BMO ETFs Inflation Report

BMO ETFs Best Ideas to Hedge Inflation

- **BMO Short-Term US TIPS Index ETF, ZTIP/ZTIP.F/ZTIP.U**
- **BMO MSCI USA High Quality Index ETF, ZUQ/ZUQ.F/ZUQ.U**
- **BMO Global Infrastructure Index ETF, ZGI**
- **BMO Equal Weight Oil & Gas Index ETF, ZEO**
- **BMO Equal Weight REITs Index ETF, ZRE**

Current Market Conditions: What is the Market Saying?

Expected Inflation, 5 Years

Source: Bloomberg, November 3, 2021 5-year U.S. inflation Swap curve.

The U.S. Federal Reserve and the Bank of Canada (BoC) both stated that in 2021, they will allow inflation to run beyond the 2% target, with no hard ceiling specified. This is exactly what has happened so far this year. Inflation has been running well above 2%, and this has been persisting over the last six months. The most recent Consumer Price Index (CPI) report in Canada showed inflation was up 4.4% which is a jump even from elevated numbers over the summer.[1] CPI is a backward looking metric, however the numbers have been rising consistently throughout the year, signalling inflation could be less transitory than expected. In Canada, the cost of transportation, shelter and food all contributed to the growth in CPI. Additionally, higher gas prices, which are up 32.8% since last year have also been adding upward pressure on inflation.[2] The market (which is forward-looking) is pricing in an average annual inflation rate of about 3.1% for the next five years, which is ahead of the Bank of Canada's and the U.S. Federal Reserve's (the Fed) initial inflation target of 2%, and has been creeping up all year (see chart above).[3]

Inflation Forecasts: What are Economists Thinking?

Many economists are forecasting inflation will remain above 2% in 2022. This prediction is based on several facts:

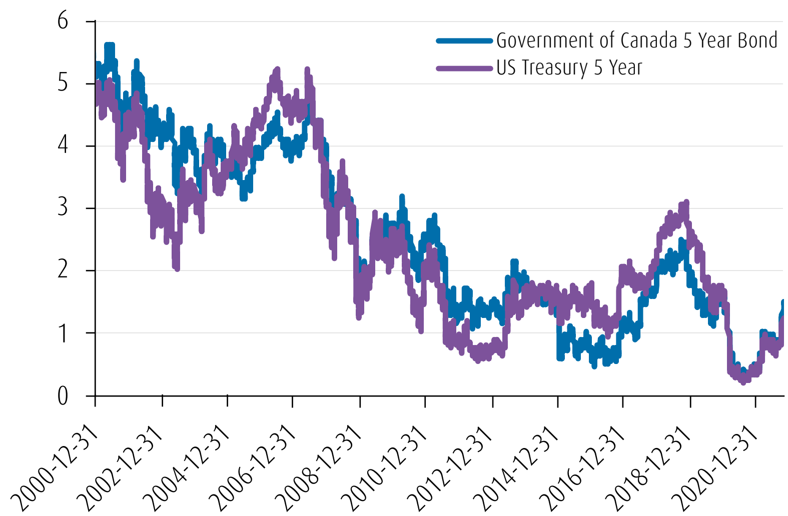
- The Fed has stated they will allow inflation to run above 2% for a sustained period before hiking interest rates and the Bank of Canada will likely follow.
- Monetary stimulus that flooded the market in 2020 and 2021 in both Canada and the U.S. is at historic levels.

[1] https://www150.statcan.gc.ca/n1/daily-quotidien/211020/dq211020a-eng.htm?indid=3665-1&indgeo=0, November 3, 2021.
[2] https://www150.statcan.gc.ca/n1/daily-quotidien/211020/dq211020a-eng.htm?indid=3665-1&indgeo=0, November 3, 2021.
[3] Bloomberg, November 3, 2021.

- While both the BoC and The Fed recently indicated they will begin to wind down their asset purchase programs, it was indicated that these historic stimulus programs have lead to inflation which could persist longer and at higher levels than they originally expected.[4]
- A sweep by the Democrats lead by the Biden Administration points to an increase in overall government spending and control of both the Senate and House increases the likelihood that these bills will pass.
- Energy prices are rising and the demand for oil is increasing as the economy reopens.
- Cost-push inflation of COVID-19 related expenses: many goods and services have had increased input costs based on investing in PPE, sanitary requirements, and increased wages for front line workers. These will be pushed forward to consumers.
- Supply chain disruptions across industries are also creating demand imbalances, adding further upward pressure on inflation.

Portfolio Positioning: How Can I Hedge My Portfolio Against Inflation?

Government Bond Yields in U.S. & Canada



Source: Bloomberg, November 3, 2021.

Fixed Income: Interest rates are at historic lows. Both the BoC and the Fed have no intention of raising their base policy rates, both at 0.25%, any time soon. This translates to very low yields on fixed income across the spectrum, but especially on the shorter end of the curve. For example, a 5-year Government of Canada bond is yielding 1.5%.[5] This presents a problem for investors who are facing 2% inflation per year. If their portfolio is yielding less than inflation, this will erode capital. We saw real rates (policy rates less inflation) go negative this year, so for investors in cash or in low yielding investments, the purchasing power of their money will depreciate over time. Even subtle inflation can have a large impact on bonds in this environment, which are challenged with very low rates. The low rate environment has also led to governments and corporations issuing longer-term debt than before, which has caused overall market duration to increase. Investors should be mindful of this as it will lead to more duration risk in portfolios.

