Views from the Desk

Updates in the Equity and Fixed Income Market

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Correction in Tech Stocks

The sell-off in tech stocks started on September 2nd and the tech-heavy NASDAQ 100 Index dropped 11% since this date. The average trailing P/E for the NASDAQ is around 20-25 (NASDAQ has a heightened P/E vs other indexes). Recently, its forward P/E hit almost 35, which indicated it was overbought. The P/E is recently 31, which is still its historical average, which could indicate a correction will continue. The sell-off was concentrated in the FAANGs, and in levered names such as Tesla, Nvidia and Zoom. The S&P 500 Index was down much less during this sell-off, given its more diversified sector exposures, but was still affected. We believe this is a healthy correction, and not a rotation out of tech names, and we believe the companies in the NASDAQ are still some of the very best in the world. The NASDAQ is up 22% this year, so these names are still strong and this does not change our long-term outlook on these stocks.

Defensive Growth in Equities This Week

The US quality exposure has a 20% overweight to tech. The **BMO MSCI USA High Quality Index ETF (ticker: ZUQ)** was down 6.3% this week vs the S&P 500 Index which was down 5.6%. But the construction of the quality exposure finds businesses with distinct fundamental strengths which can weather a short-term correction. For example, ZUQ does not hold ZOOM or Tesla which are more leveraged. Other sectors in ZUQ are also outperforming the NASDAQ. Our Low Vol exposure **the BMO US Low Volatility ETF (ticker: ZLU)** outperformed the S&P 500 by 3% this week. So, the low vol and quality combo is working well, and we continue to believe defensive growth is a great place to be.

Flows to Aggregate Fixed Income

We saw strong retail and institutional flows into aggregate bond products such as the **BMO Aggregate Bond Index ETF (ticker: ZAG)**. This was driven mostly by investors who have been sitting on cash for months who couldn't handle any more performance drag. Investors are realizing that they can no longer be sitting on the sidelines, so they are moving out of money market investments and into ZAG. Aggregate bonds are a simple and easy way for investors to stay invested while providing protection heading into the uncertainties that the market faces this fall. Aggregate bonds are a diversified exposure to the Canadian fixed income market, provide downside protection, and generate more yield than cash.

Flows into Corporate Bonds

Last week, we saw a lot of inflows into the **BMO Corporate Bond Index ETF (ticker: ZCB)**. The flows into corporates are a "search for yield" trade. We are in a period of historically low rates. Credit spreads have returned to near historical levels: Financials are around pre-covid levels (very tight) while Real Estate and Energy spreads are still quite wide. In maturities that are under 7 years duration we have seen significant spread tightening as well, thanks to the BoC bond buying programs. In the Canadian credit market, we will probably see some new issuance this month which we haven't seen all summer. This could widen spreads and increase secondary market trading. We think investors could cash in on their summer profits in the credit space and move into a higher quality asset base, quality bonds which are rated A and above, such as the **BMO High Quality Corporate Bond Index ETF (ticker: ZQB)** if you want to stay invested in credit. For investors who want to get out of credit altogether, the **BMO Mid Provincial Bond Index ETF (ticker: ZMP)** or the **BMO Government Bond Index ETF (ticker: ZGB)** are good solutions as a "flight-to-safety" trade into government bonds. The pure provincial play will provide additional yield over federals and both will provide some added duration exposure while offering less torque than we see in corporates. The government exposure will provide protection if volatility picks back up.

ZEM and Emerging Markets

It is important to stay balanced in your overall portfolio asset allocation, and investors still need equities to provide portfolio growth. This is where the **BMO MSCI Emerging Markets Index ETF (ticker: ZEM)** really fits in. The US has been the darling of the equity market for many years now and has been strong again this year. But we need to find other sources of return beyond the US. The other broad beta indexes such as those in Canada and EAFE have not been so impressive in terms of performance, both being down 1-2% on the one year. However, ZEM is up 10% over the past year, beating the other regions' broad beta indexes. The returns reflect the changing exposure of Emerging Markets. 20 years ago, these were countries who were in their early stages of development, and had concentrated sector exposures in resources, energy, and materials. The sector makeup of the index is very different now. Today, emerging markets have a very strong consumer base, and return drivers by sector have been Consumer Discretionary and Tech. China has lots of tech exposure. Regionally, China makes up 40% of the EM index and this will likely go higher as A shares become more incorporated. China is a global powerhouse and the strongest driver of returns for emerging markets YTD. Emerging markets are a good diversifying exposure to pair with US equities. The CPP went on the record and said they want a third of their portfolio in EM. A third is not appropriate for retail, but the pension interest is an indicator that investors should certainly be looking to this space to add long term growth to portfolios beyond US equities.

Flows- Outflows from Financials

We are still constructive on Canadians banks. August was good for Canadian banks. The **BMO Equal Weight Banks Index ETF (ticker: ZEB)** was up 9% in August. In general, Canadian earnings were positive and we saw earnings surprises to the upside and lower provisions for bad loans. When you look at a 2-year recovery path, this is an attractive exposure. The Canadian banks average dividend yield is 5%. Buying at this valuation is an attractive level; the long-term average is 4%. If you are assuming a recovery, the numbers are on your side: you're collecting a strong dividend yield while you are waiting for the sector and the economy to recover.