ACHMEA MORTGAGES

Investment Update H1 2025

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1. Investing in Mortgages

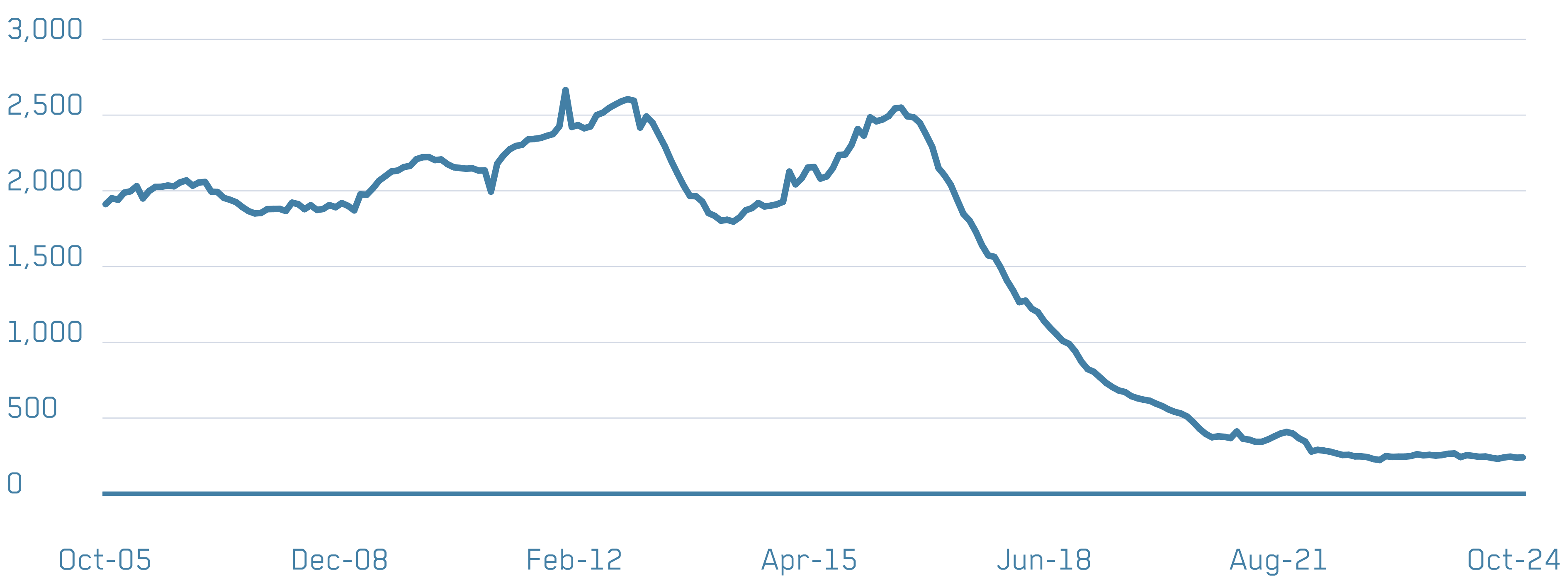
Dutch mortgages are an interesting investment category for investors. They offer an attractive combination of return and risk and also provide diversification benefits within a portfolio. The low level of unemployment, the strong payment behaviour of homeowners and the tightness of the housing market provide a solid base for mortgages as an investment category. As always, though, the outlook is uncertain.

The credit risk for an investor in residential mortgages consists of the risks of households defaulting on their mortgage and a drop in the value of properties. Both depend largely on the general macro-economic environment and the situation on the housing market in particular. More specifically, rising unemployment and rising mortgage rates are the most important warning signals, while deep recessions, especially if they are preceded by strong increases in house prices, can lead to falling property prices.

The current economic situation is favourable for this asset class. Unemployment is low and is not expected to rise materially in the foreseeable future, providing a high degree of income security. The Dutch economy stagnated last year, but returned to growth in the 2nd half of 2024 and is expected to conitnue to grow in 2025.

While mortgage rates rose sharply in 2022 as the ECB embarked upon an aggressive tightening cycle, they have traded in a relatively narrow range since early 2023. 10-year yields on government bonds have mostly moved within a range of 2.5% to 3.0% since then, and mortgage rates have reflected this pattern. The ECB has started cutting official rates in June 2024 and cut again in September, October and December. Bond yields have also fallen. As more rate cuts are likely to follow, bond yields and mortgage rates are more likely to fall further than to rise. The fall in bond yields and mortgage rates will be somewhat limited given that bond yields are significantly lower than official rates.

GRAPH 1: FORECLOSURES (FORCED AUCTIONS - 12-MNTH TOTAL)



Source: Land Registry

The payment behaviour of Dutch homeowners is strong. Even during the depth of the crises in 2008/09 and 2011/13 the rise of the default rate on mortgages was modest. Dutch households give a high priority to servicing their mortgage debt, even when they are under financial pressure. As a result, foreclosures are low. In recent years they have even been lower than prior to the financial crisis of 2008/09.

Lastly, the housing market is characterised by shortages. And despite good intentions, building activity has been low. While some improvement is appearing, the housing market remains tight, which underpins house prices.

2. Macro-Economic Developments

International: diverging patterns

The global economy has been characterised by divergence in recent quarters. The US economy has exceeded growth expectations, while China and Europe have struggled. The economy of the eurozone grew only modestly in 2023: +0.4%. Dutch economic growth had outperformed in the previous two years, but was below the eurozone average in 2023: +0.1%

The strong economic performance in the US was a surprise. In hindsight, this was due to expansionary fiscal policy, the rise in immigration and households using the financial reserves they had built during the pandemic to prop up their spending.

The outlook for the US is less upbeat. The stance of fiscal policy has become less expansionary, households have largely depleted their excess savings and the rise in official interest rates is leaving its mark. As a result, the economy is showing some signs of cyclical slowdown. The results of the presidential and Congressional elections are making the outlook for the next couple of years more uncertain.

Cyclical developments in the eurozone almost look like the mirror image of those in the US. Growth has been week in recent quarters as high inflation eroded real incomes, and the sharp rise in interest rates in 2022 was another burden for the economy that also impacted growth in 2023. In addition, the war in Ukraine affected the eurozone economy more directly than the US. Some more structural factors are further dampening the growth resilience of the eurozone economy. Energy prices are higher than in most other areas and the ever-increasing bureaucracy is making the business environment more challenging.

