FTSE Russell

Canadian Fixed Income Insight Report

Presented to you by BMO Global Asset Management

April 2021

TABLE OF CONTENTS

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Canadian Fixed Income Summary (CAD, TR) as of March 31, 2021

BMO ETF Statistics*

Fund	Ticker	YTM	Term (yrs)	Duration	Credit Ratings (%) AAA/AA	A	BBB
BMO Aggregate Bond Index ETF	ZAG	1.68	10.63	7.94	73.1	15.0	11.8
BMO Discount Bond Index ETF	ZDB	1.71	9.91	7.78	72.0	15.3	12.7
BMO Short Federal Bond Index ETF	ZFS	0.52	2.79	2.72	100.0	0.0	0.0
BMO Mid Federal Bond Index ETF	ZFM	1.47	8.01	7.49	100.0	0.0	0.0
BMO Long Federal Bond Index ETF	ZFL	1.94	25.33	17.90	100.0	0.0	0.0
BMO Short Provincial Bond Index ETF	ZPS	0.74	3.01	2.88	90.7	9.3	0.0
BMO Mid Provincial Bond Index ETF	ZMP	1.78	7.35	6.65	90.0	10.0	0.0
BMO Long Provincial Bond Index ETF	ZPL	2.74	23.12	15.77	90.2	9.8	0.0
BMO Short Corporate Bond Index ETF	ZCS	1.17	2.95	2.81	27.2	36.7	36.1
BMO Mid Corporate Bond Index ETF	ZCM	2.42	7.09	6.23	12.9	25.5	61.5
BMO Long Corporate Bond Index ETF	ZLC	3.36	21.68	13.44	1.6	55.6	42.8
BMO Government Bond Index ETF	ZGB	1.47	11.00	8.40	95.2	4.8	0.0
BMO Corporate Bond Index ETF	ZCB	1.96	8.84	6.66	15.2	41.4	43.4
BMO Short-Term Bond Index ETF	ZSB	0.75	2.89	2.79	76.3	13.8	9.9
BMO Real Return Bond Index ETF	ZRR	1.67	18.57	16.18	100.0	0.0	0.0
BMO Canadian MBS Index ETF	ZMBS	0.71	3.17	2.53	100.0	0.0	0.0
BMO Ultra Short-Term Bond ETF	ZST	0.42	0.56	0.54	26.5	26.5	47.0

*Statistics are based on ETF.

BMO ETF's Portfolio Statistics**

Total Return (12M, %)

	Short	Mid	Long	Overall
Federal	0.72	-3.10	-9.35	-1.75
Provincial	1.93	1.24	-0.59	0.62
Corporate	6.46	9.89	8.15	7.60
Overall	**2.77**	**1.73**	**-0.23**	**1.62**

Returns Volatility (12M, %)

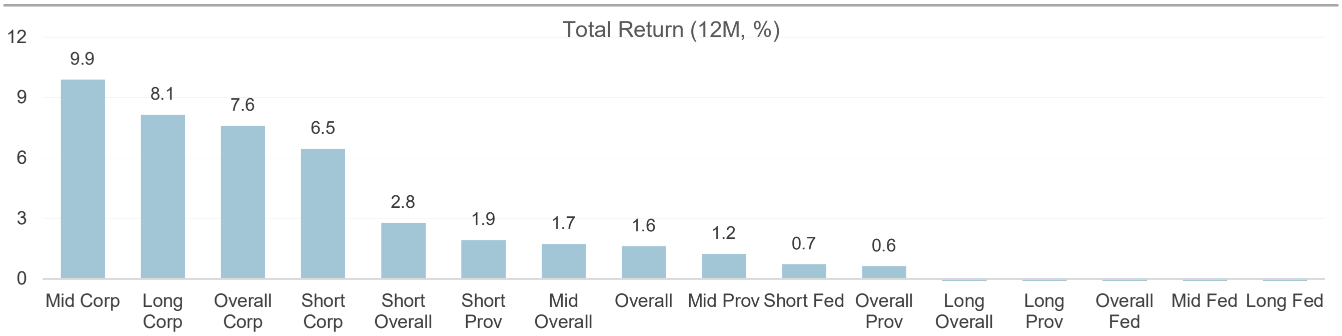
	Short	Mid	Long	Overall
Federal	0.71	3.39	9.77	2.80
Provincial	0.83	3.03	8.61	5.30
Corporate	0.91	2.88	7.05	2.96
Overall	**0.75**	**3.03**	**8.28**	**3.71**

Change in Yield (12M, bps)

	Short	Mid	Long	Overall
Federal	-10	58	69	15
Provincial	-36	7	18	2
Corporate	-164	-97	-28	-105
Overall	**-65**	**2**	**23**	**-20**

Change in Spread vs Canada (12M, bps)

	Short	Mid	Long	Overall
Federal	0	0	0	0
Provincial	2	3	12	35
Corporate	9	15	22	24
Overall	**1**	**5**	**14**	**20**



Market Maps
Fixed Income Insight Report

FTSE Russell

April 2021

Higher nominal yields and breakevens pressurize real yields

Inflation breakevens at multi-year highs and higher nominal yields are putting some upward pressure on real yields in Canada. Yield curve carry in 10s/2s is approaching 2013 Taper Tantrum levels, but further steepening is possible, given the scale of policy stimulus. Canadian high-yield credit outperformed.

Canadian govts – yield curve steepening mainly confined to 10s/2s but long end underperformed on duration effect
Unlike rest of the G7, curve has similar positive carry in 10s/2s as the peak of the Taper Tantrum in 2013. (page 4)

Canadian credit – spreads returned to pre-Covid levels, or below, in less than 12 months versus normal 2 years
Extraordinary credit cycle is evidenced in how quickly spreads returned to pre-Covid levels versus previous cycles. (page 5)

Cross assets – inflation concerns drove earlier BoC tapering fears, but equities resisted yield pressure
Higher yields turned returns negative across growth stocks and all fixed income assets, apart from HY credit. (page 6)

Macro backdrop - Inflation fears and recent bond market upheaval intensified recovery uncertainties
Tensions between central bank dovish policy goals and the bond market's more hawkish expectations remain. (pages 7-8)

Appendix – Historical bond yields, glossary.

