HRAA Quarterly Commentary

Horizons ReSolve Adaptive Asset Allocation ETF

Q1 2023

Market Overview

The first quarter (Q1) of 2023 was marked by an unexpected shock to the U.S. banking system that reverberated across global markets. It's hard to overstate the intensity of the dislocation observed in rates and government bond markets that resulted from this event, which was "the biggest one-day decline since Oct 1, 1982 (the first discount rate cut following the Sept 1981 all-time peak in yields). In particular, the March 13th decline in the 2-year rate was larger than any one day seen during the 2007 - 2009 financial crisis, following 9/11, and the 1987 stock market crash". [1]

As well, a rally across global equities and bonds occurred in Q1 2023, as decelerating inflation in the U.S. and Europe, rekindled hopes that a potential pause in monetary tightening was in sight, even though central bank Chairs on both sides of the Atlantic continued to emphasize a tightening bias. U.S. economic data was robust, especially in February, as the gross domestic product (GDP) and employment figures conveyed resilience. Despite some evidence and expectations of a meaningful activity slowdown, the European Central Bank, and the Bank of England continued raising rates.

As reopening and activity normalization began to gain traction, the People's Bank of China issued a cautiously optimistic report on the economy, which is expected to rebound and be marginally supportive of the global economy. The toll from prolonged shutdowns in China was laid bare when last year's meager three percent GDP growth was announced, a multi-decade low and barely half the 5.5% target.

Japanese GDP for the fourth quarter of last year fell short of expectations, as did several other economic indicators, while inflation accelerated. If persistent, this dynamic would pose a grave challenge to the Bank of Japan's ultra-loose monetary policy of Yield Curve Control, which has led to the Bank of Japan accumulating approximately half of the country's outstanding debt over the past few decades[2].

The war in Ukraine raged on, with both sides speculated to be preparing for a spring offensive that could break the apparent stalemate of recent months. The Black Sea Grain Initiative was renewed, allowing food and fertilizers to continue flowing from southern Ukrainian ports, though Ukrainian and Russian officials disagreed on the extension's duration.

During the second week of March, huge (albeit, unrealized) losses from U.S. Treasury holdings, that had been accumulating across the U.S. banking system since the U.S. Federal Reserve (Fed) began raising rates, precipitated the first bank run of the digital age[3]. A tsunami of depositor capital was rapidly drained from smaller regional banks, and financial institutions otherwise perceived as "non-systematically important" and into the (relative) safety and extra yield offered by U.S. Treasuries and other sovereign debt.

Just days after coordinating fresh U.S. dollar funding facilities with other central banks to alleviate the market turmoil that ensued, the Fed once again raised rates, though less than previously expected and in line with the dislocations implied by the yield curve. Importantly, the Chairman admitted the Federal Open Market Committee considered pausing , fueling speculation, especially across duration-sensitive risk assets.

[1] Jim Bianco of Bianco Research: https://twitter.com/biancoresearch/status/1635407339711787008

[2] https://asia.nikkei.com/Business/Markets/Bonds/BOJ-holds-over-50-of-Japanese-government-bonds-for-1st-time

[3] https://www.bloomberg.com/news/articles/2023-03-12/silicon-valley-bank-s-fall-was-a-faster-more-viral-breed-of-bank-run#xj4y7vzkg

[4] https://www.bloomberg.com/news/videos/2023-03-22/powell-fed-considered-rate-pause-consensus-backed-hike

HORIZONS ETFs
by Mirae Asset

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Quarter in Review

The Adaptive Asset Allocation strategy offers exposure to a global risk parity "beta" core stacked with an active macro trading "alpha" strategy. The risk parity core delivered positive returns for the first three months of the year, while the alpha component struggled, especially in March.

It is a testament to HRAA's agility and risk management tools that, despite a net short exposure to government bonds coming into this episode (which have been an important source of positive returns for the strategy over the last 18 months), the strategy experienced a relatively small loss.

Table 1. HRAA Performance Attribution – Q1 and 2023

Sector	Q1 (%)
Bonds	-1.2
Currencies	-0.3
Energies	-1.3
Grains	0.2
Indices	2.2
Volatility	-0.1
Meats	0.0
Metals	-1.3
Softs	0.0
Total	**-1.9**

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Analysis by ReSolve Asset Management SEZC (Cayman). Q1 return figures as of March 31st, 2023. Note: Results may differ due to rounding. Performance is expressed in CAD. Strategy attribution is a best effort approximation due to rounding and trade timing, net of all applicable borrowing costs, fees and fund accruals for the period.

