FORGE FIRST
ASSET MANAGEMENT INC

May 7, 2021

April 2021 Commentary

April 2021 featured a continuation of the year-to-date grind higher in stocks, enabling most North American equity indices to reach all-time highs. The catalyst for this strength remained ongoing policy stimulus and the re-opening of the U.S. economy. Meanwhile, this rally has masked significant factor volatility, which in turn has driven rising dispersion between the returns generated by different investment styles. Fortunately, given that security selection at Forge First is driven by a company's ability to generate free cash flow, our funds are largely agnostic towards factor rotation and have been able to maintain net returns in the middle of the proverbial fairway.

	YTD	1 mo	3 mo	6 mo	1 year	2 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	7.97%	2.58%	7.76%	18.15%	29.37%	13.26%	12.47%
Forge First Long Short Alternative Fund Series F	8.27%	2.65%	7.98%	18.66%	30.50%	14.29%	13.46%
Forge First Conservative Alternative Fund Series A	7.14%	1.63%	6.30%	16.76%	27.45%	12.31%	11.79%
Forge First Conservative Alternative Fund Series F	7.46%	1.71%	6.55%	17.30%	28.52%	13.33%	12.78%
TSX Total Return	10.63%	2.39%	10.99%	24.43%	33.31%	10.80%	10.12%
S&P 500 Total Return (US$)	11.84%	5.34%	12.98%	28.85%	45.98%	21.34%	20.65%

*Annualized | Inception date: April 24, 2019

The Series F of our Long Short Alternative Fund gained +2.65% after fees, boosting its year-to-date net return to +8.27% and its trailing 12-month net gain to +30.50%. All sectors except ETF and listed put option hedges contributed positively to the returns last month. The fact that leading generators of return included Alphabet Inc. (GOOG.US), Tourmaline Oil Corp. (TOU.CA), goeasy Ltd. (GSY.CA), Freeport-McMoran Inc. (FCX.US), S&P Global Inc. (SPGI.US), Visa Inc. (V.US) and Stelco Holdings Inc. (STLC.CA), validates the factor agnostic style of our investment discipline. Long Short Alternative exited April 2021 with delta-adjusted net exposure of 54% and gross exposure of 126%.

The Series F of our lower volatility Conservative Alternative Fund gained +1.71% after fees during the month, such that its year-to-date net return sits at +7.46% and its rolling 12-month net gain is 28.52%. This 13th consecutive month of positive performance was driven by contributions from the capital growth and alternative strategy sleeves, while the asset protection sleeve was a net detractor. Gains in the capital growth sleeve were widespread and included contributions from securities in each of the Financials, Consumer, Industrial, Technology and Materials sectors.

The alternative strategies bucket of the fund garnered returns from our positions in rate-reset preferred shares, partially offset by our short position in long-dated government bond funds, which saw a mild rally following a dip in the yields of long-term bonds. Exposure-wise, the multi-asset Conservative Alternative Fund exited the month of April with gross exposure of 105% and net exposure of 44%. The modestly reduced net exposure from the end of the previous month was the result of the redemption of certain preferred shares and SPACs. Month-end net exposure was split between the capital growth or common equity sleeve (35%), the alternative strategy bucket (+15%) and the asset protection sleeve (-6%).

Looking ahead, while there's less upside in broader markets than at the beginning of the year, the continuance of the same macro drivers mentioned in the opening paragraph causes us to remain cautiously constructive towards equities in the near term. Our bias continues to be towards cyclical, value and 'opening up' stocks and themes, as 1) earnings momentum favours these groups, and 2) the cyclical tailwinds will serve as headwinds for many technology stocks until the earnings yields on large cap tech become more attractive.

