

Nordea Boutiques

Economic Outlook 2019



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Introduction

Economic Outlook 2019

Each year, we compile the investment outlooks for the coming year from our various internal and external boutiques. We are pleased to share this 2019 collection of outlooks on each boutique's respective asset class with you. We thank you, valued client, for investing with Nordea and wish you a successful 2019.

Asset Management at Nordea

As an active investment manager, Nordea Asset Management manages asset classes across the full investment spectrum and aims to serve its clients in every market condition. Nordea's success is based on a sustainable and unique multi-boutique approach that combines the expertise of specialized internal boutiques with exclusive external competences allowing us to deliver alpha in a stable way for the benefit of our clients.



Internal boutiques

We have established segregated teams for key asset classes, allowing each team to focus on their primary activity: managing money. This means retaining competence centres that leave freedom to the investment managers. In addition to our Nordic expertise, we have built well-established track records over the years in both equity and fixed income strategies ranging from Credit and Covered bonds to Global, European and Emerging Markets equities as well as Multi-Assets Solutions.

External boutiques

Nordea External Partners team aims to meet investor needs by selecting best-of-breed asset managers who can generate alpha in specific regions or asset classes. The rationale is to concentrate on boutiques focused purely on money management in the belief that fund distribution distracts investment managers from their primary objective: generating exceptional investment performance.

Asset Allocation

Nordea Multi Assets Team

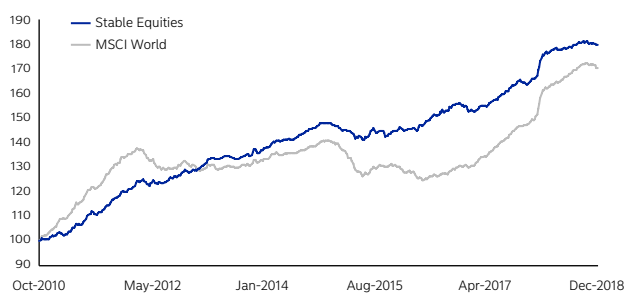
Nordea
ASSET MANAGEMENT

**Nordea 1 – Stable Return Fund,
Nordea 1 – Flexible Fixed Income Fund,
Nordea 1 – Alpha 10 MA Fund¹**

- Outlook on economic and earnings growth momentum for 2019 is weakening, but the risk of recession remains very low
- Equities earnings growth for 2019 is weaker but valuation is still supportive, while higher US yields makes duration a good hedge against equity risk and wider credit spreads combined with low near-term expected default rates still being supportive for credit

Going into 2019, we expect economic growth and earnings momentum to roll over and volatility to increase in a late cycle phase. Indeed, a hawkish FED and tighter financial conditions start to hurt global growth and raise fears of recession. From a geographical perspective, we still favour Developed markets (especially US) over Emerging Markets despite higher valuations. Lower valuation in EM comes together with weaker earnings momentum and higher risk resulting from the trade war. Thus, the catalyst for outperformance is missing. From a style perspective, we clearly favour the more defensive/low risk equity segments, which should be well positioned and outperformed in a more recessionary scenario. With earnings growth more at risk, we have a high conviction in our Stable/Low Risk Equities despite the last two years underperformance, as their earnings are more resilient and valued more fairly. As witnessed in February, October and now December, our Stable/Low risk equities don't always provide price protection during the first round of sharp sell offs, but they do offer fundamental protection as their earnings sensitivity should be lower than the overall market (see chart below). So that means in sell offs which are more sentiment and flows driven like in February; first phase of October 2018 or December 2018, their valuation improves and offer higher

Earning estimates (12M fwd)



Source: Bloomberg. Nordea Investment Management A.B., Multi Assets Team. Date: 21.12.2018. The presented figures are estimations and are based on assumptions and on information currently available. No guarantee can be given for the accuracy of the data and these estimations might not be met in the future.

expected returns and more downside protection when the environment becomes more recessionary.

All in all, equities should do relatively well, albeit higher bouts of volatility, considering valuation has come down and earnings growth is still supportive. Also the FED is clearly the elephant in the room, and should be one of the main drivers of overall equity markets performance and market sentiment in 2019.

Regarding fixed income, we still favour US over European duration as yields are more normalised and offer better diversification benefits. US yields are higher compared to the beginning of 2018, making duration risk premia more attractive and closer to neutral levels (especially at the short end). While the FED has continued their hiking path invariably in 2018, the likelihood of several hikes in 2019 is clearly lower which should be supportive for long duration. Also, high quality fixed income should fare well amidst a weaker economic growth environment coupled with weaker inflation momentum. At the current level, fixed income still offers diversification potential in case risky assets sell off and the economy goes into a slowdown or recession again but the need to have other tools available to diversify equity beta risk remains more pressing than ever, especially in a year where traditional diversification didn't play out well (i.e duration vs beta).

As for credit, default rates remain in a downward trend and despite this, spreads have widened throughout 2018, making corporate bond valuation becoming more attractive compared to one year ago. The current and expected low level of defaults are due to continued corporate earnings growth and rather muted corporate investment spending. This is also reflected in corporate ratings momentum, which currently show more upgrades than downgrades.

From a long-term perspective, it is still important to highlight that expected returns for the next decade will be very different from the returns we have seen over the last 10 years, although expected returns for certain asset classes have improved in 2018. This is especially true for fixed income, where expected returns are meagre across the asset class. As such, equities have been very much in the spotlight as the main source of returns for the coming years; here the question is whether they will be able to deliver those expected returns without any significant increase in volatility or any sizeable correction.

As such, investors must have an eye on diversification and find investment solutions which can enhance portfolio returns while exhibiting a low beta to equity markets. While we have been claiming that diversification has been at risk for some years now across traditional asset classes, 2018 has proved us right with both equities and fixed income suffering losses. That's why liquid alternatives can offer interesting investment opportunities, if wisely chosen, as they can offer low correlation to traditional asset classes and exploit alternative sources of returns.

¹) With effect as of 23 October 2017 the sub-fund is renamed from Nordea 1 – Multi-Asset Fund to Nordea 1 – Alpha 10 MA Fund.

Source: Nordea Investment Management AB. Date: December 2018. Unless otherwise stated all views expressed are proprietary to Nordea Investment Management AB.

Nordic Equities

Nordea Nordic Equities/ Nordic, Finnish & Swedish Equities Team



Nordea 1 – Nordic Equity Fund

- We are cautiously optimistic regarding the duration of the current economic cycle
- The Nordic macro development remains mixed
- Weak share price development has left the Nordic market trading below its average
- Companies with global and local stronghold are key attractions

2018 was another year of synchronised global growth resulting from loose monetary policies and increased employment supported many parts of the economy. However, increased friction in global trade and the reversal of loose monetary policies have all dented risk appetite in global equity markets throughout 2018. We are cautiously optimistic regarding the duration of the current economic cycle, with this framework in mind well-run companies with solid balance sheets and a discretionary opportunity to allocate capital in an accretive way remain a fertile ground for stock ideas.

The Nordic equity market had a below average year with large deviation between sectors. The material and health care sectors had double digit gains while IT and the consumer discretionary sector declined. Throughout the year there has been an ongoing debate between shifting consumer trends and its consequences as the benefits from tax changes in the US among other things. On an aggregate level the Nordic market is priced at 16x 12 months forward earnings. This is a level that is historically high, the 10 year average being 14x. However, bearing low interest rates in mind the level is not considered excessive.

A large part of the Nordic universe is exposed to the global economy given its historical international expansions. This combined with quality business models and strong corporate governance is key attractions for the Nordic market. Meanwhile the financial and telecom sectors in addition to smaller companies are more dependent to macro development in the Nordics where we are seeing an above trend development. In Sweden, the combination of urbanisation, strong export markets and a very accommodative Riksbank policy has positively influenced the Swedish GDP development in recent years. Going forward, a weakening housing market may curb domestic demand, especially consumer facing companies.

In Denmark, consumer spending continues to be supported by rising house prices and stable to declining interest expenses. European export growth is a positive factor impacting employment in a positive way albeit financial companies' earnings are held back by negative interest rates related to currencies pegged to euro.

