BMO ETF Portfolio Strategy Report

Fourth Quarter 2021 | BMO EXCHANGE TRADED FUNDS

It's Taper Time!

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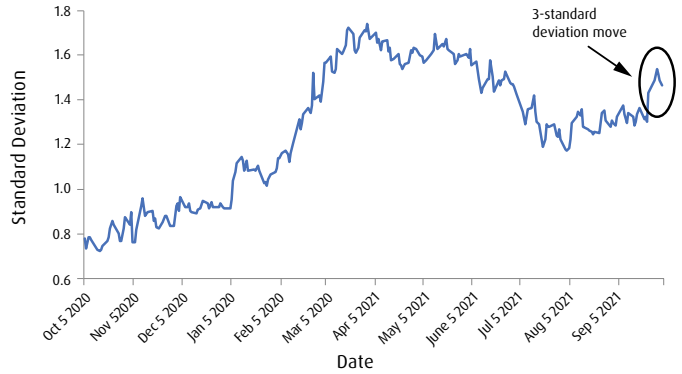
In this report:

All prices, returns and portfolio weights are as of market close on October 12, 2021, unless otherwise indicated.

- **After many months of speculation, the Federal Reserve ("the Fed") finally outlined its timeline in winding down its asset purchase program.** Although the Fed has hinted at its "tapering" process for many months, the market was seemingly not convinced it would follow through. The flattening of the U.S. Treasury yield curve over the summer months was evidence of its collective doubt. Although yields did not react until a day after the Federal Open Markets Committee ("FOMC") meeting, bond yields eventually exhibited a three-standard deviation move, essentially taking a day to digest the news, leading to a rapid repricing on the bond market (Chart 1).
- **The Fed is anticipating its tapering process to finish up in the middle of 2022.** After that, it expects an eventual hike in its overnight rate six months after the conclusion of its asset purchase wind down. As such, we believe this to be the base case. However, the main risk factors that can delay the process are the ongoing COVID-pandemic and the still-evolving Evergrande fiasco. With the total eradication of coronavirus now looking unlikely several countries have begun to accept life with COVID, including the U.K., Norway, and Singapore. Should hospitalization rates remain low, this could provide the path towards normalization in the global economy.
- **News of Merck's experimental COVID antiviral pill, "Molnupiravir," provides a further means in fighting the pandemic, with breakthrough cases of the vaccinated having been on the rise in some countries.** If this helps reduce government shutdowns, it will help ease the bottlenecks in the global supply chain and thus potentially lead to an alleviation of inflationary pressures. However, we expect overall inflation to remain high for at least 8-16 months, even in the best-case scenario. While the year-over-year consumer price index (CPI) and producer price index (PPI) measures may eventually moderate, it is unlikely that the overall levels will revert to pre-COVID. We anticipate that many industries will experience price stickiness in a post-pandemic economy.
- **While Evergrande may have ripple effects into other sectors, the market so far looks to be unconvinced that it has the same systemic risk and global reach as a "Lehman-type event."** Although China appears opposed to a bailout, it may limit the potential contagion by propping sound property developers and the real estate market.
- **Many investors are anticipating a more volatile fourth quarter, pointing to historical trends.** It should be noted, however, that over the last 30-years, the S&P 500 Composite Index has actually showed the strongest performance over the fourth quarter (Chart 2). However, the fourth quarter typically has the greatest volatility, exhibiting the highest highs and the lowest lows. While risk-assets have faced headwinds in September, we expect equities to continue to outperform, particularly with the Fed's tapering likely weighing on the bond market.
- **With many of the "reopening trades" based on early vaccine optimism now losing momentum, the market has gravitated back towards its comfort zone of defensive growth-oriented areas such as low volatility and the quality factor.** In recent months, we have seen these factors start to gain strength relative to the broader market. We continue to believe these equity factors make an efficient core to a well-rounded portfolio.

