BMO ETF Portfolio Strategy Report

Third Quarter 2021 BMO EXCHANGE TRADED FUNDS

Keep Risk in Check with Quality and Low Volatility

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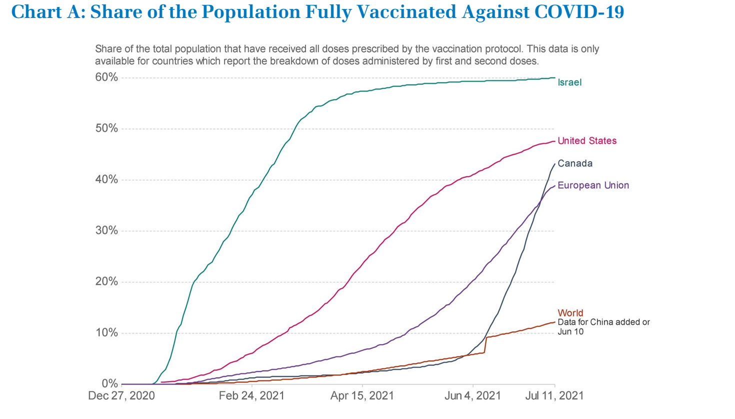
In this report:

All prices, returns and portfolio weights are as of market close on July 12, 2021, unless otherwise indicated.

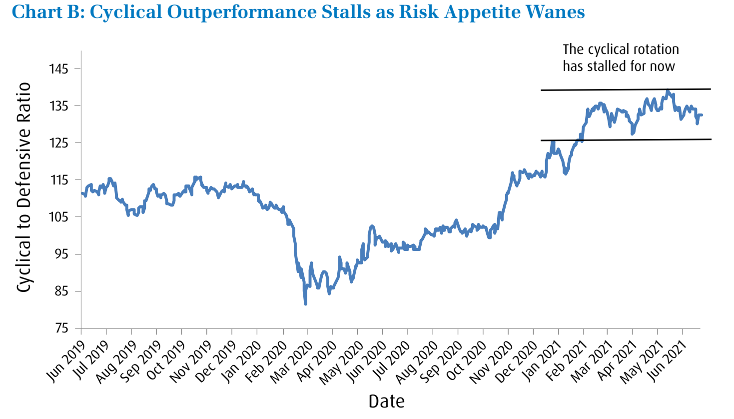
- **We anticipated the upward pressure in interest rates to alleviate in the second quarter, as the sell-off experienced in fixed income presented opportunities for investors searching for value.** In addition, the rally in stocks has led to rich equity market valuations relative to historical levels, leading some investors to pare back risk, thus rebalancing into bonds over the quarter. The 10-year yield in Canada and the U.S. are 1.31% and 1.35%, respectively (24bps and 38bps lower, respectively, than the end of the first quarter).
- **While bond yields have regressed, we believe the threat of higher interest rates are still a concern.** As the global economy continues to open up, pent up demand will lead to earnings per share (EPS) growth for companies and continued inventory shortages will allow goods and service providers to have pricing power. Should earnings expand at a faster rate than equity prices, valuations will once again look attractive, and investors will then rotate back into equities, leading bond yields to move higher.
- **The U.S. Federal Reserve ("Fed") surprised the market at its June Federal Open Market Committee (FOMC) by stating that it would raise interest rates twice in 2023.** While its tone was "hawkish", it didn't tighten monetary policy, but rather signaled that higher rates would come sooner than anticipated. With the economy clearly much better off than even six months ago, it is becoming evident that the Fed is behind the curve.
- **The COVID Delta variant remains a concern that could derail the economic recovery.** Israel, which has 60% of its population fully vaccinated, recently saw its daily case count back on the rise (Chart A). While it is estimated that roughly half of the infected individuals are vaccinated, we are hopeful that we are moving towards a more normalized environment. The other looming concern remains inflation. While it can be argued that inflation may be transitory, people need to recognize the price of many goods and services exhibit "price stickiness" after moving up.
- **Since Pfizer and BioNTech announced the success of their vaccine in early November, cyclical stocks have outperformed defensive-oriented stocks.** Cyclical stocks, which tend to be more sensitive to economic growth, experienced a more significant repricing, as investors became more optimistic for an eventual economic reopening. In the second quarter, however, that outperformance became less evident, as the appetite for risk has waned and investors have become less willing to overpay (Chart B). We anticipate equities will continue to outperform fixed income for the remainder of the year, but investors should keep risk in check and have the core of their equity exposures in factors such as quality and low volatility. More cyclical-oriented exposures can be used around the peripheral.
- **The Economic Policy Symposium in Jackson Hole at the end of August will provide us with greater insight in how central banks around the globe view inflation, and how to withdraw stimulus from the monetary system without stalling economic growth.** The Bank of Canada (BoC) remains well ahead of its global peers in already removing its asset purchase programs and may be the first to raise rates at some point in 2022.