Finland is clearly starting to benefit from an export driven rebound. Despite underlying structural issues the domestic demand is likely to remain positive with support from the construction sector and consumer sector in particular.

In Norway, oil and oil-related companies continued to scale back investment. However oil companies investment plans look to bottom out in 2018. The domestic economy has held up surprisingly well and with improvements in the labour market support domestic demand.

In general, we are cautiously optimistic regarding the duration of the current economic cycle. With this framework in mind, well-run companies with solid balance sheets and a discretionary opportunity to allocate capital in an accretive way should remain a fertile ground for stock ideas. This is reflected in the portfolio as we strive to invest in above average companies at below average prices.

European Equities

Nordea European Equities/ Fundamental Equities Team

Nordea
ASSET MANAGEMENT

Nordea 1 – European Focus Equity Fund, Nordea 1 – European Stars Equity Fund

- European macroeconomics have remained resilient during 2018 and should all remain strong in 2019. These economic fundamentals stand in sharp contrast to valuations, indicating investors' expectations of a clear macroeconomic slow-down for Europe in 2019
- The equity markets' performance in 2019 is as much about expectations for 2020 as it is about 2019, and the US yield curve indicates that US GDP growth could weaken further into 2020, which could have spill-over effects to Europe
- Market volatility is likely to remain high as the European political uncertainty does not appear to be improving

Throughout 2018 the financial markets' risk appetite was unmistakably damaged due to a deteriorating and ever more uncertain political landscape, destructive negotiations on global terms of trade, a troubled European car industry, and a US economic cycle approaching its peak.

Despite of these risk factors for the financial markets, European macroeconomics have remained resilient during 2018, exhibiting rising salaries, falling unemployment, robust consumer confidence and accelerating exports which should all remain strong into 2019.

Many uncertainties remain as we enter 2019. Questions around the strength of the US economic cycle, and how a US economic slowdown may impact European companies are on investors' minds. In addition, concerns about how the EU will fare in the face of Brexit, France's president Macron and Germany's chancellor Merkel both losing public support, and Italy fighting hard against the EU's hard line on budget over-runs.

European equities started 2018 on high hopes for the region but throughout the year confidence faded and European equities ended up with close to double-digit negative returns.

The precarious state of the European Union project turned even more fragile by the end of May as the realities of a new Italian government hit the market when Italy revealed its budget proposal for 2019 which materially deviated from earlier intentions to keep reducing the government's debt. European bank shares were the first to get hit as a Banking Union being agreed on by the EU member states now seemed increasingly unlikely, and as expectations faded for a European interest rate increase by 2019.

European GDP was hit during the summer and into the fourth quarter period as the German auto industry experienced production problems due to emission standard requirements which

had ramifications across several European countries deeply dependent on the auto industry.

Investors instead sought refuge in European information technology shares and other high-growth companies perceived to be less at risk from Europe's troubles. However, these stocks were soon thereafter hit by a combination of escalating trade negotiations between the US and Asia as well as slowing sales of tech products in the US.

As fourth quarter transpired the US financial markets increasingly showed signs of being late-cycle particularly with the US yield curve starting to show indications of an oncoming economic slowdown. This had negative spill-over effects to the European equity market where the cyclical sectors of tech, energy and materials suffered further.

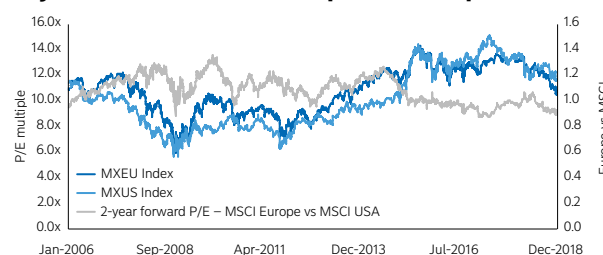
The factors determining the performance for European equities in 2019 appear to indicate a very wide range of potential outcomes.

On the one hand, European macroeconomics have remained resilient during 2018, exhibiting rising salaries, falling unemployment, robust consumer confidence and accelerating exports which should all remain strong going into 2019, and together imply European GDP growth around trend for 2019. These economic fundamentals stand in sharp contrast to the valuation of European equities which is indicating investors' expectations of a clear macroeconomic slow-down for Europe in 2019.

On the other hand, cost pressures for European companies appear to be building particularly from rising wages, indicating downside risk to consensus earnings expectations. Furthermore, the equity markets' performance in 2019 is as much about expectations for 2020 as it is about 2019, and unfortunately in particular the US yield curve indicates that US GDP growth could weaken further into 2020, which could have spill-over effects to Europe.

Finally, market volatility is likely to remain high, if not increase further, as the European political uncertainty does not appear to be improving anytime soon and as the European and US central banks continue to re-move liquidity from the financial markets.

2-year forward P/E multiple of Europe and USA



Source: Bloomberg. Time period: 31.12.2005 - 31.12.2018

North American Equities

The London Company

THE
LONDON
COMPANY

Nordea 1 – North American Value Fund

- We are not predicting a recession in the near future and believe the US consumer can continue to drive real GDP growth in the 2–3% range
- We believe 2019 will see higher inflation expectations, higher growth expectations or a rising term premium which could lift the long end of the yield curve
- In an environment of lower expected returns and greater volatility, we believe the fund offers a defensive option for equity investors as it mainly owns competitively advantaged businesses with stronger balance sheets

Looking forward to 2019, we recognize economic growth is slowing and the risk of a recession is rising. However, we are not predicting a recession in the near future and believe the US consumer can continue to drive real GDP growth in the 2–3% range. The US consumer represents roughly 70% of GDP and unemployment is low (3.7% per the U3 rate) while wages are rising (3.1% increase in average hourly earnings).

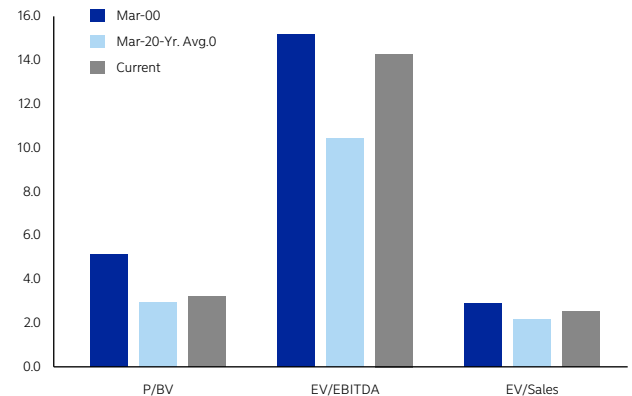
The US Federal Reserve continued to raise the fed funds rate during 2018. With concerns of a possible recession rising, the Fed appears very open to slowing the pace of future rate hikes depending on the economic data. Separately, we believe investors will continue to focus on the yield curve, which partially inverted during December. Higher inflation expectations, higher growth expectations, or a rising term premium could lift the long end of the yield curve. As the Fed reverses years of quantitative easing, that could also push longer term yields higher.

Talk of higher tariffs continued during the year. So far, any tariffs have failed to meaningfully impact trade or negatively affect the outlook for most companies. This will be important to watch in 2019.

Following the corporate tax cut at the beginning of 2018, we experienced greater dividend payments and share repurchases by companies. We expect that behavior to continue in 2019.

The combination of solid economic growth, low inflation (core inflation in the 2% range), and relatively low interest rates (but rising) usually creates a positive environment for stocks. We believe this holds true today, but we have a more balanced view of the market overall. Potential risks include relatively high valuations for stocks using traditional metrics (16x P/E, 13x EV/EBITDA), rising inflation, the impact of increasing tariffs, and a more aggressive Federal Reserve.

Market Valuations Over Time & Current



Source: Strategas, December 2018.

While we believe the risks and rewards are somewhat balanced as they relate to stocks overall, we always remain cautious and focus on limiting downside in each holding. Fortunately, we are still finding high conviction investment ideas to populate the portfolios.

