Views from the Desk

Updates in the Equity and Fixed Income Market

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Fed Impacts on Equity and Currency

Last weeks meeting the Fed came back more hawkish. The Fed wanted to show that they are serious about inflation and they want to keep things under control to get ahead of it. The narrative was transitory in nature. CPI went from 2.6% to 5% in May. The PPI numbers came in at 9.5% and then 8.7% in the last 2 months. Demand has been locked down over the last year. Producers have been able to pass on the higher costs to the consumer. The Fed is anticipating inflation will pick up more once we have full reopening. The Fed said they were going to hike rates twice in 2023. The markets had no real impact to the Fed meetings, and we recovered from all the news by the Monday.

The US dollar rallied up to 1.25 then started to fade. 1.25 seems to be a resistance level. We might have seen some technical trades if we would have broke through 1.25. Commodity strength is a headwind to the US dollar. We could get a lot of technical buying if the USD breaks through 1.25.

The market appears to be taking more risk off the table in the last 4 weeks. Investors in general are looking for EPS to finally catch up to some of the higher prices we are seeing in the market. If you are looking to weather volatility in equities, we believe a good risk off strategy for Canada is our ZLB - BMO Low Volatility Canadian Equity ETF. ZLB has a 3-year beta of 0.74 vs the Canadian equity category avg of 0.95. For the US we like ZUQ.F - BMO MSCI USA High Quality Index ETF (Hedged Units). ZUQ focuses on quality companies and its relative performance over the S&P 500 over the last month it is starting to break out.

Rise of COVID Variance and ZSP

Boris Johnson mentioned we could have a rough winter due to the delta variant. Trudeau is looking at the delta variant to see how impactful it may be and is deciding weather to open the boarders for Canada US travel right now. Rhetoric aside, COVID cases in most regions are coming down. India cases have come down significantly and Canada as well. Some Latin American countries and certain emerging markets countries such as Brazil and Columbia have still seen a lot of COVID cases. There seems to be a correlation to where the vaccines are going in the arms of people and number of cases. COVAX has started to significantly ramp up getting vaccinations to countries in need.

We don’t think a big hawkish move by the Fed is going to come through just yet. On a 1-5-year basis we are still bullish on equities. There are still some COVID concerns however, it is best to be prudent right now. Stick to your asset allocation. Its not best to be greedy right now either. ZSP - BMO S&P 500 Index ETF is a great core holding and a great tool to get exposure to some of the best companies in the US. SPIVA numbers will show the S&P 500 outperforming most active managers over time. We think ZSP can be a good disciplined approach to US equities.

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ESG and Energy

We utilize our ESG portfolio construction through MSCI. For those who want to tilt toward ESG but don't want to differ substantially from the index this could be a great solution for you. MSCI takes a sector neutral approach to investing in ESG. MSCI will take the sectors and break it down and hold the best ESG companies within that sector. For the energy sector, MSCI is trying to find the companies with the best ESG scores instead of eliminating the sector altogether. Which is a great inclusionary approach to ESG. In 2020 we launched our ESG ETFs. In general, most investors thought you have to take a performance hit when investing in ESG but that has not been the case. We have seen outperformance since we launched our ESG ETFs by about 1% to 2% vs their broad indices.

In the last 6 months performance has been more mixed. We have seen our broad Canada ZCN - BMO S&P/TSX Capped Composite Index ETF outperform our ESGA - BMO MSCI Canada ESG Leaders Index ETF. In this environment where we see oil rallying on the back of a reopening trade and optimism, some of the oil companies that are growthy and risky have seen some outperformance. However, with ESGA the underperformance was not substantial. A few other ESG ETFs we would like to highlight is ZESG - BMO Balanced ESG ETF which is a 60/40 asset allocation strategy (and is performing well) and our ZWG - BMO Global High Dividend Covered Call ETF which has been having some great performance and also distributing a 6.9% yield. We think the future for ESG strategies look good.

The Fed and High Yield Bonds

There was a rebound in high yield in the last month of 2% (partially due to currency). Spreads are around pre COVID levels. CDX high yield spreads are around 275bps prior to COVID we typically would see 290bps before widening back out. Default rates are low at 2.5% as of May.

The Fed announced it is looking to unwind some of their Bond ETFs that they acquired during the asset purchase programs over the last year in the wake of COVID. The Fed owns about 5 Billion in US listed corporate bond ETFs. 550 million of that is the JNK high yield ETF. With spreads being a little tight over the short term, there may not be a lot of buying activity to offset that selling activity. Therefore, we are going to expect spreads to widen a little as buyers might not be available. Default rates are lower, and a lot of the weaker companies have been flushed out. The high yield universe is better quality. We can expect about 20bps to 30bps of widening which presents a good buying opportunity.

There is not a lot of refinancing that needs to take place over the next 4 years. For 2021, only 78bps needs to be rolled over. 2023, 2.4% and 2024 only about 5.3%. So that's good for the universe and we think this will put a lot less stress on the issuers in terms of refinancing needs. Its not until 2025 where 15% of the index will need to be refinanced. This gives us 2 to 4 years for the economic recovery to take place before a lot of the issuers have to worry about any refinancing activity. Over the short term if spread widen due to the Fed selling, we think ZJK - BMO High Yield US Corporate Bond Index ETF, ZHY - BMO High Yield US Corporate Bond Hedged to CAD Index ETF or ZFH - BMO Floating Rate High Yield ETF are some ETFs advisors may want to put on their radar.

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