

HMP Quarterly Commentary

Horizons Active CDN Municipal Bond ETF

Q4 2023

Market Overview

North American bond yields were much higher over the last three months especially longer-term bonds as the curve steepened on North American bond yields fell significantly, and the yield curve steepened over the last three months of 2023. The fourth quarter (Q4) started off on the continuing theme of “higher-for-longer” interest rates and a general risk-off tone, but by mid-October, there was a material reversal on both fronts. The combination of several global monetary authorities hinting that rate hikes were coming to an end along with softer inflation and employment data caused markets to pivot towards lower rates. Central banks attempted to push back, but it did not stop the markets from pricing in multiple interest rate cuts starting in early 2024. At the end of 2023, investors were looking for the U.S. Federal Reserve (“Fed”) to reduce rates 158 basis points (bps) in 2024 to 3.75% with the first 25 bps cut built-in by March.

Global growth and inflation continued to decline throughout the quarter. However, U.S. growth has been stronger than expected all year led by a resilient consumer. Canadian growth was generally weak throughout 2023 as restrictive monetary policy hit both consumers and businesses. The unemployment rate has been drifting higher since the spring as labour market conditions continued to ease. The Bank of Canada (“BoC”) has kept its overnight rate at 5% since July. With the economy no longer operating in excess demand, inflation is expected to moderate further and move towards the BoC’s 2% target over time. However, the BoC’s main concern is sticky inflation, and if this materializes, they are prepared to increase rates further. Ten-year Canada bond yields fell over 90 bps during the quarter. The market is expecting the BoC to begin cutting interest rates in April and to end the year with an overnight rate of 3.72%.

In this environment short-term provincial spreads declined 6 bps to 30 bps and corporate spreads narrowed 21 bps to 121 bps. Short-term rated and non-rated municipal spread performance moved in line with provincials by approximately 5 to 6 bps.

Quarter in Review

Duration strategy helped as HMP was set up for lower rates, but curve positioning was negative as the fund was anticipating a flatter curve. HMP generated 11 bps of carry and 4 bps from duration/curve, with the remainder primarily driven by non-rated municipal and provincial spread compression. Non-rated municipal spreads in the five-year term are approximately 85 bps relative to provincials, which is historically, an attractive entry point.

The yield carry from the portfolio’s overweight in non-rated municipals declined to 38 bps from 44 bps.

Outlook and Positioning

Major central banks are now likely finished hiking interest rates for this cycle. Monetary policy is restrictive and will lead to softer growth in 2024. The U.S. economy should operate below potential, but we now expect Canada to enter a shallow recession. Inflation has declined from very elevated levels over the past year and if it continues to fall the BoC will become more confident in hitting their 2% inflation target, which will allow them to eventually begin the process of loosening monetary policy. The market is expecting multiple rate cuts in 2024, which will provide support in avoiding a hard landing in the economy. During the year, interest rates and credit spreads are expected to stay low, but we should see volatility and opportunities as central banks transition to interest rate cuts, elevated bond supply and geopolitical risks. While recent data has shown improvements on the inflation front, more work still needs to be done to support the central bank’s changing policy. The Sub-Advisor expects the BoC and the Fed to lower interest rates in the range of 75 bps to 125 bps in 2024.

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Investment grade credit spreads -- and in turn, non-rated municipal spreads -- are still historically wide despite the recent performance. HMP will remain active in this sector as opportunities present themselves and add or reduce exposure as conditions warrant.



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