

# Portfolio Management

February 2018

## Equity Strategy

### The Impact of Rising Interest Rates

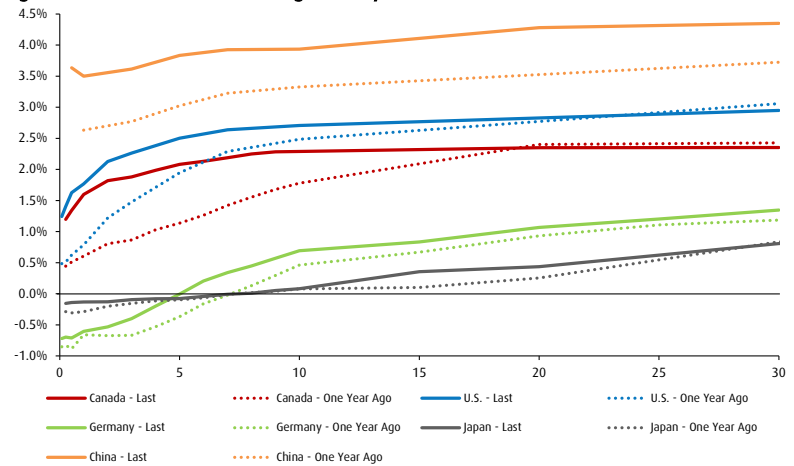
Stéphane Rochon, CFA, Equity Strategist

Interest rates are on the rise. Not just in North America but globally. The key question is how far and how fast will this trend continue and what will be the impact on markets beyond the sharp pullback we have seen over the last week.

Unfortunately, no one can predict the exact timing of rate moves but our view remains that the bond bull market which started in the early 1980s is on its last legs. Put another way, we believe long term interest rates will move up in the U.S. and Canada over time and that it is imperative for investors to consider interest rate risk when adjusting their portfolios.

Accordingly, the cornerstone of our asset allocation strategy is to continue to underweight fixed income securities and overweight equities. One thing is certain, bond markets across the globe remain very expensive. The “poster children” for this phenomenon are Germany and Japan where yield curves, despite the recent rise in rates, are actually negative for the next several years.

Figure 1: Interest Rates are Rising Globally



Source: Bloomberg

On the stock side we see a number of opportunities among large, high quality companies in North America and Europe. Our Guided Portfolios (recommended stock lists) have a large allocation to financials and particularly life insurance companies, which are one of the few sub-sectors that clearly benefit from higher rates. We also note that U.S. financials are among the biggest beneficiaries of the recently passed tax cuts south of the border.

Figure 2: BMO Nesbitt Burns Investment Strategy Committee’s Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	5	5	5	5	5	5	0	5
Fixed Income	70	70	40	45	20	25	5	0
Equity	25	25	55	50	75	70	95	95
Canadian Equity	15	15	25	25	35	35	40	40
U.S. Equity	10	5	25	15	25	20	35	30
EAFE Equity*	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

\* Within EAFE, we specifically recommend Continental European equity. Source: BMO Nesbitt Burns Private Client Strategy Committee

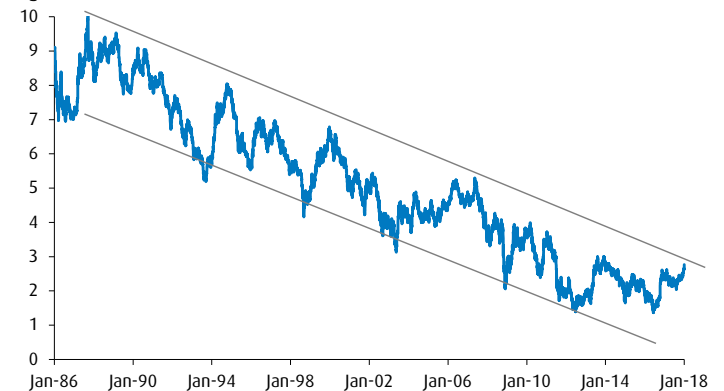
While popular perception is that rising interest rates are negative for stocks, our analysis shows that this is not necessarily the case. While the median annual return for the S&P 500 has in fact been better when interest rates are declining, our analysis of interest rate cycles going back almost 60 years shows that the market can absorb interest rate increases as long as they are gradual and do not go much above the high single digit range (the S&P has historically struggled once the 10-year goes above the 6-8% level). The good news is that we are still a very long way away from this dangerous level.

However, the changing inflation and interest rate landscape provides some interesting geographic allocation opportunities. In Canada specifically, the market has reacted quite differently, posting far better median gains when interest rates were rising, likely because these periods coincided with inflationary pressure and associated strong commodity price cycles. We remind our readers that approximately a third of the S&P/TSX market capitalization is in the energy and materials sectors versus less than 10% in the U.S.

