BMO ETFs

2025 Outlook :
Adding Portfolio Ballast with Active Allocations

BMO | Exchange Traded Funds

INTRODUCTION

ETF market snapshot

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The Canadian ETF industry continues to expand–with estimates up to the end of November of last year suggesting assets under management in ETFs were now just above $565 billion.[1] That represents a substantial increase over the prior year ($380 billion) and speaks to the growing popularity of ETFs as an investment tool.

By asset class, of the total amount of net creations, equity ETFs have contributed 58% led by funds that track U.S. indices. Nevertheless, we've also seen a substantial amount of growth in Fixed Income ETFs as well–which have contributed 38% to net creations through last year.[2]

The above being said, it's worth noting that assets held in ETFs still only represent roughly a quarter of those held in Mutual funds.[3] A comparison of the current size of both industries tells us that there's more upside in ETFs going forward, not least as they can be bought by a much broader investor base. Indeed, many now expect the total amount of assets held in Canadian ETFs to rise to $700 billion in the coming years.

With that context, a look at the themes and factors we believe will influence the ETF market in the months ahead, prefaced with a rundown of key headwinds and tailwinds:

Major headwinds in 2025

- Stretched valuation for U.S. Equities.
- Canadian households remain heavily leveraged and face refinancing risk.
- Tariff risks will hang over non-U.S. economies.
- Fragile geopolitical backdrop with conflicts in the Middle East and Ukraine continuing.

Major tailwinds in 2025

- Monetary policy is still expected to be loosened further.
- Strong fundamental backdrop for the U.S. economy remains.
- Canada to benefit if/when investors diversify regionally.

INDEX STRATEGY

Tempering broad market expectations

Hot on the heels of an impressive showing in 2023, the S&P 500 rose by another 24% in 2024.[4] By sector, this performance was primarily led by Communications, Technology and Consumer Discretionary. However, it's worth noting that since the U.S. election, gains have been more tempered. Indeed, unlike the immediate period after Donald Trump's electoral win in 2016, we haven't seen as much of a 'Trump bump' effect this time around. This is a key reason why we remain a bit more guarded when it comes to index strategies in 2025.

Certainly, we could make the case for an extension higher in U.S. Equities. There's good reason to still expect the U.S. economy to grow at trend (which we see as close to 2%) this year as the Federal Reserve eases interest rates further. Even an additional 50 basis points worth of easing would go some ways to ensuring that capital costs would remain contained for corporates at the margin and free up room for additional investment. Also, consumption should remain firm with household balance sheets in great shape while the structure of the mortgage market (which is concentrated on long-term, fixed rate mortgages) should provide cover against interest rates still hovering at restrictive levels. These are reasons to be somewhat optimistic.

However, we're still very concerned with current valuations. The consensus expects around 14% year-over-year earnings growth for the S&P 500. At the same time, forward price-to-earnings (P/E) multiples are tracking close to 2020 highs.[5] Our own estimate for earnings suggests 6–7% growth implying that P/E multiples would need to reach levels not seen since 2000 in order to justify extant valuation. That's not impossible, but it makes us a bit uneasy with chasing further upside in **U.S. Equities** from here.

For U.S. Fixed Income, our preference is to remain underweight given the still supportive economic backdrop and uncertainty with how the U.S. will address its massive budget deficit.

In Canada, we're still fairly confident that the Bank of Canada will need to ease rates further – potentially taking the overnight rate to 2.00% by the end of the year. As such, we continue to like Canadian dollar (CAD) Fixed Income instruments. However, given how well CAD sovereign bonds have performed in 2024, extant valuation (especially when compared to U.S. Treasuries) makes us a bit leery about increasing portfolio allocation.

Instead, our preference is to focus instead on ETFs that track 'spread products.' This means that we like corporates and provincial instruments in Canada. In our minds, the **BMO Short Corporate Bond Index ETF (Ticker: ZCS)**, the **BMO Short Provincial Bond Index ETF (Ticker: ZPS)** and the **BMO Canadian Bank Income Index ETF (Ticker: ZBI)** are well placed going forward.

ACTIVE & STRUCTURED OUTCOMES

Tilting toward cashflow strategies

Given our view on index allocations detailed in the prior section, one of the core themes for the U.S. next year is the potential for passive index investing to become a touch passé. Instead, a strategy focused more on active/structured outcomes that is designed to generate cashflow may be appropriate.

For U.S. Equities, that means potentially curbing some exposure to broad index trackers, and allocating towards high dividend and covered call strategies. A few that we really like this year include the **BMO US High Dividend Covered Call ETF (Ticker: ZWH)**, and the **BMO Covered Call US Banks ETF(Ticker: ZWK)**. Each offers fairly attractive yields for the coming period.

Additionally, given where current valuations are, protecting your downside risks to core exposures that track U.S. large caps is essential. The ETF market offers plenty of 'liquid alternative' investing strategies that can help protect downside risks while still allowing some topside participation. However, BMO's suite of Buffer ETFs are particularly well placed to do that with their quarterly resets offering much more flexibility. As such, we will be increasing our allocation to the **BMO US Equity Buffer Hedged to CAD ETF – January (Ticker: ZJAN)**.

