BMO ETF Portfolio Strategy Report

Second Quarter 2015 BMO EXCHANGE TRADED FUNDS

The Global Easing Party

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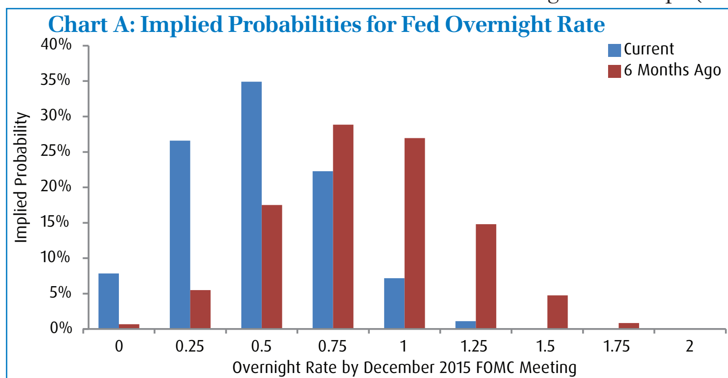
All prices or returns as of market close on April 15, 2015, unless otherwise indicated.

In this report, we highlight our strategic and tactical portfolio positioning strategies for the second quarter using various BMO Exchange Traded Funds. Our key strategy changes are outlined throughout the report and in our quarterly outlook on page six.

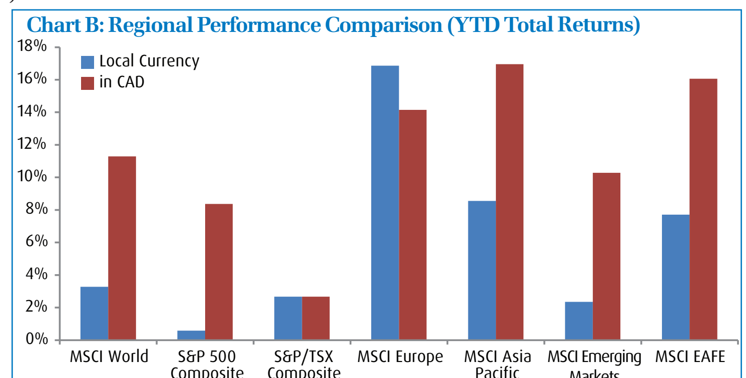
- **The implied probability of the U.S. Federal Reserve ("Fed") raising its overnight rate to 0.75% by the December Federal Open Markets Committee ("FOMC") meeting has only slight decreased over the last 6 months.** However, expectations of the overnight rate moving to 0.50% by the same meeting have notably increased. (Chart A) This is in line with our baseline expectations, as we expect the Fed to raise its rate by no more than 0.25% and potentially using 1/8 increments in getting there. Should global economic conditions continue to deteriorate, however, we would expect the Fed to stand pat in 2015, even if its own economy continues to show signs of improvement.
- **In a move to fend off lower oil prices, deflationary pressures and/or weakening economic growth, over twenty different central banks have cut their key interest rates year–to-date, which will cause the yield curves of most sovereign bonds to continue to flatten.** Consequently, a number of currencies have experienced a notable devaluation against the U.S. dollar given the Fed is the only notable central bank that may raise rates. With an improving economic backdrop in the U.S., we expect the greenback to remain strong over the long-term. However, over the short-term the *U.S. Dollar Index* looks technically overbought, having already gained 9.5% year-to-date. With the market already pricing in a higher expectation of a rate hike by the Fed, the U.S. dollar could weaken over the short-term, should the Fed hold off until 2016 in raising its overnight rate.
- **The fall in oil remains a supply-side story, with the Organization of Petroleum Exporting Countries ("OPEC") refusing to curb its output.** Rig count continues to trend lower in the U.S. due to declining margins, which has helped in stabilizing oil prices. Price for both Brent crude and West Texas Intermediate ("WTI") look to have found a bottom in January and have been trending upwards since, despite accumulating supply in the U.S. We don't anticipate significant upside during the quarter, however, as the next OPEC meeting isn't scheduled until early June and member countries will likely elect to maintain current output levels. At current supply levels, there isn't enough demand to drive the price point significantly higher.
- **Lower oil prices will continue to weigh on the Canadian economy.** The immediate impact will be on the energy related sector, however, the longer oil prices remain depressed, the greater the chance that the impact will be felt in the broader economy. With household debt to disposable income levels in Canada already at historic highs, the Canadian consumer may be reluctant to add further leverage to personal balance sheets. This will be a negative on discretionary spending and thus cyclical related areas of the economy. Lower volatility stocks in Canada will likely continue to outperform as a result.
- **With greater uncertainty for the Canadian economy, diversifying a portfolio with international and U.S. assets should be beneficial for Canadian investors.** With valuations in U.S. equities becoming stretched, we are moving from being overweight to market weight. We are becoming more constructive on international equities and we continue to increase our allocation to international dividend paying companies. Over the last several quarters, we have decreased our Canadian and U.S. weight in favour of international dividend paying companies and higher quality European equites. Year-to-date international stocks have outperformed, with the majority of the outperformance in total returns coming from Europe (Chart B).