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Chart 1: 7-10yr yields returned to pre-Covid levels, led by US and Canada, reflecting recovery forecast, though yields well below 2013 levels.

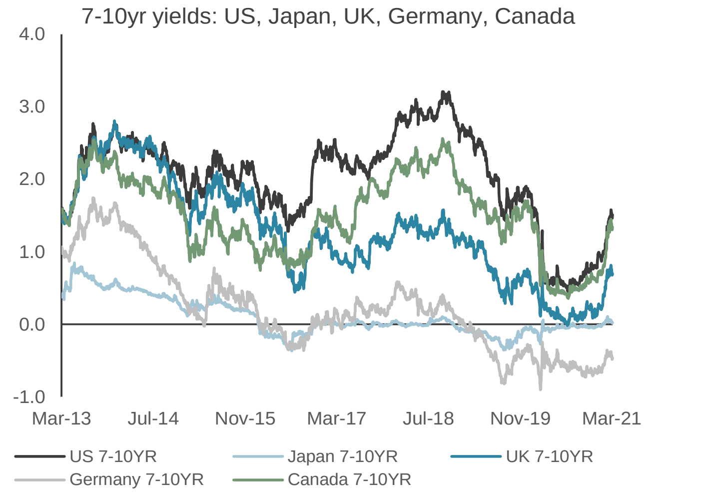
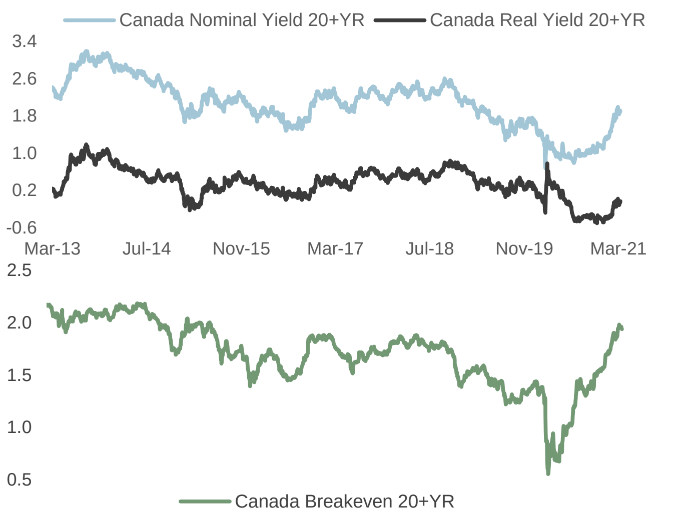


Chart 2: Long-dated Canadian breakevens increased about 150bp from post-Covid lows, and begin to pressurize real yields.



Source: FTSE Russell. All data as of March 31, 2021. Past performance is no guarantee of future results. This report should not be considered 'research' for the purposes of MIFID II. Please see the end for important legal disclosures. Bond market data is derived from FTSE Fixed Income Indexes. See Appendix for list of indexes used for each market.

Canadian Governments, Provinces and Municipalities

Yield curve steepening in Canada has been confined largely to the 10-year area, where the move leaves about the same carry versus 2 years as 2013. The long end moved less in Canada, so US spreads widened in the reflation trade, repeating the pro-cyclical pattern of recent years. Provincial spreads returned to below pre-Covid levels.

The Canadian 10-year area has reached a similar 100bp carry versus 2 years as in the 2013 Taper Tantrum (Chart 1). Further steepening is possible, given the scale of policy stimulus from QE and fiscal policy, with a 2021 rebound in inflation forecast by the Bank of Canada.

US spreads versus Canada are repeating the pattern of post-GFC cycles, widening in cyclical recoveries, though more at the long end than 10 years (Chart 2). The Bank of Canada has not attempted yield curve control in the 10-year area, like the Bank of Japan, but higher yields are moving financial conditions back towards neutral (see page 6).

Provincial spreads have narrowed to pre-Covid levels, or below in Ontario and Saskatchewan. Alberta spreads tracked oil prices, as they did in 2015/16, and have fallen from a very similar peak around 135bp in 7-10yrs (Chart 3).

Municipality yields are now very close to Provincial yields in 7-10yrs, as Chart 4 shows, as investors have latched onto the favorable credit default record of Munis (no default since the 1950s), and implicit guarantee from the state.

Chart 1: Bear steepening of the yield curve has mainly been evident in the 10-year area during the reflation trade in Canada.

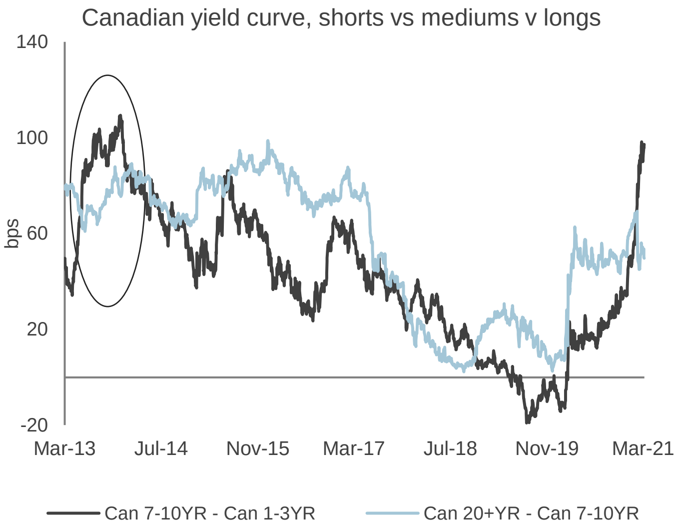


Chart 2: Spreads between the US and Canada have been pro-cyclical since 2013, rising in economic recoveries and vice versa.

