In Focus

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Nordea
ASSET MANAGEMENT

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The Danish Covered Bond Market and the Danish Economy (2019 Review - 2020 Outlook)

Nordea 1 – Danish Covered Bond Fund

ISIN: LU0076315968 (BP-DKK) / LU0229519045 (BI-DKK)

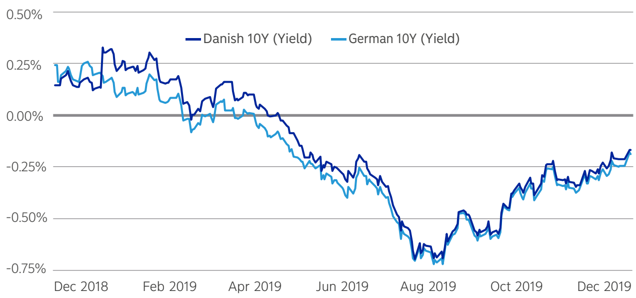
- **Good performance**, despite a **challenging move in rates**[1]
- The **Danish economy on a strong footing** to face global headwinds
- Danish covered bonds' **unique features remain key to find relative value in a safe investment**

Denmark offers one of the oldest and largest covered bond markets, with a size of around EUR 406 billion[2]. Predominantly AAA-rated, these covered bonds have not experienced a single default in more than 200 years of history. At the core of the system, the Danish 'Balance Principle' ensures the match between the mortgage borrowers' interest and capital payments, and the coupons and capital payments due to 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.

2019: the "recurring" story of low interest rates? What impact on the Danish market?

At the beginning of 2019, few would have expected the extent to which rates have been plunging over the year. Up until end of August, **yields have reached historical lows, with both Danish and German 10-year rates bottoming around –0.70%**, before their rebound over the last months of the year.

Danish and German 10-year rates development



Source: Nordea Investment Funds S.A. and Nordea Analytics, 31.12.2019.

While this had an absolute positive impact on performance, the large movements in long-term yields conveyed a **challenging year for Danish callable bonds**. This segment of the market usually underperforms more traditional bonds when rates are volatile. **The sharply falling yields over the summer gave record high prepayments**. Thus, for the October payments date 2019, prepayments reached a level of DKK 182 billion (≈EUR 24 billion). For the January 2020 payments date, the level is correspondingly high.

At the beginning of 2019, 1% bonds with a maturity of 30 years were opened for issuance. Over the summer, when yields fell further, the 0.5% bonds with 30-year maturity were opened for new issuance. Thus, homeowners in Denmark had the opportunity to borrow 30-year fixed-rate loans at historically low coupon rates. Homeowners took advantage of this situation, which led to high prepayments.

While negative yields are not new to the fixed income world, Denmark found itself on the headlines when a negative coupon made a first entry to the Danish callable bonds market. The news broadly covered that Danish banks offered negative interest rates to borrowers. This occurred with the mortgage loan opening from Jyske Bank, offering to its customers a 10-year mortgage with a negative rate of -0.5%. In effect, the borrower still had a loan with positive interest due to the mortgage bank commission (roughly 0.5%-1.5%).

In Denmark, the financing of mortgages is done through covered bonds which closely match maturity, coupon and cash flows, apart from the above-mentioned commission. In contrast to existing negatively yielding issues across Europe, a Danish callable bond cannot be issued above par (100) and therefore the interest rate level is reflected in the coupon. The Danish Balance principle and callable bond setup explain why this issuance came to the market with a negative coupon – when most market reflect negative yields in the bond price. These negative coupons are today a niche segment of the market with no significant outstanding value.

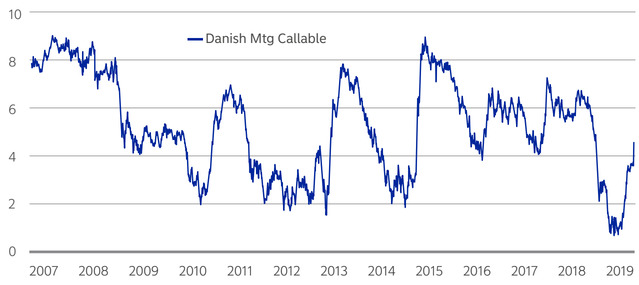
1) **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.** 2) Source: ECBC. Date: 31.12.2018.

