FTSE Russell

Canadian Fixed Income Insight Report

Presented to you by BMO Global Asset Management

October 2020

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INSTITUTIONAL CONTACTS

ETF Specialists

Ontario

Daniel Stanley, CFA
Director, Institutional & Advisory, Ontario
416-418-2354
daniel.stanley@bmo.com

Laura Tase, CFA
Director, Institutional & Advisory, Ontario
647-531-8769
laura.tase@bmo.com

Eastern Canada

Erika Toth, CFA
Director, Institutional & Advisory, Eastern Canada
514-358-2310
erika.toth@bmo.com

Western Canada

Mark Webster, MA
Director, Institutional & Advisory, Western Canada
604-562-2851
mark.webster@bmo.com

National Accounts

Mike Scheiers, MBA
Vice President, National Accounts
416-274-8174
michael.scheiers@bmo.com

Sam Kiru
Vice President, National Accounts
647-209-4413
sam.kiru@bmo.com

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BMO Exchange Traded Funds

Canadian Fixed Income Summary (CAD, TR) as of September 30, 2020

BMO ETF Statistics*

Fund	Ticker	YTM	Term (yrs)	Duration	Credit Ratings (%) AAA/AA	A	BBB
BMO Aggregate Bond Index ETF	**ZAG**	1.26	11.10	8.39	73.8	14.2	12.0
BMO Discount Bond Index ETF	**ZDB**	1.25	10.46	8.28	73.0	16.1	10.9
BMO Short Federal Bond Index ETF	**ZFS**	0.32	2.94	2.86	100.0	0.0	0.0
BMO Mid Federal Bond Index ETF	**ZFM**	0.63	7.84	7.31	100.0	0.0	0.0
BMO Long Federal Bond Index ETF	**ZFL**	1.03	24.56	18.04	100.0	0.0	0.0
BMO Short Provincial Bond Index ETF	**ZPS**	0.52	3.21	3.06	91.4	8.6	0.0
BMO Mid Provincial Bond Index ETF	**ZMP**	1.08	7.68	6.95	90.2	9.8	0.0
BMO Long Provincial Bond Index ETF	**ZPL**	1.99	23.63	16.61	89.8	10.2	0.0
BMO Short Corporate Bond Index ETF	**ZCS**	1.23	3.12	2.95	28.3	32.8	38.9
BMO Mid Corporate Bond Index ETF	**ZCM**	2.07	7.37	6.44	12.4	24.7	62.8
BMO Long Corporate Bond Index ETF	**ZLC**	2.95	21.89	13.79	1.8	53.7	44.4
BMO Government Bond Index ETF	**ZGB**	0.89	11.35	8.94	96.7	3.3	0.0
BMO Corporate Bond Index ETF	**ZCB**	1.67	9.07	6.71	18.2	43.8	38.0
BMO Short-Term Bond Index ETF	**ZSB**	0.61	3.05	2.90	76.9	12.4	10.7
BMO Real Return Bond Index ETF	**ZRR**	0.73	17.47	15.33	100.0	0.0	0.0
BMO Canadian MBS Index ETF	**ZMBS**	0.51	2.82	2.23	100.0	0.0	0.0
BMO Ultra Short-Term Bond ETF	**ZST**	0.58	0.44	0.42	16.5	42.4	41.1

*Statistics are based on ETF.

BMO ETF's Portfolio Statistics**

Total Return (12M, %)

	Short	Mid	Long	Overall
Federal	4.41	7.81	10.63	6.37
Provincial	5.02	8.23	8.58	7.76
Corporate	5.68	8.69	7.62	6.89
Overall	**4.94**	**8.22**	**8.85**	**7.08**

Returns Volatility (12M, %)

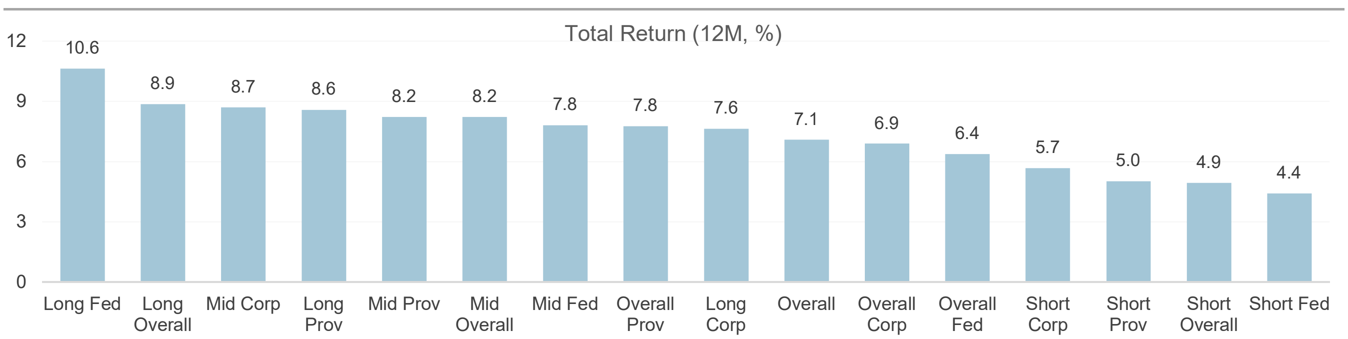
	Short	Mid	Long	Overall
Federal	1.63	4.96	13.07	4.41
Provincial	1.74	4.88	12.76	8.26
Corporate	2.36	5.55	10.56	5.17
Overall	**1.74**	**4.86**	**11.95**	**5.82**

Change in Yield (12M, bps)

	Short	Mid	Long	Overall
Federal	-128	-92	-52	-107
Provincial	-126	-89	-40	-72
Corporate	-119	-77	-30	-83
Overall	**-127**	**-87**	**-38**	**-87**

Change in Spread vs Canada (12M, bps)

	Short	Mid	Long	Overall
Federal	0	0	0	0
Provincial	2	3	12	35
Corporate	9	15	22	24
Overall	**1**	**5**	**14**	**20**



**Statistics are based on underlying index. Data from 2019-09-30 to 2020-09-30

Market Maps

Fixed Income Insight Report

October 2020 (Canadian Edition)

Low inflation expectations and Covid may accelerate BoC policy review

The risk rally and QE drove strong returns in credit, and Eurozone assets since March, but a Covid second wave poses recovery risks and the rebound in inflation breakevens has stalled. BoC has shown no immediate desire to accelerate its 2% inflation target review (due Dec.2021) but this may change.

