2019 ETF Investment Insights

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Contents

An analysis of flows and themes for 2019

2019 has the potential to see slowing global economic growth, increased market volatility and continued trade tensions and political instability. We take an in-depth look at the state of the world and what that means for ETF investors.

Summary

- **Global economic growth is expected to decelerate in 2019** and become less synchronised. The partial inversion of the US yield curve in mid-December 2018 led investors to price the fading economic momentum into global equity markets. The higher volatility regime seen in 2018 is likely to carry over through the first months of 2019 and market corrections will likely be more frequent as the global economy enters a late-cycle phase.

- **With the US yield curve now almost flat, the Federal Reserve may increase interest rates** one more time in this cycle to reach its long-term median estimate for the fed funds rate. However, it is unlikely to move into restrictive monetary territory if inflation remains close to target. Therefore, we believe the US dollar will plateau this year, benefiting emerging markets and helping to stabilise the US trade balance, which could ease tensions between the US and China. A comprehensive trade deal could have substantial upside potential for emerging markets.

- **Europe faces long-term economic and political challenges** and we may see a gradual rotation from monetary to fiscal stimulus in some core countries to boost economic growth. Meanwhile, the UK economic and market outlook is tied to the outcome of the UK Parliamentary debate about Brexit. Investors are pricing in an increasing risk of a no deal Brexit, suggesting that any breakthrough could have a positive impact on market sentiment and sterling.

- **Overall, we believe it is time to gradually de-risk portfolios.** From an investor standpoint, one way to reduce the volatility drag on long-term returns is through strategies generating high income. We foresee an increased appetite for defensive equity strategies and high-quality credit ETFs to increase income and enhance portfolio diversification away from the risk of an equity bear market.

Continued

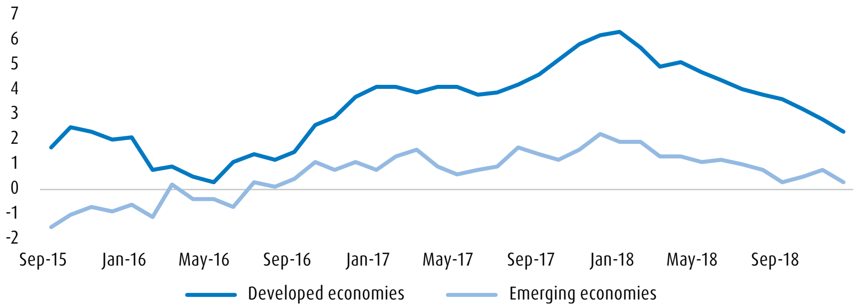
The world around us - recent trends

2018 was a year that surprised many in terms of market developments. Despite spikes in volatility, the equity bull market charged on much longer than many had predicted. How will these themes progress through 2019?

Less synchronised growth across the world

Global growth decelerated in the first half of 2018, and the expansion became less synchronised across geographies. Activity moderated in Europe, while the emerging markets expanded at a broadly unchanged pace, as per 2017.

Global growth moderated in 2018

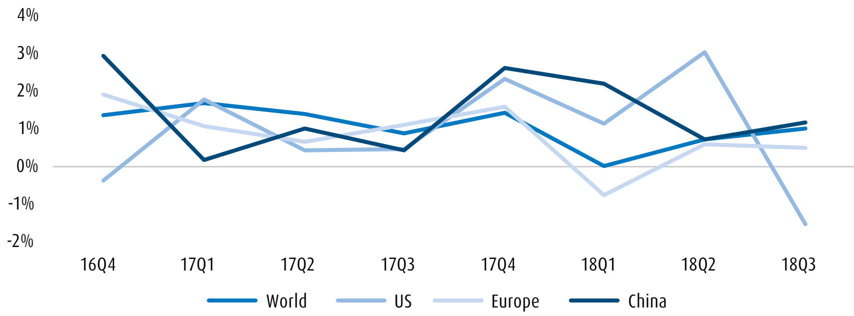


Source: JPMorgan Manufacturing PMI, Bloomberg as at 03-Jan-19. Deviation from 50.

