HAB Quarterly Commentary

Horizons Active Corporate Bond ETF

Q1 2023

Market Overview

In the first quarter (Q1) of 2023, North American bond yields finished lower but were extremely volatile. Rates decreased significantly in January, jumped higher in February, and then collapsed in March. 2023 got off to a roaring start with hopes for developed economies to achieve a soft-landing increase. Inflationary pressures showed signs of abating, and the U.S. Federal Reserve (Fed) downshifted its pace of tightening. There were also significant flows into fixed-income assets that contributed to the rally. However, a wave of risk aversion swept the markets.

Hopes for an imminent end to rate hikes and a dovish policy pivot were dashed in the wake of unrelenting signs of resilient growth, an overheated labour market, sticky inflation, and hawkish central bank rhetoric. This prompted a shift in investor expectations towards higher interest rates for longer. In March, the collapse of Silicon Valley Bank, Signature Bank, and Credit Suisse, and the fear of more contagion in the banking sector, caused a powerful flight-to-quality bid into government bonds reminiscent of the financial crisis in 2008. Governments and central banks moved very quickly to contain the situation. The market ended the quarter with expectations of the Fed cutting rates 50 basis points (bps) by the end of 2023.

The Bank of Canada (BoC) increased its target for the overnight rate in January by 25 bps to 4.50%, bringing cumulative rate hikes to 425 bps for the cycle. At this time, the BoC also indicated that it would pause to see the impact of the interest rate increases on the economy. The BoC expects inflation to drop to 3% this year and hit the 2% target in 2024. The market is looking for the BoC to cut rates from 50 bps to 4.00% by the end of the year. Rates were very volatile during the quarter. Two-year Canadian bonds started the year at 4.05%, rallied to 3.47%, sold off to 4.32%, and then fell to 3.74% to end the quarter.

In this environment, mid-term provincial spreads, on average, declined by three bps to 67 bps and corporate spreads ended four bps higher at 199 bps. At one point, in early February, corporate credit spreads had narrowed to 171 bps before selling off at the end of Q1.

Quarter in Review

In the first quarter of 2023, the duration positioning was beneficial to HAB as it was set up for higher yields and a flatter curve. The fund's credit position was also positive and came from the yield carry in the portfolio, sector allocation, and security selection.

Security selection helped HAB's positioning within the Financial and Real Estate sub-sectors.

HAB's weighted duration deviations (WDD) on corporate bonds decreased from -0.01 to -0.28 when spreads narrowed to levels that no longer reflected the base case of a modest recession. HAB took profits from several expensive corporates that had performed well and, generally, bought government bonds. Federal WDD increased by 0.22 by the end of the quarter. The fund was very selective in the primary market to take advantage of new issue concessions. These names included Ford, CIBC NVCC, Intact LRCN, RioCan, Manulife, Nova Scotia Power, and Crombie REIT.

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Outlook and Positioning

Inflation, employment, financial stability, and tighter financial conditions will be key drivers of bond yield direction. The BoC has now stopped increasing interest rates as the restrictive policy will slow activity and bring inflation back toward the BoC's target. It is believed that the Fed is getting close to pausing rate increases, especially now, with tighter financial conditions brought on by the turmoil in U.S. regional banks.

Inflation has moderated from the highs in the summer but remains well above 2%. Although the BoC stopped hiking for this cycle, it is believed that rates will remain elevated for a long period before sticky inflation falls back to target, which is at odds with current market expectations.

HAB's duration was close to the index at the beginning of the year, then cut as the market rallied in January, before increasing towards the benchmark in February when rates moved higher. The portfolio will continue to be traded as it is expected that the market will be very volatile as participants try to determine the timing of the first interest rate cut. In Canada, the market expects this to happen before the end of 2023, whereas the sub-advisor's view is that sticky inflation, driven by a tight labour market, will make this a 2024 story. Corporate spreads currently reflect our base case of a modest recession, but if they tighten too quickly, as they did during the quarter, HAB will look to take profits. If they widen to reflect a significant slowdown, HAB's exposure will increase. The yield carry from our overweight in credit is approximately 23 bps.

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