Performance – credit & real return bonds dominate on 3M

With yields more stable in Q3, currency moves and risk appetite drove strong Q3 returns in Eurozone & Australasia. (pages 2-3)

Macro backdrop − US Elections in Q4 but Covid dominates

Q3 recovery but further Lockdown risks evident. (pages 4-5)

Canadian govts − b/evens dip as 2nd wave fears resume

Inflation b/evens rolled over, as 2nd wave fears mount & BoC made no early signal on average inflation targeting. (page 6)

Canadian credit − curves steepen signaling economic risks

Steeper curve reflects economic uncertainty. Previous relationships between spreads & yield curves rupture. (page 7)

Global curves & spreads − curve control without trying?

Front end curve control, but long end steepening a policy challenge, particularly for BoJ, with b/evens falling. (page 8-9)

Cross assets − major risk rally driven by central bank put

After strong risk rally, markets face renewed Covid challenge. (page 10)

Appendix − Canadian and global bond market returns, historical bond yields, duration and market value, foreign exchange returns.

For professional investors only

Chart 1: There are signs of Canadian inflation breakevens rolling over, after the post-QE rebound, and they remain well below 2%.

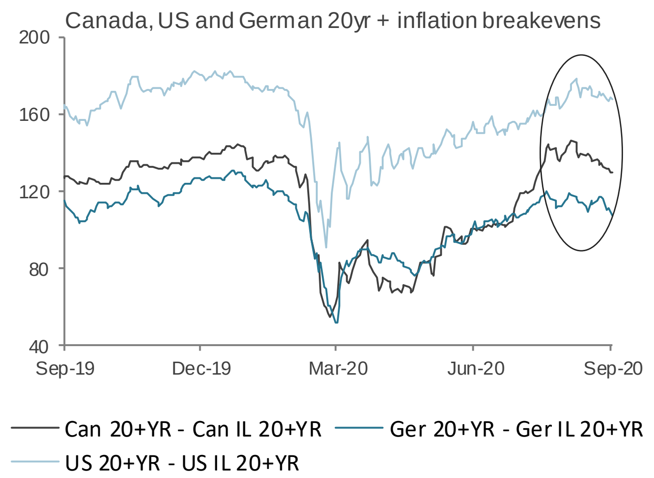
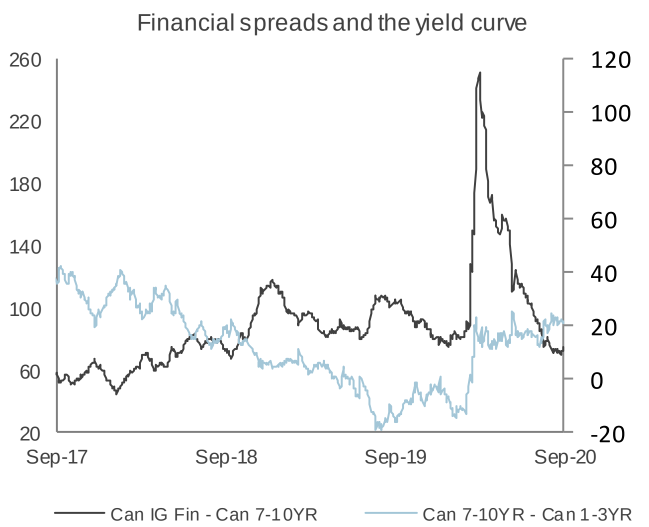


Chart 2: Don't find the BoC? Previous relationships between financial spreads and the yield curve broke down since BoC QE.



Source: FTSE Russell. All data as of September 30, 2020. Past performance is no guarantee of future results. This report should not be considered 'research' for the purposes of MIFID II. Please see the end for important legal disclosures. Bond market data is derived from FTSE Fixed Income Indexes. See Appendix for list of indexes used for each market.

Canadian Governments, Provinces and Municipalities

The BoC has no formal yield curve targets, unlike the BoJ or RBA, but the stable govt. yield curve suggests markets may anticipate it. Longer inflation b/evens have rolled over in Canada, and are well below the 2% inflation target. Provincial curves followed govt. curve moves since Covid, though Alberta spreads carry a risk premium.

After the spike in volatility in March, the yield curve remains very stable between 1-3yrs and 7-10yrs, with yields very stable, even if the BoC has not announced any yield targets (Chart 1).

Longer term inflation breakevens fell back, as second wave Covid and Lockdown fears increased (see Chart 2). The BoC made no early signal of moving towards an average inflation target, ahead of the policy review due in December 2021.

Provincial yield curves have generally followed Canadian government bond curve moves since the Covid shock (Chart 3).

The risk premium in longer-dated Alberta spreads is evident in Chart 4, which is well above pre-Covid levels. The province’s economic dependence on energy, budget strains and separatist pressures appear the main reasons.

Chart 1: There is evidence of Informal curve control by the BoC, in the stable curve since March, though BoC has no formal target.

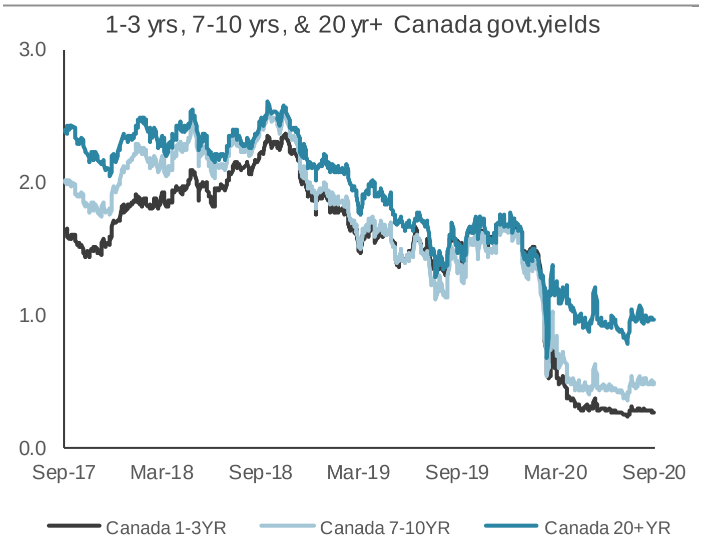


Chart 2: There are signs of Canadian inflation breakevens rolling over, after the post-QE rebound, and they remain well below 2%.