Chart A: Bond yields react to tapering announcement



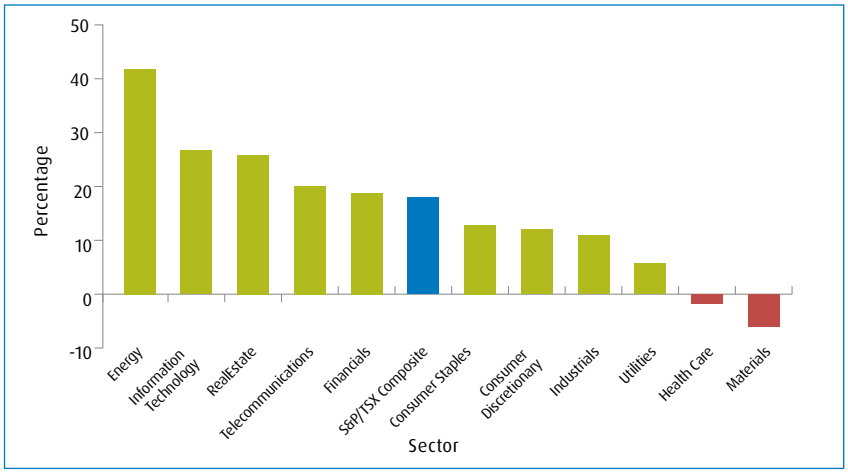
Source: Bloomberg, October 5, 2020 – October 1, 2021.

Chart B: Q4 logs historic outperformance despite volatility

	Q1	Q2	Q3	Q4
30-Year High	13.63%	19.95%	14.98%	20.87%
30-Year Low	-20.00%	-13.73%	-17.63%	-22.56%
Range	33.63%	33.68%	32.61%	43.43%
30-Year Average	1.44%	2.76%	0.65%	4.59%
2021	**5.77%**	**8.17%**	**0.23%**	**???**

Source: Bloomberg, 30-Years using S&P 500 Composite returns in local currency.

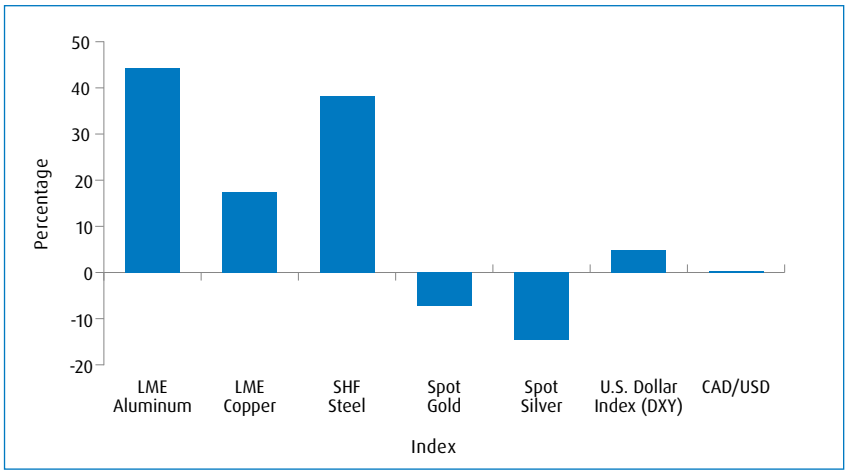
Things to Keep an Eye On



Source: Bloomberg to September 30, 2021.

Canadian equities significantly trailed the U.S. in 2020, with the *S&P/TSX Composite's ("TSX")* 5.6% total return over the calendar year lagging the *S&P 500 Composite's ("SPX")* 18.4% total return. This year, however, Canadian equities have stormed back, with the TSX and the SPX delivering an 18.0% and 17.2% total return, respectively. Three sectors have essentially led the charge in Canadian equities with the energy, real estate and financial sectors all delivering total returns in excess of 25% on the year.

