BMO ETF Portfolio Strategy Report

Third Quarter 2017 BMO EXCHANGE TRADED FUNDS

The Hawk and the Dove

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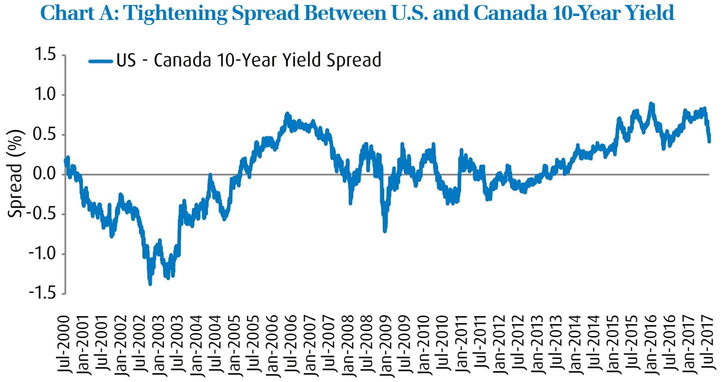
In this report:

All prices, returns and portfolio weights are as of market close on July 14, 2017, unless otherwise indicated.

In this report, we highlight our strategic and tactical portfolio positioning strategies for the third quarter using various BMO Exchange Traded Funds (BMO ETFs). Our key strategy changes are outlined throughout the report and in our quarterly outlook on page six.

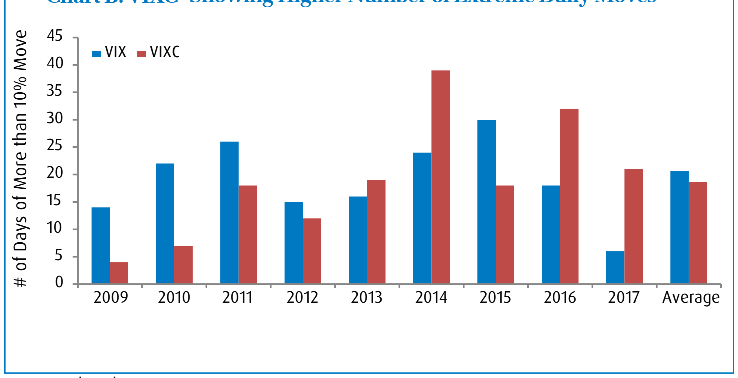
- **As the market anticipated, the Bank of Canada (BoC) raised its overnight lending rate by 25 basis points (bps) at its July 12th meeting.** Although the rate hike was largely priced in, the BoC appeared more hawkish than expected, citing confidence of continued economic growth and downplaying risk, such as sluggish inflation. With the central bank appearing willing to raise rates more aggressively, the forward curve has repriced and interest rate futures are now assigning a probability, albeit small, that the overnight rate will be 50bps higher (at 1.25%) by year end.
- **While the BoC came in more hawkish than expected, the U.S. Federal Reserve (Fed) looks more hesitant in its pace towards higher rates.** As a result, we expect the U.S. Treasury yield curve to flatten and the spread between the U.S. and Canada 10-year yield to tighten (Chart A). Consequently, we currently favour U.S. duration risk over Canadian duration risk. A continued strengthening in U.S. economic data and a more dovish stance by the Fed could present a goldilocks environment for U.S. credit, whether investment grade debt, high yield bonds or preferred shares.
- **With the spread between the U.S. and Canada 10-year yield nearly two standard deviations above its historical average, there is room for further regression towards the mean.** The Canadian dollar could continue to gain momentum relative to the greenback with a potential recovery in oil prices, providing optionality for further upside performance.
- **Implied volatility indicates that equity market uncertainty remains subdued, as readings on both the *CBOE S&P Volatility Index® (VIX®)* and *S&P/TSX 60 VIX Index® (VIXC®)* are well below historical medians.** However, when looking at the number of days that each volatility index has had more than a 10% daily move, the VIXC looks to be on pace to finish this year higher than average (Chart B). As a result, we believe low volatility equity strategies should continue to be a core strategy when investing in Canadian equities.
- **Equity market valuations look stretched with the current price-to-earnings (P/E) ratio of the MSCI World Index at 21.6x.** Bond investors should also be cautious with rising rates and central banks looking to tighten monetary policy. With each asset class posing its own set of risks, non-traditional, less correlated asset classes could help improve portfolio efficiency.

