AGF PERSPECTIVES

MARKETS

Grinding our way higher:

An inside take on the global economy, financial markets and how to position your portfolio for success

Members of AGF Management Limited's board of directors were joined by members of AGF's investment management team for a special roundtable discussion during its recent quarterly meeting in Toronto at the end of March. Informed by the diverse expertise of all six participants, the conversation provided a number of insights on a range of topics that are crucial to understanding the current landscape facing investors.

Questions and answers that follow have been edited for clarity and length.

The Participants

Jane Buchan, PhD, CAIA

Chief Executive Officer & Co-Chief Executive Officer, PAAMCO & PAAMCO Prisma Holdings

Kathleen Camilli

Founder and Principal, Camilli Economics, LLC

Kevin McCreadie, CFA, MBA

President and Chief Investment Officer
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John Christofilos

Senior Vice-President & Chief Trading Officer
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David Stonehouse, CFA, MBA

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Regina Chi, CFA

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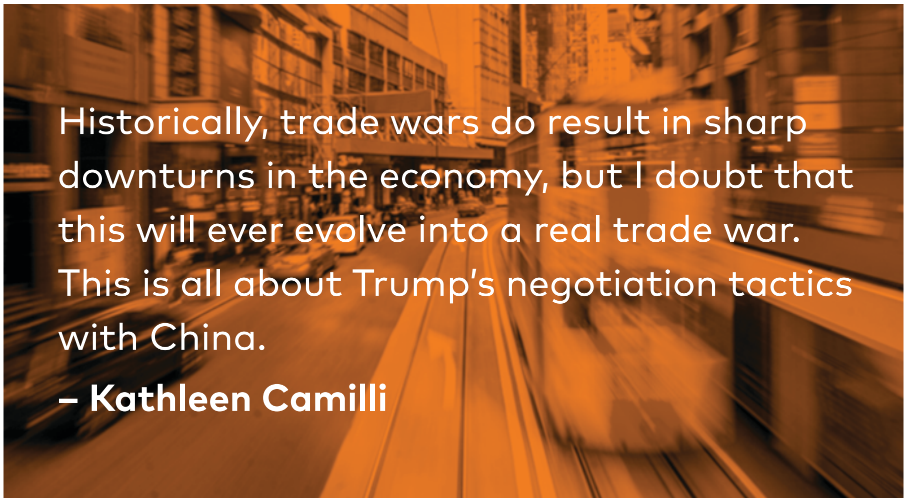

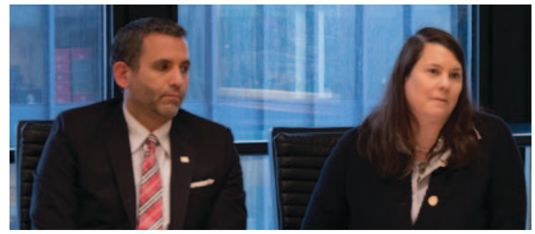

The Global Economy

What's your take on the global economy?

Kevin McCreadie: If you put market volatility to the side and don't think about what we've witnessed the past two months, the global economy is doing quite well, probably the best in 10 years. We are finally seeing a coordinated acceleration in growth across North America, Europe, Japan and even China. The question now is how much better can these economies do in the face of a possibly big [central bank} tightening regime that is beginning to play out in the developed world.

David Stonehouse: The Fed has now raised interest rates six times since the end of 2015, but if you look at the shadow fed funds rate – which takes quantitative easing into account – it really started hiking around the time of the Taper Tantrum set off by [former Fed Chair Ben] Bernanke's speech on slowing the pace of bond purchases in May 2013. Now, the Fed is being joined by some of the other central banks, notably the Bank of Canada, so we are getting later in the cycle and getting to the point where higher rates are going to bite. But looking at some of the leading economic metrics, there is no way that a recession is imminent in our view. This has room to play out.

Kathleen Camilli: In the U.S., we've got [President] Trump's tax reform and the potential of a US$1-trillion infrastructure program being put into place. We could see an end-of-cycle scenario where growth ramps up over the next two years to the 3 or 4% range that would lead to higher inflation over time given the low unemployment rate.

