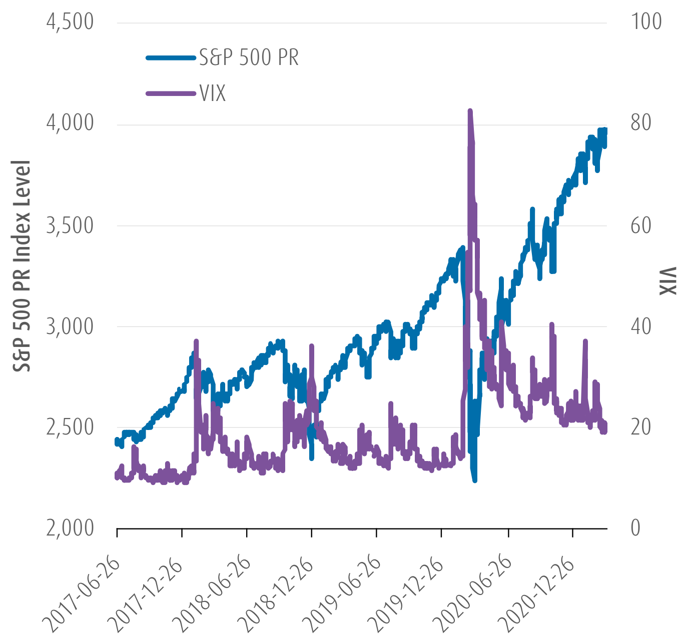
Allocating Equities in Uncertain Markets

Making sense of current market conditions

Equity markets have changed drastically since we entered the pandemic over one year ago. We witnessed a historic market crash last March, followed by an equally historic bull-market recovery. This rebound was defined as a “V Shape” recovery; an outcome which fiscal and monetary policy makers helped design using tools such as stimulus packages, monetary easing, and ultra-low interest rates. The recovery was somewhat uneven to start. New economy companies involved in innovative solutions and technologies gained the lion’s share of market returns through 2020. These companies benefitted from stay-at-home mandates and further progression into the virtual and digital era. In November, two headlines dictated a massive equity market rotation: Pfizer had successfully developed a vaccine, and U.S. president Joe Biden was elected. This prompted a huge market shift from growth-oriented equities into value-oriented companies who had until this point not been participating in the market recovery.

S&P 500 vs. VIX



Source: Morning Star Direct, April 2021

With the first year of the pandemic behind us, investors have just as many questions today as they did when the pandemic began. The VIX (CBOE Volatility Index) has settled down after hitting 83 last March yet it’s elevated relative to pre-pandemic levels. The vaccine roll-out has been uneven among regions. The U.S. is ahead in vaccine distribution but is struggling to contain virus outbreaks. Canada continues to experience strict lock down measures. Both countries are keeping short-term interest rates low, but mid and long-term rates are creeping up. And inflation has become top of mind as investors ask themselves what the impact of low rates and monetary stimulus will be on the economy.

Where can we invest today given uncertainty about the future?

Investors should consider four key tenants when thinking about positioning portfolios in today’s environment:

1. Market Cycle

2. Factors

3. Style (Value vs Growth)

4. Inflation Expectations

Market Cycle: Thanks to heavy stimulus, easy monetary policy and positive vaccine news, global markets are in a **Recovery Phase**. In this phase, consumer cyclicals do well as consumer spending increases. Unique to this recovery, energy has begun to rebound as travel restrictions ease. Financials, Materials, Infrastructure and Industrials do well in an early recovery as investment flows pick up and economic growth impacts building and development. The market cycle also effects cap levels: small and mid caps historically outperform large caps in this environment. Mid and small cap equities are overweight cyclical sectors and their higher risk reward profile give them extra pop when markets rally. Growth-oriented sectors and large caps will continue to benefit as the economy recovers and will do well as the market moves into expansion; these remain relevant positions looking out long term.

