An Exclusive View of the Canadian ETF Landscape

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The Bond Market Is in Trouble

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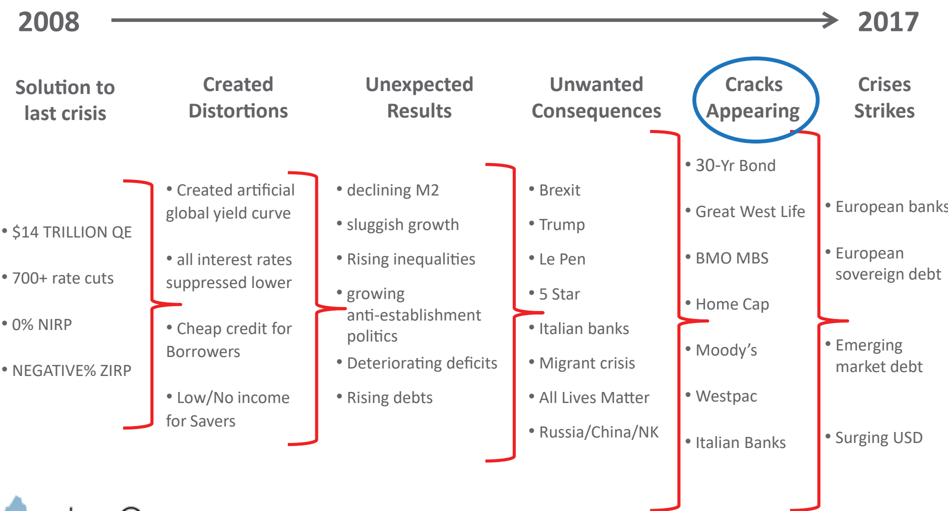
For those who are not familiar with the Toronto housing market, just know that the clock that keeps it ticking is the good ol' financial industry.

Just as the Calgary market crashed when oil crashed, and the Tokyo market crashed when the yen crashed, anyone who is forecasting the safety or the demise of the Toronto market must completely understand the main driver of the global financial industry, which is, of course, long-term interest rates.

The chart below details the evolution of the global financial system since the 2008/2009 credit crisis:



Source: IceCap Asset Management Limited

The *good news* is that after eight years of financial oppression, the playing field will once again be level for all players, including those who have not benefitted from extreme monetary stimulus.

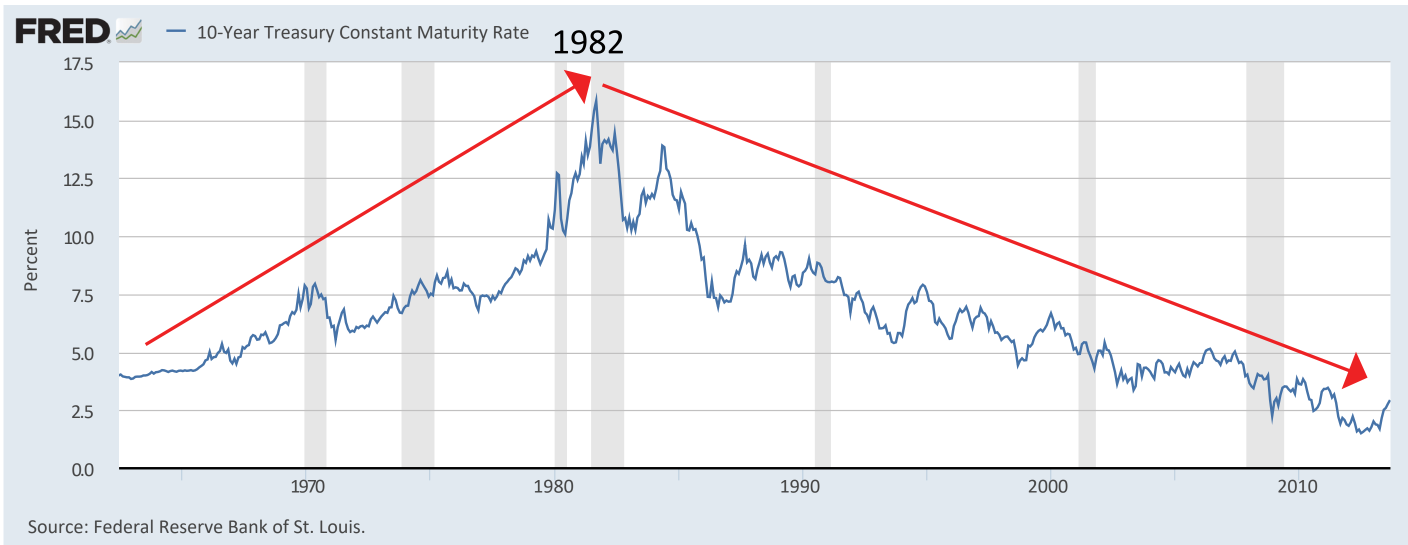
The *bad news* is that after eight years of financial oppression, those who cannot recognise the risks that have accumulated are about to be red carded right off the field.

