In Focus

Nordea
ASSET MANAGEMENT

January 2022

European Covered Bonds (2021 Review – 2022 Outlook)

Nordea 1 – European Covered Bond Fund
ISIN: LU0076315455 (BP-EUR) / LU0539144625 (BI-EUR)

Nordea 1 – Low Duration European Covered Bond Fund
ISIN: LU1694212348 (BP-EUR) / LU1694214633 (BI-EUR)

Nordea 1 – European Covered Bond Opportunities Fund
ISIN: LU1915690595 (BP-EUR) / LU1915690835 (BI-EUR)

- **Rising yields provided for a challenging backdrop for covered bonds in 2021**
- **ECB is still the driver of the market, and will be for the foreseeable future**
- **Covered bond supply in 2022 will increase, but still remain net negative, likely supporting valuations**

2021 market review

The first months of 2021 started off with a very low supply volumes for the covered bond market. In the first quarter of the year for example, only EUR 22bn worth of deals were printed, which was less than half compared to the same period in 2020, to put things in perspective. Primary market had small and temporary peaks in activity during the second quarter of the year and then later in September, but overall supply for the year ended up vastly below the last many years' average. As a matter of fact, attractive TLTROs and booming deposits have removed most of banks funding needs.

This low level of primary deals has meant that covered bond investors were facing a large negative net supply, even before adding ECB demand into the equation. The scarcity of covered bonds has indeed impacted spreads throughout 2021. The iBoxx EUR covered bond index have been tightening ever since the Covid-19 outbreak and the spread has reached its lowest level since early-2018. Contrary to the EUR covered bonds, we have seen instead a high supply in Denmark, bringing valuations to attractive relative levels for a AAA covered bond market in our opinion.

The year has also been significantly volatile 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 covered bond asset class, which is characterized by a duration of approximately 5 years. 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. In Europe, the ECB has followed a similar path, yet a bit behind the curve and with softer communication strategy implemented throughout the year.

A part from inflation per se that has dominated most of the market action in the second half of the year, market participants were called to judge on a complex mix of factors in 2021, 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. While the sentiment has held up well for most of the year with a strong risk-on tilt, it has started to turn more risk-off towards the end of the year, with a clear rotation of flows from peripheral to continental Europe in search for higher quality assets.

Eventually, we have also witnessed in 2021 a stronger and earlier than expected year end dynamic, a seasonal effect that tends to favour high quality sovereign bond and weigh on other asset classes, including covered bonds. The contribution that banks owe to the European Resolution Fund depends on the size of their balance sheet, so they typically operate towards the end of the year a shrinking exercise whereby sovereign bonds are winners as they boast the lowest risk weight. The combination of this dynamic, the risk-off sentiment spurred by Omicron and the extraordinary market operation of the Swiss National Bank that has expanded its balance sheet buying large amounts of German bunds in the attempt to limit the appreciation of the CHF vs the EUR have created a strong environment from government bonds, especially from Germany and France, that ended up trading at significantly expensive levels vs covered bonds in historical terms.

Portfolio developments in 2021

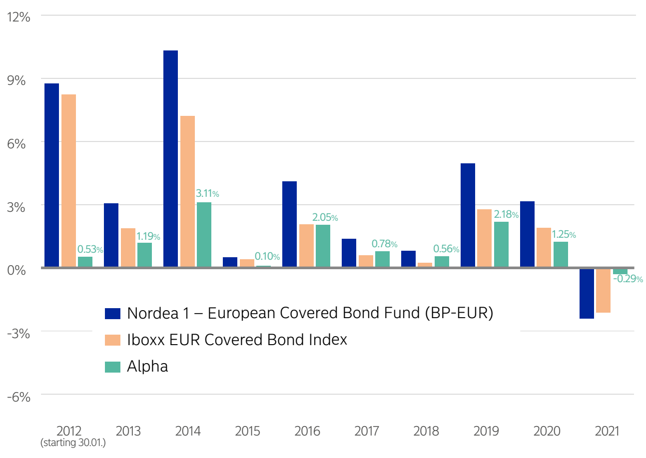
Portfolio developments can be divided into two distinct periods for 2021. Alpha has been strongly positive up until late October, before reversing and vanishing in a challenging year end.

Especially in the first part of the year, our peripheral European exposure added significantly to relative performance. Among top contributors, our positioning in Italy shined as it benefitted from the steepening of the local curve adding strongly, along with Greece that performed as well. Later into the year, we shifted the portfolio to benefit from an overall flattening of curves, which indeed added further to performance in the third quarter of the year, while at the same time retaining the Italian exposure that kept adding value. Also the underweight in core peripheral countries proved positive as spreads in these area came slightly under pressure around mid-year.

End of October marked however a turning point with the ECB press conference casting uncertainty on its actual reaction to high inflation levels, spurring tapering fears that triggered a risk-off sentiment resulting in underperformance of peripheral Europe and outperformance of core Europe. In this context, our Italian and especially Greek exposure affected relative performance. Further strengthening of risk aversion brought by the Omicron variant intensified this effect later into the rest of the year.