Regina Chi: From an emerging markets perspective, economies are much better placed than they were in the last Taper Tantrum. Most countries are in a better current account surplus position and GDP growth is two to two-and-a-half times greater than developed market growth. So we're positive on EM.

KM: This is not the EM of old. The make-up today is not so much commodity-based. These are much more balanced economies that will be able to better withstand a shock to the system.

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> **– Kevin McCreadie**

Is there any threat of a recession in the near future?

KM: No one on our team thinks a recession will happen in 2018 and if it's 2019, it's probably late in the year at the earliest. It feels like Europe will be the first to go before the U.S. The European Central Bank has negative interest rates still and it is trying to control 20 odd different economies that are now moving at different speeds with one set of policies. So the risk of a policy mistake feels higher there.

John Christofilos: The interesting thing about that is worldwide fund flows show Europe is still the number one area where money is flowing into ahead of Japan, number two, emerging markets and then the U.S. If Europe is going to be the first, it's not being dictated by the fund flows.

DS: From a North American perspective, [economic] excesses are readily apparent but in the U.S. it's more nuanced. They were hit harder during the financial crisis and growth has been pretty anemic over the past decade so the usual imbalances have not been able to build up as rapidly as in prior cycles. Sure, there are areas that you can point to that look hot: Student loans at record levels – although there are good reasons for that –, the auto cycle is pretty darn mature, commercial real estate is extended. But the economy doesn't exhibit the classic hallmarks of a post- World War II late cycle expansion characterized by a massive capital expenditure run, huge build in inventory, rampant inflation and a U.S. Federal Reserve that overshoots.

How big of a risk to the global economy is a potential trade war between China and the U.S.?

KC: Historically, trade wars do result in sharp downturns in the economy, but I doubt that this will ever evolve into a real trade war. This is all about Trump's negotiation tactics with China.

Jane Buchan: China is the largest marginal buyer of U.S. debt and so tariffs on US$50 billion is almost nothing. It's a raindrop. It's a headline that doesn't cost a lot to the relationship.

KM: To Jane's point, China is the most significant purchaser of U.S. treasuries. If they went on a strike and said, "look, we're not funding this pot of assets," that would sting a U.S. government that has to issue something close to US$1-trillion in incremental debt to fund their tax reform. So, there is a lot of leverage.

RC: Our base case is that China is going to take a conciliatory approach with the U.S. but it will still be a long process similar to NAFTA, which is into its seventh month and ninth round with no deal. We expect China's negotiation with the U.S. will be volatile, but rational minds will win out.

KM: I don't think the current U.S. administration wants to pick a trade war, but retaliatory tariffs that push price levels up would be bad for markets and certainly for inflation and higher interest rates.

What economic indicators should investors be keeping an eye on for signs of a slowdown?

KM: We may all say that rates are still accommodative but we've had a pretty vicious back up in short rates since November. If the spread between LIBOR (the average interest rate that banks charge each other for short-term, unsecured loans) and the Fed funds rate starts to widen, that would be something to watch as a harbinger of a potential credit issue.

> My biggest concern from an EM backdrop is the U.S. dollar
> **– Regina Chi**

RC: My biggest concern from an EM backdrop is the U.S. dollar. Typically when you get spikes in interest rates, the U.S. dollar goes with it, but more recently it has remained weak and EM has continued to outperform. If the U.S. dollar strengthens, then you could see emerging market assets begin to underperform because they are highly correlated. That said, any underperformance would likely be less acute than in the past because most emerging economies are in better shape.

KC: The unemployment rate in the U.S. worries me as it drops lower towards 3%. Labour shortages are pretty widespread right now, so what I think you are going to get is rising wages over the next year or two. Will it be enough wage inflation to make the Fed tighten too much? I would say no. but it's a possibility.

