Views from the Desk

Updates in the Equity and Fixed Income Market

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Global Market Rally

When looking at European markets, they are still quite low compared to their highs versus North America. We anticipate that we will see a big rally in European equities at some point however, in the meantime, we look to quality securities to navigate Europe. Exposure to companies that are cash generative, have consistent earnings stream, and that have minimal impact from downturns in the economic cycle are an important part of your core portfolio. Our ZEQ - BMO MSCI Europe High Quality Hedged to CAD Index ETF will give you exposure to companies like Nestle, Unilever and L'Oréal, where you will see consistent demand in the consumer staples sector no matter the economic backdrop. Currently, we believe it is important to look at Europe as an undervalued region but, in a conservative way by investing in quality companies that are going to be able to ride out those bumps in the road while you're waiting for the economy to bounce back.

Discount Bonds

There has been a significant rise in yield across the yield curve which has been resulting in the Yield to Maturity (YTM) and Coupon to become more aligned. Since early March in Canada, the 10-year has already moved more than 80bps to 2.5%. Over the short term, this rising rate environment has been painful for fixed income investors however, it does provide a natural re-calibration to the market. Because rates have grinded to historic lows, coupon rates have far exceeded YTM and in a non-registered account fixed income became less tax efficient. Currently, we are seeing fixed income ETFs become more aligned (for example our ZAG - BMO Aggregate Bond Index ETF now had a YTM of 2.9% and a Coupon at 2.8%). Moreover, the discount bond universe for BMOs ETFs have become much larger. If rates continue to rise, we may see discount bonds and plain vanilla FI ETFs start to converge. Furthermore, if we do get another market downturn, and central banks are forced once again to drop rates again, investors may be better positioned in discount bonds.

It is important for investors to know that if you need to hold fixed income outside of a registered account it may be more practical to use discount bonds that way investors won't have to be as concerned about the YTM and coupon being misaligned. ZDB - BMO Discount Bond Index ETF, ZCDB - BMO Corporate Discount Bond ETF, ZSDB - BMO Short-Term Discount Bond ETF.

Trading Volume and Volatility

As we come closer to the summer months, volumes do tend to naturally drop off. Currently, volumes appear to be lower than usual. Our portfolio managers spend a lot of time in the derivatives and volatility markets through our covered call and option overlay programs we manage. The average number of the VIX will give us an idea of the uncertainty in the market. A rule of thumb for the VIX is, a VIX of approximately 20 would imply market expectations to be around a 1% daily move, and a VIX around 40 that would imply a 2% move. In late February into early March, while markets were selling off, we saw high demand for downside hedges, and very quickly late March we are seeing more upside participation. When taking a look at volatility outside of equities, we are seeing high volatility in fixed income that is looking to continue over the next few months.

Generally, equity markets don't perform well when there is a lot of volatility in fixed income (can make it hard to pin down valuations in the equity markets). We look to covered call overlay strategies to help minimise volatility and allow investors to "get paid while you wait". Additionally, low volatility, quality and dividend factors should be set to outperform in the current environment.

Oil

We are seeing a lot of volatility in Oil prices even as much as 9% in one day. Short term performance can be hard to predict however, since ZEO - BMO Equal Weight Oil & Gas Index ETF bottomed back in 2020 we've seen it come back 3 times more than the TSX Capped Composite. Our outlook for Energy remains positive even though we've seen a rally in the energy sector. The structural issues that were causing demand and supply imbalances should remain elevated. With workers returning to the office, COVID restrictions easing and summer driving/traveling, we expect energy prices to remain buoyant. As, mentioned on previous podcasts we are recommending reallocating assets if you're up 10-15% (in something like ZEO) to a broad market ETF like ZCN - BMO S&P/TSX Capped Composite Index ETF or ZLB - BMO Low Volatility Canadian Equity ETF. We believe it is prudent to maintain energy exposure going forward but remembering to take the profits off the table.

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The Yield Curve inverted in the U.S market and Canada is about 10 to 15 bps away from an inversion. We think an inversion is something investors should be paying attention to since it can be an indicator to a potential economic recession/downturn. Investors are in a tough spot where they can't overweight bonds right now (since inflation and rising interest rates are negative in bonds) and we can't overweight cash (since inflation will erode away your capital). The only place to be is in equites at this point. The benefit right now is equities tend to outperform in an inflationary environment. Furthermore, the equity market doesn't really turnover until about a year after an inversion happens so, one would believe we still have time. Currently, we don't think investors should necessarily move out of Fixed income completely since fixed income is a great portfolio diversifier and can help your you if equities decline. A good example as of late is when the Russian invasion first happened, we saw investments like ZAG - BMO Aggregate Bond Index ETF rally and helped offset equity market risk. We believe that the inversion/potential inversion of the yield curve is a signal for the central banks to take their time with raising rates. If the Central Banks raise rates over a few consecutive meetings, we may see them take a pause to use forward guidance to tame inflation and cause a steepening of the yield curve. We think investors should consider de-risking their equities and looking at Low Volatility, Dividend and Quality Factor ETFs.

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