Chart A: Implied Probabilities for Fed Overnight Rate



Source: BMO Asset Management Inc., Bloomberg

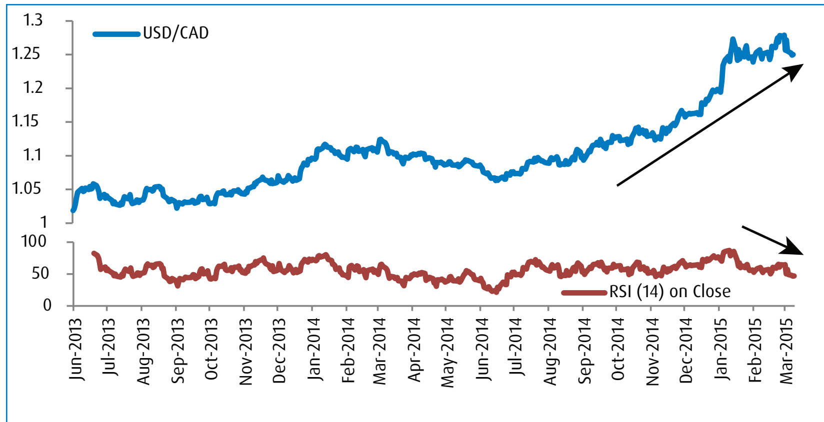
Chart B: Regional Performance Comparison (YTD Total Returns)



Source: BMO Asset Management Inc., Bloomberg (YTD Total Return of Indexes)

BMO Exchange Traded Funds

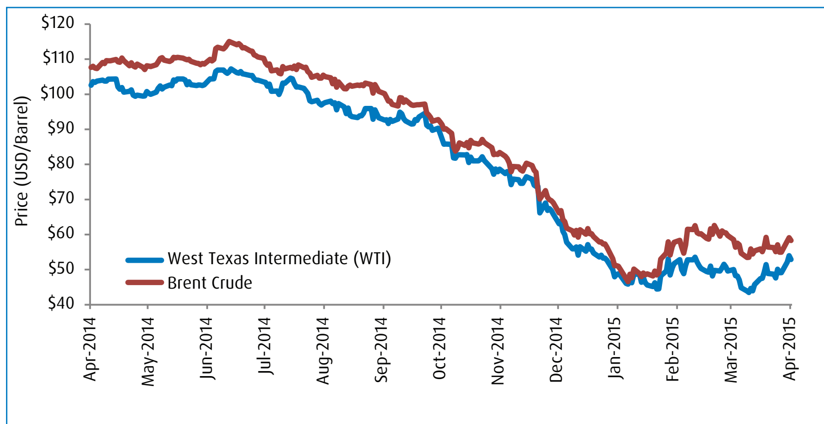
Things to Keep an Eye on...



