Quarterly Fixed Income Strategy

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

In this report, we highlight our fixed income positioning strategies for the first quarter.

Duration

- Until recently, interest rates were trending higher, which moved the term structure of bond yields from being inverted back to a positively sloping yield curve. The 10-year Government of Canada bond yield had gained 40bps between August 30, 2019 and January 20, 2020. Higher yields had resulted, as the market became more confident that we would be able to avoid a recession.
- A number of positive developments on the U.S.-China trade war front had provided a lift to global bond yields. In recent weeks, however, yields have trended lower as new risks have emerged. Rising conflicts between U.S. and Iran have become a concern, but fears of a Coronavirus outbreak have also weighed on bond yields.
- In addition, at the last Bank of Canada (BoC) meeting, the central bank had stated its concerns that the economy is no longer running at capacity. Despite the recent dovish sentiment of the BoC, interest rate futures are suggesting only one 25bp rate cut in Canada for 2020.
- After a strong performance in most asset classes last year, the recent aversion to risk has also been magnified by investors taking profit. With a 31.5% and 22.8% total return in the *S&P 500 Composite* and the *S&P/TSX Composite,* respectively, investors have rotated back into bonds to a certain degree.
- While recent concerns have been a headwind for equities, lower yields should be favourable for bonds, particularly longer bonds and government-issued bonds. Our duration positioning remains 104 points shorter than its benchmark, the *FTSE/TMX Canada Bond Universe,* given we have underweighted the long end of the yield curve. Though many geo-political risks remain, any positive developments can potentially lead long-bond yields to move higher, particularly given their strong performance in 2019. Given our broader asset mix, our goal for our fixed income strategy portfolio is to keep pace with the benchmark, but also maintain a stronger position if long-bond yields reprice higher.

Credit

- Credit spreads tightened over the last quarter, with the CDX High Yield spread contracting to 275bps. Typically, this spread tightens to roughly 290bps before widening, so we anticipated some mean reversion. Given the length of the business cycle, our preference remains to focus on investment grade debt over high yield.
- Investors looking to pick-up some yield can focus on the BBB segment of the investment-grade universe. We believe this is the "sweet spot" for more yield-oriented investors. Over the market cycle, the BBB segment tends to exhibit the strongest performance in the investment-grade space, according to FTSE/Russell data. The recently launched ***BMO BBB Corporate Bond Index ETF (ZBBB)*** provides efficient exposure to the BBB segment of the Canadian investment-grade corporate bond universe in Canada, with bonds maturing between 1-10 years.
- We continue to believe the current environment to be ideal for U.S. preferred shares. Barring a scenario where inflation runs rampant, interest rates remain low, which should leave investors stretching for yield. Aging demographics also mean that investors will prefer assets that tend to be stable in nature. Additionally, given the length of the current credit cycle, investors may want to remain focused on investment grade assets. U.S. preferred shares is the only asset class that checks all these boxes, and we view this as a way for investors to gain additional yield in their portfolios. U.S. preferred shares have fixed coupons, meaning there are no rate reset structures south of the border.

Currency

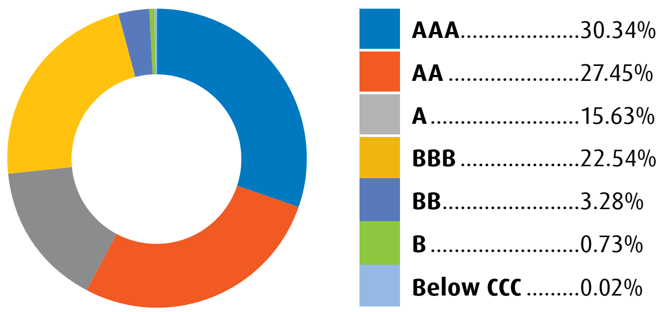
- The Canadian dollar has slowly trended higher over the last 12 months. The recent dovish tone of the BoC may create some short-term resistance for further gains in the loonie, but it has yet to break below its support level versus its U.S. counterpart. As we progress throughout the year, the upcoming decision on the Democrat front-runner in this year's U.S. presidential elections could also impact the strength of the US dollar.

Model Portfolio

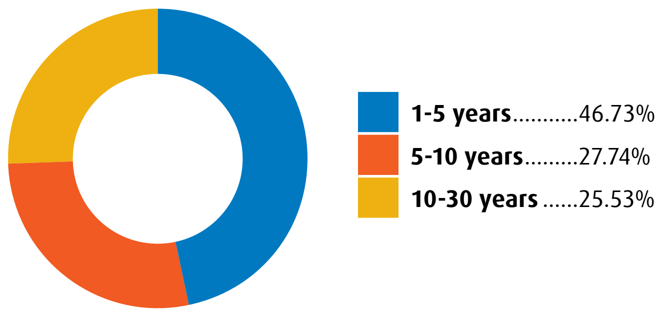
Ticker	ETF Name	Weight (%)	Duration*	Yield-to-maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	8.07	2.18%	0.09%	Canadian	Core
ZCB	BMO CORPORATE BOND INDEX ETF	17.0%	6.11	2.53%	0.15%	Canadian	Core
ZTM	BMO MID-TERM U.S. TREASURY INDEX ETF	7.0%	6.37	1.73%	0.20%	U.S.	Core
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	4.0%	3.11	5.47%	0.45%	Canadian	Non-Traditional
ZHP	BMO U.S. PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%	4.06	5.41%	0.45%	U.S.	Non-Traditional
ZMSB	BMO GLOBAL MULTI-SECTOR BOND ETF	4.0%	4.50	3.18%	0.15%	Global	Core
	Portfolio	**100.0%**	**7.03**	**2.57%**	**0.15%**		

Exposures	Duration	Yield	Weight
CORE	7.41	2.26%	90.0%
NON-TRADITIONAL	3.68	5.43%	10.0%
Total	**7.03**	**2.57%**	**100.0%**
CANADIAN	7.29	2.45%	87.0%
U.S.	5.30	3.43%	13.0%
Total	**7.03**	**2.57%**	**100.0%**

Credit Summary



Term Summary



As of December 31, 2019. Please note yields will change from month to month based on market conditions.
Source: BMO Global Asset Management, Bloomberg.

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BMO Exchange Traded Funds