BMO ETF Portfolio Strategy Report

Second Quarter 2021 BMO EXCHANGE TRADED FUNDS

Slow and Steady Wins the Race

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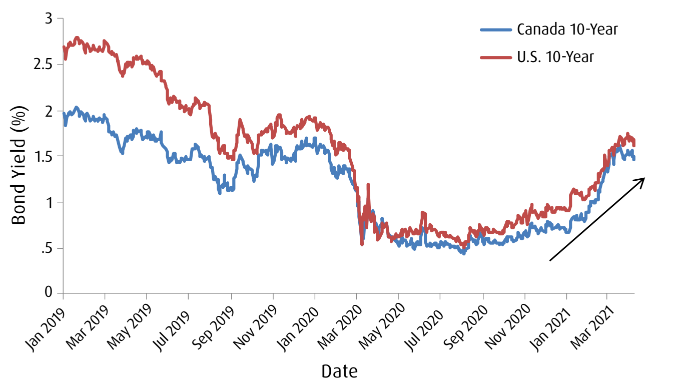
In this report:

All prices, returns and portfolio weights are as of market close on April 9, 2021, unless otherwise indicated.

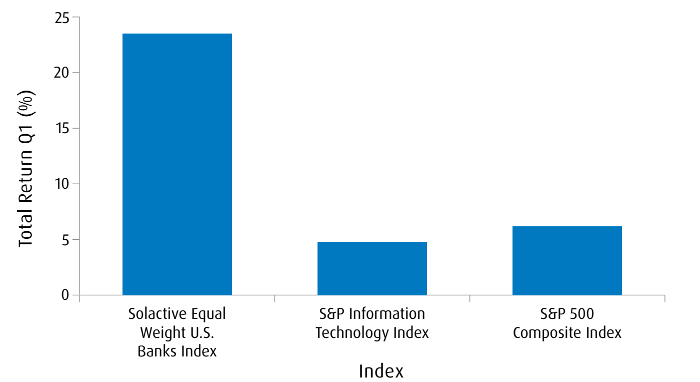
- **Rising bond yields have been the main concern weighing on markets in recent months.** Already this year, the U.S. 10-year has gained 82bps to 1.73%,[1] while the Government of Canada 10-year has increased 89bps to 1.57%.[2] Short-term rates, on the other hand, have remained extremely stable as central banks have implied that rates will stay low until there is clear evidence that the economy is standing on its own two feet.
- **In recent weeks, we have seen a natural leveling off of bond yields.** This has been due to investors seeing value in fixed income and thus reallocating from equities. In addition, higher yields have likely attracted foreign buyers and institutions, particularly liability matchers. However, as economies gradually re-open over the next several quarters, and we progressively move back to a "normal" life in the second half of 2021, we do anticipate 10-year yields to eventually move higher again and likely end the year above 2.0% (Chart 1).
- **However, we believe there is a limitation in terms of the level of bond yields.** Rates moving too high and too quickly would dampen the demand for loans and mortgages, potentially unhinging the economic recovery. If bond-buying activity is not enough to naturally provide a ceiling to yields, the U.S. Federal Reserve (Fed) can step in to initiate an "Operation Twist," in order to flatten out the yield curve as they did in 2012.
- **While a negative for bond investors, a steepening of the yield curve has created opportunities for those taking more of a tactical approach.** Higher rates have led to higher dispersion amongst certain equity factors in the month of March. Stronger growth areas faced headwinds, as some investors were likely met with greater margin requirements, which led a rotation back into low volatility stocks. In addition, while technology faced some struggles, U.S. banks have been a benefactor of a steeper yield curve. We continue to favour U.S. banks in this environment, while the recent declines in the tech sector may create opportunities particularly for the larger cap companies in the space (Chart 2).
- **The elevated price-to-earnings (P/E) ratios of the broader equity market suggest the reopening of the economy has been priced in.** While forward P/E ratios look more reasonable, the success of the vaccine rollout is imperative in allowing companies to return to normal and capitalize on pent-up demand.
- **While we do believe equities will notably outperform bonds over the year, we expect the pace to subside compared to the first quarter.** Low short-term rates discouraged investors not to be in cash, which has led to the rich valuations of the equity market. Lower bond prices and areas such as value stocks may now provide additional opportunities for investors to rotate into until we see earnings expansion justify the valuations of the broader market in the second half of the year. Staying disciplined will be important for the long-term success of investors.

