

# ETF Mid-Year Market Review & Outlook

## Record Inflows for ETFs (Again!), the Bull Market is Back

### ETF Investing Has Been on a Run, with No Signs of Slowing



**Mark Raes,**  
Managing Director, Head of Product

The first half of 2021 marked another record setting period for the Canadian ETF market. Inflows amounted to a whopping \$30 billion over the first six months of the year, breaking the inflow record set last year.<sup>1</sup> And while the ETF market globally has seen similar strength, it is Canadian ETFs leading the way: growth in ETF assets in Canada is 22% year-to-date (YTD), more than any other region with a developed ETF market globally.<sup>2</sup> The market seems to be moving quicker than ever, pivoting to each headline: vaccine news, pandemic plot lines, political shifts and company earnings. More and more investors are becoming aware of the benefits of using ETFs to be agile in this environment. With ETFs, investors can react to a changing marketplace and be nimble with their investments, all in a cost-efficient way. It's for these reasons that the Canadian ETF industry has grown to \$300 billion in assets and shows no signs of slowing yet.<sup>3</sup>

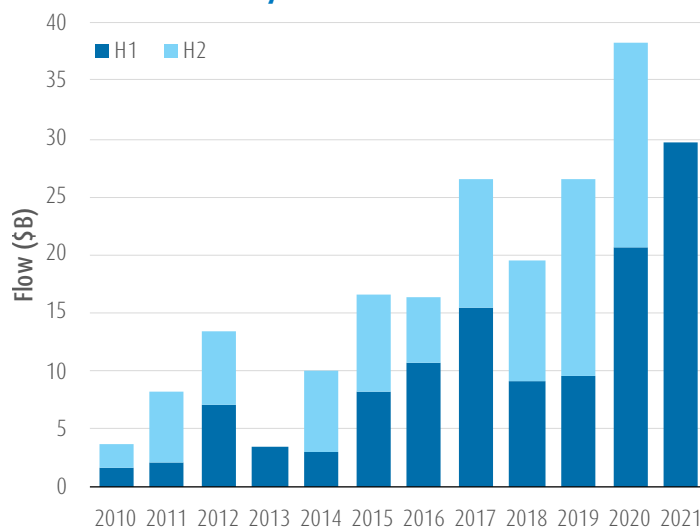
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Canadian flows into equity ETFs were \$16.1 billion in the first half of the year, most notably into broad-based regional allocations.<sup>4</sup> The **BMO S&P/TSX Composite Index ETF (ZCN)** gained more assets than any other equity ETF, with net flows of \$1.2 billion.<sup>5</sup> Canadian equity ETFs gathered \$5.3 billion, more than U.S. equities, as Canadian equities rotated into favour.<sup>6</sup> In terms of sectors, financial sector ETFs got the most attention with \$1.3 billion in flows as investors adjusted portfolios to benefit from rallying companies.<sup>7</sup> The Canadian ETF industry also made history in the first half of the year, when the first crypto asset ETFs began trading. These ETFs made a huge splash, gathering over \$3 billion in assets under management (AUM), as investors were able to access Bitcoin and Ethereum with

efficiency and liquidity, although volatility in the asset class has been high, with a 50% decline in the asset class in May.<sup>8</sup>

Rock-bottom short-term rates and rising long term bond yields have put pressure on the fixed income market as the yield curve steepened, but we still saw \$5.5 billion in flows. Canadian aggregate bond ETFs remained a favourite, as investors sought to diversify their bond exposures.<sup>9</sup> The **BMO Aggregate Bond Index ETF (ZAG)** had the most flows in the fixed income space with \$806 million.<sup>10</sup>

### Canadian ETF Flows by Half-Year Calendar Period



Source: National Bank ETF Research, June 30, 2021.

### Growth Stocks Take a Breather, But Innovation Remains Relevant



**Danielle Neziol,**  
Senior Product Manager

As the renewed bull market has developed, we have seen a rotation out of growth stocks and into value stocks. In 2020, growth stocks lead the charge out of market lows, and were relatively unscathed by the pandemic, as these tech and innovation companies benefitted from the unique online environment of the pandemic. Positive vaccine news in late 2020 coupled with successful vaccine roll outs

<sup>1</sup> National Bank, ETF Report, June 30, 2021.

<sup>2</sup> ETFGI Global Report: <https://etfqi.com>, June 30, 2021.

<sup>3</sup> National Bank, ETF Report, June 30, 2021.

