AGF Total Return Bond Fund

FUND COMMENTARY FOURTH QUARTER 2016 | **FOR ADVISOR USE WITH INVESTORS**

FUND FACTS

FUND CATEGORY:	BENCHMARK INDEX**:	DATE OF INCEPTION:	INVESTMENT STYLE:	PORTFOLIO MANAGER:
Global bond	20% Barclays Capital Global Aggregate Bond Index, 40% Barclays Capital Global High Yield Index, 40% Barclays Capital EM USD Aggregate Bond Index	June 1994	Top-down fundamental research	AGF Investments Inc. Tristan Sones, CFA

Market overview

The rise in global bond yields that started in early July continued during the fourth quarter, supported by President-elect Trump's surprise victory and a Republican sweep of Congress. Investors priced in higher inflation expectations as a result of the potential for increased fiscal spending and reduced trade under the Trump administration. As well, stronger-than-expected U.S. economic data, a proposed OPEC deal to cut oil production and an appreciating U.S. dollar also fuelled higher rates. Canadian bond yields rose as well but to a lesser degree, which resulted in their outperformance during the quarter. Third quarter U.S. GDP growth was higher than expected at 3.5% compared to 1.4% during the second quarter, the strongest pace of growth in two years.

The U.S. Federal Reserve raised interest rates by 25 basis points at its December meeting, increasing its target range to 0.5% - 0.75%, and continued to emphasize that the path for future rate hikes will be "gradual". In a closely watched referendum vote in December, Italy voted against the reforms proposed by Prime Minister Renzi raising concerns of further fuelling populist movements across Europe. While the geopolitical environment remained a headwind, economic data appeared encouraging as the Euro-area Market Manufacturing PMI came in at 54.9 in December and retail sales expanded 1.1% month over month, compared to a 0.4% contraction in September. At its December meeting, the European Central Bank (ECB) scaled back its monthly bond purchases to €60 billion from €80 billion, but extended its asset purchases by nine months to the end of 2017.

As a result of rising bond yields, government bonds in the short end of the curve (up to 5 years in maturity) outperformed the mid- and long-term potions of the curve. Investment grade corporate bonds outperformed government bonds, which succumbed to steeper losses amid higher rates and meagre coupon income to help offset against rising rates. High yield bonds significantly outperformed most other fixed income categories due to tightening spreads on the prospects of improved economic growth.

Emerging market bonds underperformed during the quarter, though EM corporate bonds were resilient. Rising yields and concern about the Trump administration's stance on trade resulted in EM external bonds underperforming. EM local currency bonds underperformed external bonds in U.S. dollar terms due to EM currency weakness.

Fund overview

As at December 31, 2016	3 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD*
AGF Total Return Bond Fund (%) (net of fees)	-0.6	4.3	4.1	5.5	4.5	6.2
Benchmark** (%)	-0.2	6.9	12.0	11.3	7.9	7.3

Source: AGF Investment Operations.

* Performance start date (PSD): July 9, 2001.

** Effective December 2012, Barclays changed the benchmark name from Barclays Emerging Markets Total Return Index to Barclays Capital EM USD Aggregate Bond Index.

The Fund underperformed its benchmark during the quarter. While the Fund's category allocation contributed positively to returns, an underweight to the U.S. dollar relative to the benchmark more than detracted as the Canadian dollar depreciated during the quarter.

Active currency management detracted from performance. The Fund's underweight to the U.S. dollar detracted as a result of the appreciation of the U.S. dollar, while the Fund's underweight to the euro partially offset results as the euro depreciated relative to the Canadian dollar in November and December.

The Fund's category allocation contributed positively. An overweight to high yield bonds positively impacted returns as spreads continued to tighten amid the rising rate environment. An underweight to emerging market debt modestly detracted as despite declining in value during the period, EM external and corporate bonds generally outperformed developed market government bonds. In particular, the Fund's overweight to EM corporate bonds contributed due to spread tightening. However, out-of-benchmark exposure to EM local currency debt detracted as a result of their underperformance as EM currencies weakened.

The Fund's cash exposure averaged approximately 9% during the quarter, which positively impacted returns as a result of the negative returns across most of the asset class during the quarter.

Outlook

The aftermath of significant geopolitical risks in 2016, which included the UK's decision to leave the European Union and the surprise U.S. election, are likely to result in further uncertainty and volatility in 2017. Prospects for U.S. economic growth look more favourable as a result of President-elect Trump's proposed stimulative fiscal policies, though will depend on what is enacted after his administration takes office on January 20th. Stocks, global bond yields and inflation expectations have moved higher on the prospects of more stimulative U.S. fiscal policy, which may lead to a more aggressive tightening path by the Fed, following the 25 basis point hike on December 14, 2016 – its second hike this cycle. This, alongside the potential for a repatriation of foreign cash held overseas, may lead to a stronger U.S. dollar, which could weigh on U.S. trade next year.

In Canada, economic growth remains challenged in the face of the possibility of increased U.S. protectionism, which could weigh on business investment going forward. However, should U.S. growth strengthen exports in Canada could benefit. As well, should energy prices continue to recover and the Federal government step up the pace of fiscal stimulus, the economy could see firmer growth next year. However, the long-rising housing market is expected to see a marked slowdown in 2017 due to the implementation of several housing policy measures, which may pose challenges to consumer spending (currently over 60% of GDP).

The U.S. should continue on a gradual path of tighter monetary policy barring any material changes to the positive economic momentum held at the end of 2016. The Fed continues to stand in contrast to the accommodative policies exhibited by other central banks around the world, including the European Central Bank and the Bank of Japan. In the European Union (EU), further Brexit negotiations and key elections in Europe are likely to keep the ECB in check. In Canada, we expect the Bank of Canada will remain on hold during 2017 given the uninspiring economic growth environment and trade policy uncertainty.

In the near term bond yields may level off or decline modestly given their rapid rise. However, we anticipate that yields will make another leg higher, supported by more favourable global growth and inflation prospects. By the latter part of the year, though, if rates have indeed moved higher, we believe that yields will be sufficiently high enough to entice investors to increase their fixed income exposure. Furthermore, the economy cannot currently handle a substantial rise in rates.

Our outlook is currently mildly positive as economic growth momentum improves, partially offset by the somewhat elevated valuations of riskier asset classes. Consequently, we prefer corporate bonds over government bonds, which may struggle with rising yields. We are neutral on high yield bonds: while defaults should not be significant in the absence of a recession, valuations are nearer the high end of the historical range, and leverage is rising even as the current economic cycle matures. We continue to be more cautious on EM, especially until we more fully understand the incoming Trump administration's policy intentions and how they will impact various EM countries. While economic growth momentum has picked up more recently, headwinds still exist. Also, while policy remains accommodative in many EM countries, Fed rate hikes will continue to pose a risk. As such, we expect to remain underweight and selective with any new additions to the portfolio.

Effective April 1, 2016, AGF reduced the MF Series management fee from 2.00% to 1.50%. AGF Canadian Bond Fund and AGF Inflation Plus Bond Fund merged into AGF Fixed Income Plus Fund on May 20, 2016. On March 21, 2016, AGF Fixed Income Plus Fund Series Q service fee changed from a maximum of 0.75% to a maximum of 0.50%. Any service fees above 0.50% were automatically reduced.

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