Chart A: 10-Year Bond Yields to Rise Through 2021 as Economy Rebounds



Source: Bloomberg, as of April 9, 2021.

Chart B: U.S Banks Continue to Gain as Yield Curve Steepens

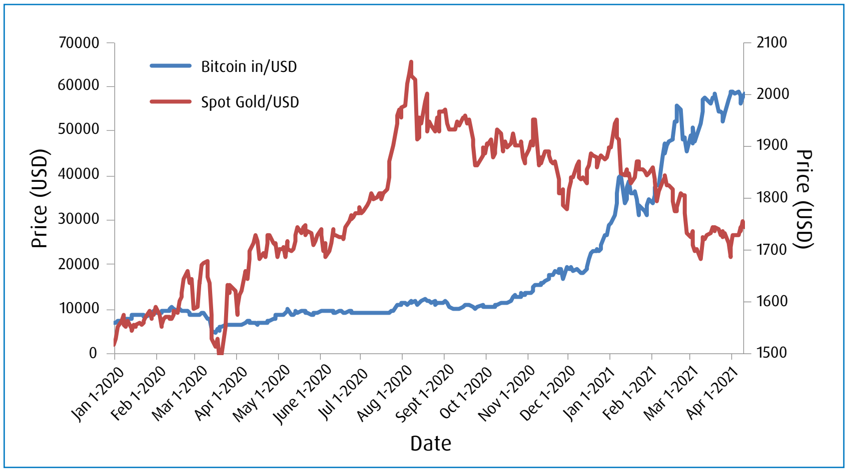


Source: Bloomberg, as of March 31, 2021.

[1] U.S. Department of The Treasury
[2] Bank of Canada

BMO Exchange Traded Funds

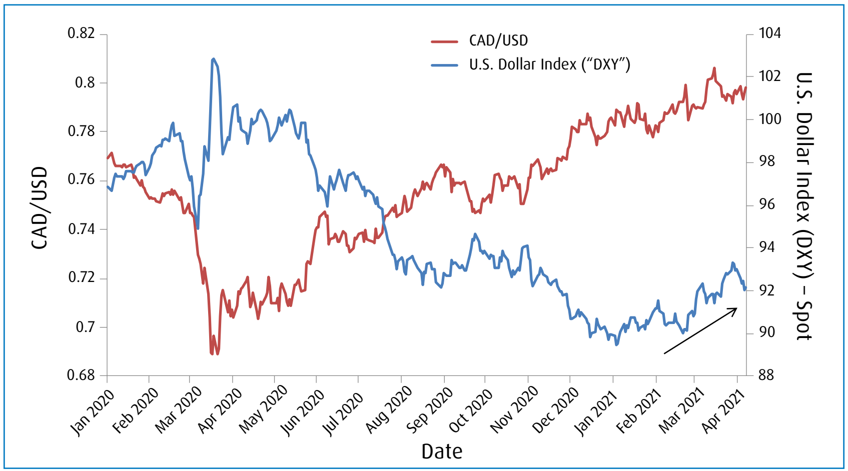
Things to Keep an Eye On



Source: Bloomberg, as of April 9, 2021.

Although gold had a significant run-up at the early stages of the pandemic, it has recently faced headwinds. Spot gold, which hit an all-time high of US$2,063/ounce in August last year, was in strong demand given investors were looking to hedge macro-economic risk and also the U.S. dollar, owing to the expansion of the U.S. Federal Reserve's balance sheet. Since the beginning of the year, gold has lost its luster, now trading below US$1,800/ounce. While concerns of inflation remain, investors have become increasingly optimistic of an economic reopening, on the back of the vaccine rollout.

