AGF Canadian Small Cap Fund

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

FUND FACTS

FUND CATEGORY:	BENCHMARK INDEX:	DATE OF INCEPTION:	INVESTMENT STYLE:	PORTFOLIO MANAGERS:
Canadian Small-/Mid-Cap Equity	S&P/TSX Small Cap Index	February 1996	Growth	Cypress Capital Management Ltd. Greg Bay, CFA Michael Fricker, MBA, CFA

Market overview

World equity markets were strong in the first quarter of 2017, with positive returns across the board. Emerging markets led the way, with the MSCI Emerging Markets Index up 11.5% (all numbers US$ except Canada in C$). Developed markets were also strong, with Europe up 7.6%, the S&P 500 in the United States up 6.1%, and Japan gaining 4.6%. Canada was the laggard, with the S&P/TSX Composite up 2.4% on weakness in the Energy sector.

A great deal of attention remains focused on the U.S. market as we progress through the early days of the Trump presidency. While investors have given him a ringing endorsement with markets rallying since election day, the reality is that several of his policy proposals have already been stymied (repeal/replace the Afordable Care Act, immigration ban) and questions remain over his ability to enact others that could be potentially more meaningful for markets (tax reform, fiscal stimulus, trade protectionism). Given this backdrop, a significant question for investors is just how much of the market rally and current valuation levels are due to the “Trump trade” and policies that may never materialize versus how much is simply due to quality, persistent U.S. economic growth and a seemingly improving global economy.

Driven by solid U.S. economic growth, the U.S. Federal Reserve followed up on its December 2016 rate hike with another 25 basis points hike in March. While longer-dated bond yields had a short-term upward reaction to the March hike, they have generally returned to pre-hike levels, with the U.S. 10-year Treasury falling slightly to 2.39% from 2.44% at the beginning of the quarter. For its part, the Government of Canada 10-year Bond fell from 1.72% to 1.63%. Also taking a breather as U.S. rates declined slightly was the U.S. dollar, down 1.8% against a basket of major world currencies. The U.S. dollar also had a slight decline versus the Canadian dollar, with the Canadian dollar rising from US$0.744 to US$0.751 despite weaker energy commodity prices and widening 2-year interest rate differentials, both typically negative for the Canadian currency.

Taking a closer look at Canadian equity markets, the S&P/TSX Composite’s 2.4% gain was broad based, with most sectors posting strong returns. Only the Energy and Health Care sectors were down over the quarter (-5.3% and -10.3% respectively). Energy was impacted by weakness in crude oil and natural gas prices as WTI declined 5.8% to US$50.60/barrel, while NYMEX gas declined 14.3% to US$3.19/mmbtu. Additionally, U.S. investors reallocated towards select large caps and U.S. energy companies, and away from some of the senior oil & gas companies in Canada. Valeant Pharmaceuticals was the primary negative factor in the Health Care sector, as it still accounts for half of the sector weight, and declined 24.6% over the quarter. Metals and Mining stocks were strong, with the subsector gaining 8.4%. Copper gained 5.4% to US$2.64/lb on expectations of potentially large U.S. infrastructure spending, while gold gained 8.5% to US$1,249/oz, perhaps driven by inflation concerns associated with Trump’s reflationary policies.

Small-caps underperformed large-caps this quarter, with the S&P/TSX SmallCap Index returning 1.5% versus the S&P/TSX Composite at 2.4%. The major drag on relative performance was the Energy sector. While the Energy weights in the large-cap and small-cap Canadian benchmarks are relatively similar, small-cap Energy names were down 15.8% over the quarter versus the large-caps down a more modest 5.3%. The difference was largely driven by a heavier small-cap weighting in the harder hit Explorers & Producers.

Fund overview

As at March 31, 2017	3 mo.	6 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD**
AGF Canadian Small Cap Fund (%) (net of fees)	2.8	4.9	16.0	3.0	5.3	2.1	8.1
[1]S&P/TSX Small Cap Index (%)	1.5	4.6	29.5	3.3	4.1	3.5	8.8

Source: AGF Investment Operations.