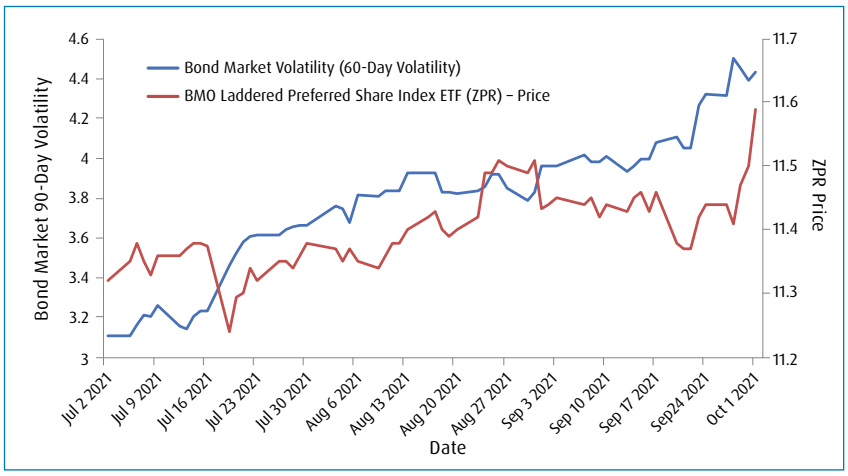
Recommendation: These three sectors are the ones in which we over-weighted in our portfolio strategy this year. We have always maintained an overweight position in financials, specifically banks through our ***BMO Equal Weight Banks Index ETF (ZEB).*** In addition, the ***BMO Equal Weight REITs Index ETF (ZRE)*** was added in our Q1 Portfolio Strategy Report (PSR), while the *BMO Equal Weight Oil & Gas Index ETF (ZEO)* was added in the Q2 PSR. Overall, we remain constructive of these three sectors and will continue to remain overweight to close the year.



Source: Bloomberg to September 30, 2021.

Over the last month, the US dollar has experienced a significant gain on the back of the Fed's more hawkish tone on its monetary policy. The *U.S. Dollar Index ("DXY"),* which measures the greenback versus a trade weighted basket of six other currencies, gained 1.7% in September. For the average Canadian, these gains went largely unnoticed as the Canadian dollar also experienced its own increase on the strength of energy and overall commodity prices. As a result, relative to the US dollar, the Canadian dollar only underperformed by 25bps over the month of September.

Recommendation: With a strengthening US dollar and COVID slowly becoming an endemic, gold will likely continue to face headwinds despite ongoing inflation concerns. Investors looking for equities that provide better inflationary protection may want to consider base metals exposure instead. In addition to providing a purer inflationary hedge, supply shortages in many metals such as aluminum, copper, and steel may offer better pricing power for the base metal companies found in the ***BMO Equal Weight Global Base Metals Hedged to CAD Index ETF (ZMT).***



Source: Bloomberg, July 2 – October 1, 2021. Bond market measured using the FTSE/TMX Canada Bond Universe.

Fixed income volatility has been on the rise and could likely continue. With the Fed's asset purchase tapering, all but sure to begin at the next FOMC meeting, yields will likely continue to face some upward pressure. In addition, with yields expected to rise, several issuers have come to the market to raise capital to look at prevailing rates should yields move higher in the fourth quarter. Though demand for corporate bonds remains strong, the increased supply over the short term could cause credit spreads to widen, adding to additional bond market volatility.

Recommendation: We continue to believe aggregate bond products such as the ***BMO Aggregate Bond Index ETF (ZAG)*** and the ***BMO Discount Bond Index ETF (ZDB)*** will serve as a cost-efficient core to a bond portfolio. However, investors may want to complement their exposure with assets that perform well in rising rate environments like the ***BMO Laddered Preferred Share Index ETF (ZPR).*** While Canadian preferred shares are not a substitute for bonds, they can be combined with traditional bonds in small allocations to offset duration risk as bond yields potentially move higher.

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
No portfolio changes					

Asset Allocation:

- Once again, we are not making any changes to our portfolio this quarter. Year to date, our strategy has performed well, both on an absolute basis and relative to its benchmark. With the Fed's imminent tapering of its asset purchase programs and headline risk out of China, we anticipate some volatility over the short term. However, we expect that equities remain better positioned over the longer term in the face of inflation and higher interest rates, which we believe will be the leading market risks over the next 12-24 months.