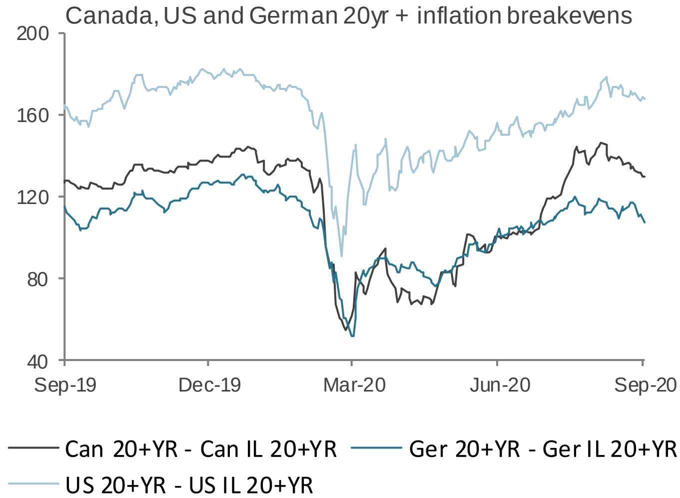


Chart 3: Curve steepening in provincial credits has broadly matched moves in the govt.yield curve, with Alberta the exception.

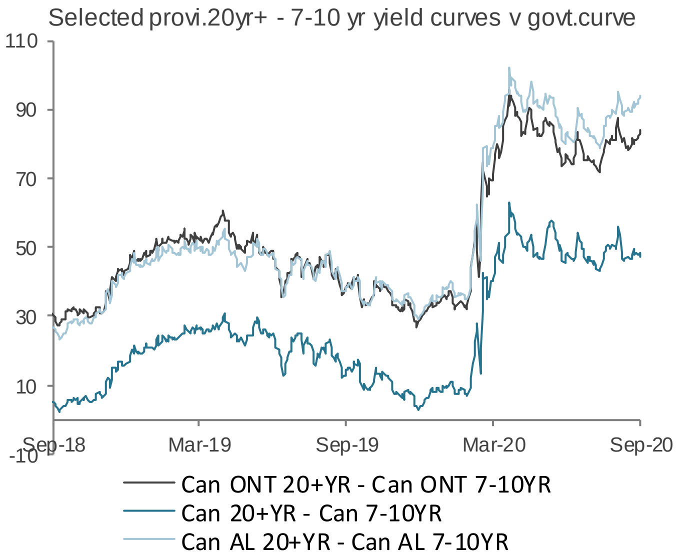
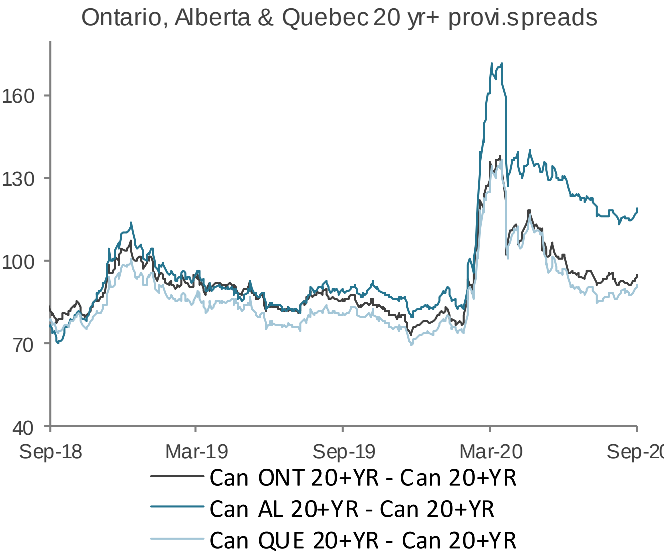


Chart 4: The post-Covid risk premium in longer dated Alberta spreads, versus other provis., shows no signs of unwinding.



Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada Short, Mid & Long Term Provincial Bond Index (Alberta, Overall), FTSE Canada RRB Canada Index.

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Canadian Corporate Bonds

Canadian high-yield spreads remain below their US equivalents, despite the BoC not including high yield in its QE. The credit curve steepened sharply since Covid and spreads fell sharply in short dates. Real estate and energy spreads remain well above pre-Covid levels. Financial spreads tightened despite higher bank loan loss provisions.

Canadian high-yield spreads widened less during the early Covid sell-off than US spreads, despite weaker energy, as Chart 1 shows. This is an untypical cycle, however, with spreads cushioned by central bank QE, despite higher default risks.

Credit curves steepened, reflecting economic uncertainty. Spreads narrowed more in short dates, due to BoC QE (Chart 2).

This is in stark contrast to the persistence of wide spreads in real estate credits, as the post-Covid business outlook is assessed by investors (Chart 3).

In the pre-Covid period, financial spreads tended to widen when the yield curve flattened (due to the perceived impact on net interest income), and vice versa. This relationship broke down, as Chart 4 shows, and this may be explained by QE.

Chart 1: 2020 has been the first credit cycle in the last decade when US high-yield spreads widened further than Canadian.

