BMO ETF Portfolio Strategy Report

First Quarter 2022 | BMO EXCHANGE TRADED FUNDS

2022 ETF Positioning

Alfred Lee, CFA, CMT, DMS
Director, BMO ETFs
Portfolio Manager & Investment Strategist
BMO Asset Managment Inc.
alfred.lee@bmo.com

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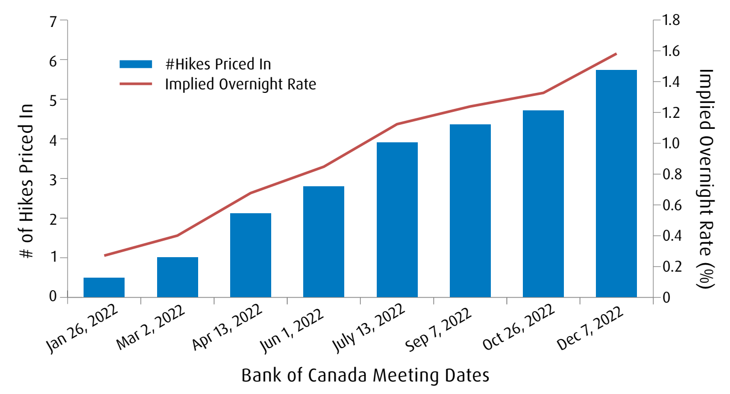
All prices, returns and portfolio weights are as of market close on December 31, 2021, unless otherwise indicated.

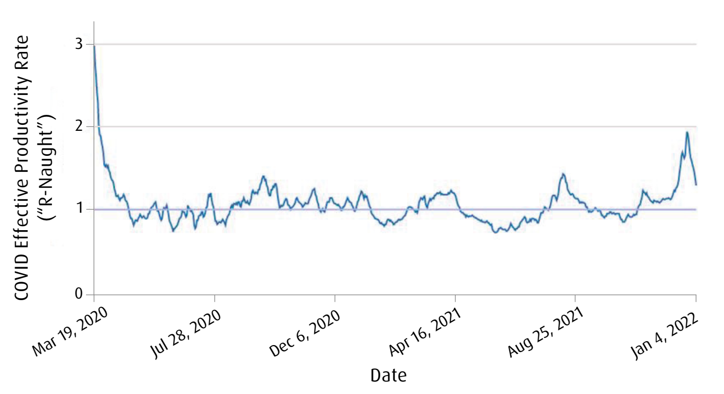
- **Happy New Year! And just like that, another year has passed.** While the coronavirus pandemic was, yet again, another overhang on the global economy and our personal lives, equity markets remained unscathed, with the MSCI World Index delivering a 21.2% total return (in Canadian dollars) on the calendar year. We anticipate many market forces will be at play in 2022, especially over the first half, as inflation, rising rates and policy response to ongoing COVID-19 developments will drive markets. In addition, equity market returns tend to be more moderate during U.S. mid-term election years.
- **Despite the sell-off in March of 2020, equities have trumped all other asset classes for the last decade.** Although we still favour stocks over bonds in 2022, we believe rising interest rates will present some headwinds in the early part of the year. While we remain constructive on equities, investors should temper expectations from the 20%-plus returns we saw from both the S&P/TSX Composite and the S&P 500 Composite last year.
- **Depending on how inflation persists, central bankers may have a difficult decision to make as the year progresses.** A balancing act must be maintained, as higher interest rates will better be able to tame inflation, but will choke off the economic recovery. Currently, the futures market is pricing in five rate hikes by the Bank of Canada (BoC) and three by the U.S. Federal Reserve (Fed) over the course of this year.
- **The current market assumptions of five rate hikes by the BoC would mean that the central bank would have to raise rates five times in their eight meetings throughout the year (Chart A).** We believe it's unlikely we get the implied overnight rate of 1.5% in Canada, as there are too many uncertainties that can transpire. For example, the current lockdowns that were unpopularly imposed by many provinces will likely slow down economic activity. It is possible, however, that the BoC can implement more than quarter point moves, which they did during the late 1970s when inflation was previously an issue.
- **Due to tighter monetary conditions, it is likely that economic growth will be sluggish, at least over the first quarter.** The current year-over-year GDP growth rate is 3.8% in Canada and 4.9% in the U.S. This means that there is room to spare, as current growth rates were unsustainable. Investors that were overweight growth may want to consider rebalancing their portfolios by lightening up on the gas. Instead, investors may want to favour defensive-oriented equities, such as quality stocks for global and U.S. exposure, and low-volatility equities for Canadian exposure.
- **The one catalyst that we believe can drive markets higher in the face of tapering is a shift on the part of policy-makers towards treating COVID-19 as an endemic rather than a pandemic.** This would mean the move away from the rolling lockdowns and a path towards some semblance of normalcy. The recent shift of hospitals to focus on treatments, such as the anti-viral pills from Merck and Pfizer and potential technologies from Regeneron, should be seen as a positive, and could potentially help drive the effective reproduction number of the virus (its "r-naught") well below 1.0 (Chart B). Capital expenditure on treatments would also allow policy-makers to shift their focus towards ICU and death rates as the key metric, rather than case counts. Such a move would be seen as a move towards an endemic phase.