Source: BMO Asset Management Inc., Bloomberg (RSI 14 - on Close is a technical momentum indicator that is used to determine overbought and oversold levels)

Similar to market consensus, we expect the Fed monetary policy to become increasingly hawkish as the year progresses. However, with the current 19.2% implied probability of the Fed overnight rate being 75bps by the January 2016 FOMC meeting, we believe the market's expectations are much too aggressive. Our view is that the Fed will be patient in hiking its overnight rate and potentially using 1/8th increments, rather than the standard ¼ point moves, making the Fed's overnight rate by next January likely lower than 75bps. Should a rate hike come by the end of the calendar year, a second follow up move would likely come notably after, as the Fed would likely take a wait and see approach. Although we believe the U.S. dollar should remain strong over the long-term, its recent momentum would suggest it is currently technically overbought, particularly versus the Canadian dollar.

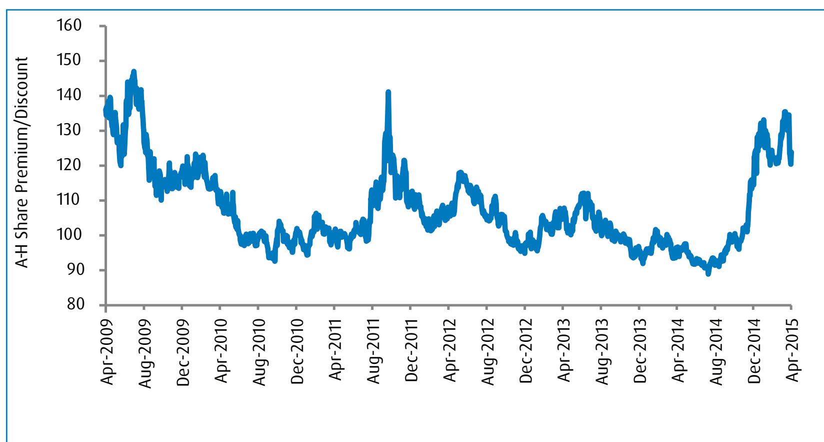
Recommendation: The one-year Canadian T-bill trading at 59.7bps would indicate that a second rate cut by the Bank of Canada ("BoC") is already priced into the market. Some market participants are also expecting a third rate cut to an overnight rate of 0.25% by the end of the year. Similar to how market expectations for monetary tightening are overly aggressive for the U.S., so too are the expectations for the BoC to become dovish. As a result, we expect some short-term gains in the Canadian dollar, but also expect the greenback to continue to strengthen over the long-term. Shorter-term investors may consider currency hedged ETFs, when looking for U.S. exposure, whereas long-term investors ought to elect to remain unhedged.



Source: BMO Asset Management Inc., Bloomberg

Depressed oil prices remain a supply side issue with OPEC refusing to curb supply. We believe this imbalance will take some time to play out. It is unlikely that oil prices will return to their 2014 levels anytime soon, as a supply glut is now building in the U.S., with inventory levels at near century highs. Brent crude and WTI are down 48.7% and 50.3% respectively from 2014 highs, but prices look to have found a base, essentially trading in a tight range since January. As prices remain depressed, profit margins will compress, naturally leading some North American producers to scale back operations, eventually decreasing the supply in the U.S.

Recommendation: Last quarter we added the ***BMO S&P/TSX Equal Weight Oil & Gas Index ETF (ZEO)*** to our portfolio strategy as a tactical position at only 3.0% of the portfolio strategy. Since that report, ***ZEO*** has returned 14.0% on a total return basis. Although we don't expect oil prices to even reach US$85/barrel this year, much of the negative sentiment has already been priced in. ***ZEO*** has a portfolio yield of 3.9% and the improving sentiment may give it further technical upside.



Source: BMO Asset Management Inc., Bloomberg

The Hong Kong stock market is used as a gateway to the Mainland Chinese market, a largely closed market to outside investors. The Shanghai-Hong Kong Stock Connect is a cross-boundary investment channel allowing limited daily quota for investors in Hong Kong to invest in the mainland and vice versa. On April 8th, southbound traffic from Mainland China investing in Hong Kong stocks, reached its maximum daily quota for the first time ever. This was due to investors looking to get exposure to Hong Kong listed "H-shares", which are currently trading at a discount to its mainland equivalent "A-shares."