Equity indices were the strongest drivers of positive returns, driven primarily by longs in the Italian MIB, French CAC40, Aussie200, Spanish IBEX, and Japanese Nikkei. A profitable short on the U.K. FTSE and active trading in the S&P 500 also contributed.

Grains offered small gains, led by shorts in milling wheat and wheat, while longs in bean oil and soy meal partially detracted.

Energies were the worst performers, with most losses concentrated in active trading of Brent and WTI crude. Gains from long gasoline and short natural gas provided partial compensation.

Metals also imposed losses to the portfolio, stemming largely from shorts in copper and gold.

Bonds contributed negatively as well, primarily from short exposures to German Bobl, Canadian 10-year, and U.S. five-year Treasury. Long U.K. Gilt partially alleviated losses.

Currencies had a marginally negative impact, led by the long Euro and short Japanese Yen, while short the British Pound offered some gains.

Softs had an overall negligible contribution because important profits stemming from long sugar and cocoa were offset by losses actively trading cotton and coffee.

Table 2. Q1 and 2023 Asset-class Highlights

	Robusta Coffee (%)	NASDAQ (%)	Sugar (%)	European Equities (%)	Nikkei (%)	Copper (%)	Gold (%)	German 30Y Buxl (%)	US 30Y Treasury (%)	Soymeal (%)	US Dollar Index (%)	Diesel (%)	Wheat (%)	US Natural Gas (%)
Q1 Returns	22.1	19.3	18.3	14.3	8.9	7.5	6.8	4.7	4.2	2.3	-0.7	-11.1	-14.0	-51.9
Annualized Volatility	22.3	21.8	23.5	18.3	13.9	22.9	15.6	27.9	13.9	21.7	8.2	39.8	25.2	81.5
Maximum Peak to Trough Loss	-6.3	-7.8	-5.4	-6.7	-5.9	-9.8	-7.2	-13.7	-7.6	-11.2	-3.6	-25.1	-17.6	-54.3

Source: Data from Tiingo. Using continuous futures contracts. Returns are expressed in USD. European Equities represent the EStoxx50 Index.

Outlook and Positioning

The Fed's tightrope has become a lot thinner; though financial stability concerns appear to be relatively contained for the moment, additional tremors of sufficient magnitude could force its hand even if inflation remains well above target. A group of midsized U.S. banks requested regulators to extend FDIC insurance to all deposits for the next two years[5]. Even if regulators can momentarily arrest the bleeding with sweeping guarantees for small and midsized institutions, the U.S. regional banking system has been dealt a heavy blow that could reshape the industry. The question of the recession may be about depth and duration, while another (and perhaps more consequential) congressional 'debt ceiling showdown' approaches just as foreign appetite for U.S. Treasury securities may have peaked.

[5] https://www.bnnbloomberg.ca/midsize-us-banks-ask-fdic-to-insure-all-deposits-for-two-years-1.1897285

Strong remarks from top Chinese officials of "conflict and confrontation" and "unprecedented grave challenges to our nation's development" showed just how strained U.S.-China relations have become after Washington imposed additional measures to restrict China's access to the most advanced microprocessors. Beijing also criticized new developments in the AUKUS defense pact between the U.S., U.K., and Australia, denouncing a "dangerous road" lay ahead. Not surprisingly, defense spending grew as a share of the budget when China announced its GDP growth target of "around five percent" [6] during its annual parliamentary gathering.

China's geopolitical ambitions were on full display as President Xi visited his Russian counterpart, reaffirming the two countries 'limitless friendship' and offering a peace proposal that would allow Moscow to keep Crimea and other territories annexed in 2014 (promptly rejected by Kyiv). The Chinese also participated in a historical rapprochement between Saudi Arabia and Iran, while the former is also reported to be considering accepting Yuan instead of Dollars for Saudi oil[7], an unprecedented break from the Petrodollar System. Intentions were further solidified when it was announced that, in partnership with Brazil, India, Russia, and South Africa, the so-called BRICS are now seeking to develop a new currency to rival the US dollar.

[6] https://www.reuters.com/world/china/chinas-economy-government-revamp-focus-parliament-set-open-2023-03-04/
[7] https://www.wsj.com/articles/saudi-arabia-considers-accepting-yuan-instead-of-dollars-for-chinese-oil-sales-11647351541

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