



Global X Active CDN Municipal Bond ETF (HMP)

Market Overview

North American bond yields declined significantly over the third quarter (Q3), and yield curves adjusted from being inverted to positively sloped, an environment which has not been seen in over two years. The U.S. Federal Reserve (Fed) started its interest rate-cutting cycle in September by lowering rates by 50 basis points (bps) which surprised some investors looking for a smaller 25-bps reduction. The Fed forecasted it will lower yields from the current restrictive level to a neutral rate over the next two years, ending at 2.875%. However, the market is well on its way to pricing in this yield level over the next year. The unemployment rate continued to nudge higher and inflation made further progress towards the Fed's 2% inflation target. Core inflation, although still elevated, has declined from 4% at the beginning of the year to 3.2% at the end of September. The Fed's rate-setting Federal Open Market Committee (FOMC) has a dual mandate to support maximum employment and return inflation to its target. Over the last several years, the Fed has been more concerned about inflation, but today it judges that the risks to achieving these two goals as now roughly balanced.

The Bank of Canada (BoC) continued to reduce its target for the overnight rate during the quarter to 4.25%. They have now cut rates by 75 basis points (bps) since early June. The economy continued to operate in excess supply, allowing inflation to move lower which gave the BoC more confidence it would be able to achieve its 2% inflation target over time. Since the start of the year, headline inflation declined from 3.4% to 2%, and core inflation on average fell 110 bps to 2.4%. The market is now expecting the BoC to cut rates another 170 bps over the next year to end at 2.6%.

Although the quarter saw some turmoil related to fears of a recession, the risk-off tone was brief due to the dovish pivot from central banks in North America. In this environment, short-term Provincial spreads declined four bps to 26 bps and short-term corporate spreads on average narrowed nine bps to 97 bps. Short-term rated municipal spreads performed generally in-line with provincials and narrowed three basis points to 27 bps over the quarter; however, non-rated municipal spreads widened by around eight basis points.

Quarter in Review

Issue selection in the municipal space was the main detractor from performance, but this was offset by 10 bps of trading gains realized during the quarter, as well as a positive contribution from sector allocation as were overweight provincials which outperformed during the quarter, and underweight rated municipals.

At the end of Q3, the portfolio had a duration of 2.68 years and was yielding 3.47%, with a yield carry of 40 bps.

Outlook and Positioning

The BoC began the process of loosening monetary policy in June, and the Fiera Capital Corporation (the Sub-Advisor) expects this to continue in 2024 and 2025. The Sub-Advisor believes the BoC will reduce rates over this period to a neutral level of approximately 2.75%. This does not mean a cut of 25 bps every meeting – the BoC could skip a meeting or even cut by 50 bps. The economy is soft, and inflation has moved lower, but we are not falling off a cliff. The Sub-Advisor's base case is for the BoC to achieve a soft landing next year, but the Sub-Advisor is anticipating volatility and opportunities through this easing cycle. Currently, investors have priced in an overly aggressive BoC making the market vulnerable to a sell-off. The U.S. economy has been more resilient than Canada, but they have also started cutting rates with a goal to get to a neutral level in two years. Restrictive policy is working in both countries but there are long and variable lags. Elevated bond supply and geopolitical events will also contribute to this environment.

Investment grade credit spreads (as well as non-rated municipal spreads) are reflective of a soft-landing scenario, where Canadian growth operates below potential but does not fall into a recession, inflation trends towards target and the BoC cuts to neutral over this period.

Source: Fiera Capital Corporation as at September 30, 2024.



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