Difficult May for Danish Callables

Stockholm (HedgeNordic) – The first five months of 2021 and the month of May in particular were more challenging for Nordic fixed-income hedge funds, on aggregate, than their international counterparts. Fixed-income vehicles within the Nordic Hedge Index were down 0.7 percent on average in May, whereas the 270 funds within the Eurekahedge Fixed Income Hedge Fund Index gained 0.4 percent on average last month. The discrepancy is partly explained by the struggle of Danish callable mortgage bonds.

About half of the Nordic fixed-income hedge funds posted gains last month, but the group's performance was dragged down by a handful of Danish vehicles including HP Hedge Fixed Income, Formuepleje Fokus, Nykredit MIRA, CABA Hedge, HP Hedge Danish Bonds, among others.

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"May 2021 was a tough month for Danish callable mortgage bonds," writes René Rømer, senior portfolio manager at Danish asset manager Formuepleje, in a monthly commentary. "Quite unusually, the price declines of callable bonds have not been reflected in either Danish adjustable-rate bonds ("fleksobligationer") or other European alternatives," he continues. "The price falls are isolated for Danish callable mortgage bonds and are due to, among other things, a large supply of bonds in connection with the large turnover in the Danish housing market."

Difficult May for Danish Callable Bonds

"Last month was hard on Danish callable bonds," corroborates Kristian Myrup Pedersen, Chief Product Manager at CABA Capital. "Actually, this segment has been under pressure several times during 2021," he continues. "The main reason is that the increase in the general level of interest rates has had some negative knock-on effects on other mortgage specific risk premiums, especially spread risk and negative convexity."

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"First of all, increasing rates lowered the outright price level of callable mortgage bonds, and in this process, their duration risk increased," explains Pedersen. "This means that some investors have reduced their exposure to the segment in order to lower their portfolio duration risk level," says CABA's Chief Product Manager. "Secondly, the higher level of interest rates on U.S. government bonds has attracted some renewed interest, and therefore, Danish bonds might have lost some shine in the eyes of foreign investors," continues Pedersen. "Thirdly, the increasing inflation risk has increased the uncertainty of the future interest rate level, and as callable mortgage bonds tend to perform the best in stable interest rate environment, this increased uncertainty has put further downward pressure on the segment."

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"In our view, Danish callable mortgage bonds have underperformed more than enough by now," argues Pedersen. "Precisely because price falls are isolated to a single segment of the bond market means that, all other things being equal, we expect price increases for callable bonds in the coming period," agrees Rømer of Formuepleje. According to Pedersen, "if interest rates were to slide back into lower levels, we think that most of the above-mentioned effects will be reversed, leading to good performance. We also think that a stabilization of the interest rate level would lead to a relief rally over time.”

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However, “in case of higher interest rates, it becomes somewhat trickier for the market as a whole, but we have identified pockets of the market that tend to perform well in this scenario too,” says Pedersen. “The risk factor, in our view, is the scenario where interest rates increase too much too fast, as this will probably be difficult for the market to absorb,” he elaborates. “To sum up, we see attractive return potential going forward.”

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