Chart A: Tightening Spread Between U.S. and Canada 10-Year Yield



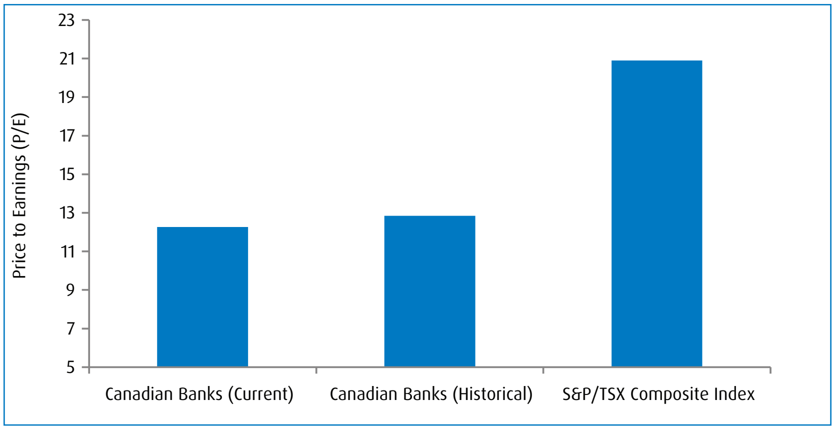
Source: Bloomberg

Chart B: VIXC® Showing Higher Number of Extreme Daily Moves



Source: Bloomberg

Things to Keep an Eye on...



Source: Bloomberg

Over the last several months, there has been an overhang on the Canadian banking sector, stemming from the recent worries of Home Capital Group Inc. Investors are concerned whether the problems with the alternative mortgage lender is a prelude to larger problems ahead, particularly with traditional lenders such as the banks. It should be noted that Canadian banks tend to be more conservative in their mortgage lending practices and have a higher quality mortgage portfolio as a whole. The share prices of the Canadian banks have declined from February highs as a result of the concerns, making the sector more attractive from a valuation standpoint. Canadian banks now have a current price-to-earnings (P/E) ratio of 12.2x, lower than its historical average of 13.4x and the 20.8x P/E of the broader *S&P/TSX Composite Index*.

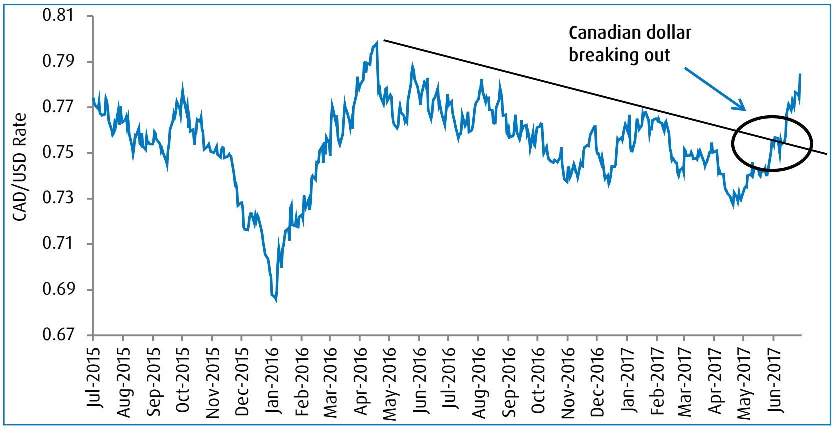
Recommendation: The businesses of Canadian banks tend to be more diversified than their global counterparts, which extends beyond the mortgages business. The BoC's recent shift to a more hawkish monetary policy should also provide a shot of confidence to the Canadian economy and potentially increase the profitability of banks. A steeper yield curve can be favourable for the sector, as banks tend to borrow using short-term rates and lend using longer-term rates. Investors can efficiently access the "Big-Six" Canadian banks through the ***BMO S&P/TSX Equal Weight Banks ETF (ZEB)*** or in a covered call format in the ***BMO Covered Call Canadian Banks ETF (ZWB)***.

