AGF Monthly High Income Fund

FUND COMMENTARY SECOND 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, 20% FTSE TMX Canada Universe Bond Index, 20% Bloomberg Barclays U.S. Corporate High Yield Bond Index (hedged to CAD)	January 2005	Bottom-up	AGF Investments Inc. Peter Frost, MBA, CFA AGF Fixed Income Team

Market overview

During the second quarter of 2017, global equities continued to move higher, following a rally that followed the U.S. election in early November of last year. Secular growth sectors such as Information Technology continued to provide market leadership, a trend that began in the first quarter. As such, portfolios with growth investment styles generally outperformed value, as opposed to 2016 when growth severely underperformed value.

From a macroeconomic perspective, data remained supportive and in some cases, saw acceleration. In the U.S., though non-farm payrolls trended lower than the first two months of 2017 which saw an average of 231,000 gains per month, the unemployment rate remained at cycle lows of 4.3%. Meanwhile, the ISM Manufacturing Index continued to accelerate well into expansion territory, hitting a high of 57.8 in June, a level not reached in three years. Similarly, the services sector remained robust, with the ISM Non-Manufacturing PMI at 56.9, signalling continued strong expansionary conditions. In response to the strong macroeconomic data, the U.S. Federal Reserve (Fed) raised the Fed Funds rate in June, the second hike this far in 2017.

In Canada, equity markets slumped in sympathy with weakness in oil prices. During the quarter, WTI oil prices fell after OPEC and other major exporters extended their current deal to limit oil production for nine months. This disappointed investors, who expected deeper cuts. Macroeconomic data, however, remained supportive during the quarter, showing that the Canadian economy grew at a 3.7% annualized rate in the first quarter, with consumer spending more than making up for a slide in exports. The Canadian labour market also remained robust, with job growth accelerating in May to its fastest pace in eight months and continuing to top consensus estimates in June. With the strong macroeconomic data, the Bank of Canada began to signal a more hawkish posture with a possible rate hike coming as early as the third quarter. As such, investors began to price in a greater likelihood of rate hikes, and the Canadian dollar rallied towards the end of the quarter, from 72 cents USD to 77 cents USD between May and the end of June.

In fixed income, the Fed's plan to reduce its balance sheet and hike rates further resulted in higher short term bond yields (up to three-year maturities), while disinflationary dynamics resulted in lower yields in the five-year and longer portion of the U.S. Treasury curve. This resulted in long-term bonds outperforming during the quarter.

A similar trend played out in Canada, though it was more pronounced. The Canadian yield curve flattened, as bond yields up to ten-year maturities rose with market participants pricing in a potential rate hike as early as July, while long-term bond yields declined as inflation and inflation expectations trended lower. Hence, long term bonds outperformed as yields declined.

Overall, corporate bonds outperformed due to spread tightening, with most global fixed income categories outperforming the Canadian bond market.

Fund overview

As at June 30, 2017	3 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD*
AGF Monthly High Income Fund (%) (MF series, net of fees)	-2.9	6.2	-1.7	3.6	3.5	5.6
AGF Monthly High Income Fund (%) F Series	-2.5	7.5	-0.4	4.9	4.7	6.7
Benchmark (%)**	-0.3	9.1	4.0	7.0	5.2	6.7

Source: AGF Investment Operations, Morningstar.

* Performance start date (PSD): Jan. 26, 2005.

For the quarter ending June 30, 2017, the Fund underperformed the benchmark. During the quarter, the Fund maintained its currency hedge on its U.S. dollar exposure. This helped protect U.S. equity returns, as the Canadian dollar appreciated during the period.

From an asset mix perspective, the Fund's modest overweight to equities detracted from relative performance, as Canadian equities generally underperformed fixed income during the quarter.

Within the equities portion of the portfolio, security selection was negative and detracted from relative performance. In particular, selection in Energy and Industrials were the biggest detractors, though this was partially offset by strong selection in Financials and Materials. Overall, sector allocation was positive and also helped offset the detracting factors, as overweight allocations to

Health Care, Consumer Discretionary and Information Technology contributed to performance.

With respect to individual holdings, the top contributors during the period included Lam Research Corp., Las Vegas Sands Corp. and Corus Entertainment Inc., while the top detractors included Ensco PLC, Bonterra Energy Corp. and Cardinal Energy Ltd.

The top contributor during the period was Lam Research Corp. Lam Research is a supplier of etch, deposition, and clean equipment serving the semiconductor industry. The company is the overall leader in the etch market. Companies providing capital equipment to the semiconductor sector have had a strong run this year, driven by continued investments in 3D NAND, which involves stacking cells on chips, reaching a much higher storage density. Though we like the company's prospects, we decided to take profits towards the end of the quarter given the strong run the company's shares have had year to date.

The top detractor during the period was Ensco PLC, which saw its shares decline 44%. Ensco is an offshore driller with 39 jackups and 20 floaters. During the quarter, the company's shares slumped in sympathy with lower oil prices as the offshore rig market remains oversupplied. Ensco also announced an acquisition of Atwood Oceanics in an all-stock transaction. The stock traded lower, however, given near-term dilution resulting from the deal, though it gives Ensco better scale to serve an offshore market seen as migrating in favour of better scaled, globally capable contractors. We continue to hold Ensco given its inexpensive valuation, flattening offshore rig counts, and improving contracting visibility.

Outlook

Since the U.S. election, we have seen a remarkably rally in global equity markets, reflecting a more business-friendly policy environment as well as stronger global economic growth. Indeed, we have seen both Canadian, U.S. and global economic data accelerate throughout the first half of 2017. With the exception of a few emerging market economies, global real GDP is expanding year over year, and manufacturing PMIs are expanding.

Energy has been a source of detraction for our portfolios this quarter, as this year has seen the Energy sector underperform the broader market by one of the largest margins in history. Energy equities have disconnected from oil prices, however, as WTI oil prices remain in a trading range. We remain of the view that over time, supply and demand balance will return to the market and oil prices should drift moderately higher. Within the sector, we continue to endeavour to own companies that can remain profitable at the current range-bound oil price environment.

With respect 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 U.S. 10-year bond yield break their 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 to 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 half of 2017. While we believe the cyclical market upturn may pause given the strong run we have already had, we believe it is likely not over, and would view any corrections as potential buying opportunities.

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

On July 1, 2016, the Fund's benchmark changed from a blended index of 50% S&P/TSX Composite Index / 30% FTSE TMX Canada Universe Bond Index / 20% Barclays Capital U.S. Corporate High Yield Index (Hedged to CAD) to a blended index of 60% S&P/TSX Composite Index / 20% FTSE TMX Canada Universe Bond Index / 20% Barclays Capital U.S. Corporate High Yield Index (Hedged to CAD). The benchmark change was applied from this date forward.

First publication date: July 19, 2017.

What are you doing after work?