While all in all the gross return of the portfolio slightly outperformed the benchmark, this backdrop has led for the first time in approximately 10 years to underperformance net of management fees on a calendar year basis (BP-EUR share class). We would hence like to add further details to the challenging year end backdrop mentioned above in the following dedicated section.

Historical alpha track record



Source: Nordea Investment Funds S.A. Period under consideration: 30.01.2011 – 31.12.2021. **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.**

What happened from October on?

The first wave of underperformance was due to the flattening of the yield curves and this took place from mid-October until the beginning of November. Such bear flattening saw the short end of the curve selling off and the longer end being more resilient in a risk-off environment brought by uncertainty not least regarding the Omicron variant. As in our portfolios we were overweight peripheral Europe and 2-3Y tenors, performance was hurt. This market move was particularly strong and following the flattening, in yield terms, the carry/roll on the 2Y tenor reached 25bp annually: a very attractive level given that the ECB is still not expected to rise short rates over the next couple of years. We have for this reason not changed much in the portfolio and even added in selected 2-3Y positions that appeared particularly interesting given an additional generous spread contribution to expected returns going forward.

The second wave of underperformance from beginning of November on was instead linked to the strong performance of government bonds that are eligible to post as collateral with the ECB. These types of government bonds always tend to perform towards the end of the year but in 2021 this happened earlier (November instead of December) and the magnitude has been larger than usual. The banks need to hold certain amounts of eligible collateral on their balance sheets at the end of the year to comply with various regulations and at the same time they do not want to hold unnecessary collateral since their fee to the EU´s resolution fund is determined by how large their balance sheet is at the end of the year. Government bonds are the only bonds that are 0% risk weighted in these calculations so they are the most optimal to keep on balance sheet over year end, but normally lose this tactical value as the new year starts. Such dynamic has been exacerbated by mainly two factors: the SNB (Swiss national bank) has intervened in the FX markets to depreciate the CHF by buying German Bunds and the ECB´s PEPP program was buying a lot of government bonds at a time when issuance was very low, further squeezing the market in the same direction.

This has led to a strong outperformance of continental Europe, specifically Germany and France, detracting from the European Covered Bond portfolio relative performance, (due to underweight in France and Germany), and from the Low Duration European Covered Bond and European Covered Bond Opportunities portfolios absolute performance (due to short German and French government bond futures to cover the portfolio duration down to 1 year).

Relative to respective benchmark, the Nordea 1 – European Covered Bond Fund BP-EUR has eventually underperformed some 30bps net of fees for the full year 2021 compared to the iBoxx euro Covered Total Return Index, whereas low duration funds delivered a stronger performance compared to the Iboxx Euro Covered Interest Rate 1Y Duration Hedged. The Nordea 1 – European Covered Bond Opportunities Fund managed to post an overall positive return for the year despite a challenging year end for both duration and spread.

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.

	Full year 2021	Jan to Sep	Oct to Dec
Nordea 1 – European Covered Bond Fund (BP-EUR)	-2.41%	-0.87%	-1.54%
iBoxx Euro Covered Total Return Index	-2.12%	-1.44%	-0.68%
Nordea 1 – Low Duration European Covered Bond Fund (BP-EUR)	-0.89%	0.23%	-1.12%
Nordea 1 – European Covered Bond Opportunities Fund (BP-EUR)	0.46%	2.55%	-2.04%
iBoxx Euro Covered Interest Rate 1Y Duration Hedged	-1.38%	-0.78%	-0.60%

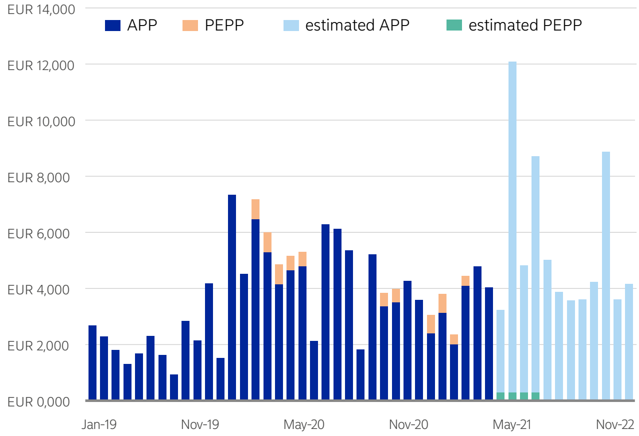
2022 Outlook

Looking into 2022, we expect EUR covered bond supply to increase to a more normal level, as we saw before 2020. The level of redemption however, is very high next year as well, which means that we probably still will see negative net supply even before taking Purchasing Programmes into account. The biggest joker that can have an impact on the supply picture is what will happen with TLTRO. It is expected that it will be prolonged, but with much less favourable conditions, e.g. shorter maturity and at a higher rate. We did already see some increased issuances late 2021, which is unusual. This could indicate that issuers already are moving some of their funding towards the covered bond market again. The less favourable TLTRO conditions will mean that it is mostly attractive for peripheral banks, and (semi-)core banks is expected to increase their funding through covered bonds.

