Weakness May Present Buying Opportunities

Monthly Strategy Report June 2011

BMO EXCHANGE TRADED FUNDS

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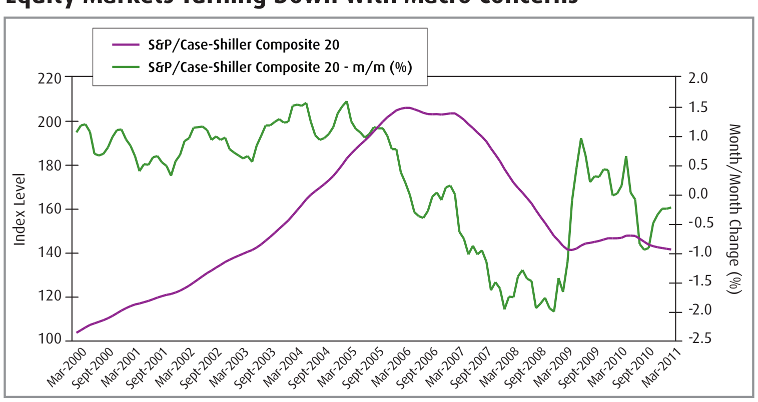
"Sell in May and go away," so goes the old adage in the investment world. Does the saying however have any validity or does it exist simply because it rhymes? Undoubtedly, those investors that followed the saying this year would have come out ahead with the major equity markets around the globe experiencing a sizable sell-off over the last several weeks. A number of recent macro-economic events are causing investor sentiment to take a turn for the worse, at least for the short-term. For example, the *S&P/Case-Shiller 20 City Index*[1] fell back below its crisis low, U.S. jobless data is waning and the end of the second instalment of quantitative easing[2] (QE2) is upon us. On the homefront, the implications of a weakening U.S. economy have investors concerned, as it may have supply chain impacts on the U.S. and Canadian trade. In addition, the CME Group Inc.'s recent margin requirement hikes to cool pricing of a number of commodities have also led to the softening of the Canadian equity market. With these concerns in the market, in addition to weaker expected growth out of China and Japan, the second and third largest economies in the world respectively, many of the global equity indices have fallen below or have traded near its 200-day moving average (MA), a key technical support level.

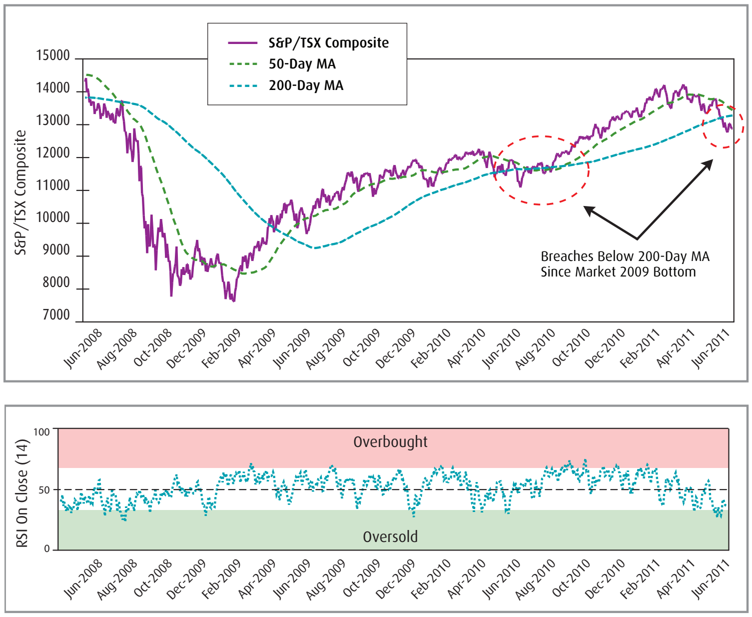
Over the last several weeks, we have received a number of emails inquiring whether this technical event would have long-sustaining bearish implications on the market. We view the market as being characterized by three main time horizons. The first, and longest, is the secular cycle, which can last several business cycles and is caused by large global demographic shifts. The next timeframe is the cyclical cycle, which is largely defined by the business cycle itself. The last, and shortest, of the cycles is the trading cycle which is largely driven by investor sentiment and trade order imbalances. In our view, the current equity market weakness, remains contained in the trading cycle, with shorter-term traders selling and longer-term investors looking for buying opportunities. As such, we believe the current weakness to be a bull-market correction, provided equity markets don't plummet aggressively below the 200-Day MA, an event which would cause the sentiment of longer-term investors, who are currently buyers, to also turn bearish and thus trigger additional selling.