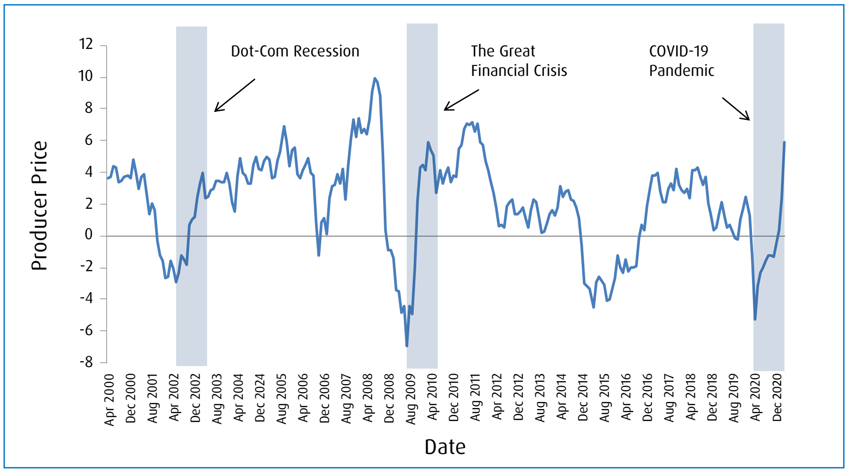
Recommendation: In recent months, a number of institutions have been reportedly looking to pivot away from gold allocations to digital currencies such as bitcoin. So far this year, the price of gold and "digital gold" has almost become inversely correlated. The recent strength of the U.S. dollar is an additional headwind that gold will have to face in coming months. Investors with a longer time horizon may want to take advantage of the recent sell-off and look for a favourable entry point. ***The BMO Equal Weight Global Gold Index ETF (ZGD)*** provides exposure to a diversified portfolio of large-cap gold companies.



Source: Bloomberg, January 3, 2020 – April 9, 2021.

While the U.S. Dollar Index (DXY) has gained year-to-date, it has been largely against the Euro and the Japanese Yen. These gains have been due to an aggressive vaccination plan in the U.S. that has progressed faster than anticipated. As such, investors are optimistic that the U.S. economy will reopen and businesses can capitalize on pent-up demand. While Canada's vaccination program has fallen behind schedule, demand for its basic materials and energy exports has strengthened the loonie.

Recommendation: The Fed's monetary policy has tended to be more liberal than that of its Canadian counterpart. The Bank of Canada (BoC) ending its asset purchase program on schedule is a good example of its prudent practices, which will likely be supportive of the Canadian currency. While we prefer having U.S. dollar exposure in a portfolio, given its ability to partially hedge risk-assets, tactical investors may want to look to hedge U.S. dollar exposure until the Canadian dollar loses momentum.



Source: Bloomberg, April 2000 – March 2021.

Many investors that have denied inflation concerns will point towards the U.S. Consumer Price Index (CPI) at 1.7%,[3] which is well below the Fedís target level of 2.0%. However, the U.S. Producer Price Index (PPI), which is the cost of inputs for domestic producers, has been telling a different story. The PPI experienced its sharpest year-over-year increase since 2009. Anecdotally, there have many examples of supply chain disruptions leading to significant shortages in many industries. Computer chips have been one well documented by financial media, while the sharp rise in lumber prices is another.

Recommendation: While we aren't expecting run-away inflation, producer prices do tend to experience a "base-effect," where there are significant gains coming off market bottoms. These reflationary effects have been evident in the last three recessions. Given the nature of this economic slowdown, we do believe supply shortages and an eventual release of the pent-up demand, will lead short-term breakeven rates to run higher than normal coming out of the slump. Further out we do expect supply/demand imbalances will naturally alleviate. Until then, the ***BMO Short-term US TIPS Index Hedged to CAD Index ETF (ZTIP.F)*** will help investors mitigate reflation risk.