Finally, we believe the Nordea 1 – North American Value fund is well positioned based on the strength of the companies owned and the overall valuation of the portfolio. In an environment of lower expected returns and greater volatility, we believe the fund offers a defensive option for equity investors. Investors in the Nordea 1 – North American Value Fund have the opportunity to own a group of competitively advantaged businesses (judged by return on capital), with stronger balance sheets (lower net debt/ebitda), at a valuation roughly in line with the market. Typically, a higher quality portfolio of companies will trade at a premium to the market. We believe this positions the fund very well for the next few years, even if the market continues to trade modestly higher.

Latin American Equities

Itaú Asset Management

Nordea 1 – Latin American Equity Fund



- Latin America can be a site of economic recovery in 2019
- Brazil could be the bright spot in the region with Bolsonaro taking office in January
- Current valuations offer a very attractive entry point

Latin America can be a site of economic recovery in 2019, led by its biggest market, Brazil, which responds for roughly 60% of the benchmark. Despite the fact that growth has been lackluster throughout 2018, we expect a recovery in the region for 2019. The economies of Brazil, Chile, Colombia and Peru should maintain or accelerate their pace of growth. The exception is Mexico, where a slowdown is expected, given uncertainties over domestic policies combined with slower growth in the US.

The election of a new president in Mexico, Mr. Andres Manuel Lopez Obrador (aka AMLO), a politician with a populist rhetoric and proposals, has affected investors' confidence in that market, which culminated with a heavy sell-off in the 4th quarter of Mexican assets, hurting both the currency and the equity market. Macroeconomic uncertainties, combined with a weaker currency, higher inflation, and tighter monetary policy in the US, have forced the Mexican Central Bank to increase interest rates. We do not believe that AMLO's macroeconomic policy will be disruptive, but history shows that populist and non-pragmatic policies imply in slower growth, and the combination of slower growth and higher interest rates is not the appropriate environment for equity investments.

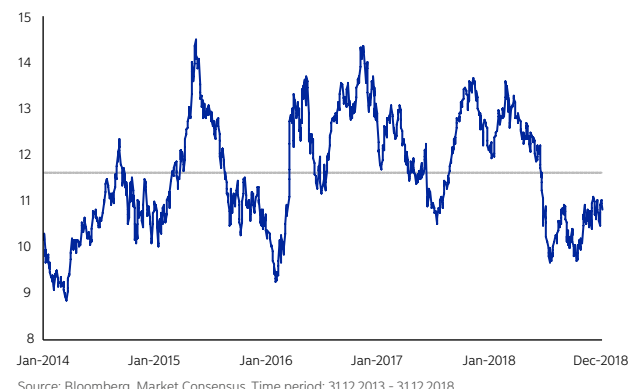
For the Andean markets, we see improving macroeconomic dynamics, but valuation is often expensive. Despite persistent headwinds for an open economy, such as global trade uncertainties and low confidence levels, Chile's GDP growth has accelerated significantly in 2018 and should maintain its pace in 2019. However, we see the Chilean equity market not very attractive in terms of valuation. Amongst the Andean markets we have had a more constructive view on Peru, as the new government counts on stronger approval ratings to implement the desired sound macroeconomic policies. Despite the fact that Peru is a relative small market, we find attractive investment opportunities from a bottom-up perspective.

Most of our optimism with the region comes from our positive view about the Brazilian economy and equity market, and politics played an important role at the end of 2018 with very positive ramifications for 2019 and beyond. Mr. Jair Bolsonaro was elected president of Brazil in October 2018, and will take office

on January 1st, 2019. Mr. Bolsonaro, a former army captain and congressman for more than 20 years, was elected advocating for more orthodox economic policies, and for fierce fight against corruption. He has been supported by respected economists known by their market friendly opinions, such as fiscal austerity, central bank independence, and privatization bias. The new government's biggest challenge will be to address the weak fiscal situation of Brazil, and in order to do so, it is imperative that a strong social security reform is approved in congress. If that goal is achieved, and chances are that it will, there will be a strong contraction of the yield curve, and cost of capital will be significantly reduced, which could be a major trigger for the equity market. We expect the Brazilian economy to accelerate growth from 1.3% in 2018 to 3.0% in 2019. Inflation is expected to remain low, and interest rate is expected to be constant (lowest level ever) until the end of 2019. From a top down perspective this is the appropriate scenario for equity investments.

From a bottom-up perspective we see the Brazilian equity market trading at a valuation below its historical average (as per graph below), and expect EPS growth for the local stock index to be close to 30% in local currency. Brazil has been our biggest overweight exposure.

P/E 12 MF Ibovespa Index



From a stock selection perspective, we find that the companies we carry in our portfolio are doing very well and are, in many cases, thriving. Some of our stocks are trading at very attractive valuations with double-digit Free Cash Flow yields and high single-digit dividend yields. They are exposed to good secular dynamics and will generate strong Free Cash Flow growth in the years to come as Brazil finally enters into a mode of sustainable growth. The combination of this top-down with the bottom-up scenarios put the Brazilian equity market, and consequently Latin America in a favorable position for 2019 and beyond.

Asian Equities

Nordea Emerging Markets Equities/ Fundamental Equities Team

Nordea
ASSET MANAGEMENT

**Nordea 1 – Asian Focus Equity Fund,
Nordea 1 – Emerging Stars Equity Fund**

- After a tough 2018, we believe that 2019 will be positive for Asian equities and new opportunities will arise
- We believe that good structural long-term fundamentals, generally attractive valuation levels, and a current relatively low view on earnings and growth towards Asian equities compared to its potential over the medium term will drive the investment universe

2018 turned out to be one of the most challenging years for Asian and Emerging Markets Equities since the global financial crisis. This was largely driven by the onset and escalation of a US-China trade war, further monetary tightening by the US Fed, ongoing Chinese deleveraging and worries about contagion from Turkey and Argentina. The contagion worries proved overblown, but the trade war and the Chinese deleveraging caused a significant deterioration in consumer and business sentiment in China which affected the performance of the entire asset class.

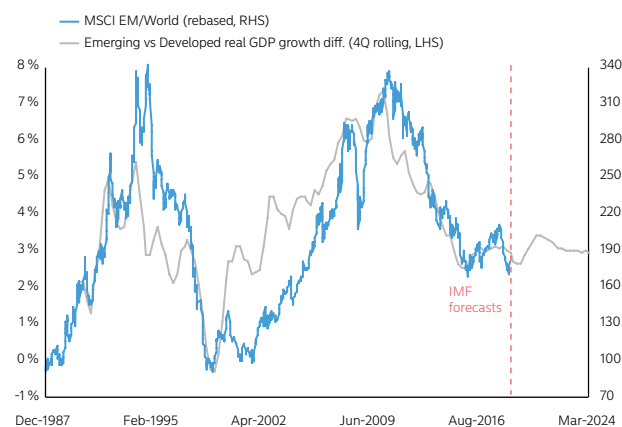
Looking into 2019, we are very positive on Asia and EM. After significant share price corrections in 2018, Asian and EM equities are very attractive from a valuation point of view and we believe there are several additional tailwinds for the asset class. First, the GDP differential between Asia/EM GDP growth is widening, as the US economy is likely to decelerate in 2019 while most Asian economies are likely to maintain a high and steady growth. This is important as it is a reversal of a decade long trend and this differential has historically driven the out-performance of Asia and Emerging Markets. Second, as the US policy rate gets closer to neutral levels, the US Fed is more likely to pause monetary tightening which would support an appreciation of many Asian and EM currencies and reverse liquidity flows. Third, there is an increased likelihood of a cyclical recovery in Asia and EM as loan growth and capex are at cyclical lows. Finally, any resolution or de-escalation of the US-China trade war will boost sentiment as the markets have already priced in a growth deceleration.

We continue to focus our investments in companies and sectors that are well-positioned to benefit from this economic transformation, have strong and sustainable competitive advantages, can generate positive returns on their invested capital, and manage all their stakeholders in a way that maximizes long-term shareholder return. We favour the Indian market where

we find great investment opportunities, particularly in the financial and consumer sectors. The Indian economy still offers huge potential in terms of urbanisation and industrialisation and most products and services are underpenetrated. We also find great opportunities in China as focus on deleveraging the overall economy are positive for China's long-term future. Earnings expectations and multiples for the Chinese equity market have come down substantially, and this provides the occasion to invest in companies within the industries that we find most attractive, which includes software, internet, e-commerce, artificial intelligence, industrial automation, online gaming, and consumer goods and services. We also see strong investment opportunities in Korea and Taiwan, primarily in the EV battery and semiconductor industries.

