AGF Fixed Income Plus 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 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

U.S. economic data undercut expectations in the second quarter, with downside surprises in manufacturing, retail sales and employment. Nevertheless, GDP growth improved from the anemic levels of the first quarter. Despite declining inflation and inflation expectations, the Federal Open Market Committee (FOMC) hiked rates in June by 25 basis points, the fourth rate hike this cycle. The Fed also indicated it intends to reduce its bond holdings, though gave no details on timing.

In Canada, the economy grew at an annualized pace of 3.7% during the first quarter, outperforming the majority of developed economies, although the pace of growth appeared to moderate in during the second quarter based on preliminary data. Employment trends continued to improve, with 54,500 jobs being added in May, well ahead of expectations. Inflation continued to trend lower in May, to the lowest level since 1999. Despite this, however, the Bank of Canada hinted that it may hike rates this year.

In Europe, the economy grew 1.9% on an annualized basis in the first quarter of 2017, its fastest pace in a year. Economic data during the second quarter showed ongoing improvement in manufacturing, but inflation remained well under the ECB's 2% target, at 1.3% year-over-year in June6. The benign outcome of the French election that witnessed centrist Candidate Emmanuel Macron beat far-right Front National candidate Marine Le Pen, also bolstered confidence, as did efforts to resolve banking challenges in Italy and Spain.

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. Despite lower oil prices, the Canadian dollar appreciated on the prospects of higher short term rates in Canada.

Corporate bonds outperformed due to spread tightening, and U.S. convertible bonds performed strongly alongside rising equity markets. Emerging market bonds also performed well as economic fundamentals showed improvement. EM sovereign bonds generally performed in line with U.S. corporate bonds during the quarter (in U.S. dollar terms), with most global fixed income categories outperforming the Canadian bond market.

Fund overview

As at Jun. 30, 2017	3 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD*
AGF Fixed Income Plus Fund (%) – Series F	0.7	0.8	3.0	3.3	4.4	5.6
AGF Fixed Income Plus Fund (%) – Series A	0.6	-0.4	1.8	2.3	3.5	4.3
Benchmark** (%)	1.1	0.0	3.8	3.3	5.1	-

Source: AGF Investment Operations.
* Performance start date (PSD): Class F: Apr. 16, 2001, Class MF: Nov. 30, 1998.
** Benchmark is FTSE TMX Canada Universe Bond Index

The Fund underperformed the benchmark during the quarter.

The Fund's overweight to corporate BBB-rated bonds relative to A-rated credits detracted, as lower quality bond spreads in sectors like Energy (oil prices) and Financials (housing concerns and rising rates) widened relative to A-rated bonds. As well, an underweight to long-dated provincial bonds, in favour of corporate bonds, detracted. Provincial bonds with long maturities significantly outperformed during the quarter as long-term bond yields declined, while spreads modestly tightened. Modest exposure to the U.S. dollar after hedging activity detracted due to the appreciation of the Canadian dollar. The Fund's small exposure to inflation-linked bonds adversely impacted returns as inflation-breakeven rates declined.

A modestly short duration stance contributed positively to performance as Canadian government bond yields up to ten years in maturity rose during the quarter. The Fund's overweight to long term Government of Canada bonds helped returns as long bond yields declined. The Fund's overweight allocation to investment grade corporate bonds and out-of-benchmark exposure to high yield bonds contributed to returns due to spread tightening. The Fund's U.S. convertible bond exposure also contributed due to the outperformance of U.S. convertible bonds.

Outlook

Global growth continues to accelerate, supported by both developed and emerging economies. The U.S. labour market remains on solid footing, while industrial output and real consumption spending are on track to grow significantly relative to the first quarter of the year. However, weak inflation is a concern and its impact on the future path of monetary policy remains to be seen. The Fed remains committed to tightening as financial conditions remain healthy, and it even modestly upgraded its growth forecast this year. We expect the Fed to announce its intention to unwind its balance sheet as early as September by rolling off maturing Treasuries, mortgage-backed securities and agency debt. On the fiscal front, the lack of progress on health care and tax reform has contributed to economic and market uncertainty, as has President Trump's political difficulties, but expectations are now so low that any policy successes may provide upside surprises. Geopolitical risks such as North Korea, as well as trade protectionism are among potential risks on the horizon.

In Canada, the strong pace of economic growth is likely to moderate with struggling oil prices and a decelerating housing market. In Ontario, the Liberal government's introduction of legislation to cool the overheated housing market has already started to work as home sales and prices have started to decline. However, it remains to be seen whether these new measures will have a temporary effect on house prices, similar to Vancouver's experience when housing measures were introduced last year. We anticipate a third quarter rate hike by the Bank of Canada, as hinted by Senior Deputy governor Wilkins and further echoed by Governor Poloz last quarter, with the potential for more hikes if the economy continues to move toward its full potential. In Europe, we anticipate that the European Central Bank will announce a reduction in asset purchases before the end of the year.

We anticipate that bond yields will move higher if global growth continues to improve. Inflation in the developed economies remains below target, and developments on this front will be a key element influencing the path of bond yields and monetary policy.

Our outlook continues to be mildly positive as economic growth momentum continues, partially offset by the somewhat elevated valuations of riskier asset classes. Consequently, we prefer investment-grade corporate bonds over government bonds, which may struggle if yields rise. We are neutral on high yield bonds: while defaults should not be significant in the absence of a recession and corporate fundamentals have improved recently, we are in the late stage of the cycle in our view, and valuations are closer to the high end of their historical range. We believe that equities, and hence convertible bonds, should still perform well relative to bonds in the medium term as earnings growth continues to rebound along with economic growth.

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