AGF Fixed Income Plus Fund

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

FUND FACTS

FUND CATEGORY:	BENCHMARK INDEX:	DATE OF INCEPTION:	INVESTMENT STYLE:	PORTFOLIO MANAGER:
Canadian bond	FTSE TMX Canada Universe Bond Index	November 1998	Top-down macroeconomic approach with bottom-up fundamental security selection	AGF Investments Inc. David Stonehouse, MBA, 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, taking 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 protect against rising rates. High yield bonds significantly outperformed most other fixed income categories due to tightening spreads and higher coupon income.

Fund overview

As at Dec. 30, 2016	3 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD*
AGF Fixed Income Plus Fund (%)	-3.2	0.3	2.9	2.3	3.3	4.3
Benchmark** (%)	-3.4	1.7	4.6	3.2	4.8	5.4

Source: AGF Investment Operations.

* Performance start date (PSD): Nov. 30, 1998.

** Benchmark is FTSE TMX Canada Universe Bond Index

The Fund outperformed the benchmark during the quarter. The Fund's overweight to investment grade corporate bonds and out-of-benchmark exposure to high yield bonds and convertible debentures contributed positively as spreads tightened. A shorter duration stance relative to the benchmark also contributed positively as bond yields climbed during the quarter. The Fund's modest exposure to the U.S. dollar (after hedging activity) contributed positively as the U.S. dollar appreciated relative to the Canadian dollar during the quarter. The Fund's overweight to long-term Government of Canada bonds modestly detracted in the higher yield environment.

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 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 (almost 60% of GDP) going forward.

As the U.S. continues on a gradual path of tighter monetary policy, barring any material changes to the positive economic momentum held at the end of 2016 or any major geopolitical or event risks, 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.

In the near term bond yields may decline modestly given the magnitude and rapidity of the rise, coupled with extreme market positioning in favour of rising yields. However, we anticipate that yields will make another move higher, supported by more favourable global growth and inflation prospects as the North American economy continues to recover from weak growth earlier last year. By the latter part of the year, though, if rates have moved higher we believe that bonds will become increasingly enticing for investors. Furthermore, a market rate increase too substantial is likely to start crimping economic activity. Already, higher mortgage rates appear to be affecting demand for housing loans.

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 investment-grade 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 believe that equities, and hence convertible bonds, should benefit from monetary and fiscal stimulus this year as economic activity improves. However, longer term annualized equity returns are unlikely to match those since the crisis due to fairly expensive valuations and subpar growth prospects versus historical norms.

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