Trade tensions dampened global trade

The imposition of US tariffs on a range of Chinese products alongside the renegotiation of the North American Free Trade Agreement (NAFTA), followed by retaliation from US trading partners, weighed on global trade. Surveys of purchasing managers suggested softer world trade volumes and lower investment amid an uncertain environment.

Volume of merchandise exports (quarterly % change)

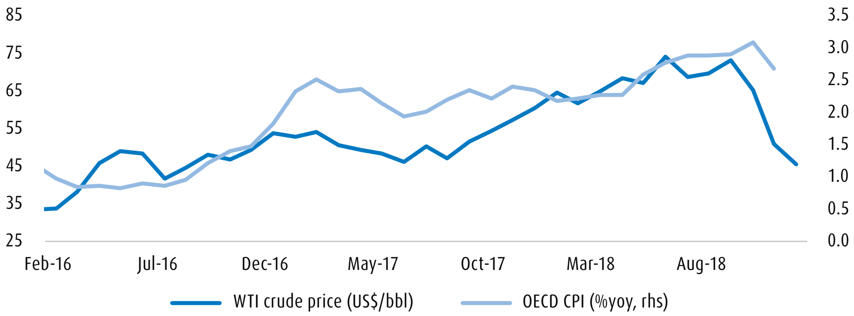


Source: WTO as at Q3 2018

Higher energy prices boosted headline inflation

Higher energy prices fuelled global headline inflation rates, while core inflation, excluding food and energy, remained subdued. Real wage growth has been muted despite tight labour markets and closing output gaps in developed markets, that is, the difference between actual and potential growth.

Higher oil prices boosted inflation



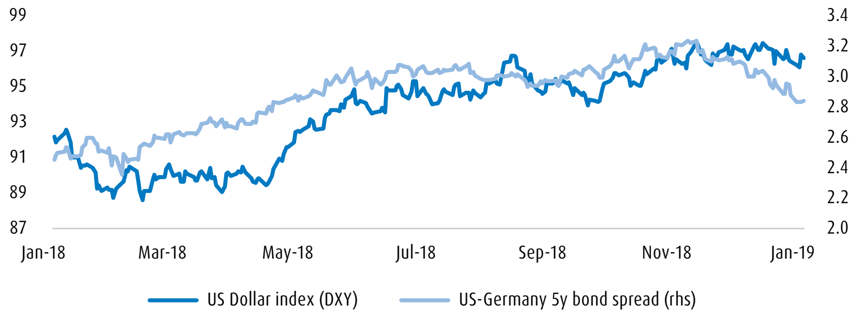
Source: OECD, Bloomberg as at 03-Jan-19

Recent trends (continued)

US dollar strengthened

The widening growth differential between the United States and the rest of the advanced economies, alongside divergences in monetary policy stances, has led to the appreciation of the US dollar versus most currencies since spring 2018.

US dollar index appreciated 7.5% since April

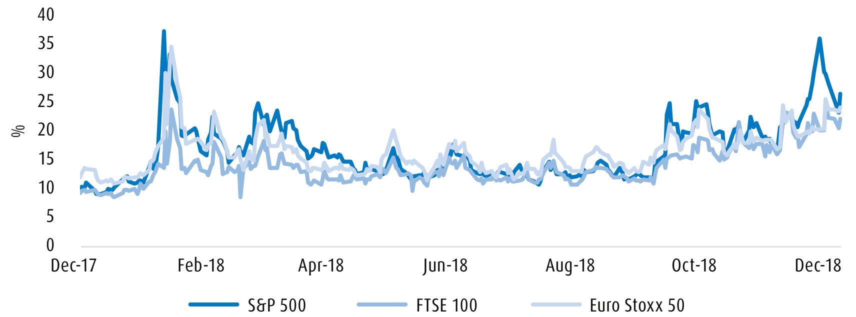


Source: Bloomberg as at 03-Jan-19

External political shocks have exacerbated market volatility

Market corrections became more frequent in 2018. Equity markets sharply declined in February, October and December, the last of which recorded the largest dip. US stock markets ended the year 7.5% lower than their January 2018 levels.

