

Market Overview

In the first quarter (Q1) of 2023, the complexity of navigating the macro investment landscape increased by several notches. On one hand, backward-looking measures of economic activity, including GDP data, have remained resilient in North America and Europe. Meanwhile, key measures of inflation, including consumer prices and wage data, have remained uncomfortably high in many countries, often well above central bank policy targets and market expectations.

On the other hand, developed countries' economic leading indicators generally remain weak. Some of the most prominent indicators, including the U.S. Institute of Supply Management (ISM) and Job Openings and Labor Turnover Survey (JOLTS), have turned sharply lower in most recent readings and developed country yield curve slopes remain inverted.

The recent outbreak of banking sector stress has yet to be reflected in economic data. Although dampened by subsequent policy interventions, this stress is expected to lead to further tightening in credit and lending conditions — for instance, due to the outflow into certificates of deposit (CDs) and money market mutual funds — and encourages more cautious spending behaviour. This gives further credence to the view that the global economy will experience a recession in the remainder of 2023, despite the expected recovery in Chinese economic activity.

Central banks are caught in the middle of these crosscurrents. Most are in the late stages of tightening cycles, and some, including the Bank of Canada and Reserve Bank of Australia, have signaled an intention to pause while appraising incoming data flow. Other central banks, including the European Central Bank ("ECB"), are likely to maintain a hawkish posture in the absence of further intensification of banking sector stress.

For the U.S. Federal Reserve (Fed), the market consensus is now pricing rate cuts as early as the second half of 2023, possibly after another 25 basis points (bps) increase in the spring. This trajectory may prove overly aggressive. The Fed has stated its desire to see a persistent slowing of economic growth and a marked cooldown in the U.S. labour market, to continue reducing inflation towards its target rate. Although these conditions are not yet met, the risk of further banking stress will likely truncate the magnitude of any further tightening. If the Fed moves to loosen its policy stance, while inflation remains uncomfortably high, this may indicate heightened nervousness around the health of the financial system.

Quarter in Review

Overall performance was positive in Q1 2023. HARC's core investment thesis remained relatively unchanged in the quarter. With the economic environment expected to deteriorate and geopolitical risk still high, the strategy has remained cautious in Q1 but did move active risk higher during the quarter, albeit to a level that remains below long-term targets. Added risk focused on continuing to position the portfolio to benefit from attractive interest rate carry in currencies that exhibit strong, or at least improving, long-term fundamentals. Recently added long positions included the Colombian peso (COP) and Hungarian forint (HUF), complementing existing core longs that included the Brazilian real (BRL), Indian rupee (INR), Indonesian rupiah (IDR), and Mexican peso (MXN). Funding continued to be sourced from a mix of pro-cycle and fundamentally unattractive currencies in Asia and Europe, as well as the Canadian dollar (CAD). With banking sector stress thus far largely restricted to the U.S., the outlook for the dollar (USD) deteriorated, leading to an increased short position in this currency during the quarter, in place of the short Euro (EUR).

BRL has continued to perform well during the early months of 2023, albeit with higher volatility. This volatility has reflected political noise related to proposed fiscal reforms and central bank policy independence and the appropriateness of the current inflation target. We expect this noise to subside without a meaningful impact on the long-term fundamental outlook for Brazilian assets. Indeed, conviction has risen recently that the government's fiscal reforms will not meaningfully weaken current spending caps. In addition, BRL continues to rank favourably across quantitative factor models, including Value and Carry.



INR appears relatively insulated from global recession risk, given the relative size and strength of the domestic Indian economy. Inflation should become a receding headwind, and the INR nominal and real carry will remain attractive. Most of HARC's long INR position is expressed against the Taiwan dollar (TWD), with supplementary positions versus the Chinese renminbi (CNH) and USD. Moderating global demand for electronics and relatively low carry make TWD an attractive funding currency. A short CNH position provides exposure to the relatively weak recovery in Chinese growth expected in the coming months. Chinese policymakers will likely resist currency strength to mitigate the impact on export demand due to the expected recessions in the U.S. and Europe. Similar to TWD, CNH interest rate carry is relatively low.

