HUF Quarterly Commentary

Horizons Active Ultra-Short Term US Investment Grade Bond ETF (HUF) **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) started off 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 2023, 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 two percent target over time. However, the BoC's main concern is sticky inflation, and if this materializes, it is prepared to increase rates further. Ten-year Canada bond yields fell over 90 bps during the quarter. The market is expecting the BoC to begin cutting interest rates in April 2024 and to end the year with an overnight rate of 3.72%.

In this environment, short-term provincial spreads declined by 6 bps to 30 bps and corporate spreads narrowed by 21 bps to 121 bps.

Quarter in Review

While a typical short-term universe portfolio generated a return of 4.11% and a universe bond portfolio delivered 8.27%, HUF maintains a very low total duration generally between 0 and 1 year. As such, the HUF underperformed longer-duration portfolios in a lower-rate environment. Corporates, yielding on average 5.46%, did provide stable carry once again in the quarter while also benefiting from spread compression.

HUF took profits from several expensive corporates that had performed well. HUF was also very selective in the primary market to take advantage of new issue concessions from the Federation des Caisses Desjardins. In the quarter, selections in financials, real estate, and pipelines provided added value.

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 we now expect 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 central banks' 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.

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Portfolio duration ended the quarter around 0.94 years. Investment grade credit spreads are still historically wide despite the recent performance. HUF will remain active in this sector as opportunities present themselves. The fund has been focused on sectors that provide more compensation or are better positioned to weather a shallow recession. Trades over the last several months have generally been defensive in nature as HUF has moved up in credit quality and bought shorter-dated securities. The yield at quarter-end is approximately 5.83%, which makes it quite attractive as the peak of the hiking cycle approaches.