<sup>4</sup> National Bank, ETF Report, June 30, 2021.

<sup>5</sup> National Bank, ETF Report, June 30, 2021.

<sup>6</sup> National Bank, ETF Report, June 30, 2021.

<sup>7</sup> National Bank, ETF Report, June 30, 2021.

<sup>8</sup> National Bank, ETF Report, June 30, 2021.

<sup>9</sup> National Bank, ETF Report, June 30, 2021.

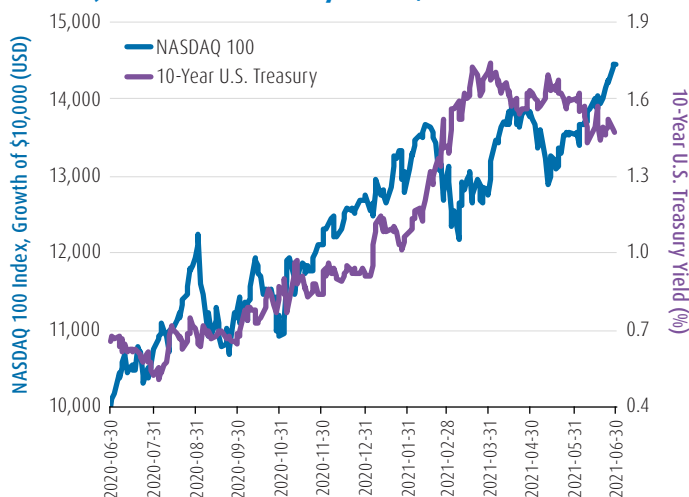
<sup>10</sup> National Bank, ETF Report, June 30, 2021.

in the spring of 2021 supported value-oriented stocks and pulled the wind out of the sails of many growth companies as the yield curve steepened. We saw treasury yields jump: the U.S. 10-year hit a high of 1.74% on March 31 before settling to 1.47% by the end of Q2 2021, which still represents a 61% spike since the beginning of the year.<sup>11</sup> Higher yields directly impact growth stocks, whose future earnings are important to current pricing, because it discounts those earnings more aggressively. However, for investors looking for long term growth solutions, short term movements in treasury yields are a small input and shouldn't deviate attention from long term growth opportunities. By the end of Q2, many growth companies had reversed course, and began trending upward.

Innovation exists in every business, every industry. For example, Tesla, a leader in autonomous technology and automotive innovation is considered a consumer stock. And Google, (who owns YouTube, Waze, Fit Bit) understands how to capitalize on an evolving digital advertising landscape. The health care company Moderna has its innovative mRNA technology being jabbed into millions of arms across the globe. Innovative companies are already part of our every day lives, and we are interacting with them every hour, every minute. Because of this, we don't see these companies going anywhere anytime soon.

Many innovation ETFs hit the market this year, and as the investing trend becomes more popular, we expect more of these products to continue to come to market.

### NASDAQ 100 & U.S. Treasury Yields, One Year



Source: Bloomberg, June 30 2021

As this is such a new style of investing, investors should understand how each innovative ETF is designed, as some ETFs provide pure exposure to emerging trends while others are growth ETFs masquerading as innovation products. The **BMO MSCI Innovation Index ETF (ZINN)** provides exposure to four main platforms of

future innovation: Fintech, Next Generation Internet, Genomics and Autonomous Technology. We partnered with MSCI who is a leader in innovation research and has precise methodology to pinpoint true innovation companies. The **BMO NASDAQ 100 Index ETF (ZNQ, ZQQ, ZNQ.U)** is also a truly innovative ETF, tracking an index of companies listed on an exchange which has a long track record of being focused on innovation, since it launched in 1971 as the world's first electronic stock market. The NASDAQ-100 Index has innovative characteristics such as greater R&D investment than peer indexes and robust patent creation among its constituents, fundamentals which truly back its innovative claims.

Innovative companies are already part of our every day lives. Because of this, we don't see these companies going anywhere, anytime soon.

As we continue to ride the reinvigorated bull market, we believe that innovation remains a pillar of the growth equation. If the pandemic taught us anything, it is that innovative companies will continue to drive and support our behaviours and habits, well after we are all vaccinated and hopefully return to our daily routines. These companies are part of exponential growth markets that will not only influence the future of how we interact with the world, but will power equity markets as well.

