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Views from the Desk

Updates in the Equity and Fixed Income Market

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US Federal Reserve Announcement

Expectations for the Federal Reserve meeting in November have been set too high. The market is pricing in a 75-bps rate hike. The more important meeting will be in December. This is when the revisions of the dot plots will be released. The Fed may start suggesting slowing down the pace of   interest rate increases, they may raise their terminal values, which would give them the opportunity to take a pause at some point next year, but still give them room to raise rates again should conditions change. In terms of a pivot, it depends on how you define it. The Fed funds futures is pricing in a rate cut for the end of 2023. Where we are sitting right now, that maybe unlikely. A pause is potentially more likely. It generally takes 18-24 months for rate hikes to take effect in the market. There are some leading indicators suggesting disinflation, especially on the goods front. *UPDATE: the Fed Increased by 75pbs as expected*

Valuations

For long term investors there are places to start picking away. From a valuation perspective, certain pockets are trading cheaply such as Canadian Banks. ZEB – BMO Equal Weight Canadian Banks Index ETF provides this exposure. REITs are starting to become more attractive, certain areas are still overvalued in the residential and industrial sectors. Office and retail are becoming more attractive. Whenever interest rates settle to a new terminal value, the attention paid to high flying tech stocks that really drove the market for the past few years is moving towards more mature dividend paying companies. Overall, the TSX for example is currently trading at 13.2 PE vs the 19.1 long term average. Over the long-term broad markets tends to revert to the mean. We encourage listeners and investors to check out the Staying Invested for the Long Term piece found on BMO's ETF Dashboard, that highlights the challenge of timing the market and the advantages of staying invested.

Nasdaq & S&P 500

The Nasdaq has been underperforming S&P 500 Composite YTD. Over the past 5 years, the Nasdaq outperformance has doubled the returns of the S&P 500 over that time period. The conditions of extremely easy monetary policy of low rates and quantitative easing rewarded growth and technology companies and indices titled towards growth. Certainly, there has been a reversal in 2022 since those conditions have changed. The S&P 500 with some tech weighting, offers a more balanced and broad-based sector exposure. With rising rates, valuations are resetting, and higher P/E tech companies have sold off. The market is pricing in a slow down in the economy as financial conditions tighten to slow down inflation, growth expectations have come down as well. This has led to the underperformance of the Nasdaq YTD. We may not see the same level of outperformance we've seen in the previous 5 years, but the Nasdaq is still a good option for long term growth. ZNQ - BMO Nasdaq 100 Equity Index ETF can act as a compliment to a core portfolio of US equities with ZSP – BMO S&P 500 Index ETF or ZUE - BMO S&P 500 Hedged to CAD. The key to know when growth will be working again, is looking at long term interest rates. We started to see a slowing down of the US 10 year, but the 10-year growth trajectory is still uncertain. Once the 10-year yield starts to settle into a defined range, that's when the growth-oriented factor can start to potentially outperform again.

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Fiscal Policy & Energy

There are rumours President Biden will propose a new tax on windfall profits, for energy companies not reinvesting in production or new infrastructure. However, from a company's point of view, there is a lot uncertainty to deploy capital right now and not enough incentive to boost production. This bill is going to be difficult to pass. From a policy perspective, ZEO – BMO Equal Weight Oil & Gas Index ETF is very well positioned. The underlying companies have cash positions that have built up. They could reinvest it into new productive capacities, but the more likely scenario is to increase share buybacks or increase dividends. We expect dividend increases for companies within ZEO to over the next couple of years. Even though clean energy is the future, if you look the current infrastructure, it is still reliant on fossil fuels. Regardless of monetary policy, you will need fossil fuels to make that transition which could last a decade

Volatility and Option Premiums

Post covid, volatility and implied volatility has reset higher in equity markets. The VIX, an index that represents market expectations of the volatility in the S&P 500 over the next 30 days, is higher. That indicates more uncertainty of the future direction of the market. Overall, to some degree this is a structural effect, a multi-year reset of higher volatility. For option writers, this is a benefit. Volatility is a primary input into option pricing. So as volatility increases, more premium can be generated selling calls or puts. Recently, Put-Call Ratios have been flat and call buying has been more prominent, bidding up their price and premiums. ZWC – Canadian High Dividend Covered Call ETF or ZWH – BMO US High Dividend ETF provides exposure to this phenomenon. For income-oriented investors, these strategies that start with a solid dividend base that have been performing well in this type of market while adding on that covered call layer to take advantage of these trends.

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BMO Exchange Traded Funds

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