Recommendation: Given the remaining overall discount of H-shares relative to A-shares is still sizable, the rally in Hong Kong stocks could potentially continue. The American Depository Receipts ("ADRs") of Chinese companies have fundamentals that tend to be in-line with H-shares. The ***BMO China Equity Index ETF (ZCH)***, invests in Chinese ADRs and may be a solution for investors looking for exposure to the stocks of Hong Kong/China. The lower financial exposure of ***ZCH***, may also help mitigate indirect exposure to China's troubled housing market.

Changes to Portfolio Strategy

Asset Allocation:

- We are leaving our asset allocation mix relatively unchanged this quarter. As mentioned in our last report, we expect opportunities to arise from the diverging monetary policies of major central banks. Consequently, we believe that greater opportunities in the interim can be found within asset classes and determining how to best attain exposure to these areas. Increasing our allocation to non-North American equities last quarter added to the cumulative outperformance of our portfolio strategy relative to its benchmark. This quarter, we continue to focus on intra-asset class adjustments to our portfolio strategy.

Fixed Income:

- In last quarter's Portfolio Strategy Report, we mentioned that a rate cut by the BoC would come only after sustained lower oil prices resulted in a lower Canadian gross domestic product ("GDP"). At the time, we believed the Canadian central bank would leave things unchanged, opting to be patient in moving its overnight rate in either direction. Consequently, we held off extending the duration of our Canadian bond exposure. In a move that surprised the market, however, the BoC went ahead and reduced its overnight rate by 0.25% at its January meeting. Historically, it has been very rare for a central bank of a developed nation to reverse the direction after having moved its overnight rate. As a result, in order to pick up a higher current yield, we are selling our 9.0% exposure in the ***BMO Short Corporate Bond Index ETF (ZCS)*** and reallocating the entire amount to the ***BMO Mid Corporate Bond Index ETF (ZCM)***.
- In addition, we are eliminating our 3.0% position in the ***BMO Ultra Short-Term Bond ETF (ZST)*** as the threat of rising interest rates in Canada has become less of a concern over the short and mid-term. Although we remain positive on this ETF, given its low duration and higher yield, we are looking to free up capital to allocate to international equity markets.

Equities:

- In the last four years, we have recommended an overweight to U.S. equities given the improving economic backdrop, attractive valuations and the accommodative monetary policy of its central bank. On an absolute basis, we remain positive on U.S. equities, however, valuation metrics such as price to earnings ("P/E") are now trading at a premium to historical averages. Although, the economic backdrop continues to strengthen in the U.S., we believe monetary policy will slowly become more hawkish, potentially placing a headwind on the equity market. The stronger U.S. currency may also present an opportunity for U.S. corporations to acquire international targets, placing a limit on the upside potential for equities over the near term. As we now see greater opportunities in international markets, we are looking to gradually increase our allocation to non-North American equities. Since dividends tend to be more sensitive to rising interest rates, we are eliminating our 11.0% position in the ***BMO US Dividend ETF (ZDY)***. Our outlook for this ETF remains positive, particularly as we believe the U.S. will remain a low interest rate environment despite any potential rate hikes. However, we see greater opportunities in international dividend paying companies.
- We still remain positive on the U.S. economy on an absolute basis, and therefore we are partially reallocating 4.0% into the ***BMO Low Volatility US Equity ETF (ZLU)*** for U.S. equity exposure. The current 18.5x P/E ratio of the *S&P 500 Composite Index* is a 12.6% premium to its 10-year average and would suggest valuations are slightly stretched unless earnings can grow faster than share price. However, if U.S. corporations look for acquisitions, higher expenses could weigh on their bottom line, making earnings expansion difficult. Therefore, we prefer ***ZLU*** for U.S. equity exposure, to provide better downside protection should a potential market correction in U.S. equities materialize.
- Over the course of the last several quarters, we have slowly been building our allocation to non-North American equities through the ***BMO International Dividend ETF (ZDI)*** and the ***BMO MSCI Europe High Quality Hedged to CAD Index ETF (ZEQ)***. We are becoming increasingly positive on international stocks for a number of reasons. First, the macro-economic backdrop is beginning to show early signs of improvement. Second, company earnings also have more upside potential to keep pace with increasing share prices. As we pointed out last quarter, lower oil prices tend to translate to higher disposable income, particularly in Europe. Last but not least, monetary policy will remain accommodative, which will keep stocks buoyant, particularly higher dividend paying companies in a low interest rate environment. We are thus increasing our allocation to ***ZDI*** by 5.0%.

