

Market Overview

North American bond yields fell significantly, and the yield curve steepened over the last three months. 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 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 basis point 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 2% target over time. However, the BoC’s main concern is sticky inflation, and if this materializes, they are prepared to increase rates further. 10-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 by 9 bps to 56 bps and corporate spreads narrowed by 19 bps to 161 bps.

Quarter in Review

Duration strategy helped as HAEB was set up for lower rates. Carry and curve positioning also proved to be a strong contributor to performance.

HAEB sector allocation to Infrastructure and Industrials were negative contributors to corporate performance, but this was offset by security selection, including within the Financials and Real Estate sub-sectors.

The fund’s weighted duration deviation (WDD) on corporate bonds increased from -0.30 years to -0.13 years as it remained cautious on spreads ahead of an economic slowdown. In the secondary market, the Sub-Advisor sold several names across the curve that had performed well and bought ones that were still attractive. The primary corporate market was very active, but the Sub-Advisor only participated in a few select issuers.

Recent ESG Developments

During Q4 the Sub-Advisor met with management of a large Canadian life insurance company. It has large-scale international operations and is aiming to further grow its non-domestic share of earnings (including jurisdictions with heightened geopolitical risk).

During the meeting, the Sub-Advisor engaged in the company’s disclosure as the level of information provided on key issues was insufficient, in the Sub-Advisor’s view. Disclosure of capital and earnings at risk in international operations was very limited and there was no geographic breakdown, which is crucial given the company’s strong growth in this segment and changing overall risk profile. Disclosure in the investment book is very high level and lacks important information around topics including geographic location and the actual type of investment. In addition, the company does not clearly disclose intragroup funding arrangements, which could have a significant impact on the overall risk profile.

The Sub-Advisor highlighted to management how other financial institutions (especially banks) are generally much more transparent and urged management to step up disclosure since geopolitical tensions continue to be on the rise and the company is looking to further grow its non-domestic operations. The Sub-Advisor highlighted its concerns and is looking to follow up on this engagement in due course.

HAEB Quarterly Commentary

Horizons Active ESG Corporate Bond ETF

Q4 2023

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 it 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.

Investment grade credit spreads are still historically wide despite the recent performance. The Sub-Advisor will remain active in this sector as opportunities present themselves. The Sub-Advisor 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 HAEB has moved up in credit quality and bought shorter-dated securities. The yield carry from HAEB's overweight in credit has increased to 23 bps from 18 bps.



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