Nevertheless, several factors should be helpful in the period ahead. Inflation has come down significantly which is supporting real incomes as wage increases now exceed inflation. As a result, consumer spending should improve. World trade is improving and European economies should be able to take advantage of that as well.

The outlook is not without risks. The factors that have led to robust growth in the US are disappearing and growth there is expected to soften. Economists who were wrong last year in forecasting a recession in the US have become more cautious and most are now calling for a ‘soft landing’, but a less favourable development cannot be ruled out.

The expected growth recovery in Europe could be dampened by structurally high energy prices and a less favourable business environment. Furthermore, increasing geopolitical tension, protectionism and fragmentation of the global economy could hurt the economy.

In addition, China has been the main growth engine for the world economy for two decades or so, but the country is now facing some significant challenges. Its demographics are unfavourable. Debt levels among local authorities are high and the real estate sector is in trouble, with many developers in financial difficulties. Moreover, a global wave of protectionism is making it more difficult for China to generate export-led growth. After a range of modest measures to boost growth, The Chinese central bank and the government have launched more substantial stimulus measures. Perhaps that will bring economic growth back to a higher level.

The Dutch economy: from contraction back to growth

The Dutch economy disappointed last year. In March 2023 the government's Bureau for Economic Policy Analysis (CPB) was expecting economic growth to amount to 1.6%, but in reality, GDP barely grew: +0.1%. Real GDP actually fell in the first three quarters of the year.

Falling exports and companies running down inventories were two unexpected negatives for growth. Government consumption, on the other hand, was stronger than expected.

While the economy shrank again in the first quarter of the current year, it bounced back strongly – albeit surprisingly – in the second quarter. Preliminary data suggest that the Dutch economy expanded 1.0% q-o-q in the April-June period. This was largely due to the strong performance of exports, apparently benefitting from the improvement in world trade. Fixed investment and government consumption also contributed to growth.

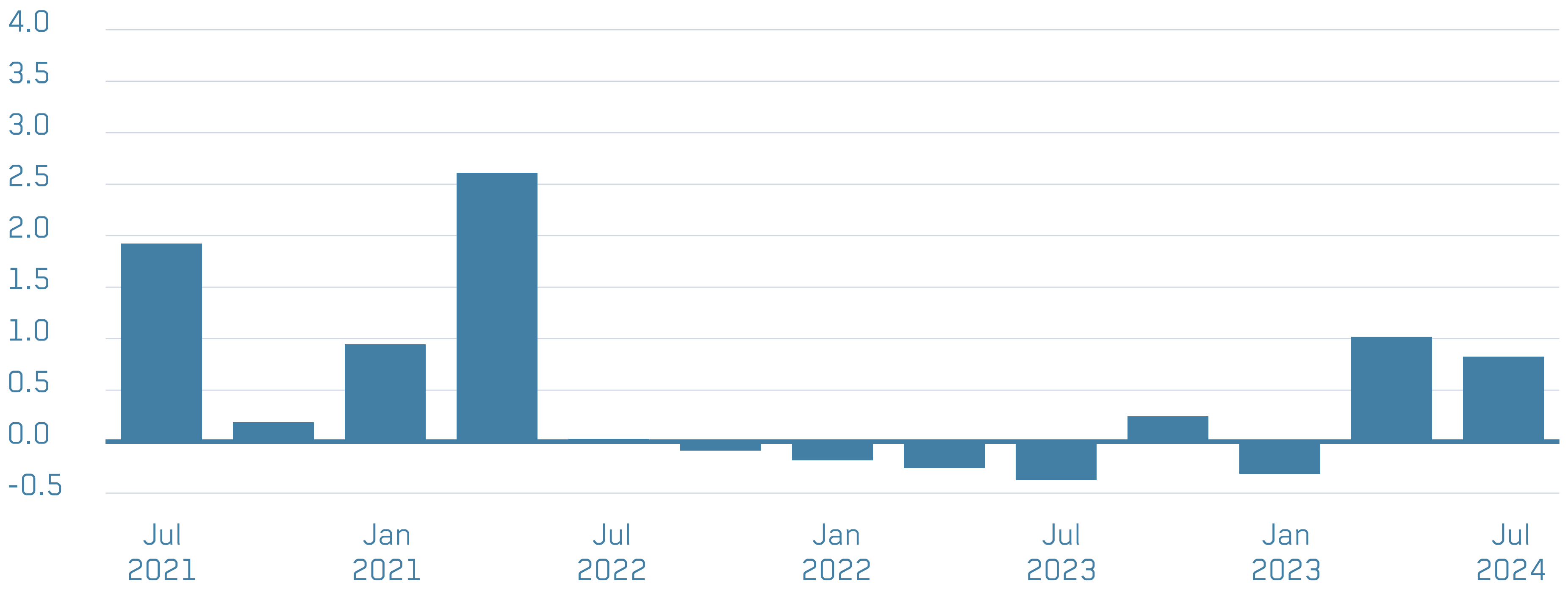
Private consumption, on the other hand, fell in the second quarter, while companies continuing to draw down inventories also contributed negatively to growth. In a strange way this can perhaps be seen in a positive perspective. As wage increases are now exceeding inflation, real incomes are rising and it can only be a matter of time before the consumer contributes to growth. In addition, companies cannot endlessly reduce inventories. When that process stops and turns into inventory building this is also bound to provide a boost to economic activity.

The ECB has cut official interest rates in June, September, October and December and is expected to ease monetary policy further. This is set to lead to a further decline in bond yields and provide some further momentum to economic growth.

