Can Normalization in a Non-Normal Market Persist?

Monthly Strategy Report February 2012

BMO EXCHANGE TRADED FUNDS

Alfred Lee, CFA, CMT, DMS
Vice President & Investment Strategist
BMO ETFs & Global Structured Investments
BMO Asset Management Inc.
alfred.lee@bmo.com

In this issue:

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See inside for details.

All prices or returns as of market close on February 21, 2012, unless otherwise indicated.

Without question, equity markets around the world are off to a good start in 2012 with a general rotation out of defensive areas and into more cyclical oriented themes. More impressive is the market's ability to shake off a number of negative headlines already seen in the new year. These include credit rating agency *Standard & Poor's (S&P)* recent move to downgrade a number of Eurozone countries including France and following that up with the downgrade of the European Financial Stability Facility (EFSF). Though lower credit ratings typically results in higher borrowing costs when bonds are auctioned, yields of the downgraded European sovereign bonds barely rose after the news. Moreover, credit default swaps (CDS), or insurance against a default on sovereign bonds, have actually been trading at lower prices since the news of the downgrades. This suggests that the moves by S&P were already priced-in, as the downgrades were largely considered to be telegraphed to the market months ago. In addition, the European Central Bank's (ECB) Long-Term Refinancing Operation (LTRO)[1] and the co-ordinated moves by the six central banks in November to provide cheaper swap borrowing rates has largely removed the perception of tail-risk[2] in the short term. Through the newly revised rules of the LTRO, the ECB allows banks to borrow funds for three years by posting collateral, to which eligibility requirements have been relaxed significantly. Thus, the perception of solvency of European banks have been significantly improved, despite a number French, Italian and more recently Spanish banks having been downgraded.

From a fundamental perspective, we have considered that most equity markets around the world to offer attractive valuations over the last three months. Though we have reduced our "overweight bonds" recommendation introduced last August to "slightly overweight" last month, we were still overly defensive in our allocation in January. While we remained largely favourable to U.S. equities throughout 2011, which in hindsight proved to be the right call, we have been waiting for momentum to return to Canadian stocks to avoid being caught in a

Policy Response Will Determine Whether Stocks Are a Bargain

Index	Country/Region	P/E (Current)	P/E (10-Year Avg.)	P/E (2009 Low)
S&P/TSX Composite Index	Canada	14.97x	17.81x	8.70x
S&P 500 Composite Index	United States	13.92x	16.85x	10.26x
Dow Jones Industrial Average	United States	13.12x	16.09x	11.16x
Nasdaq-100 Index	United States	16.37x	27.57x	13.37x
MSCI EAFE Index	International	13.71x	21.63x	8.56x
MSCI Emerging Markets Index	Emerging Markets	11.93x	13.42x	7.01x

Source: BMO Asset Management Inc., Bloomberg

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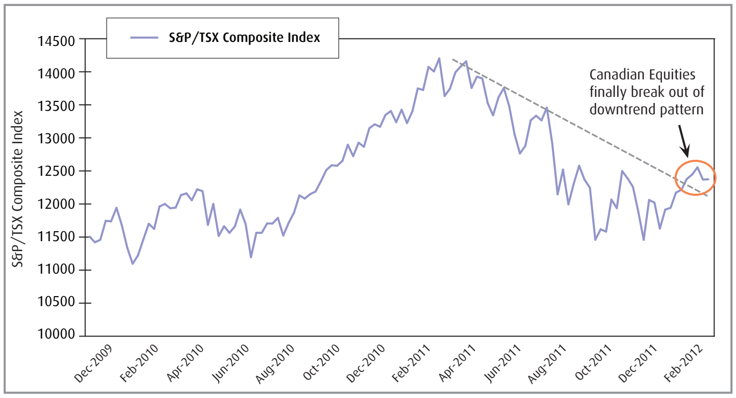
value trap. The *Dow Jones Industrial Average (Dow)*, our top broad equity market pick in 2011, showed a return of positive momentum in October, breaking out of its range-bound pattern and also recently registering a "golden-cross"[3] pattern, early January. The *S&P/TSX Composite Index (TSX)*, on the other hand, remained in a clear downtrend pattern since last March and has only recently broken out of that trend. In our equity allocation over the last year, we favoured more defensive oriented themes such as utilities, REITs and low volatility strategies. We continue to favour these themes as longer term core investments but given the strong market rally, we would use equity market pullbacks to tactically rotate some equity exposure to higher beta[4] areas, as defensive names may lag over the next several months.