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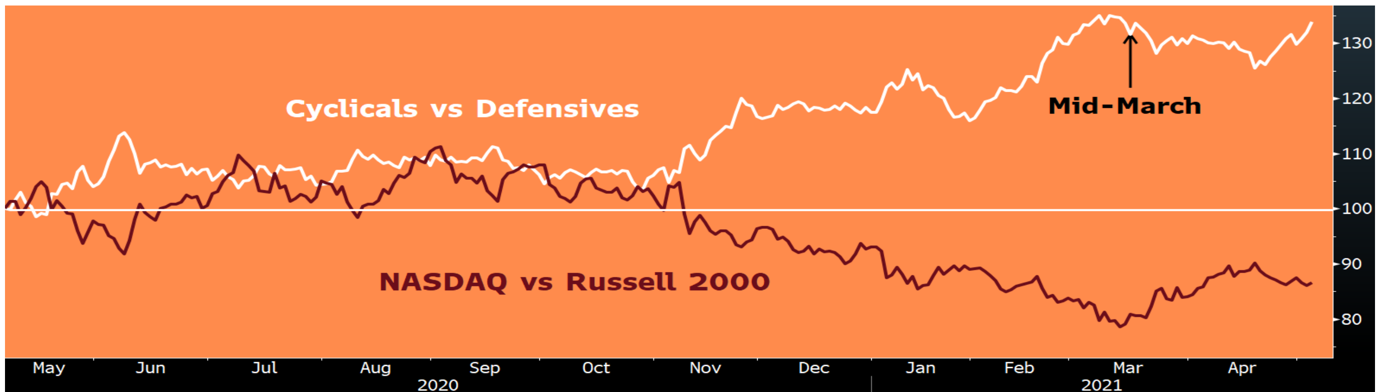
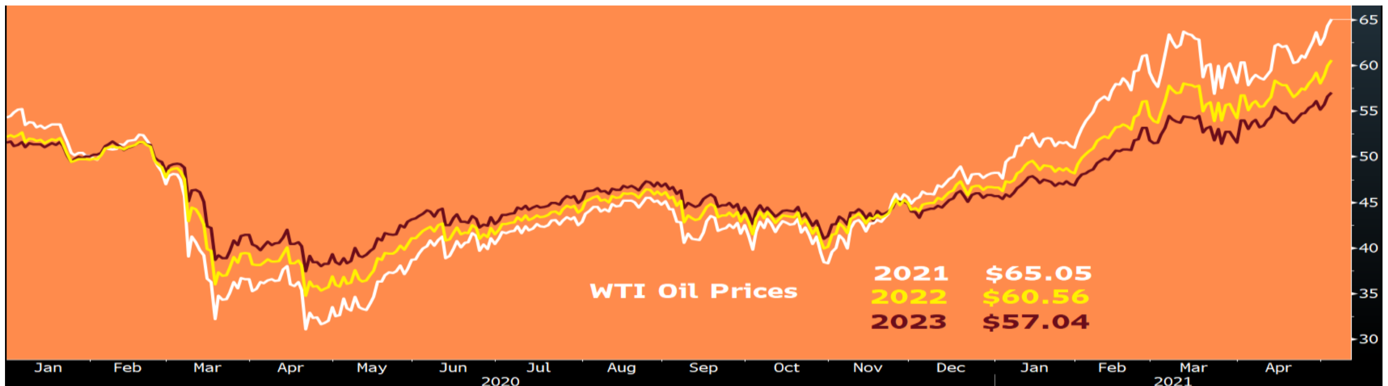


Source: Bloomberg

Further to that last statement, the indexed, 1-year graph above illustrates the relative strength of each of cyclical to defensive equities (white line) and the NASDAQ to the Russell 2000 (red line). We believe recent above-consensus economic and inflation releases have reignited the factor rotation in favour of cyclicals and the more domestically-focused, small versus large cap Russell 2000 versus the NASDAQ. Commodity prices are a key ingredient to this theme.



Source: Bloomberg

Price curves for more than 50% of all commodity markets are in backwardation as societal activity levels, measured by mobility, have resumed their upward trajectory. Consequently, it appears investors believe President Biden will meet his goal of having 70% of Americans vaccinated by July 4th with a similar percentage of Europeans vaccinated by the end of this Summer, with 70% being considered the inflection point implying 'herd immunity'. Combine those hopes with the traditional seasonal upswing in miles-driven and industrial activity, it becomes apparent why the graph above indicates that the 2021 forward strip for WTI oil (white line) now sits above US$65 a barrel.

