For professional investors only

Monthly ETF Update

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A high yield opportunity relative to equities

BMO Barclays Global High Yield Bond (GBP Hedged) UCITS ETF (Ticker: ZHYG-LN)

Economic data (including PMI, employment, corporate earnings and consumer sentiment) continues to point to stronger growth around the world. Equity markets have responded well to the increased optimism, with core indices remaining near their all-time highs. This performance, coupled with the prosperous economic backdrop makes an interesting case for an allocation into High Yield bonds; an asset class that manages to combine equity sensitivity with the increased security of fixed income. It is in times of stable growth that one of the largest risks associated with High Yield bonds, default, becomes less likely. The yield of High Yield bonds on a relative basis may now be sufficient to outperform equities, taking into account the additional income.

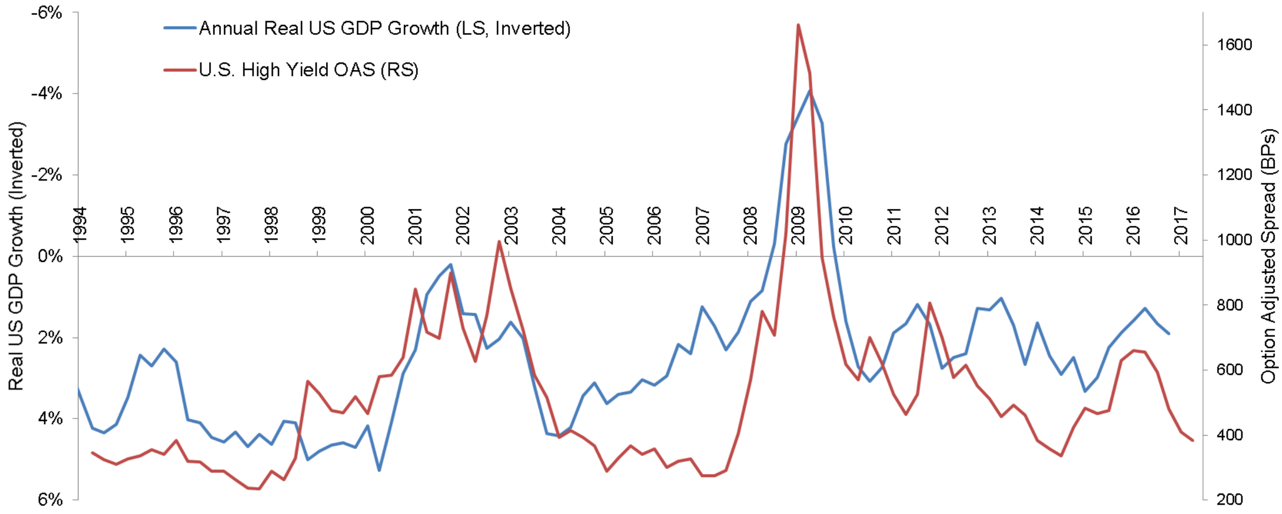
The asset class has shown over various time horizons to have a risk-return profile that sits between government bonds and equities. The lower rated credit exposure represents the companies which should benefit the most from low interest rates. These allow continued refinancing and improving balance sheets, at a time when revenues are rising due to consumer confidence and spending.

Global high yield option adjusted spread (OAS) is driven by expectations of the underlying bond holdings to stay solvent. The spread compensates investors for taking on additional credit risk. Default is linked, in aggregate, to economic growth. More stable growth will mean fewer companies defaulting; they can generate enough income to remain solvent.

The chart below shows the correlation between higher growth and lower high yield bond spreads- which are linked to default rate expectations. If growth continues and economies remain buoyant, high yield bonds should continue to be in demand, not least from investors seeking alternatives to other low-yielding assets.

Due to these factors, High yield bonds are closer in nature to equities than investment grade corporate bonds, and certainly sovereign bonds. To quantify the default rate landscape, Moody's reported a 3.8% global default rate for the first quarter of 2017, a decline from 4.5% in Q4 2016. This figure is expected to fall to 2.5% by the end of the year. Even as interest rates rise, as is already the case in the US, the cycle has a long way to go before high rates impact solvency again.

