

### Market Overview

The U.S. Federal Reserve (Fed) ushered in the Holiday Season with a gift to already high-spirited financial markets. Its December pivot in favour of earlier and more policy rate cuts than previously signalled — equivalent to three 25 basis point reductions in 2024 — provided fresh impetus to public equity markets and bond prices, and also gave more legs to the broad U.S. dollar's (USD) recent weakening trend; USD depreciated 5% from early October to year-end.

The Fed's pivot stood in marked contrast with the sentiment it expressed only three months earlier when asserting that rates would likely remain "Higher for Longer" to restrain economic activity as a means to ensure inflation returns to its policy target within a reasonable timeframe. December's Federal Open Market Committee (FOMC) economic projections showed little sign of prospective economic pain — the Fed now expects the U.S. unemployment rate to average 4.1% in 2024, only a little higher than the current 3.8%, and the real economy to skirt a recession — but did exhibit clear evidence the Fed is increasingly confident inflation will return to target no later than 2025. This more benign inflation view was likely the main factor driving the change in the Fed's assessment of the appropriate policy stance, as further disinflation from here onwards without policy easing will increase real interest rates, autonomously tightening Fed policy stance more than appears desired.

Even taking account of the Fed's pivot, the Sub-Advisor thinks markets are pricing too many policy rate cuts in 2024 (150 basis points in aggregate as at January 2). The same is true for several other Developed Market (DM) central banks, including the Bank of Canada (BoC) and the European Central Bank (ECB). Certainly, headline inflation data have been weaker in recent months than expected across a wide swath of countries. This includes the U.S., despite continued relatively resilient activity data. Core inflation data have remained stickier and still have further to go to return to rates consistent with the Fed's overall policy target. But the direction of travel has been broadly constructive, meaning the probability of a "Goldilocks" soft landing has increased markedly. But it isn't a certainty. The longer U.S. activity data stay relatively resilient — fueled by the recent substantial easing in financial conditions, renewed fiscal expansion (the budget deficit rose sharply in the second half of 2023), and expected robust growth in real incomes — the higher the risk that inflation begins to reaccelerate in the back half of 2024. This outcome would require the Fed to once again embrace "Higher for Longer", likely causing market interest rate expectations and bond yields to retrace at least part of their recent descent. In contrast to the market consensus, the Sub-Advisor assigns a similar probability to this outcome as it does to a "Goldilocks" scenario. Finally, although the risk of a mild global recession has diminished substantially, it has not gone completely. This outcome would be consistent with the current market pricing of the Fed-- but would be inconsistent with the benign U.S. economic outcome market participants currently expect alongside sharply lower policy interest rates.

The calculus is a little different for Canada. Inflation data remain above the BoC's target, but the central bank will be aided by already weak activity data. GDP dropped by 1.1% in the third quarter of 2023, and further weakness likely lies ahead, in no small part due to the substantial mortgage renewal cliff that continues to loom over consumers for 2024 and 2025. Similarly in Europe, although inflation still has further to decline the tightening in financial conditions over the past year as a whole has been more severe than in North America, as reflected in Germany's already recessionary data, and tighter fiscal policy in this region could have negative implications for economic prospects. For both the BoC and ECB, policy easing is likely to proceed a little quicker than the Fed's. Even so, the timing and extent of rate cuts priced by the market for both these central banks still appear too aggressive, suggesting some correction as they move through the first half of 2024. By contrast, Chinese policymakers likely remain biased towards more policy easing rather than less, reflecting a continued struggle against the risk of deflation.

Elsewhere in Emerging Asia, central banks appear more concerned with the risk of a rebound in inflation and are unlikely to ease policy soon. By contrast, in Latin America and Emerging Europe—with the significant exception of Turkey—further policy easing appears to be front and center. Many of these central banks were much more proactive than the Fed, and other DM's, in tightening policy early in 2021 in the face of rising inflation. They are now cutting policy interest rates in response to clear evidence of disinflation; for instance, inflation in Brazil has already returned to the central bank's policy target band.

### Quarter in Review and Positioning

The active risk was little changed through the quarter and remained low relative to the target. Core investment themes were also little changed. The Sub-Advisor continued to balance portfolio long positioning between exposure to pro-cycle interest rate carry and constructive domestic country fundamentals alongside a cautious awareness of residual recession risks and continued heightened geopolitical risks. Short positioning remained focused on currencies with low carry, inherent cyclical and secular vulnerabilities, and in the case of USD, stretched valuation and a surprisingly dovish central bank.