Inflation can still be a problem

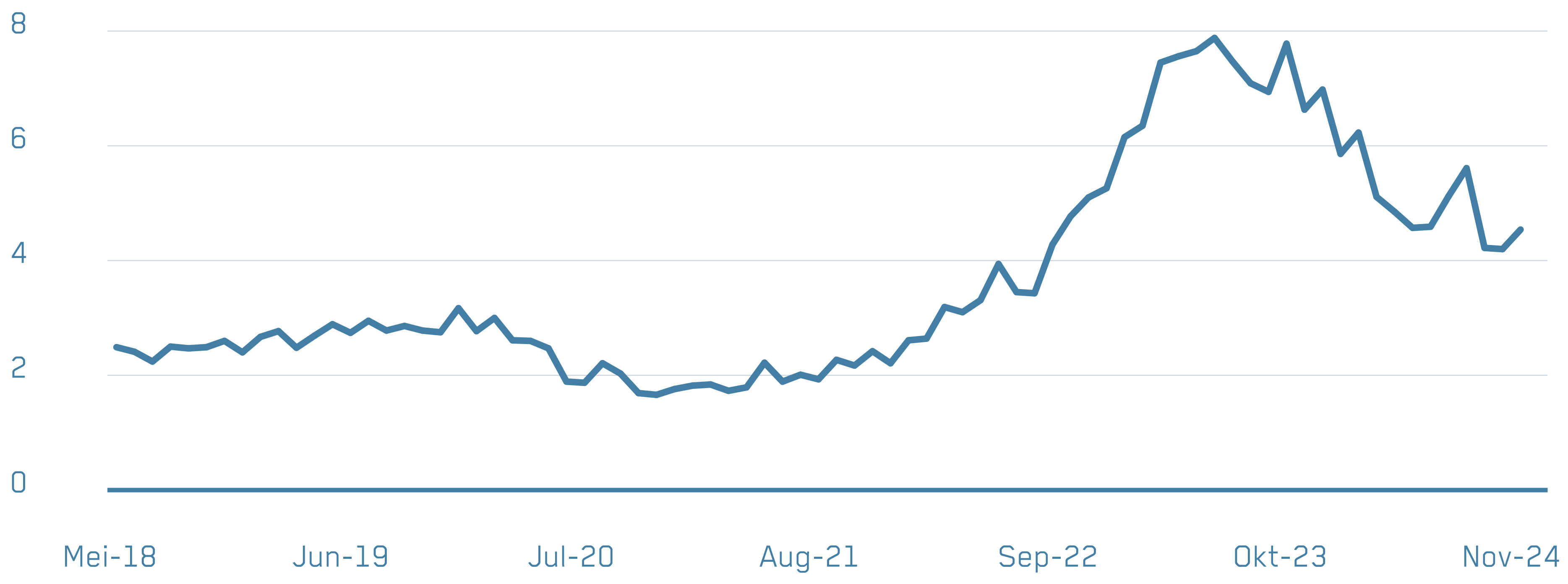
On the official CBS-measure Dutch inflation amounted to 10.0% in 2022 and then fell to an average of 3.8% in 2023. How quickly inflation can return to the 2.0% level the ECB targets for the eurozone as a whole remains to been seen. In the second half of 2024, Dutch inflation rose again, from 3.2% in June to 4.0% in November. This was caused by base effects and a significant increase in heavily regulated rents in July.

GRAPH 2: GDP GROWTH (% Q-O-Q)



Source: Macrobond

GRAPH 3: WAGE INCREASES: NEW COLLECTIVE LABOUR AGREEMENTS (% 12-MNTH BASIS)



Source: AWVN

The inflation picture is currently quite complex and confusing. Disappearing supply chain problems and lower energy prices are pushing inflation down, but this will be temporary. Wage increases have become the main driver of inflation. They are set to moderate. In fact, that has already been happening. However, the labour market in the Netherlands is unusually tight, as it is in many countries. High wage increases may therefore be more persistent than would be consistent with 2% inflation. In addition, fragmentation of the global economy may boost inflation in the medium term as may the 'energy transition'.

Monetary policy and interest rates

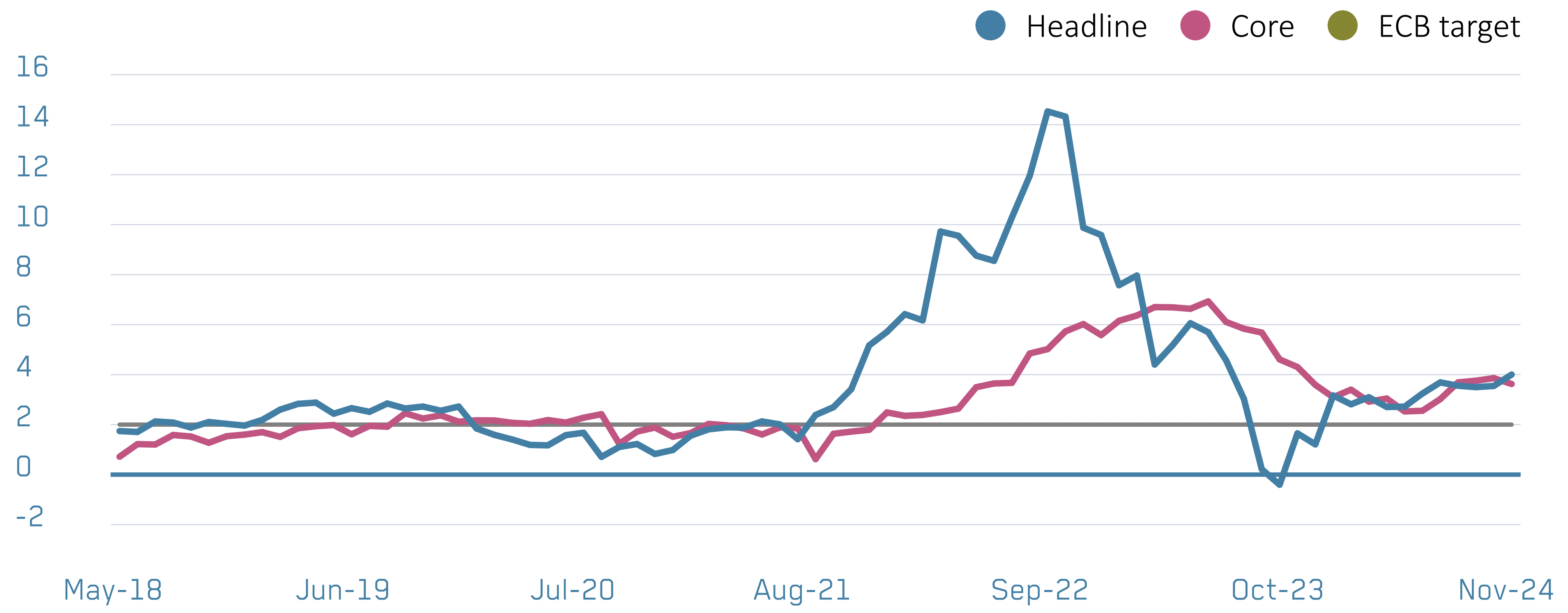
As inflation started to come down in late 2022, participants on financial markets began to price in an aggressive easing cycle by the main central banks. At some stage, markets were expecting the US Federal Reserve to cut their official rates seven times in 2024. The ECB was expected to follow suit.