However, **due to the high level of prepayments, we witnessed a change of market composition**. The 2% segment in Danish callable bonds was by far the largest bond segment at the start of 2019, with a share of approximately ⅔ of the entire market when referring to Nordea Danish callable mortgage bond index. With the significant prepayments during the year, the 2% share fell to approx. 27% by end of 2019. The new large segment in the callable market is now 1% bonds with a share of approximately 37% of the index, when 0.5% bonds represent 13%.

Throughout 2019, the callable bond spread (OAS) has tightened by approximately 40bps, which was supportive. The return in Danish callable bonds in 2019 was at the same level as German Pfandbrief with approx. 5-year duration. Keeping in mind the large yield movements in 2019, which is a difficult scenario for callable bonds, the performance of the asset class was in fact quite good.

On another note, the large fall in yields resulted in the duration reaching as low as 1 during the summer, as illustrated below when referring to the Danish covered bond callable index. **This is the lowest level of duration ever observed!** Following the rebound in interest rates since September, the duration has then increased again.

Option adjusted duration of the callable index



Source: Nordea Investment Funds S.A. and Nordea Analytics, 31.12.2019.

In this environment, the **market did not perform uniformly: there were large performance discrepancies in the different bond segments**. Regarding Danish non-callable bonds, the ARM segment has outperformed (5-year non-callable bonds have tightened by about 15bps in 2019 compared to government bonds), whereas the floaters have performed marginally better than government bonds. Within the callable market, the increased prepayment risk caused prices to fall on the high-coupon bonds, while the low-coupon bonds rose in price. These movements were common over the summer when yields dropped significantly. Conversely, the rise in yields from September onwards gave expectation of lower future prepayments in the high-coupon bonds, which resulted in price increases in the high-coupon bonds, while low coupon bonds fell in price from September onwards. Overall, we saw a better performance in the lower coupons (1% and 1.5%) compared to the high coupon (2% and 2.5%) in 2019.

Duration fluctuation and performance divergence within the different segments in the market both highlight the **value of an active and risk focused allocation**. We benefit from our ability to select issues and bond segments to harvest relative value opportunities, combined with our clear stance on risk management (keeping a portfolio duration around 4-5 years) not to rely on a duration purely derived from the market. In this context, the Nordea 1 - Danish Covered Bond Fund delivered +2.22% on the BP-DKK share class, which remains close net of fees to the general covered bond market (+2.79% as measured by the Iboxx EUR Covered Bond index) despite the unique challenges faced by the asset class[3].

A closer look at the Danish economy

Since the year 2013, the Danish economy grew at approximately 2% annually: this supported well employment, as this level was slightly above potential. More recently, material uncertainties on the global scale have however started to emerge and are likely to impact the local economy outlook.

Denmark: Macroeconomic indicators

Monetary policy rate refers to the certificate of deposit rate

	2017	2018	2019E	2020E	2021E
Real GDP, % y/y	2.3	1.5	1.8	1.5	1.5
Consumer prices, % y/y	1.1	0.8	0.8	1.2	1.4
Unemployment rate, %	4.3	4.0	3.8	3.9	3.9
Current acccount balance, % of GDP	8.0	5.7	6.1	5.5	5.1
General gov. budget balance, % of GDP	1.4	0.6	2.0	0.6	0.0
General gov. gross debt, % of GDP	35.5	34.2	33.7	33.4	33.2
Monetary policy rate, desposit (end of period)	-0.65	-0.65	-0.85	-0.85	-0.85
USD/DKK (end of period)	6.20	6.53	6.91	6.66	6.38

Source: Nordea Markets, Nordea Bank Abp. As of: 04.09.2019.

Resilience to face macro uncertainties

The Danish economy stands on strong fundamentals to face the uncertainties and effects of a potential global slowdown. Savings are high for both businesses and households. There are no major imbalances to be found in the housing market, and in fact, many homeowners have been taking the recent market opportunity to refinance their mortgages into new (lower) fixed-rates loans - a protection against future interest rates increases. Finally, Danish export remains quite diverse and therefore less vulnerable than other open economies should a global slowdown affect external demand. Expected growth for the next two years lies therefore around 1.5%; a slight decline mainly explained by projected somewhat lower investment activity and lower exports.

Exports: the effects of lower global demand

Danish exports are well positioned to withstand lower external demand, thanks to strong fundamentals of Danish exports companies. Companies' competitiveness has truly improved

3) Source Nordea Investment Funds S.A., Period under consideration: 31.12.2018 – 31.12.2019. **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.**

regarding wages over the last decade. In addition, prices on exports have started to increase at a faster pace than prices on imports. Pharmaceuticals and green technology have recently taken a higher stake of exports and have traditionally showed lower sensitivity to economic slowdown. On the other hand, the large Danish shipping sector cannot be ignored and would be adversely affected by a world trade's deterioration – yet, no sign of slowdown is perceived for now. In the coming years, growth of 2-3% is therefore expected for exports. Nevertheless, growth of imports is still expected to exceed growth of exports. This leads the decrease of the current account surplus to appx. 6% of the GDP.

