Views from the Desk

Updates in the Equity and Fixed Income Market

Omanand Karmalkar & Matt Montemurro, BMO ETFs

Fixed Income Positioning

The Bank of Canada maintained it's policy rate at 5% as well as it's hawkish forward guidance. Progress is being made in clearing excess demand, however inflation overshot forecasts and it is expected to moderate slowly with the 2% target to be in sight closer to 2025. The basic message is to be patient with higher rates for longer. They downgraded their economic outlook for 2023 and 2024, and increased their inflation expectation for the same periods. We expect the Bank of Canada to maintain it's hawkish tone, until the very last moment until they need to cut rates. We believe we'll see a bit more stability in this yield curve normalization. We are seeing investors reengage in barbell trades, investing in **BMO Ultra Short-Term Bond ETF (Ticker: ZST)**, or **BMO Short Corporate Bond Index ETF (Ticker: ZCS)** and complementing them with the long duration exposure of **BMO Long Federal Bond Index ETF (Ticker: ZFL)** or **BMO Long-Term US Treasury Bond Index ETF (Ticker: ZTL)**. So essentially calling a near peak in rates, thinking the curve is normalized and we expect more stability going forward. We continue to view **BMO Short-Term US TIPS Index ETF (Ticker: ZTIP)** as a strong complimentary piece to a portfolio. I look at it as cheap inflation insurance since one year break-evens are extremely low.

Canadian Dividend Equities

Canadian dividend stocks have faced a challenging year, lagging the broader market. We've seen a strong growth rally to start 2023, the AI fueled growth prompted a shift form these traditionally stable and defensive companies to more growth-oriented stocks. Rising interest rates have also put pressure on dividend paying stocks, with fixed income yields becoming more attractive. As well, the cost of servicing debts for dividend paying companies have gone up relative to their earnings and free cash flow. If interest rates start to stabilize it could make these dividend stocks more attractive again. And if we see a hard landing these stocks tend to be much more defensive. So if an economic slowdown does happen, focusing on dividend stocks can provide more stable long-term growth. 2022 for example, was a tough year for markets, and those dividend focused companies provided defensiveness and lower volatility in portfolios. Some ways to get exposure can be through B**MO Canadian Dividend ETF (Ticker: ZDV)** or **BMO Canadian High Dividend Covered Call ETF (Ticker: ZWC)** for more income-oriented investors. Fundamentally, these companies are trading at more attractive valuations given the recent downturn in their prices.

Interest Rate Volatility

Market volatility continues to be fueled by fixed income markets, US Treasuries in particular. We saw the 10 Year break through the 5% and aniticapted rate cuts continue to get pushed out further out the curve. Making things more complicated is the surging number of government bond issues in the US and globally as well. This spiked bond volatility has started to infect equity markets. To give you an idea of the magnitude of these moves, the volatility of Long-Term US Treasuries was 15% higher than the S&P 500 in the past 10 days. And if you compare this to the traditional relationship, the 20-Year average is that the US Treasuries are 2% lower than the S&P 500. It's important for investors to be able to protect themselves and using ETFs can greatly benefit investors that need to reallocate their portfolios rapidly to adjust to changing market dynamics. Maybe it's going short, earning an attractive yield from **BMO Ultra Short-Term Bond ETF (Ticker: ZST)** or in one of our new ETFs, **BMO USD Cash Management ETF (Ticker: ZUCM)**. Or potentially, buy the dip and add duration if you believe rates have peaked with **BMO Long Federal Bond Index ETF (Ticker: ZFL)** or **BMO Long-Term US Treasury Bond Index ETF (Ticker: ZTL**). ETFs provide excellent tools to help investors navigate challenging markets by providing targeted diversified exposure in a very liquid manner.

Technology Sector

From an earnings perspective there were some concerns regarding earnings growth. While some earnings slowed, it was not as drastic as many had predicted. Microsoft delivered much better than expected earnings being strongly positioned in the cloud and AI races. Google and Meta had strong top line earnings. Google's main ad revenue business including search and Youtube ads saw double digit growth. Their cloud revenue has a miss that impacted the stock. Other positives in the sector, we saw deep cut costs in start of the year that helps with earnings now. There are also headwinds to be cautious of, including macroeconomic uncertainty and geopolitical tensions. So looking forward taking a more disciplined approach to investing in the sector would be prudent. For exposure to the tech sector when there is higher volatility is through B**MO Covered Call Technology ETF (Ticker: ZWT),** it provides a good balance between upside market participation and income. We're able to harness a 5% yield in a sector where income is typically low. ZWT has had strong YTD returns at about 45%. The ETF holds 30 top, blue chip names, such as Alphabet, Amazon, Microsoft, and Apple. Finally, having a well diversified portfolio, in this market environment is very important, to get that growth in a more risk-controlled manner.

Listen on Apple Podcasts | Listen on Google Podcasts | Spotify

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