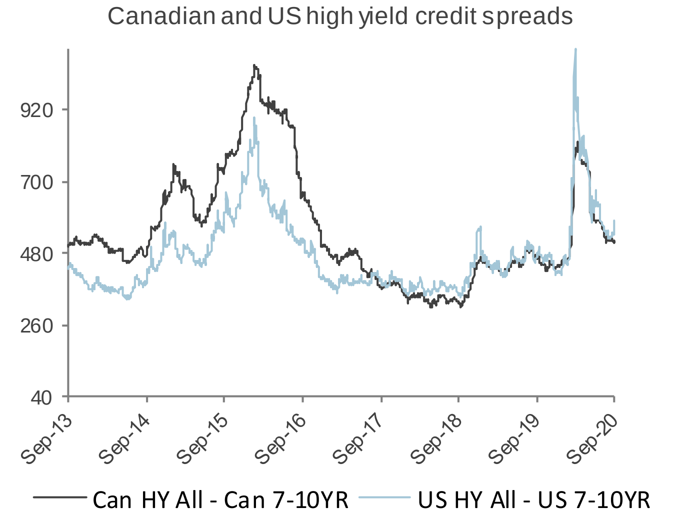


Chart 2: Canadian credit curve steepened since Covid, particularly in long dates, and short dated spreads fell sharply due to BoC QE.

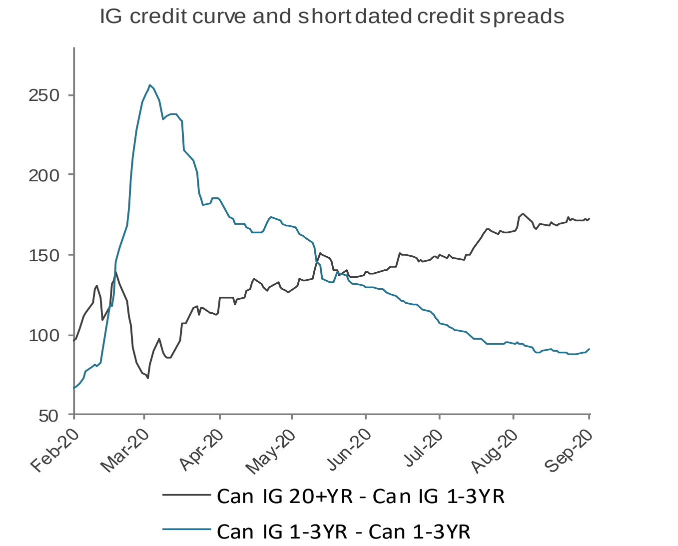


Chart 3: Real estate spreads remain well above pre-Covid levels, despite QE, reflecting structural change risks in the economy.

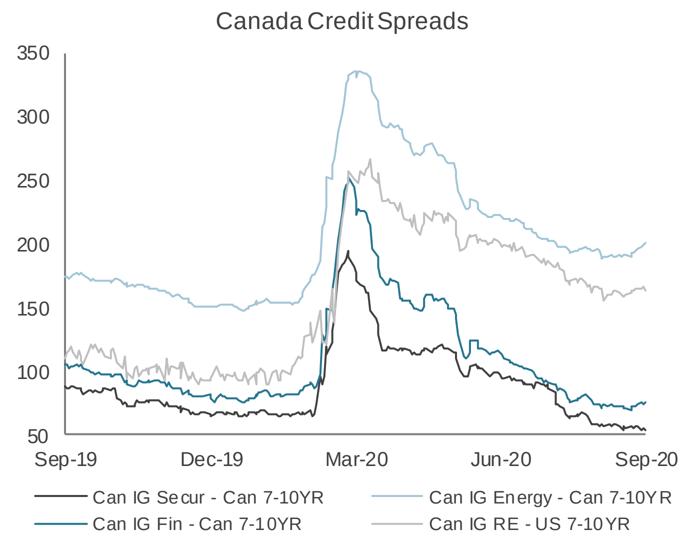
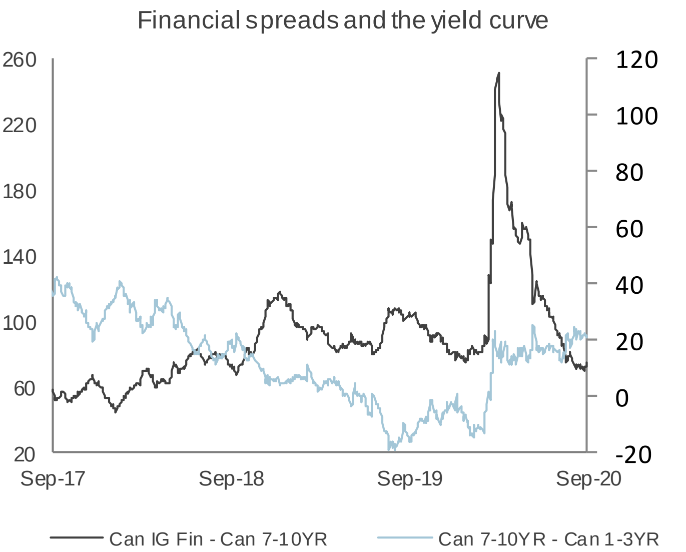


Chart 4: Previous relationships between financial spreads and the Canadian yield curve have broken down since Covid & BoC QE.



Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada Corporate Bond Indexes (BBB, Energy, Financial, Real Estate, Short, Mid, Long, Overall), FTSE Canada High Yield Bond Index.

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Cross-Asset Market Analysis and Performance

Canadian equities outperformed other Canadian assets during Q2 & Q3, though government bonds also performed well. US equities were the strongest performer globally helped by the "Fed put", but gold back fell back in Q3. US RMBS also rallied, with spreads narrowing, although higher unemployment poses a risk to lower grade mortgages.

The outperformance of Canadian equities, relative to government bonds, from the lows in March, is shown in Chart 1. Credit has also performed strongly.

Global bond markets have broadly outperformed many equity markets year to date, as shown in Chart 2, with significantly lower volatility. The Russell 1000 remains the standout performer among global equity markets. Gold's performance has lacked luster in recent months, but remains strong year to date.

The US housing market has held up well during the Covid crisis, helped by substantial US Fed QE purchases, and a less exposed housing market than pre- GFC (Chart 3). Yield spreads have fallen versus US Treasuries as a result.

However, in the sub-prime area, where there is no agency guarantee or Fed support, the spike in unemployment is driving delinquency rates much higher, posing an obvious risk to lower grade mortgages, as Chart 4 shows.

