Views from the Desk

Updates in the Equity and Fixed Income Market

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Quality and Low Vol Update

Last Thursday, the S&P 500 was down 6% in one day- which almost triggered a market circuit breaker- and the VIX shot up to the 40s. But the announced fiscal stimulus of $1 trillion and the Fed's "whatever it takes" mentality with heavy monetary stimulus have been good for the market over the past 2 months, and the last couple of days. But because volatility is still so elevated, we still have high conviction in the combination of Quality and Low Vol for US equities right now. YTD the S&P 500 is up 2%, while US Quality is up 6% and US Low Vol is down -1.2%. There an outperformance of 70bps vs the S&P 500 with this strategy. Equity valuations are still stretched and so we believe the Quality and Low Vol approach is a prudent way to be investing.

Update on Canada and the Energy Trade

There is a high correlation between oil prices and CAD however this is true more long-term. There have been pockets of short-term dislocation: for example, in late 2017 oil prices climbed but the CAD weakened. The recent rebound in oil has been related to the reopening of economic activity. Your view on oil should be related to the pace of expansion that we will experience going forward. Looking at the forward curve in the oil futures market, which projects oil prices out for the rest of the year, we see mildly higher oil prices than we do today. If there is a quicker reopening of the economy in the second half of 2020, then oil prices will increase from current projected levels. Once people begin driving more, and planes are flying more, this will create more demand for oil and energy. Once these activities become more sustained, we could see an improvement in oil prices and CAD.

Option and Derivatives Update

We keep our yield target on the covered calls consistent (3-4% annual range of added option premium). Because volatility is elevated, the value of the option is higher, so we can write calls further OTM (out-of-the-money). This means the portfolios' potential for upside increases. Canadian Banks have the lowest volatility; this month we will be writing these contracts 6-8% OTM. The High Dividend strategies will be written at 8-10% OTM and the highest volatility strategies such as US Banks can get 12-15% OTM right now. Overall the opportunity is good in the option market because a higher volatility backdrop makes it easier to hit our yield target and the ability to write further OTM will give investors a good growth profile in the next couple months.

Opportunities in Fixed Income

The bond market has stabilized, much due to Central Banks indicating they will be buying bonds, but they will be "playing it by ear" in terms of how much bond-buying they will do in the coming months. In the US, $250 billion worth of corporate buying has been announced, but so far only $5.5 billion has been purchased, a small amount of the overall total. Powell indicated if conditions return to normal sooner, the Fed will slow or even stop its buying but if market stress returns, they will ramp up purchases. In Canada, the corporate and provincial bond buying program is focused on the shorter end of the curve, bonds 1-5 years. We have seen the buying start, so spreads have come down from their March peaks, but they are still historically on the higher end. Particularly in Canada, BBBs have widened significantly. If investors are willing to accept a little short-term vol, they can lock in a nice spread relative to government bonds right now. To get exposure to the Canadian BBB space, the **BMO BBB Corporate Bond Index (ticker: ZBBB)** allows investors to pinpoint this credit segment. The BBB segment still carries some risk though, if the economic rebound is not as strong some names could get downgraded to high yield, but for investors willing to take this on the spread over government is very attractive.

Emerging Markets

The **BMO MSCI Emerging Markets Index ETF (ticker: ZEM)** is the largest Emerging Markets (EM) ETF in Canada with assets at $1.7 billion, so this would be a great way to add EM to your portfolio. EM is an active space, recently we have seen an uptick in interest especially among institutional buyers. There has been a valuation discount within EM for a long time; a consistent P/E discount vs other markets so there is a lot of opportunity here. Since the market bottom (March 23) EM has lagged all other regions including Canada and EAFE. EM is traditionally highly correlated to Canada but recently less so as it has become less of an energy play and more heavily dominated by Info Tech, especially in China and Taiwan. So, there is a place for it in Canadian portfolios, even more now than before. And the long-term story is compelling, as EM is the engine of the world's growth and population. In the short term, look to buy on weakness.