

Views from the Desk

Updates in the Equity and Fixed Income Market

Alfred Lee and Chris Heakes, Portfolio Managers, BMO ETFs

Portfolio Construction for Yield Oriented Investors

There is a lot of uncertainty around FI as rates rise and bond prices fall. [ZAG - BMO Aggregate Bond Index ETF](#) is currently providing a 3.5% YTM which is significantly higher than last year. If there are signs that inflation has peaked the central banks wouldn't have to raise rates as many times as the market is pricing in. We need the central bank to become less hawkish for the markets to bounce back. Duration risk might not be a good idea for some investors at the moment. Staying short on the yield curve can be beneficial and looking at something like [ZST - BMO Ultra Short-Term Bond ETF](#) which has a duration of 0.5 but with a YTM of 2.2% and [ZBI - BMO Canadian Bank Income Index ETF](#) with a duration of 2.6 and a YTM of 4.5% can be a good idea as both these ETFs have an attractive risk reward trade off for this current environment.

Covered Calls

[ZWG - BMO Global High Dividend Covered Call ETF](#) is down only half the amount of the MSCI world market. The rotation from growth to value continues to take place and companies with current cash flow and sustainable dividends are benefiting from this rotation. ZWG's stock selection is strong. ZWG has tech exposure however, the exposure is with mature companies such as Microsoft. The high volatility environment is beneficial to covered calls as they produce high option premiums. ZWG is writing 7% to 8% out of the money while producing a 4.2% option premium (on top of what the portfolio is already offering). If there is a run in the equity market it is good to know that we only write on half of the portfolio. Our covered call suite has appealed to those income-oriented investors and the outlook is looking good for them.

Factors at play with Junk Bonds

Spreads have widened. Higher rates have led to investors being concerned about refinancing risk (in terms of rolling debt over). As interest rates rise and non investment grade companies refinance, debt rolling over is going to be at a higher cost compared to investment grade issuers. We believe the current sell off of junk bonds might be a little overblown since only 4% of the index needs to be rolled over in the next 2.5 years. U.S investment grade ETFs such as [ZIC - BMO Mid-Term US IG Corporate Bond Index ETF](#) has a 4.4% YTM which presents a superior risk reward compared to junk bonds. High Yield bonds are still great for long term investors and our [ZHY - BMO High Yield US Corporate Bond Hedged to CAD Index ETF](#) and [ZJK - BMO High Yield US Corporate Bond Index ETF](#) are producing over 6% YTM. We believe a 5% allocation to FI would be prudent for ZJK or ZHY.

Canadian Low Volatility ETFs

When there are concerns in the market is when low volatility ETFs do well and outperform the broad market. [ZLB - BMO Low Volatility Canadian Equity ETF](#) not owning Shopify has contributed to performance and has neutralized the under exposure to the Energy sector. Utilities and Consumer Staples have contributed to the performance. Due to the disciplined approach to our low volatility ETFs, we are seeing a slow and steady performance that is winning the race and the defensive sectors outlook is looking great.

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Across the Cap Spectrum

[ZSML - BMO S&P US Small Cap Index ETF](#), [ZMID - BMO S&P US Mid Cap Index ETF](#) and [ZSP - BMO S&P 500 Index ETF](#) are performing very close this year mainly due to the overweight in tech in ZSP and underweight in ZSML and ZMID. If inflation continues to be a drag on the market IT will continue to drag down the S&P 500. The Fed is trying to drive forward by looking through a rear-view mirror which is challenging (as we know inflation is a lagging indicator). We believe it would be prudent for the central banks to take a pause in September and not raise rates to see how the economy reacts to rate increases. If the Fed becomes less hawkish, we may start to see IT outperform again which would then contribute to ZSP.

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Source: Bloomberg, All returns and data points May, 2022.

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