Chart 1: Canadian equities experienced a bout of volatility towards the end of Q3, with fixed income markets remaining relatively stable.

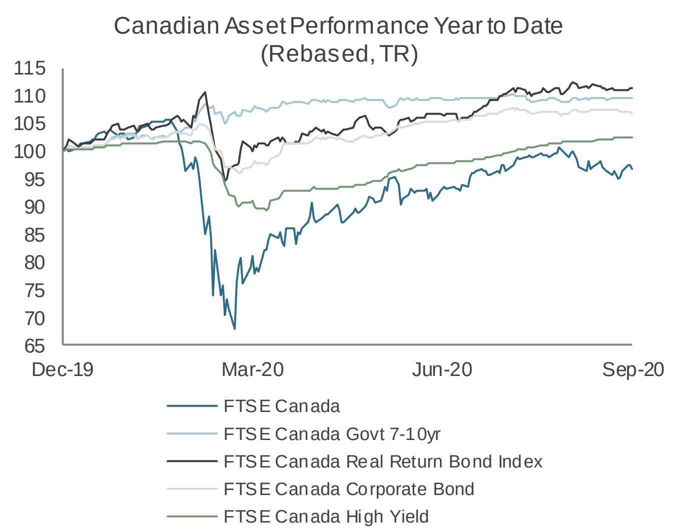


Chart 2: Gold has been the standout performer year to date, while Canada 7-10yr has performed well with relatively low volatility.

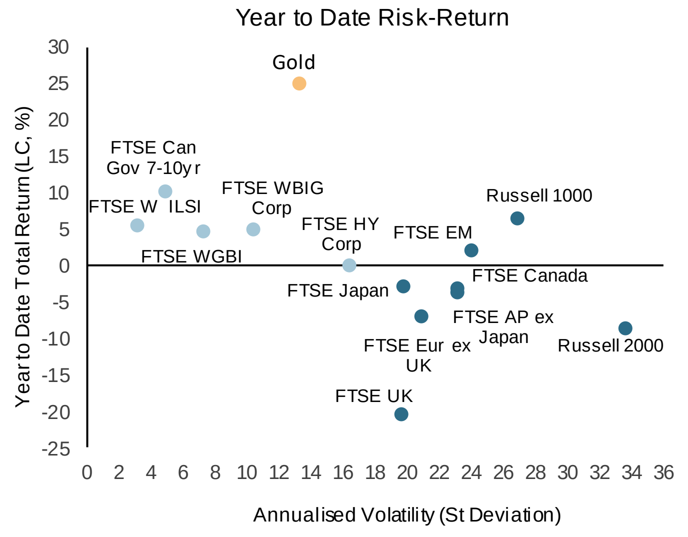


Chart 3: Fed QE, improved regulation and a less exposed housing market pre-Covid caused RMBS spreads to narrow vs Treasuries.

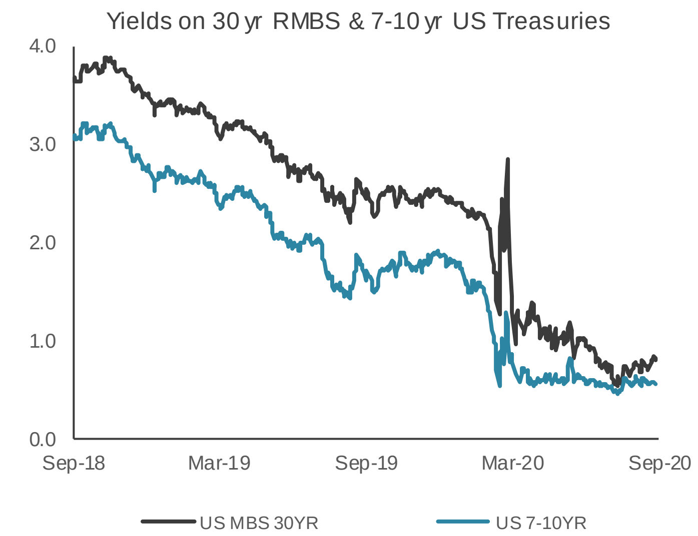
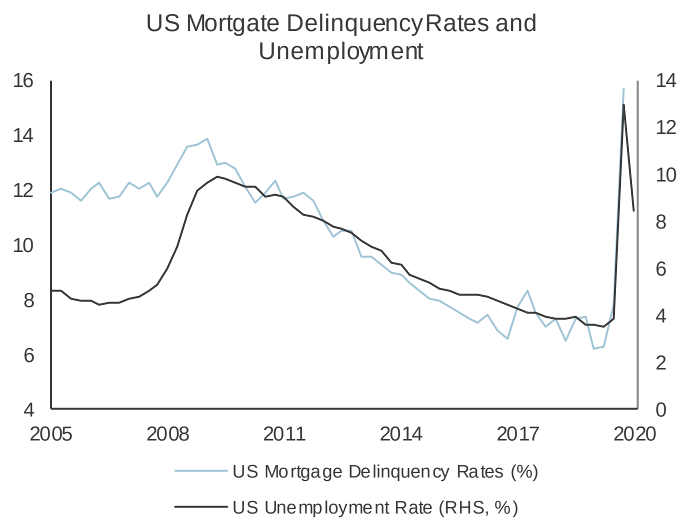


Chart 4: But risks lurk in lower-grade mortgages, and the surge in unemployment is a major issue for mortgage delinquency rates.



Indexes used: FTSE Canada Non-Agency Bond Index (Mid), FTSE Canada RRB Canada Index, FTSE Canada Corporate Bond Index, FTSE Canada High Yield Bond Index.

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Macroeconomic Backdrop – Growth and Inflation Expectations

Policy stimulus and easier financial conditions helped leading indicators recover. But 2021 forecasts were revised lower as Covid second wave and Lockdown risks increase. Inflation rates have dipped towards zero, except in the US. US Presidential elections rarely dominated bond market moves since 2000, despite frequent clean sweeps.

Regional leading indicators show evidence of economic recovery as lockdowns ease, but the risks of a second wave of infections, persistently high unemployment and weaker trend growth remain elevated (Chart 1).

