

Market Overview

Higher for Longer. Towards the end of the third quarter (Q3), a slew of Developed Market central banks signaled a willingness to keep policy interest rates at current levels, or even a little higher, well into the second half of 2024. This messaging surprised market expectations that only a few months previously had anticipated an early start to rate cuts, perhaps as soon as Q4 2023. As a result, bond yields, which had already risen earlier in the quarter in response to resilient U.S. data, took another leg higher. Market sentiment soured, negatively impacting equity and credit markets, as well as Emerging Market currency performance, particularly in Latin America. The U.S. dollar remained bid throughout the quarter.

Higher for Longer reflects two facets. First, unexpected real economic resilience in the U.S. Although some weakening in economic conditions is evident under the hood, for instance with a gradual renormalization underway between labour demand and supply, the slow speed of descent has surprised most economic forecasters, including ourselves. In turn, this resilience has helped prolong the anticipated deceleration in wage and consumer price inflation, leaving central banks still far from inflation policy targets. Looking through headline data volatility, resilience appears likely to persist in the near term. However, any additional tightening in financial conditions, including as a result of a continued rise in yields, would risk undermining this resilience and quickly tip the U.S. economy from its current soft landing trajectory into our expected mild recession. It could also risk reigniting disruptions in financial markets similar to those observed earlier in 2023.

A more pronounced weakening in activity is already visible in other economies. This includes Canada, where Gross Domestic Product (GDP) data have disappointed expectations and the labour market has also begun to loosen. But similar to the U.S., Canadian wage and core price inflation remain elevated. An unexpectedly resilient housing market underscores the likelihood that the Bank of Canada will stick with an elevated policy interest rate through much of 2024. The slowing in European economic activity appears more malignant, and consistent with recession. But similar to the U.S. and Canada, European inflation data remain uncomfortably high, presenting the central bank with a policy dilemma that likely also resolves in favour of Higher for Longer.

By contrast, many Emerging Market (EM) central banks are now firmly focused on policy easing. This includes banks in Latin America, in response to slowing inflation. It also includes the People's Bank of China, which continues to grapple with the risk of deflation, as well as disappointing growth driven by secular weakness in the Chinese property market. Incremental policy easing is being implemented to stabilize the property market and boost growth. The scope to implement more substantive policy stimulus—for instance, focused on the transformation of underdeveloped regions into mega-cities—appears limited for fear of stoking deeper secular vulnerabilities. As a result, we remain relatively pessimistic on Chinese cyclical economic prospects and expect only a tepid recovery in growth. Elsewhere in Asia, EM central banks appear more concerned with the risk of a rebound in inflation and appear unlikely to ease policy soon.

Quarter in Review

Core investment theses and positioning were little changed during the period. We continued to balance portfolio positioning between long exposure to pro-cycle interest rate carry and constructive domestic country fundamentals alongside a cautious awareness of elevated recession and geopolitical risks. These cross-currents motivated a reduction in active risk towards the end of the period.

Interest rate carry will likely remain a core determinant of positioning well into 2024 even though its attractiveness is likely to wane gradually over the next several quarters, as central bank policy easing cycles continue in Latin America and Eastern Europe. Concurrently, expected returns associated with our quantitative Value factor are likely to remain relatively high, and disparate cyclical trends across the world economy suggest the attractiveness of our quantitative Cycle factor will also persist.

HARC Quarterly Commentary

Horizons Absolute Return Global Currency ETF (HARC)

Q3 2023

Long positions in the Brazilian real (BRL) and Colombian peso (COP) remained the largest contributors to portfolio risk at the end of the quarter. Both positions were motivated by a combination of attractive interest rate carry and valuations, as well as our positive assessment of longer-term country fundamentals.

In terms of other portfolio long positions predicated, at least in part, on positive interest rate carry, we retained our Indian rupee (INR) and Indonesian rupiah (IDR) positions; the size of the latter position increased slightly during the quarter. Given the importance of domestic demand to the Indian economy, INR represents an attractive hedge against elevated global recession risk. By contrast, we closed our long in the Hungarian forint (HUF) during the quarter. This was a lower conviction position than other carry-related exposures; HUF's valuation screens as relatively unattractive. In addition, the announcement by Russia during the third quarter of a ban on energy exports represented a risk to energy importers, such as Hungary, still dependent on Russian energy. The HUF position was funded by a combination of the Czech koruna (CZK), which we also closed during the quarter, and the Euro (EUR).

The portfolio's principal funding currencies remained unchanged during the quarter, although position sizes did change. In Asia, the portfolio remained short the Chinese renminbi (CNH) and Taiwan dollar (TWD), on low interest rate carry, poor economic fundamentals, and, at the margin, heightened geopolitical risk. Indeed, for China, we see the currency as the principal policy lever available to policymakers as they seek to revive tepid growth and move away from the risk of deflation.

In North America, we maintained shorts in the U.S. dollar (USD) and Canadian dollar (CAD), although the size of both were tactically trimmed during the period. USD screens as increasingly expensive from a longer-term perspective. But with the U.S. Federal Reserve leading the central bank policy transition to Higher for Longer, along with less positive market risk sentiment, the currency is likely to be supported in the near term. CAD is a pro-cycle currency with relatively poor fundamentals that make it particularly exposed to recession risk. But in the short term, it likely benefits from continued economic resilience in its major export market, the U.S. and EUR remain attractive as a source of funding on clearer evidence of recession in that region. As part of our trim of North American shorts, we switched part of the funding of our BRL long into EUR, and also added to our existing Mexican peso (MXN) long position against this currency, too. We opened and then closed a tactical short EUR position during the quarter against the Norwegian krone (NOK).

In terms of other, idiosyncratic portfolio positions, we increased the size of our long position in the Japanese yen (JPY) funded by a short in the Swiss franc (CHF). This is a value-focused position hedged to global recession risk; JPY is the cheapest currency in our investible universe, and CHF is one of the most expensive. We did progressively trim and then closed our long JPY position against CAD during the quarter, as part of our tactical trim of the latter's overall short exposure. We closed a long Australian dollar (AUD) position against CHF, switching the long side of this exposure into JPY.

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