Horizons Active Canadian Municipal Bond ETF (HMP)

Market Review

North American bond yields have adjusted higher, and the yield curve steepened over the first quarter (Q1). The theme for Q1 in the U.S. was a resilient economy and continued elevated inflation. The U.S. Federal Reserve (Fed) said it 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 number 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 by 158 basis points (bps) in 2024 to 3.75% with the first 25 bps ease built in by March. At the end of 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 2% target, it has come down considerably. Over 2023, 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 by 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, short-term Provincial spreads declined four bps to 27 bps and corporate spreads narrowed 24 bps to reach 103 bps. Short-term non-rated spreads outperformed their provincial counterparts, tightening by 14 bps.

Quarter in Review

The short duration of HMP helped in Q1 to minimize losses as rates increased. The high carry brought by non-rated municipals also proved to be a contributor to performance. The performance of the portfolio was primarily driven by an overweight in non-rated municipal bonds. The portfolio generated nine bps of carry and three bps from duration/curve, with the remainder primarily driven by non-rated municipal and provincial spread compression. Non-rated municipal spreads in the five-year term are approximately 75-80 bps relative to provincials.

Outlook and Positioning

The Sub-Advisor is 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 the Sub-Advisor expects to 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 spread product performance. Over the past year, HMP has been taking profits and reducing exposure as spreads narrowed. The short-term nature of non-rated products in the portfolio brings decent compensation at this point. HMP is ready to increase the allocation should spreads widen on a harsher economic outlook.

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