BMO Exchange Traded Funds

January 12th, 2023

Views from the Desk

Updates in the Equity and Fixed Income Market

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2022 Overview

2022 was a tough year for markets with the TSX -6%, S&P 500 -20%, FTSE Canadian Bond Universe -12%, and the US Bond Universe -13%. The third time in over 100 years, both equity and fixed income has had this result. The Canadian ETF industry grew $35B in net new AUM, 10% growth. Total AUM was $314B. BMO ETFs led industry in flows for 12 consecutive years with $6.8B in net new assets. 63% of flows came from the top 4 ETF providers. Investors fled to safety in Cash and Short-Term Bond ETFs. Despite a challenging performance year, Fixed Income ETFs still collected in $19B new assets. A testament of how ETFs can be used as shelter for clients. BMO ETFs has a 3x3 matrix that allows investors to pick exactly where they want to be on the yield curve. In volatile markets this flexibility is attractive. Multi Asset ETFs had a strong year, although inflows slowed. Equity ETF drew $13B in inflows. Equally split between US, Canada and Int'l. Broad beta dominated flows. Thematic, Dividend and Sector ETFs are taking more share. ESG is the largest thematic category. Agriculture ETFs picked up due to inflation concerns. Early in 2022 outflows went from long to short in bonds. Later in the year, the trade reversed with recession concerns. With a more positive outlook in 2023, ETFs are well positioned to allow investors to chose risk between equity and bonds.

Factor Performance

Defensive Factors in Low volatility and Dividend were outperformers in 2022. Positive last year despite challenging markets. ZLB – BMO Low Volatility Canadian Equity ETF, contains stocks that are less sensitive to market movements, was flat for the year, TSX about -5.5%. ZLU – BMO Low Volatility US Equity ETF, outperformed by 20% in CDN dollar terms. S&P -12%, ZLU +7%. Benefitting from currency and defensive positioning. ETFs are powerful tools to customize portfolios to benefit from Factor trends. Dividends resurged in the past 12-18 months. Blue chip, high-quality dividend payers, led to outperformance of about 4-9% depending on the region. The impact on rising rates on Growth and Tech was a major theme. Nasdaq was about -30% in 2022. The focus was on Value and defense. Some challenges are spilling over in 2023 with inverted yield curves, so defense is still required. A dividend allocation, not to the highest yielding, but solid cash flowing companies. And pairing with growth can make sense going forward.

December CPI Print

CPI came and went without much commotion. The 6.5% print was down from 7.1% in Nov. Perfectly inline with consensus. Higher rates are having an impact on price levels. A sharp drop in Gasoline, with core inflation still increasing 0.3%, to 5.7%. Inflation trend is starting to move down, but still work to be done. The 3-month annualized rate does look more positive at 3.1% going into 2023. Market continues to price in optimistic expectations. Forward looking 2.3% top line CPI in June, does seem optimistic. It does give Fed ammunition to slow down the hiking cycle. Market is expecting 0.25% hike instead 0.50% and a terminal rate of under 5%. Likely means an earlier end of hiking cycle, the Fed could pause sooner. Canadian CPI coming next week.

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Covered Calls & Volatility

Slowing inflation has reduced volatility a bit. With still a healthy amount of volatility the VIX is in the 20 area. Volatility is a key input in option pricing. Pre-covid the VIX was 10-15. Post covid 20-30. So Covered Calls can still be an attractive strategy going forward. Building on a solid core of dividend payers, ZWH – BMO US High Dividend Covered Call ETF, for example can provide defensiveness with equity upside. There were strong flows into covered calls in 2022. BMO ETFs has established itself in the covered call space in 2011, with ZWB – BMO Covered Call Canadian Banks ETF becoming a flagship mandate. The team that started it all is still here, we've added more experts, but the core team remains. That expertise and experience is key in managing covered calls. These strategies will continue to attract inventors' interest, since income is one way to buffer against risk and uncertainty in 2023.

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