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Bonds & bold: Performance in Covered Bullets is Moving Closer

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Anders Skytte Aalund

A Hammer to Fall scenario has left Danish covered bullets cheap. Factors driving the underperformance will ease further into the spring and likely lead to performance

A lot is happening in the markets at the moment. Interest rates surged in March, and the liquidity situation in Denmark remains tight. Both factors have influenced the pricing of Danish bonds. In this edition of *Bonds & Bold*, I describe how covered bullets have become significantly more attractive for both outright investors and leveraged investors. I also outline why I believe this segment will perform well in the spring.

Covered Bullets Have Become More Attractive for Both Outright and Leveraged Investors

The difference between the unhedged pickup on callable and flex bonds has narrowed significantly in recent times. In the graph below, the forward rate 4Y1Y is compared to the convexity-adjusted return on a generic price-98 callable bond. This shift is a consequence of the significant steepening of the curve following the expected large issuance of government bonds in the EUR zone. Additionally, the asset swap curve has also steepened due to the liquidity situation in Denmark (read more here). More on this in the later

Given the recent market movements, it is evident that outright investors should consider flex bonds.

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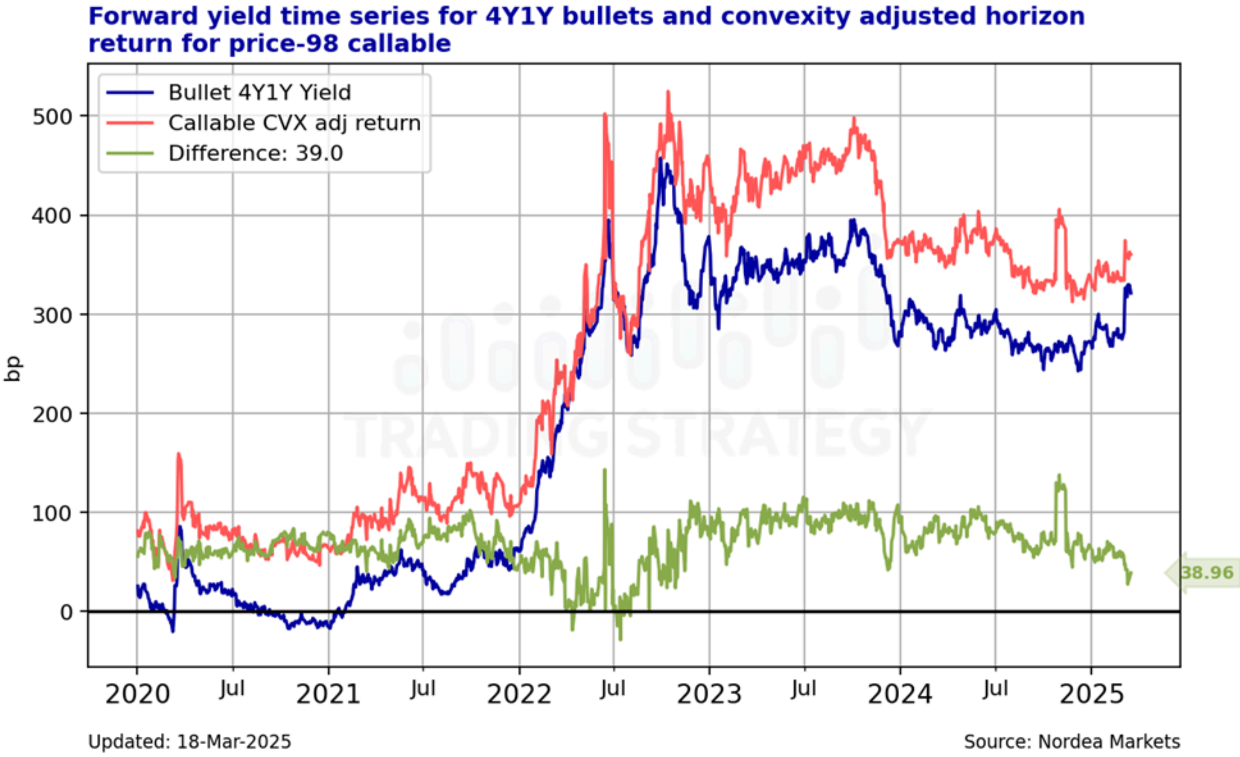
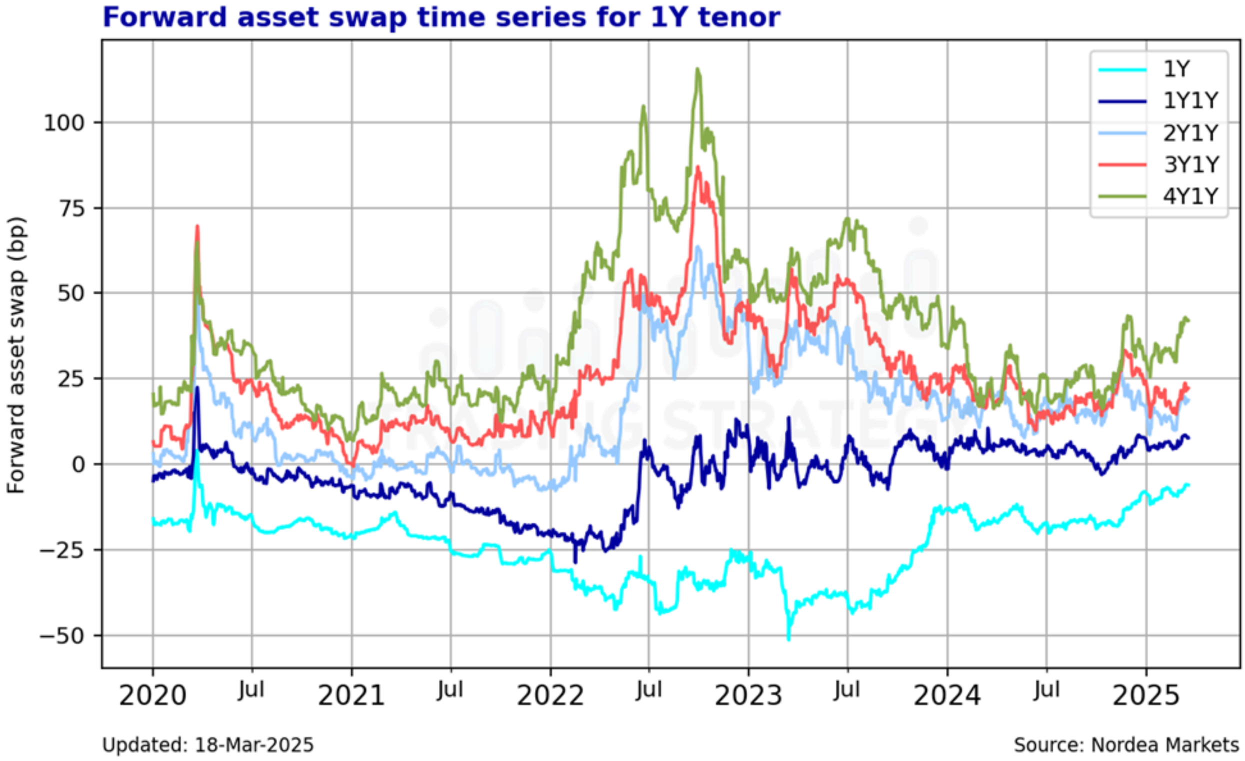
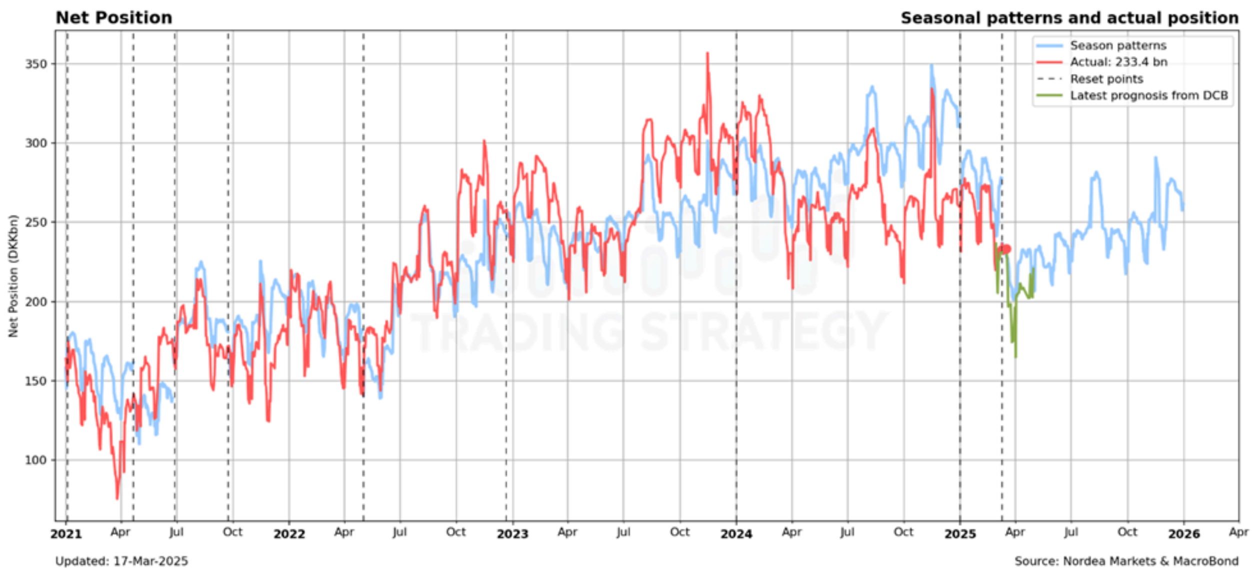


