BMO Global Asset Management ETF Outlook 2018

The exchange traded fund (ETF) industry had another record breaking year in 2017, reaching new milestones across the globe. Investors continue to recognize the efficiencies of ETFs as fundamental portfolio building blocks. As global news and events impact markets and performance expectations shift, ETFs have become effective investments to efficiently rebalance portfolios to reflect changing sentiments. ETFs occupy a unique space as go to investments for institutions, asset managers, advisors and retail investors. The growing acceptance of combining ETFs with traditional active solutions has accelerated the adoption of ETFs globally.

This outlook report examines how the ETF industry evolved in 2017 and identifies key trends that are expected to shape the industry in 2018.

Global Trends

Global equity markets continued to advance in 2017 which led to record breaking flows into ETFs. The global ETF market exceeded US$4.6 trillion in assets by year end, with over US$649 billion in new assets.[1] This tremendous industry growth has been matched by the emergence of new ETFs that transcend the traditional broad market capitalization index structure, where there are now over 5,300 ETFs globally.[1] The diversity of ETFs and array of opportunities available to investors is now greater than ever. An investor today can access traditional equity and fixed income exposures, in addition to innovative market trends such as artificial intelligence or complex derivative strategies such as swaps or covered calls.

The U.S. ETF market crossed the US$3 trillion milestone this year and now stands at US$3.3 trillion in assets, showing significant growth from previous years with inflows of US$465 billion, a 67% increase from last year.[1] Equity ETFs saw inflows of US$336 billion while fixed income ETFs continued to gain significant inflows with over US$111 billion.[1] The European market had a strong year, with total assets reaching US$762 billion, a 40% increase from last year and inflows of just over US$102 billion.[1] Japanese ETF assets increased by 60.7% to US$272.6 billion, with net inflows to ETFs of US$53 billion.[1] The Asia Pacific ex Japan market had an historic year with inflows of US$8.3 billion and the total ETF market surpassing US$165 billion.[1]

The Canadian ETF industry continued to grow proving to be a prominent player in the global market, with total assets reaching C$147 billion and inflows of C$26 billion, a 56% increase from last year.[1] Equity ETFs added C$13.1 billion in inflows as investors increased their broad market exposures. Investors continued to gravitate towards fixed income ETFs, with inflows accumulating to over C$10.7 billion.[1]

The Canadian equity ETF with the most inflows in 2017 was BMO S&P/TSX Capped Composite Index ETF (**Ticker: ZCN**) where investors pursued broad market Canadian equities in addition to exposure to the strengthening Canadian dollar.[1] While attention was focused on new ETFs and alternative exposures, the success of the ETF market continues to stem from the core exposures where investors are attracted to traditional low cost, broad based exposures to take advantage of more synchronized global growth.

The Canadian fixed income ETF with the highest inflows in 2017 was BMO Aggregate Bond Index ETF (**Ticker: ZAG**), further demonstrating that investors recognize the diversification and liquidity benefits of using ETFs for broad fixed income exposures.[1]

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Fixed Income Investing

There was an increased demand in 2017 for fixed income ETFs as institutional investors have had an increasing appetite for fixed income ETFs while contrarian investors have been looking to less risky assets to add to their portfolios. Investors sitting in idle cash have started to look at fixed income ETFs in 2018 for a way to generate additional income, without taking on a high amount of risk.

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Investors have recognized that as much as the benefits of ETFs have helped with equity investing, the benefits are even more significant with over the counter asset classes such as fixed income. ETFs have provided liquidity, transparency and diversification to an otherwise hard to access and less liquid asset class. ETFs simplify fixed income investing by giving investors easy and efficient access to broad based fixed income exposures or more precise exposure to credit qualities, durations, sectors and maturities.

Going into 2018, fixed income investors are facing a macroeconomic environment where interest rates are rising, the yield curve is flattening, and inflation might make a comeback. With ETFs investors have the ability to either build a portfolio, or tilt an existing portfolio to reflect their outlook for interest rate changes, inflation and credit spreads.

Shortening portfolio duration and adding exposure to credit through higher yielding ETFs has proven to be a popular strategy, while contrarian investors can benefit from precise exposures in long term treasuries or corporate bonds.

Preferred shares are an alternative asset class to look to in a rising rate environment where rate-reset preferred shares reset their dividends as rates rise. Rate reset ETFs such as BMO Laddered Preferred Share Index ETF (**Ticker: ZPR**) have seen heightened interest as investors have grown more confident in a steady step up in short term interest rates.

Valuation Levels and Market Growth

The bull run continued through 2017 where in the U.S., the S&P 500 Index was up 17.32%, the Dow Jones Industrial Average Index was up 24.44% and the NASDAQ Index was up 22.95%.[2] U.S. Tax Reform passed by the White House fueled equity markets. President Donald Trump signed a tax bill that slashed corporate tax rates to 21%, hoping to increase capital expenditures among American companies, create jobs, and bolster U.S. corporations.

The extremely popular FAANG stocks (Facebook, Apple, Amazon, Netflix and Google), were a fundamental driver of market growth in 2017. These global technology and communication giants have been accelerating market growth and pushing indices to new heights. This impact on equity markets has encouraged index providers to consider sector classifications. MSCI and S&P Dow Jones Indices (SPDJI) have announced changes to the Global Industry Classification Standard (GICS) for 2018. The Telecommunication Services

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sector is set to expand and be renamed Communication Services. Some Consumer Discretionary and Technology stocks will relocate to this new sector. The impact on these future sectors will be most felt by the removal or addition of some of the heavy-weighted FAANG stocks, potentially impacting ETFs that track the Information Technology, Consumer Discretionary and Telecommunication sectors.

