Views from the Desk

Updates in the Equity and Fixed Income Market

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Charles Myssie and Matt Montemurro, Portfolio Managers, BMO ETFs

Volatility

When volatility picks up, investors tend to overbuy puts to protect their portfolios or buy calls to get rich quicker. Their combined actions tend to push the implied volatility and support it at higher level. Last month we had decent earnings and headline inflation came down which brought some euphoric sentiment to the markets. Investors started buying stocks instead of calls and also monetized some hedges. But what the long-term vols are telling us is not to get too ahead of ourselves because there is still some uncertainty and risks in the long run. We've been recommending our suite of Covered Calls ETFs that do the overwriting at the individual security and ETF levels as a way of participating in the extraction of the implied volatility ups-downs while waiting for the markets to find their footing. ZWU - BMO Covered Call Utilities ETF, ZWC - BMO Canadian High Dividend Covered Call ETF, ZWH - BMO US High Dividend Covered Call ETF

High Yield Bonds

It has been a rough start to high yield bonds in 2022. CDX spreads has widened as far as 600bps. Investors are looking at these spreads and are starting to consider an entry point into high yield bonds. High yield does provide yield enhancement and a strong diversifier for traditional fixed income portfolios. High yield tends to be more correlated to equity markets while exhibiting the volatility profile of bonds. High yield spreads are higher than there 10-year historical average and there could be an opportunity for tightening this fall. We expect the BoC and Fed continue to stay firm in their monetary policies. ZHY - BMO High Yield US Corporate Bond Hedged to CAD Index ETF, ZJK - BMO High Yield US Corporate Bond Index ETF, ESGH - BMO ESG High Yield US Corporate Bond Index ETF, ESGH.F - BMO ESG High Yield US Corporate Bond Index ETF (Hedged Units)

The Fed

This Jackson Hole meeting could be a pivotal moment in defining the short-term outlook of the markets and setting the tone for September's Fed action and beyond. There is an expectation that the Fed will be hawkish on Friday and the S&P 500 positioning is bearing given the Fed's public commitment to do what it takes to curb the demand in order to contain inflation even if it means inducing a recession. But if the Fed comes out even slightly dovish or have an ambiguous guidance, there could be a reversal and a relief rally. we like the combo Low Vol + Quality as a way of getting exposure to the market in the current volatile environment. ZLU - BMO Low Volatility US Equity ETF, ZUQ - BMO MSCI USA High Quality Index ETF

Breakevens

1 year breakevens peaked in March at 6.3% and are currently at 2.7%. The Fed has acted firmly since then and breakevens have dropped significantly since then. The market expects that the Fed activity will be successful at cooling inflation. We are starting to see that cooling in both Canada and U.S. as prints came in lower than expected. This has been our first positive sign. The BoC has an inflation forecast of 8% in Q3 and the market expects that we will be under that forecast. Gas prices declined which has led to price decline. We do see above average growth in areas such as food. The market is pricing in a 50bps rate hike for September and potentially a 75bps hike in December. We are most likely looking at a reversal in mid 2023. We think we may have hit peak inflation however, we will stay cautious going forward.

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Canadian Bank Earnings

Three of the major six major banks that have reported earnings Scotia, RBC and National reported losses on some degree with TD, CIBC and BMO still to come. Banks are increasingly facing a conundrum whereby higher rates make existing debts more profitable but cloud the longer-term outlook for new business as the BoC continues to hike rates. Banks have been provisioning for potential defaults should a recession hit. Long-term investors should threat any weakness in banks valuation as an opportunity to add to their long-term holdings. Banks continue to pay stable dividends, if inflation peaks and the BoC pauses, market volatility will lessen, and banks would become more profitable. Higher volatility in the banking sector as the result of the below earnings expectation will help ZWB generate higher option premium, increase the capture ratio of those calls while the stocks remain weak. ZWB - BMO Covered Call Canadian Banks ETF, ZEB - BMO Equal Weight Banks Index ETF

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