Views from the Desk

Updates in the Equity and Fixed Income Market

Chris McHaney and Chris Heakes, BMO ETF Portfolio Managers

Market Predictions for 2021

The vaccine has begun its roll out, so there is optimism looking into 2021. Continued stimulus is also very beneficial for the market, and we are seeing a commitment from the Canadian government here, but are still waiting for the stimulus package from the U.S., which should be finalized in the new year. These are both good developments for markets overall. We remain cautiously optimistic, not overly exuberant, as there are still some unknowns in the near-term (how efficiently can we get the population vaccinated, the timing of the economic reopening). In terms of where will returns come from next year, we see two areas. The reopening trade has really benefitted the most beaten up areas of the market, (dividends, value, small caps) and with the vaccine announcement we have seen a trend reversal for these sectors which could continue into next year. The strength we saw in the Information Technology sector which came from the closed economy and work from home environment, will probably continue. **BMO Quality ETFs** are still a good way to play markets right now going forward, given they offer defensive growth.

A Steepening Yield Curve

Central banks have made it clear that short rates are not going up anytime soon. Both the Fed and the BoC have been very dovish. But as economies rebound and reopen, we could expect to see a steepening yield curve, starting with the long end. The Fed has also said they are comfortable with overshooting on inflation. So, you may see a scenario where inflation picks up in 2021. This would really move the long end of the curve higher. How to play this scenario- keep fixed income exposure shorter than the broad market and concentrate on mid to short maturity. Stay away from the long end of the curve, unless you are really concerned about equity markets selling off. High quality corporates would be a good place to pick up as much yield as you can. The **BMO High Quality Corporate Bond Index ETF (ticker: ZQB)** offers high quality corporate bonds (A and above) with 1-10 year duration, so staying away from the long end, while maintaining higher quality bonds to protect on the downside.

The S&P 500 Index Welcomes Tesla

Tesla is going to be added to the S&P 500 Index on December 18 and its weight will be about 1.5%, so this will be the largest addition in over a decade. The S&P 500 has a financial viability screen, so this is the reason why Tesla was not included for so long, even though it met the market cap requirement for some time now. This will be a huge liquidity event as many passive investors who track the index (such as the **BMO S&P 500 Index ETF (ticker: ZSP)**) will be buying Tesla on Friday. So, who might be selling Tesla? Index arbitragers, systematic funds, and hedge funds, all might be selling Tesla. Also, many active managers who trade on fundamentals might see the valuation as stretched and may trim their profits or be ready to sell after the enormous run the stock has had. Trading volumes of Tesla have been elevated this month, which is typical for a stock leading into a rebalance where it will be included. From BMO's perspective, when we look to add a new name to an index and are therefore buying a certain company, we take a lot of care with this and do analysis on these trades. We want to make sure our clients get fair prices for equities we will buy or sell. A lot of thought, consideration and strategy goes in to getting excellent execution on these types of buys.

FX

Since April, CAD has appreciated 10% against the USD, which is a lot of movement for a currency in a single year. CAD appreciation is in line with other global currencies, so this is a story of USD weakness over CAD strength. This is something that we witnessed coming out of the financial crisis in '08, as mass amounts of quantitative easing and extremely low interest rates were bearish for the USD. The BoC has indicated that they prefer a weaker currency, which will help Canadian exports. CAD could also be bolstered by a reopened economy which would be particularity bullish for the Energy sector. Investors have been using ETFs to move around this- we have seen a lot of switch trades where investors are moving out of a CAD hedged exposure, taking profits here, and moved into an unhedged version. Investors can maintain their underlying exposure while being nimble with the currency exposure. ETFs are a great tool for investors to access currency options on the same strategy so they can manage these exposures.

Chris H's top ETF pick for 2020: The BMO MSCI Emerging Markets Index ETF (ZEM)

We have talked a lot about emerging markets this year and I believe the growth story will continue in 2021 specifically as the rise of China continues to play out. We think this is an area which is under owned among Canadian retail investors. ZEM is the largest and most liquid EM exposure in Canada.

Chris M's top ETF pick for 2020: The BMO MSCI ACWI Quality Index ETF (ZGQ)

ZGQ has returned 14.1% (annualized) over the last 5 years. It is a basket of the highest-quality companies globally. These companies have strong balance sheets, good management teams, and have lower debt-to-equity than their industry peers. These characteristics offer a defensive growth profile, which we like looking out as there are still some uncertainties for markets in the near term. ZGQ makes a great core portfolio position.

Source: All returns December, 2020.