Chart A: Hawkish Expectations of the BoC



Source: Bloomberg (January 6, 2022, calculated using Overnight Index Swaps – OIS).

Chart B: Treatments Could Help Us Fight COVID



Source: COVID-19.Ontario.ca; reproduction Rate "R-naught" is a measure of how many people one person infects.

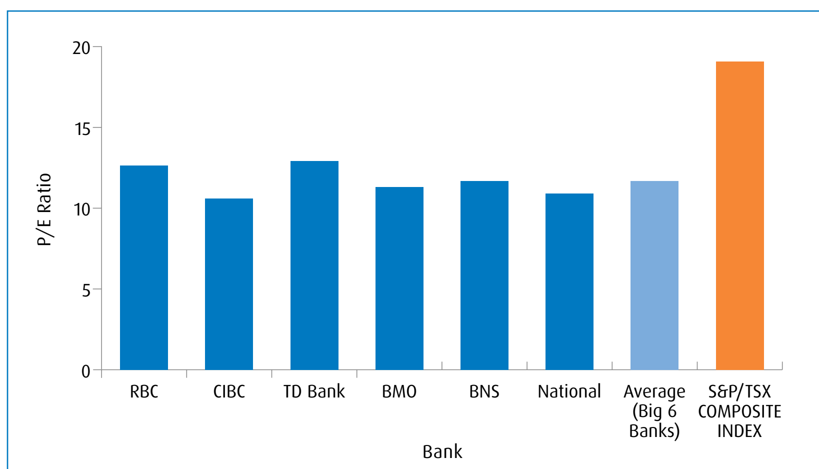
Things to Keep an Eye On

Generation (Year Born)	% of Population	% of Wealth Owned
The Greatest Generation (Before 1928)	0.52%	
The Silent Generation (1928 - 1945)	6.36%	0.8%
The Baby Boomer's (1946-1964)	21.19%	80.0%
Generation X (1965-1980)	19.85%	15.8%
Millenials (1981-1996)	21.97%	3.4%
Generation Z (1997-2012)	20.46%	
Generation Alpha (After 2012)	9.65%	
Total	**100.00%**	**100.0%**

Source: Statista 2020.

While we envision equities to face more challenges this year compared to last, we are bullish on stocks over the long run. Over the next two decades, aging baby boomers are expected to distribute their wealth to the next generation. According to *The Wall Street Journal,* it is anticipated that over US$30 trillion in assets will be passed to the next generation, setting up the greatest wealth transfer in history, which is already underway. Furthermore, given that Generation X is a smaller cohort than the Baby Boomers, the wealth will be eventually transferred in a ratio of more than 1:1.

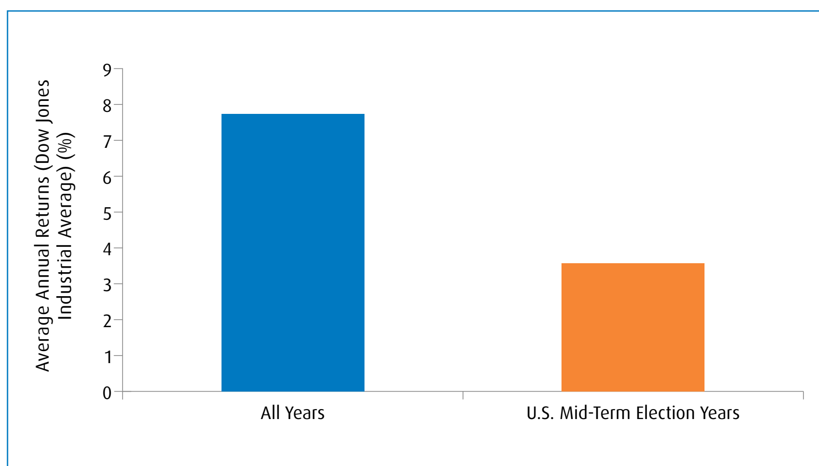
Recommendation: The transfer of wealth will mark a shift in investment assets to a younger generation, which, given the longer life expectancy, will mean a pivot towards growth assets such as equities. In addition, Generation X will enter its peak earning and spending age, meaning wealth will be driving the economy rather than being accumulated. This should be supportive of both equities and also higher interest rates over the long run. As a result, we believe an overweight towards equities is warranted, particularly for those investors that are looking to accumulate wealth.