Chart A: Share of the Population Fully Vaccinated Against COVID-19



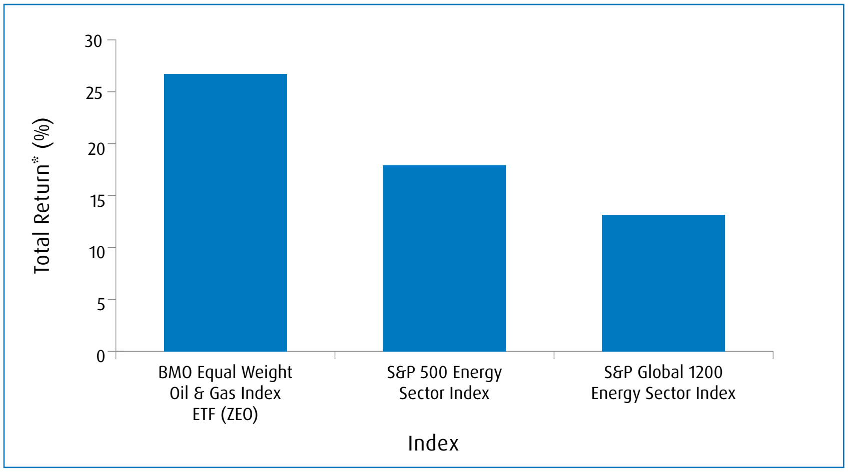
Source: Official data collated by Our World in Data. December 27, 2020 – July 11, 2021.

Chart B: Cyclical Outperformance Stalls as Risk Appetite Wanes



Source: Bloomberg June 2019 to June 2021.

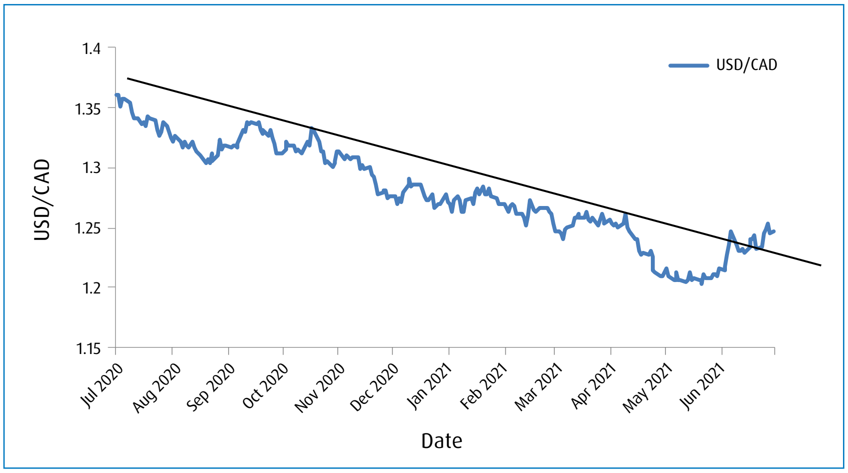
Things to Keep an Eye On



Source: Bloomberg. BMO Global Asset Management. Annualized performance for ZEO, as of June 30, 2021. 1 year 59.89%; 3 year -3.48%; 5 year -1.94; 10 year -2.8%. Performance shown is net of all fees and taxes.

Supply and demand imbalances are expected to become the norm in many different industries as the global economy begins to reopen. **Oil,** in particular, may be one that plays a key role given its use as an input cost for the transportation of goods. The resolution of the current infighting among the Organization of Petroleum Exporting Countries (OPEC) will likely be a determinant factor, as it's not clear whether it will release its excess supply or stick to the pre-agreed capacity. Should it stick to its current capacity, it's likely oil prices will face their own shortages as North American production won't be able to keep pace with the uptick in demand. Current oil rig counts in the U.S. remain well below pre-COVID levels and some companies remain reluctant to invest in infrastructure with the long-term pivot to renewable energy sources.

