HRAA Quarterly Commentary

Horizons ReSolve Adaptive Asset Allocation ETF

Q3 2022

Market Overview

The third quarter (Q3) of 2022 began with growing recessionary concerns in the wake of weak second-quarter GDP figures for the U.S. and Chinese economies, in addition to an array of negative indicators and a looming energy crisis in Germany and other European states. Sovereign yield curves – including U.S. Treasuries, U.K. Gilts, and German Bunds – inverted and global equities rallied as markets began to price in the possibility of yet another Fed pivot and an interruption of monetary tightening. Investors' hopes were dashed in August as chairman Powell delivered unequivocally hawkish remarks at the Jackson Hole symposium, promising to stay the course on the fight against inflation "until the job is done," leading to price declines across global equities, government bonds, crude oil, and metals.

The selloff intensified and spread across most major asset classes in September, as investors raised cash and adjusted allocations to an environment of tighter liquidity. The Federal Reserve (Fed) showed no signs of wavering from its hawkishness as chairman Powell vowed to "keep at it until inflation is down to two percent (...) And our monetary policy tightening will be enough. It will be enough to restore price stability," echoing former president of Italy and the European Central Bank, Mario Draghi's "whatever it takes" speech ten years ago. Quantitative tightening marched on while another 75 basis points (bps) rate hike was announced by the Federal Open Market Committee (FOMC).

The European Central Bank and Swiss National Bank increased rates by the same amount (albeit from lower base levels), while the Bank of England tightened by 50 bps. The Bank of Japan was the only major monetary authority to dissent from what has been dubbed a "reverse currency war," not only doubling down on ultra-low rates and its yield curve control (YCC) policy but also intervening in its currency for the first time in 24 years, essentially establishing a floor for the Yen.

Quarter in Review

After an exceptionally strong first half of the year, in the third quarter, HRAA suffered from a broad selloff across global markets. Longs in government bonds and energies bore the brunt of losses, while long exposure to the U.S. dollar provided small gains.

The Adaptive Asset Allocation strategy offers exposure to a global risk parity "beta" core stacked with an active macro trading "alpha" strategy. In July and August, the risk parity strategic core had positive returns that partially offset losses in the alpha strategy, while the broad market liquidation that occurred in September drove both components into negative territory.

Bonds were the worst-performing sector, led by longs in the German sovereign complex along with UK Gilts, while a short position in the five-year U.S. Treasury offered small gains.

Energies contributed negatively, especially from longs in crude oil, gasoline, and carbon emissions, partially offset by profits from long exposure to natural gas.

Equity indices also imposed losses stemming mostly from longs in Japanese and European stocks, though shorts in the Hang Seng, U.K. FTSE, and Italian MIB contributed with some positive returns.

Softs detracted due to longs in cotton and sugar, with marginal gains from long coffee.

Currencies were the best-performing sector, with profitable short positions in the British Pound, Euro, Aussie dollar, Japanese Yen, Canadian dollar, and Swiss Franc, against the U.S. dollar.

Grains were marginally positive contributors, led by shorts in soybeans and bean oil, and longs in KC wheat and soy meal.

Outlook and Positioning

The Fed appears resigned to an economic slowdown and higher unemployment to bring inflation back down to two percent. Data dependence and political considerations will likely put "whatever it takes" to the test. The Bank of Japan is now the "canary in the central bank mine" as it attempts to keep both a cap on 10-year JGB rates and a floor on the Yen. How long can they keep bond and currency "vigilantes" at bay, and how will that inform the action of other central banks as they contemplate heterodox policies of their own?

The European energy crisis deepens with the damage to the Nord Stream 1 and 2 pipelines in what appears to be an act of sabotage by unknown parties. How will that affect the continent's economic activity and resolve in supporting Kyiv as winter approaches? With economic, financial, and geopolitical uncertainty as high as they've been in several decades, diversification and risk management remain paramount for investors seeking to navigate these unchartered waters.

HORIZONS ETFs
by Mirae Asset