HARB Quarterly Commentary

Horizons Tactical Absolute Return Bond ETF

Q2 2022

Market Overview

Fixed Income markets were under extreme pressure in Q2 as the U.S. Federal Reserve (Fed) policymakers pursued a very hawkish stance in response to inflation data that reached 40-year highs. The Fed has been forced to catch up after initially seeing inflation as "transitory," and expecting to see a fairly rapid decline in the data.

Inflation increases have been driven by energy, food, and wages, with the first two being exacerbated by the Russian invasion of Ukraine. Russia is the largest supplier of energy to Europe and Ukraine is the largest exporter of grain in the world. Wage growth remains a function of supply decreases due to the COVID-19 pandemic and the surge in demand from the reopening process.

U.S. 10-year yields rose nearly 70 basis points (bps) in Q2 from 2.35% to 3.02% and briefly touched 3.50% during the quarter. This equates to a 6% capital loss in the 10-year bond – a severe selloff in an investment with a 2% income stream. Credit products usually provide some protection against rising yields but this wasn't the case as both High Yield and Investment Grade credit spreads widened contributing to even further losses in these categories. This is unusual, but credit spreads were essentially at record low levels entering 2022, and had only one direction to move. With the Fed taking a very hawkish tone, markets began to fear that recession probabilities were rising especially since the only apparent way to lower inflation was to induce a recession.

Equity markets did even worse than credit markets as the S&P 500 and NASDAQ experienced double-digit losses in Q2. Valuations were at record highs going into 2022 and the combination of rising bond yields and a weakening profit outlook led to a severe selloff.

Quarter in Review

The HARB portfolio has been kept in short duration and virtually out of credit products and, thus, it has outperformed the market. Rising bond yields and widening credit spreads are very difficult environments as there are few profitable places to invest other than being outright short.

Once yields hit 3.50%, some duration risk was taken, although the market rallied from 3.50% to nearly 2.70% in just a few days.

Credit risk is becoming more attractive and High Yield is above 9%, while the default rate remains close to 1%, a never seen before occurrence. Portfolio managers are prepared to commit to High Yield as the economy is weakening and it is unclear where the Fed will terminate its rate hike cycle. While High Yield will increase, the majority of the portfolio in will remain in highly liquid government securities until more clarity on economic weakness and Fed policy becomes available.

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Outlook and Positioning

Over the last 40 years, there has not been a time where the outlook for the economy and market is as uncertain as it is today. Inflation is at 40-year highs, the economy is slowing rapidly and valuations are still above long-term averages.

It is believed that the worst economic weakness for 2022 passed in the first half of the year. The Fed is still hawkish but will likely need to soften its stance in the year's second half (H2). Credit markets should provide some positive returns in H2 but still have material risks. We expect volatility to remain very high which gives some trading opportunities, while keeping the core duration stance close to zero.

The biggest concern is a renewed weakening of growth for 2023 and a quasi-double-dip recession. Once the Fed completes its hiking process this year, inflation is unlikely to fall rapidly, especially if oil remains elevated. This will make it difficult to retrace much of the rate hikes and produces a vulnerable economy.

HORIZONS ETFs by Mirae Asset

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