In summary, Asia and Emerging Markets continue to be supported by very attractive long-term fundamentals including higher growth, higher savings rates, lower debt levels, younger populations, reform, productivity gains and adoption of new technology. These fundamentals, coupled with low expectations and valuation levels that are attractive, should drive the investment universe in 2019.

Emerging relative to developed markets GDP differential versus performance



Source: Oxford Economics, IMF, MSCI, Credit Suisse research. Date: December 2018

Chinese Equities

Nordea Emerging Markets Equities/ Fundamental Equities Team

Nordea
ASSET MANAGEMENT

Nordea 1 – Chinese Equity Fund

- We believe that China holds some of the very best investment opportunities in the world today
- High exposure to structural winners that will benefit from the transformation to a more consumption and services-led economy

2018 turned out to be a challenging year for Chinese Equities, driven largely by the onset and escalation of a trade war against China by the United States. In addition, policy changes in several industries as well as a continued focus on deleveraging the overall economy in China put additional pressure on equity prices, though by and large we believe these structural changes are positive for China's long-term future. Uncertainty around the resolution of the trade war remains an overhang for China and the rest of the world in the first part of 2019, but we continue to remain positive in the medium and long-run and believe that China has some of the best investment opportunities globally today, many at bargain prices. Earnings expectations and multiples for the Chinese equity market have come down substantially, and this provides the occasion to invest in companies within the industries that we find most attractive, as China continues to transform into a domestically-led economy. We have long been believers in China's transition to a consumption and services-led economy, as well as China's ability to move up the technological value chain to drive long-term productivity gains and support growth.

We continue to focus our investments in companies and sectors that are well-positioned to benefit from this economic transformation, have strong and sustainable competitive advantages, can generate positive returns over their invested capital, and manage all their stakeholders in a way that maximizes long-term shareholder return.

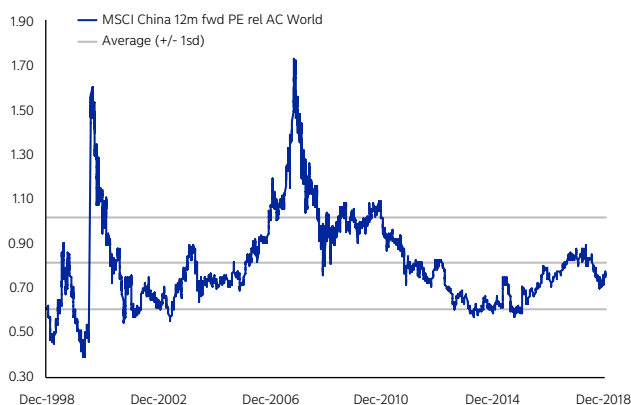
In our view software, internet, e-commerce, artificial intelligence, industrial automation, online gaming, and consumer goods and services are industries that hold great potential.

The macroeconomic backdrop has both positives and negatives in 2019. On the positive side, we see a more balanced economy in China. Growth continues in the consumer and services side of the economy, which is now more than 50% of the total, and the supply-side is much healthier on aggregate, with cash flow growth allowing SOEs to continue deleveraging, which remains the aim of the Chinese government. Despite slowing growth due to this deleveraging and some impact from the trade war,

China has been quite cautious in stimulating the economy in 2018, though they did announce an important tax cut to consumers which should influence spending in the beginning of 2019. On the negative side, China and the US have still not reached an agreement to end the trade war, though the recent agreement to pause escalation of tariffs and begin negotiations at the G20 summit is a positive development. As a consequence of playing a cautious hand with stimulus in 2018, we feel confident that China has several policy tools it can use to stabilize growth next year should we see the trade war negotiations prolonged or break down.

In summary, valuations and earnings expectations in China have come down significantly due to short-term internal and external factors, while structurally we remain constructive on the direction of travel of the Chinese economy, and we continue to find some of the best investment cases in our EM universe in China.

China PE relative to Global Equities



Indian Equities

ICICI Prudential Asset Management Company Ltd.



Nordea 1 – Indian Equity Fund

- Lower crude prices are positive for India
- Forthcoming General Elections is the key event to watch for in 2019
- Current phase of volatility provides an opportunity to accumulate Indian equities for long term returns

The year 2018 began with three major concerns – high crude prices, US China trade wars and global liquidity tightening. On the domestic front, macro headwinds, political uncertainty, currency depreciation and issues with Non-Banking Financial Companies (NBFC) weighed on both equity and fixed income markets. MSCI India has underperformed 10.4% in USD terms and remained flat in INR terms (+0.2%). Midcap and small cap indices have seen a significant correction of 25.2% and 33.7% respectively, after a sharp rally in 2017. Foreign Portfolio Investors sold equities worth USD 4.4bn, while Domestic Institutional Investor bought equities worth USD 15.9bn. MSCI India has outperformed MSCI EM index by 3.2% in 2018. (Source: Morning Star Direct, Bloomberg, Currency: USD; Data for the period from 01 Jan 2018 to 12 Dec 2018).

The Goods and Services Tax (GST) implementation in mid 2017 helped enhance the tax base and benefited exporters with input credits, although revenues still continue to trail budgeted estimates. India jumped 23 notches to rank 77 in the World Bank's ease of business survey, reflecting the structural improvements in the economy. IMF expects India's GDP to grow at 7.3% for FY19 and 7.4% in FY20 on the back of strengthening of investment and robust private consumption. The sharp correction in brent crude prices in recent months (~40% from peak seen in October 2018) has benefited the economy in terms of a reduced import bill, softening inflation and easing pressure on currency.

Dr. Urjit Patel, Governor of Reserve Bank of India (RBI) resigned nine months prior to the end of his tenure for personal reasons. The Indian Government quickly appointed Mr. Shaktikanta Das, a seasoned bureaucrat, who was involved in the Demonetization drive, GST roll-out and the enactment of the new Insolvency and Bankruptcy code. Experts believe that Governor Das's experience in finance ministry could bode well for resolving recent credit and liquidity events in NBFCs, dealing with excess RBI capital reserves and RBI's Prompt Corrective Action (PCA) framework for state owned banks.

The ruling party BJP lost power in three major states in Central India (Rajasthan, Madhya Pradesh and Chhattisgarh, contributing 15% of total seats in National Parliament). These states

had contributed significantly to the BJP's victory in the last General elections in 2014. While state election results are not a perfect indicator of General election outcome, these results have marked gains for the Congress and some setback for the BJP.

As we approach 2019, the risk related to crude oil prices seem to have abated With crude oil prices cooling off, currency along with bond yields have rallied from their recent lows. On the valuation front, while MSCI India is trading at 12 month Fw P/E of 17.5x versus its 10 year average of 15.6x, its 12 month Fw P/B of 2.94x is closer to the 10 year average of 2.98x. With the sharp correction in mid and small cap stocks, valuations on 12 month Fw PE and PB basis are below long term averages, thereby providing opportunities for bottom up stock picking.

Corporate earnings for H1FY19 (April 2018–Sept 2018) are up 15% YoY. With capex already in place, improved capacity utilization, sharp fall in commodity prices and a favorable investment cycle, earnings outlook continues to remain healthy. As India heads into General Elections in 2019, concerns over the Government taking populist measures has resurfaced. Such measures could add to the fiscal stress and inflationary pressures in the economy. We expect Indian markets to remain volatile till the General Elections and recommend investors to accumulate equities for making superior risk adjusted returns over next 18–24 months. Our portfolio construction is biased toward large-caps and bottom up stock picking in midcaps which are available at attractive valuations.

