

For professional investors only*

January 2019

The big picture – the European covered bond market

Nordea 1 – European Covered Bond Fund

ISIN: LU0539144625 (BI-EUR), LU0076315455 (BP-EUR)
LU0733666746 (AP-EUR), LU0733665771 (AI-EUR)

Nordea 1 – Low Duration European Covered Bond Fund

ISIN: LU1694214633 (BI-EUR), LU1694212348 (BP-EUR),
LU1694213072 (AP-EUR), LU1857276965 (AI-EUR)

- 2018: the most difficult year for European covered bonds since 2011
- Supply as the driving factor for 2019
- Will the ECB's withdrawal be a problem? Not for European covered bonds
- Core European covered bonds at an attractive level

2018 market review

It was a very difficult and volatile year for European bonds across the ratings spectrum, and the vast majority generated negative returns over the year. In absolute terms, European covered bonds were not completely immune from this trend and interest spreads for the iBoxx EUR Covered Bond Index widened by around 25 basis points in 2018. This degree of widening has not been seen in the European covered bond market since 2011. However, as interest rates also fell in conjunction with widening spreads, the iBoxx EUR Covered Bond Index generated a positive return of 0.24% for 2018, which is an impressive figure in relation to other European bond alternatives. Investors are increasingly acknowledging the advantages of this asset class with characteristics that are of increasing importance in a volatile, late-cycle market; these include double collateralisation, strong regulation governing the collateral pools and preferential treatment versus other asset classes under the European bank recovery and resolution directive.

2019 outlook – supply and the ECB a spoilsport?

In our opinion, supply and demand will play a significant role in 2019 for the future development of spreads for European covered bonds. While around EUR 103 billion of existing issues are due for redemption in the current year, analysts currently expect new issues of EUR 130 – 150 billion. The main reason for this is that banks could bring forward their refinancing requirements to take advantage of persistent low interest rates in Europe. Accordingly, greater supply than demand would again lead to slightly increased pressure on spreads.

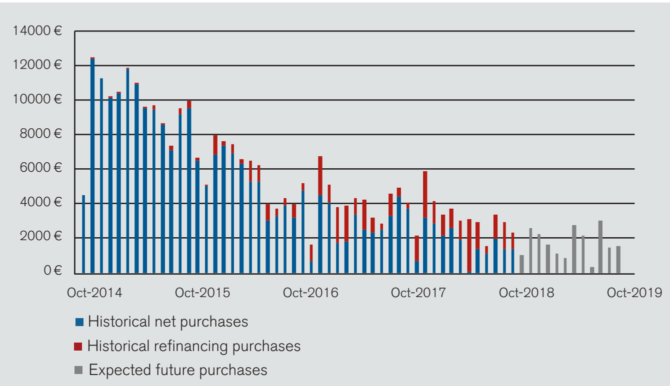
However, there are still many other factors that we believe are not fully included in the supply side of the equation. The ECB continues to offer attractive conditions for the banks' long-term refinancing requirements, and many peripheral banks with existing refinancing that expires in 2020 will need to act in 2019. Should the ECB's conditions remain attractive, then of course pressure on issuers to seek out other refinancing vehicles such as covered bonds will fall.

Of course, the end of the ECB's repurchase programme was the main topic in 2018. Yet investors in the European covered bond market should not panic on the back of this announcement, as there are two reasons why the development of spreads will not be overly dependent on this ECB decision. On the one hand, the ECB has also announced that it will reinvest the funds from maturing bonds, and the consensus currently assumes that reinvestment will be in the same asset class as the maturing instruments. In 2019, somewhere in excess of EUR 20 billion of European covered bonds held by the ECB will mature, so the ECB will remain a participant in the European covered bond market.

* investing for their own account – according to MiFID definition

On the other hand, the graph below shows very clearly that from the start of the asset purchase programme in October 2014, the ECB has already taken a massive step back from the market since mid-2016, reducing purchases by around 75%. This happened without any real fuss in the market; spreads did not widen, but rather narrowed initially – a good indication that this is a very liquid, healthy market, and that the ECB is a valued market participant, but not an essential one. In tandem with the ECB withdrawal, there was increased interest from other institutional investors for European covered bonds, which more than compensated for the gap left by the ECB.

Graph 1:
The ECB's purchase programme for European covered bonds and estimated future developments



Source: ECB. Date: December 2018.

