August 2018

US bonds: Freeze in fear or exploit the opportunity?

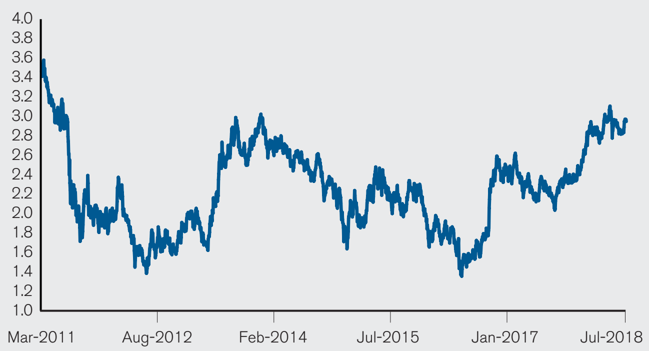
Nordea 1 – US Bond Opportunities Fund
ISIN: LU1009760643 (BP-USD)

Nordea 1 – US Total Return Bond Fund
ISIN: LU0826414673 (BP-USD)

- 10 year US Treasury rates peaked in May surpassing 3%. This was fundamentally justified but further upside is limited
- Rates remained at their highs, trading side-ways since May. Fixed income investors can still lock in the higher yields; the opportunity is still there
- In the late credit cycle, active management is key, navigating through some fixed income subsectors; investments with built-in options such as Mortgage Backed Securities help diversify a portfolio and add value

The start of the year has brought higher US rates, with 10 Year US Treasury (UST) rates crossing the psychologically important mark of 3% in May, a level not seen since January 2014. Beside easy financial conditions, a sizable fiscal stimulus and a strong US economy in general, strong US wage numbers coupled with a rise in US core inflation led to a more hawkish Fed outlook, triggering yields to rise. More recently, UST 10yr rates are trading side-ways still close to 3% which is a fair level in our view.

Historical yield on 10y US government bonds



Source: Bloomberg, 31.07.2018

While the rise in rates – peaking in May – has been driven by fundamentals, the question remains on whether another upward trend far above the 3% level would be economically sustainable in the short term.

In our view, to make this happen, an additional repricing of the FED beyond current market expectations is needed, which reduces the likelihood of a significant rise above the 3% mark. Despite the recent strong economic numbers, the US (and the rest of the developed world) is still living in an environment of **modest growth and limited inflation**. This is the main driver the FED is looking at, when setting its rate policy.

Seeing a growth in labour wages in the US as one of the key triggers for the rise in rates so far, it is highly doubtable that this is sustainable (due to e.g. the demography trend). A further, large upward swing in yields in the short term would have a **self-correcting effect**, as over-estimating the growth potential of the economy would therefore put pressure on the companies which would lead to falling yields again.

Putting fundamental factors aside for the moment, could the stimulus President Trump is creating lead to an overheating and to a further rise in inflation?

In our view, Trumponomics does create the risk of a spike in yields – primarily in the shorter maturity spectrum. More stimulus means higher demand and higher inflation further down the road. Case in point, the Fed-chair Powell indicated that fiscal policy could change the expected monetary policy path (in a more hawkish direction). Longer term yields are less reactive to this unless long term inflation potential is affected. We do not think this is the case as demographics, technological progress, low productivity growth and high debt levels prevent inflation, and in particular wage-inflation, from taking off.

What about the effect of higher deficits? Normally this should imply higher yields driven by a higher credit risk premium. Nevertheless, empirically, it is long term growth that has a much closer correlation with yield levels. And long term growth is likely to stay low for some time, also limiting the downside in bonds/upside in yields.

This combination of fundamental and political factors creates a demanding background, and US Fixed Income managers need experience to navigate such an environment successfully. Active management is key to identify opportunities and also to manage risk more diligently than passive management could do.

Rising yields – even creating an opportunity?

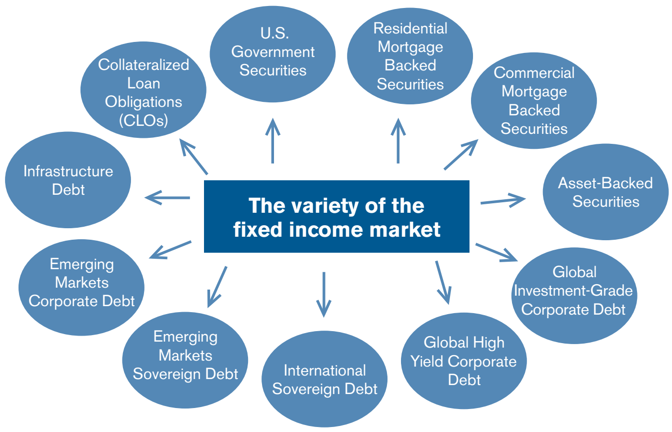
With interest rates having traded at historical lows for some time and the FED now clearly on a hiking cycle, investors believe that a **bear market in bonds is inevitable.** By doing so, they are focussing too much on the simplest fact of bond investing: when yields go up, bond prices go down, leading to a loss in the bond portfolio. Although there is no counter-argument to this, investors are ignoring the fact that **rising yields don't have to be a bad thing per se.** On the contrary, bond investors may actually even be able to take advantage of rising yields. Sounds strange to you? Then it's worth bearing the below points in mind:

