HRAA Quarterly Commentary

Horizons ReSolve Adaptive Asset Allocation ETF (HRAA)

Q2 2023

Market Overview

In the second quarter (Q2) of 2023, the seesaw of cyclical and structural forces pulling in opposite directions continued to add complexity to the future of U.S. interest rates; one of the most critical variables in determining risk appetite for global assets. Rates, bonds, equities, and energies have been mired in loose ranges for many months while economic forces play out against a backdrop of policy ambiguity along several axes.

Extraordinary short-term measures at the Treasury to manage the debt-ceiling conflagrations resulted in a surge in short-term liquidity. Once negotiations in Congress were concluded and the debt ceiling was once again extended, Secretary Yellen elected to replenish the Treasury General Account by issuing short-term Treasury bills (as opposed to longer-dated bonds) in an apparent attempt to minimize the expected impact on liquidity. This will likely dampen the effects of Quantitative Tightening and further complicate the U.S. Federal Reserve's (Fed) fight against inflation. Concerns over financial stability following the failure of important U.S. banks in March appear to have somewhat moderated, though growing signs of non-performing loans to the commercial real estate sector could add further strain to the industry[1].

After 10 consecutive hikes, the Fed kept rates unchanged in its latest Federal Open Market Committee (FOMC) meeting in June. However, optimism about a "pause" was tempered by comments by Chairman Powell indicating that the tightening cycle was not over yet, and an increase in terminal rates (as indicated by so-called Dot Plots) is expected. Inflation slowed but remained well above the Fed's target, while stronger than expected labour market and revised Q1 GDP[2] data signalled that activity remains robust. An unusually large dispersion in growth measures across different segments of the economy is further complicating the jobs of policymakers as they attempt to pursue a "data-driven" approach.

The Bank of Japan (BoJ) kept its ultra-loose monetary policy unchanged while suggesting an inflationary overshoot would unlikely lead to tighter conditions in the short term[3]. The People's Bank of China (PBOC) reduced interest rates for both its one-year medium-term lending facility (MLF) and reverse repo rate, indicating further easing might be warranted to boost a weakening economy[4].

Warning that inflation is far from vanquished, the European Central Bank (EBC) increased its policy rate to the highest level since 2001[5], days before inflation data for the Eurozone showed an acceleration in the core consumer price index (CPI)[6] despite headline figures falling more than expected. Across the channel, the Bank of England (BoE) also raised rates (by more than anticipated) as stubbornly high inflation – the highest among major economies[7] – showed no signs of abating.

Aided by a decelerating CPI (and, consequently, higher real yields), the U.S. dollar strengthened against most of its major peers. The largest U.S. technology companies rallied, also fueled by the intense hype surrounding Large Language Models (LLMs) and other applications that have fallen under the Artificial Intelligence umbrella. Japanese indices also benefitted from the "AI-mania," in addition to a weaker Yen and a recent bout of strong corporate profits. Industrial metals and the energy complex suffered from slowing demand amid growing expectations of a global economic slowdown. Gold sank to its lowest levels since March amid signs that interest rates have likely not yet peaked.

[1] https://www.morningstar.com/news/marketwatch/20230607508/treasury-secretary-yellen-warns-of-commercial-real-estate issues-that-could-strain-banks
[2] https://www.calculatedriskblog.com/2023/06/q1-gdp-growth-revised-up-to-20-annual.html?m=1
[3] https://www.reuters.com/markets/asia/boj-set-keep-ultra-low-rates-may-signal-inflation-overshoot-2023-06-09/
[4] https://www.bloomberg.com/news/articles/2023-06-13/china-credit-demand-weakens-in-fresh-sign-of-waning-recovery
[5] https://www.ft.com/content/25c99f1d-c730-4ab8-a7ff-7aca6bcd35b9
[6] https://www.bloomberg.com/news/articles/2023-06-30/euro-area-core-inflation-accelerates-again-in-setback-for-ecb
[7] https://www.cnbc.com/2023/07/04/uk-is-now-the-only-major-economy-where-inflation-is-still-rising.html

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Quarter in Review

In Q2, HRAA benefitted primarily from long exposures to global equity indices and the U.S. dollar (most notably against the Japanese Yen), while longs in grains and trading in range-bound energy markets detracted from performance.

The Adaptive Asset Allocation strategy offers exposure to a global risk parity “beta” core stacked with an active macro trading “alpha” strategy. Both components experienced positive returns, with the alpha strategy outperforming earlier in the quarter, while the risk parity core delivered strong results in June.

