Views from the Desk

Updates in the Equity and Fixed Income Market

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Canadian CPI

The sharp drop in headline inflation may seem exciting at face value, but it's important to note that underlying consumer price growth is still running high in Canada. The 12 month rate of total inflation declined from 4.4% to 3.4%. Diving into the numbers, energy prices are now being compared to the peaks that we saw in 2022. That is a main reason why we're seeing such a drop from that YOY number. Food prices were a driving factor in higher prices. If you exclude food and energy, the 12 month rate of change in the core index went from 4.4% to 4%. Headed in the right direction, but maybe not as drastic. If I was looking to positioning myself, I would still look to add **BMO Ultra Short-Term Bond ETF (Ticker:ZST)** to add a 5.36% yield. Clipping the higher yield and taking advantage of the inverted yield curve. It's an excellent complement to a core exposure like **BMO Aggregate Bond Index ETF (Ticker: ZAG)**, which has a longer a duration. Given the expectation of a another rate hike, it would be a great way to position your portfolio for the short term over the next three to six months. If the BoC continues to pause and keep the overnight rate at potentially 5% for longer.

Food Inflation

The Competition Bureau recently did a study of the Canadian food industry. There were allegations of price fixing, and they concluded it was happening with the bread industry specifically. So there's been a bit of mistrust in the groceries here in Canada. Most Canadians are familiar with the 3 major grocers - Loblaws, Sobeys, and Metro. If you don't shop at these grocery stores, you probably shop at one that is owned by them. Combined they brought in $100 billion in sales and about $3.6 billion in profits. The only foreign operators here are Walmart and Costco. There weren't any findings of price gouging, but the industry has become more concentrated. Food inflation, specifically in May was at 9%. Investors can navigate this space by looking at our recently launched **BMO Global Agriculture ETF (Ticker: ZEAT)**, it invests in global agriculture companies. So companies that are involved in the production side of the food supply chain, and that are heavily investing in newer technologies to harvest food. We screen for size, liquidity, and earning margins, so that they are able to pass on higher costs. We see ZEAT as that hedge against inflation that may prove to be sticker than anticipated in the longer term.

Fixed Income Positioning

We are starting to see the market push back on longer term rate increases. The BoC may continue to hike with a 57% chance priced in for July, and short term rates will react quickly. But the long-term rates seem to have found a resistance level. Volatility is coming down, making long corporates the best performer. It seems longer term rates are staying sticky within the 3%-3.50% range. Investors are positioning themselves and starting to add duration. Corporate spreads continue to sit wider than historical levels. This could be an opportunity to add duration and credit at discounted levels. Investors are doing that with **BMO Long Corporate Bond Index ETF (Ticker:ZLC).** And **BMO Long Federal Bond ETF (Ticker: ZFL)** for long federal exposure. ZFL is one of the fastest growing ETFs YTD with almost 3 billion in size. These wouldn't be core allocations, it can complement ZAG and maybe fit in ZST for a corporate barbell strategy.

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Volatility

Over the last three years implied volatility has been elevated. We have not seen the VIX dip below 15 until this past June. July and August do tend to have lower volatility and there also could be less demand for hedging right now. So expected volatility is falling back into a more normalized range. The impact to BMO Covered Call ETFs is earning a little less income when selling those calls. The main thing with our distribution policy for all of our ETFs is that we only pay out what we earn. Avoiding grinding the NAV down. And so, coming out of this period where volatility has been high, we are bringing distribution slightly down in recognition of volatility coming back to more normalized levels. Now, that's not to say it can't spike up again. And generally when volatility goes up, it does go up quickly. Generally what investors are looking for with covered call strategies is regular income, not necessarily the volatility, because covered calls are equity based investments. But if that volatility does strike, BMO Covered Call ETFs are able to monetize that volatility into higher option premiums, and therefore higher distributions.

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