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Views from the Desk

Updates in the Equity and Fixed Income Market

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Inflation

US CPI for March came in at 5%, which is slightly cooler than expectations. Probably not enough to hold off the Fed from raising rates again in May. Headline CPI rose by 0.1%, leaving that annual rate tracking at 5%, which is both a tick slower than what the consensus had penciled in. Looking at bit deeper into prices, excluding food and energy rose by 0.4% in March, which was in line with expectations, but overall still inconsistent with the Feds 2% target. Chairman Powell preferred measure of underlying inflationary pressures, core services, prices, excluding shelter, did show a little bit more progress. So we're moving in the right direction, but still much higher than that Fed target. Inflation may continue to be sticky and the final push from 3% to 2% target will be the most challenging. The Bank of Canada continued their pause and held the overnight rate at 4.5%. They still warn that the door is open for further hikes and overall upgraded its GDP forecast growth to 1.4% from 1%. From a portfolio perspective, it means we're in for higher rates for longer. There is still room for inflation protection in your portfolio since the market may be optimistically pricing in breakevens at sub 3%. That's a pretty lofty target at this point. I would look at **BMO Short Term Inflation Protected TIPS (Ticker: ZTIP)** or **BMO US TIPS Index ETF (Ticker: TIPS)** which is the full term, both would provide that inflation protection. I do think it's still warranted within the portfolio over the next year.

Q1 Equities

Both the equity and bond market recovered so far this year in Q1 with a leadership change of what's driving the market. From a factor perspective, low volatility was a clear winner last year. **BMO Low Volatility US Equity ETF (Ticker: ZLU)** had a total return of 8%, compared to **BMO S&P 500 Index ETF (Ticker: ZSP)** was down -12% in 2022. Long duration stocks struggled due to the Fed raising interest rates. The US Technology sector was down roughly about 30%. In 2023, we are seeing signs of inflation abating. The trajectory for Fed rate hikes has eased up and has been the major driver for the leadership change, beneficial for longer duration and technology stocks. The Fed's launch of the Bank Term Funding Program to provide a backstop for US regional banks, favor sectors like US technology. It is very similar to QE in that the end effect expands the Fed's balance sheet. Since the launch of this program the sector is up 20% YTD. There a difference between the larger and small cap technology stocks. So if you look **BMO NASDAQ 100 Equity Hedged to CAD Index ETF (Ticker: ZQQ)**, it outperformed the broader NASDAQ Composite, a good illustration of how larger cap tech stocks have outperformed. Overall we also favor **BMO MSCI USA High Quality Index ETF (Ticker: ZUQ)**. Last year Quality underperformed, due it's exposure to technology, not because of the Quality Factor. When you look at the technology stocks that are in ZUQ, they tend to be more cash rich, higher quality names like Google, Microsoft, Apple. Another way to play this is through **BMO Covered Call Technology ETF (Ticker: ZWT)**, which focused on the 30 largest technology stocks in the US, with a covered call overlay. Technology is a sector that doesn't usually pay dividends, with this strategy you're going to get a yield of about 5%. So that's another good way of playing this leadership change in the US equity market as well.

Corporate Bonds

We've seen some strong returns in fixed income as markets begin to price in peak rates in March. A testament to why you want fixed income in your portfolio, to act as a balance during equity market volatility. During the SVB crisis, bonds rallied. One concern is interest rate volatility. It has surpassed some equity market volatility in March, which is surprising. Not a massive concern, but something to keep an eye on. In both Canada and the US, the current pricing of cuts is overly optimistic. I believe we've hit a near peak rates and the current overnight levels will be held for longer than markets are pricing in. From an attribution perspective, credit has performed well. The spread gains were given back in March due to the US volatility. Overall, I continue to be constructive on credit. I see a lot of value in investment grade credit right now, especially over high yield. I believe there's more distress and downside in high yield over the near term. A longer period of higher rates may cause some financing concerns for a portion of the high yield market. Investment grade spreads currently sit 40/50 bps wider than it's 10 year historical average in Canada. That indicates credit markets are already pricing in an economic slowdown. Spreads at these levels provide some downside protection. As well you can lock in some higher yields on the short end. I like, **BMO Short Corporate Bond Index ETF (Ticker: ZCS)**, **BMO Short Term US IG Corporate Bond Hedged to CAD Index ETF (Ticker: ZSU)**, and also **BMO Ultra Short Term Bond ETF (Ticker: ZST).** All have durations of under three years and yields of close to or over 5%. That allows you to limit your interest rate sensitivity right now, take advantage of higher short term rates. Play the inverted yield curve to your advantage.

US Dollar

Headlines reported that BRICS nations (Brazil, Russia, India, China, and South Africa) got together to discuss creating a unified currency away from the US dollar. In late March, Brazil and China also signed an agreement to move away from the US Dollar as the settlement currency for foreign trade. We also saw Saudi Arabia make threats, wanting to sell oil and currencies outside the US dollars. The combination of these headlines has caused a lot questions around the US Dollar. I wouldn't say these are non-events. When you at the BRICS nations combined GDP compared to G7 nations, it is bigger from a purchasing power parity perspective. It would take a long time for the US dollar status as the world's currency reserve to be unwound. A lot of the world's infrastructure is built around the settlement of US dollars. Being the world's reserve currency, in my opinion, you would need to satisfy four conditions. Stable financial markets, large and stable economy, open market trading, which automatically disqualifies the Chinese yuan, and lastly liquidity needs for all global trading. Only the US dollar can satisfy all terms. US Dollar Index is down 11% since the end of September. But that has more to do with monetary policy. Comparing inflation in the US, Europe and Japan, the Fed is far ahead reining in inflation.

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Expectations are the Fed will reduce it's pace of interest rate hikes faster than the BoJ and ECB. From a currency hedging perspective, CAD vs Euro or Japan, you probably want to take exposure in those underlying currencies because they are still tightening monetary policy, where as the BoC has paused. The CAD/USD is a tougher call. The CAD is is trading around the upper end historically, at $1.35. In addition, oil prices have been weak over the last couple of months, but have the potential to move up with the OPEC announcement of reducing capacity. So you probably want to favor the Canadian dollar over US dollar.

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Source: Bloomberg, All returns and data points March 2023.
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