Profitable times for households and labour market?

Household income has been benefiting strongly from the robust growth of the economy over the last years: employment has gone up, inflation remained low and therefore real wages increased. Moreover, with the current mortgage loans refinancing trend, households' interest burden has clearly declined (roughly 75% lower than the last decade). This is the equivalent of roughly 10% of the annual consumption of households. Consumption is nevertheless projected to grow at a slightly slower pace compared with previous years, due to the deceleration in employment growth and increased uncertainty on the outlook. Unemployment reaches currently 3.8% of the labour force, or the equivalent of just over 100,000 full time, which is at structural level. Modest employment growth is therefore expected, remaining close to the current trend.

Evolving environment for the housing market

We are in a quite unique environment: homeowners can access the cheapest mortgage loan rate ever. Declining rates have supported the housing market's activity in this sense. Yet, this recent pick may not set the stage for a new sharp upward move in housing prices. Regulation plays a major a role: Danish authorities have tightened housing market's regulation over and over to prevent such inflationary development. As an illustration, the debt of a homebuyer cannot exceed x4 its annual income, except if its existing wealth can bear a drop of 10% of the price. With those measures in mind, terraced and single-family houses' prices are expected to rise by 2 – 3% on an annual basis, which is a slightly higher pace than the one expected for inflation.

In a few words…

Being a **small open economy, global uncertainties cannot be completely avoided** for Denmark. The expected growth of 1.5% in 2020 assumes however that **Denmark has the resilience to handle global uncertainties with relative ease**. The dovish stance of Central banks and the stability of the local housing market should support the economy, even if exports suffer from a world trade hit. For euro investors, one should not forget the peg which links DKK to EUR: the Danish kroner is only allowed to fluctuate +/- 2.25% around the Euro. On an informal basis, the Danish government strives to limit the currency fluctuation to +/- 0.5%. In brief, the foreign currency risk of the Danish kroner is minor in economic terms for euro investors – and is in fact nowadays providing an estimated hedging premium of 0.24% p.a.[4]

2020 Outlook: in a low rates environment, Danish covered bonds are an attractive safe investment

Investors looking at safe allocation nowadays face the challenge of low yields: absolute positive returns are simply getting harder to find. When some want to turn to lower credit quality investments, we remain true to our belief that portfolio risk should not be deteriorated for the sake of chasing short-term investment gains. **Danish covered bonds represent a sound, liquid investment with first-class creditworthiness.** The Danish economy stands strong to face global uncertainties and remains one of the safest economies in Europe. The stability and unique characteristics of the Danish mortgage market, combined with increasing investor protection from stricter guidelines for borrowers, are all contributing to the safety anchor of this investment.

As many safe assets, the Danish covered bond market is of course also challenged by lower yield levels. However, one cannot only look at this market with an absolute lens: **Danish covered bonds continue to offer attractive yields in comparison to their European counterparts** and to government bonds. As shown in the following table, and considering the duration risk associated to those investments, Danish covered bonds offer a potential for higher returns, especially looking at the callable bond segment.

	12-Month Horizon Return	Duration
DKK Covered Bonds (Callables)[5]	0.95	4.56
DKK Covered Bonds (Non-Callables)[6]	–0.22	1.96
EUR Covered Bonds[7]	–0.02	4.89
German Government Bonds[8]	–0.30	4.82

Source: Nordea Investment Management AB, 31.12.2019. The mentioned data are option-adjusted and estimates of Nordea Investment Management AB. They are based on assumptions and information currently available, on the basis of an external model. There can be no guarantee of the accuracy of this information, and there is also no assurance that the estimates will occur in the future. The development is merely indicative and is not an accurate prediction of future results. 5) Nordea DK Callable Mortgage Bond Index. HPR on callable bonds is more uncertain due to unknown future calls. 6) Nordea Non-callable CM3. 7) Iboxx EUR Covered Bond index. 8) EB REXX Germany Government.

An active allocation to this market, with a deep understanding and management of its complexities, is a compelling investment opportunity. By way of illustration, as of 31 December 2019, the expected return on the Nordea 1 – Danish Covered Bond Fund for the coming 12 months was 0.57%[9] before fees, based on unchanged interest rates and spreads, with an effective duration of 3.98. Our portfolio has had an average 70% allocation to the callable bond market in 2019.