Implied volatility climbed higher

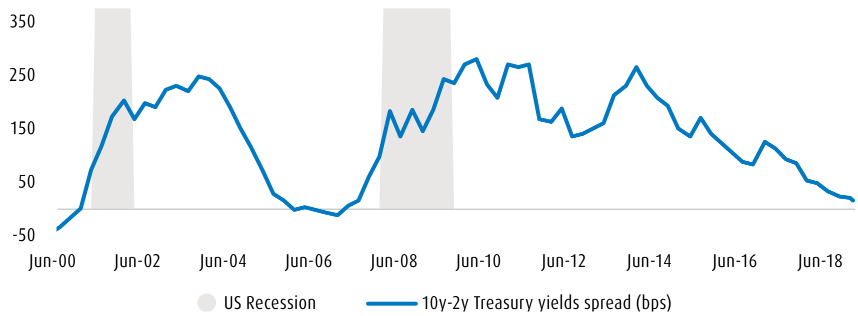


Source: Bloomberg as at 03-Jan-19

Partial inversion of the US yield curve

The Fed raised the fed funds rate range four times in 2018. This led short-term interest rates to increase faster than long-term interest rates, as risks to future growth and geopolitical uncertainty fuelled the demand for safe US Treasury bonds. The partial inversion of the US Treasury yield curve in early December 2018 raised concerns about growth prospects as yield curve inversions have been an indicator of the past two economic recessions in the US.

US yield curve is almost flat



Source: Bloomberg as at 03-Jan-19

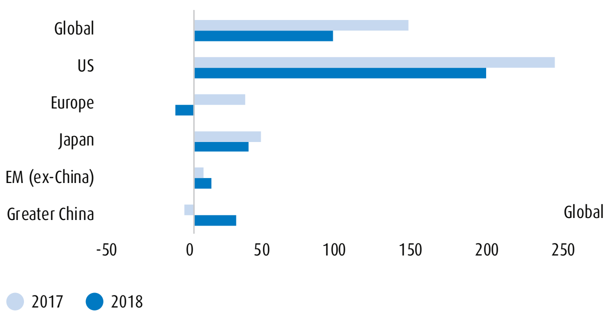
ETF flows

Here, we look at the flows for global equity and bond ETFs in 2018 and how this compared to the flows of the previous year.

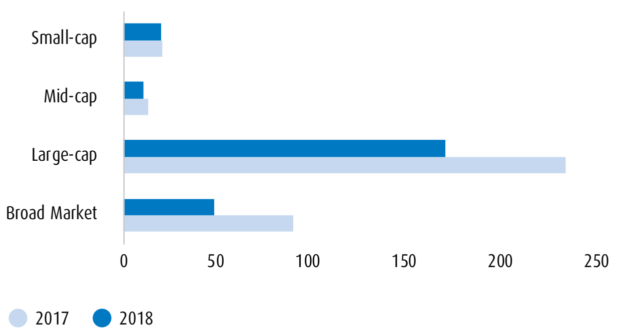
Equity ETFs

Investors favoured large caps compared to small caps in 2018 but to a lower extent than in 2017, as global trade tensions weighed on the earnings prospects for multinational companies, including technology stocks. From a sector perspective, defensive sectors focused ETFs saw increased net inflows in 2018, compared to 2017 as investors acknowledge the deceleration in global growth in the second half of 2018. The consumer staples, healthcare and utilities sectors recorded net inflows in 2018 after small inflows or net outflows in 2017. However, financials focused equity ETFs saw significant outflows, possibly negatively impacted by the flattening of the US yield curve.