Equity Markets Turning Down With Macro Concerns



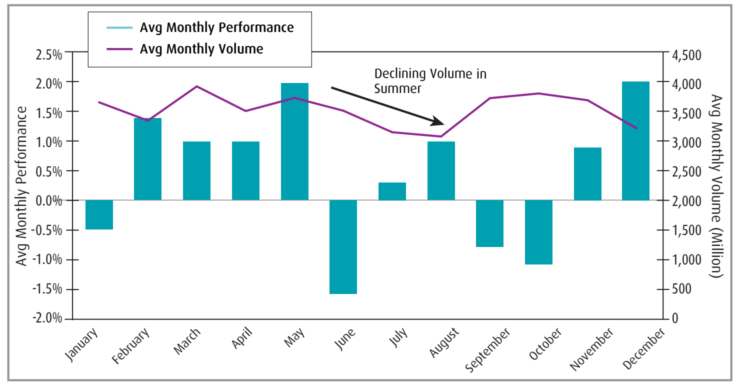
Source: Bloomberg

Indicators Suggest Equity Markets Oversold



Source: BMO Asset Management Inc., Thompson-Reuters

July and August Have Historically Shown Lower Volume but Strong Performance



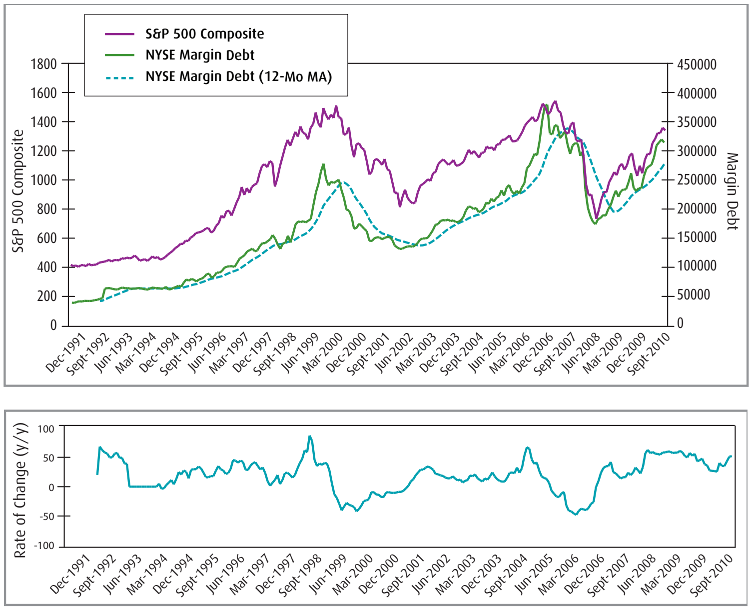
Source: BMO Asset Management Inc., Bloomberg

As we mentioned in our *Trade Opportunity Report, **"June Weakness"***, we don't subscribe to the notion that "selling in May and going away" is a winning strategy that can be implemented effectively year after year. However, we do acknowledge that equity markets exhibit some seasonality, with June being one of the weakest months in terms of historical average performance. Additionally, the summer tends to have lower volume levels than other months. Therefore, we do to a degree believe there is some truth to the notion that investors have a tendency to pare down risk assets in favour of more defensive assets before summer. We would also point out that, contrary to popular belief, July and August have historically delivered solid average returns, which may indicate that the current market weakness could lead to buying opportunities. Rather than relying blindly on seasonality, we would however recommend that before stepping back-in to less defensive areas, investors keep an eye on selling pressure to eventually capitulate and momentum to turn back up.

Revisiting Margin Debt

Despite the recent weakness and negative headlines in the market, we believe the cyclical bull market is still intact. Over the last decade the U.S. Federal Reserve has aimed for soft economic landings which involve low interest rates and most recently, quantitative easing. Though this allows for the economy and thus equity markets to rebound quickly, many structural issues remain and it can be argued that economies may not be able to naturally evolve and effectively adapt. A consequence to the easy monetary policies however is the encouragement of leverage. A closer look at the last two equity bull-markets show that they were better described as leveraging and deleveraging events, which is why correlation amongst individual equities went straight up as leverage got sucked out of the system during the downturn of the markets. Margin debt, as a result, provides a good indication of when the bull-markets or leveraging cycles are near its top. As indicated in the chart below, as the NYSE Margin Debt level still remains above its 12-month MA, we believe this still favours equities over fixed-income. Additionally, as the 12-month rate of change in the index has a tendency to go parabolic before the market top, we view this as a positive for equities as we have not seen any such movement thus far.