Fixed Income:

- Bonds will likely face some volatility in the next several months as central banks begin to outline their path towards a more normalized interest rate environment. Though bonds generate minimal yield, the asset class still serves a critical role in a portfolio, providing stability and a hedge against equity market volatility. Given the uncertainty over the near term, we are hesitant to reduce our fixed-income weighting at this time. However, investors looking to offset interest rate risk may want to consider complementing their fixed income portfolio with the ***BMO Short-Term US TIPS Index ETF (ZTIP).***

Equities:

- While higher beta areas such as value and small-cap outperformed earlier in the year, defensive growth-oriented areas such as quality and low volatility have gained strength in recent months. This has been due to fading optimism around the "reopening trade," as it now looks like it will be more gradual rather than overnight. Additionally, the low-hanging fruit seems to have already been picked, and the market is now gravitating back to less risky areas. Both quality and low volatility continue to be a central part of our equity strategy, as it has been over the last several years.
- Banks have been a long-term holding in our strategy for years. Our decision to move from the ***BMO Covered Call US Banks ETF (ZWK)*** to the ***BMO Equal Weight US Banks Index ETF (ZBK)*** in the first quarter of this year proved to be a good one. With the strong rally in the industry, moving to a non-covered call format has allowed us to participate in the upside fully. Our position in the ***BMO Equal Weight Banks Index ETF (ZEB)*** and our decisions to add the ***BMO Equal Weight Oil & Gas Index ETF (ZEO)*** and the ***BMO Equal Weight REITs Index ETF (ZRE)*** early this year have been welcome additions. All three of those have been the top three performing sectors in Canada year to date.

Non-traditional/Hybrids:

- Preferred shares remain a crucial part of our overall portfolio strategy. Both our positions in Canadian rate reset preferred shares through the ***BMO Laddered Preferred Share Index ETF (ZPR),*** and the ***BMO US Preferred Share Hedged to CAD Index ETF (ZHP)*** provide diversification to both the equity and bond portion of the strategy. In today's market, we believe implementing non-traditional assets into a traditional stock and bond portfolio is ideal for improving the risk/return attributes over the long term. Our position in ZPR protects against rising interest rates, which we expect will be a key concern for the next 12-16 months. Both ZPR and ZHP help make up for the yield shortfall left by the fixed income portion of a portfolio.

Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographies to achieve long-term capital appreciation and total return by investing primarily in ETFs.

