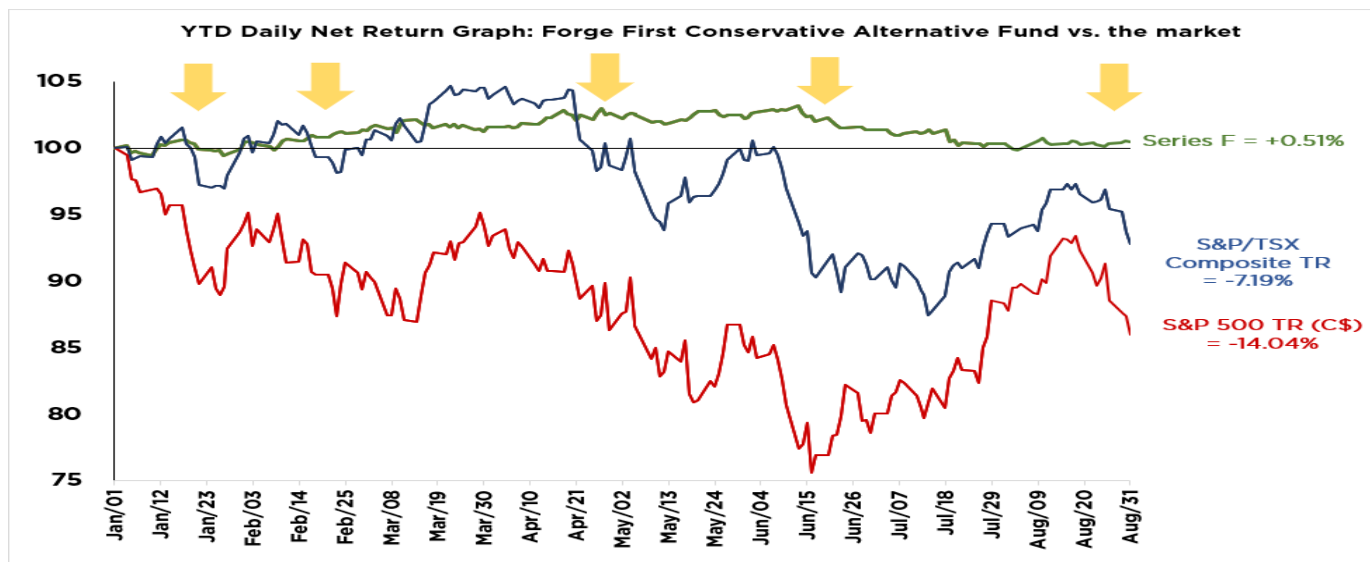
August 2022 Commentary

Several months ago, investors began to think about stagflation, yet only during the past few weeks have they started to discount the potential for such a nasty outcome into the price of stocks and bonds. Equity indices, including the S&P 500, which had exhibited sharp gains at the start of August, fell hard towards the end of the month. After failing to surpass its 200-day moving average to the upside, the 50-day moving average provided no downside support, as the S&P 500 quickly descended towards 3,900. Once again, the catalyst for this volatility was the latest flip-flop by Fed Chair Powell, as his recent remarks made it quite clear there was no 'Fed put' on the horizon.

That reality caused all North American equity indices to suffer sharp losses last month. In contrast, our two Forge First funds batted one for two. The Series F of our multi-asset Conservative Alternative Fund gained 0.17% after fees, enabling it to exit August with a year-to-date net return of +0.51%. Gains were sourced from each of the common equity and multi-asset sleeve of this portfolio. Just as important as this positive return, as demonstrated by the green line on the daily, year-to-date net performance graph below, our Conservative Alternative Fund has exhibited stability amidst the repeated market drawdowns investors have experienced during 2022.

FORGE FIRST CONSERVATIVE ALTERNATIVE FUND: EXHIBITING STABILITY & MITIGATING DRAWDOWNS



Source: Forge First

The fund exited August with delta-adjusted gross and net exposure of 118% and 12%, respectively. This net exposure was split between a 3% allocation to common equities, up modestly from the previous month, and a 9% net long weighting to multi-assets including preferred shares from Royal Bank and TD Bank. Within the common equity book, high conviction positions include Boyd Group Inc. (BYD.CA) on the long side and Louisiana-Pacific Corp. (LPX.US) on the short side.