When US inflation data started to disappoint early 2024 and the economy remained robust, markets changed their view. More recent inflation data has been more favourable while some weak spots have appeared in the real economy. This led the Fed to cut rates in September and cut them by 50bp, a relatively large step. More cuts are bound to come.

The ECB cut its official rates by 25bp, as expected, in June, September, October and December. Lower inflation and much weaker growth in Europe than in the US justify the earlier start of ECB rate cuts. Experience suggests that a string of rate cuts is likely from here. A 25bp cut every quarter between now and the end of 2025 would appear a reasonable assumption. Should the economy weaken or inflation fall further, the ECB could increase the frequency or the size of the rate cuts.

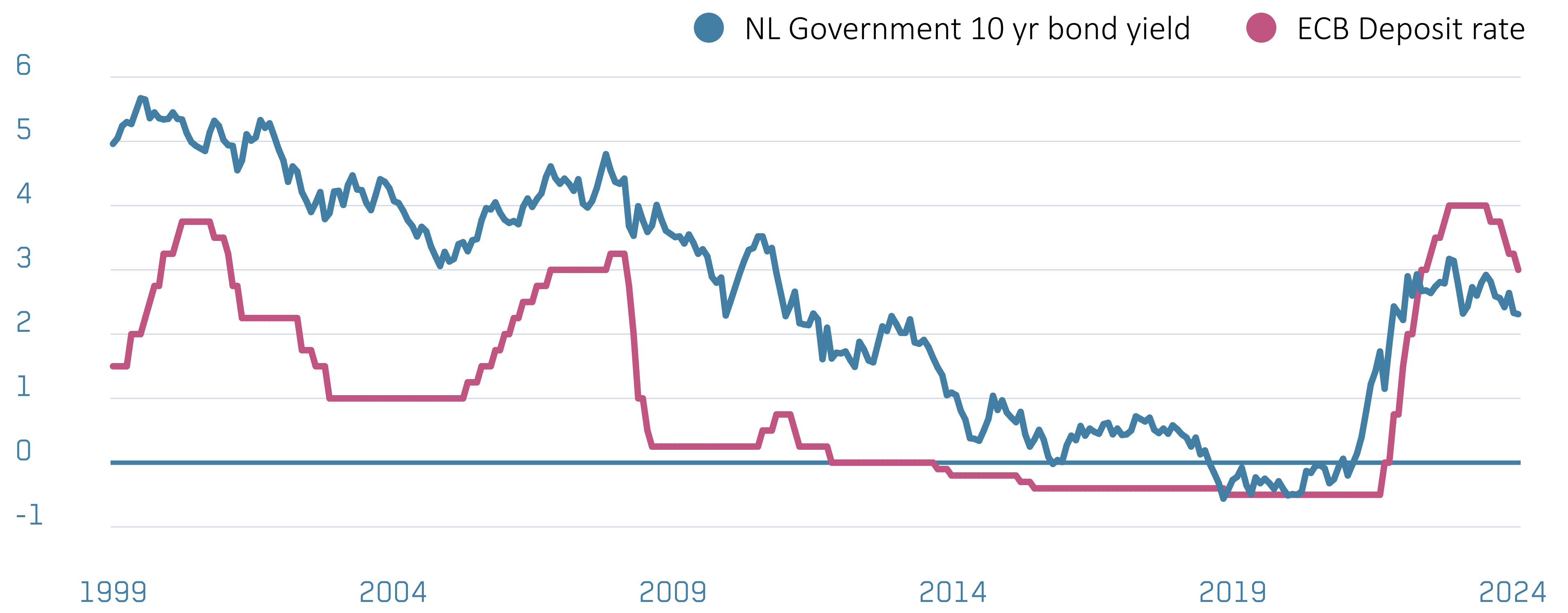
Bond yields have been below central bank rates for some time, both in Europe and the US. This limits the scope for a significant drop in yields and therefore in mortgage rates with an interest rate fixed for a long period. On the other hand, a material rise in bond yields will require a clear re-acceleration of inflation, which is unlikely. This limits the risks to the housing market.

GRAPH 4: NL: INFLATION (Y-O-Y)



Source: Macrobond

GRAPH 5: INTEREST RATES (%)



Source: Macrobond

3. Housing market

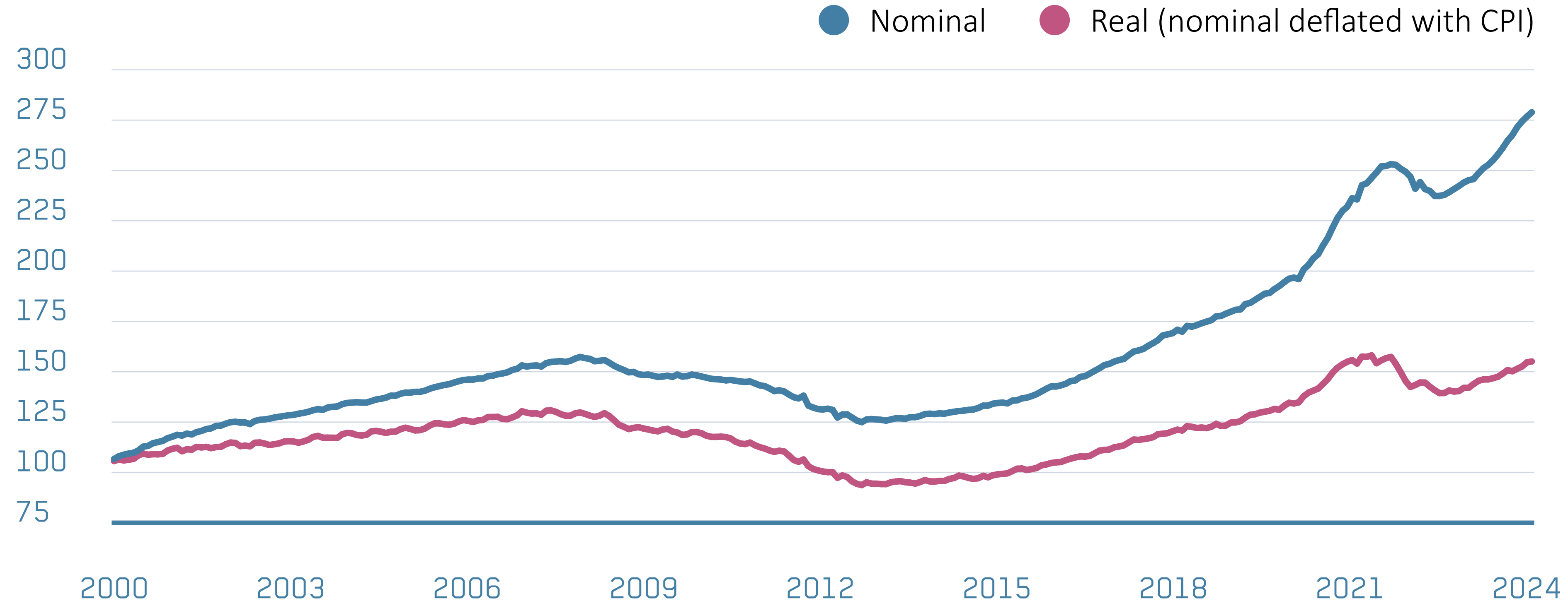
The Dutch housing market got a knock from rising mortgage rates in 2022. The very sharp increase that started right from the beginning of that year reduced the amounts home buyers could borrow, and this translated into falling house prices on a month-to-month basis from August that year. Year-on-year, house prices fell from early 2023 on.

