Views from the Desk

Updates in the Equity and Fixed Income Market

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FTX Fallout and Growth Stocks

The FTX debacle is certainly a stumbling block for the crypto community. The bankruptcy proceeding will reveal more facts, potentially fraud. To put the losses into perspective, FTX creditors are owed about $5-10B, the Madoff bankruptcy was about $64B, and Lehman was about $1.2 trillion. So not the same scale to put the entire financial system at risk. As well, only a limited number of institutional investors were in this area. Therefore, we don't see this as systemic risk to the broader market, spilling over to other assets or traditionally listed public equities. Although this has done no favours for investor sentiment towards growth stocks. While the interest rate story remains, we can expect heightened volatility in equity markets in general. But for investors that are willing to take on near term volatility, to achieve long term growth potential, from established companies, the Nasdaq still provides that. For growth oriented investors in the medium term, 3 years plus, the Nasdaq is a great place to look to get that growth potential. ZNQ – BMO NASDAQ 100 Equity Index ETF or ZQQ – BMO NASDAQ 100 Equity Hedged to CAD Index ETF provides exposure to established growth companies like Microsoft, Google, Apple, Amazon. Companies that generate high level of free cash flows. Looking into a niche growth area, ARKK has recently launched three new ETFs with BMO. Investors with an even longer time horizon, 5 years plus, can look to the main innovation ETF, ARKK – BMO ARK Innovation ETF. The underlying companies are innovative and disruptive in nature. Zoom, Roku, Draftkings, and Shopify for example, are unimpeded by the FTX story and outside of the cryptocurrency ecosystem. Rates are also headwinds to those companies in the near term but can reward investors in the long run. It's more about being invested, rather than picking when to be invested. ARKK's comments were that over the long term, this fallout maybe a necessary evil to get better regulation and transparency in the industry. Bitcoin being leader in this space, while volatile, had no trading and settlement issues. These events may set back institutional investment for now but will lay the regulation framework to get institutional investors comfortable again.

Fixed Income

Canada and the US recently released their October CPI figures, both countries surprised the market with lower-than-expected core CPI growth. Canada's seasonally adjusted CPI came in at 0.2%, the lowest reading since November 2021. In October BoC surprised the market by hiking 25bps less than forecast. The CPI prints suggests we are starting to see the impacts from previous jumbo rate hikes. It will be interesting to see whether BoC will surprise investors again, with a less hawkish stance. In the US, both headline and core CPI numbers took the market by surprise to the downside. We saw month-over-month core prices meaningfully undershot expectations, growing at 0.3% instead of 0.5%, while year-over-year core CPI also decelerated. The US CPI number sparked a big risk-on rally across asset classes, the S&P 500 surged 5.5% and the TSX jumped more than 3% that day. We saw some recovery in the bond market with treasury yields fell off a cliff. It looks like the market is now pricing in +50bps for the next Fed hike, and a 25bps hike by the BoC in December. Futures are implying another 25 to 50bps hike by both central banks in the new year. It may be a little too early to declare victory over inflation at this moment.

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Back August, the US reported its July CPI that came in well below estimates and triggered a short-lived rally. That was followed by much higher MoM CPI prints in August and September. Also keep in mind that we will get another CPI report before the next FOMC meeting. Still uncertainties going into the next rate decision. Although the market expects rates to peak around Q1/Q2 next year, there hasn't been much anticipation of a cut any time soon, which means rates are expected to stay elevated for a while. So overall, we remain cautiously optimistic going into 2023. It really depends on how much of a mean-reversion in inflation will be enough to motivate policy easing. On the bright side, I think we are now much closer to hitting peak inflation than we were a few months ago. But since it can take up to 18-24 months for us to see the impact from fed tightening, Things are not going to change overnight. In terms of portfolio positioning, we recommend keeping some core bond exposure by owning ZAG - BMO Aggregate Bond Index ETF, with a short duration tilt by holding ZST - BMO Ultra Short-term Bond ETF, in your portfolio. This combo will keep you invested, provide you with access to the full yield and credit curve while giving you the flexibility to act when the time is right.

Currency Hedging

The currency market in 2022 has been dominated by the strength of the US dollar. Globally, the USD is risk off asset and while equities and fixed income have sold off the USD has been a safe haven going to cash. The strength of the USD was also caused simply by the US Federal Reserve leading other central banks in the pace of raising rates. The differentials between US and other global markets have reached a wide point. It wasn't just with the Euro, but other global currencies felt the impacts and have depreciated. The Euro is at its lowest level since 2022, the British Pound is at its lowest level since 1985, and the Yen since 1990. These are multi decade lows, relative to USD. These are extreme levels that will be difficult to sustain without creating cracks. For countries importing goods in USD, such as oil, copper, raw materials, its has become much more expensive. So how should investors be thinking about this, if you are investing in the US or Global equities, you must decide how to manage currency. You are making a choice, whether you have a view or not. ZEA – BMO MSCI EAFE Index ETF, for example, provides exposure to broad develop market equities, relative to the Hedged version ZDM – BMO MSCI EAFE Hedged to CAD ETF, ZDM outperformed by about 8%. Conversely, when you look at a USD investment, ZSP – BMO S&P 500 Index ETF has outperformed by about 7% relative to the hedged version, ZUE – BMO S&P 500 Hedged to CAD Index ETF . You can see how the decision to hedge or not, exposes yourself to different outcomes. You can take the middle road 50/50 hedge blend with a neutral view. Institutional investors are looking for more moderation, as other countries play catch a up with raising rates, this may cause mean reversion for the USD, and an increase in international currencies relative to USD as well. BMO ETFs offer all options, whether it is US or Int'l hedged or unhedged. Similarity on the fixed income side. Currency can make a significant difference in the total return from your underlying investment.

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Low Volatility

We have experienced significant outperformance of Low Volatility strategies as the broader market sold off. ZLU – BMO S&P 500 index ETF is about +7% YTD. A positive return in environment where the S&P is about -10% in CDN dollars. It has been protecting the downside as we hope they do. Going forward, we expect higher equity volatility to persist since the days of easy monetary policy are behind us. Low volatility strategies will be more important going forward, for a risk control measure, rather than on the outperformance side. Low volatility can be a piece of your overall exposure, depending on your portfolio construction, if you were at 100%, moving the allocation to 75% or 50% can be reasonable. So Low Volatility still has a place in portfolios, even after the strong performance. We recently put out a trade idea on the BMO ETF Dashboard – BMO US ETF Blend Growth Strategy, that considers paring ZLU with ARKK. This blend provides long term growth potential, but in a more risk-controlled way by pairing it with low vol. This can help position your portfolio to capture growth when it does come back.

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Source: Bloomberg, All returns and data points November 2022.

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