Going into 2020, we expect Danish covered bonds to outperform the general covered bond market, as the high level of new issuances we have seen in DKK callable bonds in 2019 should be much lower in 2020. Currently, DKK covered bonds look attractive versus similar AAA risk EUR covered bonds.

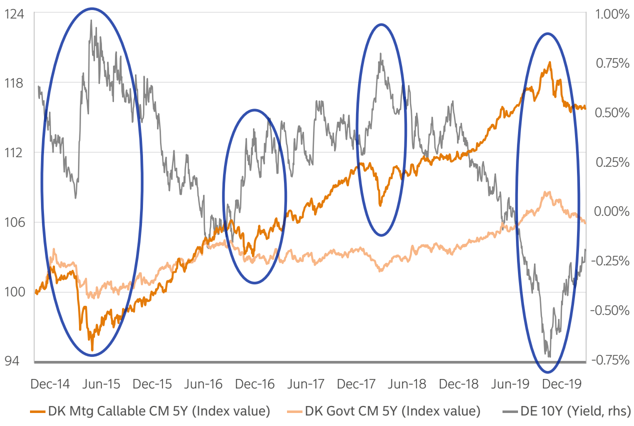
Regarding the callable bond market, investors traditionally get additional compensation for the convexity risk, which affects the asset class in environment of sharp interest rates moves. In comparison to a traditional bond, the callable bond would indeed lose more (gain less) from sharp moves up (down) in interest rates: this convexity risk is compensated by a higher yield.

4) Source: Bloomberg, referring to FXHCEUDK, as of 03.01.2020. 9) Source: Nordea Investment Management AB. Estimated yield over the next twelve months, based on current model portfolio and market conditions, assuming no change in portfolio holdings and no movement in interest rates and spreads.

Currently, the pickup offered by the covered bond callable market is around 43bps, as measured by the option adjusted spread on the 30y callable segment versus government debt. The best scenario for Danish callable bonds in 2020 would be a stable yield development, as we have seen throughout 2017 and 2018. Such an environment would give the basis for a good return relative to other covered bonds in 2020.

On a more general note, **the convexity premium is a very interesting pick up to harvest, as convexity risk – being quite unique – can be thought within a portfolio context, i.e. a diversification mindset**. Moreover, historically, periods of underperformance of callable covered bonds have been short-lived. We've witnessed strong recovery features, as the convexity risk materializing is not related to worsened credit. Danish callable bonds display thus a very strong track looking at the big picture!

Historical track of the Danish callable bond market



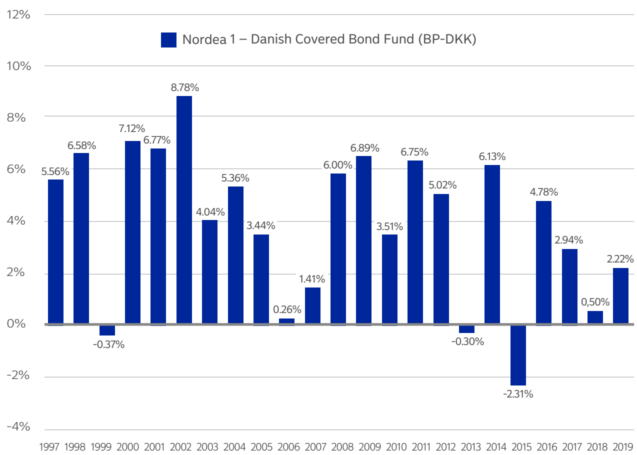
Source: Nordea Investment Funds S.A. and Nordea Analytics, 31.12.2019.

Nordea 1 – Danish Covered Bond Fund

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

With more than 40bn of AuM[10], 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 return in %[11]	2.23
Volatility in %[11]	2.05
Effective duration	4.07
Effective Yield in %	1.12
Fund Manager	Danish Fixed Income & Euro Covered Team
Fund domicile	Luxembourg
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)
Base currency	DKK
Fund size in millions	6,137 (822mEUR)
Launch date	21.02.1997

Source Nordea Investment Funds S.A., Period under consideration: 1997–2019. **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.** 10) Source: Nordea Investment Management AB. As of 30.09.2019. 11) Annualised 3 year data. As of 30.11.2019.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 31.12.1997 – 31.12.2019. 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 31.12.2019. 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. 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