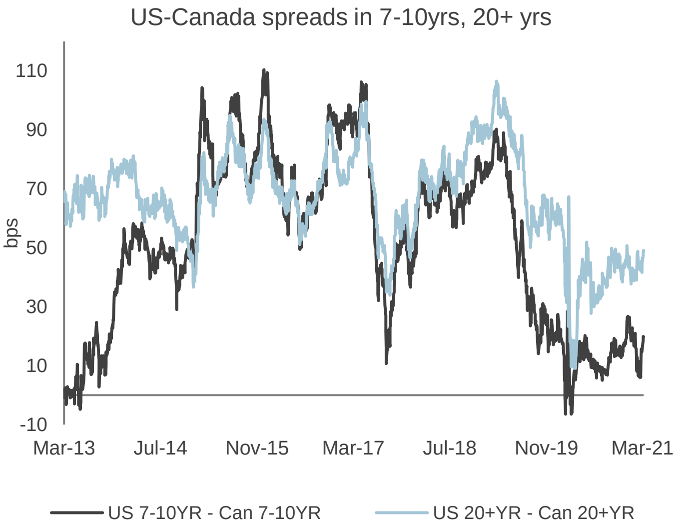


Chart 3: Provincial spreads vs 7-10yr govts returned to pre-Covid levels, or below, with higher oil prices also helping Alberta.

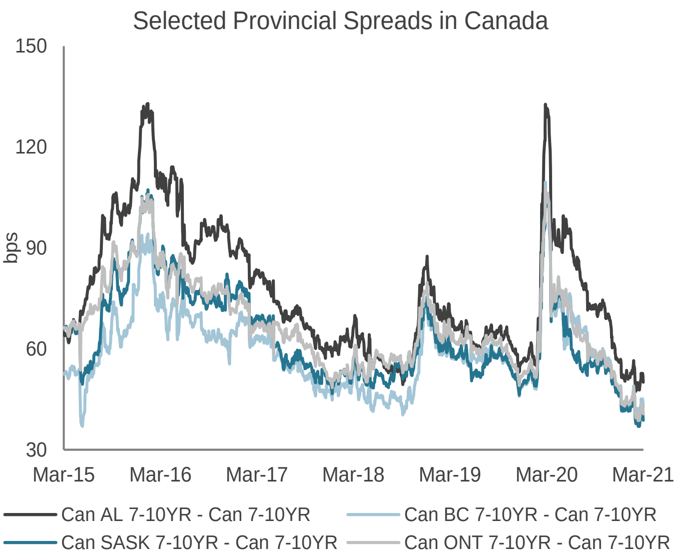
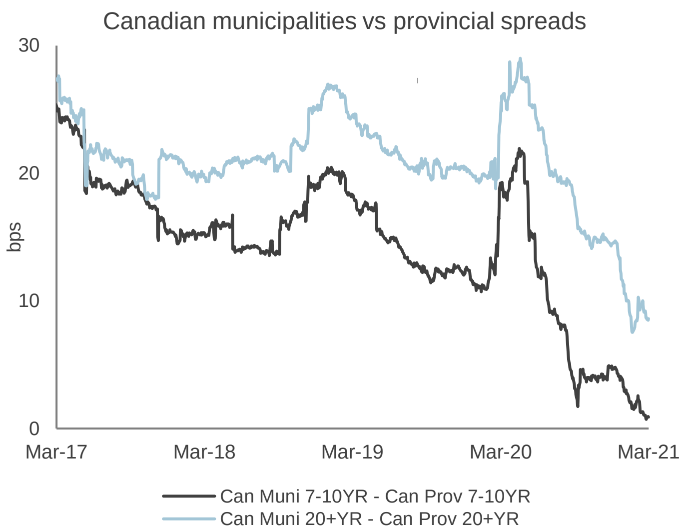


Chart 4: Canadian munis remain notable outperformers versus provis since BoC QE, with spreads tightening to multi-year lows.



Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada Provincial Bond Index (Ontario, Alberta, BC, Saskatchewan, Mid), FTSE Canada Municipal Bond Index (Mid, Long)

Source: FTSE Russell. All data as of March 31, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures. Bond market data is derived from FTSE Fixed Income Indexes. See Appendix Glossary for list of indexes used for each market. For professional investors only.

Canadian Corporate Bonds

An extraordinary credit cycle is shown in how quickly spreads returned to pre-Covid levels, compared to previous cycles. If this was purely due to QE, it is a surprise spreads have narrowed as much in longer maturities. Recent spread narrowing has been driven by bear steepening of the yield curve, helping financial spreads tighten further.

Credit spreads have generally taken about two years to return to “normal”, or pre-crisis levels, in credit spreads since 2011. In the Covid cycle, this has happened in less than 12 months, as Chart 1 shows.

The fact that corporate spreads have converged in maturities in which the BoC has not conducted QE suggests this is not only due to quantitative easing. Lower default rates than expected and record low interest rates are also factors (Chart 2).

Recent credit spread tightening is explained by higher government bond yields rising faster than corporate bond yields, as Chart 3 shows. However, Canadian high-yield issues have done well, helped by higher energy prices, so yields have barely risen and performance returns have been strong in Q1 (see page 4).

Very favorable conditions for Canadian financials continued in Q1, with higher bond yields and a steeper yield curve helping net interest income, so spreads fell further to new cycle lows (Chart 4).

Chart 1: Canadian credit spreads have returned to pre-Covid levels, or below, much faster than in 2015-17 or 2011-13, which took 2 yrs.

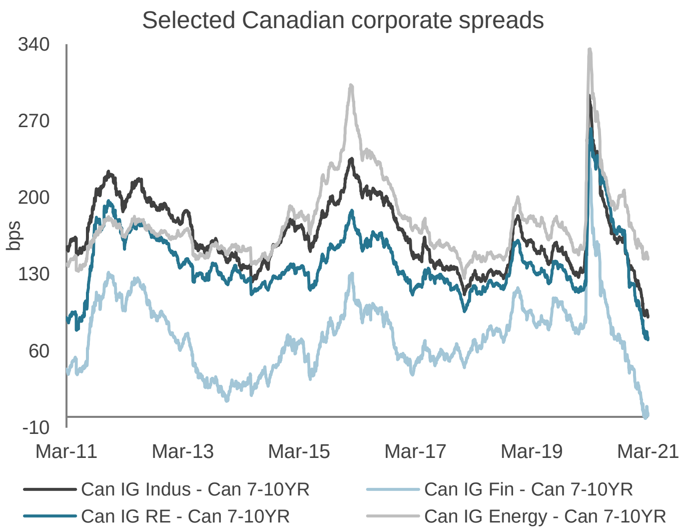


Chart 2: If faster credit spread convergence was purely due to QE, it’s surprising longer spreads have converged as much as 1-3 yrs.