### ESG ETFs in Canada surpass \$1 Billion in Assets



**Erin Allen,**  
Senior Product Manager

In 2021 we continued to see growth in ESG (Environmental, Social, Governance) ETFs in terms of both assets under management (AUM) and new product offerings. Investors, both retail and institutional, are using ESG ETFs as a core component in their portfolios. This was evidenced earlier this year when we saw significant inflows into **BMO MSCI ESG Leaders Index ETF (ESGY/ESGY.F)**, making this the largest ESG ETF in Canada with a combined AUM of \$1.69 billion.<sup>12</sup> BMO ETFs has become a Canadian market leader in ESG ETFs, with over 30% of the market share and more than 10 ESG ETF solutions available.<sup>13</sup>

The growing interest in ESG stems from a wide range of drivers including millennials entering the financial markets, improving ESG data availability, as well as emotional preference as environmental and social issues continue to dominate headlines. Investors have also become more aware of the impact ESG risks can have on a company's value and its reputation. Avoiding companies exposed to these add a forward-looking element

<sup>11</sup> Bloomberg, June 30, 2020.

<sup>12</sup> BMO Global Asset Management, June 30, 2021.

<sup>13</sup> BMO Global Asset Management, June 30, 2021.



to the risk management processes. As we come out of the pandemic and look to rebuild our economies on stronger foundations the importance of tackling issues like climate change and social inequality are of growing importance to investors.

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ESG metrics are an effective way to uncover risk factors in the fixed income market as well, and we see this as an area of growth this year. Companies with lower ESG scores tend to have a higher chance of a rating downgrade than firms with better ESG scores, according to Bloomberg Barclays data. The connection between ESG issues and credit quality is now acknowledged by the major credit rating agencies, with Moody's and S&P Global both expanding their ESG capabilities to better integrate ESG factors in their credit rating methodologies. BMO ETFs has launched three fixed income ESG ETFs focused on credit exposures, **BMO ESG Corporate Bond Index ETF (ESGB)**, **BMO ESG US Corporate Bond Hedged to CAD Index ETF (ESGF)**, and **BMO ESG High Yield US Corporate Bond Index ETF (ESGH/ESGH.F)**.

Clean energy is still a trending ESG theme this year after stellar performance for these companies in 2020. This grabbed the attention of many investors and ETF issuers alike: there have been many new product offerings listed in Canada in the first half of 2021, including **BMO's Clean Energy Index ETF (ZCLN)**, providing exposure to a diverse range of clean energy producers and clean tech equipment companies. Clean energy companies

have since cooled-off but investors in the space see this as a long-term growth trend that is here to stay.

### Dividend & Value ETFs Have Their Time in the Sun



**Chris Heakes,**  
Director, ETF Portfolio Manager

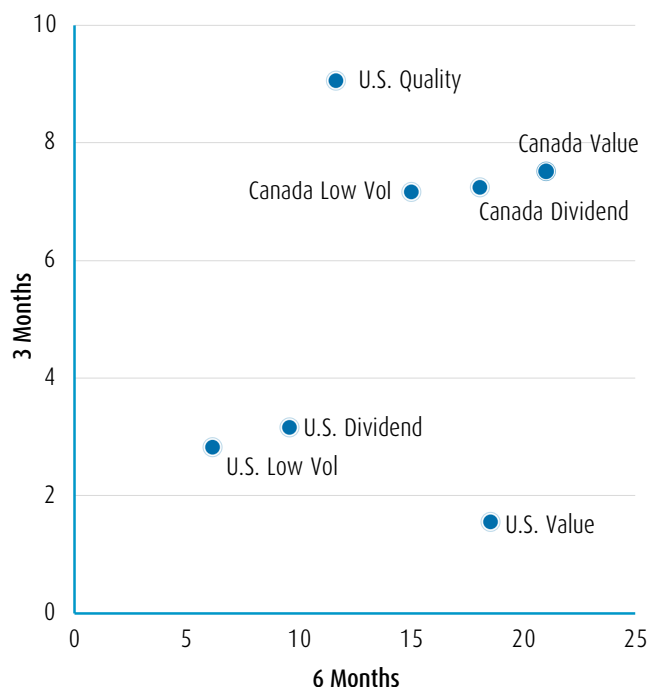
November 2020 marked a significant moment in markets for factor rotation when we first got news of a vaccine. Since then, many people in developed countries have been "double-vaxxed", contributing to economic re-openings across many regions. This marked a rotation out of quality companies, which are currently overweight to growth names, and kicked-off a factor reversal that has largely benefitted cyclical dividend and value companies. There is a natural connection between the dividend and value factors: when a company's price is depressed this will improve both its value metrics by lowering its price/earnings ratio (P/E), as well as by increasing its dividend yields, all else equal. And a strengthening economy bodes well for cash flows, sustaining dividend payments and future dividend growth. Because of these tailwinds, both the **BMO MSCI Canada Value Index ETF (ZVC)** and the **BMO Canadian Dividend ETF (ZDV)** have outperformed both the S&P 500 Index and the S&P/TSX Composite Index so far this year. Investors used ETFs to add strategic portfolio positions to capitalize on this market rotation: dividend ETFs saw \$1.5 billion in net new flows in the first half of 2021.<sup>14</sup>