DS: I'll just add that the flattening of the yield curve has become everybody's favourite metric for predicting the next recession because its batting average in the

U.S. has been so tremendous in past years. People are hanging their hats on it a little too much in my view. This has not been a normal monetary cycle and therefore you can make a case that the curve has been distorted and bearing too much scrutiny.

Financial Markets

Is the recent volatility in the market here to stay?

JC: I'll start by saying buckle up. Last year was not normal. There was no volatility, but since the calendar rolled over we've experienced a wave of heightened volatility that will last for a period of time. That should help us as active managers.

KM: We think earnings are going to be phenomenal in the U.S., probably in Europe as well and even in Asia. So the backdrop is there. But we're going to have to grind our way higher from here. It's not going to be as smooth a path. We're seeing intraday volatility at levels we haven't seen in probably 10 years.

JC: Retesting the lows of early February this past month was healthy for markets. Now we just have to hold these lows. From a trader's perspective, we can go sideways for the next several weeks to months. That is a very good sign because we're forming a nice base in the market. If we don't, however, and we break below recent lows, there's probably another significant leg down from here.

So, no end to the bull market just yet?

DS: I don't think we've seen the end of the market yet. I don't think we've seen the ultimate highs. Basically, the most you tend to get in the developed market in terms of a downturn in the absence of a recession is around 20%. That's a scenario worth contemplating. If you don't get a recession, you are unlikely to get a significant drawdown.

JC: Another data point we look at carefully is cash levels. There is still lots of cash sitting on the sidelines, both retail and institutional. That's why I'm optimistic. In a secular bull market you're going to get pullbacks and they are buying opportunities more times than not.

KM: And if there is a recession, it will be a business cycle recession, not a credit-driven recession like we saw in 2008 or because of a bubble bursting like in 2002. That means equity markets will have a tough year, but it's not going to look anywhere near like it did in 2008 or 2002. There will be some unwinding of valuations as earnings hit a hiccup but it's not going to be a 40% downturn type-of-scenario unless there is some other as-yet-unforeseen unwind out there that has to be settled through.

JC: If there's one thing I do worry about, it is the potential for a major selloff due to our current market structure. We had a flash crash in 2014 and another in January 2016 and there's really been no resolution despite the efforts of regulators. Part of the problem is the number of liquidity pools. There are 50 to 60 liquidity pools in the U.S. alone where you can trade the same security. And then there's all the "passive" money that has been added to the market in recent years through index funds and ETFs. What happens if it starts to move the other way?

KM: Higher volatility may take the shine off passive management and that does create some structural issues and systemic risk given its growing size in the market.

If the U.S. market falters, do all of the other global markets follow suit?

KM: It was an inflation print and jobs report in the U.S. that triggered the global selloff in February and if you stopped the market three days after the pullback began, the worst performing markets were not in the U.S., but elsewhere around the world. So, I would say there is still a strong correlation and what happens to the U.S. market will have a great impact on other markets.

JB: But it depends on how it happens. If it's short and violent, I agree, but if it's more of a secular long- term decline, you can have a very low correlation.

> There are pockets where global equity markets offer sufficient diversification such that I wouldn't necessarily expect them to act in the exact same way.
>
> **– David Stonehouse**

DS: There's a free flow of capital because of globalization and so contagion beyond the U.S. – not in terms of panic, but in terms of a pullback – is likely to varying degrees. However, there are pockets where global equity markets offer sufficient diversification such that I wouldn't necessarily expect them to act in the exact same way. Japan, for example, kind of feels like it's on a different trajectory. The same case can be made for emerging markets to react differently depending on how things play out.

RC: I agree and EM has outperformed for two years in a row in the face of rising rates here in the U.S. That suggests an uncorrelated asset class right now. Of course, that could change depending on what happens on the trade front and/or the future direction of the U.S. dollar.

Portfolio Management

How should investors position their portfolios?

KM: As we've said, we're entering into a period of renewed volatility as we move away from a world of near-zero interest rates. So for us, it makes sense to sit on more cash in our balanced portfolios at the moment. We are underweight fixed income to protect against rising rates and overweight equities because we believe they can grind higher. Most of our portfolios have a global tilt to give people a better chance at a positive outcome.