While equity markets have been prosperous through 2017, it is important to highlight that valuations have been high. The S&P 500 Index closed out 2017 with a price-to-earnings ratio of 22.44 which is 67% higher than valuations in 2011.[3] As such, there may be certain stocks that are more over valued than others. While momentum investing outperformed all other factors in 2017, 2018 may see a rotation out of momentum and into value. Value investing performs best when interest rates are rising and in inflationary environments. This has fueled investor interest in value investing, where the ETF market has grown to offer regional exposures to this factor such as the BMO Shiller Select US Index ETF (**Ticker: ZEUS**) which considers the CAPE® Ratio methodology along with stock momentum.

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Currency:

The Canadian dollar rallied in 2017, notably in the second and third quarters when oil prices rebounded and the Bank of Canada began to tighten monetary policy. The loonie started 2017 at $1.35 CAD/USD was at its strongest in September at $1.20 CAD/USD and then settled in to $1.25 CAD/USD to end 2017.[3] Currency volatility will likely continue going into 2018.

Currency exposure is something an investor should always be aware of. The Canadian dollar appreciated 8% against the U.S. dollar in 2017, therefore investors holding any Canadian hedged U.S. positions earned higher returns than their unhedged equivalents. With ETFs an investor can reduce currency risk by passively hedging or employ an active currency management strategy. Hedged and unhedged versions of many equity and fixed income ETFs give investors more tools to tailor their portfolios. Looking to 2018, there are several factors to monitor that will affect the CAD/USD exchange rate.

NAFTA discussions could put downward pressure on the loonie this year if President Trump dissolves the trade agreement. The sixth round of negotiations is set to take place at the end of January where Canadian politicians are looking to de-escalate tensions and salvage the agreement.

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Oil prices, which are highly correlated with the Canadian dollar, rebounded in late 2017. The price per barrel rose above US$68 in early January for the first time in over two years.[3] A drop in crude supply and OPEC-led production cuts sustained the rally. If this trend continues, the Canadian dollar will see further appreciation.

The Bank of Canada left interest rates at 1.00% to close out 2017 which signaled cautious optimism for the central bank, but implied rate increases would continue through 2018. However in the U.S., rising interest rates coupled with revamped Republican tax reform could drive the USD higher in 2018.

Thematic Investing

A growing industry trend over the past year has been investing in thematic ETFs. Thematic ETFs allow an investor to access an industry trend. There have been several industry trends in 2017 that ETF providers have pivoted to including cryptocurrencies, artificial intelligence and ESG investing.

Crypto-mania: Cryptocurrencies have been making headlines in 2017 with the Bitcoin boom. These currencies are high risk and return, are difficult to buy and sell and have low liquidity. Therefore gaining exposure to cryptocurrencies via an ETF makes accessing this market trend easier and more efficient. Globally, multiple cryptocurrency ETFs have been filed with regulators.

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Artificial intelligence (AI): AI is a sector of computer science which focuses on the advancement of computer and machine learning. Its goal is to teach computers to learn and think with a level of intelligence that is similar to our own. Investing in AI using an ETF can be done in two ways: purchasing an ETF with exposure to companies which invest heavily in AI research and development or purchasing an ETF which uses AI methodology to make investing decisions. Markets have seen both styles of AI investing grow in popularity over the year, with more than 15 North American listings which align with AI investing.

Socially Responsible Investing: Being socially aware of your investments, also known as Environment, Social and Governance (ESG) investing, has become very popular over the last year. Investors have become increasingly mindful of the types of companies their dollars are being directed to and are investing accordingly. With an ETF which has an ESG mandate, an investor can screen out stocks from a particular universe which do not support their values.

The Path Ahead

ETFs deliver efficient access to equities and fixed income across all geographic exposures in addition to low-cost and liquid access to thematic and precise exposures. Investors are becoming increasingly confident in using ETFs and have become more knowledgeable of the advantages and efficiencies of ETF investing. The growth of the ETF market is expected to remain steady, in terms of both an increase in assets and an increase in options, further developing meaningful investment possibilities for investors in 2018.

In terms of providers, there were 11 new ETF providers in Canada this year as strong industry growth inevitably attracts new issuers. There was consolidation as well, as two providers were acquired. The changing landscape demonstrates the importance of working with an established provider that delivers not just effective products, but has the experience to emphasize the entire ETF infrastructure, including trading, liquidity, education, and support. In terms of products 2017 saw 169 new ETFs in Canada, pushing the total to over 600 ETFs. The challenge for providers is to continue to launch innovative products and to educate investors on the benefits of ETFs. The growth of the industry encourages more niche products, which must be balanced against trading efficiency and liquidity.

We expect the ETF industry to increase its growth trajectory, backed by greater adoption across institutional, advisor and retail platforms. We project the global ETF industry to double to more than US$10 trillion over the next five years, and the Canadian industry to grow even faster to C$400 billion by 2023.

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[1] ETFGI, December 2017. [2] Bloomberg, one year month-end total return Jan 1 2017-December 29 2017. [3] Bloomberg, December 2017.