The decline in prices was short lived, lasting less than a year, and was relatively modest. Prices fell by just over 6% from peak to trough. While mortgage rates fluctuated in 2023, they stabilised on balance last year. More importantly, nominal incomes rose significantly in 2023. Wage increases accelerated sharply in a delayed response to surging inflation. Higher incomes increased the borrowing capacity of households, supporting house prices in the course of the year. Prices have now recovered to above the peak from before the decline, although they still fall marginally short of the peak if one corrects for inflation.

Another factor underpinning house prices is the continued scarcity of homes that has been characteristic of the Dutch housing market for some time. Despite ambitions to build significantly more houses, the number of building permits granted started falling in the course of 2021. Rising costs of building materials, a shortage of labour and problems in the process of granting permits related to the 'nitrogen crisis' were responsible. First-time buyers, in particular, suffered from the scarcity as well as the price increases that pushed many properties beyond their financial reach. Following the trend in building permits, the number of transactions on the housing market has declined, both for new and for existing homes.

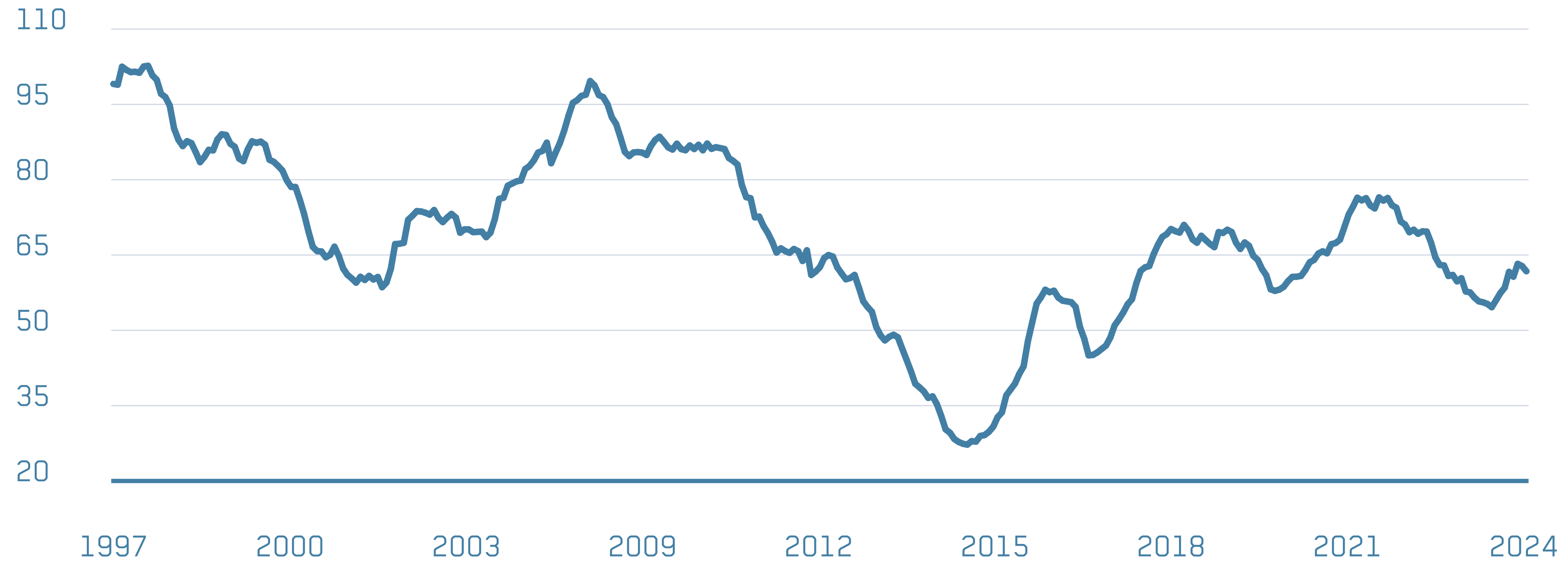
Fortunately, the market appears to have taken a turn for the better more recently. Confidence in the housing market is improving and building permits are on the rise. The number of mortgage applications has risen sharply in the first three months of the year: 26% on the year. That said, many mortgage applications are for loans to pay for renovations and extensions. These homeowners prefer to improve their current homes rather than try to find another, as the market remains tight.

GRAPH 6: HOUSE PRICE INDEX (JAN 2000=100)



Source: Macrobond

GRAPH 7: BUILDING PERMITS (RESIDENTIAL) (*1,000; 12-MNTHS TOTAL)



Source: Macrobond

Policies to address housing shortage

Successive governments have tried to address the shortage of houses, though not with overwhelming success so far. The focus has been on supporting first-time buyers, increasing the availability of affordable homes and pushing buy-to-let investors out of the market. Stamp duty for buy-to-let properties, for example, has been raised in steps to 10.4%, while it is 2% for owner-occupant buyers and even 0% for first-time buyers between 18 and 35 years old. The price cap for the 0% stamp duty was raised from €440,000 last year to €510,000 this year. In addition, local authorities can take measures against buy-to-let transactions.