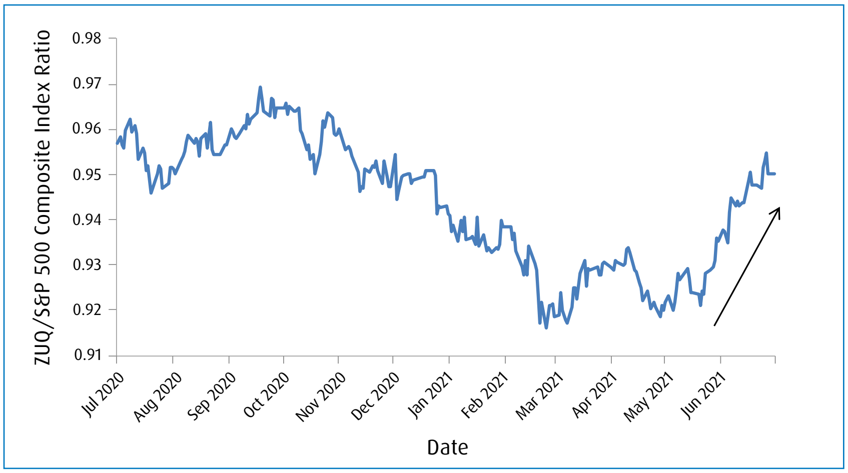
Recommendation: As outlined in our recent BMO ETF Trade Idea report, we believe higher oil prices should be beneficial for Canadian energy companies. Canadian energy companies, which tend to be higher cost producers, given their oil sands operations, may benefit more than their global peers. Since West Texas Intermediate (WTI) crude broke above US$60/barrel, the ***BMO Equal Weight Energy Index ETF (ZEO)*** has outperformed both the U.S. and global energy sectors.



Source: Bloomberg, July 13, 2020 to July 12, 2021.

The **U.S. dollar,** which has underperformed its Canadian equivalent since late March of 2020, has started to turn the corner. The loonie had essentially been on a straight-line gain against the greenback given the BoC's monetary policy was firmer than that of the Fed. In addition, it is anticipated that the demand for commodities will likely remain strong. However, the Fed's surprise hawkish tone is leading the U.S. dollar to break above its resistance. Should it continue to appreciate, this may lead to more technical buying and greater strength.

Recommendation: Over the last several months, our preference was for currency hedged ETFs when considering U.S. asset exposure. Should the U.S. dollar continue to gain, investors may want to start looking at switching to unhedged exposure. Some key indicators to watch out for are both U.S. Consumer Price Index (CPI) and Producer Price Index (PPI). Should these numbers remain elevated, they may signal to the market that the Fed may have to wind down its quantitative easing and asset purchase program faster than anticipated. We believe the Fed's current monetary policy stance remains far too accommodative given the vast improvements in its economy.



Source: Bloomberg. BMO Global Asset Management. Annualized performance for ZEO, as of June 30, 2021. 1 year 59.89%; 3 year -3.48%; 5 year -1.94; 10 year -2.8%. Performance shown is net of all fees and taxes.

The **"quality" factor** has been a consistent performer in the U.S. over the last several years, but has lagged other factors, most specifically "value" since the start of the reopening trade. Since late May, however, the ***BMO MSCI USA High Quality Index ETF (ZUQ)*** has started to outperform the broader-based S&P 500 Composite Index. As previously noted, with cyclical outperformance losing momentum, investors have been rotating back into defensive growth areas, such as the quality factor.

Recommendation: As an integral part of the core to our portfolio strategy, ZUQ continues to be one of the mainstays. This ETF provides investors efficient access to a diversified portfolio of U.S. blue chip exposure. By screening for stocks that have high return on equity (ROE), low earnings variability and financial leverage, companies with economic moats are identified, or those that boast competitive advantages within their industries.

*Total Returns since February 16, 2021 (when WTI traded above US$60/barrel).