Correlation between higher growth and lower high yield bond spreads, linked to default rate expectations



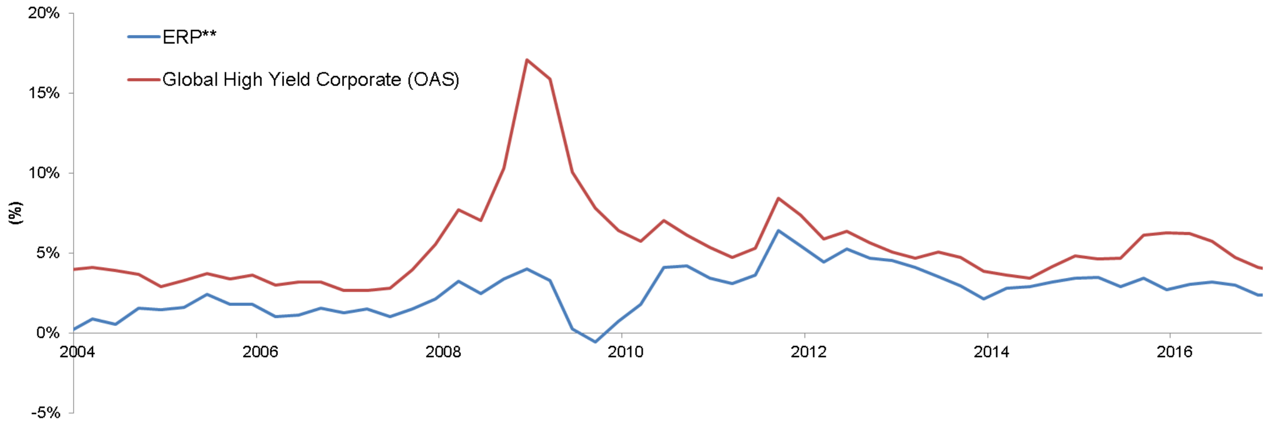
Source: Bloomberg as at 28.04.17

The following table shows similar returns with lower volatility of high yield bonds relative to equities, historically. The superior risk adjusted return is driven by the higher income stream and, additionally, an illiquidity premium that is characteristic of the high-yield market. Furthermore, high yield bonds sit further up the capital structure within companies and therefore have higher protection in the event of bankruptcy.

	Unhedged		Hedged	
	Equity	High Yield	Equity	High Yield
Total Return (annualised)	6.19%	8.69%	5.20%	8.65%
Standard Deviation	15.41%	10.06%	14.07%	9.34%
Sharpe Ratio	0.40	0.86	0.37	0.93

Equity is represented by MSCI World Index HY is represented by Bloomberg Barclays Global High Yield Corporate Data from January 2001 to April 2017. Source: Bloomberg and Barclays Capital.

The illiquidity premium is illustrated in the chart below where the global high yield OAS has been consistently higher than the equity risk premium (ERP) over the past 13 years.



Source: Bloomberg (28.04.17) **ERP = Equity Risk Premium, defined as E/P minus 10-year US Treasury

In summary, should the current environment persist, we believe now is a good time for investors to consider investing in Global High Yield Bonds, potentially replacing part of an equity allocation. BMO Global Asset Management offers a cost efficient ETF to gain access to this asset class which is outlined below.

Look out for our next article where we continue this topic; discussing the differences of high yield bonds relative to other parts of the fixed income universe, in particular assessing the trade-off between duration and yield.

BMO Barclays Global High Yield Bond (GBP Hedged) UCITS ETF- Key facts

Annualised performance (as at 28 April 2017)

1 Year: 10.17%
Since Inception: 7.80%
Since inception date: 5th November 2015

Fund Ticker	Index	Weighted Average Term	Weighted Average Coupon	Weighted Average Yield to maturity	Weighted Average Duration	Base Currency	OCF***	Inception Date
ZHYG-LN	Barclays Global High Yield Bond Corporate Very Liquid ex-144A Hedged to GBP Index	5.78 years	5.51%	4.76%	3.77 years	GBP	0.35%	05.11.2015

*Source: BMO Global Asset Management. Information as at 28.04.2017. **OCF – Ongoing charges figure

BMO Global Asset Management