Long-term Indonesian fundamentals, including interest rate carry, remain relatively attractive, and their central bank remains relatively hawkish. Resilient global demand for coal and nickel remains positive for the current account, especially in the context of a gradual economic reopening in China. A relatively sound fiscal outlook should also continue to help limit downside risks, and potentially pave the way for capital inflows to resume once we pass the peak in global monetary policy tightening.

Like BRL, MXN has been supported for an extended period by strengthening fundamentals. These include attractive carry, an improved current account balance, increased fiscal discipline, and a lower reliance on portfolio inflows. MXN was relatively hard hit by the recent outbreak of banking sector stress, but also recovered well as concerns subsided and the Fed walked back its previous hawkish tone. MXN does screen as increasingly expensive within the currency universe, and this led to trimming the size of HARC's long position towards the end of Q1 2023.

The Norwegian krone (NOK) continues to rank relatively well on quantitative screens, including as a result of Norway's strong Balance of Payments position. The recent hawkish tone of the Norges Bank will also likely offer support, especially against the Swedish krona (SEK). HARC opened a new long NOK position against SEK towards the end of Q1 and switched funding for an existing long NOK position from the U.K. pound (GBP) to the Swiss franc (CHF). SEK has experienced a relatively persistent trend of weakening in recent years. Constraints on the Riksbank, for instance from Sweden's expensive housing market, make it vulnerable to further depreciation, even though it screens as cheap.

Also, within Europe, HARC initiated a long Hungarian forint (HUF) position during the quarter, expressed against a combination of the Czech koruna (CZK) and USD. HUF has high carry and improving fiscal discipline; CZK screens as overvalued.

HARC also initiated a long Malaysian ringgit (MYR) position during the quarter, expressed against the Singapore dollar (SGD). MYR is expected to benefit from an attractive valuation and carry, as well as tourism, Liquefied Natural Gas (LNG), and manufacturing tailwinds from the Chinese economic reopening. By contrast, SGD is one of the most overvalued currencies in our investment universe. With core inflation peaking, import prices falling, and less acute labor shortage problems than in most other developed economies, expectations for a less hawkish Monetary Authority of Singapore are likely to increase, especially in a context of weaker external demand and relatively low oil prices.

Long positions in the Thai baht (THB), Australian dollar (AUD), and COP hedge the risk that the Chinese economic reopening gains traction faster than expected. THB would benefit from a resumption of Chinese tourism; AUD and COP would both benefit from a more rapid strengthening of commodity demand than expected. COP also screens as attractive from the perspective of both carry and value. In terms of funding, THB is expressed against CNH, AUD versus GBP, and COP against USD. HARC added to the COP and THB positions during the quarter but also closed its long position in the South African rand (ZAR) that was part of this theme.

On the short side of the portfolio, the outlook for GBP remains challenged by its twin fiscal and current account deficits and a sharp drop in M&A activity that has caused Foreign Direct Investment inflows to dry up. A dovish Bank of England and continued elevated



HARC Quarterly Commentary

Horizons Absolute Return Global Currency ETF

Q1 2023

inflation also represent headwinds for GBP. HARC did trim the size of this position towards the end of Q1, as a part of the reduction in MXN long.

CAD is another key source of portfolio funding. It is a pro-cycle currency that will likely continue to be challenged by slowing global growth, including via its negative impact on oil prices. In addition, the Bank of Canada has paused its policy tightening cycle to allow time to observe incoming data. This is different messaging than the Fed and, particularly, the ECB. The domestic Canadian housing market—which appears expensive and vulnerable to further correction—may partly explain this difference in messaging.

Outlook and Positioning

HARC's short USD position was increased during Q1; USD has long been screened as expensive in this investment universe. In addition, evidence of banking stress has largely been restricted to the U.S. This likely inhibits the Fed's ability to continue raising rates as it provides support to regional banks. The short position does not reflect a high conviction generalized negative USD view, given the expectation for a global recession during the remainder of 2023, which will likely encourage risk aversion supportive of USD. Instead, it reflects targeted tactical positioning against fundamentally attractive longs that include COP, HUF, and INR. Looking further ahead, USD remains one of the most expensive currencies in the investment universe, making it ultimately susceptible to a generalized correction lower, consistent with a reversion to long-term Fair Value.



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