Views from the Desk

Updates in the Equity and Fixed Income Market

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Market Protection

Inflation is still a concern in the market right now. Consumer Price Index (CPI) numbers came in higher than expectations by 0.1% at 5.4%. The high CPI numbers that we've been seeing over the last few months is partially due to the base effect which coming out of a recession, is pretty normal. We also argue that inflation this time around is a little different and isn't just the base effect alone. The Fed (and the overall market) want to see CPI come in lower than expected so the Fed can delay tapering assets and raising rates to keep stimulus going.

Inflation is something to address in your portfolios and focusing on high quality bonds is of importance. Companies that have higher credit ratings typically have strong balance sheets and are able to withstand inflationary pressures. ZQB - BMO High Quality Corporate Bond Index ETF focuses on 1 to 10-year bonds so you'll be diversified and won't be overly exposed to long term bonds if rates rise.

ZTIP - BMO Short-Term US TIPS Index ETF is also a good way to play inflation because it focuses on the short end of the yield curve. If inflation comes in higher than the breakeven rates than TIPS are going to outperform nominal bonds. Breakeven rates are the difference between the yield on nominal bonds and TIPS, the difference between the two yields is the breakeven rate. The 10-year breakeven rate is 2.4% so if CPI comes in higher than 2.4% than its better to own TIPS.

On the equity, side REITs and Commodities are two ways to play an inflationary market. When comparing the sectors in our ZRE - BMO Equal Weight REITs Index ETF to its market cap equivalent, there's a greater focus on smaller-cap REITs given the equal weighting methodology of the index. Over the long term, the equal weighting methodology provides exposure to the sector while minimizing concentration risk and therefore reducing company-specific risk. More specifically to the REITs sector, an equal weighting methodology reduces the concentration in top holdings such as RioCan Real Estate Investment Trusts (REI-U) and Allied Properties Real Estate Investment Trusts (AP-U), which are focused on retail and offices, respectively. For more information on REITs please visit Playing the Long Game in REITs.

Commodities prices typically rise when inflation accelerates and offer protection from inflation. When demand for goods and services increases, the price of goods and services rises with the price of the commodities used to produce those goods and services. If you're looking for an inflation hedge in commodities consider ZMT - BMO Equal Weight Global Base Metals Hedged to CAD Index ETF and ZGD - BMO Equal Weight Global Gold Index ETF.

ESG investing and Knowing Your Clientele

As Environmental Social and Governance (ESG) investing becomes more and more important, investors will start questioning their advisors about it. Investors will want to work with advisors who have experience and already incorporate ESG investing into their practice. Advisors will have to become more familiar with ESG investing before their clients start asking about it. If an advisor incorporates ESG into their practice now, they will be that much more ahead and in a better place for their future book of business.

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BMO has not only been a leader in ESG investing but, also an influencer in that we lead discussions and debates to help drive innovation and development worldwide. We are active owners, using considered engagement and thoughtful voting to drive positive change, reduce risk and enhance long-term performance. Our depth of expertise, industry knowledge and significant scale gives us the opportunity to talk directly with key company decision makers and bring about positive change. For more about ESG investing please visit Understanding BMO ESG ETFs.

Reverse Repo Market

The repo market has commercial banks pledge assets (Treasury Bills in this case). They post Treasury Bills with the Fed on the promise that they are going to buy it back from them some time in the future, in return they get cash for posting that collateral. The repo market allows more money into the system and improves liquidity of the overall market. Reverse Repo is the opposite where commercial banks give money back to the Fed. The Fed buys back the T-Bills and takes cash out of the system. When you see a spike in the short-term markets or "repo markets" it can signal a sell off. We saw a spike in the repo market before the 2008 crisis but that had to do with Mortgage Back Securities being pledged as collateral at that time. This time is a little different in that the assets being pledged are U.S T-Bills. The most recent spike isn't really concerned on the quality of bonds being posted.

There has been a lot of cash built up in the system. Loan growth has been stagnant over the last couple of weeks. What the commercial banks have been doing is asking their clients to buy Money Market Funds (MM) where they get a higher rate on their cash. MM funds have been growing at a fast rate as a result. The Fed has counter acted this by raising the reverse repo rate by 5 basis points which has led the commercial banks to return cash to the Fed and increased the supply of T-Bills in the market. The Fed wants to remove liquidity from the system to address inflation. As of right now we think it has been a non-event so far however, we have been keeping a close eye on this and consider reducing beta in our portfolios to focusing on factors such as quality, low volatility and covered calls on the equity side.

Earnings

We have had a strong earning season and company prices had bid up in advance of these expectations however, we haven't seen a lot of growth afterward. It seems as though the market is starting to slow down on growth stocks. In 2021 we have seen all-time highs and typically when the market reaches all-time highs investors become complacent and we usually see a low VIX however, what we have been seeing is a high VIX (which is out of the ordinary).

If we want to act defensive, we may want to look at areas where some of the option overlay programs that we run monetize that expected volatility (selling options to generate cash flow). While the VIX is still high we think it makes sense to be in our ZPAY - BMO Premium Yield ETF where we invest in those quality companies that provide strong growth going forward and selling options on these portfolios to generate cash flow. As equities come down, the equity weight of the portfolio goes up. It is a defensive strategy relative to a straight equity strategy and we are taking advantage of those high levels of volatility by monetizing it through the options market. Alternatively, if you do want a primarily fully invested portfolio than you may want to look at our covered call portfolios to take advantage of the high levels of volatility.

*To learn more about BMO ETFs, please contact your ETF Specialist.

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Source: Bloomberg, All returns and data points July, 2021.
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