

HARB Quarterly Commentary

Horizons Tactical Absolute Return Bond ETF (HARB)

Q3 2023

Market Overview

U.S. Treasury markets continued to exhibit above-average volatility in Q3 with yields generally rising. The MOVE Index – a measure of volatility, traded broadly between 95 and 140 while the long-term average is around 50. The 10-year Treasury yield traded in a huge 100 basis points (bps) range, 3.75 - 4.75, ending the Q3 at the high end of the range. U.S. Federal Reserve (Fed) policy drove these developments, but in a different way than in Q2 where short rates rose quickly and the yield curve continued to invert. In Q3, short rates were relatively stable while longer rates climbed significantly. This was a process of the market pricing out aggressive rate cuts in 2024 rather than further rate hikes in 2023. The 2-year to 10-year yield curve traded between minus 90 bps and minus 60 bps and has moved below minus 30 bps early in Q4. The Fed constantly repeated the higher for longer mantra and this has been supported by extraordinary strength in employment markets. Weekly Jobless Claims consistently came in close to 200K and the Unemployment Rate has stayed below 4% despite a significant amount of other economic data points reflecting material weakness.

Quarter in Review

We continue to actively manage duration and have stayed almost totally in U.S. Treasuries, avoiding credit markets. Duration fluctuated between approximately 3 and 13 years and the average was generally near the 7-8 years neutral position. The U.S. economy is slowing and weakening, and leverage is rising for both consumers and corporations.

HARB produced negative returns in Q3 although these were modest relative to Long Term Treasury funds. Our active management preserved capital relatively which is our objective while participating when Fed rate cuts eventually come.

Credit markets have performed well and we believe they remain expensive relative to future default rates. 2 to 3-year corporate bonds are however attractive due to the inverted yield curve.

Outlook and Positioning

We believe that we are at the point in this cycle where inflation data is losing importance and employment data is driving markets. We do not expect the CPI headline or core to get to 2% anytime in 2024. The Fed will hold rates if the Unemployment Rate stays below 4.5% and will begin cuts if it moves above 4.5%.

We are also at the point where the consensus view is that we will not see rate cuts in 2024 as the market has now fully embraced the “higher for longer” Fed mantra. This has led to the 10-year yield rising 100 bps while two-year yields have only moved ~25 bps higher. The yield curve has steepened or normalized and is approaching flat without any inversion.

The big question to be answered in the next couple of quarters is whether higher for longer is correct. While timing is always uncertain, we tend to believe in the old maxim – when everyone believes something will happen – something else will. Volatility will likely not decrease regardless of what labour markets do.

We expect bonds to outperform stocks in 2024 and a 5% 10-year yield combined with a flat yield curve (2-year yield) will be a reasonable situation to extend duration.

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