Midcaps and Small caps witness significant fall in 2018



Above chart is for the period from 01 Jan 2018 to 12 Dec 2018. Source: Morningstar Direct, Currency: USD. Data Source - © 2019 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

European Covered Bonds

Nordea Danish Fixed Income & European Covered Bond Team

Nordea
ASSET MANAGEMENT

Nordea 1 – European Covered Bond Fund,
Nordea 1 – Low Duration European Covered Bond Fund

- Core covered bonds currently offer an attractive pricing versus underlying sovereign bonds
- The supply in 2019 will play an important role for the spread development of covered bonds
- ECB will remain a supportive factor for spreads as they will reinvest redemptions

It has been a difficult year in 2018 for covered bonds: in fact, the worst for the asset class since 2011, with a spread widening of appx. 25bps (as per 15th of December). With the sell-offs in equities and other credit instruments, the overall market sentiment has turned negative, and this has driven much of the trend in covered bonds. We have seen pressure on spreads from a larger than expected supply on the primary market. This came hand in hand with the decision of the ECB to gradually cut its order size from 50 % to 40 %, further down to 30 % and finally to 10 % from October on.

Going into 2019, we see the relative pricing of covered bonds versus the underlying sovereign as attractive in core jurisdictions from a historical perspective. Even though we have seen senior preferred debt underperform covered bonds in 2018, we still see the relative pricing of these as too expensive. We therefore find a large covered bond widening in isolation unlikely.

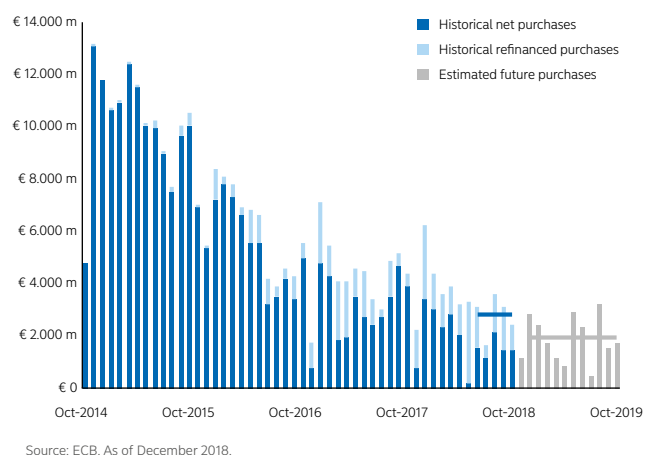
The supply of covered bonds will again play an important role in the spread development in 2019. Even though we will see around €103bn of redemptions (an increase of more than 20 % in comparison with 2018), the consensus between analysts is that between €130bn – €150bn of gross EUR benchmark will be issued in 2019. That means a relatively high net supply and a small upwards pressure on spreads. The large expected supply was backed by EBA's report on bank funding plans that was published September 2018, expecting banks to front-load some of their funding needs to benefit from the low interest rate environment.

However, we still see some uncertainty regarding the supply of covered bonds in 2019. It is expected that banks – mostly in the periphery – will have to refinance their longer-term refinancing operations (LTRO) that mature in June 2020, since the funding will no longer be considered as "Available stable funding" in Net Stable Funding Ratio (NSFR) by June 2019. Banks will have to comply with the NSFR by January 2019. Most analysts assume

that a new TLTRO will be introduced in 2019, however, with less attractive conditions. A new TLTRO will have a negative impact on supply in 2019, reducing the needs for banks – mostly in Italy and Spain – to use covered bonds as a funding tool. The need for senior bonds can also impact covered bonds. Banks need to comply with regulations such as Total Loss Absorbing Capacity (TLAC) and Minimum Requirement for own funds and Eligible Liabilities (MREL) in 2020 and these requirements can be supportive for supply of – especially – Senior Non-Preferred and hence supportive for covered bonds spreads as it reduces the banks funding need in other instruments but also decreases the likelihood of default of the issuer.

The tapering from ECB has been the talk of the town in 2018. It is expected that ECB will end net purchases in the Asset Purchase Program (APP) from January 2019 which expects to put some negative pressure on spreads. However, the ECB has indicated that they will reinvest principal payments, and it is expected that it will remain in the same asset classes as the matured bond. If ECB choose to use its new capital key when reinvesting it will be supportive for the core covered bond markets, while the periphery will be underweighted a bit. This effect will not have much impact. ECB has already started the tapering gradually over the last years and that the estimated gross purchases will not drop that significant in 2019 compared with the last six months. Furthermore, there has been indications from especially bank treasuries, that the spread in core covered bonds versus the underlying spread now has reached a level where they are ready to increase their exposure in covered bonds. We expect new investors to offset the gap that ECB leaves.

CBPP3 monthly purchases



European High Yield Bonds

Capital Four Management A/S



Nordea 1 – European High Yield Bond Fund

- Throughout 2018 volatility was elevated due to rising concerns related to geopolitics, monetary tightening and late cycle slowdown in the global economy
- Default rates are expected to remain low as fundamentals within European High Yield continue to look healthy
- As we move into 2019 it seems to become increasingly important to avoid negative tail risk

The European High Yield Market had a negative return for the year as the asset class was not insulated from several growing concerns related to geopolitics, supportiveness of central banks, energy prices, late cycle slowdown in the global economy, etc. Throughout the year volatility was elevated compared to 2016 and 2017, especially with bouts of increased volatility during early summer and during the fourth quarter.

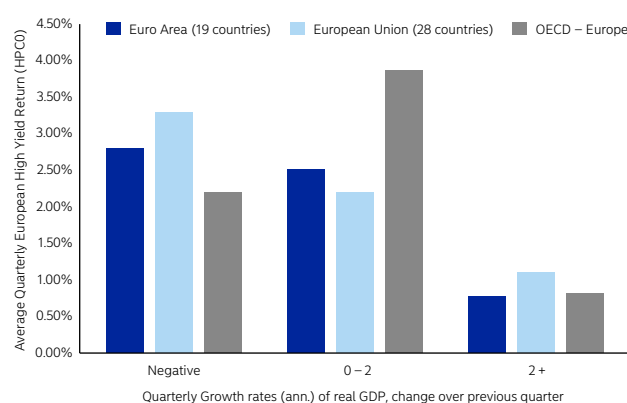
Within the European High Yield market, we saw a large dispersion of returns across sectors. In general, more cyclical sectors underperformed more defensive sectors due to the general risk off sentiment and late cycle positioning as well as business model challenges within specific areas (e.g. brick and mortar retail companies and paper pulp producers). During the last quarter of 2018 there was also a general flight-to-quality and the BB-rated part of the European high yield market outperformed the lower rated buckets.

Despite the increased volatility we saw default rates remaining at very low levels (below 1%) that are well below the long-term average (around 3%). Most strategists and researchers expect the default rate to increase slightly but remain at low levels in the 1–3% range throughout 2019 as fundamentals within European high yield continue to look healthy with high interest rate coverage ratios and leverage remaining at overall healthy levels. A good measure for the current state of the market is looking at the number of bonds trading below 80 in price. Going into 2019 this number is currently 2.6% for the European High Yield market with a low likelihood that all these bonds will default. We expect default rates to be in the 1.5% to 3.5% range in 2019 with a higher possibility of default rates ending in the lower end of the range as the default rate environment stays benign. However, we see the possibility of a more rapid increase in default rates due to increased uncertainty.

Although the expectation for the development of the economy in Europe has dampened somewhat since the beginning of

2018, where the story of synchronized global growth seemed to be the consensus, we do not see a recession as the most likely scenario in the short run. In general, economists now expect a more modest growth rate of 1–2% and the chart below shows that the European High Yield market historically has fared quite well when the growth rate has been in the 0–2% range.

Performance of European High Yield in Different Growth Scenarios



Source: OECD, BAML, Capital Four Management. Time period: Q1 1998 – Q2 2018. Past performance is not a reliable indicator for future results.

Nevertheless, as we move into 2019 it seems to become increasingly important to avoid negative tail risk as markets seem to have a more nuanced and differentiated approach to pricing idiosyncratic risk and at the same time the significant growth in the lower-rated spectrum of the investment grade universe also creates potential for interesting investment opportunities and return potential from "Fallen Angels" (Investment Grade companies downgraded to High Yield). All this should favor investors with a fundamental active and bottom-up focused process.

