ETF Market Review & Outlook Report

ETFs have played an important role in financial markets with record growth and volume during a tumultuous year. ETFs provide efficient access and liquidity across both broad and precise exposures as investors balance the stops and starts of the continued COVID pandemic with strong equity market returns. 2021 certainly saw markets rise on optimism around vaccine roll outs and economic re-openings. However, it was not without some speed bumps along the way with the latest variant of concern and supply chain challenges. We saw investors rotate from growth to value early on in 2021, a rebound in energy, and a continuation of the hunt for yield as interest rates remained low year over year.

ETFs proved their value as access vehicles once again, as Canada became the first country to launch a physical crypto ETF, and equities captured record breaking inflows. Inflation is the dominant concern heading into 2022 as investors look for sectors of the market that will benefit from increases in pricing while looking for fixed income innovation. All eyes are on central banks and whether they will become hawkish, remove stimulus and move to normalize interest rates.

Global ETF Flows in 2021

Global ETF net inflows in 2021 surpassed US$1.3 trillion, crushing the previous years record flows.[1] Assets grew globally and were driven by flows and stronger markets. At the end of December 2021, the Global ETF industry had 8,552 ETFs from 571 providers on 77 exchanges in 62 countries, and assets of US$10 trillion.[1] The U.S. continues to have the largest share of ETF assets with US$7 trillion, an increase of 33.1% from the previous year, with net new flows of US$929.7 billion.[1] The European ETF Market grew by 26.2% to US$1.5 trillion and in Asia (ex-Japan) ETF assets grew by 28.2% to US$559.5 billion.[1]

In 2021, the Canadian ETF industry reported second year in a row of record numbers with $323 billion in assets, and $53 billion in net new flows.[2] Nine ETFs reported more than $1 billion in new flows, 202 new ETFs were launched setting another record, with one new provider entering the industry.[2] There are now 1177 tickers and 40 ETF providers.[2] In 2021, BMO ETFs led the industry for the eleventh consecutive year with net new flows of $9.6 billion; 22 BMO tickers reported inflows greater than $100 million.[3]

In Canada, looking at asset classes, equity ETFs led the way with over $30 billion in net new flows, as investors capitalized on strong equity returns while uncertain about fixed income prospects. Growth was balanced across regions, Canada, U.S., International, as investors diversified with shifting pandemic risks. Balanced ETFs continued to build inroads, capturing over $5 billion in net new flows, by appealing to investors as one ticket solutions. At the ticker level, net new flows were still dominated by broad market ETFs, showing that the initial appeal of ETFs as instant market access solutions still stands, led by **BMO S&P/TSX Capped Composite Index ETF (ticker: ZCN)**.[1] New ETFs helped investors with a fear of missing out access the crypto market, with three ETFs cracking the top 20 of net new flows.

Responsible ETFs: Gaining Momentum

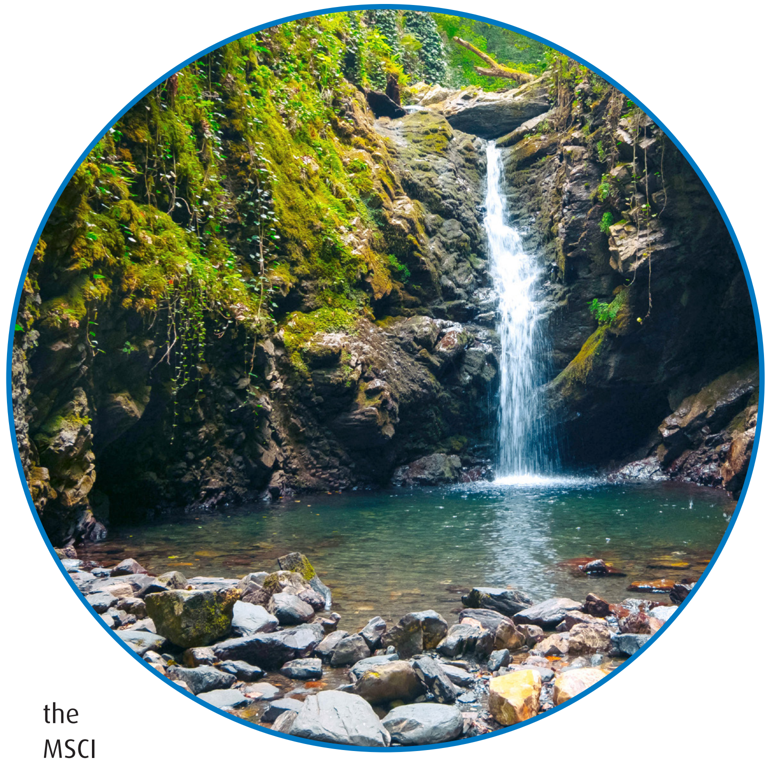
Erin Allen,
Senior Manager, Product, BMO ETFs

Major events like COP26 captured the worlds attention with a few promising agreements emerging, but failed to deliver a new round of greenhouse gas (GHG) emissions targets to keep warming to 1.5°C. The launch of the International Sustainability Standards Board (ISSB) by the International Financial Reporting Standards (IFRS) Foundation is another important development that came out of 2021, with the formation of new sustainability disclosure standards to meet investors needs for information. Finally, a historic moment in 2021 was when the small U.S. Hedge Fund, Engine No. 1, launched a successful activist campaign and secured three board seats over managements wishes, with a mandate to prepare Exxon for a fossil fuel free future.

