Fixed Income

EUR and DKK covered bonds

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- Introducing CBPP3 buying starting in October 2014, only euro area covered bonds are eligible, technical modalities expected 2 October.
- The **CBPP3 will not increase covered bond supply**, on the contrary. With the TLTRO odds are that core/semi-core banks will reduce issuance.
- TLTRO costs have been reduced **benefitting ALL covered bonds**
- Supply is already low, rates and spreads **can only go lower and tighter**
- We see **increased demand for short dated DKK paper** on the back of the actions from the Danish Central Bank. Further we expect massive issuance of longer dated DKK mortgage risk
- **Position yourself for a steepening** of the Danish mortgage curve!

Danish risk:

Short term pressure on DKK, medium term relief and possible rate cuts. See page 2.

Expected market impact of covered bond purchase programme

The ECB will initiate a third covered bond purchase programme (CBPP3), which will start in October 2014, but we do not yet know the final details or conditions, which are expected 2 October. What was said was that it would be broad based. In our opinion it was primarily the very first covered bond purchase programme that was successful. The second programme was challenged by the fact that many of the covered bonds in need of support (peripheral) were trading through their respective government bonds. This could still pose a challenge, but there are peripheral issuers of covered bonds trading above government bonds, and these stand to gain the most. In our opinion this means that the setup for CBPP3, conditions, amount, method will most likely differ from the previous programmes.

During the past years the core/semi-core covered bond market has seen supply at levels significantly below expectations. Low supply has been due to deleveraging, issuers taking advantage of other funding sources. Further selected issuers due to low OC-levels have been legally barred from issuing. We assess that these are challenges which cannot be fixed by the CBPP3.

Therefore The CBPP3 will not necessarily bring about increased covered bond issuance (core/semi-core). On the contrary it is very likely that supply could dwindle further, with issuers choosing to act opportunistically either waiting for rates and levels to fall further, or simply tapping into the TLTRO funding.

The move by the ECB can therefore ONLY move rates and spreads in one direction; lower and tighter!

- Peripheral covered bonds stand to gain the most, compared semi-core, and finally core.
- In the Nordic EUR covered bonds only Finnish covered bonds stand to gain directly, as they are a part of the euro area.
- Nordic EUR covered bonds will also perform, but the effect will be lagged.
- Dutch (and German) covered bonds already trade through Nordic names making them look cheap.
- Further widening between the two segments will in our view result in Nordic going from cheap to VERY cheap.

Contents

Effect on Danish rates

Relief in Danish rates…

…But pressure will return shortly, with issuance of DKK 75bn long dated callables!

After a period with pressure on Danish rates we have in the recent week seen a relief. This is a consequence of the fact that the majority of the ARMs refinancing auctions have come to an end and that the issuance on the back of prepayment is limited. This will however change in the coming months.

Below we have illustrated the expected issuance of long dated risk in the Danish market in the coming three months. With the 2.5%47 bond above 98 we are going to see prepayments in the scale of DKK 75bn at the January term (could become larger if rates continue down). This issuance will primarily take place in October where ECB will launch their purchase program of covered bonds. But how will this leave Danish risk relative to EUR?

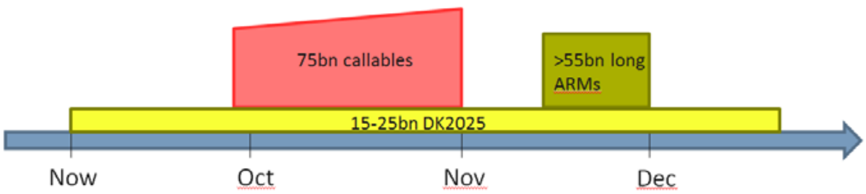
Structural demand/supply divergence between DKK and EUR.

We believe that this fundamental difference initially will hit Danish longer dated Danish rates relative to EUR. In the medium term the need for EUR alternatives for both domestic and foreign investors will support Denmark and bring performance. This will further support Danish kroner and could in the medium term lead to an isolated Danish rate cut.

Large amount of longer dated ARMs to enter market.

Further, the ARMs refinancing auction in November will entail a large amount of long dated bullets. We estimate at least DKK 55bn in maturities above 1 year. Nykredit has launched a new fee structure that will move the borrowers further out on the curve. This is a joker that very well could increase the number of long dated ARMs substantially. The effect will clearly be a reinforcement by the effects described above.

Expected issuance



Source: Nordea Markets

Too much liquidity, what’s the problem?

Callables wont benefit from CD rate-cut…

… BUT short dated DKK risk will (ARMs and govt).

Banks have large surplus of liquidity and could in theory absorb the issuance in October where there is a mismatch between the excess bond supply and the payment from the prepayment. The banks will however not buy larger amounts of the 2.5%47s (too long and to risky), but they will offset the negative CD rates by buying more ARMs.

Thus we foresee a steepening of the Danish curve.