Given where current valuations are, protecting downside risks to core exposures is essential

In Canada, our approach is going to be similar in the sense that we are going to reorient our portfolio towards generate cashflow via active and structured outcome strategies. One particular play that we like is the **BMO Canadian High Dividend Covered Call ETF (Ticker: ZWC)**.

A final note for Canadian investors. The trade-related backdrop has become increasingly uncertain, and when taken with the attendant impact on the CAD, investors should remain cautious and game plan for spikes in volatility for the period ahead. With that in mind, we see the **BMO Long Short Canadian Equity ETF (Ticker: ZLSC)** and the **BMO Long Short US Equity ETF (Ticker: ZLSU)** being important diversifiers next year. Indeed, both ETFs are well-diversified and designed to improve overall portfolio risk and return characteristics.

FOOTNOTES

[1] CAD, BMO Global Asset Management, as of November 30, 2024.

[2] BMO Global Asset Management, as of November 30, 2024.

[3] Mutual fund assets totalled $2.268 trillion (CAD), November 30, 2024. Investment Funds Institute of Canada (IFIC).

[4] Bloomberg, as of November 30, 2024.

[5] Price-to-earnings (P/E) ratio: a measure of a company's share price relative to its earnings per share (EPS). Often called the price or earnings multiple, the P/E ratio helps assess the relative value of a company's stock.

[6] Products that generate potential return from differences in credit spreads. Credit spread is a measure of the credit risk perceived by investors. Widening credit spreads indicate an increase in credit risk, while tightening spreads indicate a decline in credit risk.

Performance (%)

	Year-to-date	1-month	3-month	6-month	1-year	3-year	5-year	10-year	Since inception
ZCS	6.68	0.70	2.10	5.16	8.72	2.93	2.74	2.56	2.88
ZPS	4.67	0.49	1.34	4.26	6.14	1.60	1.55	1.57	2.00
ZBI	11.27	0.77	2.59	5.41	13.59	-	-	-	3.61
ZWH	22.01	3.35	7.10	11.63	22.93	10.18	9.63	10.48	11.33
ZWK	48.88	11.61	18.63	29.66	58.91	1.48	4.36	-	5.98
ZWC	15.75	3.39	5.73	10.33	20.06	7.88	6.99	-	6.23
ZLSC	23.05	3.85	7.76	12.80	25.14	-	-	-	24.02
ZLSU	32.95	4.55	8.96	14.58	32.25	-	-	-	36.56
ZJAN	Returns not available, as there is less than one year's performance data								

Source: Bloomberg, as of November 30, 2024. The inception dates for respective funds: ZCS, ZPS = October 20, 2009, ZBI = February 7, 2022, ZWH = February 10, 2014, ZWK = February 12, 2019, ZJAN = January 24, 2024 , ZWC = February 3, 2017, ZLSC, ZLSU = September 27, 2023.

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Changes in rates of exchange may also reduce the value of your investment.

The portfolio holdings are subject to change without notice. They are not recommendations to buy or sell any particular security.

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For a summary of the risks of an investment in the BMO ETFs, please see the specific risks set out in the BMO ETF's prospectus. BMO ETFs trade like stocks, fluctuate in market value and may trade at a discount to their net asset value, which may increase the risk of loss. Distributions are not guaranteed and are subject to change and/or elimination.

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BMO Buffer ETFs seeks to provide income and appreciation that match the return of a Reference Index up to a cap (before fees, expenses and taxes), while providing a buffer against the first 15% (before fees, expenses and taxes) of a decrease in the Reference Index over a period of approximately one year, starting from the first business day of the stated outcome period.

An investor that purchases Units of a Structured Outcome ETF other than at starting NAV on the first day of a Target Outcome Period and/or sells Units of a Structured Outcome ETF prior to the end of a Target Outcome Period may experience results that are very different from the target outcomes sought by the Structured Outcome ETF for that Target Outcome Period. Both the cap and, where applicable, the buffer are fixed levels that are calculated in relation to the market price of the applicable Reference ETF and a Structured Outcome ETF's NAV (as Structured herein) at the start of each Target Outcome Period. As the market price of the applicable Reference ETF and the Structured Outcome ETF's NAV will change over the Target Outcome Period, an investor acquiring Units of a Structured Outcome ETF after the start of a Target Outcome Period will likely have a different return potential than an investor who purchased Units of a Structured Outcome ETF at the start of the Target Outcome Period. This is because while the cap and, as applicable, the buffer for the Target Outcome Period are fixed levels that remain constant throughout the Target Outcome Period, an investor purchasing Units of a Structured Outcome ETF at market value during the Target Outcome Period likely purchase Units of a Structured Outcome ETF at a market price that is different from the Structured Outcome ETF's NAV at the start of the Target Outcome Period (i.e., the NAV that the cap and, as applicable, the buffer reference). In addition, the market price of the applicable Reference ETF is likely to be different from the price of that Reference ETF at the start of the Target Outcome Period. To achieve the intended target outcomes sought by a Structured Outcome ETF for a Target Outcome Period, an investor must hold Units of the Structured Outcome ETF for that entire Target Outcome Period.

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