Views from the Desk

Updates in the Equity and Fixed Income Market

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Market Valuations

Current P/E ratios are stretched. 40.2x is the current P/E ratio for the NASDAQ 100 Index which is the highest it's been in the last decade. The NASDAQ is loftier when compared to the S&P 500. The NASDAQ typically trades at a 20% premium to the S&P 500; today this is a 25% premium. The NASDAQ is more growth oriented and more tech heavy than the S&P 500. Earnings have been depleted overall as we face a closed economy, which is the denominator in the P/E equation, and one reason valuations have shot up. The Fed's accommodative monetary policy as really exacerbated the "P" in the P/E ratio as investors are optimistic about the economy reopening. Can prices remain at these levels? Depends on vaccine roll out and the pace at which the economy can reopen.

Inflation

It is not too early to position for inflation, and we see this with flows; assets in TIPS ETFs which are listed in the U.S. have grown by about 20% during the last year. So, investors are prepositioning their portfolios for inflation. These concerns are justified as monetary and fiscal policy has been aggressive, the Fed is targeting long term inflation and overlooking short term targets and balance sheets have been expanding. CPI has been muted but it is a backward looking. The breakeven rate is forward looking, and it is around 2.2% right now. In terms of fixed income positioning, US TIPS is a good way to hedge your fixed income portfolio from inflation risk. Because we are seeing a steepening yield curve in the U.S. investors will also need to manage duration risk. Therefore, we think the best way to play TIPS is by focusing on the short end of the curve with an ETF like the **BMO Short-Term US TIPS Index ETF (ticker: ZTIP)** which provides the inflation protection of US TIPS but removes the long term duration risk of long bonds. Click here to read our BMO ETFs Inflation Report.

Slow Roll Out for the Vaccine

Volatility is still elevated. We are seeing fresh market highs yet the VIX is over 20% which is twice as much volatility than pre-COVID. The vaccine news in November triggered a rally in more depressed, cyclical assets like small caps, Energy and Financials. The **BMO S&P US Small Cap Index ETF (ticker: ZSML)** has outperformed the S&P 500 over the last few months. Value has been the top factor so far in 2021. Dividends will also benefit from their exposure to value. Oil is at $60 a barrel. The market is shrugging off the slow roll out and looking out beyond current economic data. Biden's promised stimulus package will be another tailwind for the market. The Quality factor has always been our base case, core ETF trade idea. Quality ETFs and can address valuation concerns because our quality screen looks for fundamentally strong companies; many are tech companies but names who are profitable and who have strong earnings. These are fundamentally strong tech companies and not speculative high volatility tech names.

Clean Energy

Clean Energy was one of the most popular investment themes of 2020, but there was a lack of clean energy product in Canada. Non fossil fuel-based strategies saw the largest flows in the ESG space in the U.S. This is not a speculative trend; this is the real deal. Biden has recommitted to the Paris accord. China has a 2060 target for carbon neutrality. The growth of renewables surpassed coal in the U.S. last year- even under the Trump Administration. Governments are allocating stimulus dollars to climate friendly projects. Institutional investors are also tilting to these exposures. Clean energy is a very compelling theme, and we have been seeing lots of interest in the **BMO Clean Energy Index ETF (ticker: ZCLN)** since we launched it last month. This ETF tracks the very popular S&P Global Clean Energy Index which is the leading global index in this space with more assets benched to this index than any other clean energy index. The companies in ZCLN produce or provide equipment for renewable energy (solar, wind, hydro). We think we are still in the early innings in terms of long-term societal trend. Returns in clean energy were very strong last year, but it is still early for this trade. In a portfolio ZCLN would make an effective satellite. It has higher risk than broad market but could give investors exposure to long term themes to add to portfolios from a satellite perspective. Click here to read more about ZCLN.

Source: Bloomberg, All returns February, 2021.