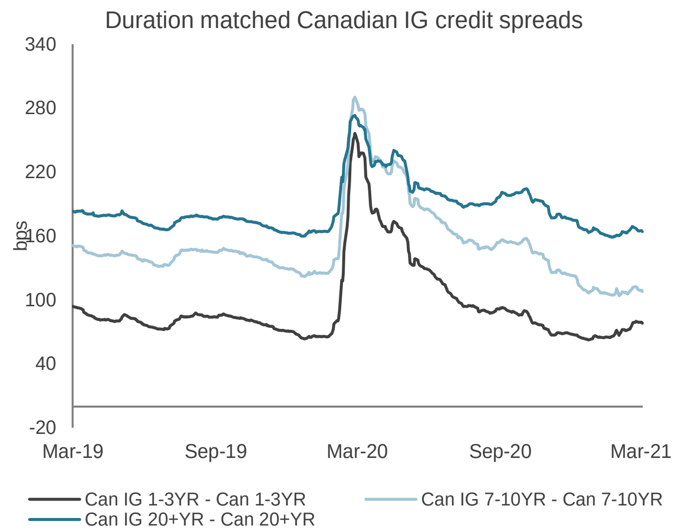


Chart 3: Government bond yields rose faster than IG corporate yields in 2021 (causing credit spreads to narrow further).

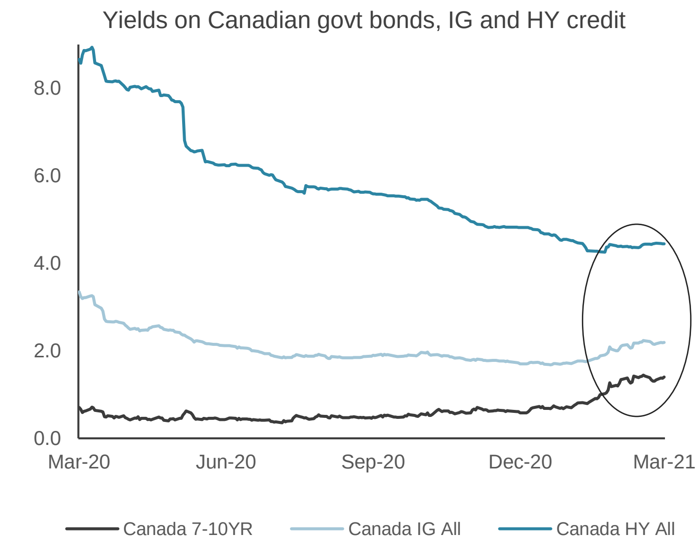
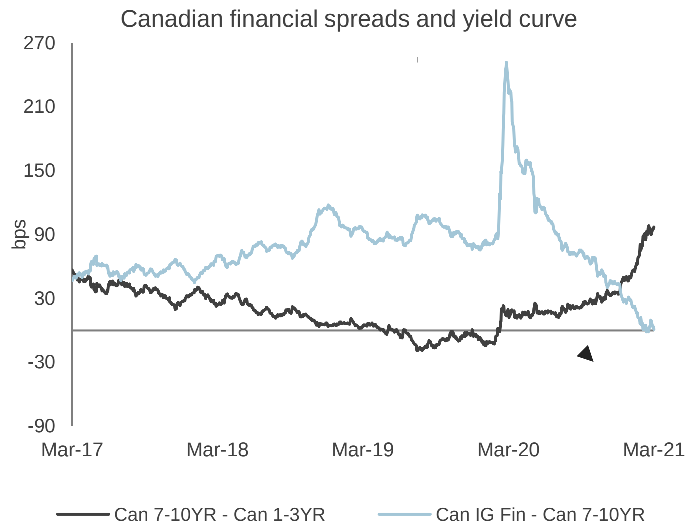


Chart 4: A notably steeper Canadian yield curve in 2021 helped drive financial spreads in sharply vs government bonds.



Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada Corporate Bond Indexes (Financial, Industrial, Energy, Real Estate, Short, Mid, Overall), FTSE Canada High Yield Bond Index

Cross-Asset Market Analysis and Performance

Canadian equities withstood bond market re-pricing of inflation risk, helped by the equity market risk premium. Higher bond yields drove outperformance by Value, and only Canadian high yield credit made positive Q1 returns. Feedback loops between higher US Treasury yields and MBS may have increased upward pressure on yields.

Although subject to higher volatility in Q1 2021, as bond yields rose, Canadian equities drew support from the sizeable equity risk premium and global growth forecast upgrades, after the Biden fiscal stimulus program was enacted (Chart 1).

Value factor returns outperformed as bond yields rose and yields curve steepened globally in Q1, with financials particularly strong. Higher growth forecasts and oil prices also helped cyclicals and the oil sector recover strongly (Chart 2).

Only Canadian high-yield bonds delivered positive returns in Q1, as the sharp increase in government bond yields dragged investment-grade credit lower, across all credit ratings (Chart 3).

Feedback loops between higher US Treasury yields and MBS hedging can increase the scale of US yield cycles, as MBS holders adjust by selling Treasuries to shorten duration. Fed QE may reduce this, but it still appears a factor (Chart 4).

Chart 1: Canadian equities withstood the rise in government bond yields as the market focused on economic recovery in 2021.