Daily Move in Interest Rates	# of Occurrences	% of Occurrences	Average Daily Return On U.S. Preferred Shares
-0.20% to -0.10%	19	1.42%	0.1531%
-0.10% to 0.00%	657	49.07%	0.0561%
0.00% to 0.10%	632	47.20%	0.0395%
0.10% to 0.20%	28	2.09%	-0.2186%
0.20% to 0.30%	3	0.22%	-0.6665%

Source: BMO Global Asset Management, Bloomberg

U.S. preferred shares are an asset class often used in the portfolio construction process of many global investors. However, Canadian investors tend to have little or no exposure to this income oriented asset class, primarily due to the misconception that preferred shares are sensitive to rising interest rates, with the majority of exchange-listed preferred shares in the U.S. having a fixed coupon. In the table to the left, we compare the daily change in values in U.S. preferred shares (as represented by the *Solactive U.S. Preferred Shares Select Index*) against the U.S. 10-Year U.S. Treasury yield. In most instances (96.09% of occurrences), yields tend to be slightly increasing or decreasing on a daily basis. When rates decline, the duration component can benefit U.S. preferred shares, while in a rising interest rate environment, tightening credit can offset the duration impact. This is particularly true, given U.S. preferred shares typically can be called at par value five years after issuance.

Recommendation: Since many U.S. preferred shares were issued with wide credit spreads, they tend to be call candidates as issuers can redeem at par and refinance at lower rates. The current environment in the U.S. is ideal for U.S. preferred shares as the Fed is now looking more dovish and it is unlikely rates in the U.S. will rise aggressively. Investors looking to gain exposure to U.S. preferred shares can do so through the ***BMO U.S. Preferred Share Index ETF (ZUP), in U.S. dollars (ZUP.U) or hedged to the Canadian dollar (ZHP)***.



Source: Bloomberg

The U.S. dollar has experienced a steady appreciation relative to the Canadian dollar since May 2016. In the second quarter of last year, the U.S. dollar began to revise upwards, with expectations of an eventual Fed rate hike. When Donald Trump was elected the next President of the United States, his plans of pro-growth economic policies put additional upward pressure on U.S. bond yields. As it was widely anticipated that the BoC would keep its overnight rate unchanged in 2016, the interest rate differential between U.S. and Canadian bond yields began to diverge, which has been supportive of the greenback. Now, with the BoC recently raising rates and in clear tightening mode, the Canadian dollar has started to gain positive momentum.

Recommendation: Last quarter, we recommended that investors consider hedging some of their U.S. dollar exposure. Over the period, the U.S. dollar fell 2.7% against the Canadian dollar, with a sizable decline in the second half of June. Overall, we remain partially hedged in our portfolio strategy, with some U.S. exposed ETFs being hedged and others not. Given the aggressive gains in the Canadian dollar in the last 2 weeks, we are going to keep our overall partial hedge unchanged, but would consider increasing our hedge if the Canadian dollar were to experience a short-term pullback.

Changes to Portfolio Strategy

Asset Allocation:

- Our asset allocation has been conservative since the inception of our strategy in June of 2012. This approach has fared well for our performance, while mitigating risk compared to a traditional 60%/40% portfolio (*S&P/TSX Composite Index*, *FTSE/TMX Canada Bond Universe*). As rising interest rates are becoming more of a concern and valuations in most equity markets continue to look stretched, we are slightly increasing our exposure to the non-traditional/hybrid category of our portfolio strategy, while maintaining our defensive stance.

