Quarterly Fixed Income Strategy

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In this report, we highlight our fixed income positioning strategies for the second quarter ended March 31, 2021 (calendar year).

Duration

- The yield curve continued to steepen over the quarter with the rise in long term rates accelerating on the back of the ongoing vaccination rollout. Although COVID-19 inoculations in Canada have fallen behind, the Bank of Canada ("BoC") has stayed on course in ending its asset purchase plans on schedule. This confirmed to investors that the BoC's monetary policy would remain more prudent than its U.S. counterpart. Over the quarter, spreads between the 10-and 2-year yields in Canada widened by 86 basis points (bps) [1].
- Although the U.S. Federal Reserve ("Fed") has been very liberal in its stimulus plans, its aggressive vaccination rollout has investors optimistic of an economic reopening. Currently, the U.S. has the fourth highest vaccination rate in the world, at 37.1%[2] of its population. Over the first quarter, the difference between the 10- and 2-year yields in the U.S. widened by 79bps[3].
- The U.S. Consumer Price Index (CPI) registered a 2.6%[4] reading year-over-year in March, which came in slightly higher than expectations. Although, this was partly due to what's known as the "base-effect," which compares data to extreme lows, there are increasing signs that inflation is possible. The U.S. Producer Price Index (PPI) recently came in at 5.9%[5] year-over-year – its highest reading since the Great Financial Crisis. As the economy opens, higher input costs for producers can eventually be passed on to end-consumers. As pent-up demand is unlocked, this will further exacerbate the existing supply and demand imbalance and eventually trickle down to CPI.
- Though we believe interest rates will end the year higher, it is likely that we will see a pause in rising bond yields over the coming quarter. As bond prices have declined, portfolio rebalancing will lead investors to take risk off the table by moving some equities back into fixed income. In addition, higher yields will likely attract foreign investors and liability matchers. Additionally, given the rich valuations in equities, investors may look to allocate to other asset classes outside of stocks until corporate earnings expand further.
- We do believe that hedging against rising rates and reflation will be the main concern for bond investors over the year. However, as stocks are fully valued for the time being, having duration exposure will also provide stability to a portfolio against a soft equity market. As a result, we believe combining exposures such as rate-reset preferred shares and U.S. Treasury Inflation Protected Securities (TIPS) to broad-based fixed income exposures will be the key to success in the coming months.

Credit

- Credit spreads continue to trade near pre-COVID-19 levels in many areas. This means investors that are looking for upside in corporate bonds will need to be more selective. We believe Canadian investment-grade credit is better positioned given where we are in the economic cycle. The recent uptick in the demand for commodities will likely persist as infrastructure development continues and vacation travel resumes. Higher oil and material prices will likely benefit the Canadian economy.
- We also continue to favour credit exposure through preferred shares. The introduction of Limited Recourse Capital Notes (LRCN) has provided much-needed stability to the Canadian preferred share market. As capital raised through LRCN issuance will be used to redeem preferred shares at par value, it has removed the risk of lower interest rates for some banks and insurance issues, as they can refinance at competitive levels through these notes.
- We continue to see limited upside in U.S. high yield bonds as spreads remain tight and default rates can still come in higher than anticipated. U.S. preferred shares remain our go-to asset class to enhance yield, as the majority of issuers are investment-grade. Moreover, bank issuers, who tend to be well represented in this exposure, have kicked off the recent earnings season with strong numbers.

Currency

- As we called for last quarter, we continue to expect the loonie to strengthen relative to the U.S. dollar. Our reasoning remains unchanged as Canadian commodity exports will be in high demand, in addition to the BoC remaining diligent in winding down its asset purchase program. We will keep our exposure in long-term U.S. Treasuries unhedged, as that position is being used as a protection against "black swan" events. However, investors looking to be tactical may want to hedge their U.S. dollar exposure.