Source: Bloomberg, BMO Global Asset Management, as of December 31, 2021 (current P/E ratios used).

As mentioned, we believe that five rate hikes by the BoC this calendar year may be an aggressive target. Many developments can easily take a few rate hikes off the table and postpone them into the future. As a result, the recent rise in rates may be too "front-loaded," and we may see higher rates transition further down the yield curve as the year progresses. This would mean that the recent flattening of the yield curve may revert to a "bull steepener," where rates move lower on the short term and higher on the long end. All else remaining equal, this should be supportive of banks, as banks are in the practice of borrowing on the short end and lending on the long end.

Recommendation: Even in the absence of a steeper yield curve, Canadian banks currently have many tailwinds in their favour right now. Despite the recent move back to COVID-driven lockdowns or restrictions in some provinces, economic activity is picking up, which means increased demand for loans, credit and mortgages. Furthermore, the Canadian banking sector has a current price-to-earnings (P/E) ratio of 11.5x, which represents a more attractive valuation than the overall 19.2x of the S&P/TSX Composite Index. Investors can access the big six Canadian banks through the ***BMO Equal Weight Banks Index ETF (ZEB).***



Source: Bloomberg, BMO Global Asset Management (Dow Jones Industrial Average annual price returns, 1898-2021).

In early November, the U.S mid-term elections will see all 435 seats of the House of Representatives and 34 of the 100 seats in the Senate contested. This typically is a drag on equity markets, as it creates uncertainty. Based on data from NBC and FiveThirtyEight, since 1946, the first mid-term of a U.S. president sees the current administration lose on average 29.4 seats. In fact, since World War 2, the only president to not lose seats was George W. Bush, who emerged with an approval rating of over 60, when the country rallied behind him in the wake of 9/11.

Recommendations: As mentioned, over the long secular term, we are bullish on equities, particularly as rising rates will be more problematic for fixed income. It should be noted, however, that Republicans can reclaim the House with just five seats. Typically, when a president has an approval rating in the 40s, which applies to President Biden, an average of 43 seats are lost. We believe a division of power is a positive, as it brings more bipartisanship; however, it can also create gridlock. The ***BMO MSCI All Country World High Quality Index ETF (ZGQ)*** allows investors to access efficient exposure to blue-chip companies from around the world that can generate profit, regardless of market environment.

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Long-Term US Treasury Bond Index ETF	ZTL	2.0%	BMO Short-Term US TIPS Index ETF (Hedged Units)	ZTIP.F	2.0%

Asset Allocation:

- Although we are not making any changes to our asset allocation mix this quarter, we would stress the importance of being overweight equities at least in the first and second quarter. In the last several months, central banks from around the world have changed their tune on inflation, now recognizing what the market has realized all along: that higher prices have not been "transitory" in nature. Guidance by a number of the G7 central banks has recently become more hawkish, outlining plans to raise rates in the very near future. Inflation and rising rates will likely place headwinds on the fixed income market.
- Although rising rates will present some challenges to certain areas of the equity markets, we believe that economic growth will still be a positive for stocks over the course of the year. The removal of liquidity, through the Fed's tapering of its asset purchase programs, will not be good for growth stocks, but less cyclical-oriented stocks should still fare well. There will be some additional challenges this year compared to the last. One major catalyst that can really provide a lift to risk assets like equities is if one of the major governing bodies, such as the World Health Organization (WHO), declares that COVID to has reached an endemic state. This would finally put an end to the pandemic, which is closing in on two years. The highly contagious, but less lethal, Omicron variant potentially allows the global population to finally build "herd immunity." A declaration by WHO could provide a similar lift to equities as the November 2020 vaccine-driven "reopening" trade. As a result, we will remain overweight to equities, as the asset class will likely outperform, whether or not COVID continues.