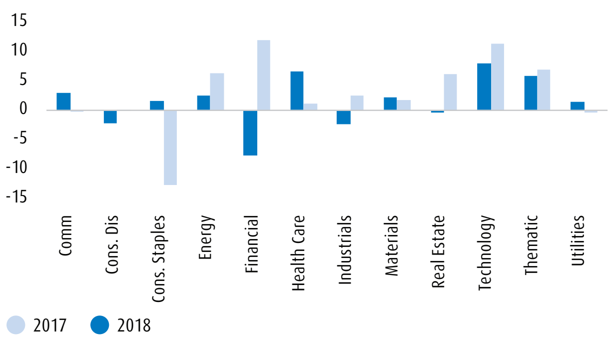
Equity – Region



Equity – Market Cap



Equity – Industry

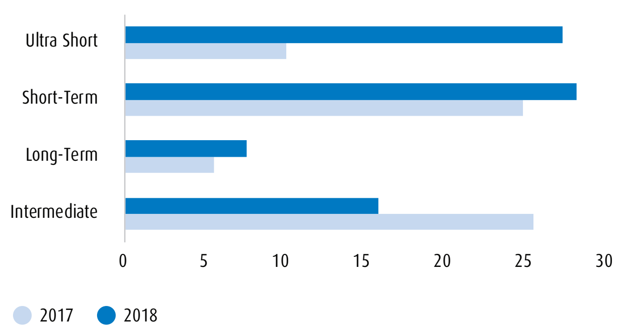


Source: Global ETF Net Flows (£bn) from Bloomberg, BMO Global Asset Management as of 02-Jan-19

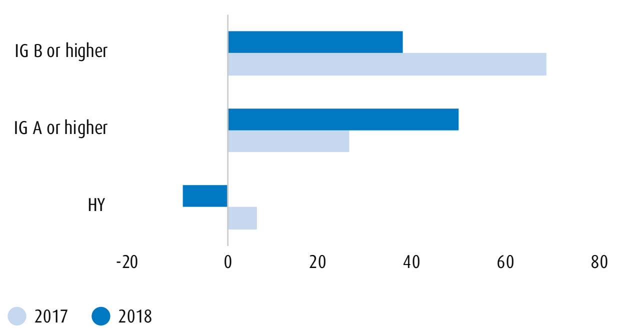
Bond ETFs

Investors turned defensive in 2018, with a preference for short-dated and high-quality bond ETFs. Ultra-short and short-dated bond ETFs garnered the largest inflows in 2018, while inflows receded in medium-term maturities, which tend to be more volatile in a rising interest rates environment. The slight increase in flows into long-dated bond ETFs in 2018 compared to 2017, suggests that some investors have revised downward their inflation and growth expectations over the long-term in the course of last year after mixed economic data. The perceived lower inflation risk is also reflected by a lower demand for inflation protected bond ETFs last year compared to 2017. Finally, the increase in volatility in equity markets has led investors to use bonds as a defensive tool in their portfolios, as suggested by the huge drop in demand for corporate bonds coupled with the spike of net inflows into government bond ETFs. High yield credit ETFs saw net outflows in 2018 that more than offset the net inflows from 2017, also highlighting the risk-off sentiment that dominated at the end of last year.

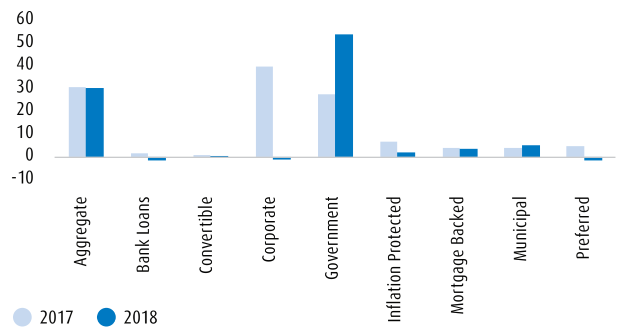
Bonds – Maturity Band



Bonds – Rating



Bonds – Strategy



Source: Global ETF Net Flows (£bn) from Bloomberg, BMO Global Asset Management as of 02-Jan-19

Global equity ETFs net inflows		Global bond ETFs net inflows	
2017	2018	2017	2018
£345bn	£252bn	£120bn	£91bn

2018

US focused ETFs
= largest net inflows

Emerging market ETFs
= recovered

European focused ETFs
= net outflows

Continued

2019 global market outlook

Does our comparison of 2018 versus 2017 help us to understand where markets might be headed in 2019?

Risk of a US recession?