The tight liquidity situation in Denmark has put upward pressure on asset swap spreads for covered bullets, as this market is dominated by hedge funds. This means that entry levels in 4Y1Y are at their highest in a year, while short tenors (1Y) have not been this elevated since the severe COVID days in March 2020. When the liquidity situation (repo) in Denmark normalizes, I expect performance to improve across the curve in this segment.



Net Position Will Decline Before It Rises

As described in the liquidity analysis, we expect the Net Position to increase during the spring, which should improve the liquidity situation in Danish covered bullets and make DKK cheaper. I expect this will drive performance to the high asset swap spreads and attractive outright interest rate levels on covered bullets.



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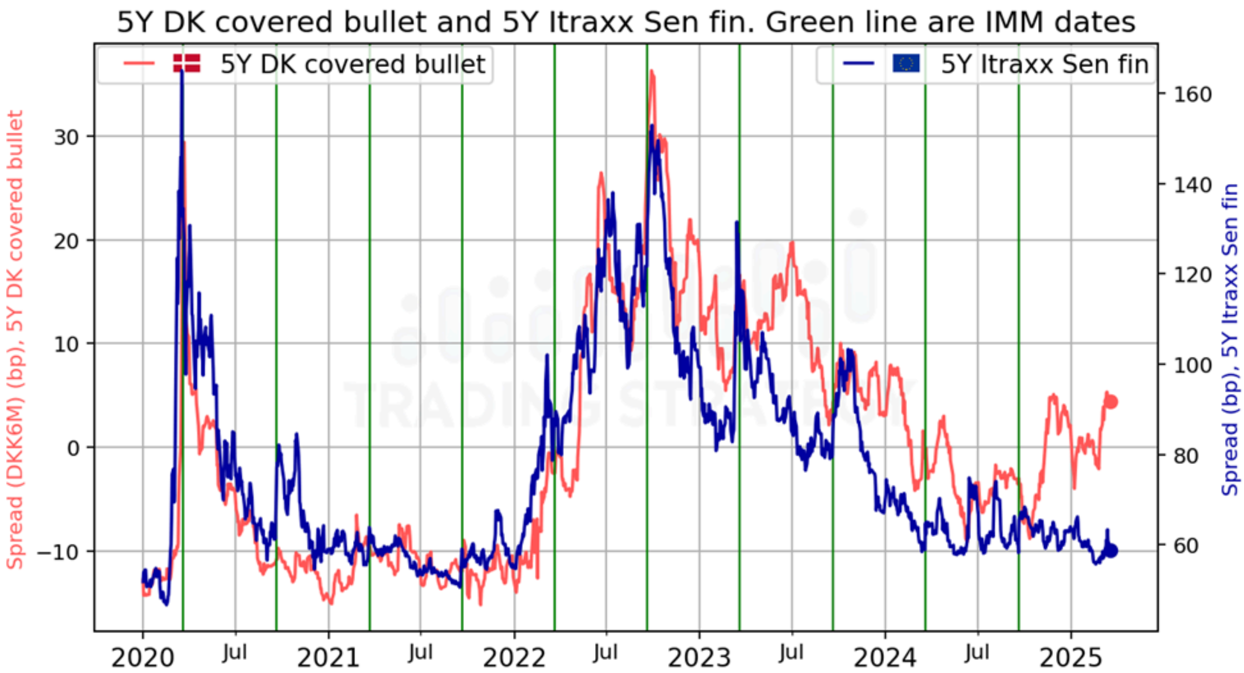
iTraxx as a Hedge for Spread Risk on Covered Bullets

I have previously argued that iTraxx could be used as an economic hedge of spread risk on covered bullets (read more here). However, this has not held up in recent times. This is due to changing assumptions—specifically, the liquidity situation is no longer the same.

