HPR Quarterly Commentary

Horizons Active Preferred Share ETF (HPR)

Q3 2023

Market Overview

North American bond yields were much higher over the last three months especially longer-term bonds as the curve steepened on the theme of higher-for-longer interest rates.

Positive economic surprises at the start of the quarter and signs of an easing of inflationary pressures gave investors hope that the U.S. Federal Reserve (Fed) may achieve price stability without tipping the economy into a recession. Meanwhile, the Bank of Canada (BoC) increased rates by 25 basis points (bps) in July to 5% as economic growth had been stronger than expected led by consumer spending. Housing was improving, the labour market remained resilient, and immigration was helping to stimulate the economy. Inflation had fallen but remained more persistent than expected. In August, Canadian data was mixed with headline inflation higher but with growth and employment lower. Investors priced in a 60% probability of another rate hike by December.

In September, rates moved materially higher as both headline and core inflation came in much hotter than expected. Markets moved immediately to price in a full 25 basis point increase by the BoC by year-end and removed rate cuts built in for 2024. The economy slowed down in Q3, but not fast enough to bring inflation to the 2% target. Population growth, employment and pent-up demand have prevented the economy from going into a recession. The job market had been showing signs of cooling after a blistering start to the year, however, the latest report surprised to the upside. The unemployment rate remains low at 5.5% and hourly wages are high at 5.2%. Key measures of core inflation are elevated at 4%. In the U.S. the economy is not slowing very quickly driven by consumer savings, pent-up demand, and a powerful fiscal stimulus. The Fed has hinted they may still need to increase rates again in this cycle, but then it will be necessary to hold rates high for a long period to bring inflation down to 2%. The repricing of rate cuts drove bond yields higher and steepened the curve.

In this environment, mid-term Provincial spreads were unchanged at 64 bps, but corporate spreads performed well in this environment as spreads narrowed from 5 bps to 182 bps.

The Canadian preferred share market underperformed in Q3 and continued to be volatile. The S&P/TSX Preferred Share Index returned -1.43% while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned -2.77%. The negative flow of funds from both institutional and retail investors mostly explained the underperformance of the asset class. The negative performance of the equity markets didn't help, despite the stable credit tone. The tone improved in September with interest rates increasing substantially and because TD Bank decided to redeem one preferred share issue. Fixed reset issues continued to outperform in Q3, particularly the ones that will reset in 2023 and 2024. Fixed-rate perpetual issues underperformed in this higher interest-rate environment. Bank and utility sectors outperformed in Q3 while real estate, telecommunications and energy sectors underperformed.

Quarter in Review

Our security selection within the energy, utility, diversified financials and insurance and our underweight position in the real estate sector were the main drivers of outperformance in Q3. Our underweight position in fixed reset rate and fixed rate perpetual was also a positive contributor. Our security section in the banking sector reduced the outperformance.

Over the last quarter, we increased our underweight position in fixed reset rate and we decreased our underweight position in fixed rate perpetual. We increased our underweight position in banks and we reduced our underweight position in insurance companies. We also increased our overweight position in fixed reset issues that will reset in 2025. Finally, we bought the new hybrid of Enbridge at an attractive coupon and reset level.

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Outlook and Positioning

We were surprised by the uptick in the core measures of inflation in September after trending lower for most of the year. If this is repeated with the next reading, the BoC will likely increase rates. This outcome is already reflected in the market. The Fed is also getting close to finishing its tightening campaign. We believe monetary policy is restrictive and over time the economy will slow and lower inflation. Our base case is for an economic slowdown in 2024 that will eventually lead to interest rate cuts, but this is getting pushed further and further out as inflation remains sticky. Investors are now looking for the first interest rate cut from the Bank at the end of the first quarter of 2025.

The average current yield of Canadian preferred shares remains attractive and could increase substantially over the next few quarters/years as fixed reset issues reset at a much higher 5-year Canada rate. Volatility will remain important in 2023 as financial conditions continue to tighten. This volatility could be exacerbated with the flow of funds especially if the Federal government decides to change the tax treatment on dividends for corporations. We would be ready to add beta to our portfolio if the price moves lower on the negative flow of funds. In this environment, we think the fixed reset issues that reset in 2024 and 2025 represent the best risk/reward opportunities as we think the 5-year Canada rate could be sticky above 3% over the next few years.