### The Quantitative/Technical View

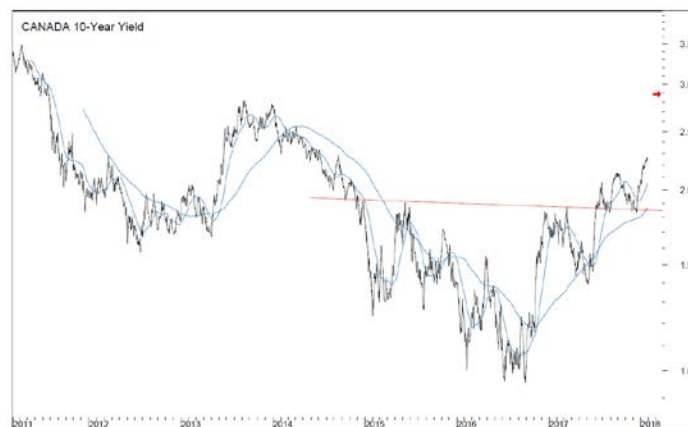
BMO Capital Markets Technical Analyst Mark Steele believes that the 35 year downtrend in rates (the bond bull market) is very close to being broken as can be seen by Figure 3. BMO Nesbitt Burns' Technical Analyst, Russ Visch, for his part, notes that "the U.S. 10-year yield has backed up sharply in recent months and broken above a number of key resistance levels. Most recently, it broke above the late 2016 peak at 2.64%, which cleared the way for a challenge of the early 2014 peak at 3.05%. While these have certainly been negative developments for the bond market, the secular (multi-year/multi-decade) trend for bonds only shifts to bearish on a close above 3.05%. It's not just U.S. bonds which have come under pressure either. Here in Canada our 10-year bond yield recently reversed back to the upside from a successful test of the base breakout near 1.86%. The initial breakout shifted the long-term trend for bonds to bearish (i.e. - higher yields) and opened an initial upside target of 2.89%."

Figure 3: U.S. 10 Year Rates since the 1980s – Broken Trend?



Source: BMO Capital Markets

Figure 4: Canada 10 Year Yield



Source: BMO Nesbitt Burns Technical Research

Figure 5: U.S. 10 Year Yield



Source: BMO Nesbitt Burns Technical Research

In our view, the key reasons for the very slow levitation of rates over the last few years have been 1) global central bank quantitative easing (the purchase of huge quantities of bonds) which has artificially suppressed rates and 2) the very low and declining inflation rate in virtually every major economy since the financial crisis. Interestingly, both those factors are starting to wane with most major central banks starting to adopt a tighter policy by reducing bond purchases or raising short term rates (or hinting that will soon do so). Also, as we have noted before, inflation is starting to perk up in major economies. Our favourite “canary in the coal mine” from that perspective is U.S. wage pressure and particularly full time worker average earnings which have been accelerating upward.

As an aside, our previous work going to the early 1960s has clearly shown that a stable or declining consumer price index is very positive for stocks as is associated with multiple expansion. This work also shows that the stock market can tolerate higher inflation up to about the 3% level after which it becomes a significant headwind to performance.

### Why Should Clients Care About Rates?

Because their portfolios are far more interest rate sensitive than most realize is the short answer. To illustrate the risk, consider that a 10 year Government of Canada Bond currently has a duration of approximately 9 years. Using back of the envelope bond math (a forte of mine), this means a 1% increase in rates would lead to a FULL 9% DECLINE in the value of the bond. In other words, long term bonds are not “safe” instruments, far from it. Typical Canadian clients also have high exposure to utilities, pipelines, telecoms and REITs, which are quite vulnerable to higher interest rates.

Recall that 10 year interest rates are the foundation of all of finance. As such, they directly impact the price of bonds (higher rates = lower bond prices; the longer the maturity, the more pronounced the impact). They also have a significant impact on equity sector valuations and performance. Typically, rising interest rates have a nefarious impact on the performance of defensive, lower growth sectors such as Utilities, telecoms and REITs. The key reasons for this are that 1) these sectors are typically very capital intensive and carry high debt loads, so as interest rates rise, their costs of funds go up (similar to the impact of higher mortgage rates on borrowers), 2) higher rates often signal a stronger economy and inflationary pressure which drives investors to more cyclical sectors and 3) it makes the typical dividend yield advantage of these sectors less attractive relative to bond alternatives.