It is important to remember that iTraxx is liquidity-neutral. As a result, asset swap spreads are now significantly wider than what iTraxx would suggest based on the historical relationship between the two.



Updated: 18-Mar-2025

Source: Nordea Markets, Bloomberg

If we turn to hedging with €STR/EONIA swaps, the situation looks different. Here, there is still a reasonable correlation, though Danish covered bullets have underperformed slightly in recent weeks. Whether this is a spurious correlation or actually indicates that €STR/EONIA swaps combined with a position in iTraxx provide a better hedge is still uncertain. However, I will continue to monitor this going forward to see if the relationship holds.

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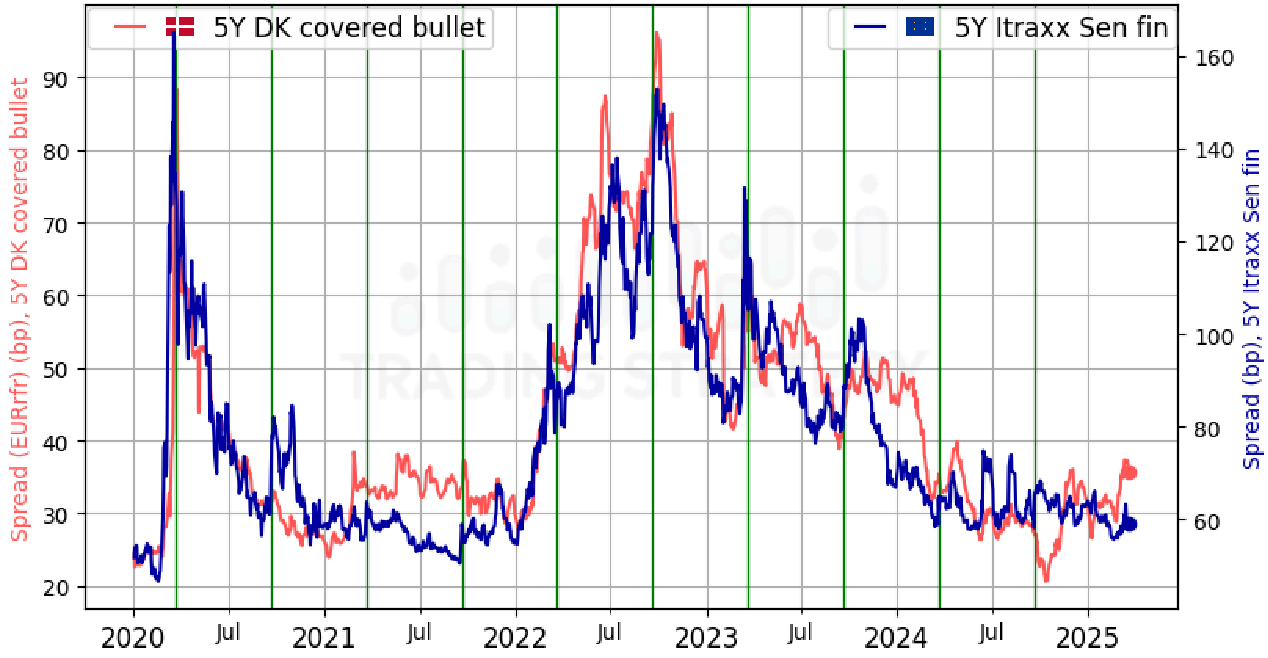
5Y DK covered bullet and 5Y Itraxx Sen fin. Green line are IMM dates