Canadian Equities Recently Broke Out of Downtrend



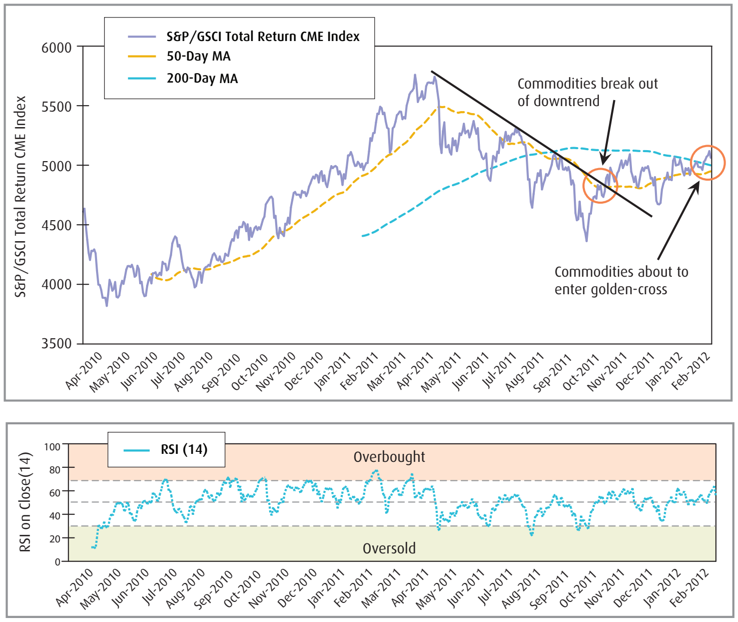
Source: BMO Asset Management Inc., Bloomberg

What Lurks Beneath?

Last year, the U.S. Federal Reserve ("Fed") announced they would pledge to keep record low interest rates until 2013. Several weeks ago, in a surprise move, the Fed extended its commitment to low rates to 2014, which was largely recognized as an overly aggressive move, particularly considering that U.S. economic data has been coming in better than expected in most cases. Nevertheless, the move showed that the Fed is willing to take significant measures to maintain a risk-rally and the market now believes that there is a higher likelihood for further quantitative easing should the improvement in economic data lose momentum. As a result, over the next several months we believe an equity market rally may be possible, despite risk assets looking very overbought over the short-term. From a fundamental perspective, global equity markets are attractive and short-term liquidity measures may lead to a multiple expansion in valuations. However, the many global macro-economic concerns that weighed on the market last year largely remain unresolved and any political responses questioned by the market could potentially cause a market sell-off. Sentiment indicators such as the *CBOE/S&P Implied Volatility Index (VIX)* are currently below historical averages but are finally showed some reaction to negative news, several weeks ago. As a result, we recommend using pull backs and trailing stop-loss orders to reallocate to equity markets. Risk mitigation tools such as stop-loss orders are critical given margin debt levels remain excessive, which makes a deleveraging event possible should investor sentiment sour over the ongoing European sovereign debt saga.

Coming into the new year, we believed the co-ordinated swap lines initiated by six key central banks, including the Fed, would continue to drive the demand for U.S. dollars higher over the first quarter. However, the Fed's decision to maintain lower interest rates for at least another year has likely reinitiated the game of global competitive currency devaluation, as no country wants higher relative interest rates and thus, a stronger currency. We believe lower currency values should favour hard assets over the long term, leading us to increase our allocation slightly to commodities to neutral and reposition our allocation within the commodity complex, again using trailing stop-loss orders. (See Cross Asset Mix Table). Despite the U.S dollar looking oversold in the short term, price action in the U.S. dollar has indicated that the greenback has lost some of its upside momentum since the Fed announcement of its pledge to low interest rates.