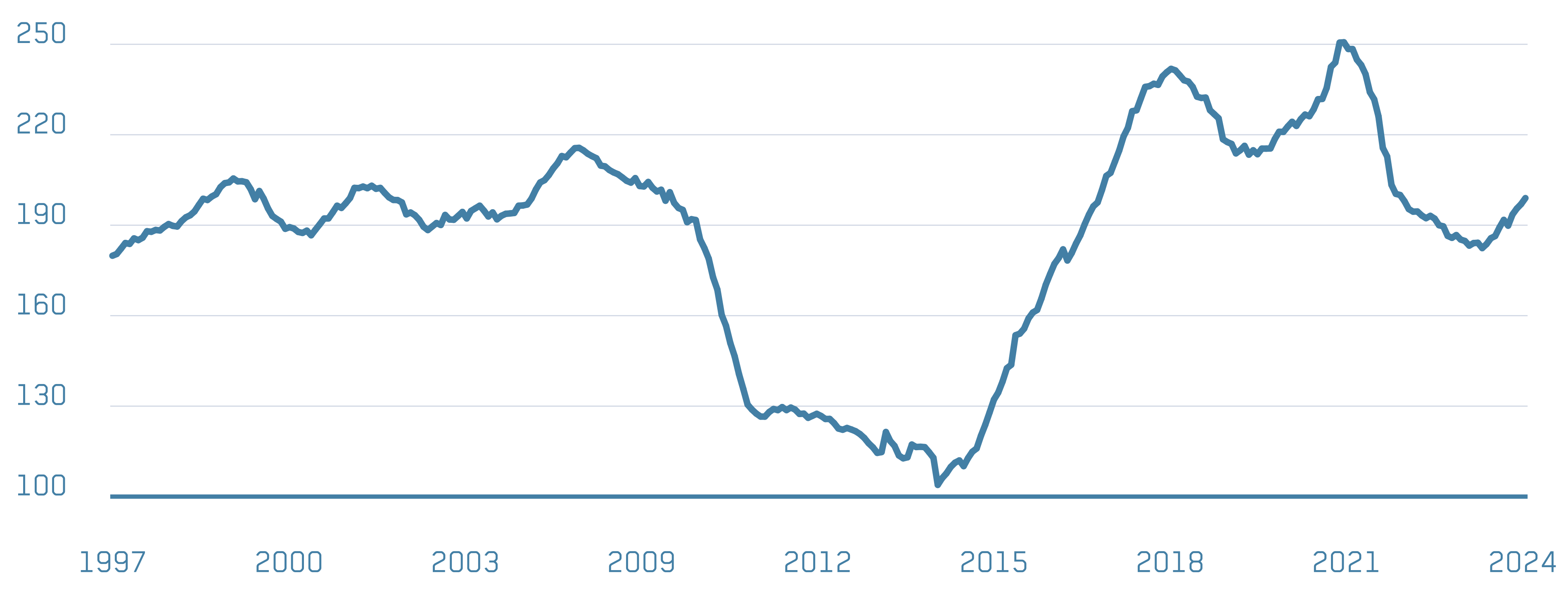
New legislation has been passed by parliament recently related to the rental market. The Affordable Rent Act (Wet Betaalbare Huur), came into force in July this year and will move a lot of properties from the free rental market onto the regulated market. It is estimated that, as a result, rents of some 300,000 properties will be reduced by some €190 per month. This legislation is controversial. It is good for the relevant tenants, but will make renting out properties less profitable for the landlords. In fact, in combination with some changes made to the taxation of properties, renting out some of these homes becomes loss making. This is triggering a number of landlords to sell these properties. That is good for the number of homes for sale, but it reduces the number of rental properties, of which there already is a significant shortage.

Housing market outlook

The outlook for house prices is positive. Economic growth is likely to pick up somewhat during the next year and a half, unemployment is expected to edge a little higher, but remain low by historical standards, incomes are rising relatively rapidly, mortgage rates are more likely to move lower than to rise and the housing market will remain tight.

The dynamics of the housing market may also improve somewhat, but the overall situation can still be described as 'very unsatisfactory' as the shortage of homes is now estimated at some 390,000 units, close to 5% of the housing stock.

GRAPH 8: NUMBER OF HOUSING TRANSACTIONS (*1,000; 12-MNTHS TOTAL)



Source: Macrobond

GRAPH 9: HOUSING MARKET CONFIDENCE (INDEX, VEH)

Source: Vereniging Eigen Huis

The recent rise of the number of building permits granted is a positive sign, although it has to be borne in mind that it will still take well over a year or even longer before more permits translate into these houses becoming available to occupants. The recent rise in mortgage applications is also a positive sign. And the various government's measures to facilitate an increase in construction may bear fruit. The government has decided to play a more active, centralised role in identifying where more homes should be built, which can make a difference, though not in the very short term. There are, however, also doubts about the effectiveness and possible unintended side- effects of some of the measures. Estate agents' association NVM, for example, questions the very strong emphasis on building affordable homes as they argue that the measures fail to facilitate people moving up the housing ladder. The process of 'moving up' is what gives the market its dynamism, they argue.

4. Outlook for the asset class

#1 Mortgage debt as a percentage of GDP is declining

At the end of the 2023, the outstanding residential mortgage debt amounted to approximately €826 billion, up some €12.9 billion or 1.6% from year-end 2022. The banks account for about 69% of the total. Pension funds and insurers together account for approximately 10% and investment institutions for more than 10%. The remainder is on the books of other financial institutions.