Expanding Margin Debt is Supportive of Equities



Source: BMO Asset Management Inc., Bloomberg

Portfolio Positioning

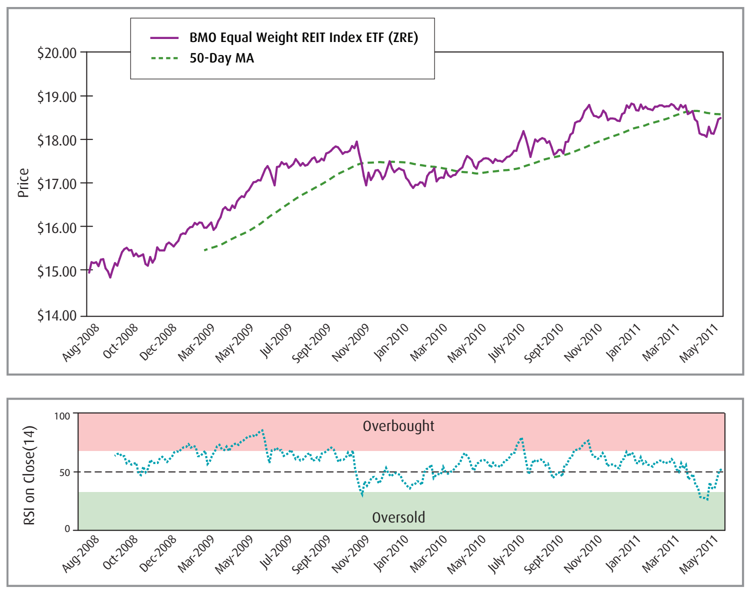
As recommended in our "June Weakness" Report, the short-term tactical positioning was to increase exposure to defensive areas such as fixed income and utilities. We also mentioned that Exchange Traded Funds (ETFs) such as the **BMO Short Corporate Bond Index ETF (ZCS)** and the **BMO Equal Weight Utilities Index ETF (ZUT)** allow investors to make portfolio reallocations quickly and efficiently. Since we expect the longer term cyclical bull-market to be intact, we believe that the recent equity market weakness has shaken out the more speculative hands, presenting some buying opportunities in the market. The following areas that we also recommended in our *April Monthly Strategy Report, **"The Economic Thawing Process,"*** are good investments over the cyclical cycle but we would look for momentum to turn positive as confirmation before allocating to these areas.

- **1) Canadian REITs.** Over the last several weeks, we believed utilities to be a better opportunity given its defensive characteristics. In addition, the recent economic softness lead market expectations that the Bank of Canada may postpone rate hikes until further into the fourth quarter. Over the longer term however, we believe REITs are more attractive during the cyclical and secular cycle since they are a better hedge against inflation and are less sensitive to interest rate hikes as compared to utilities. As we recommended a tactical shift into utilities several weeks ago, we would watch the relative strength (RS) of Canadian REITs to strengthen against utilities to give us a better indication of a switch point. In addition, we would also look for a MACD[3] crossover and the ADX[4] indicator on the pair to show a positive crossover as confirmation. To note, our *Global Index TrendSpotter model*[5] recently showed Canadian REITs as the first sector to rebound from the recent weakness and we would recommend investors with no allocation to this sector to start accumulating at this point.

Potential Investment Opportunity:

- ***BMO Equal Weight REITs Index ETF (ZRE)***

Strength in REITs Returning



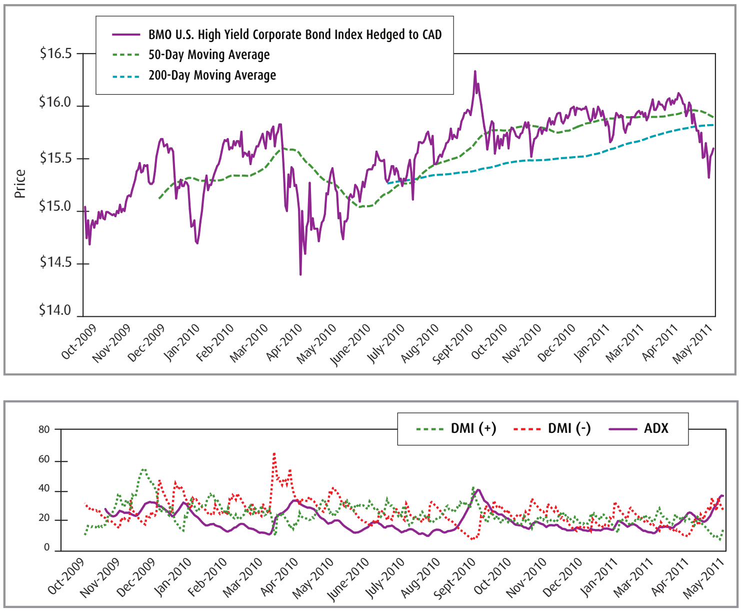
Source: BMO Asset Management Inc., Thompson-Reuters

- **2) U.S. High Yield Debt.** As we mentioned in the *April Monthly Strategy Report, **"The Economic Thawing Process,"*** we believe U.S. high yield debt is an asset class that remains attractive over the long-term. Given U.S. corporate bonds have sold off lately, we believe the recent sell-off may provide investors with a better entry point. Investors may want to access this area through ETFs given its diversification and attractive yield. A closer look at a candlestick chart shows buying pressure after sell-offs, which may suggest bullish undertones being held down by market weakness. Look for the directional movement indicator to go positive when the appetite for risk returns.

