Views from the Desk

Updates in the Equity and Fixed Income Market

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BoC Announcement

The BoC announcement came at no real surprise. The market was anticipating a 50bps or 25bps rate hike, fell on the higher end of expectations. The last two CPI readings have been mixed. The last being 6.9. Job numbers were strong as well, so the BoC is playing it safe, doing what is necessary to tame inflation. The market is anticipating the rate hiking cycle coming to a pause. This is a positive development in terms of a risk rally, good for equities and bonds overall. We've seen significant moves of the overnight rate 0.25 – 4.25%, the fastest pace on record. The BoC will have to consider the 2yr, 10y – the largest inversion since 1990, whether to continue hiking and the damage it can cause to the economy. The real estate market has been cooling, a lot of properties are being reposted at lower prices. Canadian Tire reported a build up of inventory. In terms of fixed income positioning, exposure to the short end of the curve has made sense. The correlation of long bonds and equity markets has been increasingly positive. Going forward, a bar bell approach make sense for bonds. Overweighting short credit, ZCS - BMO Short Corporate Bond Index ETF, combining it with ZFL – BMO Long Federal Bond Index ETF. or ZTL – BMO Long-Term US Treasury Bond Index ETF for US dollar exposure. 75% on the short end and 25% long, can be an appropriate way to play it, to balance risk and yield.

Dividends

Dividend investing is historically a tried-and-true approach. Not every dividend company is created equally. Dividend growers and sustainable payers have led to outperformance over time. Through covid, dividend equities took a back seat. But the past 12-18 months, they have come back to shine. Higher rates have played in well for dividend ETFs. ZDV – BMO Canadian Dividend, ZDY – BMO US Dividend ETF, & ZDH – BMO International Dividend Hedged to CAD ETF. All three dividend ETFs were positive for the year. Outperformance of 4% in Canada, 14% US, and 7% Int'l. They all contain Blue chip, high quality, dividend payers. Not reaching for high yielding companies. In terms of outlook, there is room to run for Value Dividends. At the end of hiking cycles, when the economy slow downs, blue chip dividend paying companies tend to outperform, when more cyclical companies remain challenged. There is potential for sticky inflation, and higher rates for longer, which plays into the hands in dividends. High quality dividend payers such as Canadian banks and certain energy players, trading at P/Es sub 10x look attractive. Continue to look at the BMO ETF dividend line up to provide exposure.

ETF Flows

December positioning for retail and institutional investors has been interesting. Year end tax loss selling has been driving flows this time of the year. Retail investors have been taking advantage selling fixed income investments and moving into bond ETFs. One trade that has been popular is using discount bond ETFs. Since you are taxed on coupon rate, and receive the YTM, the trick is to maintain lower coupon level than the YTM. With discount bonds ETFs, the coupon rate is lower than a plain vanilla bond ETF, while total return is similar.

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Investors have been moving into ZDB – BMO Discount Bond ETF, ZSDB – BMO Short-Term Discount Bond ETF, or ZCDB – BMO Corporate Discount Bond ETF. As well investors have moved into cash or cash related ETFs. Crystalizing losses and moving into money market ETFS like ZMMK – BMO Money Market ETF which is currently yield 4.2%. A key date, Dec 28, is the last day to do tax loss selling. On the institutional side, we've seen repositioning. Several asset allocation accounts have used ETFs to position portfolios back into equities in recent weeks. Seeing the end of the rate hiking cycle and moving slowly back into risk assets. Moving into ZSP – BMO S&P 500 Index ETF or ZLU – BMO Low Volatility US Equity ETF to be more defensive.

Energy

NYMEX traded down to $75. Surprising to see it back to these levels. Contributing factors include the overall concern of economic slowdown driven by rate policy. The thinking this time around is it might not be as slow as previous cycles, with a strong consumer base, high saving rates, and tight labour markets. Where it can go from here for oil prices, one big story is China. The potential for a China restart. They have been loosening their zero covid policy. Overall, 12 months from now it looks more constructive for oil demand. New supply constraints with the Ukraine Russian war and lack of investment are other drivers. In ZEO – BMO Equal Weight Oil & Gas Index ETF, you have a mix of companies including pipelines that should continue to do well, and explorers and integratives which are very profitable in the $60-$80 range. So, the prospects for energy equities are quite good. We recommend a minimum market weight, 5-10%.

Tax Loss Selling

Tax loss selling has been more common with equities in the past, but there is much more activity on fixed income side this time around. It could be a once in a lifetime opportunity. We don't generally see fixed income down 10% in a year, so there is an opportunity there. The largest trade we've seen was a switch from an individual bond into and bond ETF, a cost effective and diversified solution. We've also seen switches from broad beta FI ETFs into discount bond ETFs. The BMO ETF Dashboard has information and ideas in terms of tax loss selling – BMO ETFs Tax Loss Harvesting Guide 2022. Feel free to reach out to ETF wholesaler to help walk through that process of converting individual bonds into an ETF.

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