** Performance start date (PSD): February 16, 1996.

AGF Canadian Small Cap Fund outperformed its S&P/TSX SmallCap Index benchmark during the quarter, returning 2.8% versus 1.5% for the benchmark. Outperformance was driven by sector allocation, most notably by an underweight position in the worst performing Energy sector. Also contributing was an overweight Technology position, which was the top performing small-cap sector over the quarter. Somewhat offsetting was an underweight position in Materials, which rebounded strongly after a weak fourth quarter of 2016.

Security selection was largely neutral overall with positive selection in Real Estate (+11.2% performance compared to the benchmark at +6.2%) and Consumer Discretionary (+9.8% versus +0.9%) the largest contributors. Selection in Technology (+7.4% compared to the benchmark at +14.2%) and Materials (+9.5% versus 12.5%) were the largest detractors. Technology selection was impacted by not holding Sierra Wireless (up 68%)

while Materials were impacted by an underweight position in the strong Metals & Mining subsector.

The Fund had individual companies from a number of sectors that generated strong returns this quarter. Notable performers included FirstService (+26%), New Flyer Industries (+21%), Martinrea International (+21%) and Canfor Pulp Products (+20%).

At quarter end, the fund remains most significantly underweight Energy with an allocation of 12.4% versus the benchmark's 22.9% and Materials with an allocation of 16.3% versus the benchmark's 25.5%. We remain in favour of a more broadly diversified sector mix with higher weights in Real Estate, Financials and Utilities compared to the resource heavy benchmark.

Outlook

As the world's first full quarter with a Trump presidency comes to a close, we join other investors in pondering whether recent market strength has been driven by a strengthening U.S. and global economy, or whether it's been the President's pro-business/reflationary stance. If it is the latter, the risk remains that the market could be disappointed by policies that never come to fruition yet whose benefits may already be priced in. Indeed, we also wonder whether the market is ignoring the risks associated with a Trump presidency. Strident trade protectionism could actually lead to a negative economic shock. Large tax cuts and fiscal stimulus in the form of infrastructure spending could lead to outsized deficits. A tough policy on immigrants could lead to social unrest. And foreign relations with Russia, China, North Korea, Syria, etc. are a complete wild card.

In the midst of geopolitical uncertainty, and still weak global economic growth, the global economy still appears susceptible to shocks. Further concerns include China, as its growth continues to slow, and the rise of populism in Europe and potential impact on the European Union. In Canada, despite surprisingly strong recent economic figures, we face our own economic challenges, including a highly indebted consumer, a stretched housing market and a hollowed-out manufacturing base that hasn't really benefited from the lower Canadian dollar. We also now have trade concerns and the potential for the United States, led by Donald Trump, to tear up the North American Free Trade Agreement.

On balance, we're taking a moderately cautious view. Canada should be expected to benefit from a stronger U.S. economy, but we do not see a particularly robust Canadian economy with strong earnings growth, nor do we see particularly attractive valuations for equities. However, the risk/reward appears much more attractive for equities as compared to fixed income, and the fact is that valuation levels can remain at relatively elevated levels for a number of years, with the potential for markets to grow into those valuations. In this environment, our overall strategy remains the same, with a focus on companies with strong competitive positions and those who trade at attractive valuations. We expect these will perform well over the long-term, even if there is short-term market volatility.

[1]The benchmark performance is as of the nearest month-end to the performance start date of the Fund. On January 1, 2014, the Fund's benchmark changed from the BMO Small Cap Blended Total Return Index (Weighted) to the S&P/TSX Small Cap Total Return Index. The benchmark change was applied from this date forward.

AGF Canadian Small Cap Discovery Fund merged into AGF Canadian Small Cap Fund on May 20, 2016.

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