As the recent market repricing has resulted in a current spread of above 500 basis points compared to spread of below 300 basis points at the end of 2017 and with only a slight increase in default loss expectations compared to a year ago this should give investors an attractive running spread compensation for the inherent credit risk. At the same time, we also see a high probability of spread tightening in 2019 – much like what happened in the beginning of 2016 and 2011 where we had volatility without entering a recession. Nevertheless, uncertainty has increased – as has the range of outcomes – and we believe there will be volatility along the way as macro-driven factors such as oil, Italy, Brexit, the Chinese economy etc. will keep impacting markets combined with an increase in idiosyncratic credit risk.

Nordic Fixed Income

Nordea Norwegian Fixed Income Team

Nordea
ASSET MANAGEMENT

Nordea 1 – Norwegian Bond Fund,
Nordea 1 – Norwegian Short-Term Bond Fund²

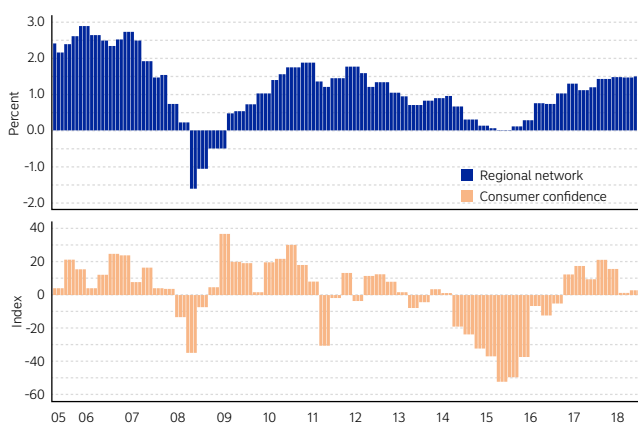
- The general positive outlook for the Norwegian economy has led Norges Bank to start hiking rates. This might add to volatility in the credit market

The Norwegian economy is ending 2018 on an upward trend, which we expect will continue well into 2019. This can be supported by positive regional network and consumer confidence indicators. Especially non-oil export related businesses could see further growth, in particular if the NOK remains on the weak side.

The general positive outlook for the Norwegian economy has led Norges Bank to move its interest rate path significantly during 2018. Norges Bank increased the policy rate by 25bp to 0.75% in September. This was the first rate hike in more than seven years, and we believe we are likely to see two more hikes in 2019, the first probably coming in March.

Going into 2019, NOK credit spreads are more aligned to the levels we see in similarly rated issuers in the EUR-market. We expect credit spreads to remain in a more volatile mode in 2019 as global monetary easing is fading.

Norway: Regional network and consumer confidence



Source: Nordea Investment Management AB and Macrobond, as of December 2018.

Nordea Swedish Fixed Income Team

Nordea
ASSET MANAGEMENT

Nordea 1 – Swedish Bond Fund,
Nordea 1 – Swedish Short-Term Bond Fund³

- The Riksbank hiked for the first time in seven years as inflation is above target. There might be good value in Swedish spread products

We expect Swedish economic annual growth to have peaked 2018 at 2.8% and to go down to 2.1% in 2019 as growth in both manufacturing and housing investment should fall. Also the Swedish central bank, Riksbank, is reducing its monetary support as they hiked interest rates in December for the first time in seven years. The rate hike was warranted as Swedish inflation is currently above the Riksbank's target of 2%.

At the end of 2018, credit spreads widened, mainly driven by declining risk appetite, and investors worrying about a global growth slowdown. After a significant spread widening, our view is that Investment Grade Bonds trade now at attractive levels.

Entering 2019, we aim to keep a high allocation in covered and investment grade bonds, as we find spreads attractive, especially in relation to government bonds. Furthermore, yield curves are steep and generate a good roll down and carry, as well as a decent risk adjusted return.

Spread of the NOMX Credit SEK Rated FRN Index



Source: Bloomberg. Time period: 30.12.2013 – 21.12.2018.

²) With effect as of November 19th, 2018 the sub-fund is renamed from The Nordea 1 – Norwegian Kroner Reserve to Nordea 1 – Norwegian Short-Term Bond Fund and the investment policy of the sub-fund was modified.

³) With effect as of November 19th, 2018 the sub-fund is renamed from Nordea 1 – Swedish Kroner Reserve to Nordea 1 – Swedish Short-Term Bond Fund and the investment policy of the sub-fund was modified.

Source: Nordea Investment Management AB. Date: December 2018. Unless otherwise stated all views expressed are proprietary to Nordea Investment Management AB.

Asian Fixed Income

Income Partners Asset Management (HK) Limited



Nordea 1 – Renminbi Bond Fund⁴

- The Asian USD fixed income market corrected sharply in 2018 mainly due to China's deleveraging policy
- Chinese policy adjustment from deleveraging towards stabilizing growth in the second half of 2018 together with the significant sell-off led us to begin to see attractive value in Asian credit
- We believe it is time to consider making an allocation into China's onshore bond market

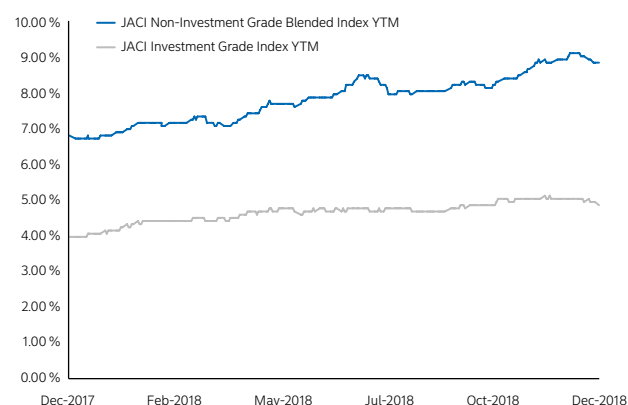
The Asian USD fixed income market corrected sharply, especially for high yield bonds, in 2018. Multiple risk factors, including Fed rate hikes, China's deleveraging policy, and the trade war, have all contributed to the sell-off. Among these factors, we believe China's deleveraging policy was the most significant driver of spread widening.

Beginning late 2016, China's deleveraging policy has effectively stabilized the country's Debt/GDP ratio and released the most significant structural overhaul for its economy in several years. The side effects have been slower economic growth and a tightening credit environment. Into 2018, Chinese companies, especially private enterprises, began feeling the lagging effect of the deleveraging policy, as the availability of credit from the onshore shadow banking system became much tighter. This became more severe after the announcement of a new high-level asset management rule by the regulator in April, which created a freeze on banks and trust companies issuing new products. From April to July 2018, total outstanding non-bank credit growth was negative, indicating a credit crunch in certain segments of the market. The tightening credit environment triggered consistent spread widening across Chinese credits, and a repricing of the whole Asian credit space.

Chinese policymakers reacted quickly to the situation and began adjusting policy from deleveraging towards stabilizing growth from July. Conditions in the onshore credit market began to normalize from July, stabilizing the total outstanding non-bank credit from further declines, and resulting in a gradual recovery in the Asian credit market.

Looking ahead into 2019, with the ongoing trade war uncertainty and slowing economy as a backdrop, we expect Chinese policymakers to continue to announce monetary easing and fiscal stimulus to stabilize the economy, which will gradually normalize the onshore credit market and further ease the refinancing risk for Chinese credits. Considering the policy turning point in China, combined with the significant sell-off year-to-date, we have begun to find good value in Asian credits, especially higher quality high yield names. We also believe it is time to consider making an allocation into China's onshore bond market, the third largest bond market in the world, which is now fully accessible for global investors. Considering the RMB's reserve currency status, the large scale of the onshore market, the advantages of being a first mover on index inclusion, as well as the diversification benefits, China's onshore bond market offers attractive opportunities.

YTM in Asian Credit



Source: JP Morgan, Time period: 29.12.2017 – 10.12.2018.

⁴ With effect as of November 19th, 2018 the sub-fund is renamed from Nordea 1 – Renminbi High Yield Bond Fund to Nordea 1 – Renminbi Bond Fund and the investment policy of the sub-fund was modified. Source: Income Partners Asset Management (HK) Limited. Date: December 2018. Unless otherwise stated all views expressed are proprietary to Income Partners Asset Management (HK).

