Living with Negative Rates on Danish Mortgages

London (HedgeNordic) – Some Danish individuals can now get a mortgage at a negative rate, and this could still be profitable for local Danish banks, which can fund themselves at interest rates that are even lower. The same logic applies to a number of leveraged investors.

“Danish bullet mortgages now have a yield curve ranging from minus 65 basis points at one year to plus 10 basis points at ten year maturities, while convertible mortgages – with prepayment risk – might only pay 0.50% to 1% even at the most common thirty year maturity”, says Formuepleje portfolio manager, Rene Rømer. These rates have come down by at least 70 to 80 basis points over the past year. But Formuepleje’s cost of leverage has now also come down well below minus 0.5% from minus 0.40% a year ago.

Soren Astrup

“This is partly because covered bonds have a preferential treatment under LCR Basel III rules, which classify Danish covered mortgage bonds as 1b. This low borrowing cost is specific to the asset class. It is worth noting that corporate bonds could cost a lot more to finance, with costs varying with issuers, ratings, and liquidity profiles, because banks cannot use them in their regulatory framework. Equity collateral also has a positive cost of leverage, of around 0.25%”, says Formuepleje director, Søren Astrup.

Is the cost of repoes fixed however? In the US in September 2019, overnight repo rates jumped as high as 10%. “This is not at all likely to happen in Denmark, because the banks can easily repo unlimited amounts with the Danish central bank”, says Rømer.

So, the gap between Formuepleje’s borrowing cost and its income on bonds is about 0.50%. With four times leverage, Formuepleje is able to generate a steady state spread income of around 2%, before its own management fees are charged. Most of the income comes from the callable bonds.

Returns this year have been low, but positive. Formuepleje, which marked its 30th anniversary in 2018, is distinguished from other leveraged Danish mortgage strategies because its leveraged strategy has more interest rate risk, and less prepayment/ option/conversion risk. The strategy has a reasonably high correlation, averaging around 0.60, with Danish government bonds. Some other managers’ strategies that emphasise prepayment risk (and may use more leverage) have been wrong footed this year by a jump in prepayments as Danes take advantage of lower and negative rates to refinance their mortgages. Formuepleje seeks to reduce prepayment risk by carefully selecting bonds where they expect a lower risk of prepayment.

In contrast to other mortgage managers who seek to minimize their interest rate risk, Formuepleje is rather like a macro or bond manager, in taking active views on yield curve trades, anticipating higher or lower interest rates at different points of the curve, which could generate either profits or losses. In late 2019, Formuepleje effectively has a “curve steepener” trade on.

They could profit from lower rates at the short end and higher rates at the long end. But even positive scenarios for both of these bets might only increase returns to 5% this year, before fees. The strategy historically generated average low double digit returns partly because wider absolute spreads, and a larger gap between income and borrowing cost, generated more income. The strategy has also clearly benefitted from the long bull market in fixed income.

Yield Curve Bets

Formuepleje does feel confident in taking some meaningful positions in interest rates term structures. It is long of interest rate risk up to around 7 years, and short between 8 and 30 years. “We see scope for rates to come down at the short end, because Eurozone economic data – especially from Germany – has been deteriorating”, says Rømer.

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Moreover, the latest round of QE has an indirect impact on Danish bonds. “Though the ECB is not actually buying Danish Krone bonds, they are viewed as a very close substitute for Euro-denominated bonds, so there is a ripple effect”, says Astrup. Conversely, the manager expects longer term rates could rise, for two main reasons. “An easing of the trade war could generally improve risk appetite”, says Rømer.

And there is some ambiguity over the outlook for QE, because it is clear that the ECB does not have a consensus for renewed QE and asset purchases. The German, Austrian, French, Dutch, Slovenian and Estonian central bank representatives have publicly spoken out against the latest QE program, and it emerged in October that the ECB’s monetary policy committee had also advised against resuming QE (this confidential advice was leaked to the media, and reported in the Financial Times).

Broader opinion is turning against negative rates. “Financial repression” clearly causes problems for Europe’s banks, and increases liabilities for pension funds and insurers. This means that some pension funds are in deficit, and some insurers could be at risk of breaching their solvency requirements; for instance, in Denmark, Qudos Insurance A/S and Alpha Insurance A/S were declared bankrupt in 2018.

And in July 2019 ECB President, Mario Draghi, has made it clear that the inflation target of 2% is not a ceiling but rather an average target that allows for symmetrical deviation in either direction, so that inflation should average at 2% over a full cycle. This implies that the many years of inflation below 2% should, in future, be mirrored by a multi-year period when inflation exceeds 2%. At some stage, investors in long dated bonds must surely pause for thought and decide that they cannot tolerate their purchasing power being eaten up by inflation. There must be some limit on the level of negative real interest rate that investors will accept.

The Future of Long Only Fixed Income Funds in Denmark?

“It is now almost impossible for long only Danish government and/or mortgage funds to generate a positive return. Since 2015, we have stopped offering an unleveraged strategy that is purely invested in Danish mortgage or government bonds. We have added assets such as investment grade corporate bonds to portfolios to maintain positive returns. It does not make sense if we cannot offer investors a positive return when they have zero as an alternative”, says Astrup.

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Ultimately, market forces can make this decision. If investors are happy with a small negative yield, they can remain invested in long only funds.

Formuepleje is the largest privately held asset manager in Denmark. Founded in 1986 Formuepleje today has more than 10 billion EUR under management in various UCITS-funds and hedge funds. Domiciled in Aarhus with a strong presence in the Copenhagen area Formuepleje’s 97 employees offer investment solutions for retail, family office and institutional clients.

This article featured in HedgeNordic’s Special Report on “Alternative Fixed Income.”