Fixed Income:

- As mentioned, fixed income may find itself in a challenging spot this year. Should the pandemic continue and policy-makers choose to chase the unattainable "zero-COVID" policy, periodic lockdowns will place further pressure on global supply chains. This would mean inflation would continue to tick higher or at least remain elevated. Central banks would then be forced to become more hawkish, raising rates and putting pressure on the bond market. On the flipside, if COVID becomes endemic and the economy truly reopens, demand will place upward pressure on interest rates, also putting pressure on fixed income. We believe the market has become too hawkish in terms of the pace of rate hikes, which may mean a steepening of the yield curve, suggesting the short end of the curve may provide better safety.
- We believe the demand for corporate credit will continue to outstrip supply, which is why we continue to overweight investment credit through the ***BMO Mid-Term US IG Corporate Bond Index ETF (ZIC).*** In our view, inflation will continue to run hot at least through the first two quarters of the 2022. Moreover, the current two-year breakeven rate of 3.2%, remains a low enough hurdle for the U.S. consumer price index (CPI) to overshoot. We will thus shift 2% from our ***BMO Long-Term US Treasury Bond Index ETF (ZTL)*** in order to add to the ***BMO Short-Term US TIPS Index ETF (Hedged Units) (ZTIP.F).*** This will allow us to get better inflation protection through Treasury Inflation Protected Securities (TIPS)and increase our exposure to the short end, which may see rates rise less than the long end.

Equities:

- We believe our equity positioning remains relevant in the current environment. Our core exposure remains in defensive, growth-oriented exposures, such as the ***BMO Low Volatility Canadian Equity ETF (ZLB)*** and the ***BMO MSCI USA High Quality Index ETF (ZUQ).*** As previously mentioned, we believe rising rates will be a drag on high-growth areas, such as technology; however, our tactically positioned, sector-based exposures are well positioned in both a pandemic or endemic state. Canadian and U.S. banks, represented by the ***BMO Equal Weight Banks Index ETF (ZEB)*** and the ***BMO Equal Weight US Banks Index ETF (ZBK)*** respectively, are both undervalued and tend to benefit from a steepening yield curve. Our exposure in the ***BMO Equal Weight REITs Index ETF (ZRE)*** may benefit from an eventual reopening, while the ***BMO Equal Weight US Health Care Hedged to CAD Index ETF (ZUH)*** is a play on the long-term secular trend of aging demographics.

Non-traditional/Hybrids:

- We remain constructive on both Canadian and U.S. preferred shares. Both provide diversification benefits to traditional stocks and bonds, yet are unique in their return characteristics. The ***BMO Laddered Preferred Share Index ETF (ZPR)*** provides a hedge against rising interest rates, given its exposure to rate resets. The ***BMO US Preferred Share Hedged to CAD Index ETF (ZHP),*** provides stability and yield, as a large number of issues are expected to be called at par and refinanced at tighter credit spread levels.

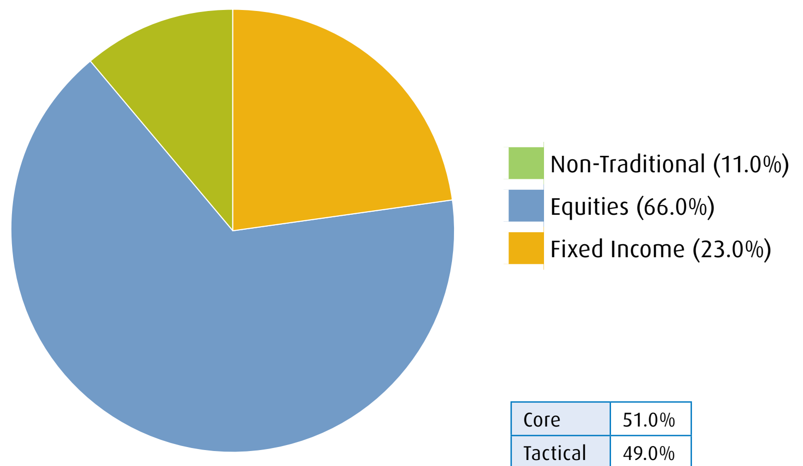
Stats and Portfolio Holdings

Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographies to achieve long-term capital appreciation and total return by investing primarily in ETFs.