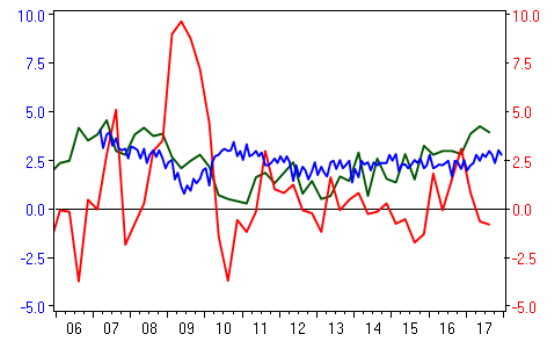
The increased cost of debt may also be exacerbated in the U.S. by the recently passed tax bill. While the net effect of the bill is undeniably positive for equities, the impact of the reduced ability to use interest payments as a tax shield will magnify the negative impact of interest rate increases for profitable but highly indebted companies (again the REIT, Pipeline, Utility and Telecom sectors have many companies that fit the bill).

Starting in 2018, a company can only deduct interest expense of up to 30% of its EBITDA (earnings before interest, taxes, depreciation, and amortization). Any amount in interest expense beyond it will no longer be deductible. This will tighten further in 2022, when the deductibility of corporate debt will be capped at 30% of earnings before interest and taxes but after depreciation and amortization expenses. This is a much smaller number than EBITDA. And interest expense deduction is capped at 30% of that much smaller amount. This will raise the tax bill further (source: Business Insider).”

### The Impact of Long Term Interest Rate Cycles on the Stock Market

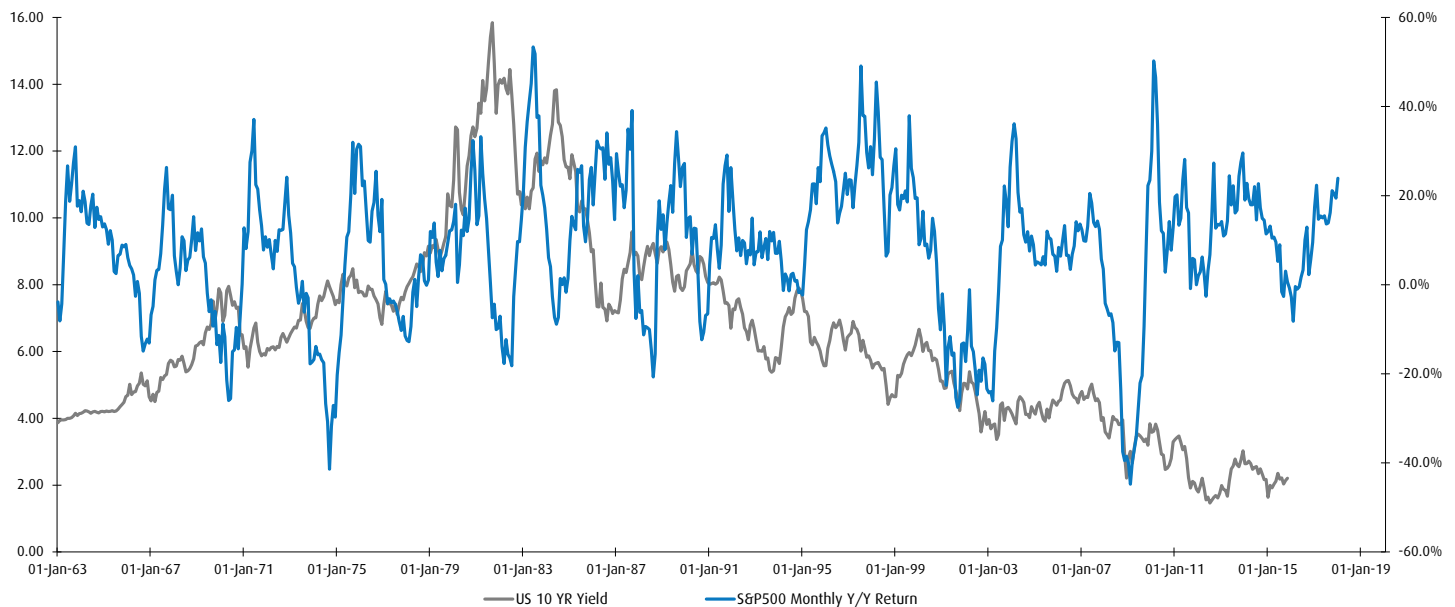
In order to better address this issue, we conducted a detailed analysis of the impact of Fed Fund rate cycles on stock returns going back to 1963. As the chart below shows, we decomposed the data into 23 cycles of varying length –some multi month, others multi-year- where interest rates generally increased or decreased.