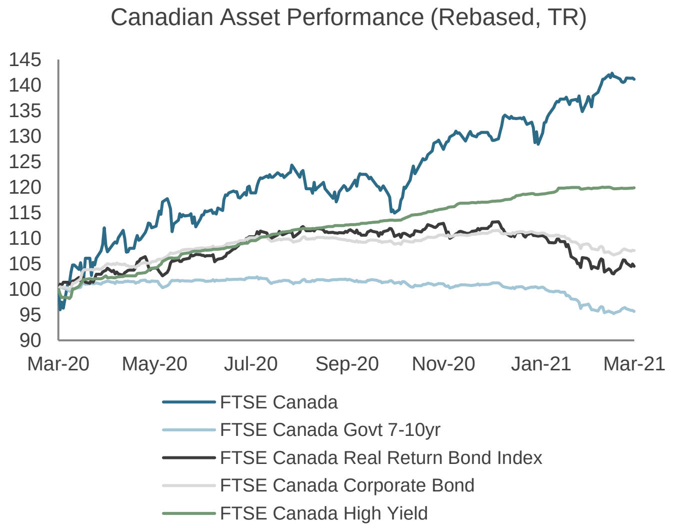


Chart 2: Value factor stocks outperformed as bond yields rose and curves steepened, with financials and energy very strong.

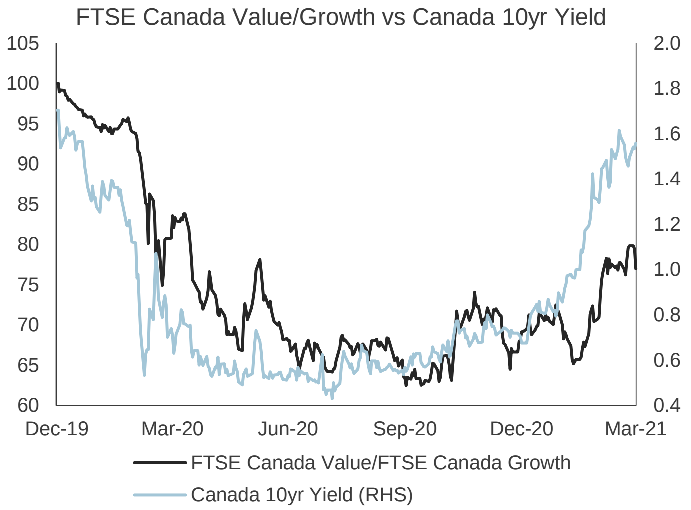


Chart 3: Most Canadian fixed income asset classes were dragged lower by higher govt bond yields in Q1, apart from high-yield credit.

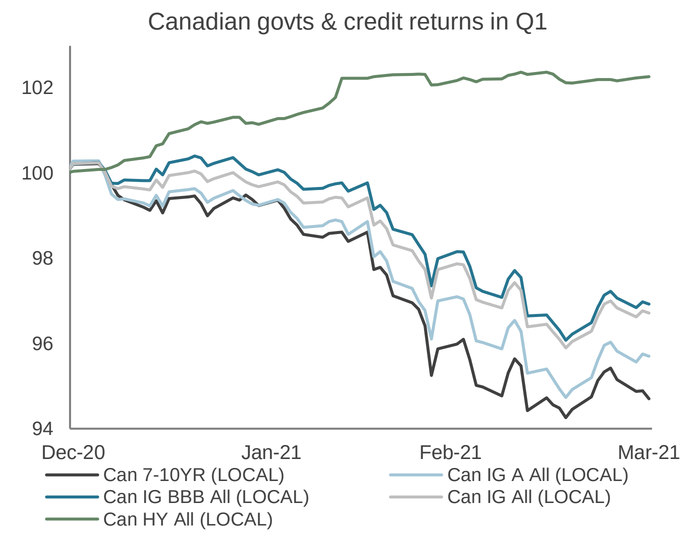
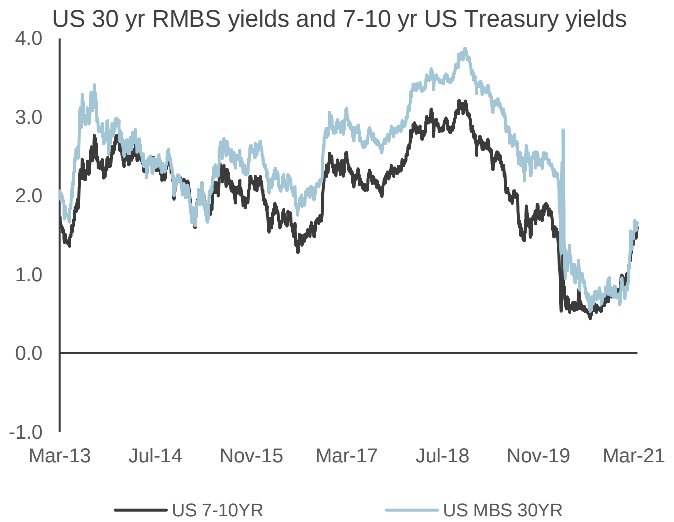


Chart 4: Evidence of a feedback loop is seen in higher US Treasury yields dragging up MBS yields; typical of cyclical turning points.



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Macroeconomic Backdrop – Growth and Inflation Expectations

Forecasts for the post-pandemic economic recovery have strengthened, spurred by faster-than-expected vaccine progress and optimism about the global spillover effects from the US$1.9 trillion US stimulus package. The rosier GDP outlook has hardened inflation fears, notably in the US, driving a sharper back-up in bond yields.

The OECD forecasts global growth of 5.6% in 2021, up 1.4% from its Q4 2020 forecast, led by a near doubling in US growth (to 6.5%), and upgrades for the UK (to 5.1%) and Europe (but to only 3.9%), after slow vaccine rollout (Chart 1). The OECD projects advanced economies return to pre-Covid growth paths by end 2022, but EM remaining 3-4% below pre-virus levels by then.

Rolling consensus 12-month-forward GDP forecasts underscore this stronger outlook for the world's largest economies (Chart 2).

As Chart 3 indicates, rising inflation expectations dominated the back-up in longer bond yields since November, led by the US, as the focus shifted to stronger growth and reflationary forces taking hold. This is in contrast to the 2013 Taper Tantrum, when inflation fears were not fanned by fiscal stimulus of the same scale (see page 9).