[3] U.S. Bureau of Labor Statistics

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO High Quality Corporate Bond Index ETF	ZQB	5.0%	BMO Short-Term US TIPS Hedged to C$ Index ETF	ZTIP/F	3.0%
BMO MSCI Europe High Quality Hedged to CAD Index ETF	ZEQ	5.0%	BMO Equal Weight Oil & Gas Index ETF	ZEO	4.0%
			BMO Discount Bond Index ETF	ZDB	2.0%
			BMO Equal Weight REITs Index ETF	ZRE	1.0%

Asset Allocation:

- Over the first quarter, our portfolio strategy kept pace with its benchmark (60% S&P/TSX Composite and 40% FTSE/TMX Canada Universe Bond Index). The S&P/TSX Composite Index had a total return of 8.1% over the quarter, where investors were forced out of cash and bonds, and into equities. Despite not adding to equities last quarter, our tactical adjustments within the strategy have paid off. In addition, we did increase our equity weight coming into the fourth quarter last year on anticipation that the vaccine would lead to investor optimism of an economic reopening. Although we believe equities will outperform over the year, the recent uptick in bond yields will likely lead some asset allocators to take a portion of risk off the table this quarter, by rotating back into bonds.

Fixed Income:

- The rise in bond yields over the quarter posed some significant difficulties for fixed income. The FTSE/TMX Canada Universe Bond Index dipped to -5.0% over the quarter. Higher yields in bonds will likely attract not only asset allocators now, but also foreign investors and liability matchers. Consequently, we expect the sell-off in bonds, and consequent rise in yields to take a moderate pace over the next several months before moving higher again as the economy opens up further later this year.

- We do anticipate reflationary pressures to continue to build in the coming months. While we are less concerned about the narrative over the size of central bank balance sheets, we believe supply shortages will be further exacerbated by the demand spike as the economy opens up. Currently, given that demand has been relatively low, it has been more difficult for producers to pass on higher input costs to consumers. This will be made easier once the vaccine rollout allows the economy to return to a more normal state. To hedge against reflationary pressures, we are adding a 3.0% allocation to the ***BMO Short-Term US TIPS Hedged to C$ Index ETF (ZTIP.F).***

- To fund the purchase in ZTIP.F, we are eliminating the 5.0% position in the ***BMO High Quality Corporate Bond Index ETF (ZQB).*** The remaining 2.0% will be allocated to the ***BMO Discount Bond Index ETF (ZDB),*** which provides tax-efficient, broad-based exposure to the Canadian bond market.

Equities:

- Oil prices have made a significant recovery since trading at a negative value a year ago. While much of the anticipated increase in demand is already priced in, the longer crude can sustain these levels, the more positive it would be for higher-cost energy producers such as Canada. Given our core in low volatility strategies, we have little to no exposure to the energy sector. As such, we are adding a 4.0% position in the ***BMO Equal Weight Oil & Gas Index ETF (ZEO).***

- In order to fund the purchase of ZEO, we are eliminated our position in the ***BMO MSCI Europe High Quality Hedged to CAD Index ETF (ZEQ).*** Though we believe ZEQ is well-positioned, we are confident that Canadian equities, particularly energy, is better placed over the coming quarters. The remaining 1.0% allocation will be used to increase our weight in the ***BMO Equal Weight REITS Index ETF (ZRE)*** to 4.0%.

Non-Traditional/Hybrids:

- Canadian preferred shares will continue to experience a number of tailwinds in the coming quarter, such as stronger yields, demand for higher quality assets that generate yield, and continued supply/demand imbalances. The launch of Limited Recourse Capital Notes (LRCN) has structurally changed the preferred share market in Canada, creating much-needed stability. Our position in the ***BMO Laddered Preferred Share Index ETF (ZPR)*** will help mitigate duration risk, should yields continue to move higher.