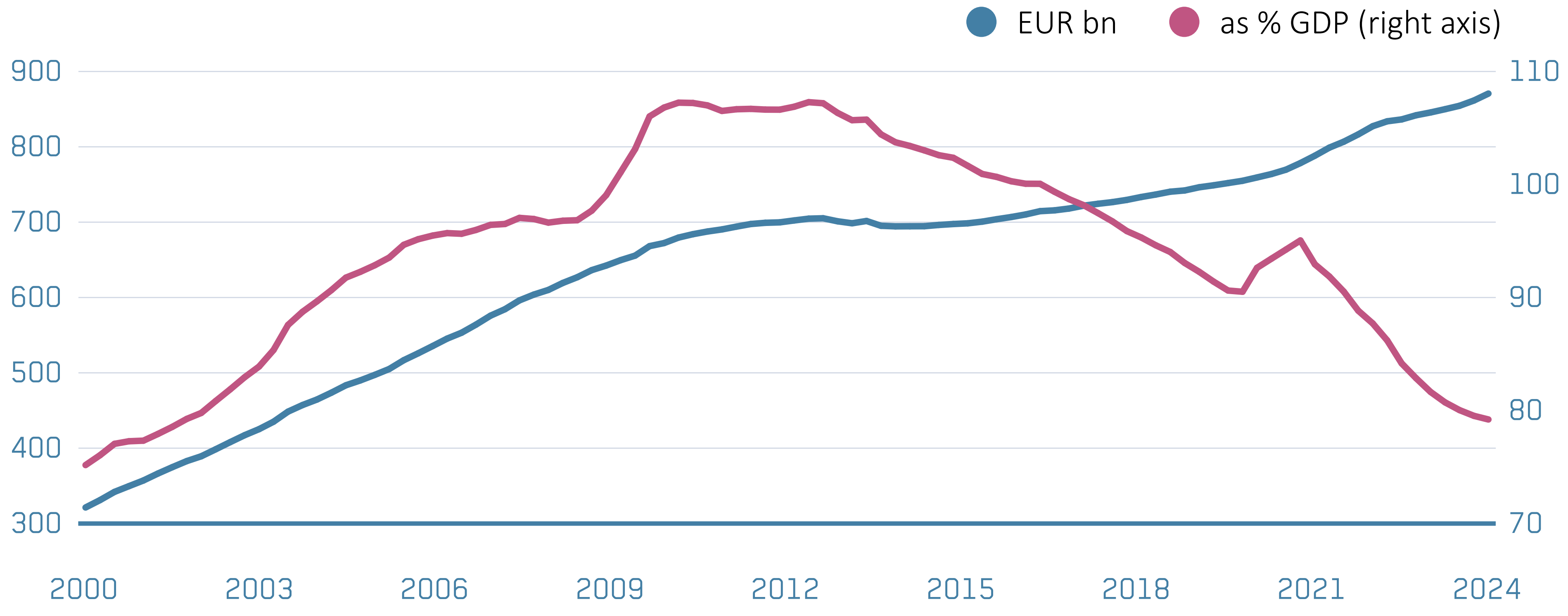
As nominal GDP is growing faster than mortgage debt, the ratio of mortgage debt to GDP has been falling for a number of years. This has been a target of policymakers as they considered household finances too vulnerable to adverse developments on the housing market. Measures to get the ratio down were implemented in the crisis of 2011-2013. The drop in the ratio suggests these measures have been very effective. This is positive for financial stability and provides comfort to mortgage lenders.

The sharp rise in mortgage rates caused activity on the mortgage market to decline significantly in 2022 as higher borrowing costs made refinancings unattractive. While the number of new mortgages has been cautiously trending up in recent quarters, refinancings have not recovered as mortgage rates have not fallen materially. As a result, turnover in the mortgage market is still significantly below pre-2022 levels. In 2024, turnover did increase compared to 2023 signalling a bottom in the market. For 2025, we again expect a higher turnover in the mortgage market.

#2 Fundamentals of the owner-occupied housing market remain very solid

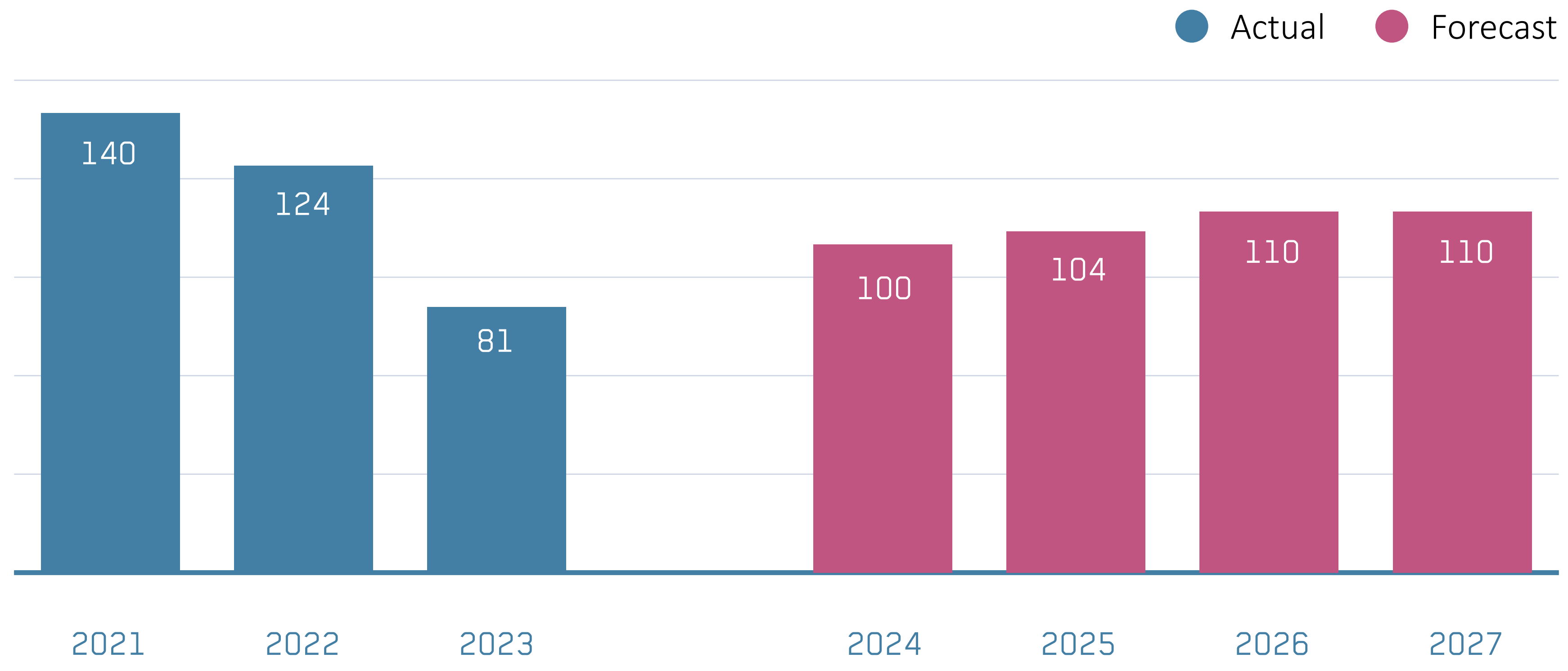
The economic outlook is moderately positive. Economic growth is bound to pick up. While unemployment may edge up somewhat as a delayed response to last year's economic stagnation, any rise should be small, and the absolute level of unemployment will still be historically low. As a result, a rise in defaults on mortgage loans is not anticipated. In fact, as mortgage rates are more likely to fall than to rise, the financial burden on a given mortgage is likely to ease somewhat.