Rising commodity prices and manufacturing input costs helped drive inflation expectations higher. Shifts in the US ISM Prices Paid Index and headline CPI are closely correlated (Chart 4). A key question remains whether companies can pass cost increases onto consumers in the uncertain economic climate – or face a margin squeeze.

Chart 1: Global GDP growth forecasts were significantly upgraded following the approval of the mammoth US relief package.

Latest OECD GDP Forecasts (%, March 2021)			
	2020	**2021**	**2022**
US	-3.5	**6.5**	**4.0**
UK	-9.9	**5.1**	**4.7**
Eurozone	-6.8	**3.9**	**3.8**
Japan	-4.8	**2.7**	**1.8**
China	2.3	**7.8**	**4.9**
Canada	-5.4	**4.7**	**4.0**

Chart 2: Rolling 12M-forward GDP forecasts show a steady brightening in the recovery outlook, particularly for the US.

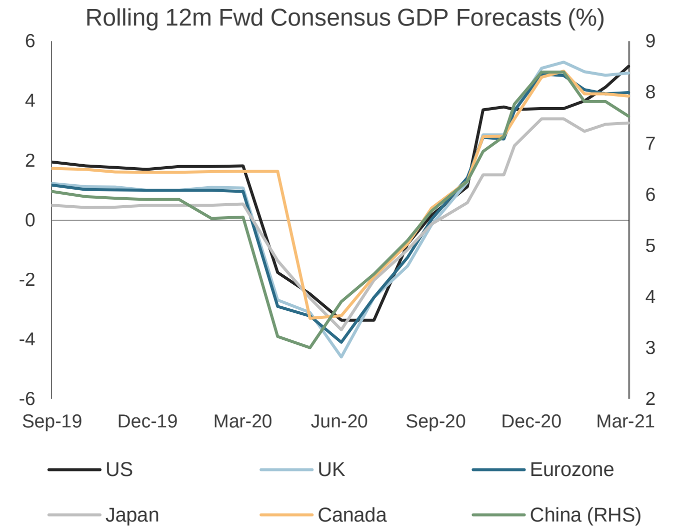


Chart 3: Long-term inflation breakevens have moved sharply higher in the 2020/21 reflation trade, unlike the 2013 Taper Tantrum.

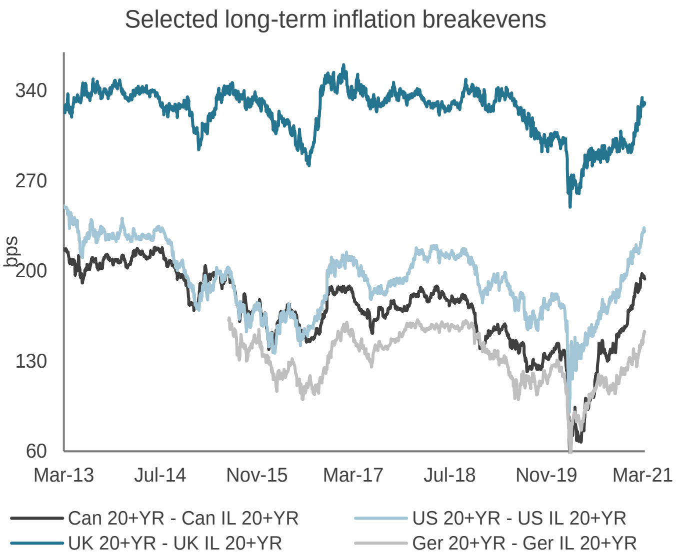
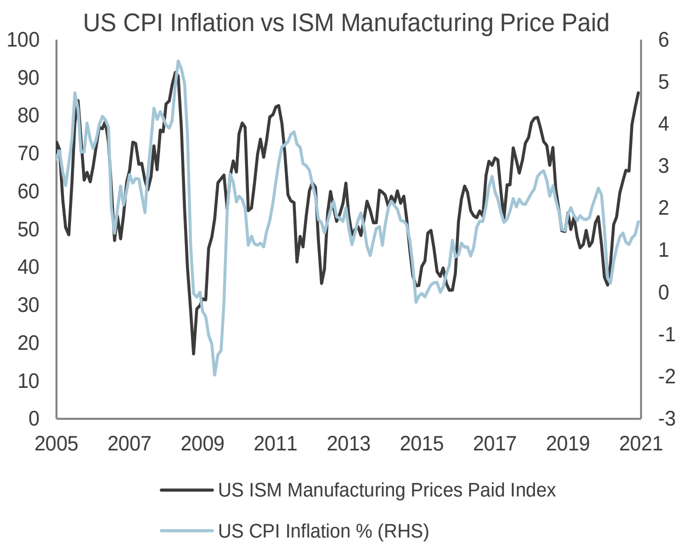


Chart 4: US ISM Prices Paid Index and CPI are closely correlated, suggesting a potential build-up of cost-push inflation pressures.



Indexes used: FTSE Canada Non-Agency Bond Index (Long), FTSE Canada Real Return Bond Index (Long)

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Macroeconomic Backdrop – Financial Conditions Analysis

Rising inflation fears and the recent bond market upheaval intensified recovery uncertainties and raised tensions between central bank policy goals and the bond market's more hawkish expectations. Financial conditions have tightened with the back-up in bond yields, and stronger Canadian dollar, so they are now close to neutral in Canada & US.

Improving recovery prospects drove bond yields higher but stirred anxiety about inflation and Fed policy. A further rise in yields (or earlier Fed tightening) could jeopardize recoveries, though yields are well below 2013 Taper Tantrum levels. Fed tolerance of higher breakeven levels and bond yields – and some short-term funding-market stress – added to uncertainty. Bond yields soon fell in 2014 as the Fed sustained QE, and did not rise until tapering finally began in late 2014 (Chart 1).

Fed funds projections are close to the Fed's December dot-plot projections for official interest rates for 2021, but are edging up for 2022/23. This contrasts with the FOMC, which does not foresee raising rates until early 2024 (Chart 2).

The Canadian dollar has trended higher since the reflation trade began in Q3 2020, boosted by higher energy prices (Chart 3).