Environmental, Social and Governance (ESG) ETF investing continues to grow with new ESG products, government policies and corporate commitments rolling out. The number of ESG ETFs in Canada doubled year over year from around 50 to 100.2 The largest ESG ETF in Canada is the **BMO MSCI USA ESG Leaders Index ETF (ticker: ESGY/ESGY.F)** at over $1.7 billion in assets. With ESG ETFs approaching 3% of the Canadian ETF market as of the close of 2021, and with the growing number of tickers, investors are finding ways to add ESG or even replace existing exposures.

> The growing attention of securities regulators, the launch of new reporting frameworks and the demands of investors for higher quality more transparent ESG information will continue to propel ESG investing forward.

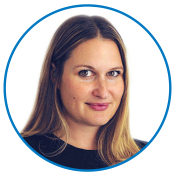
ETFs are effective tools for ESG exposure with leading index and ESG research providers like MSCI providing indexes that aim to provide an overall exposure that minimizes tracking error to the broad market, while cleansing the holdings to eliminate the worst offenders from an ESG perspective. **BMO MSCI Global ESG Leaders Index ETF (ticker: ESGG)** tracks



the MSCI World ESG Leaders Index investing in the higher ESG rated securities in each sector relative to their peers, while eliminating those companies involved in controversial businesses such as unconventional oil and gas extraction and thermal coal, nuclear weapons, tobacco, and gambling.

In 2022, the growing attention of securities regulators, the launch of new reporting frameworks and the demands of investors for higher quality more transparent ESG information will continue to propel ESG investing forward. Growth in ESG ETFs should continue across the broad-based solutions, and products focusing on the environment "E" will capture an increasing share of investor attention with the acceleration of climate change. It has become evident that there are not just severe risks associated with ignoring climate change, but also investment opportunities as companies begin to transition their businesses. While there are challenges around disclosure on emissions, this will continue to improve with investors demanding the full picture of scope 1 (direct emissions), scope 2 (production indirect emissions), and scope 3 (all other indirect emissions). Large corporations like Walmart and General Mills are already taking action to reduce scope 3 emissions. Walmart introduced an incentive program for its suppliers to cut emissions, and General Mills is collaborating with its suppliers through its regenerative agriculture strategy to reduce emissions.

Innovation: Progress Continues to Build



Danielle Neziol,
Vice-President, Distribution, BMO ETFs

After a gangbuster run for innovation in 2020, many of these stocks reversed course, moving into correction territory by the end of 2021. This was due to several factors: the market rotated into value and out of growth, rising interest rates and yields added pressure on growth stocks' future cash flows, and inflation fears pushed investors towards more defensive industries. Despite these short-term macroeconomic challenges, we have not seen anything which threatens the long-term growth of these stocks. In fact, the main disruptive innovation platforms (genomics, fintech, next generation internet, autonomous technology) have become more relevant today than they were even a year ago; much has happened in 2021 to support these megatrends' relevance in the future.

For example, genomic innovations have been front and center in combating COVID-19. The leaders in mRNA technology such as Moderna and BioNtech posted significant returns in 2021. The next generation of the internet saw progress on many fronts, notably the increased use of Non-fungible tokens (NFTs), the expansion of the metaverse and the increasing demand these advancements will place on cloud computing and cyber security infrastructure. Innovative companies are investing aggressively in the development and advancement of future technologies and will be positioned for a "winner takes all" advantage as these innovations mature.

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The most bullish investors in megatrends believe innovative stocks are in "deep value" territory after their decline in 2021. Whether you agree with this or not, valuations for these growth stocks are much more attractive now than they were 12 months ago, and this could provide a more attractive entry point to get access to these trends. If 2021 showed us anything about innovative stocks, it is that single stock picking is hard and can expose investors to higher portfolio volatility.