Even with both US and global growth slowing, the Federal Reserve may continue to normalise its monetary policy towards a neutral policy stance. Based on the past two US economic cycles, a recession typically occurs between 12 to 24 months after the yield curve inverted. With the yield curve now almost flat, the Fed may increase interest rates one more time in this cycle to reach its long-term median estimate for the fed funds rate, of 2.75%, as of December 2018 projections. However, it is unlikely that the Fed moves into a restrictive monetary territory if inflation remains close to its target. Market expectations regarding Fed rates hikes in 2019 have reverted with no rate hike in 2019.

Volatility on the rise through 2019

US equity markets could continue to reprice if current conditions prevail, i.e. the expected fading of fiscal stimulus with a Democrat-controlled house, slowing global growth, and tighter profit margins due to tariffs and wage increases. According to International Monetary Fund (IMF) forecasts, the US economy is expected to grow 2.5% in 2019 after rising 2.9% in 2018. Market sentiment is likely to increasingly fluctuate with the economic data flows, especially now that most central banks are removing extreme monetary stimulus. The US dollar strongly appreciated in 2018 based on diverging growth trends and interest rates between the US and the rest of the developed economies.

No respite for Europe's political challenges

Europe's economic and political challenges are likely to carry on through 2019. The "gilets jaunes" protests in France, the populist government in Italy, and Brexit, all reflect a profound economic and social discontent due to a decade of sluggish growth, stagnant real wages and rising inequality across the region. The European economy will receive less financial support from the European Central Bank (ECB) with the termination of the corporate bond buying programme, and there are also signs that economic activity is slowing. Business surveys in Europe fell sharply following anti-government protests in France and weak manufacturing activity in Germany. Meanwhile, Italy is on the edge of recession. The IMF forecasts economic growth in Europe of 1.9% in 2019, down from 2.3% in 2018.

Potential protracted procrastinations for the UK

The outlook for the UK economy is tied to the progression of Brexit negotiations. The depreciation of sterling in December suggests investors see the risk of a no deal Brexit on the rise. We think there is a significant upward potential for the pound if progress is made. The draft agreement states that both the UK and the EU want to achieve limited trade disruptions after the UK departure from the EU, which should reassure investors on the economic outlook for the region, although near-term hurdles remain significant.

A slowing China back to the fore in emerging market risks

Emerging markets (EM) should benefit from a possible pause in the Fed's tightening path and a likely stable US dollar in 2019. However, the major risk for EM is a larger-than-anticipated Chinese slowdown. China reported lower industrial production and retail sales at the end of 2018, suggesting a lower external demand and sluggish domestic activity. Chinese exports are likely to drop in the event of a sustained economic slowdown in the EU, which is China's first trading partner. Other headwinds to EM include the volatility of commodity prices and the expected lower demand for industrial metals from softer global activity, which might negatively impact commodity exporter countries. Overall, from a balance of payments perspective, this negative impact on EM exports could be partially offset by capital inflows if the US dollar stabilises and the interest rate differentials between emerging and developed markets remains wide amid a more dovish Fed.

Geopolitics will continue to play a central role in the outlook for EM in 2019. Concerns may return at the end of February if the US is not satisfied with the volumes of Chinese imports of American products. At the G20 summit in December, the US agreed to hold off on implementing a tariff increase from 10% to 25% on US$200bn worth of Chinese imports in exchange for higher imports. However, we expect a plateauing of the US dollar this year, which could help stabilise the US trade balance, and possibly ease tensions between the US and China regarding trade. A comprehensive trade deal could have a substantial upside potential for EM. What's more, several major emerging economies will hold elections this year, including Argentina, India, Indonesia, and South Africa, with possibly large implications for their policy stance and potential market repercussions.

2019 ETF Investment Themes

How do you operate in an environment where you want to participate in the upside but also protect from downside uncertainties?

The global economy is entering a late-cycle phase, where economic growth remains strong but is losing momentum. Fundamentals looks good but some vulnerabilities are building, including the high level of public and corporate debt, and the rise of populism and protectionism. As a result, we expect that market volatility will remain elevated and believe that market corrections will become more frequent. One way to reduce the volatility drag on long-term returns is through strategies generating high income.