Consensus forecasts for 2021 have been revised lower as renewed Lockdown risks increase (Chart 2).

Aggregate inflation rates fell towards zero, despite higher food price inflation, after the Covid shock (as Chart 3 shows).

There is little compelling evidence US election results have high significance for bond markets. Other events have generally dominated market moves (Chart 4). Yields rose after the “Trump reflation trade” but the Fed had already begun tightening.

Chart 1: Leading indicators affirm economic recovery, even as risk of weaker post-Covid-19 trend growth remains high.

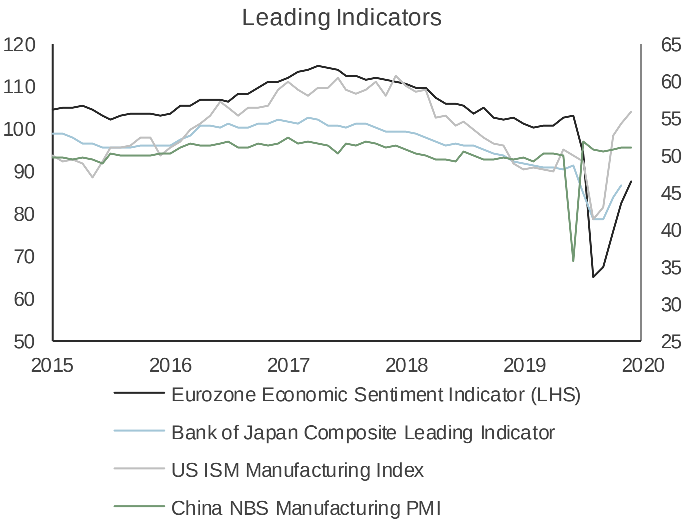

Chart 2: Consensus 2021 GDP forecasts have been scaled back in recent months, as risks of a second Covid wave mount.

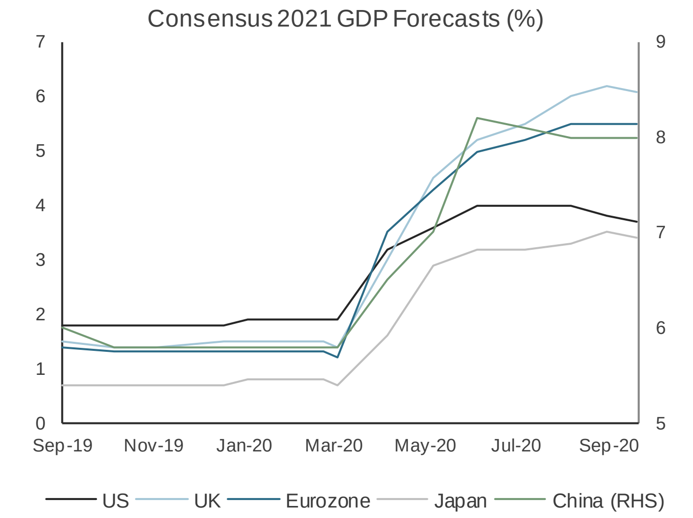

Chart 3: Data shows Eurozone inflation dipping sharply, as euro strengthens, and only US inflation recovering, helped by weak US$.

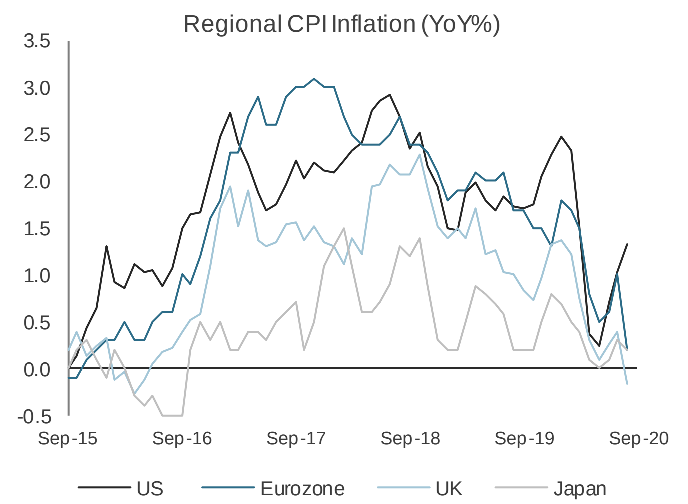

Chart 4: .US election results show frequent clean sweeps by one party, but market impact is often overpowered by force majeure.

			Markets - 3 Month Moves Following Election Result			
President	Congress	Economic Backdrop	US 2-Year Yield (Bps)	US 10-Year Yield (Bps)	US 7-10 Year Real Yield (Bps)	US 7-10 Year Breakevens (Bps)
2000-G. Bush (Republican)	Clean Sweep	TMT Bubble Bursts, Bear Market Follows	-126.8	-66.6	-44.0	-23.4
2004-G. Bush (Republican)	Clean Sweep	Fed Tightening Cycle	71.7	6.9	8.3	-2.9
2008-B. Obama (Democrat)	Clean Sweep	Global Financial Crisis & Fed QE Begins	-41.3	-85.1	-132.7	41.3
2012-B. Obama (Democrat)	House of Reps-Rep Senate-Dem	Concern over Fed Tightening, Eurozone Crisis	-4.7	22.6	9.3	16.1
2016-D. Trump (Republican)	Clean Sweep	Tax Cuts and Reflation Trade	29.6	49.0	22.7	31.4

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Macroeconomic Backdrop – Financial Conditions Analysis

Financial conditions eased most in the US and UK. Canadian dollar strength reduced the easing in Canada. Rapid M2 growth in the G7 reflects QE, but lower monetary velocity reduces inflation risks. Central bank forward guidance cemented expectations for zero rates for a long period.

The substantial easing in US and UK financial conditions since January 2020 remains evident, as does the more modest loosening elsewhere, with Canadian easing offset by currency strength since March, despite the dip in September (Charts1).

The risk rally since April has caused demand for safe-haven currencies like the US dollar and yen to fall (see Chart 2), pushing these currencies lower and driving the euro higher. The Canadian dollar dipped with energy prices in September.

