

# Inter-Market Analysis in Guiding Cross-Asset Allocation

Monthly Strategy Report September 2011

BMO EXCHANGE TRADED FUNDS

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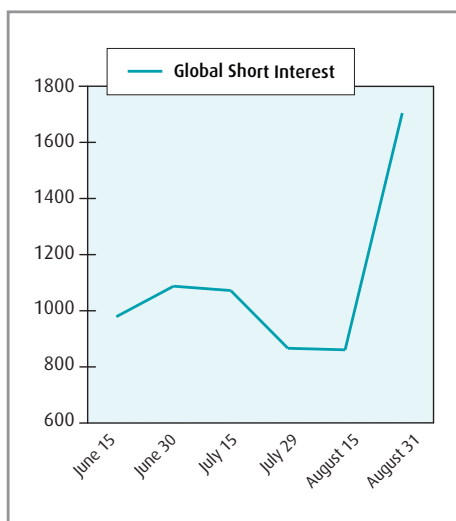
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All prices as of market close  
on September 26, 2011 unless  
otherwise indicated.

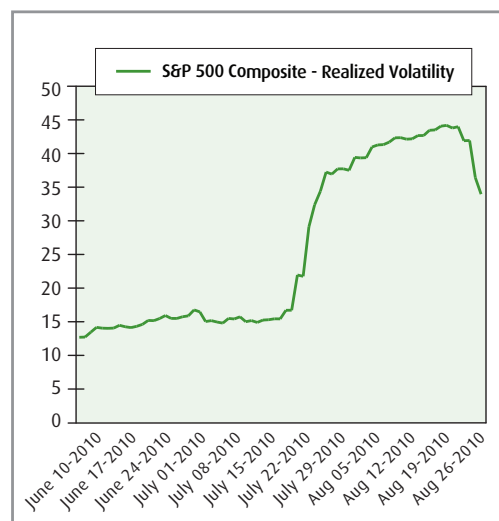
Although it is debated in financial academia as to what percentage asset allocation contributes to portfolio volatility<sup>1</sup>, we can perhaps agree that it is significant. Therefore in a volatile market environment, in which the *CBOE Implied Volatility Index* ("VIX")<sup>2</sup> remains elevated, as we have recently witnessed, portfolio construction becomes increasingly important. In fact, we will go further and say that going forward your asset allocation will be one of, if not the most, important drivers in the returns of your portfolio strategy. This month we wanted to take a closer look at the recent trends developing between the three major asset classes we track: equities, fixed income (or credit) and commodities. For our own purposes, we also monitor currencies and volatility as alternative asset classes, to better understand the inter-market relationships between the three major asset classes previously mentioned.

About a month ago, shortly after U.S. Treasuries were downgraded by the credit rating agency *Standard & Poors (S&P)*, we issued a special bulletin recommending investors increase their allocation to bonds. Although, we wouldn't be surprised to see frequent relief rallies in equities, we anticipate stock market volatility to remain elevated over the short-term. This is due to increased shorting activity in the market, leading to short-covering, causing upside and downside moves to be exaggerated. In addition, macro-economic uncertainty remains, further compounding price movements as the market will have difficulty pricing the fair value of assets. As a

## Rising Global Short Interest<sup>4</sup> Exacerbates Equity Volatility



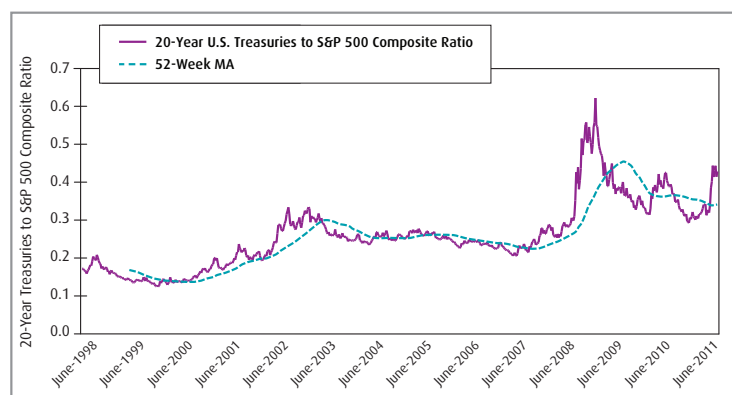
Source: BMO Asset Management Inc., Bloomberg



result, we believe bonds at this time are a good solution to increase stability in volatile times. Furthermore, as we have mentioned in previous reports, the amount of leverage in the financial system makes diversification within one asset class ineffective in providing downside protection as intra-market correlation remains elevated.