ECB will also next year be an dominant investor in covered bonds. Even though the market is pricing in tapering of the PEPP programme, it will (at least not directly) impact covered bond purchasing from the central banks. PEPP have – through the life of the programme – not been used to buy covered bonds, as only around 0.4% of the envelope has been covered bond purchases so far. As seen in the graph, tapering of PEPP will only slightly reduce purchases of covered bonds. The purchases from ECB will increase next year due to higher redemption in their portfolio. All this should be spread positive (relative) for covered bonds. There is, however, some uncertainty as we don't know what will happen after PEPP. It could very well be that the programme will be formed into an extra envelope in APP.

Going into 2022, covered bonds looks very attractive versus other asset classes. Core government bonds have performed strongly in November and a the short end (5-year) covered bonds in France pays 40bps pickup versus government bonds. This is a historical high pickup. We would therefore like to increase covered bond exposure – mostly from core jurisdictions – versus government bonds. We also see value in the CEE region and South Korea/Japan which normally pays a high pickup versus core covered bonds. DKK covered bonds still looks attractive versus EUR-denominated. In the 5-year maturity it yields better than other lower rated covered bond, also after FX hedging.

European Central Bank covered bond purchase (mln EUR)



Source: European Central Bank and Nordea Investment Funds S.A.

Nordea's Covered Bond Family

With a dedicated investment team managing around EUR 45bn of assets[1] across Danish and European Covered Bonds strategies, we stay true to our safe investment offering: **managing covered bonds in a very active and dynamic way is our expertise**.

Our investment strategy is the common ground of our covered bond solutions: three portfolios that adapt the exposures of the strategy, providing solutions with tailored duration and spread risks. **Our covered bond investment solutions offer high-quality investments combined with the attractive returns that only an active and seasoned manager can bring to your portfolio!**

Nordea 1 – European Covered Bond Fund

The quality upgrade for your investment grade fixed income allocation!

Annualised Performance (BP-EUR) in %	
2021	-2.41%
Since launch[2]	3.40%
Risk budget	Interest rate duration ≈ 4 - 5 years and spread exposure ≈ x1
Currency	EUR
Fund Size in millions	EUR 5,707
ISIN codes	LU0076315455 (BP-EUR) / LU0733666746 (AP-EUR) LU0539144625 (BI-EUR) / LU0733665771 (AI-EUR)
Annual Man. Fee	0.60% (BP-EUR/AP-EUR) 0.30% (BI-EUR/AI-EUR)
Reference Index	iBoxx Euro Covered Total Return Index
Launch date	30.01.2012

Source: Nordea Investment Funds S.A, as of 31.12.2021. In the prospectus dated 30 January 2012 the Nordea 1 – Euro Bond Fund was renamed to Nordea 1 – European Covered Bond Fund, the investment policy of the sub-fund was modified and the NAV history prior to this date is not used for performance measurement.
1) Source: Nordea Investment Management AB. As of 31.12.2021. 2) 30.01.2012.

Nordea 1 – Low Duration European Covered Bond Fund

Think out of the box for your short-term allocation!

From our European covered bond strategy, we lower the duration which leads to a portfolio less sensitive to rates movements.

Annualised Performance (BP-EUR) in %	
2021	-0.89%
Since launch	0.36%
Risk budget	Interest rate duration ≈ 1 year and spread exposure ≈ x1
Currency	EUR
Fund Size in millions	EUR 7,646
ISIN codes	LU1694212348 (BP-EUR) / LU1694213072 (AP-EUR) LU1694214633 (BI-EUR) / LU1857276965 (AI-EUR)
Annual Man. Fee	0.50 % (BP-EUR / AP-EUR) 0.25 % (BI-EUR / AI-EUR)
Reference Index[3]	Iboxx Euro Covered Interest Rate 1Y Duration Hedged
Launch date	24.10.2017

Source: Nordea Investment Funds S.A, as of 31.12.2021.

Nordea 1 – European Covered Bond Opportunities Fund

Get the best out of the covered bonds' inefficiencies!

From our European covered bond strategy, we lower the duration and we increase the spread exposure which leads to a high conviction portfolio less sensitive to rates movements and more exposed to spread, the expertise of our team.

Annualised Performance (BP-EUR) in %	
2021	0.46%
Since launch	2.67%
Risk budget	Interest rate duration ≈ 1 year and spread exposure ≈ x2
Currency	EUR
Fund Size in millions	EUR 692
ISIN codes	LU1915690595 (BP-EUR) / LU1915690835 (BI-EUR)
Annual Man. Fee	0.70 % (BP-EUR) / 0.35 % (BI-EUR)
Reference Index[3]	Iboxx Euro Covered Interest Rate 1Y Duration Hedged
Launch date	29.01.2019

Source: Nordea Investment Funds S.A, as of 31.12.2021.

3) With effect from December 2020, the official reference index of the Nordea 1 – Low Duration European Covered Bond fund and of the Nordea 1 – European Covered Bond Opportunities Fund is the Iboxx Euro Covered Interest Rate 1Y Duration Hedged. Prior to this date, the funds did not have an official reference index.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 31.01.2012 – 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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