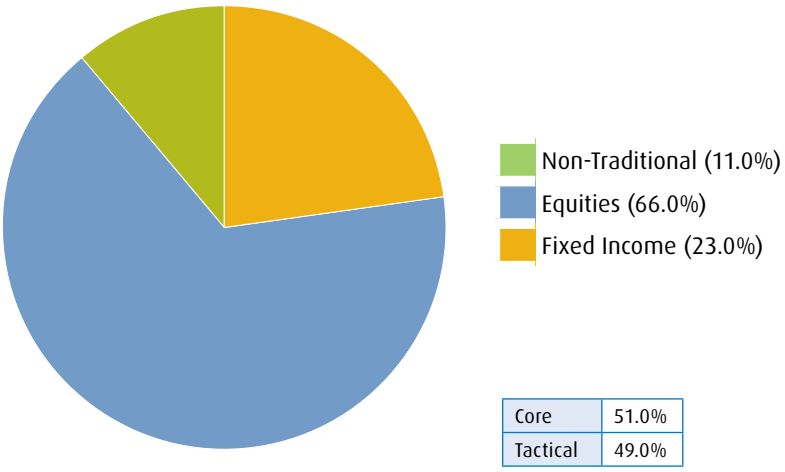
Stats and Portfolio Holdings

Ticker	ETF Name	Sector	Position	Price	Management Fee*	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)**	Yield/ Vol
	Fixed Income									
ZDB	BMO DISCOUNT BOND INDEX ETF	Fixed Income	Core	$16.38	0.09%	9.0%	4.4	4.2%	2.2%	0.50
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.86	0.25%	6.0%	9.5	6.0%	3.4%	0.36
ZTIP/F	BMO SHORT-TERM US TIPS HEDGED TO C$ INDEX ETF	Fixed Income	Tactical	$31.12	0.15%	3.0%	2.0	0.6%	0.4%	0.20
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	Fixed Income	Tactical	$54.15	0.20%	5.0%	4.1	2.2%	2.5%	0.61
	Total Fixed Income					23.0%		13.0%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$38.86	0.35%	17.0%	6.9	12.5%	2.5%	0.36
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	Equity	Tactical	$26.60	0.55%	4.0%	11.2	4.8%	4.1%	0.37
ZLU	BMO LOW VOLATILITY US EQUITY ETF	Equity	Core	$41.52	0.30%	8.0%	11.2	9.5%	1.9%	0.17
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$25.43	0.40%	7.0%	9.5	7.1%	2.4%	0.25
ZEO	BMO EQUAL WEIGHT OIL & GAS INDEX ETF	Equity	Tactical	$46.43	0.55%	4.0%	19.9	8.4%	3.4%	0.17
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	Equity	Tactical	$80.77	0.35%	4.0%	12.8	5.4%	0.2%	0.02
ZEB	BMO EQUAL WEIGHT BANKS INDEX ETF	Equity	Tactical	$37.03	0.55%	6.0%	10.2	6.5%	3.3%	0.33
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	Equity	Core	$56.25	0.30%	10.0%	12.4	13.2%	0.9%	0.07
ZBK	BMO EQUAL WEIGHT US BANKS INDEX ETF	Equity	Tactical	$35.64	0.35%	6.0%	22.9	14.6%	2.0%	0.09
	Total Equity					66.0%		82.1%		
	Non-Traditional/Hybrids									
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	Hybrid	Tactical	$11.59	0.45%	5.0%	4.7	2.5%	4.7%	1.00
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$24.34	0.45%	6.0%	3.8	2.4%	5.4%	1.42
	Total Alternatives					11.0%		4.9%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.32%**	**100.0%**	**9.4**	**100.0%**	**2.6%**	**0.27**

Please note yields of equities will change from month to month based on market conditions.
The portfolio holdings are subject to change without notice and only represent a small percentage of portfolio holdings.
They are not recommendations to buy or sell any particular security.

Ticker	Name	Weight
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	17.0%
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	10.0%
ZDB	BMO DISCOUNT BOND INDEX ETF	9.0%
ZLU	BMO LOW VOLATILITY US EQUITY ETF	8.0%
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	7.0%
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	6.0%
ZEB	BMO EQUAL WEIGHT BANKS INDEX ETF	6.0%
ZBK	BMO EQUAL WEIGHT US BANKS INDEX ETF	6.0%
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	5.0%
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	5.0%
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	4.0%
ZEO	BMO EQUAL WEIGHT OIL & GAS INDEX ETF	4.0%
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	4.0%
ZTIP/F	BMO SHORT-TERM US TIPS HEDGED TO CAD INDEX ETF	3.0%

Source: Bloomberg, BMO Asset Management Inc., as of September 30, 2021.

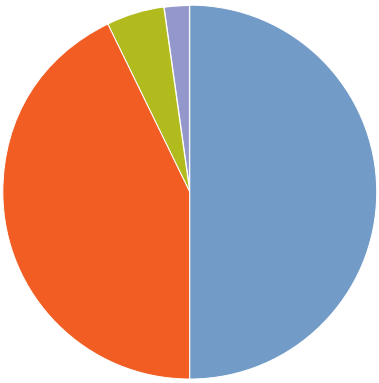


*Management Fee as of September 30, 2021.

**Yield calculations for bonds is based on yield to maturity, which includes coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity and for equities it is based on the most recent annualized income received divided by the market value of the investments.

Portfolio Characteristics

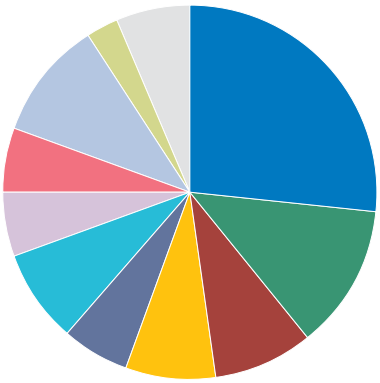
Regional Breakdown (Overall Portfolio)



Canada	50.0%
United States	43.0%
Europe	5.0%
Asia	2.0%

*Regional Breakdown includes equities, fixed income and non-traditional/hybrid sleeves.

