AGF Diversified Income 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 balanced	50% FTSE TMX Canada Universe Bond Index / 25% Barclays Capital U.S. Corporate High-Yield Index (local) / 10% S&P/TSX Composite Index / 15% MSCI All Country World Total Return Index (local)	March 2003	Equity: GARP Fixed income: Top-down fundamental approach with a bottom-up approach to corporate bond 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 years1. In response, 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 Europe, a closely watched referendum vote in December saw Italy voting 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 September2. 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 20173.

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.

Canadian equities recorded a strong fourth quarter, outperforming U.S. equities during the quarter and for the calendar year. In both markets, cyclical sectors outperformed with Financials significantly outperforming due to rising interest rates, while Energy and Industrials also recorded strong outperformance as a result of Trump`s proposed policies, and OPEC's deal in the case of Energy.

Fund overview

As at Dec. 31, 2016	3 mo.	1 yr.	3 yr.	5 yr.	10 yr.	PSD**
AGF Diversified Income Fund (%)	-0.9	1.5	3.6	4.9	4.1	9.4
Benchmark (%)	-0.7	8.9	5.4	5.6	4.8	-

Source: AGF Investment Operations.
**Performance start date (PSD): March 31, 2003.

The Fund's equity exposure detracted from returns relative to the benchmark. Sector allocation detracted, while security selection did not materially impact performance. An underweight to the outperforming Financials and Energy sectors and overweights to the underperforming Health Care and Consumer Staples sectors detracted. An underweight to Real Estate and Utilities contributed positively.

The Fund's fixed income positioning contributed positively to returns. An overweight to investment grade corporate bonds contributed positively due to their outperformance as credit spreads tightened. The Fund's overweight to U.S. and Canadian high-yield bonds, including convertible bonds also contributed positively as credit spreads tightened. The Fund's shorter duration stance relative to the benchmark also contributed as yields rose materially during the quarter.

Outlook

The aftermath of significant geopolitical events 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 and border adjustability tax reform, may lead to a stronger U.S. dollar, which could weigh on U.S. trade next year.

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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 if the federal government steps 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 as well as modestly higher rates, 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.

** On April 2, 2012, the benchmark changed from a blended index of 50% FTSE TMX Canada Universe Bond Index / 25% Barclays Capital U.S. Corporate High-Yield Index / 15% S&P/TSX Composite Index / 10% MSCI World REIT Index Net to a blended index of 50% FTSE TMX Canada Universe Bond Index / 12.5% Barclays Capital U.S. Corporate High-Yield Index (local) / 12.5% FTSE TMX Canada High-Yield Bond Index / 15% S&P/TSX Composite Index / 10% MSCI World REIT Index Net. Then on June 1, 2013, the benchmark changed to a blended index of 50% FTSE TMX Canada Universe Bond Index / 20% Barclays Capital U.S. Corporate High-Yield Index (local) / 5% FTSE TMX Canada High-Yield Bond Index / 15% S&P/TSX Composite Index / 5% MSCI World REIT Index Net / 5% MSCI All Country World Total Return Index (local). Then on June 1, 2016, the benchmark changed to a blended index of 50% FTSE TMX Canada Universe Bond Index / 25% Barclays Capital U.S. Corporate High-Yield Index (local) / 10% S&P/TSX Composite Index / 15% MSCI All Country World Total Return Index (local). In all cases, the benchmark change was applied from that date forward. In all cases, the benchmark change was applied from that date forward. On August 12, 2009, unitholders approved a change in the investment objective increasing the portfolio's diversification to include high-yielding and dividend-paying securities. AGF Investments Inc. replaced Acuity Investment Management Inc. as portfolio manager, effective April 17, 2015. Commentary and data sourced from Bloomberg, Reuters and company reports. The commentaries contained herein are provided as a general source of information based on information available as of December 31, 2016 and should not be considered as personal investment advice or an offer or solicitation to buy and/or sell securities. Every effort has been made to ensure accuracy in these commentaries at the time of publication; however, accuracy cannot be guaranteed. Market conditions may change and the manager accepts no responsibility for individual investment decisions arising from the use of or reliance on the information contained herein. References to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations by AGF Investments. The specific securities identified and described in this commentary do not represent all of the securities purchased, sold or recommended for the portfolio, and it should not be assumed that investments in the securities identified were or will be profitable. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in share and/or unit value and reinvestment of all dividends and/or distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed; their values change frequently and past performance may not be repeated. The payment of distributions should not be confused with a fund's performance, rate of return or yield. If distributions paid by the fund are greater than the performance of the fund, your original investment will shrink. Distributions paid as a result of capital gains realized by a fund, and income and dividends earned by a fund, are taxable in your hands in the year they are paid. Your adjusted cost base will be reduced by the amount of any returns of capital. If your adjusted cost base falls below zero, you will have to pay capital gains tax on the amount below zero.The information contained herein is designed to provide you with general information related to investment alternatives and strategies and is not intended to be comprehensive investment advice applicable to the circumstances of the individual. We strongly recommend that you consult with a financial advisor prior to making any investment decisions.

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