Fixed Income:

- To reduce our sensitivity to Canadian interest rates, we are decreasing our exposure to the ***BMO Mid Corporate Bond Index ETF (ZCM)*** by 3.0%. Several months ago, the market did not anticipate a rate hike until the end of 2017 at earliest, with some even forecasting the BoC to keep rates unchanged until 2018. The BoC's recent move to raise its overnight rate by 25bps last week may have signalled that the central bank wanted to raise rates to slow the momentum in household debt growth while simultaneously cooling the housing market. As the BoC is clearly in a tightening phase, we are increasing our exposure to the ***BMO Short Corporate Bond Index ETF (ZCS)*** by 3.0%.
- The Fed, which is also in a tightening phase, appears to be more dovish than anticipated. We expect its pace in raising rates to be less aggressive than the market anticipates. Rising interest rates in the U.S. is therefore likely already priced in to bond yields and we expect a further flattening in the yield curve. We are slightly decreasing our weighting in the ***BMO Mid-Term U.S. IG Corporate Bond Index ETF (ZIC)*** by 2.0% in favour of U.S. preferred shares. Due to the higher dividends and callable nature of U.S. preferred shares, they can be less sensitive to rising interest rates, while still benefitting from interest rates repricing lower.

Equities:

- As mentioned, the recent concerns raised by Alt-A mortgages have led to a sell-off of the share prices of Canadian banks. From a valuation perspective, the banking sector is trading below both its historical average and relative to the *S&P/TSX Composite Index*. We expect the market will require some time digesting the remaining uncertainty in the banking sector, consequently we are utilizing the ***BMO Covered Call Banks ETF (ZWB)*** to take advantage of the potential volatility that may arise. Over the long-term, we expect earnings of Canadian banks to continue trending in a positive direction. We are decreasing our exposure in the ***BMO Low Volatility U.S. Equity ETF (ZLU)*** by 2.0% in favour of ***ZWB***.

Non-Traditional/Hybrids:

- The current interest rate environment is beneficial for holdings in the non-traditional/hybrid portion of our portfolio strategy. Canadian rate reset preferred shares would likely benefit from rising interest rates in Canada, while a strengthening business environment in the U.S., coupled with predictable rate hikes by the Fed could benefit U.S. preferred shares. Combined, the two asset classes provide a balanced approach to income investing. As demonstrated on the previous page, U.S. preferred shares can exhibit positive performance even if interest rates are slowly and steadily rising. Although preferred shares are perpetual by nature, they are typically callable after five years, which greatly reduces duration risk when interest rates rise. We have already seen a number of underlying issues in the ***BMO U.S. Preferred Shares Hedged to CAD ETF (ZHP)*** being called by issuers, given they currently can be refinanced at lower rates. We are increasing our weight in ***ZHP*** by 2.0%.

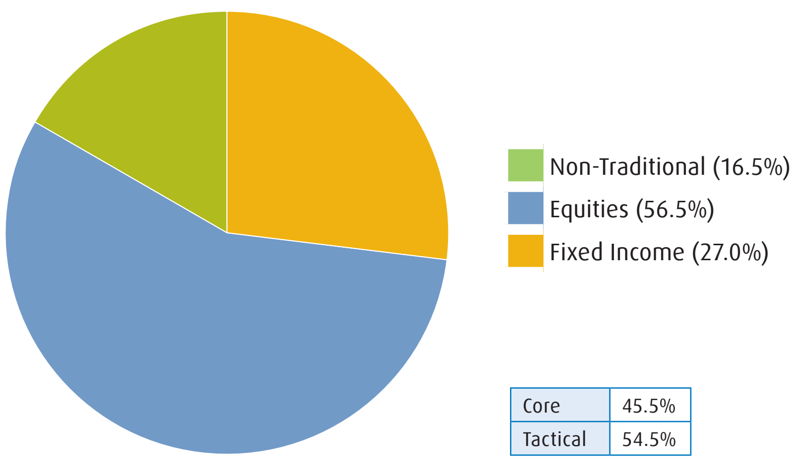
Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Mid Corporate Bond Index ETF	ZCM	3.0%	BMO Short Corporate Bond Index ETF	ZCS	3.0%
BMO Mid-Term U.S. IG Corporate Bond Index ETF	ZIC	2.0%	BMO U.S. Preferred Shares Hedged to CAD ETF	ZHP	2.0%
BMO Low Volatility U.S. Equity ETF	ZLU	2.0%	BMO Covered Call Banks ETF	ZWB	2.0%
Total		**7.0%**	**Total**		**7.0%**

Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange traded funds (ETFs).