Non-Traditional:

- For a portfolio diversifier, we are adding the ***BMO Equity Linked Corporate Bond ETF (ZEL)*** to our portfolio strategy mix. This ETF holds short and mid-term corporate bonds and buys options seeking to achieve a diversified exposure to Canadian equities, if exercised. Given its composition, it provides equity upside and bond downside and it has a similar return and risk profile to convertible bonds. Unlike convertible bonds, however, which tend to lack liquidity as they are issued by smaller corporations, ***ZEL*** holds only liquid investment grade corporate issuers.

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Short Corporate Bond Index ETF	ZCS	9.0%	BMO Mid Corporate Bond Index ETF	ZCM	9.0%
BMO Ultra Short-Term Bond ETF	ZST	3.0%	BMO International Dividend ETF	ZDI	5.0%
BMO US Dividend ETF	ZDY	11.0%	BMO Low Volatility US Equity ETF	ZLU	4.0%
			BMO Equity Linked Corporate Bond ETF	ZEL	5.0%
Total		**23.0%**	**Total**		**23.0%**

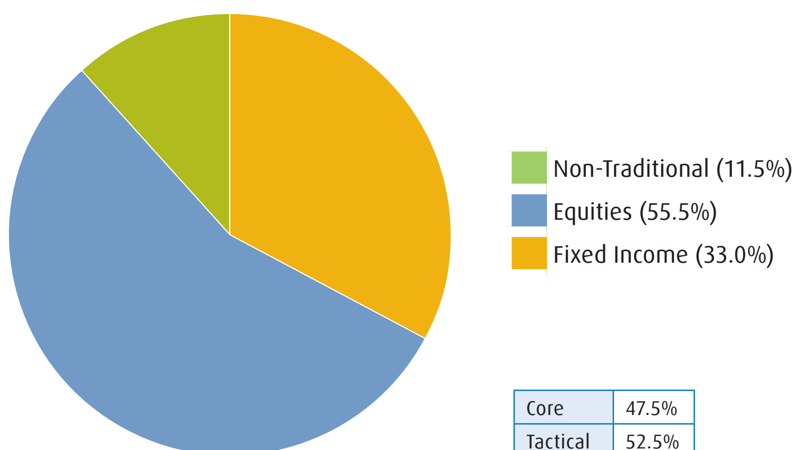
Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange traded funds (ETFs).

Stats and Portfolio Holdings

Ticker	ETF Name		Position	Price	MER[1]	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/ Vol
	Fixed Income									
ZDB	BMO DISCOUNT BOND INDEX ETF	Debt	Core	$16.23	0.20%	14.0%	4.9	5.9%	2.0%	0.41
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Debt	Tactical	$18.26	0.25%	10.0%	10.7	9.1%	3.2%	0.30
ZCM	BMO MID CORPORATE BOND INDEX ETF	Debt	Tactical	$16.83	0.12%	9.0%	5.3	4.0%	3.4%	0.64
	Total Fixed Income					33.0%		19.0%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$27.65	0.35%	8.5%	10.6	7.6%	2.0%	0.19
ZDV	BMO CANADIAN DIVIDEND ETF	Equity	Core	$17.56	0.35%	5.0%	14.4	6.1%	4.1%	0.28
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	Equity	Core	$25.70	0.10%	9.0%	14.3	10.9%	1.9%	0.13
ZDI	BMO INTERNATIONAL DIVIDEND ETF	Equity	Core	$22.00	0.40%	11.0%	19.2	18.0%	3.8%	0.20
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	Equity	Tactical	$18.56	0.40%	7.0%	14.8	8.8%	1.9%	0.13
ZWB	BMO COVERED CALL BANKS ETF	Equity	Tactical	$16.70	0.65%	3.0%	15.0	3.8%	5.3%	0.35
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	Equity	Tactical	$13.42	0.55%	3.0%	31.9	8.1%	3.1%	0.10
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	Equity	Tactical	$19.87	0.65%	3.0%	13.7	3.5%	4.7%	0.34
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	Equity	Tactical	$17.96	0.35%	4.0%	21.8	7.4%	1.3%	0.06
	Total Equity					53.5%		74.2%		
	Non-Traditional/Hybrids									
ZFH	BMO FLOATING RATE HIGH YIELD ETF	Debt	Tactical	$15.10	0.40%	3.5%	5.6	1.7%	4.8%	0.85
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Debt	Tactical	$12.16	0.45%	5.0%	9.6	4.1%	4.7%	0.49
ZEL	BMO EQUITY LINKED CORPORATE BOND ETF	Debt	Tactical	$21.05	0.40%	5.0%	2.6	1.1%	0.9%	0.33
	Total Alternatives					13.5%		6.9%		
	Total Cash					0.0%	37.6	0.0%	0.0%	
	Portfolio				**0.32%**	**100.0%**	**11.8**	**100.0%**	**2.9%**	**0.25**

