Views from the Desk

Updates in the Equity and Fixed Income Market

Alfred Lee and Chris Heakes

BMO ETF Portfolio Managers

Fixed Income Update: The Fed Extends Bond Buying to Fallen Angels

The Fed announced late last week that it will include fallen angels (bonds downgraded from IG to HY), in addition to buying high yield ETFs in its corporate bond-buying program. This announcement was supportive of credit. There have been some concerns in the BBB space; these names are vulnerable, especially if the lock down persists, because these companies have weaker balance sheets than A+ companies. However, the BBB segment is a more conservative way to boost portfolio yield while maintaining IG bonds. For exposure to Canadian BBB corporate bonds, BMO offers the Canadian BBB Corporate Bond Index ETF (ZBBB). Investors who are looking for AAA assets should look to BMO's Canadian MBS Index ETF (ZMBS) where investors can access similar credit as a Federal bond but with additional yield. ZMBS offers about a +40 bps yield pick up above federal bonds. This is also risk-free because the mortgages are guaranteed by the Canadian government.

Equity Update: Suspensions of Dividends and Share Buy Back Programs

In the UK, banks and insurance companies were asked by the Bank of England to suspend dividends for the time being so that these companies would have more financial flexibility to weather this correction. There is no immediate concern with the balance sheets of these companies, this is a more a precautionary and prudent measure to promote market stability. The ECB is encouraging a similar directive where they have asked banks to suspend their dividends and share buy backs until at least October. This is just a temporary regulatory measure. In the US, banks have halted buy-backs for now. There have been some calls for US banks to suspend dividends but there has been no strong movement to do this yet. In Canada this would be extremely unlikely. For the BMO Dividend strategies, dividend growth is a key component of our screen. This is a forward looking metric, and therefore any short-term temporary dividend suspensions would not require us to sell these names as they will be paying and growing their dividends in the future. Methodologies which use a back-ward looking metric such as current yield will cause a lot of turnover in the coming months. There have been real legitimate dividend cuts within the Energy sector and some in Consumer Discretionary. Within the BMO portfolios, the weight of the names with cuts is around 1-5% of the North American Portfolios and 8% in the Europe portfolio. Because the portfolio construction uses a sustainable overly, the impact of dividend cuts to our portfolios is small.

US and Canadian Banks

US banks have been putting aside historical levels of capital to guard against potential loan losses. This is spooking the market. The upcoming earnings numbers and economic data for the US banks which come out this week will be poor. Loan loss provisions are larger than expected. However, he US banks are in quite good shape and are very capitalized. Companies have never been so profitable and prepared going into a correction. US banks have higher volatility than Canadian banks, so we see them as a good satellite position in a portfolio (~5% weight). A satellite weight could reap a lot of returns if you're willing to look out 12-24 months. Negative fundamentals are coming down the pipeline, but a longer-term outlook is positive. Canadian banks have made no indication that they will be cutting dividends. Canadian banks did not cut in 2008, and there is no plan to cut now. These banks are well capitalized, even more so than the US. The energy shock will play in as a risk, but for a 12-24 outlook with dividend yields north of 5% this is an attractive trade.

REITs at Historic Lows

REITs have hit historical lows and are matching or lower than 2008 levels. With REITs we look at the metric Funds From Operations (FFO) which is how much cash flow they are generating from their properties. FFO is around the 10% range for most REITs today, while the Government of Canada 10 year is yielding less than 1%, so this is a compelling trade for investors looking for yield. BMO Equal Weight REIT Index ETF (ZRE) offers a portfolio of high-quality REITs which own good properties, and they entered the crisis with really strong balance sheets. Residential and retail REITs are the most exposed right now as people may not be able to pay rents during the economic shutdown. As the economy unlocks, REITs could see a great bounce back over the next 12-24 months.

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