Figure 6: Average Weekly Earnings



Source: BMO Economics

Figure 7: S&amp;P 500 versus the 10-Year Treasury Yield



Source: Bloomberg

Specific market return data for every cycle is included in the table in Figures 8 through 9. The key conclusions from our work are as follows:

- For the S&P, the median annual return has been stronger when interest rates are declining with a median annual price return of 12.9% vs. 4.6% when they rise (although the average annual return is much closer at 9.5% vs. 8.9%). Of course, the economic context is extremely important so when we exclude the periods characterized by the recessions of 2001 and 2007-2009, the performance discrepancy rises to a 16% median return when interest rates decline.
- In Canada, the market has reacted quite differently, posting far better median gains when U.S. interest rates were rising (+9.7% vs. +2.7%), likely because these periods coincided with strong commodity prices (e.g., oil shock of the late 1970s and early 1980s, commodity super cycle pre and post financial crisis).
- The S&P 500 can absorb interest rate increases as long as they are gradual and do not go much above the high single digit range. Notably, since the mid-1990s, the market has produced good results even when rates were rising (Jan. 96 – March 97, Oct. 98 to Jan 00, Jun 03 to Jul 07, Apr. 09 to March 10 – post financial crisis- and Aug. 12 to Dec. 13).
- Trajectory matters. If rates are declining (a positive for consumption and cost of funds), the market tends to do well since things are getting incrementally better. This is true even when rates remain at high absolute levels as was the case in periods 2, 6, 8 and 12.
- Conversely, the S&P has historically struggled once the 10 year goes above the 7-8% level (although we think anything north of 4% would be problematic in the current environment given the run stocks have had over the last few years) presumably as bonds become far more appealing than stocks for investors and the corporate cost of capital goes up, sapping profitability. As shown below, the market actually produced negative returns in periods 1, 3, 7 and 11 and very lackluster performance in periods 5 and 9. The common thread for all these periods is that 10 year rates started or went above this threshold.
- The good news, is that our models show fair value for the U.S. (and Canadian) 10 year at between 3.5 to 4%, so even when we do get upward pressure on rates, we are unlikely to hit this level for some time. The global macroeconomic environment remains reasonably supportive for metals and bulk commodities. Even with rate hikes now coming through, monetary policy remains loose. More importantly, however, global industrial growth continues at a steady pace. We are still in a stage of the commodities cycle which is demand-led, with supply lagging.

Figure 8: 10-Year Treasury Yield Cycle and Market Returns – When the 10-Year is Rising

Period	Dates	10 Year Starting Level	10 Year Ending Level	No. of Months	S&P Price Return	Annualized Price Return	TSX Price Return	Annualized Price Return
1	Jan 62 - Dec 69	4.1	7.9	96	33.7%	3.7%	49.3%	5.1%
3	Apr 71 - Sep 75	6.1	8.5	54	-19.3%	-4.7%	-2.4%	-0.5%
5	Sept 77 - Sept 81	7.4	15.8	49	20.4%	4.6%	88.3%	16.8%
7	May 83 - Jun 84	10.8	13.8	14	-5.7%	-4.9%	-8.3%	-7.1%
9	Mar 87 - Mar 89	7.5	9.3	25	1.1%	0.5%	-4.3%	-2.1%
11	Oct 93 - Nov 94	5.4	7.9	14	-3.0%	-2.6%	-3.8%	-3.3%
13	Jan 96 - Mar 97	5.6	6.9	15	19.0%	15.0%	17.7%	14.0%
15	Oct 98 - Jan 00	4.6	6.7	16	26.9%	19.6%	36.6%	26.4%
17	Jun 03 - Jul 07	3.5	5	49	54.3%	11.2%	99.1%	18.4%
19	Apr 09 - Mar 10	3.1	3.8	12	34.0%	34.0%	29.1%	29.1%
21	Aug 12 - Dec. 13	1.6	3	17	31.4%	21.3%	14.0%	9.7%
23	Aug 16 - Jan 18	1.5	2.7	18	30.1%	19.2%	9.3%	6.1%
379								
<i>Average</i>					<b>18.6%</b>	<b>9.7%</b>	<b>27.1%</b>	<b>9.4%</b>
<i>Median</i>					<b>23.6%</b>	<b>7.9%</b>	<b>15.9%</b>	<b>7.9%</b>

Source: Bloomberg, BMO Nesbitt Burns

Figure 9: 10-Year Treasury Yield Cycle and Market Returns – When the 10-Year is Declining