Investors should also be mindful of narrowly focused innovation ETFs which might miss out on areas of a megatrend as it grows and evolves. A diversified ETF such as the **BMO MSCI Innovation Index ETF (ticker: ZINN)** holds over 200 of the most relevant innovation companies globally, and equally weights each of the four innovation pillars (genomics, fintech, next generation internet and autonomous technology) to give investors maximum exposure to the most relevant global megatrends while minimizing stock specific risk. The progress innovative companies are making is continuing to build, and it is still early innings for the companies exposed to these life-altering trends. So even though the market is currently favouring more defensive assets due to rising inflation, this could be short-term noise for the exponential growth story of innovative stocks.

Crypto: A Wild Ride

Mark Raes,
Head of Product (Canada), BMO ETFs

The Canadian ETF market once again showed its ability to innovate as the first jurisdiction to allow crypto-currency ETFs. This reaffirms one of the core benefits of ETFs, as access vehicles for harder-to-trade asset classes, where just like gold and other commodities, ETFs have brought crypto-currencies to the mainstream by providing efficient trading over the exchange. We've now seen the listing of over 30 tickers across providers, with over $5 billion in assets.

Starting in February 2021, and quickly followed by further products, **Purpose Bitcoin ETF (ticker: BTCC)** captured global attention and earned outsized trading volumes. For investors who can stomach the volatility, crypto-currencies via an ETF have provided another portfolio tool, with the benefit of low correlation to traditional asset classes. Crypto-currencies provide quite a ride, from the sell off in the summer, to the rapid rise in the fall, and now a further correction late in the year, they have experienced volatility of around 70% standard deviation since market entry, showing that a small allocation can still have a meaningful impact to portfolio returns.

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Inflation: A Look Ahead

Alfred Lee,
Director, Portfolio Management, BMO ETFs

Inflation will continue to be a headline statistic in 2022. With the ongoing COVID pandemic, policy makers in different countries have had varied responses. As Omicron and potentially new variants linger, its likely that further lockdowns will add to supply chain shortages and thus inflationary pressures. If Omicron proves to be the last disruptive variant, and if we see countries dealing with COVID as here to stay, this will allow economies to open further. This scenario would increase demand, with added supply side constraints. Consequently, higher prices are likely to persist even as central banks are looking to temper inflationary pressures through tighter monetary policy. Equities may prove the most effective inflation hedge, should central banks increase rates at a prudent rate that will not hamper the economic cycle. With inflation likely to continue, an overweight to equities may be warranted as the asset class has historically outperformed during periods of higher anticipated inflation.

For equity exposure, investors are showing increased interest in the quality factor, as quality typically includes mature industry leaders with strong cash flows. **BMO MSCI USA High Quality Index ETF (ticker: ZUQ)** screens for blue chip companies exhibiting better pricing power and that carry lower debt loads, making them less interest rate sensitive. Investors may also look to overweight sectors that outperform as inflationary pressure builds, such financials and energy. Assets that perform well when interest rates rise, such as rate reset preferred shares, such as the **BMO Laddered Preferred Share Index ETF (ticker: ZPR)** can complement the fixed income side of a portfolio. Investor interest in preferred shares picked up significantly, as ZPR returned 23.5% over 2021, while most fixed income exposures had negative returns.

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Factors: Value vs. Growth Reversal

Chris Heakes,
Director, Portfolio Management, BMO ETFs

Looking back to 2021, factor performance was marked by continued strong performance by quality, a late comeback by low volatility, and most notably a resurgence of the value factor, outperforming the broad market for the first time in a decade. Dividend based strategies also performed well, as they tend to be correlated with value. This factor reversal towards value kicked off in late 2020, as the first positive news around vaccine approvals hit the market, and further propelled a trade fueled by the economic reopening. This reopening trade benefitted cyclical sectors such as financials, energy, and industrials which had been hampered by the COVID related drawdown.

> Value should continue its recent outperformance versus growth, led by the continuing economic reopening as well as stronger historical performance during periods of increasing rates and elevated inflation.

As we begin 2022, several key risks are on the minds of investors, including the continuing COVID pandemic, as well as geopolitical tensions, however arguably the most significant and volatility-inducing market dynamics have been driven by concerns on rising interest rates and inflation. Investors expect that value should continue its recent outperformance versus growth, led by the continuing economic reopening as well as stronger historical performance during periods of increasing rates and elevated inflation. Dividend-based strategies are also expected to benefit alongside value. Investor interest has increased in dividend ETFs such as **BMO Canadian Dividend ETF (ticker: ZDV)** and value ETFs such as **BMO MSCI USA Value Index ETF (ticker: ZVU)**. Dividend ETFs captured the most net inflows of any factor in Canada, at almost $2.9 billion. Looking at the U.S. market, value was the best performing BMO factor ETF in 2021, catching investor attention, with ZLU returning 27.4% over the year.

Quality factor ETFs select more cash-forward businesses resulting in a long-term hold that is not likely to be as impacted as more speculative growth stocks where the impact of rising rates plays a larger role. With global diversification at the forefront of investor allocations, an ETF with rising interest is **BMO MSCI All-Country World High Quality Index ETF (ticker: ZGQ)**.

