Quarterly Fixed Income Strategy

Alfred Lee, CFA, CMT, DMS
Director, BMO ETFs
Portfolio Manager & Investment Strategist
BMO Asset Management Inc.
alfred.lee@bmo.com

In this report, we highlight out fixed income positioning strategies for the fourth quarter.

Duration

- Since COVID-19 became a growing concern in February, yield curves around the globe have flattened. In addition to fiscal stimulus, accommodative monetary policy will help keep yields compressed, providing individuals, businesses and corporations a better chance of recovery. Canada will look to keep rates low as its central bank has made its first foray into non-traditional measures by way of its various bond purchase programs. This will not only help keep interest rates low across the curve, but also play a vital role in market functionality and providing liquidity, especially during times of market exacerbation.
- The Bank of Canada (BoC) has also implied that it will keep its overnight rate at 0.25% until at least 2023. This should help maintain low rates on the front end. Longer-term rates may eventually rise if either a viable vaccine is introduced and/or if the coronavirus eventually peters out. Either of these scenarios would likely cause a repricing of risk, leading to a rise in yields on the long end and potentially around the belly of the curve.
- Inflation is another potential trigger that could lead central banks to hike its overnight rates ahead of schedule. This would result if economic conditions improve far quicker than anticipated, leading the velocity of money to significantly tick upward. It should be noted that the U.S. Federal Reserve's (Fed) recent switch to a more relaxed approach in fighting inflation signals that it will likely delay raising rates unless inflation comes in far ahead of its target on a sustained basis.

Credit

- Canadian corporate credit spreads have narrowed considerably since the height of the crisis in March. Canadian investment grade bonds have tightened 118bps to its current 1.38% over Federal bonds since March 26, 2020. Lower-grade BBB corporate credit will likely outperform over the long-run, but we currently prefer higher-quality ex-BBB, which provides an extra layer of downgrade protection. Bonds that get downgraded below BBB are not supported by the BoC's Corporate Bond Purchase Program (CBPP).
- In addition, given our allocation to both Canadian and U.S. preferred shares, which fall further below bonds in the capital structure, our preference is for higher-quality corporate bonds in order to better budget risk. In a fixed income portfolio, preferred shares play a vital role in generating yield, but its credit component must be offset with longer-duration government bonds. This is particularly true for Canadian rate reset preferred shares, which are negatively impacted in a falling interest rate environment.

Currency

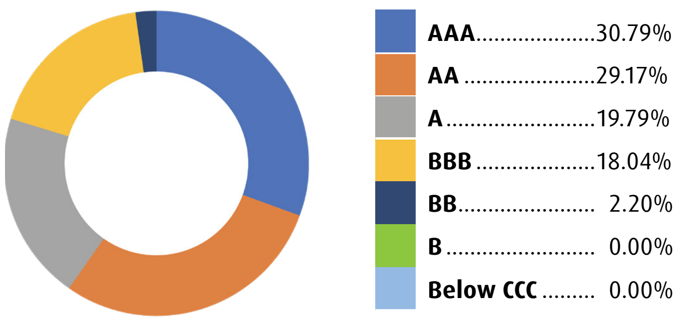
- As outlined in our previous report, fixed income portfolios tend to have their currency exposure hedged in order to reduce volatility. However, we do believe having some US dollar exposure provides stability given that the greenback tends to be inversely correlated to risky assets. The 1.9% gain in the U.S. Dollar Index (DXY) in the month of September is a perfect example as the Markit CDX North America High Yield 5-Year spread widened 42bps over the period.
- We are not making any changes to our portfolio this quarter as we feel it strikes a balance between yield generation and mitigating the impact of both rising and falling interest rates.

Model Portfolio

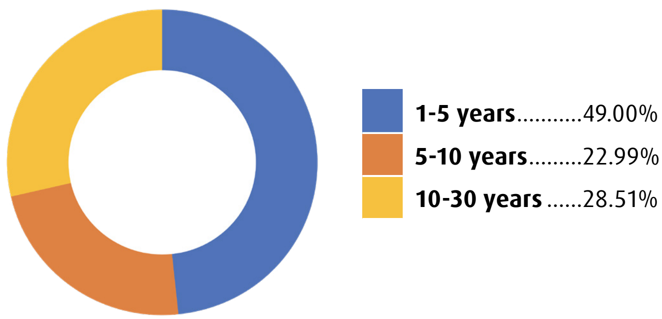
Ticker	ETF Name	Weight (%)	Duration*	Yield-to-Maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	8.39	1.26%	0.08%	Canadian	Core
ZQB	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	16.0%	3.61	1.01%	0.10%	Canadian	Core
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	5.0%	6.52	1.75%	0.25%	U.S.	Core
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	7.0%	19.06	1.37%	0.20%	U.S.	Core
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	4.0%	3.11	5.92%	0.45%	Canadian	Non-Traditional
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%	5.00	5.96%	0.45%	U.S.	Non-Traditional
	Portfolio	**100.0%**	**7.86**	**1.72%**	**0.14%**		

Exposures	Duration	Yield	Weight
CORE	8.26	1.25%	90.0%
NON-TRADITIONAL	4.24	5.94%	10.0%
Total	**7.86**	**1.72%**	**100.0%**
CANADIAN	7.20	1.44%	82.0%
U.S.	10.89	3.01%	18.0%

Credit Summary



Term Summary



*As of October 14, 2020. Please note yields will change from month to month based on market conditions.
Source: BMO Global Asset Management, Bloomberg.

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