Stats and Portfolio Holdings

Ticker	ETF Name		Position	Price	Management Fee[1]	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/ Vol
	Fixed Income									
ZDB	BMO DISCOUNT BOND INDEX ETF	Fixed Income	Core	$15.82	0.09%	7.0%	3.7	3.1%	2.1%	0.56
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.32	0.25%	11.0%	16.1	21.2%	3.3%	0.21
ZCM	BMO MID CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$16.25	0.30%	3.0%	4.3	1.5%	3.0%	0.70
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$14.27	0.10%	6.0%	2.1	1.5%	2.9%	1.37
	Total Fixed Income					27.0%		27.3%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$29.48	0.35%	14.5%	5.8	10.1%	2.5%	0.43
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	Equity	Core	$20.48	0.05%	3.0%	8.5	3.0%	2.9%	0.34
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	Equity	Core	$29.16	0.30%	12.0%	7.7	11.0%	2.0%	0.26
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$22.21	0.40%	7.0%	13.1	11.0%	2.0%	0.15
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	Equity	Tactical	$20.05	0.40%	5.0%	12.0	7.2%	2.0%	0.17
ZUH	BMO EQUAL WEIGHT U.S. HEALTH CARE HEDGED TO C$ INDEX ETF	Equity	Tactical	$47.63	0.35%	3.0%	9.4	3.4%	0.4%	0.05
ZWB	BMO COVERED CALL BANKS ETF	Equity	Tactical	$18.45	0.65%	5.0%	10.5	6.3%	5.1%	0.49
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	Equity	Tactical	$21.31	0.65%	3.0%	6.2	2.2%	4.6%	0.74
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	Equity	Tactical	$23.71	0.35%	4.0%	19.6	9.4%	1.2%	0.06
	Total Equity					56.5%		63.6%		
	Non-Traditional/Hybrids									
ZFH	BMO FLOATING RATE HIGH YIELD ETF	Hybrid	Tactical	$15.29	0.40%	3.5%	3.8	1.6%	4.7%	1.24
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	Hybrid	Tactical	$11.56	0.45%	7.0%	6.9	5.8%	4.2%	0.61
ZHP	BMO U.S. PREFERRED SHARES HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$25.70	0.45%	6.0%	2.4	1.7%	5.0%	2.08
	Total Alternatives					16.5%		9.1%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.33%**	**100.0%**	**8.4**	**100.0%**	**2.9%**	**0.35**

Ticker	Top Holdings	Weight
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	14.5%
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	12.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	11.0%
ZDB	BMO DISCOUNT BOND INDEX ETF	7.0%
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	7.0%
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	7.0%
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	6.0%
ZHP	BMO U.S. PREFERRED SHARES HEDGED TO CAD INDEX ETF	6.0%
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	5.0%
ZWB	BMO COVERED CALL BANKS ETF	5.0%
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	4.0%
ZFH	BMO FLOATING RATE HIGH YIELD ETF	3.5%
ZCM	BMO MID CORPORATE BOND INDEX ETF	3.0%
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	3.0%
ZUH	BMO EQUAL WEIGHT U.S. HEALTH CARE HEDGED TO C$ INDEX ETF	3.0%
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	3.0%



Core	45.5%
Tactical	54.5%

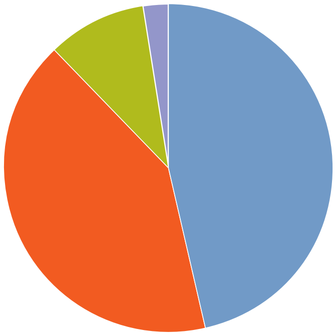
Source: Bloomberg, BMO Asset Management Inc. (Data as of July 14, 2017)

*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.

**Cash is based off the 3-quarter Canadian Dealer Offered Rate (CDOR).

Portfolio Characteristics

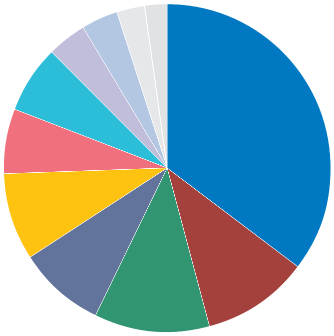
Regional Breakdown (Overall Portfolio)



Canada	46.5%
United States	41.5%
Europe	9.6%
Asia	2.4%

*Regional Breakdown includes equities, fixed income and alternative sleeves.

