



Global X Active Corporate Bond ETF (HAB)

Market Overview

The quarter began with the theme that the U.S. economy was resilient, inflation was persistent, and the U.S. Federal Reserve (Fed) would have to keep rates higher for longer. Economic data started showing signs that the Fed's restrictive monetary policy was working to cool the economy. Later in the quarter, the probability of a soft landing increased, requiring interest rate cuts before the end of the year. The Fed still needs to see further evidence that inflation is moving lower before it starts loosening monetary policy. At the end of March, investors were looking for the Fed to reduce rates by 70 basis points (bps) to 4.63% with the first 25 bps ease built in by July. At the end of the second quarter, forecasted rate cuts had been reduced to just 40 bps for the year with the first cut in U.S. rates now expected in November.

The Bank of Canada (BoC) reduced its overnight rate to 4.75% from 5.00% in June. The Canadian economy has been operating in excess supply and inflation continued to move lower, giving the BoC more confidence it would be able to achieve its 2% inflation target over time. As a result, the BoC's Governing Council said monetary policy no longer needed to be as restrictive and cut 25 basis points. Inflation has come down from the highs in 2022 and the breadth of price increases has narrowed. Since the start of the year, headline inflation declined from 3.5% to 2.9% and core inflation on average fell by 70 bps to 2.9%. However, investors were disappointed in June with the latest inflation print as it bounced slightly higher after falling for four consecutive months. The market is now only expecting the Bank to cut rates twice in 2024 to 4.25%, with the next move anticipated in September. At one-point investors were looking for an additional 75 bps in cuts before year-end.

In this environment, mid-term Provincial spreads declined by 4 bps to 55 bps and corporate spreads narrowed by 4 bps to 149 bps.

Quarter in Review

Duration helped as HAB was set up for lower rates, but curve positioning was slightly negative as the Sub-Advisor was expecting a flatter curve. Spread management was also a key driver to the outperformance over the period.

The HAB's sector allocation to Financials and Real Estate was a positive contributor to performance. Security selection also helped and came from HAB's positioning within the Financial, Energy and Infrastructure sub-sectors.

HAB's weighted duration deviation (WDD) on corporate bonds increased from -0.25 to -0.08 as HAB remained cautious on spreads in front of an economic slowdown. In the secondary market, HAB sold several names across the curve that had performed well and bought some that were still attractive. The primary corporate market was again highly active, but the Sub-Advisor remained very selective. HAB bought TD Bank Non-Viability Contingent Capital (NVCC), Wells Fargo, Reliance, Federation des Caisses Desjardins, Sun Life Financial, Ford Fast, Bell Canada, Choice Properties, RioCan Real Estate, Eagle Canada Credit Card Trust, Coastal Gas Link, CIBC NVCC, BMW Canada Auto Trust, Canadian Western Bank and Pembina Pipeline.

The bond market continued to be in a trading range through most of the quarter. Rates were being pulled up and down as participants tried to determine the timing of interest rate cuts. This volatility gave HAB opportunities to add and reduce its long-duration position, which contributed to performance.

Outlook and Positioning

The BoC has begun the process of loosening monetary policy and the Sub-Advisor expects this to continue in 2024 and into 2025. It will not be a straightforward exercise where the BoC cuts at every meeting until it gets to a neutral level. The Sub-Advisor expects stops and starts as the economy is not falling off a cliff and there are still risks to the inflation outlook. The U.S. economy has been more resilient than Canada, but it is also starting to show signs of weakening which will eventually lead to an interest rate cut from the Fed. Restrictive policy is working in both countries but there are long and variable lags. We expect a heightened level of interest rate volatility as the market transitions to lower rates, which will provide HAB with trading opportunities. Elevated bond supply and geopolitical events will also contribute to this environment.

Investment grade credit spreads are close to long-term historical averages. The Sub-Advisor's base case is for an economic soft landing, where Canadian growth operates below potential but does not fall into a recession, inflation trends towards the target in 2024 and 2025, and the BoC cuts rates to neutral over the period. Credit spreads reflect this



environment, HAB has a modest overweight but has reduced its exposure over the last year. The Fund's focus today is on the high-quality sectors or on names where spreads are attractive. Most of the overweight is now on the short end of the curve. The Sub-Advisor will continue to actively trade this sector. The yield carry in the portfolio continues to decline and ended the quarter at 22 bps.

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Published August 7, 2024