Updated: 18-Mar-2025

Source: Nordea Markets, Bloomberg

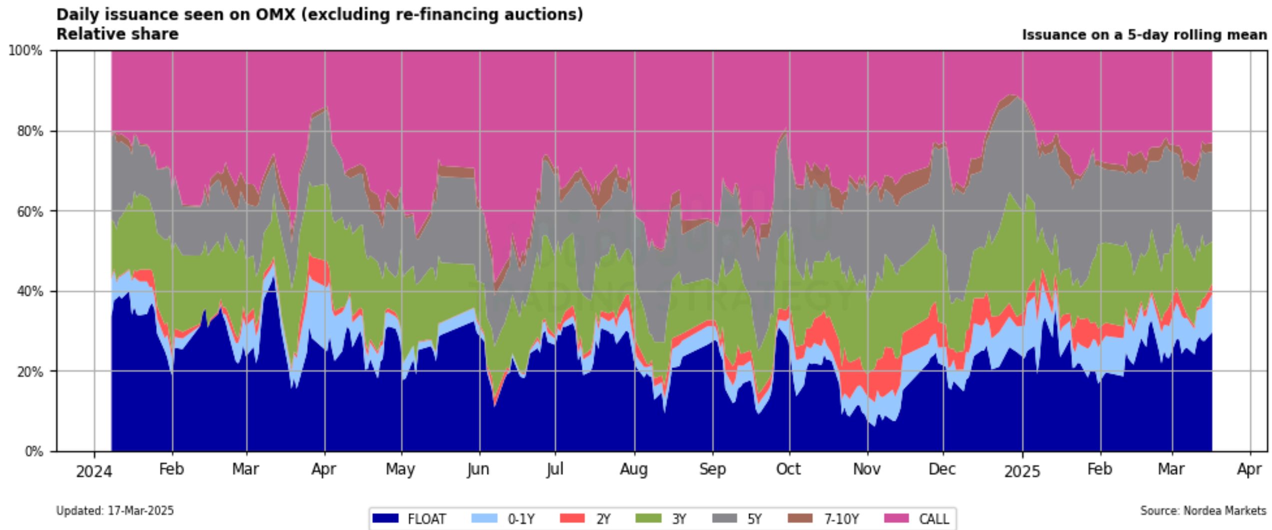
Will We See a Shift in Issuance?

Despite the sharp rise in long-term rates, we have not yet seen a significant shift in borrowers' preferred segments. There has been much discussion about borrowers moving towards shorter tenors, particularly floaters and short-term covered bullets. However, this trend has yet to materialize.

We have seen a decline in the share of callable bond issuance from 33% in 2024 to 26% in 2025, and floaters have increased slightly since the second half of 2024, though they remain lower than in the first half of the year. Meanwhile, 5-year covered bullets now account for 22% of issuance which is larger than both H1 and H2 in 2024. However, this increase is not large enough to justify the high spreads on these bonds and if my expectation of an improved liquidity situation holds, these bonds will have upside potential despite of the increased issuance.

	H1-2024	H2-2024	H1-2025
FLOAT	27%	19%	25%
0-1Y	4%	5%	8%
2Y	1%	4%	3%
3Y	17%	16%	14%
5Y	14%	20%	22%
7-10Y	2%	3%	3%
CALL	33%	33%	26%