Pullbacks in Commodities May be Buying Opportunities



Source: BMO Asset Management Inc., Bloomberg

Some Notable Changes to the Mix

- ***Asset Allocation Changes:*** As we stated at the onset of the year, we anticipate that 2012 will be a year where investors have to be increasingly tactical. Though many risk assets have broken out of their downtrend channels, many of the shorter-term indicators suggest they are overbought. While Eurozone officials approved a second bailout for Greece, this does not mean default risk looks to have been removed. However, the Greek debt situation has been inoculated in the short-term, which could give risk-assets a tailwind if the investors continue to have the perception that the proverbial can has been kicked further down the road. For that period, we are less bearish and we would use the potential short-term pullbacks over the next several weeks to decrease our fixed income allocation and reallocate to equities, with a small allocation to commodities. (See Cross Asset Mix Chart to see new allocations) With the VIX showing a slight reaction to negative headlines a few weeks ago however, investors should remember not to get overly optimistic by excessively overweighting risk assets. In addition, while the swap lines and the ECB's LTRO have provided improved liquidity which could lead to the rally continuing over the next few months, the ongoing solvency concerns are far from being resolved.

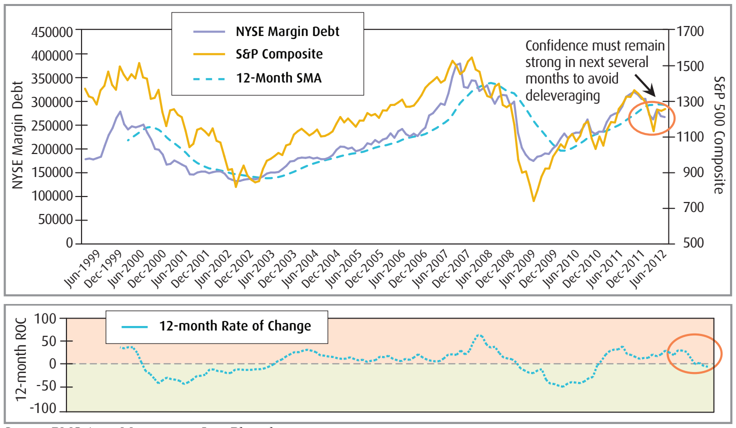
New Positions:

- ***BMO S&P/TSX Equal Weight Global Base Metals Index ETF (ZMT):*** Improving economic data out of the U.S and lessening concerns of a hard landing in China has led to gains in base metal prices over the last several weeks. In addition, copper inventories tracked by the London Metal Exchange sits at a two-year low as global mine output dropped significantly last year. As a result, investors may want to consider increasing their exposure to base metal equities over the next several months. Investors should mitigate risk by using trailing stop-loss orders and limit exposure to no more than 10% of a portfolio, for a more aggressive investor. (Satellite Position).

- ***BMO Emerging Market Equity Index ETF (ZEM):*** Since China has managed to bring down inflation over the last six months, as indicated by its Consumer Price Index (CPI) falling from 6.5% in July to 4.5% in January, this should give the Bank of China (PBOC) some flexibility in easing monetary policy over the next few months. With a number of other emerging market nations also looking to reduce interest rates, the equity markets should fare well in the short-term. Investors looking to tactically increase their weighting to emerging markets can do so efficiently through an exchange traded fund (ETF). As emerging market indices are trading at lower valuations than other broad measures, we see this as providing the biggest multiple expansion potential. Given the many macro-economic risk items on the horizon however, investors should note that emerging markets are the most sensitive when we experience a sell-off in equities. As we stated at the onset of the year, keeping risk in check will be critical this year and again we recommend limiting allocation to emerging markets. (Core Position).

Things to Keep an Eye on...

