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Views from the Desk

Updates in the Equity and Fixed Income Market

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Defensive Factors and How to Use Them

When it comes to defensive strategies we look at the Quality, Dividend and Low Volatility factors.

For the quality factor, we view it as having less volatility than a typical beta one strategy (over a long-time horizon). The quality factor focuses on companies with stable earnings growth, high return on equity and low financial leverage. If you're thinking about inflation being more transitory and "what has been working will continue to work" going forward. You'd want to look at the quality factor to give you the most growth potential going forward. ZUQ - BMO MSCI USA High Quality Index ETF, ZGQ - BMO MSCI All Country World High Quality Index ETF

For the dividend factor, we view this factor as being less volatile than the quality factor. The dividend factor will choose companies that essentially pay out dividends and in turn may not have as much growth as the broad market. Dividend paying companies have more of a "floor" when there is a broad sell off since the dividend yield gets higher as the stock price goes lower (dividend can act as a cushion). In a rising rate environment, you may want to look at the dividend factor to get dividend support and be less interest rate sensitive. ZDY - BMO US Dividend ETF, ZDV - BMO Canadian Dividend ETF.

Lastly, the low volatility factor will invest in companies that don't move as much as the broad market and will invest in defensive sectors such as utilities and REITs (are more "recession proof"). If you are concerned about inflation over the short term you may want to look at companies that are in the low volatility factor. ZLB - BMO Low Volatility Canadian Equity ETF, ZLU - BMO Low Volatility US Equity ETF.

Long Term Growth with ZINN

Performance so far has been flat for the year with ZINN - BMO MSCI Innovation Index ETF and has lagged the S&P 500. Having said that we believe it could be a great entry point right now. ZINN is more of a long-term growth strategy and focuses on companies that are at the front of innovation. The performance from next generation cloud computing from business and individuals working from home appears to be set up for success going forward and ZINN will have a diversified basket of these companies in its portfolio.

Thematic Investing is a new way of looking at the market, in a much different way than we have done in the past. Thematic investing approaches the market by identifying "Megatrends": future drivers of market growth driven by the adaptation of new economy technologies which will impact our behaviours, our needs, and how we interact with the world. These are trends so large in scale that they are predicted to impact businesses, companies and industries across the globe in the future (for example electricity and computers are two Megatrends which we've seen play out this century).

Investment professionals are becoming increasingly aware of the power of adding Megatrends to portfolios because of the exponential growth profiles of companies associated with these innovative themes. Therefore, researchers, investment professionals, active managers and index providers are looking to identify, define and capture megatrend and the companies attached to these investment themes.

For more on innovation ETFs please visit Megatrends and Thematic Investing with BMO ETFs

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Updates in the Equity and Fixed Income Market

High Yield Bonds

High yield has been one of the best performing segments of fixed income since the COVID crash in 2020. Investors have been starving for yield and have been pouring into the high yield asset class. Default rates are below pre COVID levels. Spread levels right now are in line with historical levels over the last 5 years. High yield credit spreads could be volatile in the short term, but we view high yield as an important factor in a fixed income portfolio. The correlation in high yield vs the Canadian aggregate is approximately 0.3. High yield can provide extra stabilization benefits from a portfolio perspective. High yield issuers have tapped the market and companies have locked in financing at historical low rates. Furthermore, these companies have time before they need to renew their loans. Steepening of the yield curve and tapering are headwinds for high yield. ZFH - BMO Floating Rate High Yield ETF is a great substitute to neutralize some of that rising rate risk while still getting that high yield correlation to your fixed income portfolio.

Canadian Banks

We have seen 130 million in net new assets flow into ZEB - BMO Equal Weight Banks Index ETF since we announced the fee cut from 55bps to 25bps a month and a half ago. The last earnings announcement from Canadian banks gave investors some confidence that the worst of the pandemic is behind us from an economic point of view. We saw Canadian banks reduce reserves for bad loans significantly and reinforced investors that we are in a re-growth/expansion phase.

We've seen the yield curve steepen about 40bps which helped the banks and their lending books. The steeper the yield curve is the better it is for their long-term rates. Additionally, we don't believe a steeper yield curve is fully priced into the market and there is still some opportunity there from an investment point of view.

Furthermore, dividend yield from the Canadian Banks is approximately 3.6% and regulators still have not let the Canadian banks raise rates yet. For those income-oriented investors, the potential of the dividend yield going up will make Canadian banks even more attractive to them.

For more on ZEB please visit The Benefits of ZEB.

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