Chart 4 shows that despite higher bond yields tightening financial conditions, they remain accommodative in some major economies, however they are now close to neutral in Canada, with the stronger exchange rate also contributing.

Chart 1: 10yr govt bond yields increased sharply in 2020/21, but remain well below 2013 Taper Tantrum, and 2018 levels.

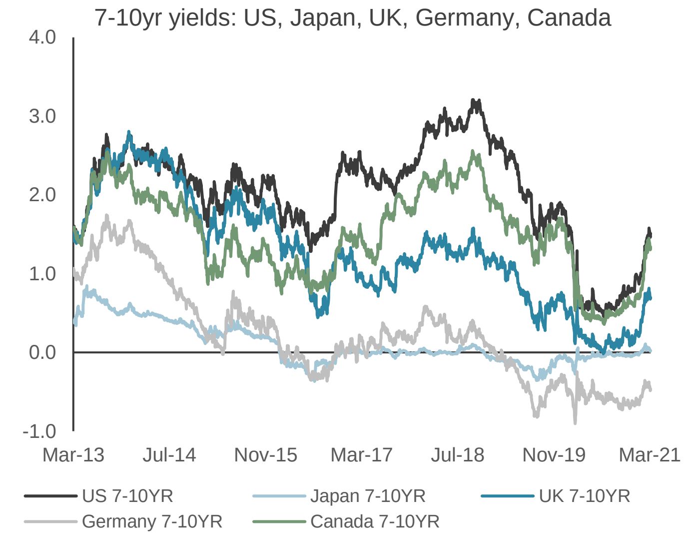


Chart 2: Futures markets are aligned with Fed rate guidance for this year. Could an unexpected pick-up in inflation change that?

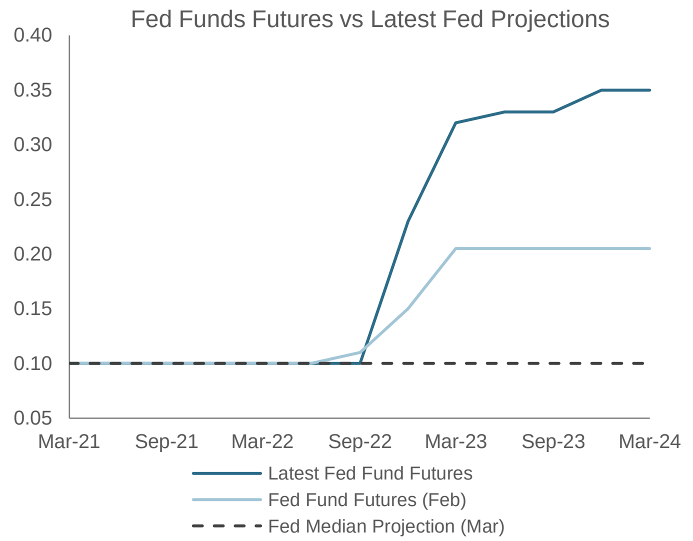


Chart 3: Strength in the Canadian dollar, helped by higher energy prices in 2020/21, also helped to tighten financial conditions.

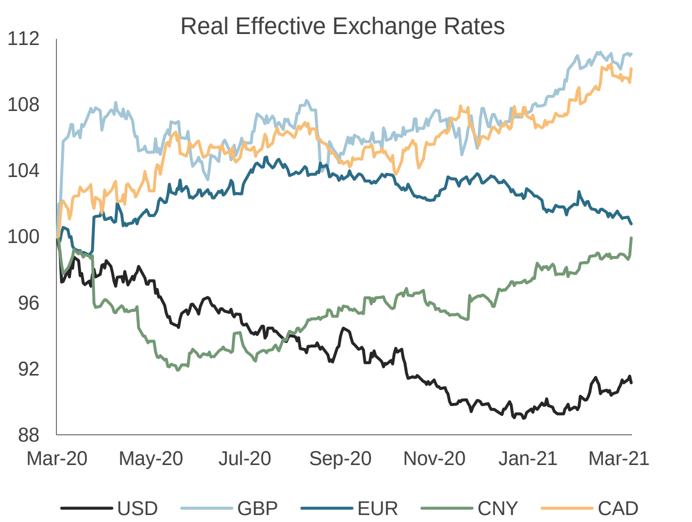
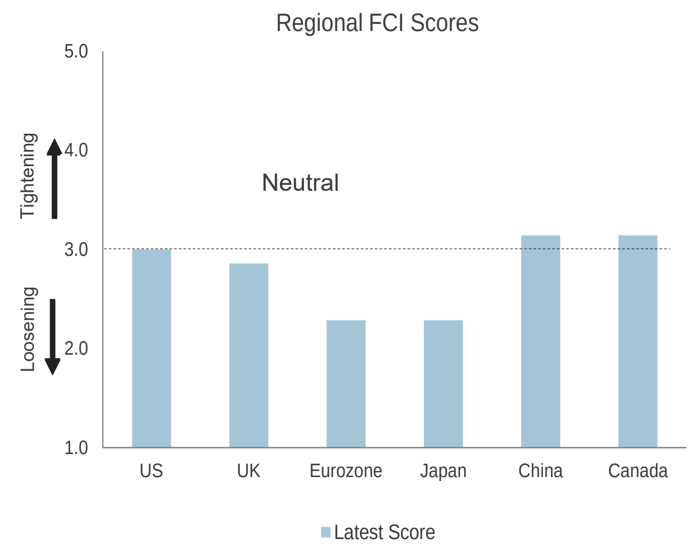


Chart 4: Higher US & Canada govt bond yields mean financial conditions are close to neutral, after being expansionary in 2020.



