HARC Quarterly Commentary

Horizons Absolute Return Global Currency ETF (HARC)

Q2 2023

Market Overview

In the second quarter (Q2) of 2023, U.S. and Canadian economic data remained resilient, defying expectations of significant weakening. This includes labour markets in both countries, which remain tight and are a core focus of the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed). Progress in returning inflation to policy targets has been slower than expected, likely motivating further policy tightening during the second half of 2023. Central Bank communication during the quarter also led market participants to eliminate interest rate cuts previously expected for the second half of 2023 and to moderate the extent of policy easing in 2024. All these developments were consistent with policy remaining tighter for longer. Although European activity data have remained relatively weak, the European Central Bank is also grappling with uncomfortably high inflation and will also likely keep its policy stance tight for an extended period. Appreciably tighter central bank policy in North America and Europe means the probability of recession remains high; delayed, not avoided.

There remains less policy uniformity in other regions of the global economy. An earlier start to interest rate tightening cycles has begun to bear fruit in key economies in Latin America, including Brazil and Chile. Moderating inflation has allowed central banks in both countries to signal an intention to begin easing policy stances in the second half of 2023. Real interest rates will, though, likely remain relatively high for the foreseeable future in both countries and not stimulative. By contrast, policymakers in China and Japan are squarely focused on stimulating economic growth. Chinese activity data have disappointed expectations in the months following an initial, post-COVID burst of strong growth. With consumer price inflation close to zero and producer prices falling, policymakers are likely to implement further policy loosening in the coming months. In Japan, efforts to engineer a persistent exit from low or negative inflation have kept the Bank of Japan (BoJ) policy stimulative, and government policy focused on encouraging persistently higher wage inflation and stimulative corporate sector reform. Market participants do expect a revision of the BoJ's Yield Curve Control Policy during the remainder of 2023, but a switch from stimulative to restrictive policy appears unlikely.

Risk sentiment remained resilient during the quarter, despite the hawkish shift by many developed market central banks. Market participants continued to discount weak economic leading indicators, including business and consumer confidence and yield curve inversion. And rising corporate costs and weakening earnings and profits were largely taken in stride by risk assets, including currencies. More recently, the first week of Q3 did see a shift towards risk aversion in response to another round of robust labour market data in the U.S. and Canada, with yields backing up, equities, pro-risk currencies, and credit all selling off. In the context of our continued expectation for a global recession, market resilience could be tested further by the upcoming corporate earnings season.

Quarter in Review

Performance was positive in Q2. Core investment theses were little changed during the quarter. We continue to balance portfolio positioning between long exposure to interest rate carry, for which expected returns are at levels unmatched for most of the past two decades, and more cautious positioning to reflect our view a recession remains likely in coming months. The active risk was broadly unchanged during the quarter and remains below our long-term target due to uncertainty on the timing of the expected shift to a less constructive market risk environment, as well as continued heightened geopolitical risk.

High conviction long positions motivated by attractive interest rate carry included the Brazilian real (BRL), Colombian peso (COP), Hungarian forint (HUF), Indian rupee (INR), and Indonesian rupiah (IDR). We pared back the size of our long Mexican peso (MXN) position during the quarter; although MXN carry and domestic fundamentals remain attractive, and its exposure to the resilient U.S. economy is also a positive attribute, it screens as increasingly expensive from a value perspective. We also switched positioning during the quarter in the Australian dollar (AUD) from short to long; the recent Reserve Bank of Australia's hawkishness likely benefits AUD, with this position, expressed versus a short in the Swiss franc (CHF).

Funding for directional carry positions was spread between the Taiwan dollar (TWD) and Chinese renminbi (CNH) in Asia, the Canadian (CAD) and U.S. (USD) dollars in North America, and the Euro (EUR). Moderating global demand for electronics and relatively low carry continue to identify TWD as an attractive funding currency within our investment universe. And a short CNH position provides exposure to the tepid recovery in Chinese growth we expect to continue in the coming months. Chinese policymakers will likely resist any sign of currency strength to mitigate the impact on export demand of expected recessions in the U.S. and Europe. And similar to TWD, CNH is relatively unattractive from a carry perspective. For CAD, more central bank policy tightening, including from the Bank of Canada, likely worsens the global cyclical growth outlook. In turn, this solidifies our conviction that CAD, a pro-cycle currency, is likely to weaken further against fundamentally more attractive carry currencies, including BRL.

We remained short USD throughout Q2 and also reintroduced a short EUR position towards the end of the period. This positioning was consistent with the positive market risk environment that generally held sway during the quarter. But we are cognizant that both currencies, and particularly USD, will likely appreciate if the market becomes more sensitive to recession risk as we move into the remainder of 2023, and so plan to be tactical in our management of these positions. Longer-term, we still see USD as substantially overvalued and likely to experience a trend depreciation.

Outlook and Positioning

With market sentiment expected to become less constructive in the remainder of 2023, we added safe-haven Japanese yen (JPY) exposure against CAD during the quarter. This position has subtracted from portfolio performance thus far; the BoJ policy stance has remained stimulative concurrent to an increase in central bank hawkishness in Canada and other Developed Markets, leading to renewed JPY weakness. But we continue to like the safe haven hedging attributes of this position. We also began the quarter with a focus on idiosyncratic currency pairs that do not exhibit significant directional risk. Examples included the long Thai baht (THB) versus CNH, the long Malaysian ringgit (MYR) versus the Singapore dollar (SGD), the long Norwegian krone (NOK) versus the Swedish krona (SEK), and long HUF versus the Czech koruna (CZK). A number of these positions were tactically pared back or removed at the end of the quarter. We see continued merit in the investment theses motivating these positions but tactically stepped away in the face of adverse data—weak Chinese data have hurt near-term MYR and THB prospects, for example—and price action.