HARB Quarterly Commentary

Q3 2022

Horizons Tactical Absolute Return Bond ETF

Market Overview

Fixed Income markets remained under significant pressure in the third quarter (Q3) of 2022, as markets continued to react to higher interest rate expectations. Inflation data is showing signs of peaking, but remained sticky and has not shown any material declines.

Food and energy prices have moderated somewhat, however, wages and rents have continued to increase keeping inflation indices at elevated levels. The Federal Reserve (Fed) has repeatedly indicated that it is looking to see sustainably lower prices before either slowing or stopping its rate hike cycle. Indications of this have not yet happened.

After rising 70 basis points (bps) in the second quarter, U.S. 10-year yields rose 130 bps in Q3 as the market repriced its estimate of the terminal Fed funds rate. Despite these unprecedented increases in bond yields, employment markets have remained strong with the unemployment rate under 4% and weekly jobless claims staying in the low 200,000 area. The Labour Force participation has risen slightly to offset job openings, but employment markets have yet to reflect a weaker economy.

Credit markets have held up very well as corporate balance sheets are solid and the economy hasn't weakened substantially. Both Investment Grade and High-Yield spreads materially outperformed rates and equity markets as leverage have remained below average. This leaves these markets expensive and vulnerable to a sharp decline in economic activity.

Equities were off slightly in Q3, but not without a nearly 15% rally during the quarter. Earnings have yet to reflect the slowing U.S. economy and the very strong U.S. Dollar. Q3 earnings, so far, have beaten estimates and we expect weaker earnings over the next several quarters.

Quarter in Review

HARB has generally kept duration very close to zero unless the market has become very oversold. Almost all of the declines in the NAV this year have come from two situations where duration was extended to average levels in the face of extreme oversold conditions in the U.S. Treasury Market. In each case, the selling accelerated rather than bouncing higher leading to NAV declines.

HARB has continued to avoid exposure to credit spreads. However, it maintains credit exposure to higher quality short duration - high yield (less than 10% of portfolio) hedged with short positions in the CDX derivatives. As higher rates begin to lead to economic weakness in 2023 we expect credit spreads to widen.

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Outlook and Positioning

The Fed has continued to raise rates well beyond the market's expectations as inflation hasn't declined and employment markets haven't weakened.

An end to rate hikes is anticipated in early 2023, with the terminal Fed Funds rate somewhere between 4.5 and 5.0%. Fed speakers have repeatedly spoken about keeping rates at these levels for 12-18 months to see how the economy responds. This view is unlikely to occur as it is more likely for either the economy to weaken materially, forcing rate cuts, or the economy holds on and inflation doesn't decline leading to further rate hikes. While none of the aforementioned outcomes are ruled out, rate cuts in 2023 as more likely. If this is correct it implies a weaker economy, higher unemployment, weaker commodity prices, lower rents and wages, and lower corporate earnings.

History suggests higher U.S. Treasury prices next year and this enforces the base case. So far, 2022 has been one of the worst years for fixed-income returns in modern history and this has generally been followed by material gains expected in the next year.

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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