Index used: FTSE Canada Non-Agency Mid Bond Index

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Appendix – Canadian Historical Bond Yields % as of March 31, 2021

Canadian Bond Yields

Top 15% | Bottom 15%

		1-3YR	7-10YR	20+YR	All Mat
Canada	Current	0.43	1.40	1.90	
	3M Ago	0.25	0.59	1.09	
	6M Ago	0.26	0.49	0.98	
	12M Ago	0.50	0.67	1.18	
IL	Current			-0.04	
	3M Ago			-0.49	
	6M Ago			-0.35	
	12M Ago			0.42	
Provincial	Current	0.75	1.82	2.74	2.06
	3M Ago	0.48	1.08	1.97	1.42
	6M Ago	0.53	1.11	1.98	1.43
	12M Ago	1.11	1.75	2.56	2.04
Ontario	Current	0.75	1.81	2.73	1.95
	3M Ago	0.48	1.07	1.94	1.33
	6M Ago	0.54	1.09	1.94	1.35
	12M Ago	1.11	1.70	2.50	1.94
Quebec	Current	0.68	1.79	2.68	2.08
	3M Ago	0.45	1.05	1.92	1.43
	6M Ago	0.47	1.05	1.92	1.40
	12M Ago	1.09	1.69	2.48	2.00
Alberta	Current	0.78	1.90	2.89	2.17
	3M Ago	0.51	1.15	2.17	1.49
	6M Ago	0.60	1.22	2.20	1.56
	12M Ago	1.19	1.96	2.84	2.24
BC	Current	0.77	1.83	2.62	2.08
	3M Ago	0.49	1.06	1.87	1.41
	6M Ago	0.51	1.08	1.87	1.39
	12M Ago	1.04	1.71	2.42	2.03
Municipal	Current	0.83	1.82	2.83	2.07
	3M Ago	0.55	1.13	2.12	1.48
	6M Ago	0.57	1.13	2.14	1.48
	12M Ago	1.21	1.94	2.82	2.15
Corporate	Current	1.21	2.48	3.54	2.19
	3M Ago	0.92	1.82	2.84	1.71
	6M Ago	1.19	2.05	2.97	1.90
	12M Ago	2.85	3.45	3.82	3.24
High Yield	Current				4.45
	3M Ago				4.82
	6M Ago				5.59
	12M Ago				8.58

		1-5YR	5-10YR	20+YR	All Mat
AAA/AA	Current	0.87	1.96	3.21	1.15
	3M Ago	0.60	1.23	2.50	0.76
	6M Ago	0.72	1.35	2.71	0.88
	12M Ago	2.18	2.37	3.17	2.23
A	Current	1.18	2.16	3.26	2.13
	3M Ago	0.87	1.44	2.55	1.65
	6M Ago	1.14	1.61	2.68	1.85
	12M Ago	2.76	2.88	3.39	3.05
BBB	Current	1.49	2.70	3.91	2.59
	3M Ago	-1.69	-1.33	-0.43	2.09
	6M Ago	-1.22	-1.11	-0.36	2.35
	12M Ago	0.12	-0.34	-0.09	3.93
Comm	Current	2.49	4.00	1.40	2.64
	3M Ago	1.66	3.25	1.09	1.95
	6M Ago	1.81	3.33	1.38	2.08
	12M Ago	3.23	4.41	3.48	3.40
Energy	Current	1.40	2.70	3.58	2.84
	3M Ago	1.09	2.14	2.91	2.29
	6M Ago	1.38	2.45	3.02	2.50
	12M Ago	3.48	4.21	4.02	3.97
Financial	Current	1.09	2.24	4.02	1.41
	3M Ago	0.79	1.51	3.52	1.03
	6M Ago	1.03	1.65	3.72	1.23
	12M Ago	2.78	2.96	5.03	2.89
Industrial	Current	1.44	2.30	3.72	2.31
	3M Ago	1.19	1.68	3.06	1.92
	6M Ago	1.47	1.84	3.22	2.11
	12M Ago	3.24	3.34	4.19	3.55
Infrastructure	Current	1.11	2.25	3.29	2.86
	3M Ago	0.83	1.51	2.55	2.20
	6M Ago	1.04	1.69	2.68	2.35
	12M Ago	2.31	2.68	3.34	3.14
Securitization	Current	1.02			1.02
	3M Ago	0.82			0.82
	6M Ago	1.02			1.02
	12M Ago	2.44			2.44

Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada RRB Canada Index, FTSE Canada Corporate Bond Index (Short, Mid, Long, AAA/AA, A, BBB), FTSE Canada Provincial Bond Index, FTSE Canada High Yield Bond Index.

Source: FTSE Russell. All data as of March 31, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures. Bond market data is derived from FTSE Fixed Income Indexes. See Appendix Glossary for list of indexes used for each market. For professional investors only.

Appendix − Glossary

Bond markets are based on the following indexes:

FTSE Canada Universe Bond Index for all Canadian government and corporate bond markets*
FTSE Canada High Yield Bond Index for the Canadian high yield market
FTSE Canada RRB Canada Index for the Canadian inflation-linked bond market
FTSE World Government Bond Index (WGBI) for all global government bond markets
FTSE World Inflation-Linked Securities Index (WorldILSI) for all global inflation-linked bond markets
FTSE US Broad Investment-Grade Bond Index (USBIG®) for the US corporate bond market
FTSE US High-Yield Market Index for the US high yield bond market
FTSE Euro Broad Investment-Grade Bond Index (EuroBIG®) for the Euro-denominated corporate bond market
FTSE European High-Yield Market Index for the European high yield market
FTSE Chinese Government and Policy Bank Bond Index (CNGPBI) for the Chinese government bond market
FTSE Emerging Markets Inflation-Linked Securities Index (EMILSI) for the emerging markets inflation-linked bond market
FTSE Emerging Markets Broad Bond Index (EMUSDBBI) for the emerging markets corporate bond market

*** FTSE Canada Bond Indexes**

1-3YR = Short Term Bond Indexes
7-10YR = Mid Term Bond Indexes
20+ YR = Long Term Bond Indexes

List of Abbreviations used in charts:

IL = Inflation-linked bonds
IG = Investment-grade bonds
HY = High-yield bonds
BPS = Basis points
EM = Emerging market
LC = Local currency

This article is for information purposes. The information contained herein is not, and should not be construed as, investment, tax or legal advice to any party. Investments should be evaluated relative to the individual's investment objectives and professional advice should be obtained with respect to any circumstance.

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