Views from the Desk

Updates in the Equity and Fixed Income Market

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Office REITs

Office REITs have been facing a lot of concerns with investors. A recent CBRE report stated the national office vacancy rate in Canada was 17.7% in Q1, an all time high. A lot of industries have been slow to come back to the office. It is going to take few years for the office space to recalibrate. Looking deeper however, Montreal, London and Calgary are reporting net vacancy declines. Calgary's office conversation program, re-purposing office for residential use, has been working. As well some end-of-life office buildings are being demolished, reducing supply. South of border we are seeing more acquisitions that is supportive of the office space, and more companies are becoming less reliant on hybrid work. Ultimately, we may have 2-4 years before we see a turnaround in demand and eventually create a bottom. In terms of playing the REIT space, a good way to access exposure is through **BMO Equal Weight REITs Index ETF (Ticker: ZRE)**. In addition to the office REIT exposure, which is a longer value play, you get exposure to other sub industries. Such as industrial REITs, residential REITs, and retail-oriented REITs. Diversifying your REIT exposure is a good way to play it, so your not just exposed to the office sector. Especially if interest rates start coming down in 2024, REITs can be an attractive opportunity. ZRE has a 4.9% distribution yield, the dividends can help you wait out the potential headwinds in the office REIT space.

Fixed Income Diversification

We saw yet another interest rate hike from the Federal Reserve yesterday of 25 bps to bring their overnight rate to about 5.5%. The Fed warned of another 25 bps hike this fall. The market is anticipating with headline inflation at 3%, rates are very close to a sufficient level. For Canadian investors looking for ideas to diversify a Canadian centric fixed income portfolio and perhaps add some US exposure as a core position, would narrow in on the short end of the curve to take advantage of higher shorter term yields. I would also focus on investment grade credit since IG spreads sit wider than their 10 year averages. High yield may begin to feel the crunch of higher rates and refinancing may stress a lot of business models to result in a uptick of HY defaults. The ETFs we offer in these categories are **BMO Short-Term US IG Corporate Bond Hedged to CAD Index ETF (Ticker: ZSU)** or **BMO Ultra Short-Term US Bond ETF - USD Units (Ticker: ZUS.U)**. Both ETFs are extremely well positioned and would be an excellent complement to a traditional core fixed income portfolio.

Gold

We highlighted gold as something to keep an eye on in the beginning of the year. Earlier this year gold hit a high of about 2050 before retreating back to 1900 US dollars per ounce. Currently, it's trading about 1960 per ounce. The gold VIX hit a high of about 22 this year before settling to about 12.5. Over the short term, the price has partly been driven by the US dollar. If you expect the US dollar to weaken, that is a positive for gold. Over the long term the demand for gold looks strong, as the BRICS nations are looking to unify a currency backed by gold. Gold stocks are a good way to leverage gold prices. **BMO Equal Weight Global Gold Index ETF (Ticker: ZGD)** was up 30% earlier this year before retreating. But again, that's a good way to get exposure to gold. We don't think you need a lot of exposure in the portfolio. Having 3%- 5%, is a good way to get exposure to gold prices through the gold companies, which is going to give you that inherent operating leverage to gold prices.

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Discount Bonds

For taxable investors, it is important to be aware of the tax implications of any investment that you make. We offer a suite of discount bond ETFs that can help investors maximize their after tax returns. Going through our suite, it starts with **BMO Discount Bond Index ETF (Ticker: ZDB)**, that provides tax efficient aggregate bond exposure to the Canadian bond universe. For more targeted exposure **BMO Short-Term Discount Bond ETF (Ticker: ZSDB)**, provides 1-5 year exposure to the Canadian aggregate universe. And for more corporate exposure, **BMO Corporate Discount Bond ETF (Ticker: ZCDB)** provides 1-10 year corporate bond exposure, to take advantage of higher corporate yields. In terms of allocation, I would use ZDB as a core full term exposure. And complement that core position by shortening my overall duration by using ZDSB. And then use ZCDB to beef up my corporate exposure, to take advantage of those wider spreads. With our discount bond suite you don't have to give up specific exposures to maximize your after tax returns.

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