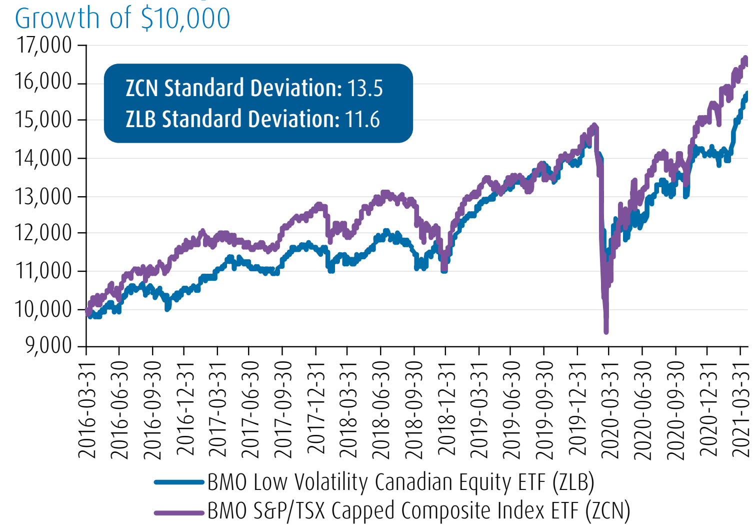
We are here

Cycle	Recession	Early Recovery	Slowdown	Late Recovery	End of Cycle
Style	Defensive, Income	Value	Growth	Momentum	Defensive, low Vol / Quality
Size	Large	Small	Mid	Large	Large
Sectors	Defensive Utilities, Health Care, Consumer Staples	All Cyclicals → Early Cyclicals Utilities, Health Care, Consumer Staples	Early Cyclicals → Mid Cyclicals Financials, Energy, Materials, Industrials	Late Cyclicals Industrials, Resources, Technology	Defensive Utilities, Health Care, Consumer Staples
Rates	Falling	Falling	Rising → Falling	Rising	Falling

Factors: Just as market sectors rotated in November, so did market factors. Value oriented stocks, which were beat up in the early days of the pandemic, are enjoying a revival thanks to the positive vaccine news. Companies with low price to earnings ratios have been leading the charge, especially in Q1 of 2021. Dividend companies, which are tilted to value, have also been strong as a strengthening economy bodes well for cash flows, sustaining dividend payments and future dividend growth. Quality companies were the favourite factor in 2020 as stocks with strong balance sheets, sustainable cash flows and less debt than peers were able to weather the volatility and economic hardships of 2020. Quality companies are currently overweight to growth names, which have cooled off so far this year. Low volatility strategies, which were a favourite at the beginning of 2020, provided protection through the market crash last March but have since rotated out of favour as their defining low-beta characteristic meant they lagged in the market rally. Value and Dividend factor companies continue to be in the spotlight and can be strategic portfolio positions to capitalize on the current market cycle. Quality companies remain favourites as a long-term core growth solution and low vol strategies continue to deliver less volatility and market risk than their peers.

Low Volatility vs Broad Market in Canada, 5 Years

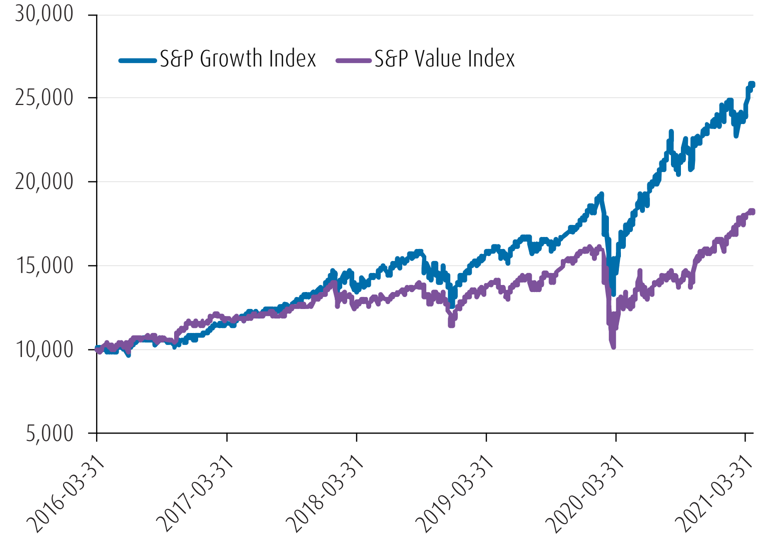
Growth of $10,000



Source: Morning Star Direct, April 2021. Standard deviation based on 5 years

Style: In the Value vs. Growth debate, growth has been the clear winner over the past 5 years. However, we are starting to see this trend reverse. Companies which have lower prices relative to their earnings have been on a run, while growthier equities are cooling off. This reversal has happened before: in 2009 value stocks shot past all other investing styles coming out of the 2008 financial crisis. Investors are taking note of this timing, and flows are starting to make their way back to value-oriented companies and sectors (Financials, Energy). The growth side of the equation has been dominated by a handful of mega cap companies such as Facebook, Apple and Amazon, so value investors are enjoying not only the recent rebound, but also the added diversification as well.

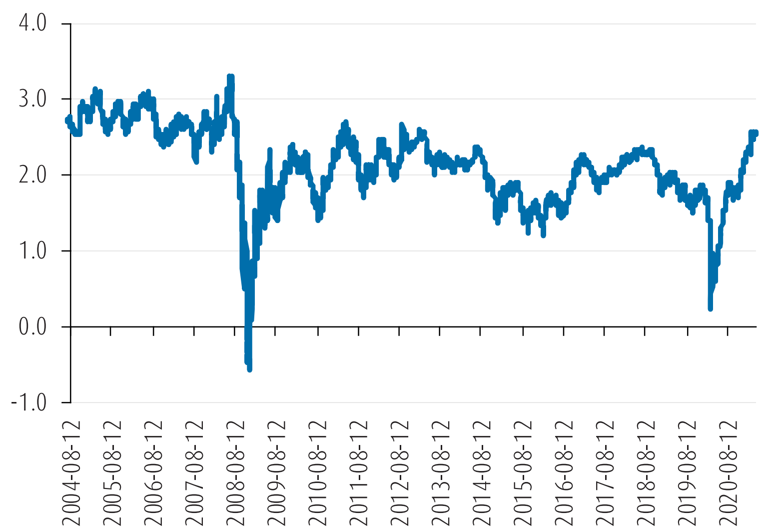
Value vs Growth 5 years



Source: Bloomberg, April 2021. Returns in USD. You cannot invest directly in an index.