Although, we came into the year more bullish on equities, our appetite for risk has deteriorated as the year has progressed. Economic data now suggests that the market weakness is more than just seasonality or a soft-patch largely caused by supply chain disruptions, and the market awaits clues of further monetary stimulus after the market's negative reaction to "Operation Twist<sup>3</sup>." In response, the bond market has rallied significantly against equities over the last month, as global investors seek out safe-havens. This recent trend in both U.S. and Canadian fixed income over their respective equity markets supports our thesis that fixed income is the preferred asset class for the time being.

### Bonds Have Rallied on Global Search for "Safe-Haven"



Source: BMO Asset Management Inc., Bloomberg

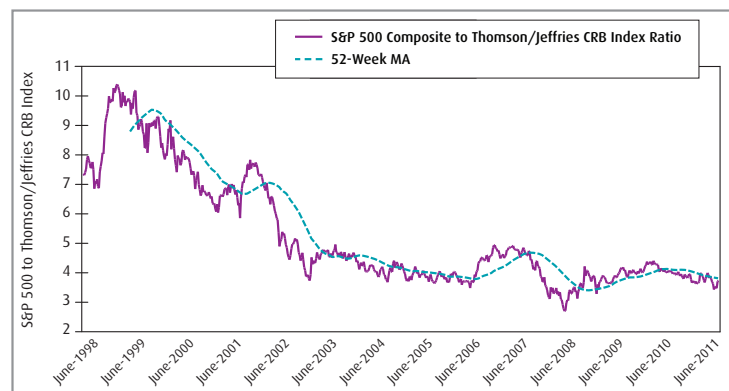
### Fixed Income Exposure:

In terms of traditional fixed income, investors may want to consider slightly extending their duration exposure. With the Bank of Canada (BoC) taking a much more dovish tone towards monetary policy at their last meeting, interest rate hikes, barring surprise inflation, is likely pushed-off until 2012. Some have even called for an interest rate decrease before the end of this year. A change in direction of lending rates is more significant than the amount of a rate move in our opinion and unless conditions deteriorate dramatically, the BoC will likely stand pat. Regardless, this should benefit the long end of the yield curve, especially if the U.S. Federal Reserve's (Fed) Operation Twist impacts the Canadian yield curve by bringing down the long end. For traditional fixed income, increasing duration to the middle of the curve may be warranted, which would also help increase yield.

### Potential Investment Opportunities:

- *BMO Mid-Corporate Bond Index ETF (ZCM)*
- *BMO Mid-Federal Bond Index ETF (ZFM)*

### Commodities Have Lost Ground Against Equities



Source: BMO Asset Management Inc., Bloomberg

### Commodities Losing Ground to Equities, Target Your Exposure Wisely

As we have highlighted in the past, we believe commodities to be in a super-cycle and for that reason, we have a secular bias towards commodities. However, the *Thompson/Jeffries CRB Index*, which is a broad commodity index, recently started losing ground to equities in the short-term. As the different commodity sub-groups react very differently to macro-economic and political risk, a more targeted approach to investing in commodities is warranted at this point.

As our readers are aware, we have been positive on gold over the long-term. However, we stated that we wouldn't be surprised to see some retracement over the short-term. Moreover, any temporary band-aid solution to the European sovereign debt issues could lead gold to quickly fall. The recent rally in the U.S. dollar could also serve as a temporary headwind.

### Potential Investment Opportunities:

- *BMO Precious Metals Commodity Index ETF (ZCP)*  
– Buy on pullbacks and use stop loss order
- *BMO Junior Gold Index ETF (ZJG)*  
– Buy on pullbacks and use stop loss order

We also believe agriculture commodities are a good long-term investment despite short-term pressure. *The Economist* magazine has estimated world population to

hit 7 billion at the turn of the year, a factor contributing to food shortages, driving prices higher. Moreover, with elevated oil prices, the demand for bio-fuels is placing further demand on corn. Agriculture based futures allow investors to gain pure price exposure to the underlying grains. Though agriculture-based companies may also benefit from higher prices, they may not always be successful in passing on food price inflation to the end consumer, which may negatively impact their bottom line. We therefore recommend investors to consider futures-based ETFs when looking at agriculture commodity exposure.