Ticker	ETF Name	Sector	Position	Price	Management Fee*	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)**	Yield/ Vol
	Fixed Income									
ZDB	BMO DISCOUNT BOND INDEX ETF	Fixed Income	Core	$16.41	0.09%	9.0%	5.7	4.8%	2.2%	0.38
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.92	0.25%	6.0%	8.4	4.7%	3.5%	0.41
ZTIP.F	BMO SHORT-TERM US TIPS HEDGED TO CAD INDEX ETF	Fixed Income	Tactical	$31.18	0.15%	5.0%	2.1	1.0%	0.4%	0.18
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	Fixed Income	Tactical	$55.54	0.20%	3.0%	4.8	1.3%	2.4%	0.50
	Total Fixed Income					23.0%		11.8%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$40.11	0.35%	17.0%	8.9	14.1%	2.4%	0.27
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	Equity	Tactical	$27.24	0.05%	4.0%	14.2	5.3%	4.0%	0.28
ZLU	BMO LOW VOLATILITY US EQUITY ETF	Equity	Core	$46.22	0.30%	8.0%	11.3	8.4%	1.8%	0.16
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$25.93	0.40%	7.0%	9.6	6.2%	2.3%	0.24
ZEO	BMO EQUAL WEIGHT OIL & GAS INDEX ETF	Equity	Tactical	$47.87	0.55%	4.0%	21.0	7.8%	3.3%	0.16
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	Equity	Tactical	$79.83	0.35%	4.0%	15.6	5.8%	0.3%	0.02
ZEB	BMO EQUAL WEIGHT BANKS INDEX ETF	Equity	Tactical	$39.90	0.55%	6.0%	11.7	6.5%	3.1%	0.27
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	Equity	Core	$60.96	0.30%	10.0%	16.0	14.9%	0.8%	0.05
ZBK	BMO EQUAL WEIGHT US BANKS INDEX ETF	Equity	Tactical	$37.64	0.35%	6.0%	24.1	13.4%	1.9%	0.08
	Total Equity					66.0%		82.5%		
	Non-Traditional/Hybrids									
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	Hybrid	Tactical	$11.66	0.45%	5.0%	6.6	3.1%	4.7%	0.72
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$24.05	0.45%	6.0%	4.7	2.6%	5.5%	1.16
	Total Alternatives					11.0%		5.7%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.32%**	**100.0%**	**10.8**	**100.0%**	**2.5%**	**0.23**

Please note yields of equities will change from month to month based on market conditions.
The portfolio holdings are subject to change without notice and only represent a small percentage of portfolio holdings.
They are not recommendations to buy or sell any particular security.

Ticker	Name	Weight
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	17.0%
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	10.0%
ZDB	BMO DISCOUNT BOND INDEX ETF	9.0%
ZLU	BMO LOW VOLATILITY US EQUITY ETF	8.0%
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	7.0%
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	6.0%
ZEB	BMO EQUAL WEIGHT BANKS INDEX ETF	6.0%
ZBK	BMO EQUAL WEIGHT US BANKS INDEX ETF	6.0%
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%
ZTIP.F	BMO SHORT-TERM US TIPS HEDGED TO CAD INDEX ETF	5.0%
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	5.0%
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	4.0%
ZEO	BMO EQUAL WEIGHT OIL & GAS INDEX ETF	4.0%
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	4.0%
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	3.0%



Core	51.0%
Tactical	49.0%

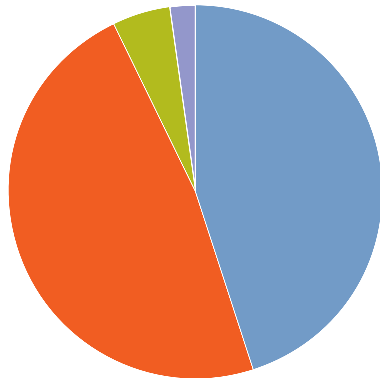
Source: Bloomberg, BMO Asset Management Inc., as of December 31, 2021.

*Management Fee as of December 31, 2021.

**Yield calculations for bonds is based on yield to maturity, which includes coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity and for equities it is based on the most recent annualized income received divided by the market value of the investments.