Table 1. HRAA Performance Attribution – Q2 2023

Sector	Q2
Bonds	-0.1%
Currencies	1.8%
Energies	-1.3%
Grains	-2.3%
Indices	2.7%
Volatility	0.0%
Meats	0.0%
Metals	0.4%
Softs	0.3%
Total	**1.4%**

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Analysis by ReSolve Asset Management SEZC (Cayman). Q2 return figures as of June 30th, 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 once again provided the lion’s share of gains, primarily via longs in the Japanese Nikkei and Topix indices. Long French CAC40, short UK FTSE, and active trading in the Aussie200 also contributed positively.

Currencies were an important source of profits, mostly stemming from a short position in the Japanese Yen against the US Dollar. The long British Pound and short Australian Dollar led to further gains.

Metals also contributed with positive results, driven by short copper and long silver.

Softs were led primarily by profits from long cocoa and short coffee.

[8] https://seekingalpha.com/news/3978337-gold-tumbles-to-lowest-since-march-as-us-yields-hit-fresh-june-highs

Grains were the worst performers, with most losses originating from strategic longs in soy meal, Kansas City wheat, soybeans, and corn.

Energies also detracted, largely from active trading in Brent crude and long WTI crude, though partially offset by active trading in heating oil, diesel, and long natural gas.

Bonds had a negligible contribution, given that losses from longs in 5-, 10- and 30-year US Treasuries were mostly countered by gains from shorts in 5- and 30-year German government bonds.

Table 2. Q2 2023 Asset-class Highlights

	Nikkei (%)	Robusta Coffee (%)	Nasdaq (%)	US Natural Gas (%)	S&P500 (%)	European Equities (%)	US Dollar Index (%)	US 10y Treasury (%)	Gold (%)	Brent Crude (%)	UK 10y Gilts (%)	Copper (%)	Japanese Yen (%)	Milling Wheat %	Corn (%)
Q2 Returns	18.3%	17.8%	13.9%	8.2%	7.4%	3.2%	0.8%	-3.0%	-3.9%	-5.3%	-7.7%	-8.2%	-9.3%	-11.7%	-15.4%
Annualized Volatility	14.3%	26.1%	16.6%	63.4%	11.6%	11.6%	6.0%	6.9%	12.4%	35.6%	11.1%	19.6%	8.8%	27.4%	32.6%
Maximum Peak to Trough Loss	-3.0%	-10.3%	-3.7%	-20.6%	-2.7%	-4.1%	-2.1%	-4.5%	-7.6%	-17.3%	-10.1%	-13.7%	-10.7%	-16.7%	-21.4%

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

Outlook and Positioning

In early June, Ukraine began its long-awaited counteroffensive, which appears to be making slow progress[9]. As the conflict escalated over the past few weeks, the destruction of the Nova Kakhovka dam will likely have dire effects over huge swathes of grain-producing regions in southern Ukraine, while Russian officials have indicated the Black Sea Grain Initiative would not be extended past July[10]. These events could have severe implications for global food supplies[11]. Still, on the geopolitical front, Italy announced it will no longer participate in China's Belt and Road Initiative[12], in yet another sign that great power competition is leading to a more fragmented global economy. Meanwhile, a top U.S. military officer warns of an arms race in the Western Pacific[13].

A study released by Deutsche Bank expects an imminent wave of debt defaults in the U.S. and Europe, likely peaking in the fourth quarter of 2024[14], while the odds of an economic hard landing appear to be rising[15]. As the interplay between economics and geopolitics grows more complex every day, it's not surprising that macro uncertainty appears high relative to other historical periods, at least according to these measures[16].

While range-bound conditions are especially difficult for intermediate-term quantitative strategies, the biggest payoffs tend to occur when equilibrium transitions to disequilibrium, setting the stage for new trends and sustained price moves. It's impossible to know when major shifts will happen, but it is believed that we are likely closer to the end than the beginning of this process.

[9] https://www.reuters.com/world/europe/ukraines-counter-offensive-slower-than-expected-too-soon-judge-pentagon-2023-07-07/
[10] https://www.reuters.com/world/europe/kremlin-aide-says-russia-unlikely-quit-grain-deal-before-july-17-renewal-date-2023-06-16/
[11] https://www.reuters.com/world/europe/ukraine-warns-over-impact-kakhovka-dam-collapse-farmland-2023-06-07/
[12] https://www.euronews.com/2023/05/12/italy-abandons-the-belt-and-road-initiative
[13] https://www.voanews.com/a/top-us-military-officer-warns-of-arms-race-in-western-pacific/7026600.html
[14] https://www.reuters.com/markets/default-wave-imminent-will-peak-2024-deutsche-bank-2023-05-31/
[15] https://www.researchaffiliates.com/publications/articles/987-odds-of-a-hard-landing
[16] https://mcusercontent.com/6750faf5c6091bc898da154ff/files/a5581dc3-204b-d360-891e-38cce411f39e/AQR_Certainly_Uncertain.pdf

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