- Ignoring default rates as a second component for the pricing of bonds for the moment, **the loss** on a fixed bond arising from rates **is limited** by nature. Unlike an equity investment, where the loss might be unlimited, investors just need to think long-term and show stamina: the level of coupons, which is not affected by the movement in rates, as well as the price reversion to par value upon maturity, help investors to recover from their losses, so that **low bond prices might even lead to attractive entry points.**
- When it comes to reinvestment of coupons or the capital of a matured bond however, yields do matter. While investors over the past years were forced to re-invest into the low or even negative yielding bond markets, with the recent lift in yields investors are **able to lock in higher returns on bond investments** again, boosting the expected return of their portfolios.
- Markets are forward-looking. There is a broad consensus in the market about the hiking path of the FED, and the markets are pricing in future rate hikes. This means for bonds to really underperform, it's not about rising yields – it's about **yields rising even more than the market predicts.** As mentioned above, fundamentals for now might not be strong enough to support a more hawkish FED. Hence the **further upside in yields and thus the risk for further drawdowns for bond investors seems to be limited.**

I. Which type of bond investment matters

From a yield perspective, US Fixed Income currently looks undoubtedly attractive compared to the rest of the developed world. However, especially in the US, markets are in the late stage of the cycle, which might trigger some volatility across the various asset classes.

Investors should not be caught in the trap of thinking that investing into the well established and transparent US Fixed Income market is an easy call these days. On contrary, with the high variety of bond types, ranging from very secure government bonds to investment grade or even EM bonds (looking outside the US) and their different sensitivity to interest rates, it becomes **increasingly difficult for investors to select the right mix** in the bond portfolio and **active management is gaining importance.**



Source: Nordea Investment Funds S.A.

While US treasuries are more rate sensitive, US High Yield and EM bonds are more closely correlated to the growth of the economy. Over and above these, there are some sectors in the fixed income market which often go unnoticed by the broad investor base, but which add value in the current market environment. One of those is Mortgage Backed Securities ("MBS").

Unlike most fixed income instruments, which have fixed cash flows with known principal return timing, the **cash flows and timing of principal return** of MBS is **uncertain** due to prepayments. This unique prepayment risk brings with it an **extra compensation, hence higher yield** for investors.

In a rising interest rate environment MBS perform **generally better** than Investment Grade ("IG") as well as High Yield ("HY") bonds as the sector is generally shorter in duration and prepayment risk decreases – borrowers no longer have the incentive to refinance. We therefore consider MBS as a better option than IG and HY bonds in the current volatile market environment for the following reasons:

- Non-agency MBS are highly customised and do not share the same characteristics or risks of the broader credit market, hence they are **de-correlated to credit markets.**
- **Relative valuation** of agency and non-agency MBS is clearly **more attractive** on a risk-adjusted basis than IG and HY bonds.
- MBS are a very **low volatility asset class.**

In a nutshell, MBS not only combine higher yields with lower volatility than traditional US Fixed Income but also exhibit diversification benefits in a broad bond portfolio.

II. Finding the right active manager is key

As part of its multi-boutique approach, Nordea has selected **DoubleLine Capital LP ("DoubleLine"),** an authority in the US mortgage market, as a trusted partner in US Fixed Income. DoubleLine is widely recognised for its **expertise and strong track record in fixed income active management.** The portfolio managers have worked together for an **average of 15 years and have 22 years of average industry experience.** The company uses a unique investment decision process combining a sub-sector allocation (top-down) led by Jeffrey Gundlach, known as Wall Street's Bond King, with a security selection decision (bottom-up). The multiple award winning company is known to have a **strong expertise in the MBS market,** which is of utmost importance to manage the unique risk profile of this market and to fully exploit the yield potential as well as the diversification benefits of this asset class.

Nordea's solution to benefit from the current market environment

Nordea offers two solutions investing in the broad US Fixed Income market with allocations to the MBS market. Both **actively manage duration** and are **well positioned to benefit** particularly from the prevailing market conditions.

- **The Nordea 1 – US Bond Opportunities Fund** exploits **inefficiencies within the subsectors** of the fixed income market while maintaining active risk management constraints. The fund looks to and beyond the standard Bloomberg Barclays U.S. Aggregate Index sectors, allowing for **additional yield pick-up** in areas such as High Yield, USD-denominated Emerging Markets Debt and non-Agency mortgages.
- **The Nordea 1 – US Total Return Bond Fund** invests into US MBS, offering **attractive income and strong diversification** in the current market environment.

Main characteristics As at June-18	US Total Return Bond	US Bond Opportunities
Effective duration	4.63	4.85
Yield to maturity (%)	3.61	3.81
AuM (USD mn)	2,017	123
Launch date	Sep-12	Apr-16
ISIN (BP-USD)	LU0826414673	LU1009760643

Source: Nordea Investment Funds S.A. and DoubleLine, 30.06.2018

Both solutions are designed for investors who believe **active management matters** and who want to **enhance the yield that traditional bond markets offer.**

Whilst current yield levels are fundamentally supported, further upside is limited. Don't let fear control your thoughts. Exploit the opportunities!