Portfolio Characteristics

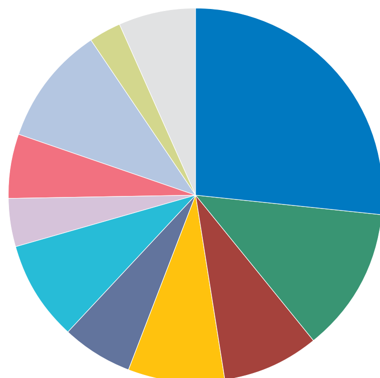
Regional Breakdown (Overall Portfolio)



Region	%
Canada	45.0%
United States	48.0%
Europe	4.9%
Asia	2.1%

*Regional Breakdown includes equities, fixed income and non-traditional/hybrid sleeves.

Equity Sector Breakdown



Sector	%
Financials	26.92%
Health Care	12.44%
Consumer Staples	8.40%
Utilities	8.26%
Industrials	5.95%
Information Technology	8.75%
Consumer Discretionary	4.20%
Communication Services	5.59%
Real Estate	10.13%
Materials	2.92%
Energy	6.44%

Fixed Income Breakdown

Category	%
Federal	48.3%
Provincial	14.5%
Investment Grade Corporate	37.3%
Non-Investment Grade Corporate	0.0%

Characteristic	Value
Weighted Average Term	12.01
Weighted Average Duration	9.54
Weighted Average Coupon	2.21%
Weighted Average Current Yield	2.07%
Weighted Average Yield to Maturity	1.79%

Weighted Average Current Yield: The market value weighted average coupon divided by the weighted average market price of bonds.

Weighted Average Yield to Maturity: The market value weighted average yield to maturity includes the coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity.

Weighted Average Duration: The market value weighted average duration of underlying bonds divided by the weighted average market price of the underlying bonds. Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates.

The portfolio holdings are subject to change without notice and only represent a small percentage of portfolio holdings. They are not recommendations to buy or sell any particular security.

Source: Bloomberg, BMO Global Asset Management, as of December 31, 2021.

The Good, the Bad, and the Ugly

Conclusion: Central banks tightening monetary policy, persistent inflation, the ongoing COVID pandemic, developments in China and the U.S. mid-terms are the main risks that equities face this year. Fed tapering and steepening yield curves will cause investors to rotate out of high-growth areas and into more defensive-oriented equities. We are constructive on equities this year, but we expect returns to be more moderated compared to last year. The one caveat, however, that can supercharge the stocks markets is a global authority, such as the WHO, declaring COVID to be endemic. We continue to see higher rates ahead in most scenarios. For example, a continuation of the same pandemic policy responses, such as lockdowns, would further stress supply chains and keep inflation high. However, COVID being declared endemic could cause the economy to thrive, putting upward pressure on rates. As such, we believe equities will present better risk/reward than bonds in 2022.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• A growing number of countries adopting the "live with COVID" model and opening up their economies will also help normalize the current situation. • GDP rates remain high in many countries, providing some leeway for central banks to raise rates. • Unemployment continues to trickle down in the U.S., and Canada has claimed that it has restored all of its jobs lost to COVID.	• A deviation in the performance differences between equity factors is good evidence that the markets continue to normalize. • Many companies have experienced earnings growth over the last several quarters, which was critical in justifying some of the lofty equity prices we've been seeing. • Some of the recent market softness could be healthy, to allow sales and earnings to catch up with prices.	• While equities continue to perform well, the recent outperformance of defensive growth strategies is a good sign that shows the markets are normalizing and some of the excessive risk taking is abating. • Equity markets have exhibited continued momentum with shorter-term averages staying well above longer-term averages.
Bad	• Inflation is a growing concern, but central banks are now at least recognizing its no longer "transitory." • If central banks overshoot their monetary tightening without calming inflation, stagflation may be an outcome. • If Omicron isn't near the end of the pandemic, civil unrest may become a problem, as COVID fatigue is on the rise.	• Valuations of higher-growth stocks have become rich. Earnings need to catch up, which may be difficult with higher rates ahead.	• The US dollar continues to exhibit strength, which will be a headwind for goldbugs; however, inflation may eventually provide a lift for gold stocks.
Ugly	• Household debt in Canada is still one of the main concerns, which can be a problem with higher rates to come.		• Margin debt is still one of the key contributors to how quickly risk assets can rise and fall. The Archegos fiasco is an example of misuse of leverage.

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The viewpoints expressed represents herein is our assessment of the markets at the time of publication. Those views are subject to change without notice as markets change over time.

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