

Views from the Desk

Updates in the Equity and Fixed Income Market

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Fixed Income Update

August was quiet in the Canadian fixed income market. Corporate spreads tightened a bit. The yield curve is steepening which could be a sign of inflation expectations. We think the quality trade is wise to protect on the downside as we enter the fall where credit could face some headwinds. Mid-term or long-term government bonds would work as a flight to quality trade, ETFs such as the **BMO Mid Federal Bond Index ETF (ZFM)** or the **BMO Long Federal Bond Index ETF (ZFL)**. Provincial spreads remain a bit elevated vs pre pandemic levels so we could see further spread compression here, and provincials add additional yield over federals. The **BMO Mid Provincial Bond Index ETF (ZMP)** or the **BMO Long Provincial Bond Index ETF (ZPL)** would be a good trade in this space. The **BMO Government Bond Index ETF (ZGB)** is a one-stop shop for exposure to federals and provincials and is one of our fastest growing ETFs right now. The Bank of Canada purchasing program will provide a safety net for federal and provincial bonds so spreads here should remain range bound, and the benefit to adding duration is the yield pickup.

Emerging Market Bonds

The **BMO Emerging Market Bond ETF (ticker ZEF)** which provides exposure to EM debt is an ETF we are hearing a lot about right now. For clients who have yield needs, ZEF can be a good solution. ZEF is emerging market debt issued in USD, with durations from 1-10 years. The USD is currency hedged. The bonds must pass liquidity screens, so they are very liquid. There are four regions in the portfolio: Eastern Europe, Middle Eastern Africa, Asia, and Latin America. The portfolio uses a GDP weighting methodology which allocates more to countries with strong GDP and have a stronger ability to grow and service debt. This creates a quality screen within the portfolio which adds downside protection. ZEF is 70% investment grade and 30% high yield. With yields historically low, ZEF can provide yield enhancement, (current yield to maturity is 2.7%). ZEF has a low correlation with the Canadian fixed income universe, so can be a good diversifier to reduce overall portfolio volatility.

The Dow Jones Index Rebalances

This index is made up of true mega-cap, industry leaders which are exposed to global consumers. This is a price-weighted index, so it is the equivalent of owning one stock of each of the 30 names in the index. Apple's stock split therefore affected its constitution. Apple was the largest component, about 12% weight before it split, and now it is a 3% weight. ExxonMobil was replaced with Salesforce, as the index looked to trade out an Energy name and add another Tech name to keep the Tech weight up after dropping 9% once Apple split. Raytheon and Pfizer also left, and Amgen and Honeywell have been added. Sector weights- Tech did still come down a bit from 28% to 24% and Health Care went from 14% to 18%. **The BMO Dow Jones Industrial Average Index ETF (ticker ZDJ)** provides exposure to the Dow Jones Index.

Currency

Throughout March we continued to see the USD weakening. This trend is expected to continue based on stimulus and monetary easing all putting downward pressure on USD. What does this mean for CAD? CAD is dependent on commodity prices. If industrial metals increase in value, there will be some strengthening relative to USD. In 2008, the USD really weakened with QE, and CAD was propped up by strong gold and oil prices. Canada also did not use QE during this time. Oil prices are not as strong this time around. The outlook is a bit mixed for CAD. The US election could affect the USD. Trump policies prop it up but Biden has a softer approach to USD policies, so we will see how this plays out.

Update on Quality

The Quality trade performed very well through August and specifically the **BMO MSCI USA High Quality Index ETF (ZUQ)** outperformed broad-based US equities during this period. We added currency hedged (**ZUQ.F**) and USD (**ZUQ.U**) options for this ticker during summer. ZUQ.F returned 8% in August which was over 2% more than the unhedged ZUQ as the USD depreciated relative to CAD. We continue to recommend the quality trade through the fall as we face a period of uncertainty with the US election, and a heightened focus on the economic recovery. Remember, one factor in the quality screen is low levels of debt and we think there will be a lot of strain on balance sheets moving forward.

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