In our opinion, this interest will increase further in 2019, as core European covered bonds are currently trading at historically attractive levels versus their government bond counterparts.

Nordea 1 – European Covered Bond Fund versus the market

As already mentioned, 2018 certainly marked a turn in the trend for investing in the European bond market.

Many investors have resigned themselves to the fact that attractive returns cannot be generated with European bonds in the current low interest rate environment. Provided this is accompanied by low volatility in markets, it is annoying, but tolerable for many. Yet 2018 has shown that taking such a relaxed approach and holding onto European bonds in the portfolio can itself become a problem; specifically if market volatility rises. Over the course of the year, European bonds were confronted with the two main risks associated with this asset class: duration risk (at the beginning of the year) and credit risk (since May 2018).

Investors were helpless in the face of this dilemma, seeing no escape. And indeed, all European bond categories across all risk profiles suffered from at least one of these two phenomena. For example, German government bonds (as measured by the REXP) lost around 1.3% in value during the period of rising interest rates, recovering during the credit crisis as they acted as a safe haven. In contrast, European corporate bonds trended sideways for a long time, eventually falling sharply from the time of the Italian crisis in May. The majority of investors' bond portfolios using these asset classes for diversification were in negative territory in 2018.

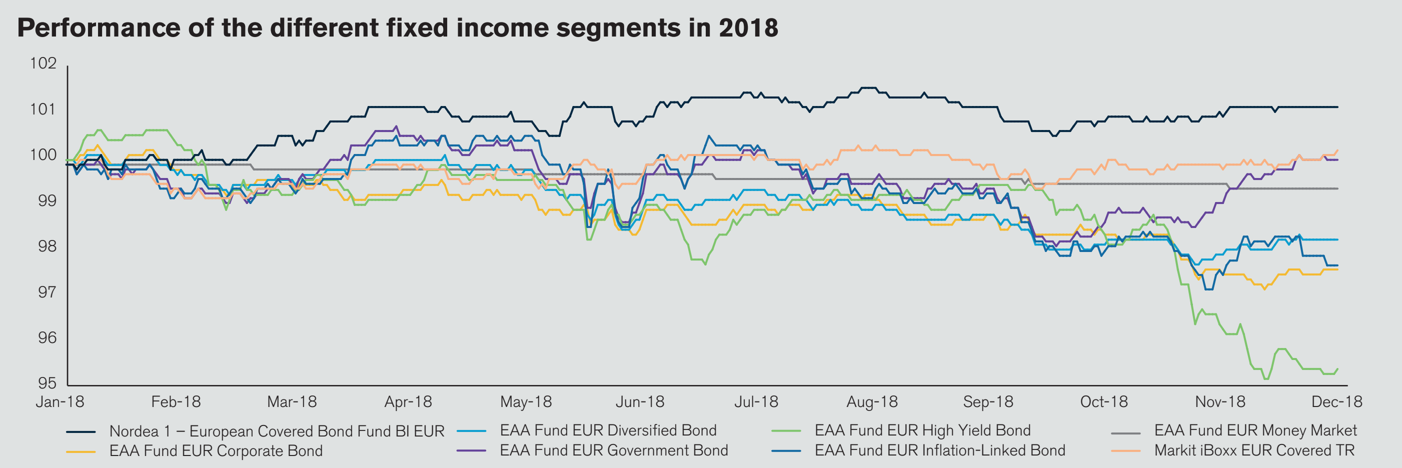
As described above, European covered bonds posted a positive return for 2018, offering an initial solution to this dilemma. Yet this alone is often not enough in a late-cycle market characterised by volatility. Precisely during these difficult periods, it makes sense to combine the security and resilience of the asset class with the experience of an investment team specialised in active management, which has delivered proven alpha generation in recent years without increased risk levels versus the broad market for European covered bonds.

The graph below illustrates these arguments and highlights the resilience of Nordea 1 – European Covered Bond Fund during the year. A comparison of the fund's performance since the beginning of the year with that of its Morningstar peer groups shows that it was the only fund in a position to:

a) minimise losses – and even generate alpha – during the period of rising interest rates in January and February, and

b) show positive performance during the Italian credit crisis in contrast with the market, and to subsequently maintain this accumulated performance.

