AGF Canadian Small Cap Fund

FUND COMMENTARY SECOND 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 generally positive in the second quarter of 2017, with most markets posting strong returns. Emerging markets as a group were the strongest, gaining 6.4% (all numbers in US$ except Canada in C$). Developed markets were also strong, with Europe up 7.7% on a much improved outlook and Japan gaining 5.2%. Foreign market returns recieved a boost from a weakening U.S. dollar, which declined 4.7% for the quarter against a basket of major currencies. In North America, the S&P 500 in the Unites States hit a new all-time high in June and closed the quarter up 3.1%. Canada was the laggard, with the S&P/TSX Composite posting a negative return for the quarter, down 1.6%.

Taking a closer look at Canadian equity markets, the S&P/TSX Composite's 1.6% decline was driven by the largest three sectors with Energy, Materials and Financials all in negative territory, down 8.3%, 6.4% and 0.9%, respectively. Energy continued to be impacted by weakness in crude oil and natural gas prices, with WTI oil declining 9.0% to US$46.04/barrel while NYMEX natural gas declined 4.9% to US$3.04/MMBtu. Materials weakness was driven by the Metals and Mining subsector, which also saw some weakness in commodity prices. All other sectors were in positive territory, with Health Care leading the way up 13.5% (driven by Valeant Pharmaceuticals +53.4%) and Industrials up 6.0%.

Small-caps underperformed large-caps this quarter, with the S&P/TSX SmallCap Index declining 5.5% versus the S&P/TSX Composite down 1.6%. While small-cap underperformance was broad based with most sectors underperforming, the largest drag on relative performance was the hard-hit Energy sector. While overall Energy weights in the large-cap and small-cap Canadian benchmarks are relatively similar, the small-cap index has a heavier weighting in Explorers & Producers, which are more sensitive to changing commodity prices. Small-cap Energy names were down 15.9% over the quarter versus the large-caps down a more modest 8.3%.

Looking beyond equity markets, the other significant market event over the quarter was central bank activity and posturing. The U.S. Federal Reserve hiked rates by 25 basis points (bps) in June, following similar rate hikes in December 2016 and March 2017. The reduction in monetary stimulus reflects the strength of the U.S. economy, notably unemployment hitting a 16-year low of 4.3%. Further tightening of the labour market is expected to return inflation to more normalized levels and drive a gradual normalization of monetary policy. This will mean further Fed rate hikes and a gradual unwinding of the bulk of the Federal Reserve's US$4.5 trillion balance sheet, which will also contribute to rising interest rates.

In Canada, the central bank shifted their tone suddenly and dramatically during the quarter, driven by a surprisingly strong start to the year for the economy. With strong job growth and the Canadian consumer remaining resilient, the Bank of Canada called into question the need to maintain the two "emergency" 25 bps cuts implemented in 2015 as oil prices were crashing. Having prepped the market, the BoC proceeded to hike rates by 25 bps in early July and expectations are that they will follow up later in the year with another 25 bps hike.

The Canadian economy has been solid, with unemployment down to 6.6%, while corporate profits are almost back to the levels of 2014's pre-oil crash. The consumer has remained strong, and concern about rate hikes driving the Canadian dollar even higher and negatively impacting exports is somewhat mitigated by expectations that the U.S. Federal Reserve will also continue hiking rates. Driven by the Bank of Canada's change of tone, the Canadian dollar has rallied 2.7% over the past quarter and 6.1% since early May.

Fund overview

As at June 30, 2017	3 mo.	6 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD**
AGF Canadian Small Cap Fund (%) (net of fees)	1.1	3.9	11.8	1.6	7.5	1.3	8.0
[1]S&P/TSX Small Cap Index (%)	-5.5	-4.1	3.8	-1.6	5.7	2.2	8.2

Source: AGF Investment Operations.
** Performance start date (PSD): February 16, 1996.

The AGF Canadian Small Cap Fund outperformed its S&P/TSX SmallCap Index benchmark during the quarter, returning 1.2% versus a 5.5% decline for the benchmark. Outperformance was driven by security selection to a greater extent and sector allocation to a lesser. Standout contributors were Materials (+8% performance compared to the benchmark at -5%), Consumer Discretionary (+10% versus -8%) and Financials (+6% versus -4%). The largest contributor from a sector allocation perspective was an underweight position in Energy, the worst performing sector over the quarter, down 16%.

Materials outperformance was driven by a notably underweight position in Metals & Mining, which performed poorly. Consumer

Discretionary performance was aided by the portfolio's Sleep Country Canada position, up 28%, and no position in Aimia Inc., down 78%. Financials were bolstered by Home Capital Group, up 76% and Real Matters, up 31%.

The Fund's position In Home Capital was initiated opportunistically during the quarter following the dramatic sell-off in the company's shares, and closed out following a strong recovery in the share price. Real Matters, a long-time holding of the Fund, completed its IPO during the quarter. Other standout performers over the quarter were Merus Labs (+32%) on the news that it had received an attractive takeover offer, and Major Drilling Group (+20%).

Outlook

While we view the recent Bank of Canada rate hike as appropriate, increasing rates in the face of highly indebted consumers, a stretched housing market, and bank regulators looking to further cool the housing market does pose a notable risk to the strength of the Canadian economy. Other challenges include a hollowed-out manufacturing base that hasn't really benefited from the lower Canadian dollar and ongoing trade concerns related to the renegotiation of the North American Free Trade Agreement.

While global economic momentum appears solid, with a European recovery underway and North America reaching new employment and GDP peaks post the financial crisis, the global economy still appears susceptible to shocks. The gradual unwind of the massive worldwide stimulus that supported the recovery looks set to begin, posing a headwind to growth. In the United States, all of the elevated risks associated with a Trump presidency remain. And in China, the world's second largest economy, credit-fueled growth appears to us increasingly unsustainable. Broad geopolitical risks involving Russia, China, North Korea, Syria, etc. remain.

As for market risks, notwithstanding the strength of the U.S. economy, the risk remains that much of President Trump's pro-business/reflationary stance (i.e. tax reform, fiscal stimulus, trade protectionism) may never come to fruition. The reality is that several of his policy proposals have already been stymied or hampered (repeal/replace Obamacare, immigration ban) and much of Trump's political capital has been destroyed by the ongoing investigations into Russian involvement in the election. To the extent that U.S. equity market strength has been driven by the proposed agenda, the risk remains that the market could be disappointed.

On balance, we're taking a moderately cautious view on equity markets. Within the context of well above average valuations, a tightening Federal Reserve and Bank of Canada, and a significantly extended period without a market correction, we wouldn't be surprised to see some downside volatility ahead for markets. Expanding valuations (i.e. P/E multiples) have been the main driver of market performance for quite some time, and a shift to earnings growth as a driver poses challenges if expectations are not met. However, we believe that stock picking will be increasingly more important and provide opportunities as stock correlations have dropped significantly of late. In this environment, our overall strategy remains the same, with a focus on good companies with strong competitive positions, that trade at attractive valuations and that we expect will perform well over the long-term, despite 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.

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