HAB Quarterly Commentary

Horizons Active Corporate Bond ETF (HAB)

Q2 2023

Market Overview

In the second quarter (Q2) of 2023, North American bond yields were much higher over the last 3 months, especially at the front end of the curve. The quarter started with yields moving lower in the belief that the regional banking crisis would have tightened lending standards, and that the U.S. Federal Reserve (Fed) would pause after hiking in early May to assess the impact of the 500 basis points (bps) of tightening. Then a series of events reversed the direction of the bond market: first, the U.S. debt ceiling was raised, which removed a bid for U.S. Treasuries. Second, the fiscal situation remains challenging for the bond market with the deficit running at more than 7% of GDP over the last year.

Another factor putting upward pressure on yields was persistently high core inflation, while growth continued to the upside. As expected, the Fed did not raise its policy rate in June after 10 consecutive rate hikes, but Chairman Powell was adamant that they are not done, and more rate hikes will be needed this year to bring inflation back down to target. Investors are coming around to the idea that the expected economic slowdown will be delayed and that the Federal Open Market Committee (FOMC) will keep rates higher for longer.

The Bank of Canada (BoC) surprised investors and restarted its tightening campaign in June after a 5-month hiatus. The BoC increased rates by 25 bps to 4.75% on the back of the strength in consumption and housing along with a tight labour market and sticky inflation. The previous 425 bps of rate hikes failed to put demand and supply into balance and to get inflation on a sustainable path to 2%. The market is also looking for at least one more interest rate increase later in the summer.

Risk assets performed well in this environment as midterm Provincial spreads on average declined by 5 bps to 62 bps and corporate spreads narrowed by 15 bps to 183 bps.

Quarter in Review

In Q2, security selection was a positive contributor to HAB, primarily from its positioning within the Financial and Communications sub-sectors.

Our weighted duration deviation (WDD) on corporate bonds increased but remained short with regard to the index. Federal WDD remained fairly stable, decreasing slightly. These names included Inter Pipeline, CNH, Eagle Credit Card Trust, National Bank, Industrial Alliance, and Rogers. In the secondary market, we focused on the Financial, Pipeline, and Real Estate sectors.

Outlook and Positioning

The labour market is not showing significant signs of cooling, consumers are continuing to spend, and inflation is not falling fast enough. The BoC hiked rates in June and we expect them to go at least one more time this year. Our base case remains a modest recession, but if the BoC continues to hike rates, the probability of a hard landing increases. Monetary policy is restrictive, and we expect growth and inflation to fall over time. The Fed is also getting close to finishing its tightening campaign. However, we expect rates will have to be kept elevated for a long period before sticky inflation falls back to the 2% target.

Portfolio duration ended June close to its benchmark, but we were both long and short of the Index during the quarter. We will continue to trade the portfolio as we expect the market to be very volatile as participants try to determine when Central Banks will finish hiking and then the timing of the first interest rate cut. Corporate spreads generally reflect our base case of a modest recession. If they tighten too quickly, we will look to take profits, if they widen to reflect a significant slowdown, we will increase our exposure. The yield carry in the portfolio increased to 25 bps.

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