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
No portfolio changes					

Asset Allocation:

- As we had outlined in our report last quarter, we had anticipated that global investors would take advantage of higher bond yields to reallocate some of their equity gains back into fixed income. Although that is what transpired, we did not expect bond yields to retrace to these levels, where we believe they are currently overbought. Though technicals may keep yields low over the short term, we continue to believe that rising rates may come back on the table later this quarter, or early next. Inflation data will likely remain elevated, leading the Fed to signal tapering as early as its September meeting. To clarify, we don't think the Fed will actually taper this quarter, but rather give an indication to the market that it will intend to do so at some point in the near future. We believe our asset mix is well suited for the current environment and will not be making any changes.

Fixed Income:

- What happens in fixed income this quarter may depend at least partially on what transpires in the equity market. With current price-to-earnings (P/E) ratios of major benchmark indices well above historical averages, company earnings per share (EPS) must expand at a faster rate than prices over the quarter. If valuations can return to a more reasonable level, investors will then rotate back into equities, particularly with bonds paying very little. Furthermore, we believe continued inflationary concerns will bring "taper" talks into the Fed's regular dialogue over the coming months. This will further add to rising bond yields near the end of this quarter, or potentially the start of the fourth. Currently, our mix of an overweight to credit and exposure to rate reset preferred shares ***(BMO Laddered Preferred Share Index ETF – ZPR)*** and U.S. Treasury Inflation Protected Securities ***(BMO Short-Term U.S. TIPS Hedged to C$ Index ETF – ZTIP.F)*** is well positioned, should rising rates be back on the table.

Equities:

- With earnings season underway, it is imperative that corporations can display an uptick in profitability that will justify the lofty prices in the market. We don't expect earnings to necessarily provide a direct catalyst to a rally, but falling short, will likely lead to equities repricing lower given forward estimates are already pricing in higher expectations. As mentioned, it is important that we continue to see corporate earnings expand in order to keep valuations low so as to ensure investors rotate back into equities, which we expect to happen later this quarter, or in the fourth quarter.
- Similar to the fixed income side of the portfolio, we are not making any changes to the equity portion of our strategy this quarter. We believe our core holdings in the "quality" and "low volatility" factors are well positioned, particularly with the recent outperformance of defensive growth assets. Furthermore, the additions we made into the ***BMO Equal Weight Oil & Gas Index ETF (ZEO)*** and the ***BMO Equal Weight REIT Index ETF (ZRE)*** last quarter continue to provide growth and outperformed the broader S&P/TSX Composite over the second quarter.

Non-Traditional/Hybrids:

- Our combination of Canadian and U.S preferred shares continue to deliver yield and diversification properties. We believe this part of the portfolio is critical in making up for the lack of yield generated from fixed income. Investors searching for alternatives in non-traditional yield may want to consider the ***BMO Premium Yield ETF (ZPAY),*** which holds T-bills and then sells both call and put options to generate yield. The total return profile of ZPAY is similar to U.S. preferred shares or U.S. high yield.

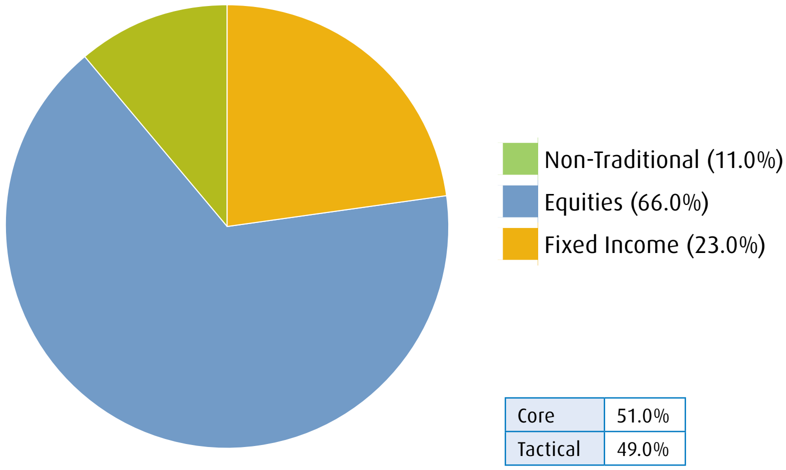
Stats and Portfolio Holdings

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	$16.60	0.09%	9.0%	4.5	3.8%	2.2%	0.48
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.97	0.25%	6.0%	8.1	4.5%	3.7%	0.45
ZTIP/F	BMO SHORT-TERM US TIPS HEDGED TO C$ INDEX ETF	Fixed Income	Tactical	$30.21	0.15%	3.0%	1.9	0.5%	0.4%	0.21
ZTL	BMO LONG-TERM US 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 US 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 US 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 US 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.
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 S&P/TSX 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%
ZTL	BMO LONG-TERM US 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 US 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%