However, the 2-year, indexed graph below highlights that it's not just oil prices that have risen markedly during the past year. While idiosyncratic supply and demand issues facing these various commodities have been instrumental in driving the price strength to date, we believe a weakening U.S. dollar could catalyze additional price strength for a subset of the group, including oil and copper.

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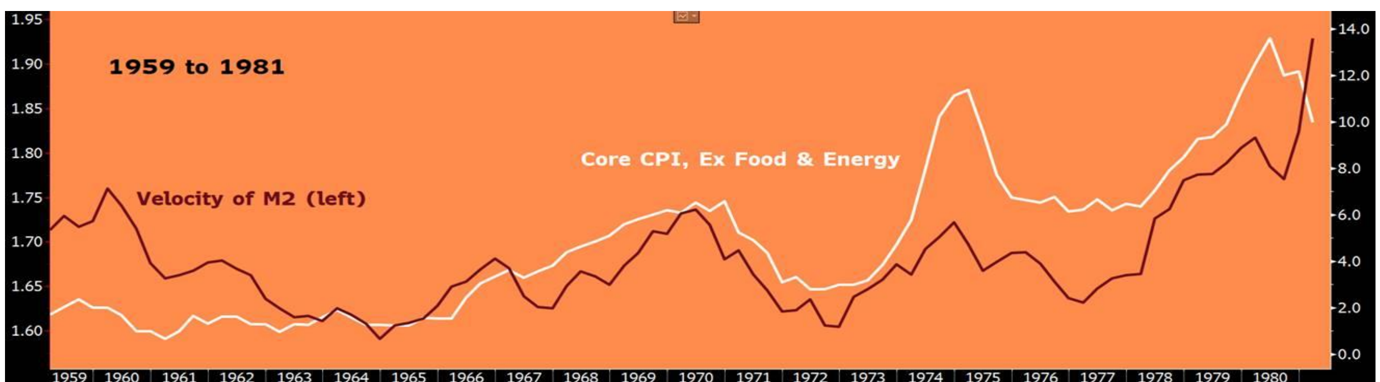
While the rise in net debt issuance and implicit currency debasement are often flagged as catalysts for the USD to take another leg lower, activities in Europe could become the principal driver for the remainder of this year. Waiting for Europe's economic recovery has been as elusive as 'Waiting for Godot'. However, after years of writing about the misgivings of the EU economy in these commentaries, we are finally hopeful that three items could finally catalyze enough change to a make a difference.

First, after a slow start (Canada too), the targeted 70% vaccination rate appears within reach. Second, on April 21st, the German constitutional court declined to block the EU's COVID-19 recovery fund, removing one of the last major hurdles before the bloc can launch its US$900B debt-financed fund. As a result, funds could begin to be dispersed this summer, with Spain and Italy receiving as much as 50% of ultimate payments. Third, Germany's Presidential and Parliamentary election (to replace Chancellor Merkel) is September 26th, 2021 and recent polls indicate the fiscally expansive Green Party is leading with a 26% share. While coalitions are a way of life in German politics, it appears the Green Party will play a significant role in the next government.

Taken together, these factors have us thinking that as 2021 progresses, forex markets will begin to discount a shift in the forward rates of relative economic growth between the U.S. and the EU, a likely driver of a weaker US dollar. One other variable potentially supportive of the EUR/USD pair is the continued dovish stance towards asset purchases by the Fed, while at its June meeting, the ECB may join the Bank of England in identifying the time frame of its transition from QE to QT.

The outlook for inflation will also play a pivotal role in determining the health of broader equity markets and the outlook for sector dispersion during the remainder of the year. To date, our stance has been that due to competitive forces in a number of sectors of the economy, only a portion of rising core PPI will translate into a sustainable boost of core CPI, with the 'amazon effect' being the simplest way to characterize this dichotomy. In addition, economic textbooks state that the velocity of money also plays a key role in generating inflation.