The attractiveness of the quantitative Carry factor has waned a little since the middle of 2023, as rate-cutting cycles have begun in several Emerging Market (EM) countries. Even though its attractiveness is likely to ebb further over the next several quarters, as central bank policy easing cycles continue in Latin America and Central and Eastern Europe and begin in DM economies, this factor will likely remain a core determinant of positioning well into 2024. 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.

The main portfolio change in the quarter was the addition of a small long position in the Turkish lira (TRY), expressed versus USD. The Sub-Advisor's quantitative factor models are highly constructive on TRY, including Carry, Value and Cycle. Recent developments in Turkey have caused the Sub-Advisor to adopt an increasingly positive view on Turkish macro fundamentals, as well as central bank governance and its ability to implement the recently adopted conventional policy path. This marks a significant shift from years of deteriorating macro fundamentals and poor, unconventional central bank policy. A critical factor in our more positive assessment has been support from President Erdogan for central bank governor Erkan. Erdogan seems to have accepted the need for aggressive, but conventional policy action. This reflects, at least in part, opinion polls suggesting a favourable assessment of the government's recent management of the economy.

Long positions in the Brazilian real, and the Colombian, Mexican (MXN) and Chilean (CLP) pesos remained the largest contributors to portfolio risk. All four longs continued to be motivated by a combination of attractive interest rate carry and our positive assessment of longer-term country fundamentals. In addition, valuations in Brazil and Colombia, particularly, remained supportive. The Sub-Advisor switched part of the funding for the MXN long position from the Canadian dollar (CAD) to the Swiss franc (CHF), which exhibits low carry, a weak quantitative Cycle factor score, and extreme overvaluation. They also trimmed the size of the CLP long on a more dovish domestic central bank.

In terms of other portfolio long positions predicated, at least in part, on positive interest rate carry, the Sub-Advisor retained its Indian rupee (INR) and Indonesian rupiah positions. Given the importance of domestic demand to the Indian economy, INR represented an attractive hedge against elevated global recession risk. The Sub-Advisor switched part of the funding for INR from the Euro (EUR) to USD on the Fed's dovish pivot.

In Asia, the portfolio remained short the Taiwan dollar, despite a recent improvement in cyclical economic data, and the Chinese renminbi (CNH). Both currencies exhibit low carry, poor economic fundamentals, and, at the margin, elevated geopolitical risk. Recent Chinese stimulus measures helped mitigate domestic deflation tail risk but did little to change our assessment of CNH. Indeed, the Sub-Advisor continued to view CNH's weakness as one of the principal policy levers available to policymakers as they seek to revive tepid growth. That said, they did reduce the size of the CNH short with a close of our long Thai baht position; tepid growth is unlikely to drive as much outward Chinese tourism as they had expected, likely meaning less improvement in the Thai Balance of Payments. More constructively, Chinese policy stimulus measures did improve the outlook for pro-cycle currencies; this includes the South African rand, for which they retained a small long position. The Sub-Advisor closed the long Australian dollar position funded by the U.K. pound. This position was no longer supported by their quantitative factor models.

# HARC Quarterly Commentary

Horizons Absolute Return Global Currency ETF (HARC)

Q4 2023

In North America, the Sub-Advisor maintained core short positions in the Canadian dollar (CAD) and USD. CAD is a pro-cycle currency with relatively poor fundamentals that make it particularly exposed to - domestic and global - recession risk. The size of the USD short position was increased in November, in response to the unexpectedly dovish Fed. This repricing may have been a little too aggressive, particularly relative to other central banks, suggesting the risk of a USD bounce in the near term against some other DM currencies. But from a longer-term perspective, the USD remains one of the most expensive currencies in our investment universe, which argues for a significant weakening over the coming years as a whole.

EUR remains an attractive long-term funding currency on clearer evidence of recession in Europe compared with a more resilient US economy. Persistent underlying structural weaknesses also continued to contribute to our short EUR conviction. Elsewhere in Europe, the Sub-Advisor opened long positions in the Norwegian krone and Swedish krona. Both were expressed against CHF and ranked favourably in terms of both Valuation and Cycle.



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