Equity Sector Breakdown



Financials	35.5%
Consumer Staples	10.5%
Health Care	11.4%
Utilities	8.7%
Consumer Discretionary	8.5%
Real Estate	6.4%
Industrials	6.8%
Information Technology	3.7%
Telecommunication Services	3.8%
Materials	2.6%
Energy	2.2%

Fixed Income Breakdown

Federal	8.6%
Provincial	8.1%
Investment Grade Corporate	73.3%
Non-Investment Grade Corporate	10.0%

Weighted Average Term	6.77
Weighted Average Duration	5.31
Weighted Average Coupon	3.2%
Weighted Average Current Yield	3.2%
Weighted Average Yield to Maturity	2.8%

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 July 14, 2017)

The Good, the Bad, and the Ugly

Conclusion: The Bank of Canada raised its overnight rate by 25bps last week, in a move that was considered an outside probability two months ago. While there are data points which show an improving economy in Canada, it looks unclear in why the BoC has become so hawkish in recent weeks. Regardless, we view a tighter monetary policy as being prudent as debt continues to grow amongst Canadian households. As the market adjusts to higher rates, an investor needs to appropriately position country, duration, credit and factor risk to tactically manage in the current market.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• The U.S. remains at near full employment, with the unemployment rate at 4.37%, its lowest level since June 2001. • Application for U.S. unemployment has hit lows not seen since 1973. • GDP (y/y) in Canada continues to trend upwards. • Retail sales in Canada both including Autos and without came in higher than expected. • Manufacturing in the U.S. continues to expand, with the PMI coming in at 52. • Unemployment in the Eurozone continues to trend lower, now at 9.47% and moving lower since June 2013. • There are a growing number of central banks looking to raise interest rates, which can prevent the growth of asset bubbles. • Inflation in the U.S. has stayed in the range of the Fed's target rate.	• Implied current yield for rate reset preferred shares has risen above the current yield, suggesting the market is beginning to price Canadian preferred shares using the forward curve. • The recent sell-off in banks has created an opportunity to pick up the sector at a more reasonable valuation level.	• Higher beta stocks have been gaining relative strength versus low beta stocks in the U.S. This illustrates risk appetite has been increasing. • Small cap stocks are also gaining strength relative to larger cap stocks. • The Canadian dollar is gaining momentum as it recently broke above resistance. • The Canadian dollar has also broken out against most major currencies such as the Euro, British Pound and Japanese yen. Investors should strongly consider currency hedged vehicles when investing in foreign markets.
Bad	• The rise in housing prices across Canada has gained momentum, registering a 13.9% y/y gain in May, its 12^{th} straight month of double digit gains. • Despite GDP rising in Canada, inflation remains well below target, but still positive. • Canadian housing starts came in higher than expected, which can help soften prices. • Durable goods orders in the U.S. came in at -0.8%, but at expectations.	• The market cap of the *S&P 500 Composite Index* as a percentage of GDP has risen to levels which preceded the last two recessions. • High yield credit spreads have tightened to post-crisis lows due to technical factors such as low supply. With expected new issues coming to market, high yield bonds may experience some widening. • Trailing earnings per share on average for the *S&P 500 Composite Index* is lower than 2014. However, have increased in recent months. • Price to earnings and forward looking price to sales are well above the historical median in European stocks. However, there is potential upside on earnings and sales growth.	• The appetite for risk remains low in Canada as bonds have outperformed stocks year to date. • Put option open interest for *S&P/TSX Composite (TSX) Index* has grown, reflecting a bearish view on Canadian equities.
Ugly	• Household debt levels in Canada remains our primary concern. Sitting at an all-time high, it limits how much the BoC can reduce its overnight rate. This may have prompted the BoC's recent change in monetary policy.		• Margin debt has increased to all-time highs. A quick rise in interest rates can cause markets to deleverage.

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