Views from the Desk

Updates in the Equity and Fixed Income Market

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Cap Levels in the U.S.

We have seen small and mid cap equities outperform large caps in the U.S. YTD. There has been a sector rotation as well, from IT and health care stocks (which are being hit hard by rising rates) to value-oriented cyclical sectors (Industrials, Energy, Financials), sectors which are overweight in the small and mid cap space. Historically small and mid cap equities tend to outperform coming out of recessions and we saw this in 2009. Small and mid caps are more economically sensitive because their businesses are more localized and less diversified compared to global large caps. Small and mid caps are more leveraged toward the economic reopening trade. The current rally in this space is largely driven by stimulus. Stimulus checks will be directed towards the small and mid cap corporations. We think it could be a good time to reallocate some core position to small and mid caps (combined). We still believe the core should be overweight to large caps but there is an opportunity right now to tactically adjust part of your portfolio to the small and mid cap space because there are lots of tail winds to this trade. The **BMO S&P US Small Cap Index ETF (ticker: ZSML)** and the **BMO S&P US Mid Cap Index ETF (ticker ZMID)** offer exposure to these cap level spaces.

Dividends

Dividends didn't perform well in 2020 when large cap tech stocks dominated the markets. After the vaccine news was announced, the reopening trade began to play out, which was more value oriented. Dividends and value have a strong connection (as price drops, dividend ratio increases). Value and Dividends have been performing well in this reopening environment. Within the BMO ETF Dividend suite, all 3 regions (Europe, Canada, US) are outperforming their broad beta equivalents since early November. The **BMO Global High Dividend Covered Call ETF (ticker: ZWG)** employs a covered call strategy based on a well diversified global dividend portfolio. Dividends are still seeing tail winds, lead by stimulus and the reopening trade. Monetary authorities are keen to keep stimulus going so policy continues to play a huge role. Options strategies require a certain amount of liquidity, so ZWG skews towards to large cap blue chip companies with sustainable dividends.

Short End Positioning in Fixed Income

The yield curve is steepening in US and Canada, but the front end has been stable which means yields have been flat on the short end. This is driven by the Fed's and the Bank of Canada's commitments to keeping overnight rates locked in at 0.25% for the next 12-24 months. Uptick in yields are more meaningful around the 5 year mark. Short end is a good spot to park assets but there is not much yield here.

Clean Energy Update

We are seeing a pull back in clean energy companies, around 30% since January. We believe this presents a buying opportunity. Clean Energy will be a multi-year trend and this trend is not going anywhere. Renewables are currently 25% of electricity, and we are expecting this to go to 55% over the next 30 years. These aggressive targets will require significant investment. We can feel comfortable that this is a megatrend that will be significant and meaningful on long term basis. It is always hard to time entry points, especially in asset classes with higher volatility profiles such as clean energy. Clean energy has higher volatility exposure but with this comes along the potential for higher returns. Investors need to look at time horizon and risk tolerance, if they can check these boxes, clean energy could be a useful satellite to fill out a growth sleeve of a portfolio, especially at current valuations. The longer time you have the better odds with this trade. Canadian renewables are near a 5-year valuation metric…so for long term investors ZCLN interesting as a satellite vehicle.

Source: Bloomberg, All returns and data points March, 2021.
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