Covered call ETFs, many of which use a dividend-based portfolio to provide enhanced income to investors, also kept pace. The **BMO Canadian High Dividend Covered Call ETF (ZWC)** also edged out the S&P 500 by 4.4%, thanks to its exposure to Canadian equities (which outperformed U.S. equities so far this year), and to its dividend factor exposure.<sup>15</sup>

<sup>14</sup> National Bank, ETF Report, June 30, 2021.

<sup>15</sup> Bloomberg, June 30, 2021

### BMO ETF Factor Performance



Source: Morningstar Direct, June 30, 2021.

Low volatility strategies provided protection through the market crash last March but have since rotated out of favour as their defining low-beta characteristic meant they lagged in the recent market rally, and volatility has since reduced to pre-Covid levels. Quality companies remain favourites as a long-term core growth solution and at the end of Q2 the Quality factor temporarily resumed market leadership, as growth stocks picked back up.

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### Inflation Expectations Pick Up



**Alfred Lee,**  
Director, ETF Portfolio Manager

Inflation has been top-of-mind for investors in 2021, and for good reason. Short term interest rates have been held at 0.25%, and the U.S.

Federal Reserve and the Bank of Canada are committed to overshoot short-term inflation targets.<sup>16</sup> Inflation will likely be an issue that most central banks will have to contend with as the economic reopening continues. Supply chains in many industries have been disrupted and consumer demand has created

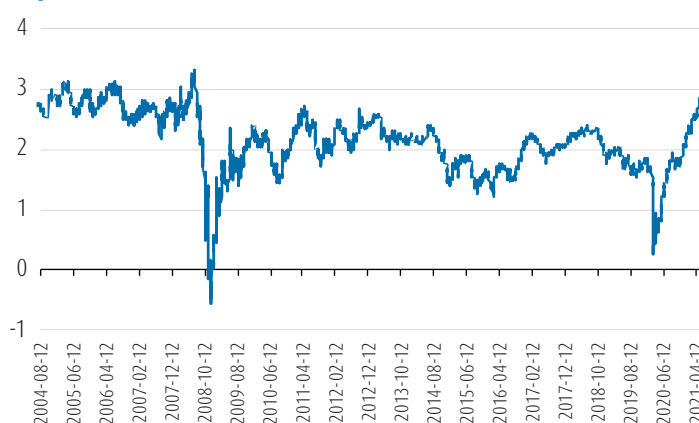
<sup>16</sup> Bloomberg, June 30, 2021.

<sup>18</sup> Bloomberg, June 30, 2021.

<sup>17</sup> <https://www.statcan.gc.ca> as of May 31, 2021.

imbalances, like the lumber story that most home renovators are living through. The computer chip (semiconductor) shortage is another example of a supply shortage, and it has affected many industries. Input costs are also on the rise including labour and energy. CPI is currently reporting 3.6% inflation in Canada, but this is a backward-looking metric on a year over year basis and is reflecting the extreme lows of last spring.<sup>17</sup> Today, the market (which is forward looking) is pricing in closer to 2.6% looking out 5 years.<sup>18</sup> While equities are better equipped to handle an inflationary environment than bonds, there are certain sectors which do better when inflation creeps up such as those which are exposed to goods and services that have better demand inelasticity, which allows companies to protect profit margins in the face of inflationary uncertainty.

### Expected Inflation, 5 Years



Source: Bloomberg, June 30, 2021.

For example, as the economy continues to expand and borders re-open, the industrial sector will likely benefit as the transportation of goods and human capital increases. The **BMO Equal Weight Industrials Index ETF (ZIN)** provides exposure to subsectors such as construction, railroads and airlines which can benefit from balance sheet expansion and continued economic growth. As manufacturing picks up, base metals and materials such as copper and steel also act as an inflation hedging sector. It should also be noted that while increasing the equity weight in a portfolio can have inflation hedging benefits, it can also bring on other risks.