**Potential Investment Opportunity:**

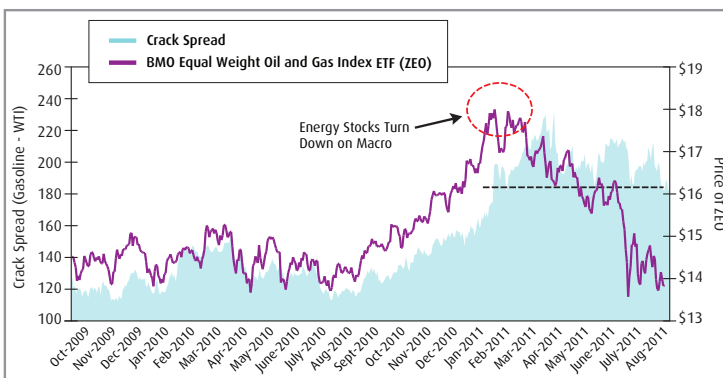
- **BMO Agriculture Commodities Index ETF (ZCA)**

We remain less bullish on energy and base metals in the absence of monetary stimulus as those assets remain more sensitive to economic growth. Though *Brent Crude* (*Brent*) trades at a premium to *West Texas Intermediate* (*WTI*), this spread has remained from the Middle East political concerns earlier in the year. In our view, *WTI* is more reflective of the true price of oil right now, even though *Brent* is believed to be the better benchmark in normalized conditions. The difference between oil products such as gasoline (or heating oil) to crude, or what is known as the “*crack spread*” remains high. Therefore, investors looking to add energy exposure may be better served looking at energy based companies, particularly the refineries. Keep in mind however this may be a longer-term investment as energy companies have been heavily weighed down by macro.

**Potential Investment Opportunity:**

- **BMO Equal Weight Oil and Gas Index ETF (ZEO)**

**Energy Stocks Selling Off Despite Crack-Spreads Remaining High**



Source: BMO Asset Management Inc., Bloomberg

## Equities: Opportunities in Areas

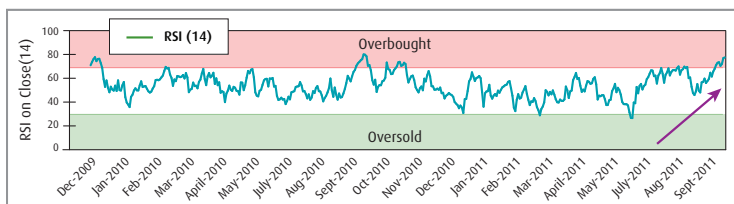
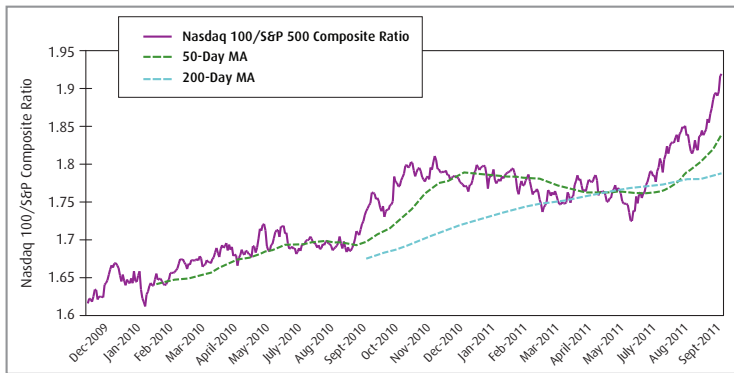
We unfortunately believe volatility in equities to persist for some time, however, that's not to say that there are not opportunities. Investors will need to be more selective in their exposure and more tactical in their approach. An area we like is lower beta equities, the themes being lower volatility and increased yields. An efficient way of increasing yield and potentially lowering volatility is through covered call strategies. (For a more detailed discussion of a covered call strategy, please see our whitepaper, “*The Mechanics of a Covered Call Strategy*”). Our covered call strategy on the Canadian banks may potentially be a better alternative for investors to gain their exposure to the big six Canadian banks. If Operation Twist partially dictates the Canadian yield curve, it may potentially impact the Canadian banks. A call writing overlay would allow for investors to increase their yield while also maintaining their bank exposure. If the Canadian banks rally aggressively however, this strategy may underperform.

