Global X Active Ultra-Short Term Investment Grade Bond ETF (HFR)

Market Overview

North American bond yields were generally higher and the yield curve steepened over the second quarter. 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 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, short-term Provincial spreads declined by 4 bps to 27 bps and corporate spreads narrowed by 4 bps to 104 bps.

Quarter in Review

While a typical short-term universe portfolio generated a return of 1.24% and a universe bond portfolio delivered 0.86%, HFR maintains a very low total duration generally between 0 and 1 year. In Canada, short yields were lower over the quarter, but rates were being pulled up and down as participants tried to determine the timing of interest rate cuts. This volatility gave HFR opportunities to add and reduce the HFR's long-duration position which contributed to performance.

HFR took profits from several expensive corporates that had performed well. The Sub-Advisor was also very selective in the primary market to take advantage of new issue concessions. HFR bought Pembina Pipeline, TD Bank Non-Viability Contingent Capital (NVCC), Ford Fast, Wells Fargo, Reliance LP, Federation des Caisses Desjardins, Sun Life Financial, Choice REIT, RioCan REIT, Eagle Credit Card Trust, Coastal Gas, CIBC NVCC, BMW Canada Auto Trust, GMF Canada Leasing Trust, BMO NVCC and Canadian Western Bank. In the quarter, our selection of Banks, Energy, and Real Estate issuers provided added value.

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 HFR with trading opportunities. Elevated bond supply and geopolitical events will also contribute to this environment.

Portfolio duration ended the quarter around 0.85 years. 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 target in 2024 and 2025, and the BoC cuts rates to neutral over this period. Credit spreads reflect this environment, HFR has a modest overweight but has reduced exposure over the last year. The Sub-Advisor's focus today is on the high-quality sectors or on names where spreads are attractive. The Sub-Advisor will continue to actively trade this sector. The yield at quarter end is approximately 5.49%, which makes it quite attractive.

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