Emerging Market Debt

PGIM Limited



Nordea 1 – Emerging Market Bond Fund, Nordea 1 – Emerging Market Bond Opportunities Fund

- EMD faced a series of headwinds in 2018 including an increase in US rates, a stronger dollar, and several idiosyncratic developments in EM
- A widening growth differential between developed market and emerging market economies should be supportive for EM assets in 2019

While the Emerging Market Debt (“EMD”) sector faced a series of headwinds in 2018 – an increase in US rates, a stronger dollar, and several idiosyncratic developments in EM – more attractive valuations and still solid fundamentals position the sector for constructive performance in 2019.

As part of our macro base case, we expect continued global growth in 2019, albeit with some moderation. Importantly, we see a widening differential between developed market and emerging market economies next year. With this backdrop, we continue to expect the Fed to hike the Fed funds rate twice in 2019 and for quantitative tightening to continue as well. However, we see downside risks to the forecast for Fed rate hikes, and the FOMC will likely review economic conditions frequently.

	2018-Forecast		2019-Forecast	
	Bloomberg Survey	PGIM Fixed Income	Bloomberg Survey	PGIM Fixed Income
Emerging Markets	4.9	4.7	4.9	4.8
Developed Markets	2.4	2.3	2.1	2.1
Difference EM vs DM	2.5	2.4	2.8	2.7
Global	3.8	3.7	3.8	3.7
U.S.	2.9	2.9	2.5	2.5
Euro Area	2.1	2.0	1.8	1.8
China	6.6	6.3	6.3	6.3
Japan	1.1	1.2	1.0	1.0

As of October 2018. Source: PGIM Fixed Income and Bloomberg. Survey forecast for global growth based on average forecast from several broker dealers and PGIM Fixed Income calculations. There can be no assurance that these forecasts will be achieved.

We believe the macro conditions shaping up into 2019 create a sound environment for risk assets. One caveat being that the continued uncertainty regarding trade wars could affect risk sentiment next year. That being said, we believe there is scope for a workable tariff agreement given the domestic considerations of Presidents Trump and Xi.

As for the EMD sector, hard currency spreads may be biased to tighten as yields on the hard currency index recently approached the widest levels seen since 2006 (with the exception of the 2007/08 GFC blowup), spreads are reasonable, and EM fundamentals are generally solid. The local rate opportunities we see in 2019 are predicated on the stable US rates backdrop, supported by the fact that many GBI countries have steep curves, which overestimate the potential increase in local central bank policy rates. Our positive base case view for EMFX in 2019 rests on the macro backdrop and the relatively attractive valuations. Indeed, real effective exchange rates recently returned to the lows of 2016, and going forward, performance may be driven by improved and manageable current account deficits.

In terms of potential flows into the sector in 2019, while retail flows fluctuate year-to-year and can be difficult to predict, strategic (institutional) investors increased their allocation to both hard and local currency EM mandates in each of the past six years. In 2019, J.P Morgan estimates that strategic flow into the sector could be flat compared with inflows of approximately +\$20 billion through late 2018.

Of the prominent risks we’re watching in 2019, we continue to focus on China as it pertains to sentiment, flows into the sector, commodity prices, and EMFX vis-à-vis the U.S. dollar. In general, we expect China’s authorities to dial up debt-creating stimulus until concerns about debt sustainability re-emerge or until trade-war fears recede.

US Fixed Income Asset Allocation

DoubleLine Capital LP

Nordea 1 – US Bond Opportunities Fund



- We continue to believe that US corporate bond investors are not being adequately compensated for the combination of interest rate risk, liquidity risk and credit risk
- US Treasuries and credit sensitive sectors with attractive yield per unit of duration profiles should remain cornerstones in multi-sector portfolios

The strong performance of risk assets to start the year was driven by continued improvement in corporate earnings, increased global growth expectations, highly accommodative monetary policy from global central banks and a benign inflation environment. As a result, credit spreads also approached near cycle tight. Volatility increased in February and persisted at elevated levels, however global markets remained synchronized throughout the later stages of the first quarter. In Q2 and Q3 however, a significant divergence between the US markets and the rest of the world took place as ex-U.S. developed markets and emerging markets faltered as trade concerns and less accommodative global central bank monetary policies came to the forefront.

At the beginning of 2018, Mr. Gundlach coined 2018 a “don’t lose money year”. His expectation was for US Treasury (UST) yields to rise, volatility to increase and equities to have a down year as quantitative tightening continued in the US and the Federal Reserve looked to forge ahead with its rate hike agenda. Despite making these proclamations when most experts were calling for a ‘melt up’ given strong global growth data, US Treasury yields across the curve reached levels that have not been breached in years. Further, the global equity market, as measured by the MSCI ACWI Index, is negative for the year despite being up more than 7% just 18 business days into January. Volatility, as measured by the VIX Index, hit a level that was more than triple where it started the year and still remains well above its January level today.

As we enter 2019, we believe UST yields will continue to rise, however we believe UST securities, especially on the front end of the curve, should remain a cornerstone in any multi-sector portfolio due to the high quality and liquidity they provide. We continue to be underweight US investment grade corporate bonds due to their long duration profile and the large amount of issuance that has occurred in the space since the financial crisis. Since 2008 corporate CEO’s have taken advantage of the market opportunity and increased their leverage by issuing long dated debt at low rates. Alarming, nearly half of this issuance has been in the BBB-rated space, only one downgrade away from being considered below-investment grade i.e. junk bonds. From a credit perspective we favor securities with more attractive yield per unit of risk profiles which can be found in certain areas of structured products. In addition, while we do not predict a recession over the near-term and the majority of our internal indicators signal continued expansion, we remain biased towards higher credit quality. One rationale for this is the flattening of the yield curve that has taken place throughout 2018. Historically, as the economic environment starts to deteriorate the curve flattens. As of November 30th, 2018, the difference in yield between the 10YR UST and 2YT UST has narrowed to 20 basis points.

Emerging market debt has become more attractive as we enter 2019. Tensions between the US, a stronger USD and the threat of slowing growth in China has caused spreads to widen significantly within the asset class throughout the course of the year. While DoubleLine has not added to the sector within multi sector portfolios, active management allowed us to use the volatility as an opportunity to selectively add risk at more attractive valuations within the sector itself.

Moving forward, we continue to keep an eye out for market moving events and catalysts that could create disruption within the markets. We believe volatility will persist as investors await clarity around key policy decisions from central banks and monitor trade negotiations between China and the US. Globally, idiosyncratic risks such as a China slowdown, Brexit uncertainty, and high debt levels in Italy are likely to remain a concern for investors heading into 2019. Given increased volatility and a global economy that appears to be in the late stage of the economic cycle, we continue to favor fixed income portfolios that are well diversified, actively managed and have a bias to higher credit quality heading into 2019.

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US Investment Grade Corporate Bonds

MacKay Shields LLC, Global Fixed Income Team



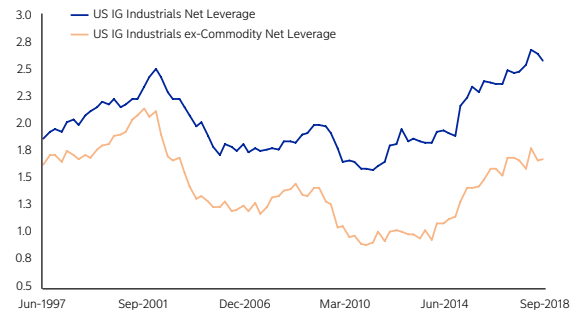
Nordea 1 – US Corporate Bond Fund

- US investment grade corporate bond spreads have widened in 2018 due to weaker technicals
- Spreads might widen further in 2019 as the Fed is expected to continue to be more restrictive and leverage ratios are high

US credit spreads have been widening out over the past couple of months as investors digest the prospects for slower global growth, impact from trade wars, tighter monetary conditions in the US and overall valuations. In the investment grade market, spreads have leaked wider all year notwithstanding the snap-back in Q3. The movement has been relatively orderly and much of it can be attributed to weaker technicals rather than deteriorating fundamentals. More specifically, heavy supply from M&A transactions, headwinds from FX hedging costs for foreign buyers and consequently, reduced demand from this cohort have all contributed to wider spreads. It is also worth mentioning that idiosyncratic risk is more prevalent in the market today, as we have seen with names such as General Electric and the auto manufacturers.