**Potential Investment Opportunity:**

- **BMO Covered Call Canadian Banks ETF (ZWB)**

As we mentioned in our recent *Trade Opportunities Report*, for those investors looking for a short-term play, U.S. technology is a sector that tends to display seasonality in the last quarter of the year. The shares of technology stocks have at times been stronger closing the calendar year since investors anticipate stronger revenues for tech based companies heading into the Christmas season. The tech heavy *Nasdaq-100 Index* has recently outpaced other broad measures of the U.S. stock market such as the *S&P 500 Composite* and the *Dow Jones Industrial Average (Dow)*. Though we still favour the Dow over the long-term based on attractive valuations and blue-chip exposure, we acknowledge that the Nasdaq has been displaying stronger performance as of late. The recent rally in the *U.S. Dollar Index*<sup>5</sup>, due to the “risk-off” behaviour may also weigh on the Dow over the near-term. The *Nasdaq 100 Index* also provides Canadians with a more robust exposure to the technology space.

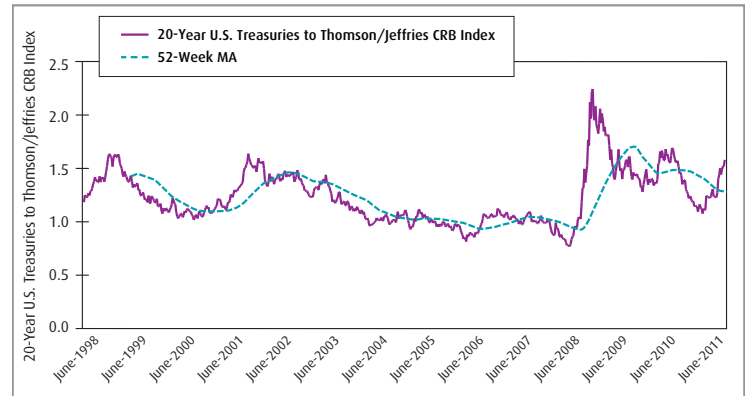
### Seasonality in Effect: Nasdaq 100-Index Outperforming S&P 500 Composite



Source: BMO Asset Management Inc., Bloomberg

Although we believe we are still within a secular bull-run in commodities, we are at the time overweight bonds relative to commodities. Given the uncertain macro-economic backdrop and renewed fears of a global slowdown, bonds have rallied against commodities. Therefore, for the time being, from a tactical perspective we favour fixed income and credit over commodities unless the Fed and/or European Central Bank (ECB) signals further monetary stimulus, which would cause a risk rally (and not solve any inherent structural issues).

### Fixed Income Rallying Against Commodities



Source: BMO Asset Management Inc., Bloomberg

Though asset allocation often gets overlooked in the portfolio construction process, we believe it is increasingly important in this volatile environment. A continued pattern that we see within our *BMO Global Inter-Market TrendSpotter Model*<sup>6</sup> is that correlations within an asset class have remained elevated whereas the movement between different asset classes remains less correlated. As such, even the most aggressive of investors, those where traditional asset allocation models have suggested all equity portfolios, will need exposure to other asset classes. In an environment where intra-market correlation continues to tick up with volatility, an investment strategy built from the top down will be crucial in helping investors mitigate some of the recent market volatility, which unfortunately looks likely to be with us for some time.

## Footnotes

<sup>1</sup> Academic studies of Brinson, Beebower and Hood (BBH) have argued asset allocation determines over 90% of the variance in a portfolio. A later study titled "Does Asset Allocation Policy Explain 40, 90, 100 Percent of Performance?" by Ibbotson and Kaplan however have argued for a lower contribution to portfolio volatility.

<sup>2</sup> The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The VIX has been considered by many to be a barometer of investor sentiment and market volatility and hence has been dubbed the "fear-index."

<sup>3</sup> Operation Twist: The Fed would first sell shorter-dated securities and would then hold a second auction to buy bonds of longer maturities from primary dealers. Both auctions would settle the following day. While it would lower rates at the back end of the yield curve, Operation Twist could also nudge front-end rates higher, possibly to the benefit of money market funds scrambling for ultra-safe securities with a yield above zero. (Bloomberg).

<sup>4</sup> Short Interest: The total amount of shares that have been sold short by customers and/or securities firms/dealers.

<sup>5</sup> The U.S. Dollar Index ("The Dixie"): A measure of the value of the U.S. dollar relative to the currencies of its most significant trading partners. The basket of currencies in which it is measured against are: the euro, the Japanese yen, the Canadian dollar, the British pound, the Swedish krona and the Swiss franc.

<sup>6</sup> Global Inter-Market TrendSpotter Model: A proprietary trend-based inter-market (cross-asset) model created by BMO Asset Management Inc. that monitors short- and long-term trend developments and changes across various major global asset classes and equity sectors.

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