FIRST ASSET
A CI Financial Company

FIRST ASSET LONG DURATION FIXED INCOME ETF
MANAGER COMMENTARY
Fourth Quarter 2016
TSX: FLB

This is a summary of the First Asset Long Duration Fixed Income ETF's (the "Fund") performance in the fourth quarter, our outlook for the markets and the Fund's positioning.

Looking back – Cyclical forces mainly behind the move in the markets

Economic growth and inflationary pressures in the U.S. and globally had been cooling for about a year and a half before bottoming around mid-year 2016. Leading indicators of industrial growth and inflation have been on the rise since then, pushing real interest rates and inflationary expectations priced into the bond market consistently higher.

The perception of policy imbalance and inadequacy on all fronts (monetary, fiscal, trade) leading to societal inequality suddenly dawned on the consensus after Brexit and the Trump movement in the United States. This is behind the reluctance of central banks in Europe and Japan to extend further accommodation, which in turn takes away one of the major tailwinds behind the bond market since the Global Financial Crisis (GFC).

Inflationary expectation priced into the U.S. bond market over the next 10 years rose approximately 0.36% during the final quarter of 2016. Throughout the same period, nominal interest rates in the U.S., Canada, UK, Germany and Japan rose by 0.85%, 0.73%, 0.49%, 0.33% and 0.14% respectively.

Performance Analysis

The total return of the Fund was primarily driven by the substantial rise in Canadian long-term interest rates alongside the increase in rates globally in the wake of the U.S. elections.

In Benchmark relative terms, Fund positions in inflation-linked bonds were a source of alpha, as these bonds outperformed relative to nominal developed market sovereign bonds. Residual U.S. dollar currency exposure, net of hedging, also supported the alpha of the Fund during the quarter. Foreign currency exposure within the Fund is actively managed via a hedging overlay.

These influences were offset by the negative impact of duration and yield curve exposure and government credit positioning on portfolio alpha. U.S. duration positions underperformed relative to Canadian duration during the period, and government credit exposure was sold to reduce Fund duration amid a period of spread tightening in this sector.

Looking forward – Structural shifts are challenging but cyclical turns are a certainty

The recent sell-off in the bond market has the pundits calling once again for the end of the bond bull market. The proposed policy changes under the new U.S. administration are the main reason for the consensus optimism.

As drastic as the ideological and policy changes in the new U.S. administration might be, their impact on the U.S. and global long-term potential economic growth might be limited or uncertain. On the other hand, free market economies will continue to experience cyclical downturns and upturns. These cyclical turns are going to be more pronounced if the European and Japanese central banks are not as accommodative as they have been in the recent years and the U.S. Federal Reserve is on the tightening path. Our strategy remains focused on anticipating cyclical changes in growth and inflation for navigating the investment environment.

The new fiscal policy agenda in the U.S. has injected another source of uncertainty surrounding the Canadian economic outlook, which is already grappling with a lackluster trade picture, and the unclear efficacy of domestic fiscal measures and new mortgage rules. In turn, the Bank of Canada will likely face ongoing pressure to sustain an accommodative monetary policy stance until greater clarity is achieved and other areas of support for the domestic recovery take the reins.

Positioning – Duration, Curve, and Spreads

In our valuations, the U.S. benchmark 10-year bonds are trading at the top end of the fair value range of about 1.8% - 2.60%.

We are short duration relative to the Benchmark, primarily concentrated in the 20-year portion of the yield curve. Furthermore, we remain underweight in the government credit sector and retain exposure to U.S. inflation-linked bonds and nominal bonds.
During the fourth quarter, we have net sold duration primarily from our U.S. nominal bond holdings, and also trimmed these positions to purchase U.S. inflation-linked bonds. In addition, we modestly reduced our underweight position in government credit spreads.

Kamyar Hazaveh, MMF
Vice-President, Portfolio Management and Portfolio Manager
Signature Global Asset Management

Signature Global Asset Management manages a diverse range of equity, balanced and income funds, and is CI Investments' largest in-house portfolio management group. The team of over 40 investment professionals, led by Chief Investment Officer Eric Bushell, manages over $55 billion and has offices in Toronto and Hong Kong.

Investment Philosophy

The Signature investment philosophy is designed to deliver the best possible risk-adjusted returns in today's complex environment and is based on these key elements:

- The globalization of the world economy has resulted in increased complexity, requiring specialized knowledge.
- The increased interconnectivity of the global economy demands collaboration.

First Asset - **Smart Solutions™**

First Asset, a CI Financial Company, is a Canadian investment firm delivering a comprehensive suite of smart ETF solutions. Rooted in strong fundamentals, First Asset's smart solutions strive to deliver better risk-adjusted returns than the broad market while helping investors achieve their personal financial goals.