Inflation Expectations: Inflation has been top-of-mind for investors going into 2021, and for good reason. Short term interest rates are locked in at 0.25%, monetary and fiscal stimulus is flooding the market, and The Fed and BoC are committed to overshoot short-term inflation targets. These factors, coupled with rising energy prices, are making investors see inflation as a growing concern. CPI is currently reporting 2.2% inflation in Canada, but this is a backward-looking metric.[1] Today, the market (which is forward looking) is pricing in closer to 2.5% looking out 5 years(see graph to the right). While equities are better equipped to handle an inflationary environment than bonds, there are certain sectors which do better when inflation creeps up such as gold and base metal equities.

Expected Inflation, 5 Years



Source: Bloomberg, April 2021. 5-year U.S. Inflation Swap Curve

Using ETFs to Keep Pace:

To keep our portfolios working for us as efficiently as possible, it is good **to find investment solutions that are aligned with our market expectations and portfolio goals** so we can continue to participate in markets, earn income on capital, and avoid cash drag. Based on current market conditions and their effects on the four tenets discussed above (market cycle, factors, style and inflation) we have identified a potential tactical investing opportunity in several equity ETFs (see pg 4). Which ETF you choose depends on a decision framework: your market conviction, views on the economy, views on valuations and your investing time horizon. ETFs are extremely liquid and low cost which means you'll be able to access each exposure efficiently and cost effectively. With ETFs, investors can rotate into and out of exposures to react to market and economic developments as they unfold.

[1] Source: www.statcan.gc.ca, April 2021.

Decision Framework:

1. What is your outlook on the economy?
- Are you bullish or bearish?
- What are your thoughts on the shape economic recovery and the ability to control future virus waves?
- How effective will monetary and fiscal stimulus be in the near and long-term?
- How concerned are you about inflation?

2. What is your view of market valuations?
- Will stimulus continue to re-inflate markets or will confidence in markets decline?
- Do you view the recent pull back in high growth sectors (IT, healthcare) as attractive entry points to play on long term trends or do you want to add cyclical exposures (value, dividends, small cap) to take advantage of the reopening trade?

3. What is your time horizon?
- Do you want to add tactical exposures so you can quickly react to market events as they unfold?
- Are you looking for core long-term growth positions, with less concern about short term market volatility?

Equity Trade Ideas

I am an investor who is unsure if the effects of the pandemic on the economy have really been understood yet, so am uncertain which direction the market will go in the short-term. I would like to be more defensively positioned and believe that the best companies have low debt and strong balance sheets and will outperform if there is another market pull back in the short-term. Therefore, I am looking for a defensive equity solution with high quality, blue chip companies to keep exposure to equity markets as the economy recovers.
- Read the BMO Premium Yield ETF (ticker: ZPAY) Trade Opportunity
- Read the BMO MSCI USA High Quality Index ETF (ticker: ZUQ) Trade Opportunity

Look to ZPAY
BMO Premium Yield ETF

Look to ZUQ
BMO MSCI USA High Quality Index ETF

I am an investor who is bullish on the economy on the long-term. I believe monetary and fiscal stimulus, in addition to the vaccine roll out, will benefit equity markets. I'd like exposure to companies who will benefit from this current environment and the reopening trade.
- Read the BMO S&P US Small Cap Index ETF (ticker: ZSML) Trade Opportunity
- Read the BMO Equal Weight Banks Index ETF (ticker: ZEB) trade Opportunity

Look to ZSML
BMO S&P US Small Cap Index ETF

Look to ZEB
BMO Equal Weight Banks Index ETF

I am an investor who has a long time horizon and am looking for a long term growth solution to fill out the growth sleeve of my portfolio. I would like a solution that has the potential to outperform over the next 5-10 years.
- Read the BMO MSCI Emerging Markets Trade Report
- Read the BMO Investing in Innovation Report

Look to ZEM
BMO MSCI Emerging Markets Index ETF

Look to ZINN
BMO MSCI Innovation Index ETF

I am an investor who thinks monetary stimulus will lead to inflation in the long-run. I'd like to find an equity solution to hedge against inflation and to diversify my portfolio over the next 1-3 years.
- Click here to read the BMO ETFs Inflation Report

Look to ZGD
BMO Equal Weight Global Gold Index ETF

Look to ZGI
BMO Global Infrastructure Index ETF

BMO | Exchange Traded Funds