Views from the Desk

Updates in the Equity and Fixed Income Market

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BoC Rate Decision

The Bank of Canada increased the overnight rate by 0.25% to 4.50%. Many expect that to be the last of this hiking cycle and for a pause to see how the economy reacts. Yields have fallen across the board. The December Consumer and Business Survey suggested inflation for longer, and that it may become entrenched. The 5 year inflation breakeven sits at 1.8% while realized CPI is 6.3%. So there is lots of room to go. The BoC mentioned that; if economic developments evolve broadly in line with their outlook, they expect to hold the policy rate at the current level, while they assess the impact of rate increases. Doubling down on Dec comments that decisions will be data dependent. These statements suggest more stability in the near term and supports the view of perhaps adding back longer duration products. This strategy piece can work well – BMO ETFs: Bank of Canada Update "We Love Barbells" .

New BMO Covered Call ETFs

We are launching two new innovative covered call products to the market. BMO ETFs established the Covered Call ETF space in 2011 with ZWB – Covered Call Canadian Banks ETF. Since then we've expanded that line up and have become the leading covered call provider in Canada with 2/3 of the market share. Two sector strategies that can be added as satellite positions to portfolios. ZWEN – BMO Covered Call Energy ETF is targeting a yield of 8%. With a underlying dividend yield of 3.8%, the remaining coming from option premium. We've seen dividend increases in the Energy sector and geopolitical conflicts and China re-open serve as tailwinds as well. ZWHC – BMO Covered Call Health ETF is a more defensive strategy to help cope with the challenges of 2023. Holdings will consist of more US healthcare names. Both strategies will help investors generate more income and create more tailored portfolio to help investors achieve their goals.

New BMO Fixed Income ETFs

BMO ETFs is adding two core building blocks to our fixed income suite. Both are priced very competitively. ZUAG – BMO US Aggregate Bond Index and TIPS – BMO US TIPS Index, MER of 0.08% and 0.15%, respectively. ZUAG uses the landmark Bloomberg index that covers the entirety of the US fixed income market, the largest bond market in the world. A great diversifer, especially for Canadian heavy bond portfolios. It provides a yield premium of appox 0.30% relative to ZAG and a shorter duration of about 6 years. The US universe is 73% AAA with a correlation in the 70s, to help reduce overall volatility. The issuer base is deeper to diversify away the sector overweight found in the Canadian market. ZUAG.F and ZAUG.U are all well suited in the current environment.

TIPS can help investors navigate the evolving inflation and rate environment. ZTIP – BMO Short-Term US TIPS Index ETF, worked well 2 years ago. At that time shorter duration made sense. Today, investors are still concerned about inflation, but where rates are now, they may want to lengthen duration and get full market exposure. TIPS duration is 6.7 years, well positioned for the current market. As well the structural changes in the real return Canadian bond market have made it more difficult to access liquidity and inflation protection through real return bonds. So TIPS.F – BMO US TIPS Index ETF Hedged to CAD can be excellent solution to ensure you have liquidity while providing inflation protection.

BMO Exchange Traded Funds

January 25th, 2023

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Canadian REIT Outlook

With rates likely to pause, ZRE – BMO Equal Weight Canadian REITs Index ETF is worth considering in 2023. Inflation has a push/pull effect on real estate. Real assets hold their value during periods of inflation. The ability to reset lease agreements also acts as an inflation buffer. However, with rising rates cost of capital increases and raises the hurdle rate to start new projects. Overall REITS were negatively impacted in 2022 alongside Utilities. Both bond proxy type of equities. With rates moderating and becoming less of an issue, this sets the stage for a potential rebound in the sector. ZRE is up +9% YTD. And if rates fall, this tends to favor REITs.

Taxes on Buybacks

A stock buyback is when company has excess cash and do not necessarily have new projects to invest in, so they return cash back to shareholders via buying it's own shares on the exchange. This lowers the existing share count, making the existing shares worth more. Similar effect to paying a dividend, however, it falls on the capital gain side in terms of taxation. Governments intend to put a tax on buybacks. In Canada it will be a 2% tax starting January 2024. In the US, a 1% tax just came into effect in January 2023. We believe this is not a game changer, companies may just choose to pay dividends instead. This may benefit dividend ETFs such as ZDY – BMO US Dividend ETF or ZWH – BMO US High Dividend Covered Call ETF. Where the focus is on blue chip payers with solid cash flow. Dividends held up well in 2022, and with challenges spilling over to 2023, we still favor dividends going forward.

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