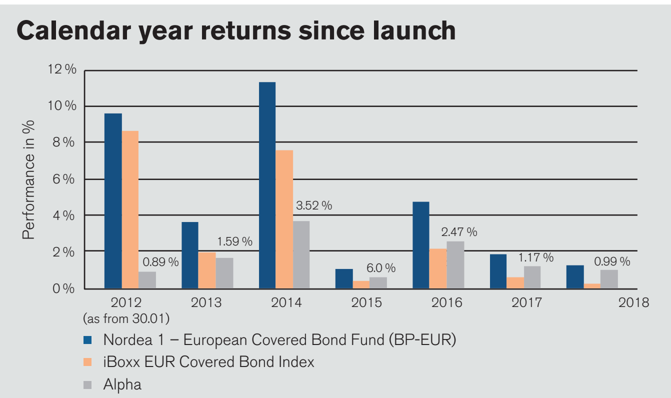
Graph 2:
Nordea 1 – European Covered Bond Fund versus the various Morningstar categories



Source: © 2019 Morningstar, Inc. All Rights Reserved as of 04.01.2019. European Open End Funds database. Period under consideration: 31.12.2017 – 31.12.2018. 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 31.12.2018. 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.** 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. **Comparison with other financial products or benchmarks is only meant for indicative purposes.**

Investors should not fall into the trap of believing that this performance could be achieved with a passive investment approach. The European covered bond market is a very safe and liquid market, but also a very inefficient one. It therefore requires a highly experienced portfolio manager to generate attractive absolute and relative returns. The following graph shows that this has been possible year after year, over both the short and long term, since the fund's launch:

Graph 3:
Annual performance of Nordea 1 – European Covered Bond Fund versus its benchmark (iBoxx EUR Covered Bond Index)



Source: Nordea Investment Funds S.A. Period under consideration: 30.01.2012 – 31.12.2018. 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 31.12.2018. 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.** 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	LU0539144625 (BI-EUR) / LU0076315455 (BP-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	2,317
No. of holdings	130

Source: Nordea Investment Funds S.A., Date: 31.12.2017.

Nordea 1 – Low Duration European Covered Bond Fund – in the shade of its brother, yet still strong

For all investors fearing a turnaround in interest rates and in light of this, with overly high duration in the portfolio, we developed and launched a new fund in October 2017, which combines the attractive alpha potential of our existing investment solution with significantly lower interest risk: the **Nordea 1 – Low Duration European Covered Bond Fund.**

Since its launch just over a year ago, the Nordea 1 – Low Duration European Covered Bond Fund has already seen **fund inflows of EUR 1,416 million** (as at 31 December 2018). This reflects **investors' demand for promising investment alternatives to low-risk asset classes.**

Especially at the beginning of 2018 when interest rates rose sharply over an extremely short period of time, this fund (that was developed precisely for such a climate) proved its strength. While solutions with a longer duration such as German government bonds or even European covered bonds (measured by the iBoxx EUR Covered Bond Index) lost value over this period, the Nordea 1 – Low Duration European Covered Bond Fund not only managed to limit losses from rising interest rates, but also generated attractive alpha.

During the remainder of the year, the downside to this low duration was evident in the fund. While the fund has the same credit sensitivity as the Nordea 1 – European Covered Bond Fund and accordingly suffered from widening interest spreads, it was unable to fully benefit from the concurrent fall in interest rates, so that it constantly lost value from its February high to close the year –0.09 % (for the BI-EUR unit class). However, in comparison to other low duration investment solutions or the money market, which the graph above indicates was down around –0.50 %, this performance was very successful in relative terms.

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	1,416
No. of holdings	113
Launch date	24.10.2017

Source: Nordea Investment Funds S.A., Date: 31.12.2018.

Expansion of the range: the European Covered Bond Opportunities strategy

Building on the success of our two existing products, at the end of January we will expand the range for our investors with the European Covered Bond Opportunities strategy. Like the Nordea 1 – Low Duration European Covered Bond Fund, this strategy has low interest rate sensitivity, however in contrast, it leverages the risk twofold so that investors can expect around double the return from this strategy (0.8 – 1.6 % over 12 months before fees)[1]. Leveraging the credit sensitivity also means leveraging the expertise of the team and the historically strong alpha generation from its unique selection of bonds.

We look forward to presenting you further details on the advantages of this investment solution in a meeting.

1) **There can be no warranty that an investment objective, targeted returns and results of an investment structure is achieved.**