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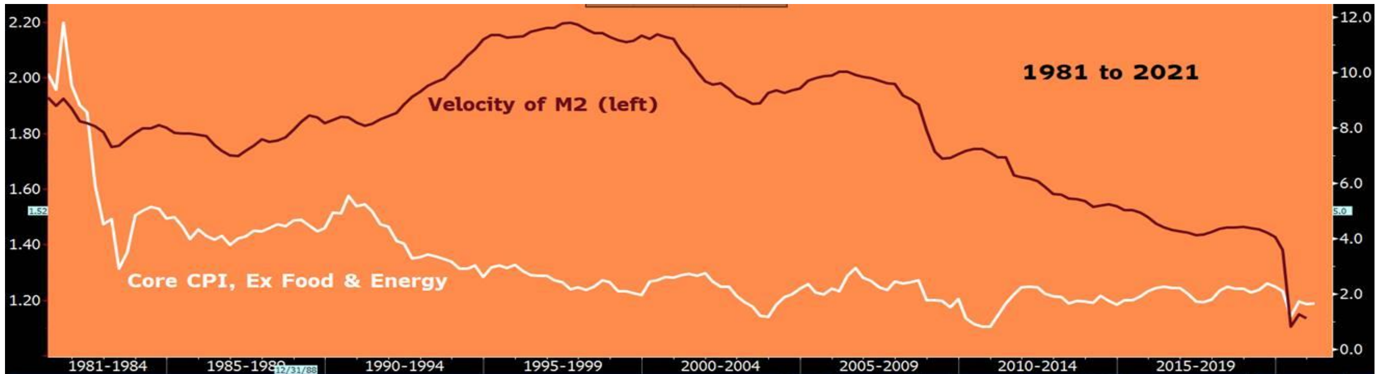
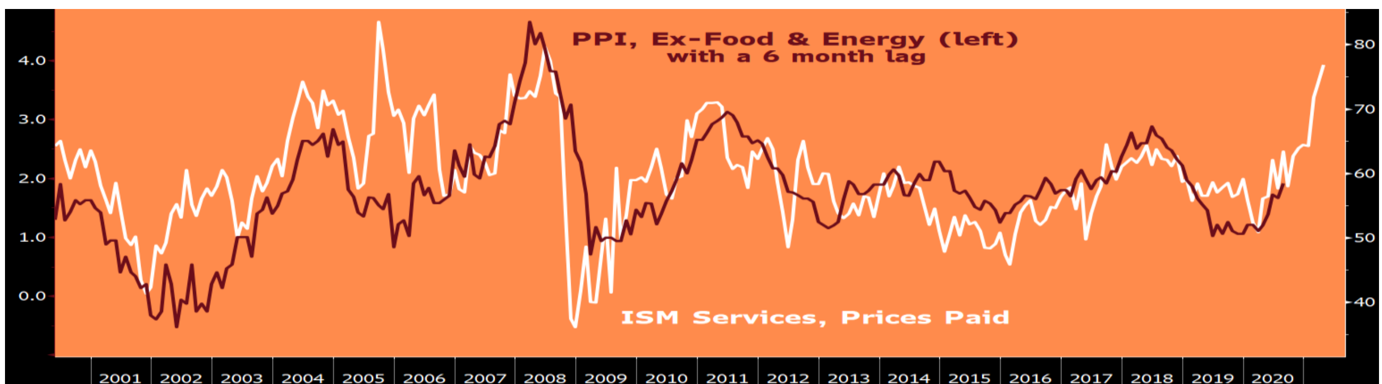
The velocity of money is the rate at which consumers and businesses collectively spend money. It is equal to the GDP of an economy divided into the money supply. As can be seen from the graph above, between 1960 and 1980, there was a strong positive correlation between core CPI, Ex-food and Energy, and the velocity of money. However, the following graph, highlighting the years 1981 through early 2021, suggests little linkage between these two variables. This large disparity could cause a person to wonder if the 1960-1980 correlation was spurious; however, our work suggests that is not the case. Instead, since 1981, the decoupling between money velocity and key economic variables has likely been driven by several institutional and other fundamental changes in the early 1980s that served to weaken the relationships. It's probable these changes were catalyzed more by the money supply side of the fence than the GDP side, with the evolution in financial infrastructure playing a large role in this development.



