AGF Tactical Income Fund[1]

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

FUND FACTS

FUND CATEGORY:	BENCHMARK INDEX:	DATE OF INCEPTION:	INVESTMENT STYLE:	PORTFOLIO MANAGERS:
Canadian Balanced	60% S&P/TSX Composite Index / 25% FTSE TMX Canada Universe Bond Index / 15% S&P/TSX Capped REIT Index	March 2003	Fundamental Bottom-up	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.	10yr.	PSD**
AGF Tactical Income Fund (%) (net of fees)	3.0	6.5	14.4	6.4	7.3	2.3	7.9
[2]Benchmark (%)	2.3	4.3	13.0	5.8	6.6	4.9	8.6

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

The AGF Tactical Income Fund outperformed its benchmark over the quarter, returning 3.0% compared to the benchmark at 2.3%. The outperformance was driven in part by asset allocation, specifically an overweight in equitities which outperformed bonds, and a position in preferred shares, which outperformed both bonds and equities.

Within the equity component of the portfolio, the Fund outperformed the S&P/TSX Composite Index, with sector allocation being the primary driver. Specifically, the Fund was underweight the poor performing Energy, which was the worst performing sector outside of Health Care. The Fund also benefitted from its U.S. and International Equity holdings, which outperformed their Canadian equity counterparts. Offsetting somewhat was an underweight position in Materials.

Security Selection also contributed to outperformance, driven by Financials (Brookfield Asset Management +10%) and Real

Estate (Milestone Apartments REIT +12%). Selection in Consumer Discretionary was a relative drag during the quarter (Magna -1%).

A number of the portfolio's larger holdings performed very well, including Apple (+25%), Rogers Communications (+15%), Algonquin Power & Utilities (+13%) and Milestone Apartments REIT (+12%). The Fund's position in preferred shares was up 9% as a group.

Within the fixed income portion of the portfolio, the Fund outperformed relative to the FTSE TMX Canada Universe Bond Index due to an overweight position in corporate bonds, notably high yield bonds, and an underweight position in government bonds.

From an asset allocation standpoint, the Fund made no major tactical changes over the quarter. However, several new positions were opportunistically initiated in Canadian equities that we believe present attractive value and growth profiles.

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]On August 12, 2009, the Fund changed its investment objective to permit investments in corporate debt of any grade.
[2]On May 1, 2012, the Fund's benchmark changed from a blended index of 75% S&P/TSX Composite Index / 25% FTSE TMX Canada Universe Bond Index to a blended index of 60% S&P/TSX Composite Index / 25% FTSE TMX Canada Universe Bond Index / 15% S&P Capped REIT Index. The benchmark change was applied from this date forward.

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