Views from the Desk

Updates in the Equity and Fixed Income Market

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Defensive Growth Strategies

We still believe that a defensive growth approach, which we view as a combination of the quality factor and low volatility factor, is appropriate for investors today. In general, higher quality companies are better positioned to manage COVID related issues, and low volatility companies will be less turbulent if volatility returns. And both factors offer downside protection vs the broad market. The U.S. economy has been a market leader for a long time, but they are facing some potential volatility in the near-term. The U.S. is still encountering a lot of problems managing COVID-19, and they are facing an upcoming election. However, the Tech sector in the U.S. is as strong as ever, evidenced by earnings reports we saw last week from companies such as Apple and Facebook. These are the types of companies which can be found in the **BMO MSCI USA High Quality Index ETF (ticker: ZUQ, ZUQ.F, ZUQ.U)** which is overweight to the Info Tech sector. For the income-oriented investor, **The BMO Premium Yield ETF (ticker: ZPAY, ZPAY.F, ZPAY.U)** is another way to get exposure to high quality US equities with an enhanced income overlay. ZPAY carries an equity weight of around 35% in normal market conditions and utilizes an innovative option overlay to provide enhanced yield. The yield today is 6% (annualized) and is tax efficient.

Fixed Income Flows

We have seen large flows into fixed income ETFs in July, after historic flows into equity ETFs in May and June. Much of this can be explained by portfolio rebalancing. As equities grind higher, investors need to invest more into bonds to keep their equity and fixed income ratio in line. Investors are also looking to fixed income right now to maintain defensive posture as the global economy still faces risk and uncertainty. Fixed income ETFs also provide liquidity and they continue to trade through market stress, unlike many of the underlying bonds which went "no-bid" back in March. We have also seen active global fixed income strategies, such as the **BMO Global Multi-Sector Bond ETF (ticker: ZMSB)**, getting lots of flows. When yields are as low as they are, investors are looking to active managers who can make meaningful asset allocation decisions to add value.

Core Satellite Investing with Broad Market Index ETFs

"New economy" companies are driving the broad country indices right now. For example, in Canada Shopify is the largest position in the S&P/TSX Capped Composite Index at 6.7%. Historically the largest company has been Royal Bank, topping out at around 7% at its highest weight. If Shopify breaks through 7% it will mark the largest index weight in the Canadian index since Nortel, which at the time caused serious concentration risk. A single company holding a 6-7% weight in an index can really influence that index's overall returns. Therefore, looking back on Q2, most Canadian Equity active managers underperformed the broad index because they were underweight Shopify, which was driving the index returns. In the U.S., Apple is the largest weight in the S&P 500 Index at 6.5%. These companies are becoming historically large weights in their indicies. Investors are realizing if they allocate to the broad index, they will be holding the companies which are driving the return of that index. Owning the broad market in an ETF such as the **BMO S&P/TSX Capped Composite Index ETF (ticker: ZCN)** or the **BMO S&P 500 Index ETF (ticker: ZSP)** makes a lot of sense as a core portfolio holding because you have exposure to all the large companies who are driving returns. You can allocate to the broad market, and then build around this based on your outlook over the next 12 months. You can add value around these core index holdings by using a sector or factor ETFs in the satellite.

Sector Rotation

- **Information Technology**: We are not going to bet against Tech. The changing nature of the "new world economy" favours these companies. Many Tech companies have very good fundamentals and strong balance sheets, which is why the sector is overweight in ZUQ. *BMO MSCI USA High Quality Index ETF (ticker: ZUQ), BMO NASDAQ 100 Index ETF (ticker: ZNQ, ZQQ)*
- **Gold**: Gold is a good portfolio diversifier because it has a low correlation to equities. The supply of money is expanding, inflation expectations are rising, and bond yields are historically low, all tailwinds for the outlook on gold. Gold just crossed $2000/oz this week, a record level. We advocate for a small position here, because it can be volatile. Gold equities give leverage to the gold price. *BMO Equal Weight Global Gold Index ETF (ticker: ZGD).*
- **Financials:** In Canada, banks are yielding around 5.5%, and they are still down about 20-25% from pre-COVID levels. Historically, this is an attractive entry point for Canadian banks and it makes a good medium-term trade. U.S. banks are riskier but more growth-oriented. Their loan books are riskier, they have more regional exposure, and are more volatile. However, they have similar foundations as the Canadian banks and the dividend yield here is above 4%. *BMO Equal Weight Banks Index ETF (ticker: ZEB), BMO Covered Call Canadian Banks Index ETF (ticker: ZWB), BMO Equal Weight US Banks Index ETF (ZBK, ZUB), BMO Covered Call US Banks Index ETF (ZWK).*

Outflows in Preferred Share ETFs

RBC issued LRCNs last month which is a novel type of bond that provides the bank with a cheaper source of financing relative to rate reset preferred shares. This caused the price of preferred shares to gravitate to par, as the probability of them being called increased. There is speculation that other Canadian banks will follow RBC and issue LRCNs. This could lead to redemptions in the rate reset deferred space and will continue to pull these preferred shares to par. We believe this to be a positive driver for the preferred share asset class. The **BMO Preferred Share Index ETF (ticker: ZPR)** has a 6% yield right now, which is tax efficient.

For a summary of the risks of an investment in the BMO ETFs, please see the specific risks set out in the prospectus. BMO ETFs and ETF series trade like stocks, fluctuate in market value and may trade at a discount to their net asset value, which may increase the risk of loss. Distributions are not guaranteed and are subject to change and/or elimination.

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