Quarterly Fixed Income Strategy

Third Quarter 2021

BMO EXCHANGE TRADED FUNDS

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In this report, we highlight our fixed income positioning strategies for the third quarter ended June 30, 2021 (calendar year).

Duration

- As we outlined in our previous report, the rise in interest rates paused over the second quarter. We anticipated investors would gravitate towards bonds, given the rebalancing of asset allocators, higher yields attracting foreign investors and investors taking profits as equity markets became more than fully valued. However, with the Canadian and U.S. 10 year currently at 1.14% and 1.18%, respectively (42bps and 56bps lower, respectively, than the end of the first quarter), we did not anticipate yields to back off to this degree.
- The two main threats that can derail the economic recovery are inflation and the Delta variant (or some new variant) leading to rising global infection rates again. With the recent sell-off in risk assets, the U.S. Federal Reserve (Fed) may have to perform a balancing act in which it will have to withdraw monetary stimulus, while still providing enough confidence to the market.
- With U.S. economic data, such as gross domestic product (GDP) and the unemployment rate, trending in the right direction, the Fed's focus should be on tapering its asset purchase program and continuing to signal for higher rates on the horizon. While central bank monetary policy will likely be ineffective in addressing supply chain disruption, it is important its policy is not additive in stoking inflationary pressure. Should economic growth stall, it can always delay its path towards normalizing interest rates.
- While the Fed has kept its monetary policy rather accommodative, the Bank of Canada (BoC) has been far more prudent in reducing its asset purchase programs. The recent rise in the US dollar now allows the BoC to potentially raise its overnight rate ahead of schedule, with less concern on the impact of the Canadian dollar on its exports.
- We believe a healthy consolidation of equity markets is required, given the significant rally year-to-date. With current equity market valuations still at healthy premiums, a combination of earnings expansion with a market pull-back is what is necessary for risk assets to move higher later in the year. We still believe higher rates are on the longer-term horizon, however, the lower appetite for risk is likely going to keep rates low for the remainder of the summer. As a result, duration exposure is still necessary to offset equity market volatility, but assets that protect against rising rates should be still be considered as complementary.

Credit

- Although concerns around the Delta variant have led to widening credit spreads in recent weeks, current levels remain tighter than pre-COVID. U.S. high yield bonds, in particular, which are currently at 290bps, should remain fairly tight with a very small percentage of the index maturing in the next three years. This should provide ample time for the economic backdrop to strengthen before high yield issuers need to refinance. Given the majority of high yield issues can be called by issuers at any point, those that have stronger balance sheets can take advantage and refinance at current rates.
- Though we view any meaningful pullbacks in the U.S. high yield market to be a long-term buying opportunity, we continue to prefer the U.S. preferred share market as a more effective means to generating portfolio yield.
- Over the last several quarters, our preference was Canadian corporate credit over its U.S. market peers. While a firmer US dollar may be a headwind for commodities and therefore Canadian credit, we still remain constructive on Canadian investment-grade corporate bonds. However, we believe a strong earnings quarter should be a positive for U.S. investment-grade bonds.

Currency

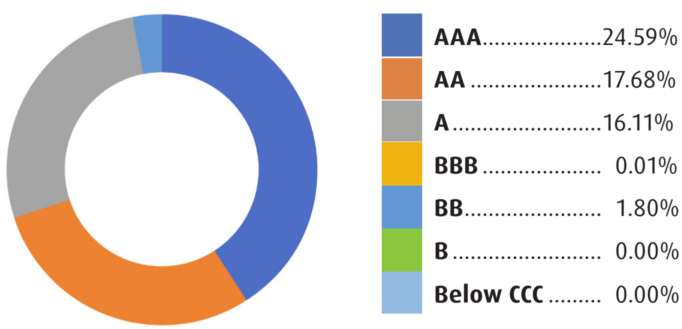
- As noted earlier, the US dollar has ditched its downward trajectory against its Canadian counterpart. The Fed's tone came in more hawkish than anticipated at its last Federal Open Markets Committee (FOMC) meeting. This led assets to reprice the tighter monetary stance. In addition, as the US dollar broke above its resistance relative to the loonie, further technical buying has provided additional tailwinds. This creates breathing room for the BoC to move rates higher on an earlier timeline than expected if it so chooses. Currently, we would elect to have some US dollar portfolio exposure to offset additional weakness in risk assets.

Model Portfolio

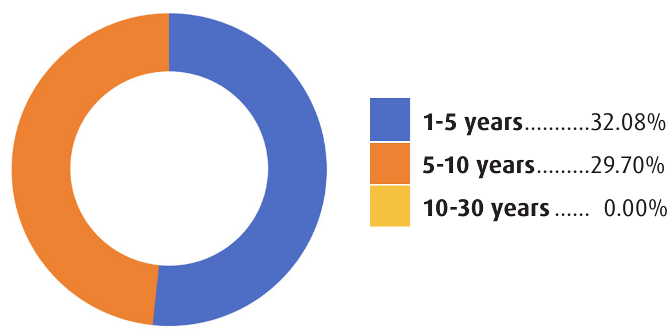
Ticker	ETF Name	Weight (%)	Duration*	Yield-to-Maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	37.90	1.71%	0.08%	Canada	Core
ZCB	BMO CORPORATE BOND INDEX ETF	20.0%	1.20	2.01%	0.15%	U.S.	Core
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	5.0%	100.00	2.14%	0.20%	U.S.	Core
ZTIP.F	BMO SHORT-TERM US TIPS INDEX ETF (HEDGED UNITS)	3.0%	100.00	0.31%	0.15%	U.S.	Non-Traditional
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	4.0%	3.01	4.76%	0.45%	Canada	Non-Traditional
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%	5.00	5.27%	0.45%	U.S.	Non-Traditional
	Portfolio	**100.0%**	**32.16**	**2.09%**	**0.14%**		

Exposures	Duration	Yield	Weight
CORE	33.03	1.80%	87.0%
NON-TRADITIONAL	26.31	3.90%	13.0%
Total	**32.16**	**2.08%**	**100.0%**
CANADA	35.79	1.89%	66.0%
U.S.	25.12	2.43%	34.0%

Credit Summary



Term Summary



*As of June 30, 2021. Please note yields will change from month to month based on market conditions.
Source: BMO Global Asset Management, Bloomberg.

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BMO Exchange Traded Funds