Over the past several months, the financial press has highlighted the growth of the BBB credit market and the potential risk of downgrades into the high yield market. Today, BBB rated issuers represents nearly half the US investment grade corporate bond market. Maintaining higher quality ratings has become less important to corporate management teams over the past several years as demand for credit has been robust and interest rates low. Consequently, the rating agencies have been much more tolerant of debt-funded acquisitions and placed greater emphasis on qualitative criteria and interest coverage ratios rather than leverage levels. This resulted in a higher representation of investment grade companies operating with aggressive leverage ratios that are typical among high yield issuers.

Net leverage of US IG Industrials



Source: Bank of America Merrill Lynch, MacKay Shields LLC. Time period: 30.06.1997 – 30.09.2018

As we move forward, our expectation is that spreads present further downside risks over the next 6-12 months. Volatility is likely to remain elevated for the foreseeable future. Forward guidance from a number of companies as it relates to capital spending, revenue growth and earnings expectations is being reduced, while wage inflation and transportation costs are headwinds. Although it can be difficult to predict the beginning of the next economic downturn, caution is warranted. The Fed is expected to raise rates in December whereas the outlook for 2019 is less clear. However, even if the Fed were to pause at some point next year (on November 28th Jerome Powell believed interest rates were just below the range of estimates for neutral), it is important to keep in mind that the unwind of the central bank's balance sheet recently accelerated to \$50 billion per month and will contribute to restrictive credit conditions in the US. The recent correction in crude oil does provide some near-term stimulus, particularly for the consumer, but the Fed is faced with a delicate balancing act as it looks to slowly achieve a neutral rate following an extended period of ultra-low interest rates.

US High Yield Bonds

Aegon USA Investment Management, LLC



Nordea 1 – North American High Yield Bond Fund

- Fundamentals remain healthy but there are several headwinds that will continue to be at play in 2019
- Given the magnitude of macro uncertainties, we anticipate volatility to remain high

The US high yield market spent most of 2018 trading lower as it dealt with the macro headwinds of higher rates, volatile equity and currencies markets, and uncertainties around late cycle credit market conditions. This was despite strong US GDP growth and solid high yield issuer fundamentals (low defaults, strong earnings, etc.). Through the first three quarters, the high yield market absorbed some of the move in underlying interest rates as spreads tightened by 25 basis points. However, as future global growth expectations were lowered in the fourth quarter, weakness in commodities and broader credit markets overwhelmed the supportive high yield technical conditions, and spreads pushed wider by over 100 basis points. While disappointing, relative to other fixed income assets (treasuries, investment grade, and emerging markets bonds), high yield still managed to be a modest outperformer.

Looking ahead to 2019, we anticipate the high yield market will continue to grapple with many of the same concerns that have plagued the market in 2018. Headwinds to markets in 2019 may include further trade escalation, further quantitative tightening by central banks, uncertainties around Brexit and Italian politics, slowing Chinese growth, weak energy prices, tight labor markets in developed economies, etc.

However, offsetting these risks, the high yield market appears to be starting from a relatively strong position. Fundamentals remain healthy as most issuers' earnings have been strong and most high yield companies have not aggressively added leverage to their balance sheets. Interest coverage ratios are solid with balance sheets termed out in relatively low coupon debt.

This combination should result in another year of below-average defaults. Additionally, the technical environment remains solid as there has been a very limited supply of new issue. Despite the elevated leverage of many BBB issuers, we believe fallen angel risk from investment grade remains contained in 2019. Finally, valuations are at reasonable levels given the current interest rate and default environment, with yields higher than they have been since mid-2016 and spreads outside of 400 basis points. Given our view that the high yield market is starting from a reasonable level, we believe the market is better positioned to deal with the negative headwinds than it was in 2018. Therefore, we expect returns will be modestly better, with our base case pointing to 4–6% returns in 2019. That being said, given the magnitude of macro uncertainties, we can envision scenarios where returns deviate materially and anticipate volatility to remain high.

YTW of the ICE BofAML US High Yield Index



Source: Bloomberg. Time period: 27.12.2016 – 26.12.2018.

US Mortgage Backed Securities

DoubleLine Capital LP

Nordea 1 – US Total Return Bond Fund



- We continue to think securitized products are better positioned than their corporate debt counterparts, especially in a rising rate environment
- Long-term demographic trends including household formation and limited housing supply should support the US housing market going forward

We continue to think securitized credit looks more attractive than both US Treasuries (UST) and corporate credit. Rising UST yields are a headwind for all fixed rate investments, but US corporate credit – and investment grade bonds in particular – are uniquely exposed due to their relatively long duration. As of November 30th, 2018, the Option Adjusted Duration of the Bloomberg Barclays U.S. Credit Index was 6.82 years, compared to the duration of the Bloomberg Barclays U.S. Mortgage Backed Securities Index of 5.30 years. Additionally, in a rising rate environment securitized credit has historically outperformed corporate credit as amortizing principle can be reinvested at higher yields.

During 2018, Agency MBS has experienced roughly \$1.2 billion in gross issuance, largely in line with 2017's figures. Issuance will likely be similar in 2019 with prepayment expectations subdued as mortgage rates continue to be near their highs of recent years. Spreads largely widened for the MBS sector with MBS OAS widening roughly 15 basis points (bps) and current coupon spreads against 5/10 yr US Treasuries widening roughly 20 bps. This will likely continue next year as concerns surrounding potential excess supply resulting from the Federal Reserve (Fed) no longer reinvesting MBS paydowns remain. The Fed's runoff caps stepped up throughout 2018 to reach their ultimate limit of \$20 billion per month. In 2019, we expect monthly runoff will average roughly \$15 billion per month, with seasonal turn-over factors contributing to month-to-month variance around this number. However, bank demand will likely be higher which should help absorb some of this excess supply. We also believe money managers are likely to step in to help absorb this larger supply as price declines in the corporate sector and improving seasonals within mortgages may result in a reallocation from corporate credit into Agency MBS.

In the non-agency space, residential mortgage credit was well supported during 2018 as strong investor demand kept spreads at tight levels. While the sector was not immune to the broad-market volatility experienced during the 4th quarter, we believe it will continue to perform well on a relative basis due to a balanced fundamental backdrop and positive supply/demand technicals. Issuance during 2018 reached a post-crisis high as over \$100 billion came to market. We expect similar volumes during 2019 due in part to continued growth in the non-qualified mortgage (non-QM) market and positive securitization economics in the Jumbo 2.0 space. Re-performing loans (RPLs) will likely remain the largest source of supply as the government-sponsored enterprises (GSEs) and banks have an estimated \$200 billion remaining on their balance sheets that could come to the securitized market. While there have been negative headlines recently around weakness in the US housing market, we believe long-term demographic trends including household formation and limited housing supply should support the market going forward. However, we expect the current pace of home price appreciation to decelerate due to decreasing levels of affordability. Housing market performance is likely to be more dispersed on a regional basis as well.

Regarding private label Commercial MBS, short duration, floating-rate "Single Asset Single Borrower" (SASB) investments saw the strongest demand in 2018 as investors sought a hedge to rising rates. Partly a result of a relatively flat yield curve, we continue to prefer floating-rate SASB investments. We are comfortable going down in credit in this space given the short term nature of the underlying loans, coupled with institutional sponsorship, amongst other factors.

2018 ABS supply is on pace to set a post-crisis high, with year-to-date issuance of approximately \$250 billion. We expect this robust level of securitization activity to remain healthy in 2019. The collateral comprising ABS continues to benefit from the overall strength of the US economy and healthy consumer balance sheets. A tight labor market – which has added nearly 2.5 million jobs over the past year – coupled with an unemployment rate holding at its lowest levels over the past 50 years have provided a solid base for consumer debt. Additionally, growing issuance in ABS subtypes that are secured by hard assets such as transports, renewable energy and data technology can offer investors attractive opportunities and improved security through collateralization in strategic sectors. We believe the ABS sector offers a compelling return per unit of risk with a combination of high credit quality, shorter duration, strong liquidity and attractive yields relative to more traditional sectors of the fixed income market.

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