Substantial QE has driven rapid M2 growth, as Chart 3 shows, but inflation risks are reduced by the decline in velocity.

Chart 4 shows forward rate guidance from central banks has strengthened expectations of a long period of unchanged, or negative, short rates (Chart 4).

Chart 1: US & UK financial conditions eased the most since Covid. Canadian easing has been reduced by Canadian dollar strength.

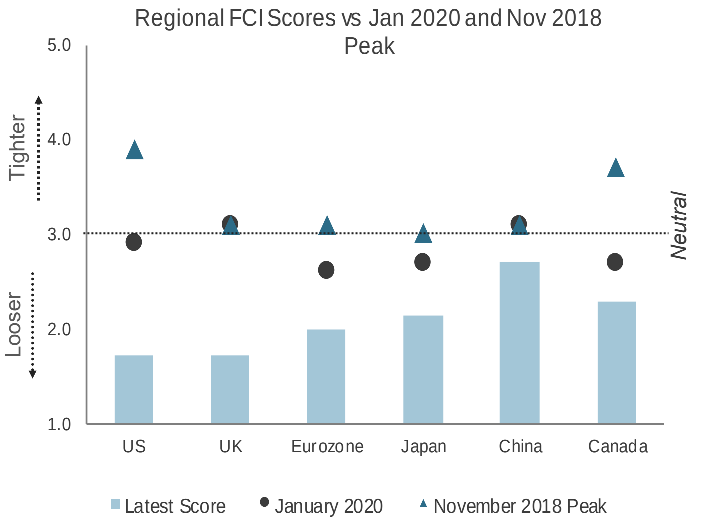


Chart 2: US dollar weakness and euro strength have been the most notable features since Covid. The Canadian dollar fell back in Sept.

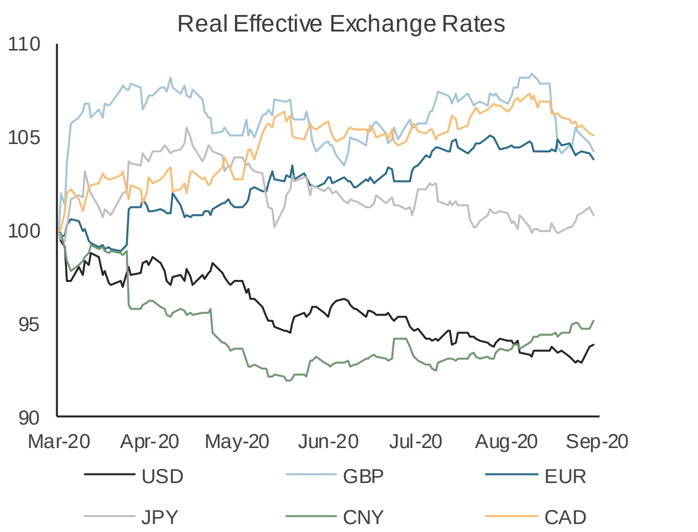


Chart 3: Average M2 growth accelerated sharply, due to the QE since March, but falling velocity reduces inflation risks.

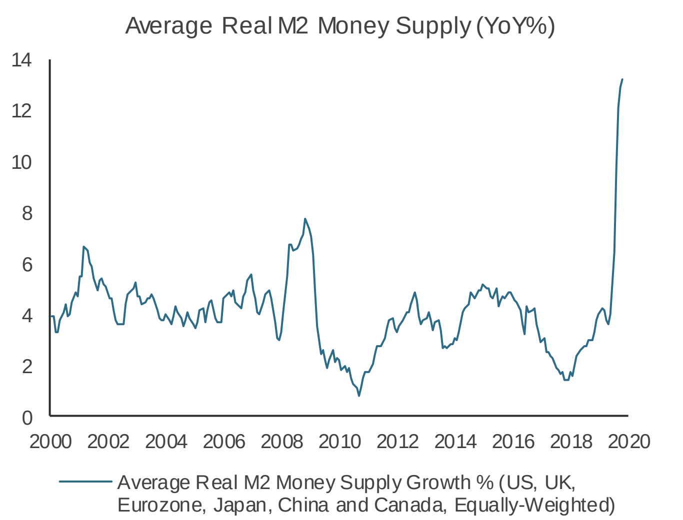
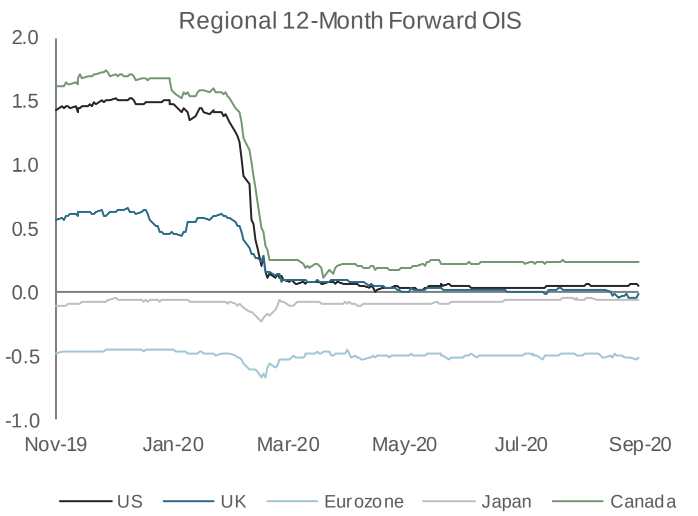


Chart 4: Regional rate expectations confirm zero interest rate policy from the G7, and guidance this will not end quickly.



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Appendix − Canadian Historical Bond Yields % as of September 30, 2020

Canadian Bond Yields

Top 15% | Bottom 15%

Green highlight indicates top 15%, red indicates bottom 15%.