Margin Debt Must Turn Up

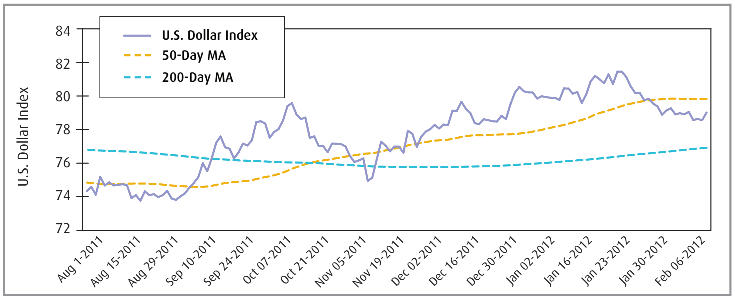


Source: BMO Asset Management Inc., Bloomberg

Why we remain cautious: Last year, in August, the downgrading of U.S. Treasuries caused margin debt levels to dip below its 12-month moving average (MA), suggesting a market deleveraging. Consequently, we recommended that investors tactically overweight fixed income. While equity markets have rallied, even more so this year, we have remained overly defensive. Though we have increased our equity allocation this month, we remain cautiously optimistic as margin debt levels remain below its 12-month MA and its rate of change (year over year), is dangerously close to moving negative. Policy measures in the Eurozone will be critical in keeping the recent investor optimism buoyant, and thus avoiding a deleveraging event. We continue to keep track of intra-market correlations, which have a tendency to rise during deleveraging events.

Recommendation: Trailing stop-loss orders will be the key to help investors mitigate risk. In addition, investors should not excessively overweight risk assets, despite the New Year rally. Stay diversified among asset classes.

Can U.S Dollar Maintain Strength?

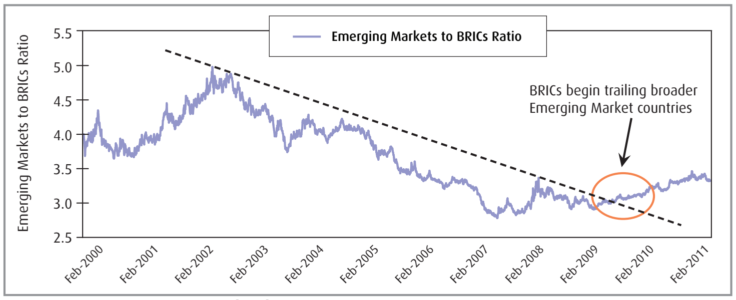


Source: BMO Asset Management Inc., Bloomberg

Greenback watch: The strength of the U.S. dollar will be key in determining whether commodities continue to outperform. Coming into the New Year, we anticipated the U.S. currency to strengthen through the first quarter as a number of central banks were accessing the U.S. dollar via the recently initiated swap lines designed to improve liquidity. However, the Fed's recent announcement of its pledge to keep interest rates low until 2014 suggested lower relative interest rates in the U.S., causing commodities to rally over the last several weeks. Developments in the European debt situation will determine the future demand for the U.S. dollar as a move back towards a risk-off environment would bring the greenback strongly back in favour. Commodity currencies look short-term overbought, suggesting sell-offs could present buying opportunities in commodities.

Recommendation: If commodities continue to rally, use pullbacks as an opportunity to build a small exposure in economically sensitive areas such as base metals. Investors may want to consider the ***BMO S&P/TSX Equal Weight Global Base Metals Hedged to CAD Index ETF (ZMT)*** with a trailing stop-loss order.