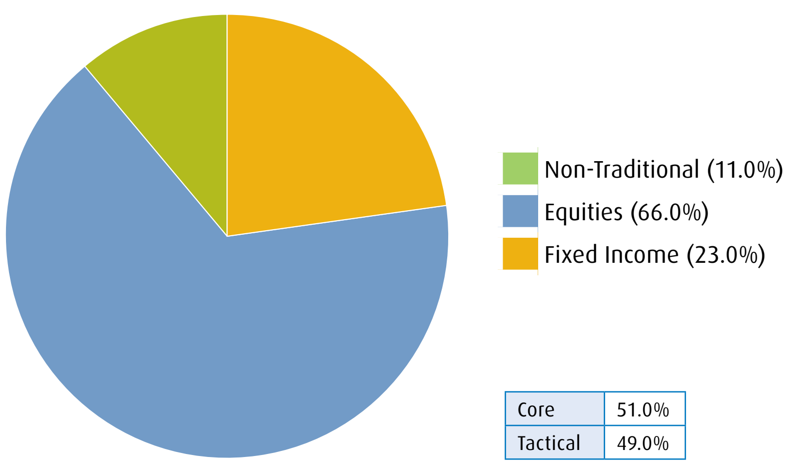
Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographies to achieve long-term capital appreciation and total return by investing primarily in ETFs.

Stats and Portfolio Holdings

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	$16.60	0.09%	9.0%	4.5	3.8%	2.2%	0.48
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.97	0.25%	6.0%	8.1	4.5%	3.7%	0.45
ZTIP/F	BMO SHORT-TERM US TIPS HEDGED TO CAD INDEX ETF	Fixed Income	Tactical	$30.21	0.15%	3.0%	1.9	0.5%	0.4%	0.21
ZTL	BMO LONG-TERM U.S. TREASURY INDEX ETF	Fixed Income	Tactical	$52.87	0.20%	5.0%	4.2	2.0%	2.7%	0.63
	Total Fixed Income					23.0%		10.8%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$37.25	0.35%	17.0%	8.5	13.4%	2.7%	0.31
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	Equity	Tactical	$24.11	0.05%	4.0%	12.8	4.8%	4.6%	0.36
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	Equity	Core	$40.46	0.30%	8.0%	11.1	8.3%	2.0%	0.18
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$24.72	0.40%	7.0%	10.0	6.5%	2.5%	0.25
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	Equity	Tactical	$36.42	0.55%	4.0%	27.0	10.0%	4.2%	0.16
ZUH	BMO EQUAL WEIGHT U.S. HEALTH CARE HEDGED TO CAD INDEX ETF	Equity	Tactical	$74.86	0.35%	4.0%	15.6	5.8%	0.3%	0.02
ZEB	BMO S&P/TSX EQUAL WEIGHT BANKS INDEX ETF	Equity	Tactical	$33.56	0.55%	6.0%	11.0	6.1%	3.6%	0.33
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	Equity	Core	$52.80	0.30%	10.0%	15.0	14.0%	1.0%	0.07
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	Equity	Tactical	$31.97	0.35%	6.0%	27.0	15.0%	2.2%	0.08
	Total Equity					66.0%		83.9%		
	Non-Traditional/Hybrids									
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Hybrid	Tactical	$10.86	0.45%	5.0%	5.1	2.4%	5.0%	0.98
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$24.71	0.45%	6.0%	5.3	2.9%	5.4%	1.02
	Total Alternatives					11.0%		5.3%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.32%**	**100.0%**	**10.8**	**100.0%**	**2.7%**	**0.25**

Please note yields of equities will change from month to month based on market conditions.

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 U.S. EQUITY ETF	8.0%
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	7.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	6.0%
ZEB	BMO S&P/TSX EQUAL WEIGHT BANKS INDEX ETF	6.0%
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	6.0%
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%
ZTL	BMO LONG-TERM U.S. TREASURY INDEX ETF	5.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	5.0%
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	4.0%
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	4.0%
ZUH	BMO EQUAL WEIGHT U.S. HEALTH CARE HEDGED TO CAD INDEX ETF	4.0%
ZTIP/F	BMO SHORT-TERM US TIPS HEDGED TO CAD INDEX ETF	3.0%



Core	51.0%
Tactical	49.0%

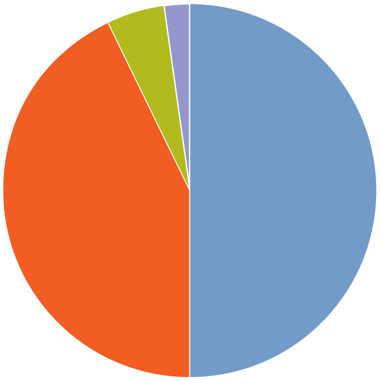
Source: Bloomberg, BMO Asset Management Inc. (As of March 31, 2021).

