AGF Traditional Income Fund[1]

FUND COMMENTARY FIRST QUARTER 2017 | **FOR ADVISOR USE WITH INVESTORS**

FUND FACTS

FUND CATEGORY:	BENCHMARK INDEX:	DATE OF INCEPTION:	INVESTMENT STYLE:	PORTFOLIO MANAGER:
Canadian equity balanced	60% S&P/TSX Composite Total Return Index, 30% FTSE TMX Canada Universe Bond Index, 10% Barclays Capital US Corporate High Yield Index (Hedged to CAD)**	May 2010	Equity – Bottom-up Bond – Relative value	AGF Investments Inc. Peter Frost, MBA, CFA AGF Fixed Income Team

Market overview

During the first quarter of 2017, global equities continued to move higher, continuing a rally that followed the U.S. election in early November. However, leadership in the market shifted, as the reflation trade that followed the election of Donald Trump to the U.S. Presidency in late 2016 waned, with Financials and cyclical leadership giving way to secular growth sectors. As such, portfolios with growth investment styles performed relatively better in comparison to late-2016 when growth severely underperformed value.

From a macroeconomic perspective, economic data remained supportive and in some cases, saw acceleration. In the U.S., non-farm payrolls exceeded market expectations for the first two months of 2017, averaging gains of 231,000 per month, which was well above consensus, as well as the pace in 2016. Meanwhile, the ISM Manufacturing Index continued to accelerate well into expansion territory, hitting a high of 57.7 in February before settling at 57.2 in March. Similarly the services sector remained robust, with the ISM Non-Manufacturing PMI at 57.6, signalling strong expansion conditions. In response to the strong macroeconomic data, the U.S. Federal Reserve raised the federal funds rate for a third time this cycle in March andtelegraphed more rate hikes to come in 2017 while also mentioning that any future hikes would be “gradual”.

In Canada, equity markets continued their move higher as macroeconomic data remained supportive. Data released during the quarter showed that the Canadian economy grew faster than expected in January, up 0.6% on a monthly sequential basis, and 2.3% on a year over year basis. In fact, seven out of the past eight months have reported monthly GDP gains of 0.3% or better, which is nearly double the 15-year average of 0.17%. Growth was broad-based, with 15 out of 20 major industries reporting gains, led by manufacturing, resources and wholesale trade. The strong GDP print, in addition to other improving Canadian data, is expected to result in upwardly revised growth forecasts, though the Bank of Canada remains dovish and is widely expected to keep rates on hold throughout the year.

After a sustained rise in bond yields during the second half of 2016 due to reflation trends, rising economic activity and optimism following the U.S. election, yields in the first calendar quarter of 2017 remained in a tight range. Bond yields generally fell more in Canada than in the United States, resulting in Canadian bond outperformance during the quarter. Canadian bond yields with maturities of six years and longer declined, while most yields in the short term portion of the curve (maturities up to five years) saw little to no change. However, three-month yields rose about 10 basis points as market participants priced out an interest rate cut by the Bank of Canada as economic growth improved and the U.S. Federal Reserve’s surprise rate hike in March. The long-term portion of the curve outperformed during the quarter, supported by a modest decline in bond yields. Investment grade corporate bonds outperformed government bonds due to tightening spreads, while high yield bonds continued to perform strongly due to spread tightening and higher coupon income. Convertible securities significantly outperformed on the back of a strong rise in equities.

Fund overview

As at Mar. 31, 2017	3 mo.	1 yr.	3 yr.	5 yr.	PSD*
AGF Traditional Income Fund (%) (net of fees)	2.2	10.3	1.9	4.9	5.7
Benchmark (%)**	2.1	12.5	6.1	6.4	6.3
Canadian Equity Balanced category average	2.3	12.7	5.3	7.2	-
Quartile Rank	3	3	4	4	-

Source: AGF Investment Operations, Morningstar.

* Performance start date (PSD): May 7, 2010.

For the quarter ending March 31, 2017, the portfolio outperformed the benchmark, returning 2.2% versus 2.1% for the benchmark. The Fund outperformed due to strong security selection effect within the equities portion of the portfolio. During the quarter the Fund maintained its currency hedge on its U.S. dollar exposure, though this did not impact relative performance as the Canadian dollar remained relatively flat in U.S. dollar terms.

From an asset mix perspective, the Fund’s modest overweight to equities contributed to relative performance, as Canadian equities outperformed fixed income during the quarter.

Within the equities portion of the portfolio, strong security selection in the Energy, Health Care and Financials sectors contributed to relative performance. Overweight allocations to Information Technology and Consumer Discretionary also contributed, while overweights to Health Care and Energy detracted. In terms of individual holdings, the top contributors during the period were Philip Morris International, Lam Research Corp. and Tiffany & Co., while the top detractors were Peyto Exploration & Development Corp., AGT Food & Ingredients Inc. and Perrigo Co. PLC.

The top contributor during the period was Philip Morris International. Having built the world's most iconic tobacco business, Philip Morris has embarked on a strategy to rid the world of cigarettes. Management's vision for a smoke-free future will likely accelerate the decline of its traditional tobacco business, but the development is viewed positively as the company maintains a competitive advantage in reduced risk products, and is scaling the opportunity this year and next. Confidence in Philip Morris' reduced risk business is increasing and has helped drive outperformance in the first quarter.

The top detractor during the period was Peyto Exploration & Development Corp. Peyto is a low-cost, gas-weighted dividend paying intermediate exploration and production company focused on horizontal drilling in the Deep Basin of Alberta. The company reported a relatively uneventful fourth quarter, but its shares declined due in part to a softening in natural gas prices and a challenging outlook through the summer. However, we believe this is the type of market dynamic where Peyto's low cost and profit-focused strategy stands out. Peyto's low cost structure, above average margins, disciplined hedge policy and returns focused strategy are combined with a strong, relatively low risk asset base, which we expect will drive attractive growth through a full gas price cycle.

Outlook

Since the U.S. election, we have seen a remarkable rally in global equity markets, reflecting a more business-friendly policy environment as well as stronger global economic growth. Indeed, we have seen global economic data accelerate throughout the first quarter. With the exception of a few emerging market economies, global real GDP is expanding year over year, and manufacturing PMIs are expanding.

With regards to bond yields, last quarter we wrote about our expectation that the secular low in bond yields may already be behind us, given the acceleration in economic growth that we expect. This remains true, as we have seen the U.S. 10-year bond yield break its multi-year downward trend line, and we are seeing inflation increasing (which we expect to continue). We continue to expect that yields will slowly drift higher, and that low growth, long duration assets will continue to be pressured. As such, we are favouring companies that are demonstrating secular earnings growth momentum.

Overall, despite the assortment of global economic risks, we remain relatively optimistic and constructive on equities. Our view is that both Canada and the U.S. have emerged from recession-like conditions last year, and have accelerated in the first quarter this year. While we believe the cyclical market upturn may pause given the strong run we have already experienced, we believe it is likely not over, and would view any corrections as potential buying opportunities.

We continue to be focused on selecting what we deem to be high-quality stocks with quality assets, high return on investment, strong balance sheets and both sustainable and growing dividends. We believe this approach will endure and over time will prove to outperform through all economic scenarios.

[1] AGF Traditional Balanced Fund merged into AGF Traditional Income Fund on July 10, 2015.

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