

# HPR Quarterly Commentary

Horizons Active Preferred Share ETF (HPR)

Q4 2023

## Market Overview

North American bond yields fell significantly, and the yield curve steepened over the last three months of 2023. The fourth quarter (Q4) began 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 the year, 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 central bank’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 Canadian 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 mid-term provincial spreads declined 9 bps to 56 bps and corporate spreads narrowed 19 bps to 161 bps.

The Canadian preferred share market outperformed in Q4 and continued to be volatile. The S&P/TSX Preferred Share Index returned 7.28% while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned 7.37%. The preferred share market also pivoted in late October helped by the risk-on environment driven by the perception that central banks were done hiking and could consider cutting rates soon. The decision by the Federal government to not change the tax treatment on preferred share dividends also helped the asset class. Some surprise redemptions were also supportive. Fund flows were positive in November and December but remained negative for the quarter. Fixed reset issues continued to outperform in Q4 while fixed-rate perpetual issues underperformed despite lower interest rates across the yield curve. The Insurance, Financial Services, Energy and Telecommunications sectors outperformed in Q4 while real estate, following the downgrade of BPO’s rating, and utility sectors underperformed.

## Quarter in Review

The fund’s overweight position in the Utilities and Telecommunication sectors and in hybrids and limited recourse capital notes (LRCNs) were the main drivers of the performance in the quarter. HPR’s underweight and security selection in Banks, Financial Services and Insurance reduced performance. Also, the underweight position in fixed reset rates was a negative contributor to performance.

Over the last quarter, HPR increased its position in fixed-rate perpetual to be less underweight while it reduced its overweight position in hybrids/LRCNs and its position in floating rate to underweight. HPR also increased its overweight position in fixed reset issues that will reset in 2025 and 2026. HPR took some profit on fixed reset issues that reset in 2024 and became underweight.

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## 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 the Sub-Advisor now expects 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 its 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.

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 should remain important in 2024 subject to the timing and amplitude of central bank interest rate cuts in this low and potentially negative Canadian GDP growth environment. Fund flows should improve in 2024 as the decision by the Federal Government to not modify the tax treatment on preferred share



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