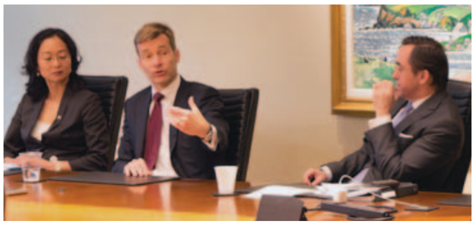
RC: From a global equity team perspective, we're focused on quality companies that earn a rate of return above the cost of capital as it moves higher in this backdrop of rising rates.

DS: We're less enamoured of the credit markets than we used to be. We're still neutral but high yield spreads have come in about as tight as they look like they can for this cycle. Convertible [bonds] look better to us. If we haven't seen the highs in equities yet, convertibles are probably the best fixed income tool to capture some additional value. This is true of EM debt to some extent too. We're being careful here, but sovereign balance sheets in the developing world are generally strong, debt levels are relatively low and GDP growth is higher than in the developed world.

JB: What's also interesting relates to David's earlier comment on the flattening yield curve. Investing on the short end is becoming less painful and less risky than being long.

DS: In Canada, basically from five or seven years to 30 years out on the yield curve, you only get another 20 basis points, which is almost nothing for a tonne more volatility and interest rate risk. So, being long doesn't look like it's going to pay as well right now as it has at previous points in the cycle, certainly from a carry perspective.

JB: As a former academic, the one thing we teach is that the only free lunch is diversification. This is particularly true now given what's going on in the markets today with generalized, coordinated global growth.



KM: I think there is also going to be a growing need for alternatives within portfolios, not just institutional but at the retail level, to provide different correlations than traditional asset classes and potentially offer an inflation hedge in these portfolios.

DS: Alternatives has been one of the hallmarks of our fixed income solutions for two and half decades now and that remains very much at the forefront.

How important is active management today?

JB: The market is really narrow. It's being driven by a very few names in both fixed income and equities. It's very hard to transact outside those names in any size, which means we're seeing active management outperform in the U.S. over the past six months.

DS: You have to be that much more thoughtful when you get late in a cycle. There are opportunities to make adjustments right now, but you have to make the trade successful. And it's not just one trade, but two – you have to make a good buy and then a good sell, or vice versa. So, it's not about trading for the sake of it, but looking for really material adjustments to capitalize on.

JB: The one thing to remember is that gains are driven by very few days in the market and trying to time the returns is really dangerous. The right thing to do is find the right long term game plan and stick to it. I've seen so many people panic and bail out.

JC: I've never seen a successful market timer.

KM: They might get one side of the trade right – but usually only once.

Jane Buchan, PhD, CAIA

Chief Executive Officer & Co-Chief Executive Officer, PAAMCO & PAAMCO Prisma Holdings

Ms. Buchan is the Chief Executive Officer of PAAMCO and Co-Chief Executive Officer at PAAMCO Prisma Holdings. In these roles, she oversees and is jointly responsible for the business strategy and direction of both firms.

Jane is member of the Board of Directors for Torchmark (NYSE: TMK), is a founding Angel for 100 Women in Finance, is an active board member for Girls Who Invest, and is a trustee for the Standards Board for Alternative Investments.

Jane holds both a PhD and an MA in Business Economics (Finance) from Harvard University. She earned a BA in Economics from Yale University.

Kathleen Camilli

Founder and Principal, Camilli Economics, LLC

Ms. Camilli is one of the top macro-economic forecasters in the USA.

She started her career at the Federal Reserve Bank of NY, was the US economist on the global team at Credit Suisse Asset Management, and the Chief Economist at Tucker Anthony Sutro.

Ms. Camilli has served on three public company boards, and is currently an independent director at the UniFirst Corporation (NYSE). She is a strategic advisor to two start-ups, one in social media, and the other in fintech. She is a National Association of Corporate Directors Governance Fellow, a member of Women Corporate Directors, and a member of the National Association for Business Economists.

