BMO ETFs Inflation Report

Current Market Conditions: What is the Market Saying?

The U.S. Federal Reserve stated that in 2021, they will allow inflation to run beyond its 2% target, with no hard ceiling specified. The most recent inflation reported in Canada was 1% (y/y), which is below its 10-year average.[1] This reflects the economic collapse from the pandemic and is not forward-looking. Today, the market (which is forward-looking) is pricing in an average annual inflation rate of about 2.1% for the next five years, which is roughly in line with the Bank of Canada's (BoC) and the U.S. Federal Reserve's (the Fed) initial inflation target of 2%. Many indexes notched new highs to close out 2020 signalling the market has priced in an economic recovery and predicts growth in the new year, and with growth comes inflation.

Expected Inflation, 5 Years

Source: Bloomberg, January 5, 2021 5-year U.S. inflation Swap curve.

Inflation Forecasts: What are Economists Thinking?

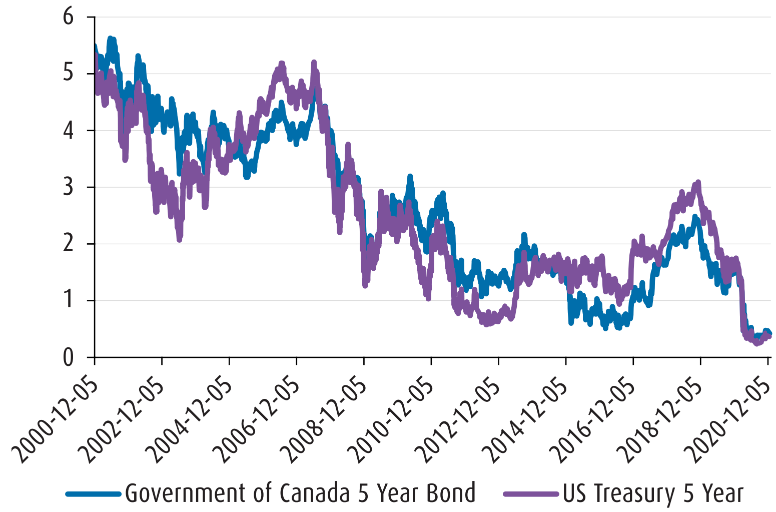
Many economists are forecasting inflation above 2% in 2021 and 2022. This prediction is based on several facts:

- The Fed has stated they will allow inflation to run above 2% for a sustained period before hiking interest rates and the Bank of Canada will likely follow.
- Monetary stimulus that flooded the market in 2020 in both Canada and the U.S. is at historic levels.
- Government spending has skyrocketed in order to prop up shut down economies. In Canada, the stimulus package is to the tune of $100 billion and the U.S. is close to inking a $900 billion stimulus bill.
- A sweep by the Democrats lead by the Biden Administration points to an increase in overall government spending and control of both the Senate and House increases the likelihood that these bills will pass.
- Energy prices are rising; as the vaccine is disseminated and the economy reopens, the demand for oil will increase. Ultra-low energy prices last year was a large contributor to the below-average inflation rate in 2020.
- Commodity and Material prices are rising; gold, silver and copper all rallied in 2021. Lumber also increased in value. As these inputs become more expensive, the overall cost of goods will increase.
- Cost-push inflation of COVID-19 related expenses: Many goods and services have had increased input costs based on investing in PPE, sanitary requirements, and increased wages for front line workers. These will be pushed forward to consumers.

Portfolio Positioning: How Can I Hedge My Portfolio Against Inflation?

Fixed Income: Interest rates are at historic lows. Both the BoC and the Fed have no intention of raising their base policy rates, both at 0.25%, any time soon. This translates to very low yields on fixed income across the spectrum, but especially on the shorter end of the curve. For example, a 5-year Government of Canada bond is yielding 0.39%.[2] This presents a problem for investors who are facing 2% per year inflation (or more): if their portfolio is yielding less than inflation, this will erode capital. We saw real rates (policy rates less inflation) go negative this year, so for investors in cash or in low yielding investments, the purchasing power of their money will depreciate over time. Even subtle inflation can have a large impact on bonds in this environment, which are challenged with very low rates. The low rate environment has also led to governments and corporations issuing longer-term debt than before, which has caused overall market duration to increase. Investors should be mindful of this as it will lead to more duration risk in portfolios.

