Horizons Active Hybrid Bond and Preferred Share ETF (HYBR)

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

The Canadian preferred share market strongly outperformed in Q1. The S&P/TSX Preferred Share Index returned 9.62% while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned 12.01%. The positive credit tone particularly on Hybrids and Limited Recourse Capital Notes (LRCNs) helped support the preferred share market. Bank issues outperformed in Q1 as investors became more confident about potential redemptions as some banks have extra Additional Tier 1 (AT1) capital and some preferred share issues now look expensive versus the LRCN new issue level on an after-tax basis. The Energy and Real Estate Sectors outperformed in Q1 while Telecommunications, Insurance and Financial Services underperformed. Redemption in other sectors than Banks was also beneficial to the asset class. Fixed reset issues continued to outperform in Q1, particularly the issues that reset in 2024 and 2025 while fixed rate perpetual and floating rate issues underperformed.

Quarter in Review

Over the last quarter, HYBR reduced its overweight position in hybrids/LRCNs while the fund increased its allocation in fixed reset preferred shares, including the most recent institutional issues from RBC and CIBC. The fund increased its allocation in Banks with these new issues by increasing its allocation on issues resetting in 2025 and taking some profit late in the quarter on specific issues resetting in 2024. HYBR reduced its overweight position in Energy.

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 United States. 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.

The average current yield of Canadian preferred shares remains attractive historically and could potentially increase substantially over the next few quarters/years as fixed reset issues reset at a much higher 5-year Canada rate. Banks and issuers in other sectors should continue to redeem some expensive preferred share issues versus hybrid and LRCNs new issue levels, which should be supportive of the Canadian preferred share market. Volatility could pick up in the following quarters of 2024 subject to the timing and amplitude of central bank interest rate cuts in the current low Canadian Gross Domestic Product growth environment. Fund flows should remain strong in 2024 following strong and positive technical trends and the tax advantage of the asset class. The Sub-Advisor would be ready to add risk to the portfolio if opportunities arise and would be ready to take profit if needed. In this environment, the Sub-Advisor thinks the fixed reset issues that reset later in 2024 and in 2025 represent the best risk/reward opportunities as it thinks the 5-year Canada rate could be sticky above 3% over the next few years.

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