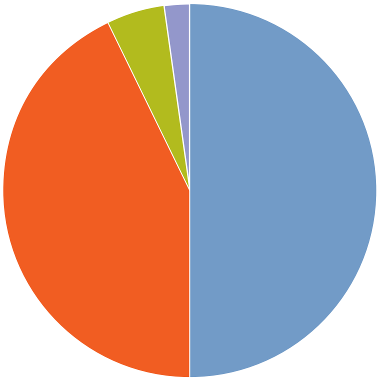
Source: Bloomberg, BMO Asset Management Inc. (As of June 30, 2021).

*Management Fee as of June 30, 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

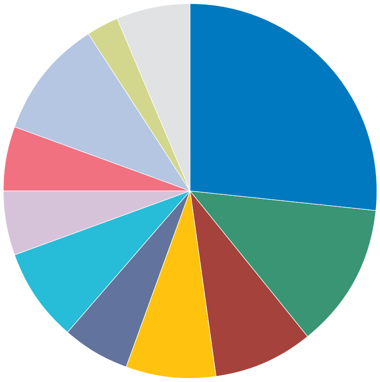
Regional Breakdown (Overall Portfolio)



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	26.79%
Health Care	12.54%
Consumer Staples	8.53%
Utilities	7.75%
Industrials	5.95%
Information Technology	8.12%
Consumer Discretionary	5.31%
Communication Services	5.65%
Real Estate	10.40%
Materials	2.80%
Energy	6.14%

Fixed Income Breakdown

Federal	48.3%
Provincial	14.5%
Investment Grade Corporate	37.0%
Non-Investment Grade Corporate	0.0%

Weighted Average Term	11.80
Weighted Average Duration	9.35
Weighted Average Coupon	2.2%
Weighted Average Current Yield	2.1%
Weighted Average Yield to Maturity	1.8%

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 June 30, 2021).

The Good, the Bad, and the Ugly

Conclusion: This quarter, corporate earnings will likely be playing catch up, as earnings season must meet expectations to justify the lofty prices in stocks. While we expect equities to start rallying again later this year, we believe higher inflation numbers will lead the market to acknowledge that the Fed will have to dial down stimulus, which will likely create headwinds for stocks over the very near term. We believe the greater market expectation for tighter Fed monetary policy will lead to a firmer U.S. dollar, and some commodity price gains to moderate (except oil) as a result, before moving higher due to continued supply and demand imbalances. Over the long term, we are still bullish on equities, but expect risk assets to consolidate before moving higher in the third or fourth quarter.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• Many developed countries are seeing its vaccination rates increase exponentially. This should allow these countries to move toward a full economic reopening. • After a slow start, Canada now leads the world in terms of its vaccinated population with at least one dose. • U.S. unemployment continues to significantly decrease, now at 5.9%[1]. This will likely continue to drift lower as the population is increasingly vaccinated.	• Decreasing correlation among 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.	• While equities continue to perform well, the recent outperformance of defensive growth strategies is a good sign that shows the markets are normalizing.
Bad	• While numbers have shown that COVID cases are on the decline, numbers have been slowly trickling up in Israel, which has had the highest percentage of fully vaccinated individuals in its population across countries. • Household debt in Canada is still one of the main concerns, and the recent easing of monetary policy will only intensify this further. This limits 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 pricy at this point. High yield spreads have tightened almost to pre-COVID-19 levels, while there is still an expectation for further insolvency.	• Though we believe bonds are overbought at these levels, technical buying could keep bond yields low.
Ugly	• While developed countries have seen its vaccination rates increase, developing countries have had much lower rates of inoculation. Programs like COVAX need to be better utilized by wealthier nations to ensure the less fortunate can also recover.		• 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 leverage misuse.

[1] U.S. Bureau of Labor Statistics

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BMO Exchange Traded Funds