Emerging Markets Outperforming BRICs

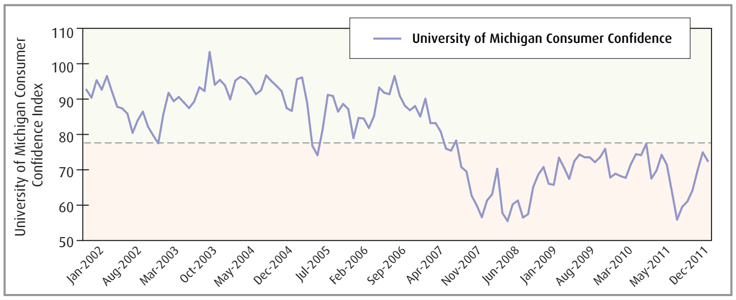


Source: BMO Asset Management Inc., Bloomberg

Avoiding a hard landing: Last year, investors became increasingly concerned that the Chinese economy would experience a hard landing. Recent readings on China's Purchasing Managers Index (PMI) came in at 50.3 in December and rose again to 50.5 in January, which has eased those concerns. A reading above 50 is expansionary while a reading below 50 suggests a contraction. Nevertheless, concerns of a slower economy still remain and the Shanghai Stock Exchange Composite Index has yet to break out of its downtrend. Furthermore, of the BRIC nations, only Brazil has broken out of its downtrend channel. Recently, the BRICs (Brazil, Russia, India and China) have begun to underperform broader emerging market equities.

Recommendation: Investors looking for exposure in emerging market equities may want to consider a broader exposure than the BRIC nations. The ***BMO Emerging Markets Equity Index ETF (ZEM)*** is an efficient way for investors to access broad exposure to emerging market equities at a low cost. As emerging market equities tend to decline more than U.S. equities during sell-offs, again a trailing stop-loss order is an efficient way for investors to build exposure to emerging market equities.

Consumer Confidence Improving, but Still Low

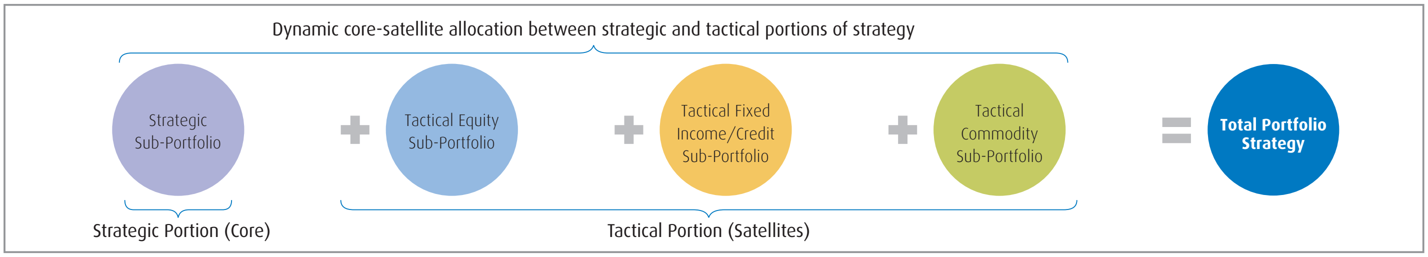


Source: BMO Asset Management Inc., Bloomberg

U.S. consumer confidence has improved... however the University of Michigan Consumer Confidence Index remains below its pre-credit crisis range. In many cases, U.S. economic data has come in better than expected this year, but consumer confidence must continue to improve in order to stimulate the business environment and thus the economy. Last month's reading of 72.5 for February came in lower than expected and if this downtrend continues, equity markets could potentially sell-off. Given the economic instability that remains, even the most aggressive investors should retain some exposure to fixed income should the recent encouraging economic data stall. As the U.S. remains Canada's main trading partner, economic activity south of our border will have a direct effect on ours.

Recommendation: We continue to favour the mid-part of the yield curve given our expectations that the Bank of Canada (BoC) will likely keep interest rates unchanged for the time being. By taking some duration risk, investors can increase the yield in their portfolio. However, taking too much duration risk, such as overweighting the long-end of the curve, could put investors at risk as longer duration bonds have a tendency to sell-off when investor sentiment improves. Investors may want to consider the ***BMO Mid-Corporate Bond Index ETF (ZCM)*** and the ***BMO Mid-Federal Bond Index ETF (ZFM)***.