For a number of reasons, the vast majority of investors around the world solely look at the stock market. Everything good and everything bad always comes from, and away from, the stock market. In truth – the grease that keeps the world's mighty economy and debt-eating machine chomping through the night is interest rates. To better grasp the vital importance of this discussion, just know that long-term interest rates are to the bond market what oil prices are to the energy market. And since 1982, long-term interest rates have declined from nearly 20% to 0%, creating the perfect scenario for all positive-interest-sensitive investments.

Summary of Recommendations:

BMO Short-Term US Treasury Bond Index ETF (Ticker: ZTS)

BMO Low Volatility US Equity ETF (Ticker: ZLU)



Also note, that today's global rate structure has been artificially suppressed by nearly $15 trillion in central bank money printing, 672 interest rate cuts, and eight years of zero and negative interest rates across the developed world.

Two things are about to happen, which will have enormous effects across all investment strategies and asset classes:

1. Long-term rates will surge higher, re-escalating a crisis in the bond market
2. The majority of investors are completely unprepared for this event

Over the last eight months, long-term rates have twice surged, instantly creating losses and anxiety across bond markets. In November 2016, rates increased from 1.70% to 2.40%, generating $1.7 trillion in global bond market losses. Then, in July 2017, long-term rates spiked 0.20%, creating $400 billion in losses around the world.[1] In other words, the tiniest, unexpected increases in long-term rates are creating havoc in bond markets.

Additionally, and unknown to many, the reason most investors cannot see the bond bubble is simply because over the last 30 years, every single crisis in the financial world eventually manifested itself in the stock market. In fact, no one working in the industry today has ever experienced a crisis in the bond market and for this reason, linear thinking and naivety has made most people oblivious to the elephant in the room.

Estimated Losses:
$5 trillion

2000 Tech Bubble
(Private Sector)

Estimated Losses:
$15 trillion

2008
Housing Bubble
(Private Sector)

Estimated Losses:
$?? trillion

2017 Government
Bond Bubble
(Public Sector)

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Source: IceCap Asset Management Limited

The sovereign bond market is in a bubble. Long-term rates have been suppressed by central bank quantitative easing, and zero and negative rates. As well, the structure of the Eurozone is flawed as there was never a fiscal and debt union. This means every country is running different tax and spending policies, while also funding their deficits and debt rollovers through their own debt issuance. The direct result has been the creation of the world's second largest monetary region without any federal bonds. The secondary result has been a financial system and its regulated capital supported by sovereign debt from 19 different countries.

A re-escalation of the crisis in Europe will likely be the fuse to trigger long rates higher, and when it occurs we expect the following:

1. Capital losses across all fixed-income strategies
2. Surging US dollar
3. Very strong equity markets (ex-financials)

Another neglected aspect of global financial markets is understanding how the mega-wealthy invest. Yes, they own stocks, real estate, infrastructure and the like, but it is imperative to understand that during times of crisis, they pack up and run.

The name of the game is to first preserve your capital – avoiding capital losses is so critical. After all, a 50% loss in anything requires a 100% gain just to get back to where you started. As the sovereign debt crisis re-escalates, expect the wealthy to shift their financial assets away from the trouble and towards safe-havens. And since the crisis will be in fixed income, capital will flee fixed income and since the only market big enough to absorb these types of capital movements is the US dollar, one should also expect it to strengthen significantly.

In this environment, Canadian-dollar portfolio strategies are structured to have minimum allocations to fixed income, increasing allocation to US-dollar currencies as a separate asset class strategy, and equity portfolios positioned toward U.S. equities with lower exposures to interest-rate-sensitive sectors:

- **ZTS (BMO Short-Term US Treasury Bond Index ETF)** has 100% exposure to 1-5 yr US Treasury Bonds, which can provide currency appreciation as a safe-haven market.
- **ZLU (BMO Low Volatility US Equity ETF, Non-Hedged)** with exposure to diversified U.S. equities, and with a small allocation to the financial services sector (less than 3%), this ETF will also benefit from an appreciating US dollar.

A full version of the IceCap Global Outlook is available at icecapassetmanagement.com.

[1] Bloomberg.

IceCap Asset Management Limited Disclosure:

The information in the body of this communication is intended to provide trading and market structure commentary and is not intended to provide a sufficient basis for an investment decision and should not be considered a Research Report.

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