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Views from the Desk

Updates in the Equity and Fixed Income Market

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Inflation

Inflation has come in beyond expectations. Yesterday we seen the CPI YOY number come in at 5.4% vs the expectation of 4.9%. Core CPI was also 50bps above expectation and its been the 4th consecutive month where Core CPI has been higher than the target of 2%. We believe the Producer Price Index (PPI) should be a leading indicator in terms of what is going to happen with CPI. The economy has been locked down, its been harder for producers to pass on those higher input costs to the end consumer. Now as the economy starts to open up, demand is starting to pick up. We are starting to see producers having an easier time passing higher input costs to the end consumer. Moreover, the markets seem to be shaking off inflation. Most investors are chalking it up to Inflation being transitory in nature. The general consensus is that will moderate once the global supply chain starts to normalize. Most goods and services exhibit price pickiness, so when prices go up, they don't necessarily go down very easily. One way to play this is by actually looking at companies that have a better ability to pass higher input costs to the investor. Sticking with the quality factor is a good way to get exposure to these types of companies. Our quality methodology filters for companies that have high return on equity, stable earnings and low financial leverage. These companies tend to have competitive advantages and healthy durable balance sheets. ZUQ - BMO MSCI USA High Quality Index ETF is a good way to move through these markets. ZGQ - BMO MSCI All Country World High Quality Index ETF is a broad way of playing the opening trade. Additionally, the quality factor started to break out in the month of May compared to the broad S&P 500 index.

On the fixed income side, if inflation continues to pick up, the Fed is going to realize that they are behind the curve. We believe the level of monetary policy is no longer appropriate for where we are for the current state of the economy. We think the Fed is going to be forced to start tapering ahead of expectations. What happens with US interest rates is going to have an impact on global yield curves and Canada will be no exception to this. We think that the BOC is waiting for the Fed to move first because it doesn't want a stronger Canadian dollar. How we want to play this environment is to stay on the short end of the curve and stay with corporate credit. ZCS - BMO Short Corporate Bond Index ETF

Gold

Inflation has ticked up. Gold is down approx. 5% YTD. Gold is typically used for three things; a hedge against macro economic risk, weak USD, and Inflation. Even though inflation has ticked up, macro economic risk has dissipated in the last 6 months. Most of the gold buying that has happened in the last year has been due to macro economic risk. As vaccination rates have gone up, we are finally starting to see economies open up. Gold being used as a tail risk hedge has been on a decline. The USD has strengthened in the last few weeks and has ticked up since the June FOMC meeting and the Fed came in with a more hawkish tone then the market had anticipated. A catalyst for gold would be sustained inflation. If you think inflation is something to be concerned about than you may want to put ZGD - BMO Equal Weight Global Gold Index ETF and ZJG - BMO Junior Gold Index ETF on your radar.

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US Banks

Banks in the US have had strong earnings and have been beating analyst expectations by approximately 30%. Bank stocks are up marginally and still showing fundamental strength. Trading revenue is a little bit down and there are some increased concerns about cost of employment with the US banks. Economic reopening has been going well for the US. Interest rates steepening has been a positive. Overall, US Banks are still benefiting and are making money more than they ever have before. ZWK - BMO Covered Call US Banks ETF is a great way to play US Banks as you get upside with a high distribution yield at 7%. If you are very bullish on US banks then we'd look at ZBK - BMO Equal Weight US Banks Index ETF or ZUB - BMO Equal Weight US Banks Hedged to CAD Index ETF.

Dividend Methodology

There is more of a value bias to dividend paying stocks. Value stocks have had a reversal and started to do well starting from November of last year. ZDY - BMO US Dividend ETF was outperforming the S&P 500 up until June and we have been bullish on value and dividends. We made changes to our dividend methodology in December to focus on total dividends not just dividend yield. Total dividend is market cap times dividend yield, which would give you a blend of size and yield. In turn, this change brings more of a quality tilt to the portfolio. We've also added credit rating screens to the portfolio (if a company is struggling to pay its debt, they may not be able to pay the dividend yield therefore, the company would be excluded from the portfolio). Overall, we've made the dividend methodology ETFs more robust. Some of the holdings in our ZDY ETF are Apple, Home Depot, Microsoft, Cisco and Walmart. The new methodology was implemented in December of 2020 across all of our dividend ETFs ZDY - BMO US Dividend ETF, ZDV - BMO Canadian Dividend ETF and ZDI - BMO International Dividend ETF to make these portfolios more stable.

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