

# Quarterly Fixed Income Strategy

Fourth Quarter 2021

BMO EXCHANGE TRADED FUNDS

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

### Duration

- Although interest rate volatility was rather muted for most of the quarter, bond yields surged to the upside a day after the September Federal Reserve Open Markets Committee (FOMC) meeting. As we pointed out earlier this year, bonds will experience some repricing in the fourth quarter, based on the Federal Reserve's (the Fed) intent to taper its asset purchase programs.
- Between the September 22 FOMC meeting to now, the two-year U.S. Treasury yield almost doubled from 21bps to 41bps. The recent steepening of the yield curve, particularly between the 2- and 10-year terms, illustrates the market's disbelief that the Fed would actually taper this year, despite numerous indications by the central bank.
- Canada's bond yield experienced similar moves, as the Fed's tightening would allow it to potentially move closer to raising its overnight rate, without further strengthening the loonie. Recent news that Canada had added back approximately all of the jobs lost to the pandemic, should provide further reason for the Bank of Canada (BoC) to tightening up its monetary policy. Although we don't expect the BoC to raise rates for at least six months, we believe it will happen significantly before the Fed. Canada's monetary policy has always been far more prudent than its U.S. counterpart. However, high household debt in Canada will limit the pace and implement a potential ceiling on the BoC's monetary tightening.
- Although concerns that a collapse of the China Evergrande Group could bleed over to global markets, China has hinted that it would stop contagion by propping up the fiscally responsible developers. We believe the bigger concern that may weigh on the market is the combination of the ongoing COVID pandemic and growing inflation fears. Should COVID limit the ability of economies to normalize, and inflation pressure continues to mount, limited growth and increasing prices could change the narrative to "Stagflation."
- We anticipate bonds will be volatile over the quarter, as yield continues to reprice to tighter monetary policy. Given central banks seem to be comfortable (at least on the surface) to let inflation run high, we don't envision the Fed will speed up its pace from the timeline provided at the last FOMC meeting. Bond market volatility should potentially dissipate at some point in the first quarter of 2022.

### Credit

- Higher yields have driven some corporate issuers, particularly in the U.S., to come to market for capital. With these companies anticipating higher yields ahead, they have decided to lock in the cost of funding, or refinancing rates, at current levels, increasing supply over the short term. Consequently, investment grade credit spreads in the U.S. have recently widened. Over the long term, we anticipate demand to outstrip supply, meaning the wider spreads are a buying opportunity. As such we are switching our exposure in the **BMO Corporate Bond Index ETF (ZCB)** for the **BMO Mid-Term US IG Corporate Bond Hedged to CAD Index ETF (ZMU)**.
- In Canada, credit spreads have remained relatively stable given the strength of the banking and energy sectors. The strength of these two sectors, in addition to the recovery of the REITs sector, should keep Canadian credit spreads relatively tight.
- We believe exposure to government bonds is critical in a portfolio, as it mitigates equity risk over the long term, particularly long-term U.S. Treasuries. We do anticipate bonds to provide limited shelter over the next quarter however, as rates continue to move higher. At this point, we would continue to overweight credit, as the progression towards a further reopening continues to lead to a strengthening economic backdrop, in both Canada and the U.S.

### Currency

- The Canadian dollar has been relatively rangebound compared to its U.S. counterpart over the last quarter, trading between US\$0.78 and US\$0.81 since the end of June. However, both currencies have gained strength relative to a basket of other currencies, which has largely masked the recent gains of the loonie.
- Despite both the US and Canadian dollar gaining strength, both currencies have been driven by different factors. While the improving economic backdrop in both countries has been a common element, the US dollar has also been driven by the increased expectation of the Fed's tapering. The Canadian dollar, on the other hand, has been largely driven by commodity strength.



Exchange Traded Funds

Sell	Ticker	%	Buy	Ticker	%
BMO CORPORATE BOND INDEX ETF	ZCB	-20%	BMO MID-TERM US IG CORPORATE BOND HEDGED TO CAD INDEX ETF	ZMU	20%
<b>TOTAL</b>		<b>-20%</b>	<b>TOTAL</b>		<b>20%</b>

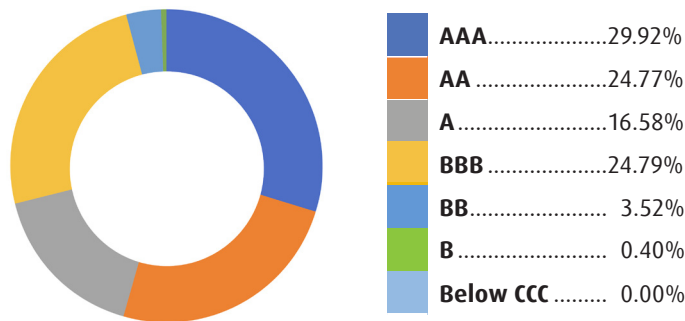
Source: BMO Global Asset Management, Bloomberg.

## Model Portfolio

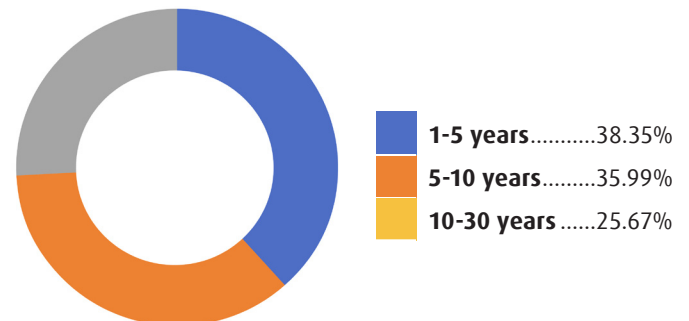
Ticker	ETF Name	Weight (%)	Duration*	Yield-to-Maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	8.25	2.57%	0.08%	Canada	Core
ZMU	BMO MID-TERM US IG CORPORATE BOND HEDGED TO CAD INDEX ETF	20.0%	6.65	3.01%	0.25%	U.S.	Core
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	5.0%	19.05	2.28%	0.20%	U.S.	Core
ZTIP.F	BMO SHORT-TERM US TIPS INDEX ETF (HEDGED UNITS)	3.0%	2.80	0.33%	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
<b>Portfolio</b>		<b>100.0%</b>	<b>7.90</b>	<b>2.82%</b>	<b>0.14%</b>		

Exposures	Duration	Yield	Weight
CORE	8.50	2.65%	87.0%
NON-TRADITIONAL	3.88	3.90%	13.0%
<b>Total</b>	<b>7.90</b>	<b>2.81%</b>	<b>100.0%</b>
CANADA	7.94	2.70%	66.0%
U.S.	7.84	3.03%	34.0%

### Credit Summary



### Term Summary



As of September 30, 2021. Please note yields will change from month to month based on market conditions.

Source: BMO Global Asset Management, Bloomberg.

The portfolio holdings are subject to change without notice. They are not recommendations to buy or sell any particular security.

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