Updated: 17-Mar-2025 Source: Nordea Markets

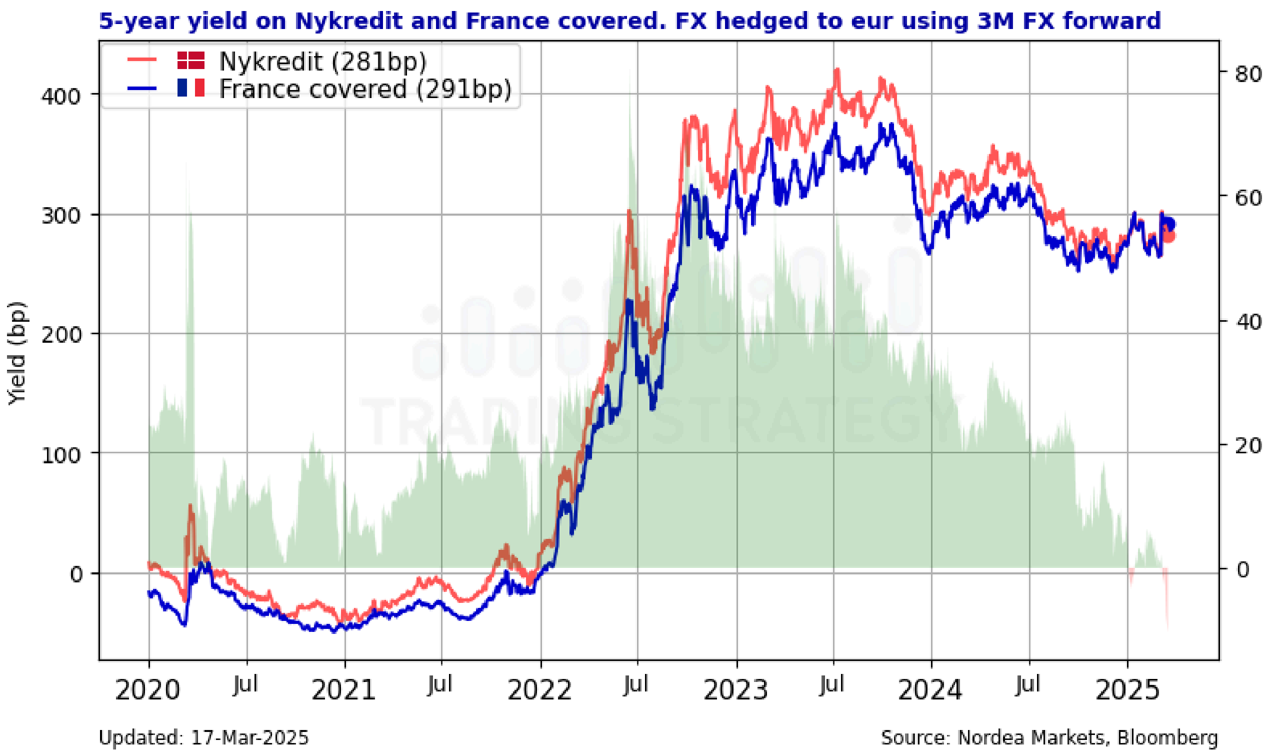


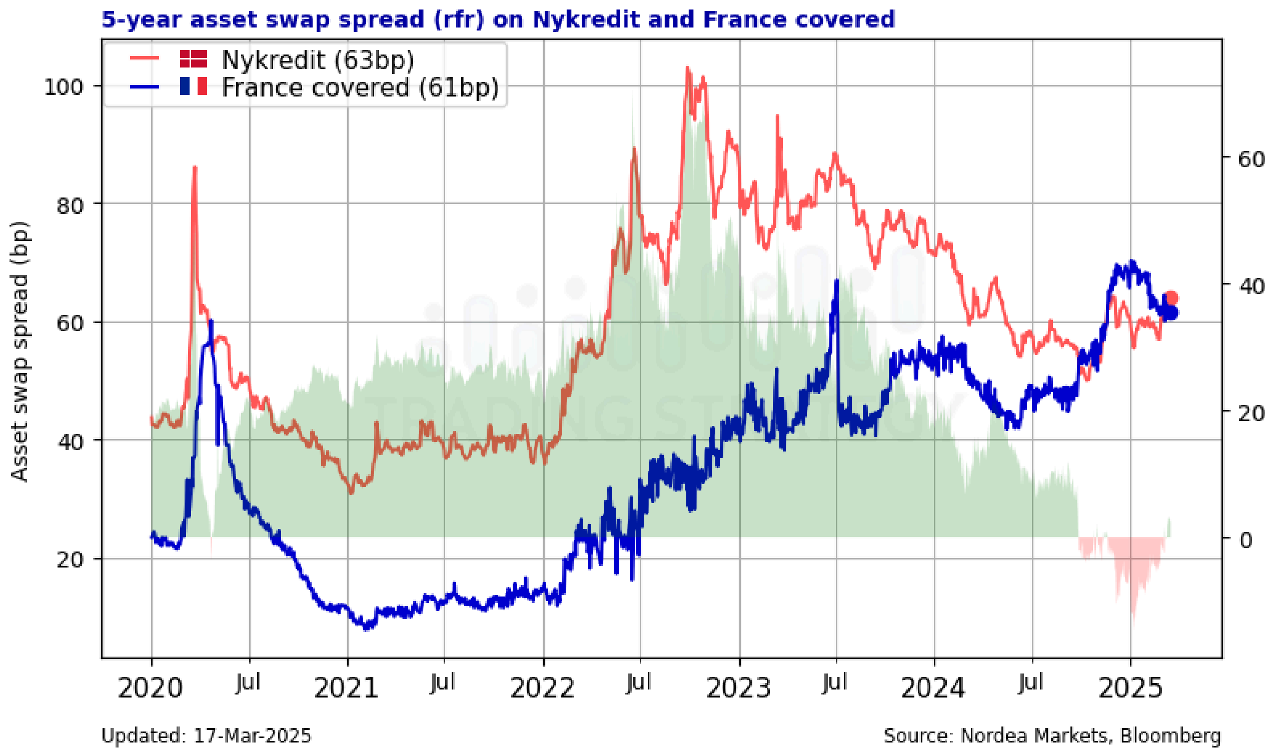
Since the increase in yields during March, floaters have become the cheapest loan option, with the cost difference to 5-year bullets per borrowed million now roughly equivalent to the price of a Danish *fastelavnsbolle* (a pastry in Copenhagen). This may push some borrowers toward floaters, but many remain concerned about the uncertainty that has emerged after January 20th. As a result, many are willing to pay a slight premium for the security of a 5-year fixed-rate loan, which likely explains the increased demand for loans with 5-year fixed-rate periods.