GRAPH 10: RESIDENTIAL MORTGAGE DEBT



Source: Macrobond

GRAPH 11: MARKET SIZE (IN € BN)



Source: Achmea Mortgages

Incomes will continue to grow more rapidly than inflation this year and next while the new government has announced modest tax cuts. The consequence is that households will be able to take out larger mortgages which will contribute to a sustained rise in home prices. There may be a shift in the housing market as borrowers are now allowed to secure somewhat higher mortgages for the purchase of homes with a better energy rating.

Finally, although it looks like building activity will pick up somewhat, the delays between permits being granted and homes being completed are considerable. The housing market is therefore expected to remain tight.

#3 Interest rates set to fall

Now that the ECB and the US Fed have started cutting interest rates against a background of declining inflation, it is reasonable to assume that many more rate cuts will materialise. Bond yields and mortgage rates have recently also moved lower and this is likely to continue. However, the drop in mortgage rates will be more modest than the cuts in official rates as bond yields are well below official interest rates. This interest rate outlook is supportive of the housing market.

A rise in inflation is the most obvious development that could throw a spanner in the works. While forecasting interest rates is a mug's game and a rise in inflation can never be ruled out, this would appear to be an unlikely scenario at this stage.

5. Update Investment Focus

Investing in Dutch residential mortgages

The Dutch residential mortgage market has a lot of variation in types of mortgages based on Loan-to-Value (LTV), fixed interest periods and guarantee with or without NHG. Based on these variables, the interest rate and ultimately the risk-return ratio for an investor are determined. The LTV and NHG in particular determine the risk profile. Although mortgages with a high LTV (greater than 80 percent when originating new mortgages) still have a positive risk-adjusted return compared to mortgages with a low LTV, spreads have tightened in recent years and in combination with LTV mitigation there is limited spread pickup in that segment. However, in seasoned and well diversified mortgage portfolios which have profited from repayments by consumers and increasing house prices, the segment still has value for investors.

Since the bottom of the Dutch economy in 2013, it has been a favorable segment of the mortgage market. A more defensive attitude would include a strategy that focuses on mortgages with a low LTV (less than 80 percent), possibly supplemented with NHG mortgages. If a strategy with more credit risk is chosen, the mortgage segment with an LTV greater than 80 percent still has value. The major macroeconomic changes in recent years have resulted in a constant recalibration of the strategy in relation to credit risk. Examples are lockdowns due to the pandemic. The war in the Ukraine, sharply increased energy prices and, as a result, sharply increased inflation. In addition, the unprecedented tightening of monetary policy by central banks in response after more than a decade of monetary expansion. Central banks have raised interest rates at a record pace to slow the demand side of the economy in order to cope with soaring inflation. All this has led to so much uncertainty that it requires a constant recalibration of the strategy depending on economic expectations and the desired credit risk. Looking forward, the consensus is that the economy is headed for a soft landing.

Central banks have started lowering interest rates to curb for the slow down in demand and curb the risks of an overshooting in monetary tightening and therefor limiting the risk of a recession. As inflation has decreased and labor markets have become less tight, central banks have room to implement a looser monetary policy going forward. After a brief decrease in house prices, they have been on a upward trajectory since mid 2023 and are expected to keep increasing given an expected increase in wages, lower mortgage rates and a structural shortage. This limits credit risk for new mortgages with a high LTV but as spread differential between NHG mortgages have decreased, they make the most sense in a well-diversified portfolio.

As a rule, residential mortgages with a term of twenty to thirty years fit well with the investment horizon of institutional investors. It has been successful in recent years due to the high demand from consumers to originate mortgages with long fixed interest rate terms. Given the higher mortgage interest rates, consumer demand has shifted to a fixed interest rate period with a term of 10 years. The market share of this segment has therefore increased significantly in 2022 (54%). This picture has persisted in 2024. It is expected that this picture will continue into 2025 as consumers will want to profit from the expected further decrease in mortgage rates. A limited market share of around 15%-20% for long dated maturities remains. The silver lining is that market turnover is expected to increase in 2025 and further as the market activity has picked up in 2024 which is expected to continue. The extent to which this leads to a need to adjust the strategy depends on the desired volume of mortgages to be originated.

ESG is also an essential component for mortgage investments. Investors ask for defined ambitions, objectives and a concrete approach for, among other things, the sustainability of the homes on which the mortgage rests. The SFDR legislation has a stimulating effect on this. This is made concrete with energy labels and options to reduce CO_2 emissions.

Mortgage lenders can stimulate energy efficiency and climate resilience of homes with interest discounts on a mortgage with a sustainable home or extra borrowing capacity and actions regarding sustainability of existing mortgages. Mortgage lenders can distinguish themselves from this.

The goal to further improve the sustainability of mortgage portfolios and reduce CO_2 emissions for the portfolio will lead to more measures being implemented going forward.

Climate risks will play an increasingly important role in investing in mortgages. The Fund carries out a climate scan to identify climate risks. The next steps will be to implement policies that mitigate climate risks and implement climate adaptations policies.

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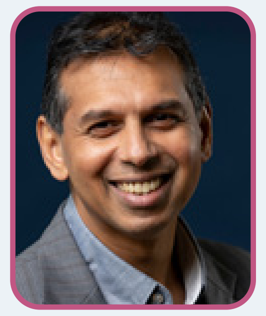

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