Sell	Ticker	%	Buy	Ticker	%
BMO HIGH QUALITY CORPORATE BOND INDEX ETF	ZQB	-16%	BMO CORPORATE BOND INDEX ETF	ZCB	20%
BMO MID-TERM US IG CORPORATE BOND INDEX ETF	ZIC	-5%	BMO SHORT-TERM US TIPS INDEX ETF (Hedged Units)	ZTIP.F	3%
BMO LONG-TERM US TREASURY BOND INDEX ETF	ZTL	-2%			
TOTAL		**-23%**	**TOTAL**		**23%**

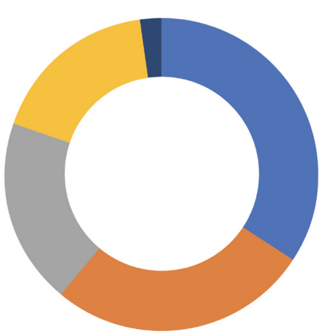
Source: BMO Global Asset Management, Bloomberg.

Model Portfolio

Ticker	ETF Name	Weight (%)	Duration*	Yield-to-Maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	7.96	1.66%	0.08%	Canada	Core
ZCB	BMO CORPORATE BOND INDEX ETF	20.0%	6.69	1.94%	0.15%	Canada	Core
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	5.0%	18.61	2.30%	0.20%	U.S.	Core
ZTIP.F	BMO SHORT-TERM US TIPS INDEX ETF (CAD HEDGED)	3.0%	2.65	0.35%	0.15%	U.S.	Non-Traditional
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	4.0%	3.01	4.95%	0.45%	Canada	Non-Traditional
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%	5.00	5.61%	0.45%	U.S.	Non-Traditional
	Portfolio	**100.0%**	**7.70**	**2.08%**	**0.14%**		

Exposures	Duration	Yield	Weight
CORE	8.28	1.76%	87.0%
NON-TRADITIONAL	3.84	4.11%	13.0%
Total	**7.70**	**2.07%**	**100.0%**
CANADA	7.43	1.88%	86.0%
U.S.	9.36	3.22%	14.0%

Credit Summary



- **AAA**....................31.46%
- **AA** 24.87%
- **A**..........................17.69%
- **BBB** 16.09%
- **BB**....................... 1.80%
- **B** 0.00%
- **Below CCC** 0.00%

Term Summary

- **1-5 years**...........48.24%
- **5-10 years**.........22.47%
- **10-30 years** 29.28%

*As of March 31, 2021. Please note yields will change from month to month based on market conditions.
Source: BMO Global Asset Management, Bloomberg.

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Definitions:

Basis Points: Basis points (BPS) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as follows: 1% change = 100 basis points and 0.01% = 1 basis point. Basis points are typically expressed in the abbreviations "bp," "bps," or "bips."

Duration: A measure of the approximate sensitivity of a bond's price to a change in interest rates. A duration of, for example, means that the price of the bond would decrease/increase by approximately 2% if the interest rate increased/decreased by 1%.

Positioning: The amount of a security, asset, or property that is owned (or sold short) by some individual or other entity. A trader or investor takes a position when they make a purchase through a buy order, signaling bullish intent; or if they sell short securities with bearish intent.

Weight: The percentage of an investment portfolio that a particular holding or type of holding comprises.

Yield: The annual income distributed from an investment expressed as a percentage of the investment's current value. For example, a money market instrument that pays $30 in interest with a current value of $1,000 has a yield of 3%.

Yield-to-Maturity: The total return anticipated on a bond if the bond is held until it matures. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate. In other words, it is the internal rate of return (IRR) of an investment in a bond if the investor holds the bond until maturity, with all payments made as scheduled and reinvested at the same rate.

Source: Duration and Yield – BMO Global Asset Management Simplified Prospectus, May 22, 2020; all other definitions – Investopedia.com.

[1] Bank of Canada https://www.bankofcanada.ca/rates/interest-rates/canadian-bonds/. [2] Our World in Data https://ourworldindata.org/covid-vaccinations

[3] U.S. Department of the Treasury https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield. [4] U.S. Bureau of Labor Statistics https://www.bls.gov/cpi/

[5] U.S. Bureau of Labor Statistics https://www.bls.gov/ppi/