Government Bond Yields in U.S. & Canada



Source: Bloomberg, January 5, 2021

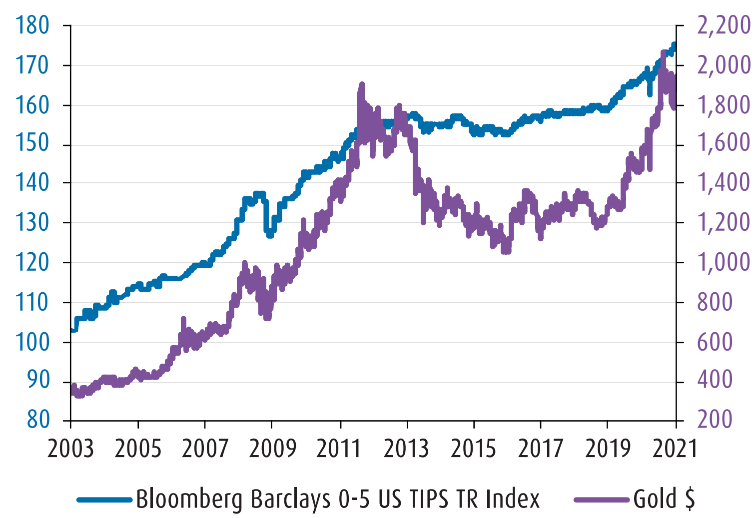
Equities: Equities generally do a better job at protecting against inflation than fixed income but there are certain asset classes which act as an inflation hedge better than others. Gold has been the classic go-to investment for investors looking to inflation hedge. Gold is a store-of-value hard asset which protects against inflation and of currency debasement. Gold usually attracts flows when market sentiment declines (such as in the spring and summer 2020). Infrastructure is another asset class which can protect against inflation – it is exposed to hard assets, and to companies which have long-term contracts. Infrastructure also tends to be a direct beneficiary from increased government spending which is a precursor to inflation.

Using BMO ETFs to Hedge Inflation

BMO Short-Term US TIPS Index ETF, ZTIP: U.S. Treasury Inflation Protected Securities (TIPS) are bonds backed by the U.S. treasury and their par value adjusts to inflation. ZTIP offers the security of government bonds and its short duration (2.7 years) offers lower volatility than longer term bonds. Lower duration means more security (less duration risk) and is a more pure play inflation hedge. ZTIP is also offered as hedged to CAD (ZTIP.F) and in USD (ZTIP.U).

BMO Real Return Bond Index ETF, ZRR: Provides inflation protection on the long end of the curve. These are government of Canada bonds where the par value is adjusted for inflation. Because its duration is 16.8 years, we recommend ZRR as an inflation hedge for long bonds, as its longer duration means it's exposed to duration risk.

Gold vs US TIPS



Source: Bloomberg, January 5, 2021

BMO Equal Weight Global Gold Index ETF, ZGD: The price of gold is largely driven by inflation expectations. Gold does not have a yield, which has been one of its critics' main arguments. But in a low rate environment gold is attracting more interest from investors as real bond yields turn negative and as inflation expectations increase. ZGD offers exposure to gold equities which provide a levered exposure to the price of gold. Gold equities have more volatility than inflation protected bonds but offer more growth opportunity on the back of inflation. ZGD is equally weighted to avoid concentration risk and to increase its exposure to smaller cap gold producers.

BMO Global Infrastructure Index ETF, ZGI: ZGI invests in companies which have exposure to hard assets such as cell phone towers, pipelines, water systems, bridges and airports. These assets generally hold their value when inflation rises. Many of these companies have long-term government contracts and could see an increase in contracts as government spending is often directed towards infrastructure.

Hedge Inflation Using These BMO ETFs:

Depending on your views, investment goals and asset mix, will determine how much of your portfolio to hedge against inflation.

Ticker	Sample Portfolio Weight: Bullish (>2% inflation)	Sample Portfolio Weight: Neutral (2%)	Comments	Further Reading
ZTIP & ZRR	10–20% of fixed income	5–10% of fixed income	ZTIP to decrease duration ZRR to increase duration	ZTIP Sales Aid ZRR Overview
ZGI & ZGD	10–15% of equity	5–10% of equity portfolio	ZGI has stable long-term contracts ZGD has lower correlation with broad equities	Alternative Investing with BMO ETFs

BMO ETF	Distribution Yield	YTM (with inflation assumption)	Duration	Risk Rating*	Management Fee
ZTIP/ ZTIP.F /ZTIP.U	-	0.89%	2.5	Low	0.15%
ZRR	1.99%	0.16%	16.7	Low to Medium	0.25%
ZGD	0.00%	-	-	High	0.55%
ZGI	3.69%	-	-	Medium	0.55%

Source: BMO Global Asset Management, December 31, 2020. Distribution yields are annualized.

BMO Exchange Traded Funds

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[1] Bloomberg, January 5, 2021.

[2] https://www.statcan.gc.ca/eng/subjects-start/prices_and_price_indexes/consumer_price_indexes, January 5, 2020.

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