Period	Dates	10 Year Starting Level	10 Year Ending Level	No. of Months	S&P Price Return	Annualized Price Return	TSX Price Return	Annualized Price Return
2	Jan 70 - Mar 71	5.5	7.8	15	18.0%	14.1%	3.4%	2.7%
4	Oct 75 - Aug 77	7.9	7.1	23	8.7%	4.4%	7.8%	4.0%
6	Oct 81 - Apr 83	14.6	10.3	19	34.9%	20.8%	27.0%	16.3%
8	Jul 84 - Feb 87	12.9	7.2	32	88.6%	26.9%	63.5%	20.2%
10	Apr 89 - Sept 93	9.1	5.4	54	48.2%	9.1%	10.0%	2.1%
12	Dec 94 - Dec 95	7.8	5.6	13	34.1%	31.1%	11.9%	10.9%
14	Apr 97 - Sept 98	6.7	4.4	18	26.9%	17.2%	-6.1%	-4.1%
16	Feb 00 - May 03	6.4	3.4	40	-29.5%	-9.9%	-24.9%	-8.2%
18	Aug 07 - Mar 09	4.7	2.7	21	-45.2%	-29.1%	-37.1%	-23.3%
20	Apr 10 - Jul 12	3.7	1.5	28	16.2%	6.7%	-4.5%	-1.9%
22	Jan 14 - July 16	2.6	1.5	30	21.9%	8.3%	6.5%	2.5%
293								
<i>Average</i>					<b>20.3%</b>	<b>9.1%</b>	<b>5.2%</b>	<b>1.9%</b>
<i>Median</i>					<b>21.9%</b>	<b>9.1%</b>	<b>6.5%</b>	<b>2.5%</b>

Source: Bloomberg, BMO Nesbitt Burns

## Higher Rates and Sector Returns

To gauge the historical impact of 10 year interest rate increases on sectors we looked at both the U.S. and Canada.

Our partners at Ned Davis Research conducted an analysis looking at the following periods of rising 10-year Treasury Yields: March 30, 1972 to September 30, 1975, December 31, 1976 to March 31, 1980, January 30, 1987 to March 31, 1989, October 29, 1993 to November 30, 1994, October 30, 1998 to January 31, 2000, and June 30, 2003 to May 30, 2006.

The results were generally consistent with our expectations, with Energy and Materials systematically outperforming and utilities lagging. One surprise was the weaker performance for financials perhaps because consumer lending is such a large component of earnings for banks and specialty finance companies and consumer borrowing is curtailed when rates rise.

Conducting our own analysis for Canada (using different time intervals since the sector data only started in the late 1980s) yielded similar results with the exception that the financial sector performed very strongly with rising rates. As expected, Energy and Materials had better performance when rates rose than when they declined.

Figure 10: S&P 500 Sectors

S&P 500 Sectors	Mean Gain %
Energy	32.37
Information Technology	15.74
Materials	10.68
S&P 500 Index	<b>5.67</b>
Industrials	3.93
Health Care	2.05
Telecommunication Services	1.29
Consumer Staples	-1.52
Consumer Discretionary	-2.55
Utilities	-6.95
Financials	-7.96

Source: Ned Davis Research

Figure 11: 10-Year Treasury Yield Cycle and Market Returns – When the 10-Year is Rising

Dates	10 Year Starting Level	10 Year Ending Level	No. of Months	TSX Financials Annualized	TSX Life Insurance Annualized	TSX Energy Annualized	TSX Materials Annualized	TSX Utilities Price Return
Oct 93 - Nov 94	5.4	7.9	14	-1.6%	-4.8%	-12.5%	3.9%	4.1%
Jan 96 - Mar 97	5.6	6.9	15	39.1%	34.6%	25.5%	-5.7%	9.0%
Oct 98 - Jan 00	4.6	6.7	16	-7.9%	-13.7%	4.8%	-0.5%	-27.2%
Jun 03 - Jul 07	3.5	5	49	16.9%	18.1%	27.3%	26.7%	11.3%
Apr 09 - Mar 10	3.1	3.8	12	39.5%	14.9%	23.2%	35.7%	28.8%
Aug 12 - Dec. 13	1.6	3	17	18.8%	43.3%	7.2%	-21.7%	-5.2%
Aug 16 - Jan 18	1.5	2.7	18	14.0%	19.5%	-4.4%	0.8%	0.1%
379								
Average				<b>17.0%</b>	<b>16.0%</b>	<b>10.2%</b>	<b>5.6%</b>	<b>3.0%</b>
Median				<b>16.9%</b>	<b>18.1%</b>	<b>7.2%</b>	<b>0.8%</b>	<b>4.1%</b>

Source: Bloomberg, BMO Nesbitt Burns

Figure 12: 10-Year Treasury Yield Cycle and Market Returns – When the 10-Year is Declining