For callable bonds to see significant growth, I have previously shown that absolute interest rates must drop below 3–3.5%. Given the recent rate hikes, we are still far from that level.

EUR Covered Bonds Have Also Become Cheaper

Some investors consider EUR covered bonds as an alternative to Danish covered bonds. In the charts below, I have compared the yield developments of a 5-year Danish and a 5-year French covered bond, where the Danish bond is FX-hedged to EUR using a 3-month FX forward. We see that over the past two years, EUR covered bonds have underperformed relative to Danish covered bonds. The same conclusion holds when comparing the two markets hedged with DESTR/€STR swaps. This is mainly a result of the QT from ECB and thus I do not believe this will cause Danish covered bullets to remain cheap once the liquidity situation improves.





A few reflections on callable bonds: Beware of Empirical Durations

I have previously demonstrated that model-based durations optimize risk/reward ratios, such as Sharpe ratio. Last year, however, we observed that interest rate movements did not impact the prices of callable bonds as much as our model predicted. This phenomenon is common in the callable bond market when rates exhibit mean reversion, as was the case last year, particularly in the first half of the year. By decomposing returns into various factors, we can clearly see that the interest rate component and OAS moves in different direction demonstrating that parts of the moves in yields is not factored into the price but rather OAS.

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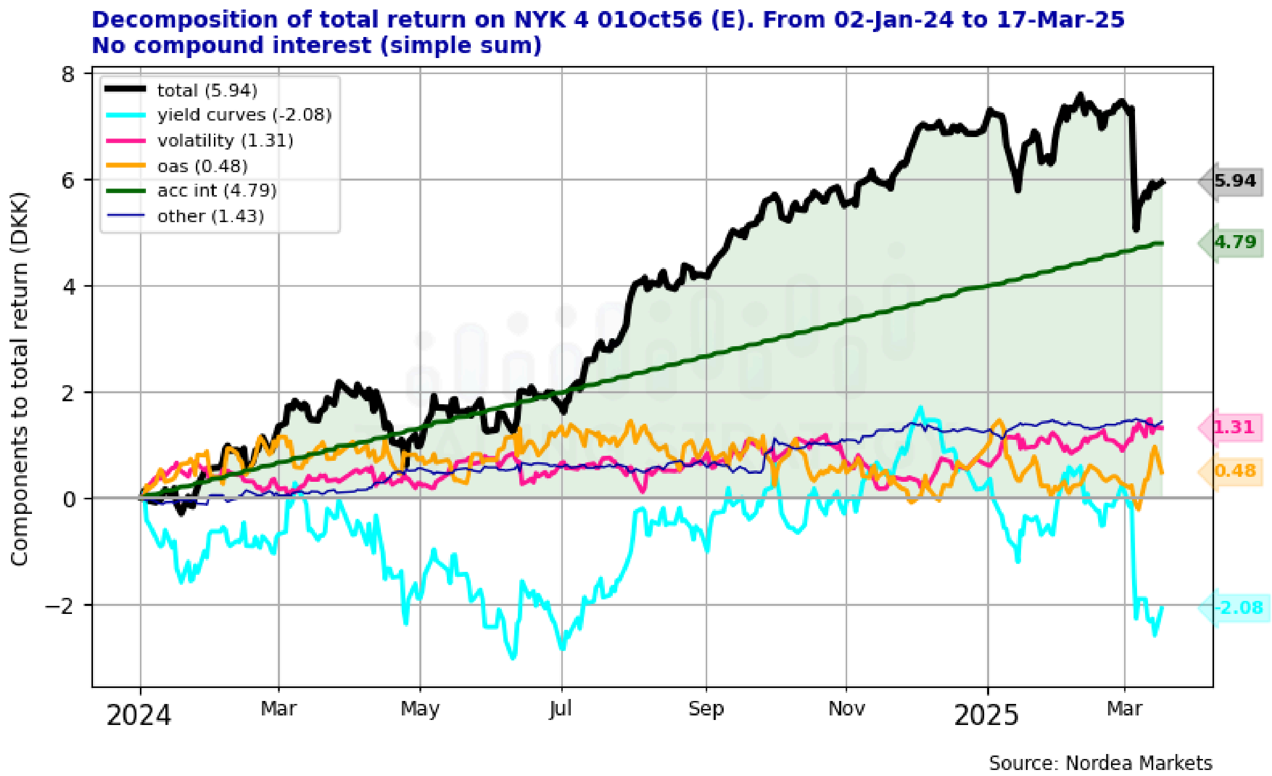

In March, interest rates have risen significantly, and the relationship between OAS and rates no longer holds. To emphasize this, I have created a simplified version of the graph below.

