Views from the Desk

Updates in the Equity and Fixed Income Market

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Update on Quality

Quality outperformed the broader market in July. This is because quality names have strong balance sheets, good cash levels and less debt to service. This enabled these companies to navigate the market stress in March better than peers. **The BMO MSCI USA High Quality Index ETF (ticker: ZUQ)** holds names such as Apple, Google, Visa, Microsoft, and Amazon. These companies are market leaders, set trends, and create high margin products. These companies also have stronger management teams and have a more efficient use of capital. This has been one of the core tenets of quality investing and much of the reason why they have outperformed. The quality factor appeals to both bulls and bears, because it offers protection on the downside and participation on the upside.

Update on Low Volatility

Low Volatility, by design, offers more value on the downside, because the portfolio captures much less downside than the broad market. So, in March BMO's low volatility strategy did not drop as hard relative to other factors and the broad market. Low Volatility tends to generate value over time. When you think about market valuations, the U.S. market is more expensive now than pre-Covid, so an argument can be made for the growing importance of defensive positioning. Going forward, we will watch how momentum and higher beta names perform, if will they continue to run or will they cool off, we will see.

Corporate Spreads

2020 has been a wild ride for credit. March was disastrous but now we are in the fifth consecutive month for corporate spread tightening. There is improved risk sentiment driven by several factors. The supportive yet underutilized corporate bond buying programs, and better than expected market earnings are factors which are contributing to the tightening of corporate spreads across the board. But spreads are still 20% wider than pre-Covid levels. Therefore, we remain constructive on credit. **The BMO Mid Corporate Bond Index ETF (ticker: ZCM)** is a good way to play the credit space right now. The middle part of the yield curve hasn't tightened as much as we have seen in the short end. And about 40% of the mid-universe is comprised of sectors such as Energy, REITs and Utilities which have wider spreads right now relative to other sectors and so we think there will continue to be credit spread compression in this space.

Gold

Gold pulled back this week due to a reaction in bond yields rising (moderately) and some profit taking in the space. When real yields go up, gold price goes down. However, we believe this sector still has some longer-term tail winds the strongest of which is the amount of money-printing the Fed and other global central banks have been doing, which could lead to inflation down the road. Market volatility and uncertainty can also help the price of gold, and with renewed geopolitical tensions between China and the U.S. and a U.S. election on the horizon, this can contribute to market uneasiness. Gold miners are also enjoying a record high price of gold, which hit $2000/oz this month, and lower input costs with the price of oil so low. The last time gold rallied, the price of oil was in the $120-$140 per barrel range, so for this gold run the miners are better positioned than last time gold rallied. We still think there is a place in portfolios for gold as a diversifier and the **BMO Equal Weight Global Gold Index ETF (ticker: ZGD)** would be a good way to play this sector right now.

Fixed Income- Coupon vs YTM

A bond's coupon remains fixed, but yields overall have dropped significantly in the last six months. This causes a wider spread between a bond's coupon and its yield-to-maturity (YTM). In 2019 as rates began to rise, we saw a convergence of coupon and YTM but this has now all been reversed with rates dropping to historically low levels. In 2019 the Coupon-YTM spread was about 60bps and now we are at 200 bps. This 200bps differential can be significant from a tax perspective because investors are taxed on the coupon% not the YTM%. This means investors should be paying attention as to which accounts they are holding their fixed income in. We suggest holding fixed income in nontaxable accounts whenever and wherever possible. This tax burden can be a significant drag on portfolio performance. If a non-taxable account is not available, BMO offers the **BMO Discount Bond Index ETF (ticker: ZDB).** This ETF provides a Canadian universe bond exposure but in a more tax efficient manner. We aim to build a bond portfolio which replicates the Canadian universe (matching risk, duration, yield, sector makeup) while minimizing the differential between coupon and YTM. This is achieved by buying more recently issued bonds, so the yield is more in line with the coupon while continuing to offer a diversified universe bond exposure. So the performance and portfolio makeup is very close to **the BMO Aggregate Bond Index ETF (ticker: ZAG)** while its tax profile is much more efficient.