The fixed income portfolio is where we can see inflation have a larger impact. For example, a 5-year Government of Canada bond is yielding 0.85%.<sup>19</sup> This presents a problem for investors who are facing 2% per year inflation (or more): 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

<sup>19</sup> Bloomberg, June 30, 2021.

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. U.S. Treasury Inflation Protected Securities (TIPS) are bonds backed by the U.S. treasury and their par value adjusts to inflation, so these securities can provide inflation hedging in a portfolio. ETFs offer exposure to these bonds, such as the **BMO Short Term US TIPS Index ETF (ZTIP)**. ZTIP offers the security of government bonds and its short duration (2.9 years) offers lower volatility than longer term bonds. Lower duration means more security (less duration risk) and is a more pure play inflation hedge.<sup>20</sup> ZTIP is also offered as hedged to CAD (ZTIP:F) and in USD (ZTIP:U).

### Banks, Financials Become a Sector Favourite



**Chris McHaney,**  
Director, ETF Portfolio Manager

As the Canadian economy emerges from virus related lockdowns, the Canadian banks have been leading the way. Canadian banks have rebounded strongly since November and have been leaders in the “reopening trade”. Credit losses continue to drop, and revenue growth remains strong and diversified among business lines which has led to both Q1 and Q2 earnings beating street estimates.<sup>21</sup> In their most recent earnings announcements, many of the banks reduced the amounts they have reserved for non-performing loans, reflecting a better than expected economic rebound from the significant disruption in 2020. As well, with Common Equity Tier 1 capital ratios at an average of over 13% (with the regulatory requirement at only 9%) this provides significant buffer against the risks of an uneven economic recovery going forward.<sup>22</sup> It also creates the possibility of dividend increases. Share buybacks could also be initiated if the current capital restrictions are lifted by OSFI. The average dividend yield today for a Big 6 Bank is around 3.7%, which is below the historical average.<sup>23</sup> Dividends were well supported throughout 2020 and the sector is sitting on significant excess capital (excess provisions for loan losses) leading some to believe dividend hikes could be on the horizon.

We believe the banks will continue to outperform as the market recovers. Continued stimulus and progress on vaccines are

tailwinds as the economy strengthens and reopens. Financial sector ETFs took in \$648 million in just June alone, of which \$391 million went into The **BMO Equal Weight Banks Index ETF (ZEB)** as investors flocked to the sector.<sup>24</sup>

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ETFs have maintained their popularity as portfolio staples, proven by another record half year of flows and continued trading liquidity.

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It has been a similar story for U.S. banks who also reported much stronger than expected earnings this year. However, expectations for growth going forward are a bit more measured, as many of the drivers of the recent round of earnings are viewed as temporary by investors. At the same time, a strong economic recovery would be a tailwind for U.S. banks, as this would likely be accompanied by an increase in loan activity. As well, a steepening yield curve would improve the environment for loan activity. In advance of the Canadian banks doing so, U.S. banks have begun to announce capital return programs after passing the latest round of Fed stress tests. This includes dividend increases and share buy back programs, providing support to share prices and cash flow for income-oriented investors. The **BMO Equal Weight US Banks Index ETF (ZBK)** has been sought out by investors looking to pinpoint the U.S. banks segment of the Financials sector, which tends to be more regionally focused, has a greater growth profile than other regions in the Financials sector, but carries slightly more volatility.

### Looking Forward

With 40 providers now participating in the Canadian ETF marketplace, and over 900 ETF strategies listed, investors are benefiting from precise exposures and innovative strategies to pair with broad-based market exposures. This provides more advanced portfolio construction opportunities using ETFs as core and satellite exposures to address market opportunities, and investor beliefs. ETFs continue to maintain their popularity as portfolio staples proven by another record half year of flows and continued trading liquidity. We see the record trading volumes this year as another proof point of future ETF acceptance.

<sup>20</sup> BMO Global Asset Management, June 30, 2021.

<sup>21</sup> Bloomberg, June 30, 2021.

<sup>22</sup> Bloomberg, June 30, 2021.

<sup>23</sup> Bloomberg, June 30, 2021.

<sup>24</sup> National Bank, ETF Report, June 30, 2021.



**Forward-Looking Statement:**

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