Horizons Active Corporate Bond (HAB)

Market Review

North American bond yields adjusted higher, and the yield curve steepened over the last three months. The theme for the quarter in the U.S. was a resilient economy and continued elevated inflation. The U.S. Federal Reserve (Fed) said they will likely cut interest rates later in the year, but they need to see further evidence that inflation is moving lower. As a result, investors reduced their expectations for the total amount of rate cuts this year and pushed the start of the easing cycle further out. At the end of 2023, investors were looking for the Fed to reduce rates 158 basis points (bps) in 2024 to 3.75% with the first 25 bps ease built in by March. At the end of the first quarter (Q1), forecasted cuts had been reduced to just 74 bps for the year with the first cut now expected in July.

Softening global growth and inflation added to the view that financial conditions are tight and are working their way through the global economy. The Swiss National Bank has already started to loosen monetary policy and the table is now set for the Bank of Canada (BoC), the European Central Bank, and the Fed to start modestly cutting rates. The U.S. backdrop supports the view of slowing inflation and heightened risks of keeping rates too high for too long. The Canadian economy has been operating below potential and although inflation is still above the BoC's two percent target it has come down considerably. Over the last year headline inflation declined from 5.2% to 2.8% and core inflation fell 170 bps to 3.2%. The market is expecting the BoC to cut rates 70 bps in 2024 to 4.35%, with the first cut also anticipated in July. Adding to this dynamic is ongoing quantitative tightening, strong wages, and an increase in the net supply of government bonds.

In this environment mid-term Provincial spreads declined one bps to 56 bps and corporate spreads narrowed 16 bps to reach 148 bps.

Quarter in Review

The duration and curve strategy helped as HAB as it was generally set up for higher rates and a steeper yield curve. Credit holdings were positive and came from the yield carry in the portfolio, sector allocation and security selection.

HAB's sector allocation to Financials, Real Estate, Communications and Energy were positive contributors to corporate performance. Security selection also helped and came from the fund's positioning within the Financials, Real Estate and Industrial sub-sectors.

Our weighted duration deviation (WDD) on corporate bonds decreased slightly to -0.24 from -0.18 as HAB remained cautious ahead of an economic slowdown. In the secondary market, HAB sold several names across the curve that had performed well including a Manulife Limited Recourse Capital Note. The primary corporate market was highly active, but we only participated in a few select issuers, which included Royal Bank of Canada, Crombie, RioCan REIT, Telus and Ford.

Outlook and Positioning

We are awaiting interest rate cuts in North America, but more evidence of falling inflation is still required before this can begin. Monetary policy is restrictive and will lead to softer growth in Canada and the U.S. 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 Sub-Advisor expects this to start in the summer and several rate cuts will be needed this year and next to support the economy and help avoid a hard landing. 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.

Investment grade credit spreads have now tightened to long-term historical averages. A decent economy along with expected rate cuts and asset allocation into fixed income have all contributed to recent corporate performance. HAB has a modest overweight to credit with a focus on high-quality names at the shorter end of the curve. Over the past year, HAB has been taking profits and reducing exposure as spreads narrowed. HAB currently has an underweight position in long credit as the Sub-Advisor does not believe it is being fully compensated for the risks in the market. The yield carry in the portfolio ended the quarter at 20 bps.

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