Equity Sector Breakdown



Financials	26.79%
Health Care	12.54%
Consumer Staples	8.53%
Utilities	7.75%
Industrials	5.95%
Information Technology	8.12%
Consumer Discretionary	5.31%
Communication Services	5.65%
Real Estate	10.40%
Materials	2.80%
Energy	6.14%

Fixed Income Breakdown

Federal	48.3%
Provincial	14.5%
Investment Grade Corporate	37.3%
Non-Investment Grade Corporate	0.0%

Weighted Average Term	12.01
Weighted Average Duration	9.54
Weighted Average Coupon	2.2%
Weighted Average Current Yield	2.1%
Weighted Average Yield to Maturity	1.8%

Weighted Average Current Yield: The market value weighted average coupon divided by the weighted average market price of bonds.

Weighted Average Yield to Maturity: The market value weighted average yield to maturity includes the coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity.

Weighted Average Duration: The market value weighted average duration of underlying bonds divided by the weighted average market price of the underlying bonds. Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates.

The portfolio holdings are subject to change without notice and only represent a small percentage of portfolio holdings. They are not recommendations to buy or sell any particular security.

Source: Bloomberg, BMO Global Asset Management, as of September 30, 2021.

The Good, the Bad, and the Ugly

Conclusion: We anticipate markets will potentially experience some volatility over the quarter as the Fed looks to initiate the tapering of its asset purchase programs. Given interest rates will likely continue to reprice higher, we expect fixed income will also experience some weakness. As such, we expect the correlation between stocks and bonds to increase over the quarter unless the concerns of global contagion caused by the China Evergrande Group escalate. In that case, that would likely lead the Fed to hold off on its tapering process, which we view as a low probability at this point. While we anticipate Evergrande driven headlines to continue and cause market softness, China would likely step in to support the healthy developers if needed. Over the longer term, we still favour equities over bonds, particularly as the narrative of "Stagflation" starts to grow in the coming months.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• Vaccination rates continue to climb, and the introduction of other therapeutics such as the pill from Merck will help restore normalcy in the global economy. • A growing number of countries adopting the "live with COVID" model and opening up their economy will also help normalize the economy. • Unemployment continues to trickle down in the U.S., and Canada has claimed that it has restored all its jobs lost to COVID.	• A deviation in the performance differences between equity factors is strong evidence that markets continue to normalize. • Many companies have experienced earnings growth over the last several quarters, which was critical in justifying some of the lofty equity prices we have been seeing. • Some of the recent market softness could be healthy to allow sales and earnings to catch up with prices.	• While equities continue to perform well, the recent outperformance of defensive growth strategies is a good sign that shows markets are normalizing and some of the excessive risk-taking is abating.
Bad	• Inflation is a growing concern, with many now believing that it will be persistent rather than transient. We believe inflation will be here to stay in many industries. • The ingredients for stagflation are there. If COVID numbers remain high and economies can't open up, slow economic growth will be coupled with higher prices. • Household debt in Canada is still one of the main concerns, with tighter monetary policy to come.	• Higher commodity prices will cut into the profitability of some companies if they cannot pass on the higher costs to end consumers.	• The US dollar continues to exhibit strength, which will be a headwind for goldbugs. In addition to the world learning to live with COVID, lower macro-risk will also weigh on gold prices.
Ugly	• While developed countries have seen their vaccination rates increase, developing countries have had much lower inoculation rates. Programs like COVAX need to be better utilized by wealthier nations to ensure the less fortunate can also recover. The IMF has now stated that the difference in inoculation rates will create a dangerous divide between the vaccinated and the non- vaccinated.		• Margin debt is still one of the key contributors to how quickly risk-assets can rise and fall. The Archegos fiasco is an example of the misuse of leverage.

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