*Management Fee as of March 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

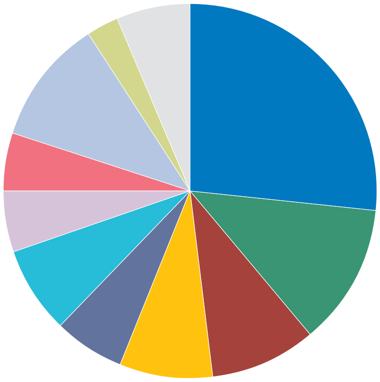
Regional Breakdown (Overall Portfolio)



Canada	50.0%
United States	43.0%
Europe	5.0%
Asia	2.0%

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

Equity Sector Breakdown



Financials	26.71%
Health Care	12.23%
Consumer Staples	9.20%
Utilities	8.11%
Industrials	6.14%
Information Technology	7.44%
Consumer Discretionary	5.24%
Communication Services	5.04%
Real Estate	10.76%
Materials	2.94%
Energy	6.20%

Fixed Income Breakdown

Federal	65.3%
Provincial	19.8%
Investment Grade Corporate	14.8%
Non-Investment Grade Corporate	0.0%

Weighted Average Term	13.32
Weighted Average Duration	10.32
Weighted Average Coupon	1.8%
Weighted Average Current Yield	1.8%
Weighted Average Yield to Maturity	1.6%

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.

Source: Bloomberg, BMO Asset Management Inc. (As of March 31, 2021).

The Good, the Bad, and the Ugly

Conclusion: The rally in equity markets over the past year has led valuations of the broader market to reach near historical highs. While this was partially due to optimism of an economic reopening, it has also been equally driven by low short-term rates, discouraging investors to be in cash. Additionally, the momentum behind equities has caused investors to act on the fear of missing out (FOMO). Given the rise in yields, we do anticipate some investors to take a portion of risk off the table by reallocating to fixed income. However, we do expect equities to continue to outperform, albeit at a more moderate pace this quarter. We encourage investors to stay disciplined, as much of the optimism is already priced in and companies must grow earnings to meet market expectations.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• U.S. unemployment continues to significantly decrease, now at 6.17%.[4] This will likely continue to drift lower as the population is increasingly vaccinated. • The political divide in the U.S. seems to be on the decline since the transition in the White House. • While higher interest rates have wreaked havoc, particularly in the fixed income market, it does indicate better economic health.	• Decreasing correlation amongst and within asset classes has been a positive for investors to add value. In addition, lower intra-market correlations tend to be a positive sign for markets normalizing.	• Put-to-call ratio for U.S. equities is at 0.45, which indicates a balanced market. • Stocks that have been negatively impacted by lockdowns have rallied significantly against those that performed well during those periods.
Bad	• While political unrest is on the decline, civil unrest due to the ongoing lockdowns is on the rise. Riots and protests are becoming more common. • Household debt in Canada is still one of the main concerns, and the recent easing of monetary policy will only intensify this further. This places a limit in terms of how much policy makers can cool the housing market. • The economic backdrop seems primed for inflation to pick up. With the economy reopening and a rise in activity, the velocity of money could potentially increase, leading to higher inflation.	• Equities look expensive at current valuations. The economy must open up in order for earnings to expand and justify these prices. • Risk assets are looking extremely expensive at this point. High yield spreads have tightened almost to pre-COVID-19 levels, while there is still an expectation for more insolvency.	• Fear/greed levels indicate that the equity market is looking short-term overbought. Which is further indication that the rally in the equity market will continue, but at a more moderate pace. • Shorter-term oscillators have also moved above longer-term averages, which indicates lot of buyers are already long.
Ugly	• It is imperative that the vaccination rollout occurs at a quicker pace as the population is unlikely to support another lockdown. Any further restrictions will likely lead to increased rioting.		• 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.

[4] U.S. Bureau of Labor Statistics

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