Potential Investment Opportunity:

- *BMO High Yield US Corporate Bond Hedged to CAD ETF (ZHY)*

U.S. High Yield Bonds Will Bounce Back with Market's Appetite for Risk



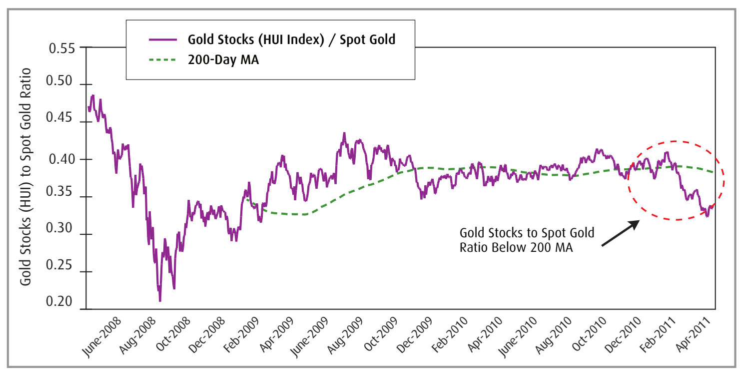
Source: BMO Asset Management Inc., Bloomberg, Thompson-Reuters

- **3) Gold Equities:** Without question gold based equities have not held up since the equity market fell from its April peak. Given the risk factors in the market right now, that should not come as a surprise as commodity based equities will have tendencies to react more like stocks than their underlying commodities at times. A closer look at the pair ratio between the *NYSE Arca Gold Bugs Index*[3] and spot gold shows the relative strength of gold based equities significantly underperforming bullion over the last eight weeks. If equity markets continue to weaken, we believe the ratio will continue to fall. However, longer term investors may want to look for gold companies to turn up and for this ratio to eventually expand towards it long-term average. This is especially so given gold bullion trades relatively near its all-time record high of ***$1,563.70***. As some of the weak economic numbers in the last several weeks were a result of poor weather, we believe data will soon improve, especially since the recent soft patch has likely led market expectations lower. In terms of overall portfolio construction, gold bullion exhibits low overall correlation to financial assets such as equities and fixed-income. Investors looking to increase gold related equities should look for the pair ratio between the NYSE Gold Bugs Index to spot gold for better indication of an entry point.

Potential Investment Opportunity:

- *BMO Precious Metals Commodity ETF (ZCP) for portfolio diversification*
- *BMO Junior Gold Index ETF (ZJG) – but wait for overall equity market strength to return first*

Gold Stocks Impacted By Broad Market Beta



Source: BMO Asset Management Inc., Bloomberg

Although there are a number of negative headlines that have investors concerned, we believe much of the fear is already embedded in the marketplace. All previous equity market bull-runs have seen corrections. In addition, June has historically been the weakest in terms of monthly performance, with July and August faring better. While the short-term tactical shift may have warranted a more defensive stance, we believe the recent weakness may lead to potential accumulation opportunities for longer-term investors.

Footnotes

[1] **S&P/Case-Shiller Home Price Indices** A strategy in which an investor sells a certain currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. A trader using this strategy attempts to capture the difference between the rates, which can often be substantial, depending on the amount of leverage used. The carry trade can also be applied to non-currency assets as investors can borrow funds in low interest rate countries to invest in non-currency investments that may be more volatile. When these assets sell off, investors are forced to liquidate assets to pay back loans.

[2] **Quantitative easing:** An unconventional monetary policy used by some central banks when traditional measures have not produced the desired effect. Money supply is typically increased in an effort to promote increased lending and liquidity.

[3] **Moving Average Convergence Divergence (MACD:** A trend-following momentum indicator that shows the relationship between two moving averages of prices. The MACD is calculated by subtracting the 26-day exponential moving average (EMA) from the 12-day EMA. A nine-day EMA of the MACD, called the "signal line", is then plotted on top of the MACD, functioning as a trigger for buy and sell signals.

[4] **Average Directional Index (ADX):** An indicator used in technical analysis as an objective value for the strength of trend. ADX is non-directional so it will quantify a trend's strength regardless of whether it is up or down. ADX is usually plotted in a chart window along with two lines known as the DMI (Directional Movement Indicators). ADX is derived from the relationship of the DMI lines.

[5] **Global Index 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 asset classes and equity sectors.

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