Sectors: Banks, Energy and Consumer Discretionary

Chris McHaney,
Director, Portfolio Management, BMO ETFs

2021 began with banks and other financials performing well, as vaccine rollouts and the hoped for end to the pandemic meant that banks would escape the worst-case scenario of a prolonged recession. As the yield curve steepened throughout the year, this provided further tailwinds for banks, as higher yields generally provide opportunities for higher margins on banks' loan portfolios. Provisions set aside early in the pandemic for non-performing loans proved to be more than enough buffer to lockdown related disruptions and provided a boost to earnings later in 2021 when those provisions were reduced. To no surprise then, investor interest in financials picked up, leading the sector story with over $2.7 billion in net inflows. **BMO Equal Weight Banks Index ETF (ticker: ZEB)** returned 39.3% over the year. As economic normalization continues into 2022, banks are expected to continue benefiting from increased economic activity.

> Demand for energy is expected to increase further in 2022, as global travel patterns and economic activity continue to drift towards more "normal" levels.

The other major sector story in Canada in 2021 was the rebound in energy, as demand for oil provided a boost to energy prices in general. **BMO Equal Weight Oil & Gas Index ETF (ticker: ZEO)** achieved the highest return of any BMO ETF in 2021 at 65.1% on the back of that demand. While much focus and investment has recently gone towards more sustainable sources of energy, oil and gas provide the majority of supply for the world's current energy use demands. That demand for energy is expected to increase further in 2022, as global travel patterns and economic activity continue to drift towards more "normal" levels.

Fixed Income

Matt Montemurro,
Director, Portfolio Management, BMO ETFs

2021 proved to be a difficult environment for fixed income investors as interest rates rose from historic lows and volatility spiked as the world continues to deal with the wide-ranging effects of the COVID-19 pandemic. Investors, while holding broad exposures as portfolio anchors, have been using ETFs to position around increasingly hawkish central bank comments, inflation concerns, and economic reopening.

Central banks are expected to act swiftly in 2022, mainly to fight inflation concerns that have been emerging for several months. The Bank of Canada (BoC) is expected to be more aggressive in their monetary policy decisions, with the market forecasting the first interest rate hike to happen in March 2022 – with a total of six hikes for 2022. While the Fed continues to increase the pace of the unwinding of their bond purchase programs, the market has continued to be hawkish with their expectations of Fed monetary policy decisions. The market expects the Fed to act in March to raise interest rates – now forecasting that the Fed will raise rates upwards of four times in 2022.

From 2021 net inflows, **BMO Aggregate Bond Index ETF (ticker: ZAG)** led the way in Canadian fixed income net inflows, as investors sought security via the broad market to offset risks elsewhere in their portfolios. With inflation concerns, investors also focused on shorter duration, credit focused products that will help protect in an environment of rising rates such as **BMO Short Corporate Bond Index ETF (ticker: ZCS)**. Reducing your exposure to longer duration bonds will help to mitigate some of the downside in a rising rate environment while corporate bonds will enhance portfolio yield help to offset the impacts of rising interest rates. Combined, broad market fixed income and short-term fixed income captured over 90% of the fixed income ETF net inflows in 2021, leaving minimal flows for long-term fixed income ETFs. Lastly, the fastest growing area of Canadian fixed income ETFs in 2021 was inflation protected, or real return bonds, with almost $500 million in net inflows as investors looked for fixed income inflation solutions. **BMO Short-Term US TIPS Index ETF Hedged Units (ticker: ZTIP.F)** participated in this inflation protection growth, will also minimizing interest rate exposure.

The Path Ahead

Mark Raes,
Head of Product (Canada), BMO ETFs

After another record-breaking year for growth in the ETF market, it's worth a moment to step back and see how far the industry has come. From ten years ago, with just over $40 billion in assets across 230 tickers, to today's $323 billion in assets and close to 1200 tickers, ETFs have emerged from a hot topic to a mainstream investment. From dominant broad beta ETFs that provide market returns for investors, to precise ETFs that allow investors access and efficiency, ETFs have combined the best of exchange trading with the benefits of pooled investment products.

Most importantly for investors, the maturation of the ETF industry has allowed new providers and new investors to confidently enter the market, and helped support products that best assist investor's portfolio construction, across asset classes and alternatives. As well, as ETF volumes typically increase during volatile days, ETFs have proved to be both a strategic and tactical tool for investors, greatly enhancing investor's ability to build the best possible portfolios.

BMO Global Asset Management

[1] ETFGI Global ETF and ETP industry insights, December 2021
[2] NBF Research and Strategy, Canadian ETF Flows, January 6, 2022
[3] Bloomberg, December 31, 2021