[1] MER as of April 15, 2015

Ticker	Top Holdings	Weight
ZDB	BMO DISCOUNT BOND INDEX ETF	14.0%
ZDI	BMO INTERNATIONAL DIVIDEND ETF	11.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	10.0%
ZCM	BMO MID CORPORATE BOND INDEX ETF	9.0%
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	9.0%
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	8.5%
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	7.0%
ZDV	BMO CANADIAN DIVIDEND ETF	5.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	5.0%
ZEL	BMO EQUITY LINKED CORPORATE BOND ETF	5.0%
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	4.0%
ZFH	BMO FLOATING RATE HIGH YIELD ETF	3.5%
ZWB	BMO COVERED CALL BANKS ETF	3.0%
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	3.0%
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	3.0%



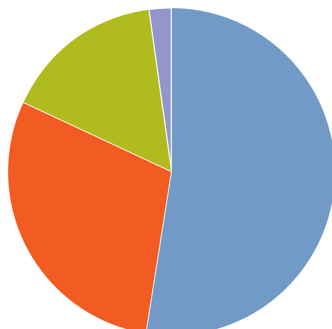
Core	47.5%
Tactical	52.5%

*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.

**Cash is based off the 3-quarter Canadian Dealer Offered Rate (CDOR).

Portfolio Characteristics

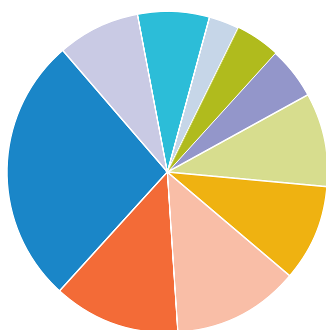
Regional Breakdown (Overall Portfolio)



Region	
Canada	52.5%
United States	29.5%
Europe	15.9%
Asia	2.1%

*Regional Breakdown includes equities, fixed income and alternative sleeves.

Equity Sector Breakdown



Sector	
Financials	26.8%
Health Care	8.4%
Industrials	7.3%
Information Technology	3.0%
Materials	4.5%
Telecommunication Services	5.2%
Utilities	9.4%
Consumer Discretionary	9.9%
Consumer Staples	12.9%
Energy	12.8%

Fixed Income Breakdown

Federal	12.6%
Provincial	11.4%
Investment Grade Corporate	67.6%
Non-Investment Grade Corporate	8.4%

Weighted Average Term	7.76
Weighted Average Duration	6.01
Weighted Average Coupon	3.5%
Weighted Average Current Yield	3.2%
Weighted Average Yield to Maturity	2.3%

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 Good, the Bad, and the Ugly