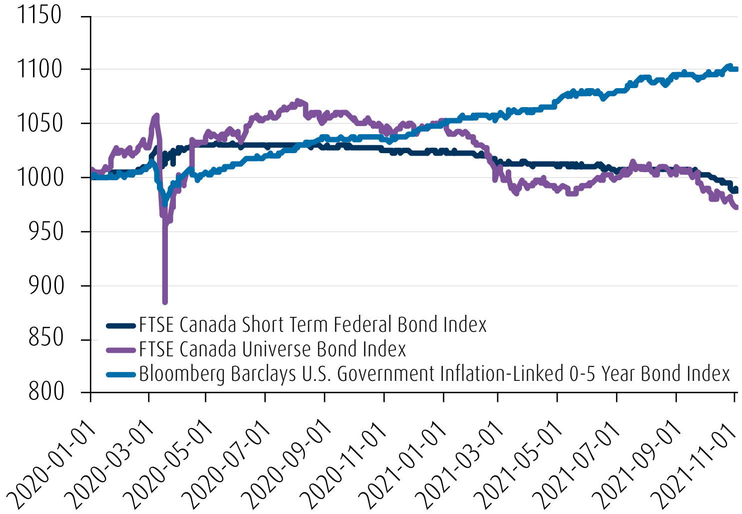
Equities: Equities generally do a better job at protecting against inflation than fixed income but there are certain asset classes which act as an inflation hedge better than others. Hard assets such as real estate and infrastructure have been popular investments for investors looking to inflation hedge. Hard assets tend to better protect against inflation and currency debasement. Infrastructure can protect against inflation because it is exposed to hard assets, and to companies which have long-term contracts. Infrastructure also tends to be a direct beneficiary from increased government spending which is a precursor to inflation.

[4] https://www.nbcnews.com/business/economy/federal-reserve-set-announce-withdrawal-emergency-support-economy-rcna4423, November 3, 2021.
[5] Bloomberg, November 3, 2021.

Using BMO ETFs to Hedge Inflation

BMO Short-Term US TIPS Index ETF, ZTIP: U.S. Treasury Inflation Protected Securities (TIPS) are bonds backed by the U.S. treasury and their par value adjusts to inflation. ZTIP offers the security of government bonds and its short duration (2.6 years) offers lower volatility than longer term bonds. Lower duration means more security (less duration risk) and is a more pure play inflation hedge. ZTIP is also offered as hedged to CAD (ZTIP.F) and in USD (ZTIP.U).

US TIPS vs Canadian Aggregate Bonds and Short Term Federal Bonds



Source: Bloomberg, November 3, 2021.
Please note you cannot invest directly in an index.

BMO MSCI USA High Quality Index ETF, ZUQ: Provides exposure to high quality, blue chip companies which can whether rising inflation relative to their peers. These companies are more resilient to inflation because they tend to have better pricing power, they have an easier time passing on higher input costs to end consumers, and their lower debt profile means there will be less burden on interest payments as rates rise. ZUQ is also offered as hedged to CAD (ZUQ.F) and in USD (ZUQ.U).

BMO Equal Weight Oil & Gas Index ETF, ZEO: Commodities are a hedge against inflation because they are priced in real terms. The reopened economy, economic expansion, and supply imbalances have placed strong demand on oil and gas. ZEO provides exposure to the Canadian energy sector while mitigating company specific risk through equal weighting.

BMO Global Infrastructure Index ETF, ZGI: ZGI invests in companies which have exposure to hard assets such as cell phone towers, pipelines, water systems, bridges and airports. These assets generally hold their value when inflation rises. Some of these companies even have revenues which are indexed to inflation. Many of these companies have long-term government contracts and could see an increase in contracts as government spending is often directed towards infrastructure.

BMO Equal Weight REITs Index ETF, ZRE: Real estate is considered a hard asset and property values tend to increase during inflationary periods. Certain segments of the real estate sector, such as commercial and office REITs may potentially benefit as the economy continues to open up and people return to the office.

Hedge Inflation Using These BMO ETFs:

Depending on your views, investment goals and asset mix, will determine how much of your portfolio to hedge against inflation.

Ticker	Sample Portfolio Weight		Comments	Further Reading
	Bullish (>2% inflation)	Neutral (2%)		
ZTIP	10–15% of fixed income	5–10% of fixed income	ZTIP to decrease duration	ZTIP Sales Aid
ZUQ	15–20% of equity	5–10% of equity portfolio	Quality companies have greater purchasing power, and less debt to service than their peers.	Quality ETFs Whitepaper
ZEO, ZGI, ZRE	10-15% of equity	5-10% of equity	Commodities and hard assets are less affected by rising inflation. These ETFs will also provide a sector tilt to a portfolio.	–

BMO ETF	Distribution Yield	YTM (with inflation assumption)	Duration	Risk Rating*	Management Fee
ZTIP/ ZTIP.F /ZTIP.U	0.40%	0.34%	2.6	Low	0.15%
ZUQ/ ZUQ.F/ ZUQ.U	0.90%	-	-	Medium	0.30%
ZEO	3.21%	-	-	High	0.55%
ZGI	3.20%	-	-	Medium	0.55%
ZRE	3.91%	-	-	Medium	0.55%

Source: BMO Global Asset Management, November 2021. Distribution yields are annualized.

For more information, listen to our BMO ETFs Inflation Podcast

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