		1-3YR	7-10YR	20+YR	All Mat
Canada	Current	0.26	0.49	0.98	
	3M Ago	0.27	0.44	0.91	
	6M Ago	0.50	0.67	1.18	
	12M Ago	1.54	1.38	1.51	
IL	Current			-0.35	
	3M Ago			-0.09	
	6M Ago			0.42	
	12M Ago			0.25	
Provincial	Current	0.53	1.11	1.98	1.43
	3M Ago	0.61	1.17	1.93	1.45
	6M Ago	1.11	1.75	2.56	2.04
	12M Ago	1.79	2.00	2.38	2.15
Ontario	Current	0.54	1.09	1.94	1.35
	3M Ago	0.62	1.14	1.89	1.38
	6M Ago	1.11	1.70	2.50	1.94
	12M Ago	1.80	1.99	2.37	2.13
Quebec	Current	0.47	1.05	1.92	1.40
	3M Ago	0.54	1.07	1.85	1.42
	6M Ago	1.09	1.69	2.48	2.00
	12M Ago	1.79	1.95	2.32	2.12
Alberta	Current	0.60	1.22	2.20	1.56
	3M Ago	0.67	1.36	2.17	1.57
	6M Ago	1.19	1.96	2.84	2.24
	12M Ago	1.79	2.03	2.41	2.19
BC	Current	0.51	1.08	1.87	1.39
	3M Ago	0.62	1.17	1.82	1.42
	6M Ago	1.04	1.71	2.42	2.03
	12M Ago	1.76	1.96	2.28	2.10
Municipal	Current	0.57	1.13	2.14	1.48
	3M Ago	0.72	1.29	2.17	1.58
	6M Ago	1.21	1.94	2.82	2.15
	12M Ago	1.86	2.12	2.57	2.26
Corporate	Current	1.19	2.05	2.97	1.90
	3M Ago	1.55	2.28	2.94	2.12
	6M Ago	2.85	3.45	3.82	3.24
	12M Ago	2.38	2.82	3.27	2.73
High Yield	Current				5.59
	3M Ago				6.23
	6M Ago				8.58
	12M Ago				6.01

		1-5YR	5-10YR	20+YR	All Mat
AAA/AA	Current	0.72	1.35	2.71	0.88
	3M Ago	1.02	1.43	2.53	1.12
	6M Ago	2.18	2.37	3.17	2.23
	12M Ago	2.14	2.25	2.61	2.17
A	Current	1.14	1.61	2.68	1.85
	3M Ago	1.52	1.85	2.63	2.03
	6M Ago	2.76	2.88	3.39	3.05
	12M Ago	2.39	2.51	2.98	2.69
BBB	Current	1.60	2.34	3.33	2.35
	3M Ago	-0.87	-0.78	-0.15	2.63
	6M Ago	0.57	0.01	0.19	3.93
	12M Ago	0.40	0.19	0.54	3.07
Comm	Current	1.81	3.33	1.38	2.08
	3M Ago	2.02	3.31	1.87	2.25
	6M Ago	3.23	4.41	3.48	3.40
	12M Ago	2.82	3.82	2.48	2.93
Energy	Current	1.38	2.45	3.02	2.50
	3M Ago	1.87	2.62	3.01	2.65
	6M Ago	3.48	4.21	4.02	3.97
	12M Ago	2.48	3.13	3.35	3.11
Financial	Current	1.03	1.65	3.72	1.23
	3M Ago	1.40	1.90	4.03	1.57
	6M Ago	2.78	2.96	5.03	2.89
	12M Ago	2.32	2.55	3.90	2.42
Industrial	Current	1.47	1.84	3.22	2.11
	3M Ago	1.95	2.12	3.22	2.38
	6M Ago	3.24	3.34	4.19	3.55
	12M Ago	2.58	2.79	3.57	2.90
Infrastructure	Current	1.04	1.69	2.68	2.35
	3M Ago	1.38	1.91	2.61	2.38
	6M Ago	2.31	2.68	3.34	3.14
	12M Ago	2.22	2.38	2.99	2.83
Securitization	Current	1.02			1.02
	3M Ago	1.41			1.41
	6M Ago	2.44			2.44
	12M Ago	2.20			2.25

Indexes used: FTSE Canada Non-Agency Bond Index (Short, Mid, Long), FTSE Canada RRB Canada Index, FTSE Canada Corporate Bond Index (Short, Mid, Long, AAA/AA, A, BBB), FTSE Canada Provincial Bond Index, FTSE Canada High Yield Bond Index.

Source: FTSE Russell. All data as of September 30, 2020. Past performance is no guarantee of future results. Please see the end for important legal disclosures. Bond market data is derived from FTSE Fixed Income Indexes. See Appendix Glossary for list of indexes used for each market. For professional investors only.

Appendix − Glossary

Bond markets are based on the following indexes:

FTSE Canada Universe Bond Index for all Canadian government and corporate bond markets*
FTSE Canada High Yield Bond Index for the Canadian high yield market
FTSE Canada RRB Canada Index for the Canadian inflation-linked bond market
FTSE World Government Bond Index (WGBI) for all global government bond markets
FTSE World Inflation-Linked Securities Index (WorldILSI) for all global inflation-linked bond markets
FTSE US Broad Investment-Grade Bond Index (USBIG®) for the US corporate bond market
FTSE US High-Yield Market Index for the US high yield bond market
FTSE Euro Broad Investment-Grade Bond Index (EuroBIG®) for the Euro-denominated corporate bond market
FTSE European High-Yield Market Index for the European high yield market
FTSE Chinese Government and Policy Bank Bond Index (CNGPBI) for the Chinese government bond market
FTSE Emerging Markets Inflation-Linked Securities Index (EMILSI) for the emerging markets inflation-linked bond market
FTSE Emerging Markets Broad Bond Index (EMUSDBBI) for the emerging markets corporate bond market

*** FTSE Canada Bond Indexes**

1-3YR = Short Term Bond Indexes
7-10YR = Mid Term Bond Indexes
20+ YR = Long Term Bond Indexes

List of Abbreviations used in charts:

IL = Inflation-linked bonds
IG = Investment-grade bonds
HY = High-yield bonds
BPS = Basis points
EM = Emerging market
LC = Local currency

FTSE Russell

This article is for information purposes. The information contained herein is not, and should not be construed as, investment, tax or legal advice to any party. Investments should be evaluated relative to the individual's investment objectives and professional advice should be obtained with respect to any circumstance.

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