

Market Review

In the first quarter (Q1) of 2023, North American bond yields finished lower but were extremely volatile. Rates decreased significantly in January, jumped higher in February, and then collapsed in March. 2023 got off to a roaring start with hopes rising for developed economies to achieve a soft landing as inflationary pressures showed signs of abating, and the U.S. Federal Reserve (Fed) downshifted its pace of tightening. There were also significant flows into fixed-income assets that contributed to the rally. However, a wave of risk aversion swept the markets.

Hopes for an imminent end to rate hikes and a dovish policy pivot were dashed in the wake of unrelenting signs of resilient growth, an overheated labour market, sticky inflation, and hawkish central bank rhetoric that prompted a shift in investor expectations towards higher interest rates for longer. In March the collapse of Silicon Valley Bank, Signature Bank, and Credit Suisse and the fear of more contagion in the banking sector caused a powerful flight-to-quality bid into government bonds reminiscent of the financial crisis in 2008. Governments and central banks moved very quickly to contain the situation. The market ended the quarter with expectations of the Fed cutting rates 50 basis points (bps) by the end of 2023.

The Bank of Canada (BoC) increased its target for the overnight rate in January by 25 bps to 4.50%, bringing cumulative rate hikes to 425 bps for the cycle. At this time the BoC also indicated it would pause to see the impact of interest rate increases on the economy. The BoC currently expects inflation to drop to 3% this year, before hitting the 2% target in 2024, while the market is looking for the BoC to cut rates 50 bps to 4.00% by the end of the year. Rates were very volatile during the quarter. Two-year Canada bonds started the year at 4.05%, rallied to 3.47%, sold off to 4.32%, then fell to 3.74% to end the quarter.

In this environment, short-term provincial spreads, on average, declined by two bps to 32 bps and corporate spreads ended two bps higher at 159 bps. At one point, in early February, corporate credit spreads had narrowed to 127 bps before selling off at the end of Q1.

Quarter in Review

During the quarter, HFR's very low total duration, kept between 0 and 1 year in the quarter, limited rate compression impact on the strategy. Corporates, yielding on average 5.33%, did provide stable carry in the quarter – this more than offset slight spread widening.

HFR took profits on several expensive corporates that had performed well. The Sub-advisor was also very selective in the primary market to take advantage of new issue concessions. These names included CIBC, Intact, RioCan, Manulife, and Crombie REIT. New issuances provided an attractive breakeven framework in this environment with decent concessions. In Q1, HFR's selection in Energy, Telecom, Banks, and Real-Estate added value.

Outlook and Positioning

Inflation, employment, financial stability, and tighter financial conditions will be key drivers for the direction of bond yields. The BoC has now stopped increasing interest rates as restrictive policy will slow activity and bring inflation back towards the BoC's target. We also believe the U.S. Federal Reserve is getting close to pausing rate increases, especially now, with tighter financial conditions brought on by the turmoil in U.S. regional banks.

Inflation has moderated from the highs in the summer but remains well above 2%. Although the BoC has stopped hiking for this cycle, it is believed that its rates will remain elevated for a long period of time before sticky inflation, falls back to target, which is at odds with current market expectations.



HFR Quarterly Commentary

Horizons Active Ultra-Short Term Investment Grade Bond ETF

Q1 2023

Portfolio duration ended the quarter around 0.47 years. HFR will continue to trade the portfolio as the sub-advisor expects the market to be very volatile while participants try to determine the timing of the first interest rate cut. In Canada, the market expects this to happen before the end of 2023, however, the sub-advisor's view is that sticky inflation, driven by a tight labour market, will make this a 2024 story. Corporate spreads currently reflect the base case of a modest recession, but if they tighten too quickly, as they did during the quarter, HFR will look to take profits. If spreads widen to reflect a significant slowdown, HFR will increase its exposure. The yield at the quarter end is quite attractive approaching the peak of the hiking cycle.



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