Ms. Camilli has an MBA in Finance/MA in French Studies from New York University. She has served on the boards of numerous not-for-profit organizations.

Kevin McCreadie, CFA, MBA

President and Chief Investment Officer AGF Investments Inc.

Kevin McCreadie provides direction and leadership to AGF's investment management teams and leads the firm's global institutional business. Mr. McCreadie brings more than 30 years of investment management experience to AGF, with extensive expertise in retail and institutional asset management, direct portfolio management and over a decade of combined experience as CIO for two major U.S. financial services firms.

Prior to joining AGF, Kevin was President and CIO of PNC Capital Advisors, LLC, a division of PNC Financial Services Group, one of the largest U.S. diversified financial services organizations. While there, he was responsible for leading the firm's institutional effort and overseeing over $58 billion in AUM. Kevin began his career in 1982 at J.P. Morgan where he held progressively senior positions, ultimately becoming a U.S. large-cap equity manager. He went on to join Brown Investment Advisory where he was a Partner and Senior Portfolio Manager.

His experience includes a focus on portfolio construction and enhancing investment processes as well as managing asset allocation and alternative strategies for clients.

He holds the Chartered Financial Analyst designation and has an MBA in Finance from the Wharton Graduate School of Business.

John Christofilos

Senior Vice-President and Chief Trading Officer AGF Investments Inc.

John Christofilos is Senior Vice-President, Chief Trading Officer at AGF Management.

In this role, John and his team are responsible for trading the $37 billion assets under management across the AGF Retail, Institutional, High Net Worth and ETF portfolios.

John has extensive experience and a career that spans more than a 25-years in the Canadian and International Capital Markets Industry. Prior to joining AGF, John was Managing Director at Canaccord Genuity focused on electronic and algorithmic trading solutions.

He also worked as Executive Vice-President at E*TRADE Financial based in Palo Alto, California.

John has held Board appointments on industry associations, CSTA – Canadian Securities Traders Association & IETA – Institutional Equity Traders Association.

John holds a Bachelor of Science degree from United States International University in San Diego, California.

David Stonehouse, CFA, MBA

Vice-President &Portfolio Manager
AGF Investments Inc.

David Stonehouse manages both fixed-income and balanced portfolios and is a member of the AGF Fixed Income Team, which has expertise in all the major fixed-income categories including high yield, investment grade, sovereign bonds and global convertibles, in both emerging and developed markets, as well as global currencies. His rigorous and disciplined investment process is a combination of a top-down approach to duration and asset allocation with a bottom-up approach to security selection.

David was previously Director, Fixed Income and Portfolio Manager with Acuity Investment Management Inc. AGF Management Ltd. acquired Acuity Funds Ltd. and Acuity Investment Management Inc. in February 2011. Prior to joining Acuity, David was a senior analyst specializing in Canadian equities at a major Canadian pension plan and worked in the telecommunications industry specializing in financial analysis.

He received a B.Sc. in Applied Science from Queen's University, an MBA in Finance and Accounting from McMaster University and is a CFA charterholder.

Regina Chi, CFA

Vice-President & Portfolio Manager
AGF Investments Inc.

Regina Chi is Vice-President and Portfolio Manager with lead responsibility for AGF Emerging Markets strategies. She has an investment philosophy consistent with AGF's Global Equity Team and looks for quality companies that have long-term sustainable competitive advantages at attractive valuations.

Regina brings 23 years of international equity experience to this role. She was most recently a partner at DePrince, Race & Zollo Inc. where she was portfolio manager for the Emerging Markets and International Value disciplines.

She was also head of portfolio management and research as they related to Emerging Markets, Global, International and International Small Cap strategies. Prior to this role, she held senior investment management roles at Oppenheimer Capital, Federated Investors and Clay Finlay Inc.

Regina is a CFA charterholder. She received her Bachelor of Arts in Economics and Philosophy from Columbia University. Regina has a working knowledge of Korean and Spanish.

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For more information, visit AGF.com

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