Dynamic Core-Satellite Strategy



Cross-Asset Allocation Mix Using BMO ETFs:

	Current Weighting	Change	Notes
Core-Satellite Mix			
Core (Strategic Asset Allocation)	Underweight	—	• Broad Beta ETFs
Satellite (Tactical Asset Allocation)	Overweight	—	• Sector/Thematic ETFs
Asset Allocation Mix			
Equities	Slight Overweight	▲	• Equity markets look short-term overbought. Trailing stop-loss orders are a way to reallocate to equities
Bonds	Slight Underweight	▼	• We are tactically relocating to equities and commodities as the appetite for risk has improved in new year
Commodities	Neutral	▲	• Lower U.S. interest rates should favour commodities
Cash and Cash Equivalents	Underweight	▼	
Equity Themes			
Low Beta/Defensive Oriented Equities	Slight Overweight	▼	• BMO Low Volatility Canadian Equity ETF (ZLB) • BMO Equal Weight Utilities Index ETF (ZUT) • BMO Covered Call Utilities ETF (ZWU) • BMO Global Infrastructure Index ETF (ZGI) • BMO U.S. Equal Weight U.S. Health Care Hedged to CAD Index ETF (ZUH)
Cyclical Stocks	Neutral	▲	
Dividend Paying Equities	Slight Overweight	—	• BMO Canadian Dividend Equity (ZDV) • BMO Equal Weight REIT ETF (ZRE)
U.S. Equities (Multinationals)	Slight Overweight	▼	• BMO Dow Jones Industrial Average Hedged to CAD Index ETF (ZDJ) • BMO Covered Call Dow Jones Industrial Average Hedged to CAD ETF (ZWA)
Emerging Market Equities	Neutral	▲	• BMO Emerging Markets Equity Index ETF (ZEM)
Fixed Income Themes			
Canadian Bonds			
Mid-term Federal Bonds	Overweight	—	• BMO Mid-Federal Bond Index ETF (ZFM)
Mid-term Corporate Bonds	Overweight	—	• BMO Mid-Corporate Bond Index ETF (ZCM)
Short-term Bonds	Neutral	—	• BMO Short-Federal Bond Index ETF (ZFS) • BMO Short-Corporate Bond Index (ZCS)
Long-term Bonds	Underweight	—	
Provincial Bonds	Underweight	—	
Non-Traditional Fixed Income			
U.S. High Yield Bonds	Overweight	—	• BMO High Yield U.S. Corporate Bond Hedged to CAD Index ETF (ZHY)
Emerging Market Debt	Overweight	—	• BMO Emerging Market Bond Hedged to CAD Index ETF (ZEF)
Commodity Themes			
Agriculture	Underweight	▼	
Base Metals	Overweight	▲	•BMO S&P/TSX Equal Weight Global Base Metals Hedged to CAD Index ETF (ZMT) ***– Limit to no more than 10% of portfolio***
Energy	Slight Overweight	▼	•BMO S&P/TSX Equal Weight Oil & Gas Index ETF (ZEO)
Precious Metals	Neutral	—	•BMO Precious Metals Commodities Index ETF (ZCP)

Footnotes

[1] **Long-Term Refinancing Operations (LTRO):** a major financing method used by the European Central Bank to provide liquidity to its member banks. Although the operation has been in existence for well over a decade, its rules were recently revised to make it considerably easier for banks to obtain funding. First, through LTRO banks can now post collateral to borrow funds for three years rather than several months. Second, the eligible collateral to obtain funding has been relaxed significantly.

[2] **Tail-risk:** The risk of an outlier or improbable event occurring. Statistically, the event is said to be three standard deviations away from the mean under a normally distributed curve.

[3] **Golden-Cross:** When a security's 50-day moving average moves above its 200-day moving average, it is said to have entered a "golden-cross." This is traditionally seen as a positive and potentially indicates a bull market on the horizon.

[4] **Beta:** a measure of the tendency of a security or portfolio's returns to respond to swings in the market. A beta of 1.0 indicates that the security's price will move with the market, while a beta of less than 1.0 means that the security will be less volatile than the market and a beta of greater than 1.0 indicates that the security's price will be more volatile than the market.

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