Dates	10 Year Starting Level	10 Year Ending Level	No. of Months	TSX Financials Annualized	TSX Life Insurance Annualized	TSX Energy Annualized	TSX Materials Annualized	TSX Utilities Price Return
Apr 89 - Sept 93	9.1	5.4	54	0.3%	1.4%	5.1%	1.3%	0.7%
Dec 94 - Dec 95	7.8	5.6	13	12.9%	21.6%	14.1%	8.5%	-1.2%
Apr 97 - Sept 98	6.7	4.4	18	6.2%	59.6%	-12.4%	-23.0%	14.6%
Feb 00 - May 03	6.4	3.4	40	14.5%	12.3%	21.9%	2.1%	20.6%
Aug 07 - Mar 09	4.7	2.7	21	-29.1%	-38.8%	-23.8%	-8.9%	-19.2%
Apr 10 - Jul 12	3.7	1.5	28	-1.8%	-14.8%	-3.7%	-6.3%	6.8%
Jan 14 - July 16	2.6	1.5	30	5.4%	-1.1%	-8.6%	3.5%	6.4%
293								
Average				<b>1.2%</b>	<b>5.7%</b>	<b>-1.1%</b>	<b>-3.3%</b>	<b>4.1%</b>
Median				<b>5.4%</b>	<b>1.4%</b>	<b>-3.7%</b>	<b>1.3%</b>	<b>6.4%</b>

Source: Bloomberg, BMO Nesbitt Burns

## Stock Fair Value Update

Our fair value discounted cash flow models for the S&P/TSX and S&P 500 yield fair values of ~18,000 and 2,850 to 2,900 respectively.

Figure 13: S&P 500 Fair Value

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2018-2021)	\$535.49	18.7%	7%	9.0%
Period 2 (2022-2026)	\$582.64	20.3%	5%	9.0%
Period 3 (2027 - )	\$1,750.42	61.0%	3%	9.0%
<b>Rounded Fair Value</b>	<b>\$ 2,870</b>	100.0%	Next 12 month consensus Implied terminal mult.	140 16.2 X
<b>Current Price</b> (February 5, 2018)	<b>\$ 2,649</b>		Long Bond	2.5%
<b>Upside Potential</b>	<b>8%</b>		Historical Equity Risk Premium	4.5%
			Additional Risk Premium	2.0%
			Total discount rate	9.0%

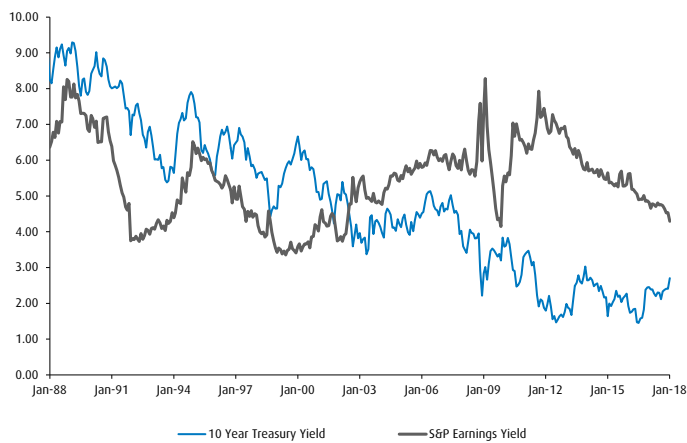
Source: Bloomberg, BMO Nesbitt Burns

Figure 14: S&P/TSX Fair Value

	Present value	% of value	Earnings per share growth	Discount rate
Period 1 (2018-2021)	\$3,424.30	19.0%	7%	9.0%
Period 2 (2022-2026)	\$3,725.80	20.7%	5%	9.0%
Period 3 (2027 - )	\$9,720.86	54.1%	2%	9.0%
<b>Rounded Fair Value</b>	<b>\$ 18,000</b>	93.8%	Next 12 month consensus Implied terminal mult.	970 14.1 X
<b>Current Price</b> (February 5, 2018)	<b>\$ 15,606</b>		Long Bond	2.5%
<b>Upside Potential</b>	<b>15%</b>		Historical Equity Risk Premium	4.5%
			Additional Risk Premium	2.0%
			Total discount rate	9.0%

