BMO Global Asset Management ETF Outlook 2018

The exchange traded fund (ETF) industry had a record breaking year in 2017, reaching new milestones across the globe. Investors continue to recognize the efficiencies of ETFs as fundamental portfolio building blocks. As global news and events impact markets and performance expectations shift, ETFs are increasingly utilised as effective investments to efficiently rebalance portfolios to reflect changing sentiments. ETFs occupy a unique space as go-to-investments for institutions, asset managers, advisors and retail investors. The growing acceptance of combining ETFs with traditional active solutions has accelerated the adoption of ETFs globally.

This outlook report examines how the ETF industry evolved in 2017 and identifies key trends that are expected to shape the industry in 2018.

Global Trends

Global equity markets continued to advance in 2017 which led to record breaking flows into ETFs. The global ETF market exceeded US$4.6 trillion in assets by year end, with over US$649 billion in new assets.[1] This tremendous industry growth has been matched by the emergence of new ETFs that transcend the traditional broad market capitalization index structure, where there are now over 5,300 ETFs globally.[1] The diversity of ETFs and array of opportunities available to investors is now greater than ever. An investor today can access traditional equity and fixed income exposures, in addition to innovative market trends such as artificial intelligence or complex derivative strategies such as swaps or covered calls.

The U.S. ETF market crossed the US$3 trillion milestone this year and now stands at US$3.3 trillion in assets, showing significant growth from previous years with inflows of US$465 billion, a 67% increase from last year.[1] Equity ETFs saw inflows of US$336 billion while fixed income ETFs continued to gain significant inflows with over US$111 billion.[1] The European market had a strong year, with total assets reaching US$762 billion, a 40% increase from last year and inflows of just over US$102 billion.[1] Japanese ETF assets increased by 60.7% to US$272.6 billion, with net inflows to ETFs of US$53 billion.[1] The Asia Pacific ex Japan market had a historic year with inflows of US$8.3 billion and the total ETF market surpassing US$165 billion.[1]

Fixed Income Investing

There was increased demand in 2017 for fixed income ETFs as institutional investors increased appetite for fixed income ETFs while contrarian investors looked to less risky assets to add to their portfolios. Investors sitting on idle cash have also started to look at fixed income investments in 2018 for a way to generate additional income, without taking on a high amount of risk.

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Investors have recognized that as much as the benefits of ETFs have helped with equity investing, the benefits are even more significant with over the counter asset classes such as fixed income. ETFs have provided liquidity, transparency and diversification to an otherwise hard to access and less liquid asset class. ETFs simplify fixed income investing by giving investors easy and efficient access to broad based fixed income exposures or more precise exposure to credit qualities, durations, sectors and maturities.

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Going into 2018, fixed income investors are facing a macroeconomic environment where interest rates are rising, the yield curve is flattening, and inflation might make a comeback. With ETFs, investors have the ability to either build a portfolio, or tilt an existing portfolio to reflect their outlook for interest rate changes, inflation and credit spreads.

Shortening portfolio duration and adding exposure to credit through higher yielding ETFs has proven to be a popular strategy, while contrarian investors benefitted from precise exposures in long term treasuries or corporate bonds.

Valuation Levels and Market Growth

The bull run continued through 2017 where in the U.S., the S&P 500 Index was up 17.32%, the Dow Jones Industrial Average Index was up 24.44% and the NASDAQ Index was up 22.95%.[2] U.S. Tax Reform passed by the White House fueled equity markets. President Donald Trump signed a tax bill that slashed corporate tax rates to 21%, hoping to increase capital expenditures among American companies, create jobs, and bolster U.S. corporations.

The extremely popular FAANG stocks (Facebook, Apple, Amazon, Netflix and Google), were a fundamental driver of market growth in 2017. These global technology and communication giants have been accelerating market growth and pushing indices to new heights. This impact on equity markets has encouraged index providers to consider sector classifications. Indeed, MSCI and S&P Dow Jones Indices (SPDJI) have announced changes to the Global Industry Classification Standard (GICS) for 2018. The Telecommunication Services sector is set to expand and be renamed Communication Services. Some Consumer Discretionary and Technology stocks will relocate to this new sector. The heavily-weighted FAANG stocks will have the greatest impact on ETFs that track the Information Technology, Consumer Discretionary and Telecommunication sectors.

While equity markets have been prosperous through 2017, it is important to highlight that valuations have been high. The S&P 500 Index closed out 2017 with a price-to-earnings ratio of 22.44 which is 67% higher than valuations in 2011.[3] As such, there may be certain stocks that are more over valued than others. While momentum investing outperformed all other factors in 2017, 2018 may see a rotation out of momentum and into value. Value investing performs best when interest rates are rising and in inflationary environments. This has fueled investor interest in value investing, where the ETF market has grown to offer regional factor exposure to this factor.

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The Path Ahead

ETFs deliver efficient access to equities and fixed income across all geographic exposures in addition to low-cost and liquid access to thematic and precise exposures. Investors are becoming increasingly confident in using ETFs and have become more knowledgeable of the advantages and efficiencies of ETF investing. The growth of the ETF market is expected to remain steady, in terms of both an increase in assets and an increase in options, further developing meaningful investment possibilities for investors in 2018.

In terms of exchange traded products (ETPs), 2017 saw 22 new ETPs in Hong Kong, pushing the total to over 133 ETPs.[4] The changing landscape demonstrates the importance of working with an established provider that delivers not just effective products, but has the experience to emphasize the entire ETF infrastructure, including trading, liquidity, education, and support. The challenge for providers is to continue to launch innovative products and to educate investors on the benefits of ETFs. The growth of the industry encourages more niche products, which must be balanced against trading efficiency and liquidity.

We expect the ETF industry to increase its growth trajectory, backed by greater adoption across institutional, advisor and retail platforms. We project the global ETF industry to double to more than US$10 trillion over the next five years.

BMO ETFs

In Asia, BMO offers seven ETFs listed on the Hong Kong Stock Exchange. The diverse range of products is designed to provide local access to global markets and generate high quality income for investors. Recognized for quality and innovative ETFs, BMO has received multiple industry awards, including the recently announced ETF Provider of the Year, Hong Kong, and for the second consecutive year, House Awards for Most Innovative ETF, by the BENCHMARK Fund of the Year Awards 2017 Hong Kong.

To access BMO's range of ETFs in Hong Kong, click here.

[1] ETFGI, December 2017.
[2] Bloomberg, one year month-end total return January 1, 2017 - December 29, 2017.
[3] Bloomberg, December 2017.
[4] HKEX, January 2018.

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