Source: Bloomberg

This analysis explains why the Fed is not fussed that the magnitude of money sloshing around the system will inevitably lead to runaway inflation. Further, given that recent decades have witnessed the flattening of the Phillips Curve, from the historical 'hockey stick' shaped relationship between unemployment and inflation, it is likely the Fed views this association as a second reason to explain their nonchalance. However, we all know that 'history rhymes but doesn't repeat'!



Source: Bloomberg

Demographics and the advancement of each of technology and globalization are three huge differences between the current post-COVID-19 cycle and any other 20th or 21st century economic cycle. Hence, given that 77% of the U.S. GDP is sourced from the Service sector of the economy, it's tough not to look at the 20-year graph above showing ISM Services, prices paid (white line on right axis, advanced six months) against the PPI, Ex-Food & Energy (red line on left axis) and be convinced that the Fed has considered all possible scenarios in reaching their almost apparent dogmatic insistence towards the potential for sustainable inflation.

As shown in the 2-year graph below that disaggregates the yield on a U.S. 5-year government bond, breakevens, a crude proxy for the average, expected rate of inflation during the next five years, are yielding levels that are at odds with the thinking of the Fed. If the Fed is wrong on inflation, all equities will be in for a nasty re-rating, especially the high-priced

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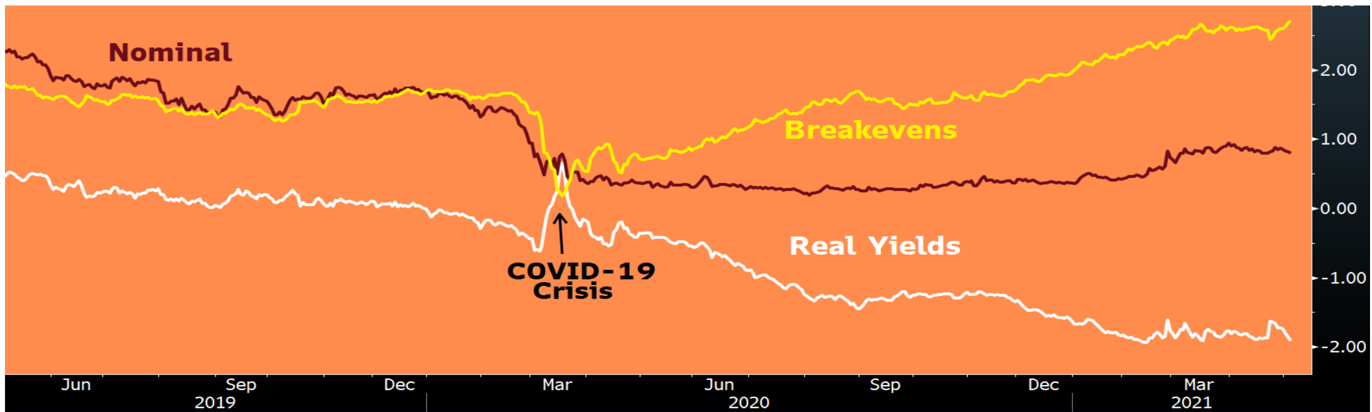
growth stocks ('GAAP' or growth at any price). If not, and near-term inflation proves to be transient (our base case), then equities have a degree of upside, biased towards securities characterized as being in the value and/or cyclical camp.



Source: Bloomberg

History demonstrates that every cycle features valuation overshoots in various classes of assets. It could be argued that segments within broader financial markets including unprofitable tech stocks, credit spreads and Bitcoin are examples within the current cycle. As these valuation overshoots are irregular in duration and magnitude, it's next to impossible to pinpoint when the music will stop. Hence, cognizant that valuations remain elevated, we have consistently rolled listed put options to hedge a significant portion of the net long exposure of our funds. When asked what our 'risk budget' is for such activities, we respond that our budget is not a fixed amount. That's because our twin goals are to 1) offer a competitive risk-adjusted net return, and 2) strive to preserve client capital in rougher market environments.

Thank you for the interest in our funds. For more information, please visit our website at www.forgefirst.com or call us at 416-687-6771 should you have any questions.

Thank you,

Andrew McCreath
President and CEO

Daniel Lloyd
Portfolio Manager

Keenan Murray
Portfolio Manager

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