Conclusion: The importance of geographical diversification will continue to be an investment theme for us in 2015. From a regional perspective, we favour European stocks given the potential opportunities for earnings expansion. Despite our overweight to U.S. equities over the last four years, we are becoming more neutral on U.S. stocks as valuations are becoming stretched. Overall, we remain more positive on Canadian bonds than we are on its equity market, however, we see lower beta stocks outperforming the *S&P/TSX Composite Index* in Canada. Given the growing divergence in the monetary policy of central banks around the globe, we expect currency volatility to remain higher than equity market volatility. Investors should consider which regions to currency hedge and which areas to remain unhedged.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• Eurozone Employment y/y continues to increase, suggesting an improving economic backdrop in the Eurozone • U.S. existing home sales continues to remain steady registering 4.88 million units in February 2015. • The *S&P/Case Shiller Composite 20 Home Price Index* also continues to trend up, suggesting the home recovery in the U.S., continues to gain traction. • GDP y/y for Canada registered 2.4% in January. There will be a focus on its February number to see if lower oil prices will have had an impact. • The declining U.S. unemployment rate will put pressure on the Fed to raise its overnight rate.	• The trailing 12-month EPS on the S&P/TSX Capped Energy sector has fallen to post-recession lows. Forward looking EPS have also declined significantly. Unless oil prices fall further, much of the negativity is already priced into Canadian energy stocks. • The Canadian REIT industry is currently trading at a P/CF of 13.6x, a 7.8% premium to its 10-year average. A persistent low interest rate environment should be good for REITs, as long as a deterioration in the economy not weigh significantly on occupancy rates.	• Lower beta stocks in Canada continue to gain relative strength against the *S&P/TSX Composite Index*. We expect low volatility stocks to outperform in Canada. • We continue to expect correlations between and within asset classes to drift lower. This is a positive for multi-asset strategies. • Short-term momentum in European stocks is declining, potentially creating a buying opportunity. Over the longer-term, we are bullish on European stocks. • Equity market volatility has again abated with the *CBOE/S&P Implied Volatility Index (VIX)* at 15.3. We expect equity market volatility to likely remain lower than currency volatility.
Bad	• *Consumer Price Index (CPI)* y/y has fallen below 2.0% in Canada, indicating a slowdown in its economy. • Unemployment in Canada ticked up to 6.80% in February, a 20bp jump from January. • Concerns are growing in China about its LGFVs. • The *HSBC China Manufacturing PMI Index* dipped to 49.6%. A value of less than 50% suggests a contracting manufacturing. • A rising U.S. dollar versus most major currencies will have a negative impact on its exports.	• Trailing 12 month EPS for the *S&P 500 Composite Index* is at historic highs. Continued price expansions are unlikely to be met with earnings growth. • Valuations on defensive oriented sectors such as utilities and telecoms continue to trade richer.	• The *S&P/TSX Composite Index* has been range-bound since the drop in oil prices. We continue to see better opportunities in international equity markets. • Over the longer-term, the U.S. dollar is the only major currency with technical strength. Investors should place emphasis on currency exposure when deciding to invest outside of Canada. Over the long-term we continue to favour unhedged in the U.S. and currency hedged in other areas. • The *Shanghai Composite Index* has rallied 15.9% year to date. Shorter-term indicators suggest the market is overbought. With more accommodative monetary policy expected, the technical underpinnings suggest further upside, despite the growing macro-economic concerns.
Ugly	• Our concerns about the Canadian economy continue to mount. Household debt to income levels have been running at historic highs. A combination of lower oil prices and potentially falling real estate prices, will place pressure on the Canadian household. • OPEC is showing no signs that they will curb its oil output. As inventories also build in the U.S., this will have a negative impact on the energy sector in Canada and overall Canadian GDP.	• The Russian equity market has a current P/E of 4.6x. Although inexpensive, lower oil prices could place further headwinds on its market. Russian equities to remain inexpensive for an extended period, as geo-political risks remain.	• The *Margin Debt Index* is at all-time highs. Interest rates moving higher too quickly, would force margin calls. A sizable market sell-off would likely lead a deleveraging event more severe than the great financial crisis of 2008-2009. • Commodity related currencies such as the Canadian dollar, Norwegian Krona and the Australian dollar have flat-lined relative to the U.S. dollar. Lower oil prices could cause interest rates to diverge, putting further downward pressure over the long-term.

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