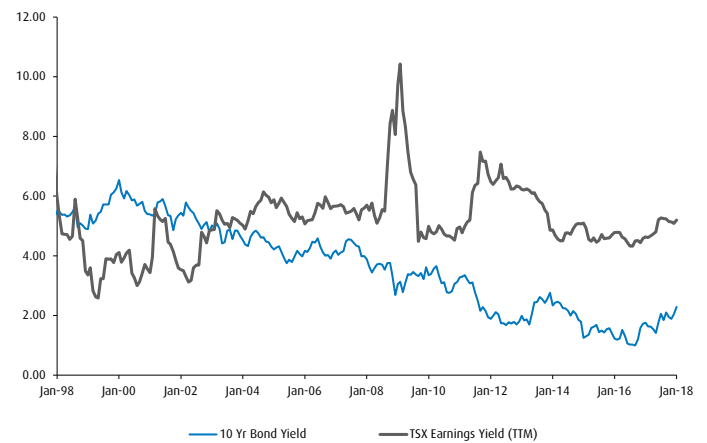
Source: Bloomberg, BMO Nesbitt Burns

Figure 15: S&P 500 Earnings Yield versus 10-year Treasury Yield



Source: Bloomberg

Figure 16: S&P/TSX Earnings Yield versus 10-year Canada Bond Yield



Source: Bloomberg

Figure 17: S&P 500 Index Sector Total Returns to January 2018

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Cons. Discretionary	9.34	9.34
Info. Technology	7.63	7.63
Health Care	6.65	6.65
Financials	6.48	6.48
<b>S&amp;P 500 Index</b>	<b>5.73</b>	<b>5.73</b>
Industrials	5.31	5.31
Materials	4.14	4.14
Energy	3.81	3.81
Consumer Staples	1.59	1.59
Telecom. Services	0.55	0.55
Real Estate	-1.94	-1.94
Utilities	-3.07	-3.07

As of January 31, 2018

Source: Bloomberg

Figure 18: S&P/TSX Composite Sector Total Returns to January 2018

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Info. Technology	5.42	5.42
Financials	0.77	0.77
Cons. Discretionary	-0.34	-0.34
Materials	-0.61	-0.61
Real Estate	-1.21	-1.21
<b>S&amp;P/TSX Composite Index</b>	<b>-1.39</b>	<b>-1.39</b>
Industrials	-1.83	-1.83
Consumer Staples	-1.86	-1.86
Health Care	-4.12	-4.12
Utilities	-4.34	-4.34
Telecom. Services	-4.54	-4.54
Energy	-5.38	-5.38

As of January 31, 2018

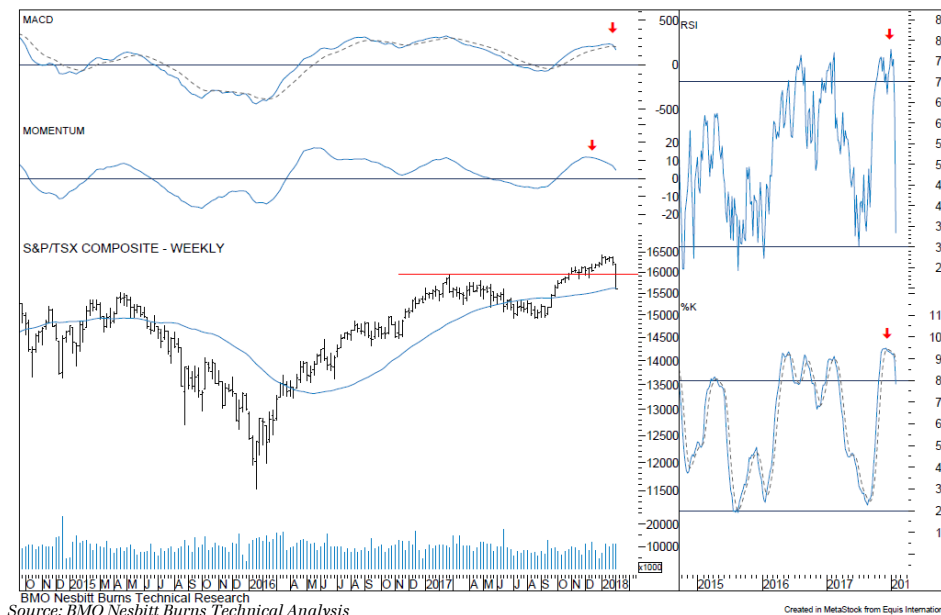
Source: Bloomberg

## The Technical Picture— This Pullback is a Buying Opportunity

Russ Visch, CMT, Technical Analyst

Last month, our comments in this publication were titled “First Quarter Pullback is a Buying Opportunity.” At the time, we were concerned that our medium-term timing models for North American equities were stretched into overbought extremes. Those concerns were only exacerbated as the month progressed until at one point the S&P 500 was more overbought on a medium-term basis than at any time in the 60 years of price history that we have. (This also resulted in the highest reading in our Composite Sentiment Indicator in history!)