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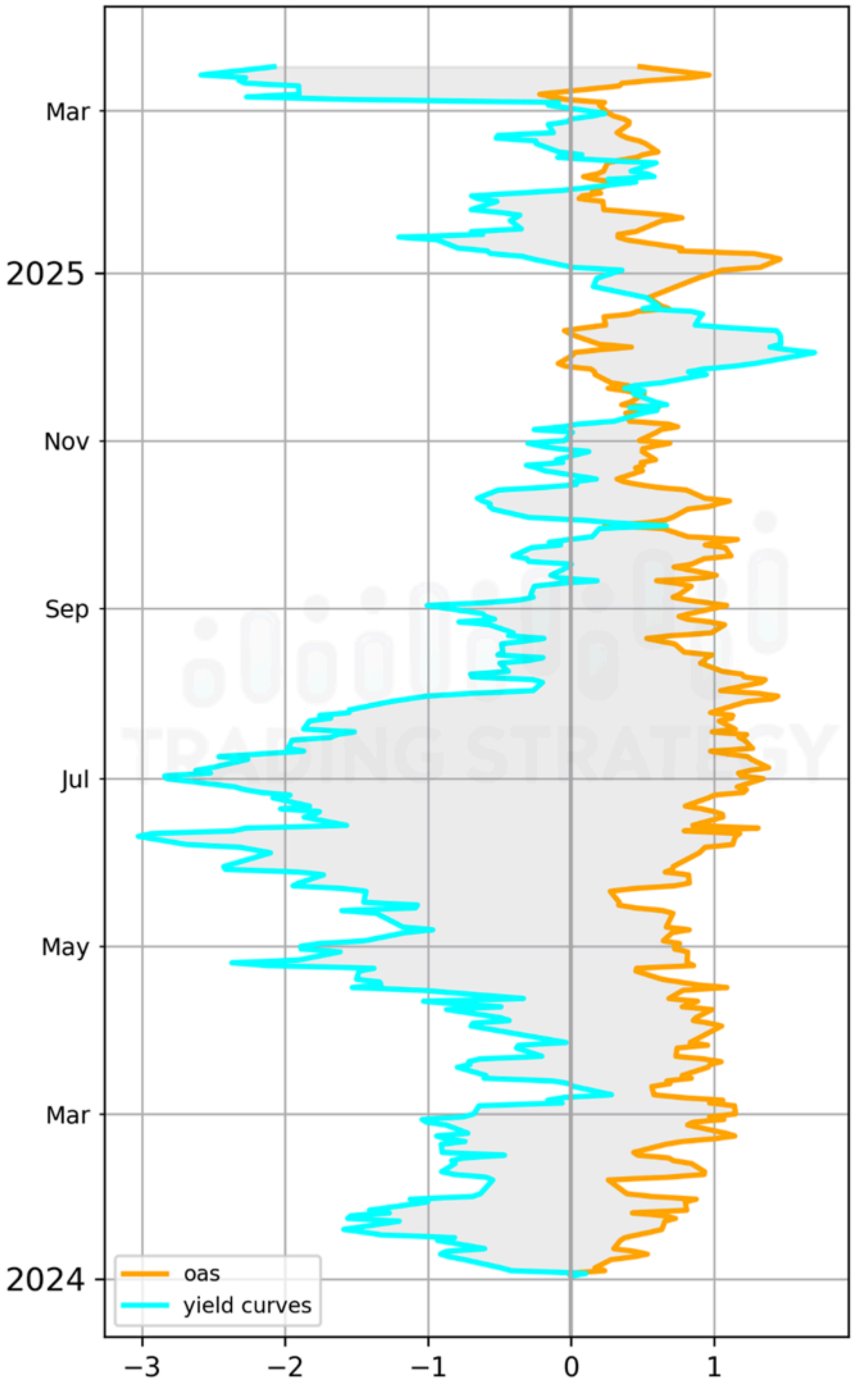
Return from yield curve and from OAS NYK 4 01Oct56 (E).



Source: Nordea Markets

In other words, investors (and market makers) should be cautious when using empirical durations during periods of mean-reverting interest rates. When rates begin trending, there is a risk of detecting the shift too late, making the necessary stop-loss adjustment costly.

Conclusion

I find covered bullets attractive at current levels. If investors has the possibility to buy them I clearly recommend doing that before we move further into the spring where the liquidity situation improves.

Anders Skytte Aalund
Director
anders.aalund@nordea.com
4555471854

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