Fixed income

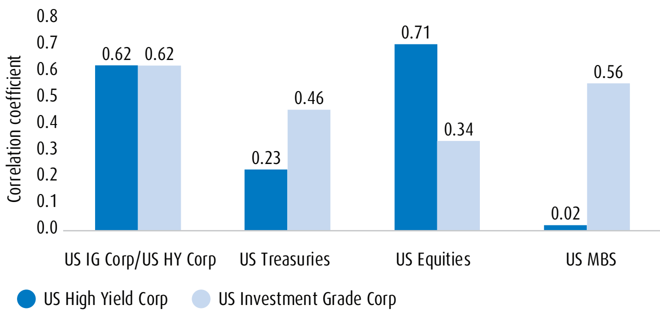
While yields remain low, some strategies exist to minimise interest rate risk while providing higher income, such as a barbell strategy. You can implement this strategy with only two ETFs, a short-dated bond ETF for capital preservation and a longer-dated equivalent for higher yield. This strategy performs particularly well when yield curves are flattening (i.e. the shorter rates are increasing faster than longer-term rates).

Alternatively, investors looking for yield without taking extra credit or duration risks, Could consider the BMO ETF 1-3 year global investment grade corporate bond exposure. This maturity bucket offers good diversification benefits given its limited drawdowns, attractive yield, low duration and credit risks, and low correlation to equities. The 'belly' of the curve (i.e. medium-term maturities) currently provides a less attractive risk/reward trade-off (i.e. a lower yield per unit of duration). Besides, with rising interest rates, the refinancing and re-rating risks are on the rise. Solid but slowing economic growth may put the credit market under pressure when interest rates rise as non-financial corporate debt has reached new highs, particularly in the US. Therefore, investors seeking income and diversification may be interested in investment grade corporate bond exposure, to balance the need for a higher yield and downside protection.

Equities

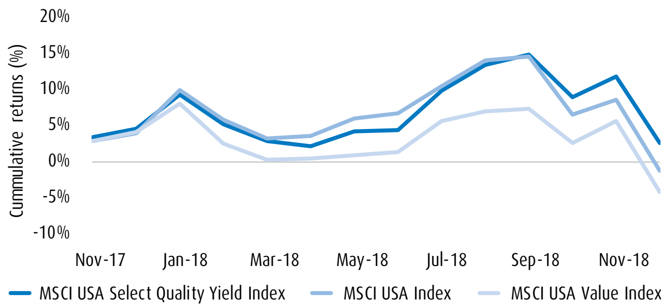
The easiest way to increase income is through investing in high dividend companies. But this comes with the risk of falling into a 'yield trap'. US corporate profit growth is likely to continue to decelerate in 2019, with declining growth prospects, labour cost increases and tighter profit margins. Therefore, we believe it is advisable to screen for quality before screening for dividend yield. This is our approach in the BMO Income Leaders ETF range, which tracks the MSCI Select Quality Yield Index. Alternatively, you could also opt to diversify away from traditional sources of income by using derivatives. One way to achieve higher income with relatively lower risk is to implement a covered call overlay whereby index call options are sold against an equity index in exchange for an immediate additional cash flows (the option premiums) on top of the underlying stock dividend, increasing the overall yield of the portfolio. In this way, investors can combine superior income and investment growth from market returns. This strategy has been comprehensively implemented in the BMO Enhanced Income ETF range, which takes away the operational complexities for investors.

Bond correlation with other asset classes



Source: BMO Global Asset Management, Bloomberg Barclays Index from 30-Sep-08 to 31-Dec-18

Defensive characteristics of Quality and Yield factors



Source: BMO Global Asset Management, Bloomberg as at 31-Dec-18.

Overall, we feel it is timely to gradually de-risk portfolios. We believe defensive equity strategies (defensive sectors focused ETFs, and quality and yield strategies), alongside high-quality credit ETFs that offer additional income and diversification, can help investors protect against the risk of an equity bear market as well as reduce the volatility of portfolios.

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