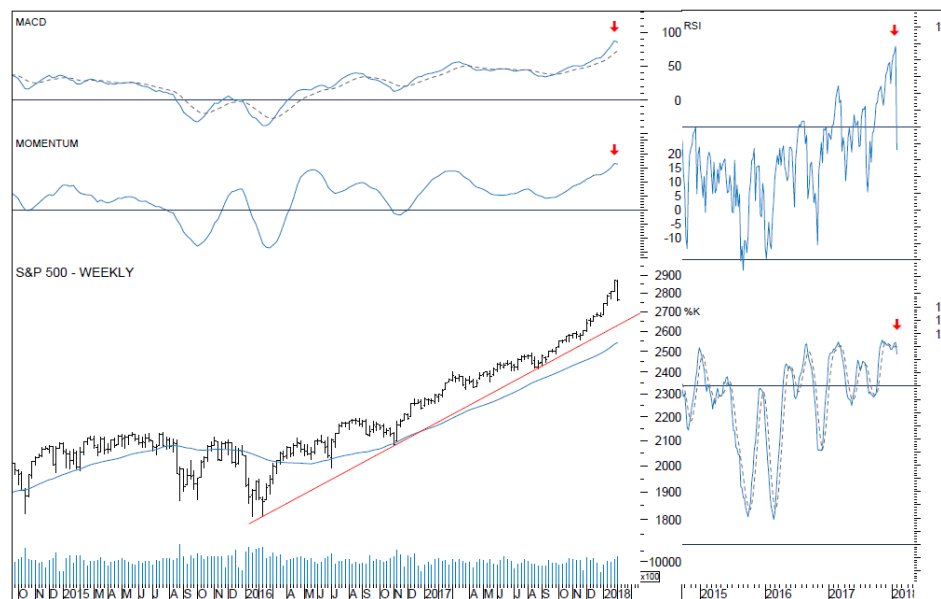
Figure 19: S&P/TSX Composite Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

Created in MetaStock from Equis International

Figure 20: S&P 500 Index Weekly Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis



The pullback materialized in early February, resulting in the biggest one day sell-off in the S&P 500 in more than two years at the beginning of the month. The magnitude of that decline had a material impact on our medium-term timing models, all of which are now deteriorating. This includes price momentum as well as the percentage of stocks above their 10 and 30-week moving averages. Bullish sentiment has also begun to contract from outrageously bullish extremes too which, let’s be frank: if a pullback in equities serves to bring a little fear or skepticism back into the markets, that would be extremely bullish in the long run for stocks.

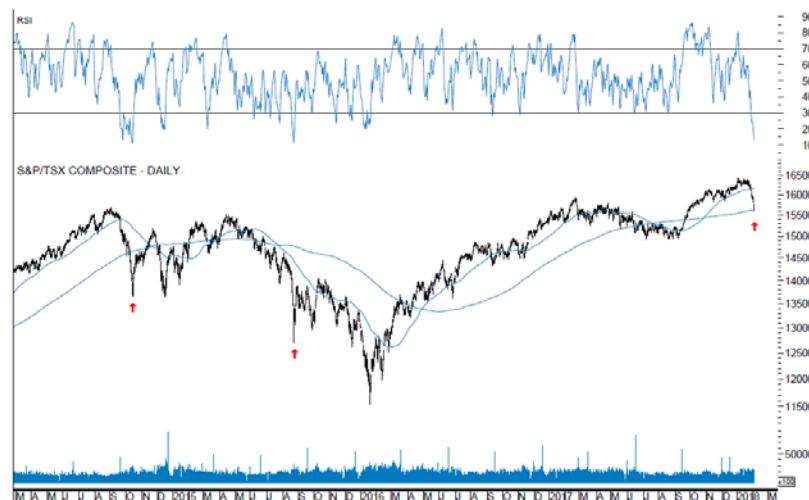
Figure 21: Composite Sentiment Indicator



Source: BMO Nesbitt Burns Technical Analysis

In terms of downside risk for U.S. equities we’re not talking about anything too dramatic. A typical short-term pullback tends to bring an index back to its rising 50-day moving average, which for the S&P 500 is currently at 2715. The next support below that is a rising trendline drawn from the 2016 low currently near 2655. Peak-to-trough that’s a fairly benign 6-7% drop which gets us back to where the index began the year.

Figure 22: S&P/TSX Composite – Daily Momentum Indicators



Source: BMO Nesbitt Burns Technical Analysis

Here in Canada the S&P/TSX Composite has been correcting for more than a month already and is now more oversold on a short-term basis than at any point in the past two and a half years. As we write, the index is also testing support at its rising 200-day moving average. In fact, it’s only ever been this oversold twice in the past five years and in each instance the TSX rallied 10%+ in the following 4-6 weeks. This is the ideal entry point for investors looking to put money to work in Canadian equities since seasonally, the bias for equities remains bullish well into the second quarter.

## General Disclosure

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