HAL Quarterly Commentary

Horizons Active Cdn Dividend ETF

Q2 2022

Market Overview

Rising interest rates, inflation, geopolitics, and supply chain issues have caused market volatility since early this year and continued throughout the second quarter. Concerns surrounding growth and the possibility of recession amid tightening monetary conditions led to a further pullback in equities globally. The Bank of Canada (BoC) raised its key interest rate by 50 basis points (bps) twice over the quarter (April 13, 2022, and June 1, 2022), the first time in 25 years it has increased rates by 50 bps back to back. The move was widely expected by economists as the BOC is attempting to clamp down on high inflation levels. In June, the U.S. Federal Reserve (Fed) raised its benchmark Fed funds rate by 75 bps, and, with inflation expected to rise the Fed has penciled in further hikes in the months to come.

Given the higher sensitivity to interest rates for growth stocks, earnings multiple compression has contributed to some of the most significant declines for growth stocks seen in recent history. At the same time, this has brought dividend equities, which have outperformed the broad market this year, back into focus. The most cyclical factors, such as high beta, high volatility, and stocks with negative earnings underperformed during the quarter, while the top-performing factors were more value factors, dividend factors, and dividend growth. Canadian equities have outperformed this year, supported by higher commodity prices, and the S&P/TSX Composite Index™ is heavily weighted in the Energy and Materials sectors.

Quarter in Review

On a sector level, Energy was the largest contribution. In the Information Technology sector, Open Text led to a positive stock selection effect.

In the Utility sector, Brookfield Infrastructure Partners led to a negative stock selection effect and Maple Leaf Foods had a negative stock selection effect in the Consumer Staples sector. In the REIT sector, Summit Industrial Income and Allied Properties led to a negative stock selection effect.

Outlook and Positioning

With slowing growth and earnings per share (EPS) expectations, and as purchasing manager's index (PMIs) move lower, cash flow visibility has become more important, as the market is rewarding businesses with stable earnings and cash flow growth, an environment, that is potentially much more favourable to those businesses that tend to pay growing dividends over time.

Weakness in data across major areas of the economy, such as housing data, consumer data, and PMI data, has contributed to rising fears of a recession in the markets during the quarter. When PMIs are under pressure and growth slows, typically increased volatility, wider credit spreads, deteriorating financial conditions, the underperformance of high beta companies, and fewer positive EPS revisions is seen. Multiple indicators suggest a challenging outlook over the next several months amid evolving monetary policies and rising interest rates, and the multiple compression seen so far this year could continue, as long as risks continue rising. With valuations under pressure, earnings will be critical to supporting equities and generating further gains.

Against this backdrop, the focus on Artificial Intelligence "AI" model predictions for earnings growth and dividend growth will be even more important going forward. The machine learning algorithms aim to forecast earnings and dividend growth one year forward. Over the next 12 months, our artificial intelligence model is currently projecting earnings growth to decline in most sectors globally, and this decline is the most pronounced in Europe. Our strongest conviction for dividend stocks is in Energy, while we see greater uncertainty in the Financials and Consumer Discretionary sectors. Although the Energy sector has recently started to decline as well, due to fears of recession and dislocation of supply and demand dynamic of the sector, it still stands out as the sector with the highest predicted earnings growth combined with strong dividend yields.

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In this environment, the careful selection of companies able to sustain cash flows and grow dividends is paramount. The portfolio is well positioned during this market cycle. In order to provide additional downside protection, Managers added resilient companies in the Consumer Staples and Health Care sectors during the quarter and exited companies with higher valuations and potential earnings disappointments. This will potentially help the portfolio to provide a higher yield and fare better during periods of volatility, and at the initial stages of tightening cycles.

However, the ETF does not invest in companies based on yield alone. With the market uncertainties putting pressure on corporate earnings, high-yielding companies that don't have financial strength and discipline may not be able to sustain future payout and could be prone to dividend cuts and suspensions. At the same time, high-quality stocks that have sustainable and growing dividends may provide greater income over time, therefore buffering against market volatility and addressing some of the risks of rising rates and inflation. The portfolio aims to invest in a combination of both dividend payers and dividend growers.

The ETF's long-term investment approach focuses on finding high-quality companies with robust growth prospects and secure streams of cash flows that will continue to sustain earnings and dividend growth. Managers continue to focus on high-quality companies with strong fundamentals, visible cash flows, and sustainable and growing earnings, and dividends –defined as the Growth, Payout, and Sustainability (GPS) of dividends. Using algorithms, which aim to forecast earnings, dividend growth, and dividend and earnings cuts, enables the assessment of risk of the overall portfolio and focus on owning companies with lower downside risk, while remaining well positioned for potential upside.

HORIZONS ETFs
by Mirae Asset

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