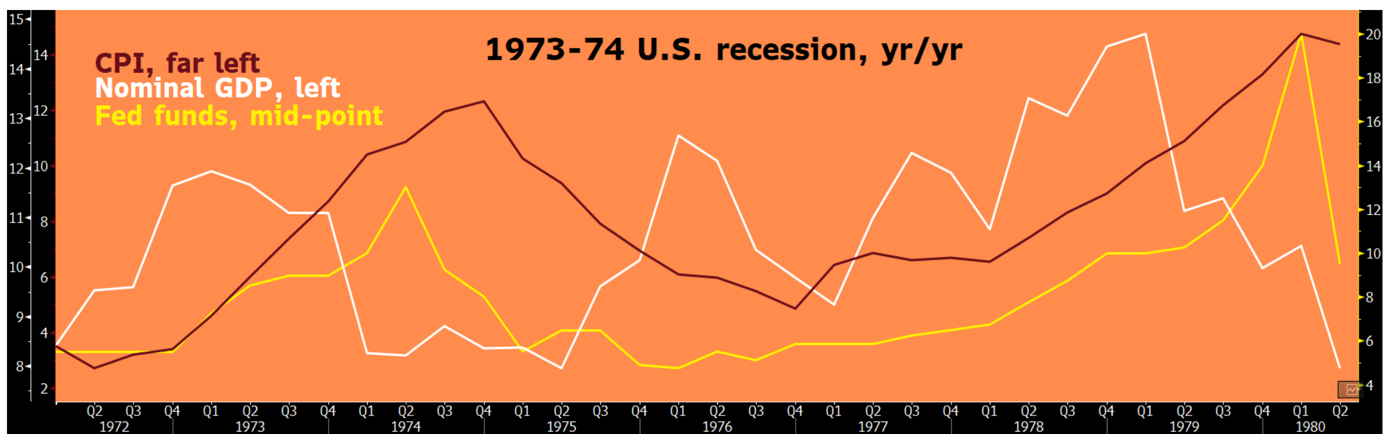
	YTD	1 mo	3 mo	6 mo	1 year	2 year*	3 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	-1.72%	-1.16%	-5.48%	-4.50%	-1.16%	8.66%	9.43%	7.82%
Forge First Long Short Alternative Fund Series F	-1.10%	-1.06%	-5.21%	-4.02%	-0.24%	9.64%	10.43%	8.78%
Forge First Conservative Alternative Fund Series A	-0.10%	0.07%	-1.92%	-1.15%	-0.40%	9.16%	8.40%	7.28%
Forge First Conservative Alternative Fund Series F	0.51%	0.17%	-1.70%	-0.69%	0.52%	10.17%	9.39%	8.24%
S&P/TSX Composite Total Return Index	-7.19%	-1.61%	-5.99%	-7.07%	-3.38%	11.31%	8.75%	7.56%
S&P 500 Total Return Index (C$)	-14.04%	-2.06%	-0.79%	-6.65%	-9.27%	6.51%	9.97%	8.38%

*Annualized | Inception date: April 24, 2019

The Series F of our more directional Long Short Alternative Fund fell 1.06% in August, pushing its year-to-date net return to -1.10%. Besides a small gain in our Consumer book, profits during the month in this fund were restricted to our sleeve of listed put options and other short positions. Sector losses were broad-based, although there were no downside outliers. In contrast to the common equity sleeve of the Conservative Alternative Fund, which tends to be oriented to GARP stocks, at this juncture the bias of the Long Short Alternative Fund is towards common equities generally associated with hard assets. This decision is predicated on the belief that the combination of years of capital underinvestment and continued geopolitical strife across many borders will continue to be supportive of most resources. The Long Short Alternative Fund exited the month with delta-adjusted gross and net exposure of 129% and 15%, respectively.

Looking ahead, we still don't believe investors are out of the woods from what has turned out to be a cyclical bear market and, consequently, each of our two funds continues to be conservatively positioned. Our preconditions for becoming more constructive towards equities have yet to be achieved. Specifically, valuations remain too high, the worst point in the economic cycle is not yet in sight and, while we may have reached the peak in inflation, we certainly have not reached the peak in interest rates. According to Goldman Sachs, cyclical bear markets last an average of two years, take roughly five years to recapture previous highs, and decline around 30% peak to trough. For three reasons, we expect the recent volatility to continue for the foreseeable future.

First, U.S. inflation is likely to be market-friendly during the next few months thanks to falling energy, used car and transportation pricing. At the same time, similar to 1973-1974 and 1979-1980, for reasons discussed in past commentaries we believe inflation will ultimately remain stickier for longer at uncomfortably high levels, especially relative to nominal growth. In the graph below, notice how in these two periods, CPI (red line, left axis) far exceeded nominal GDP growth (white line, left axis). We believe weak nominal growth causes sticky inflation, say 3.5% or higher, to be untenable for Central Bankers.

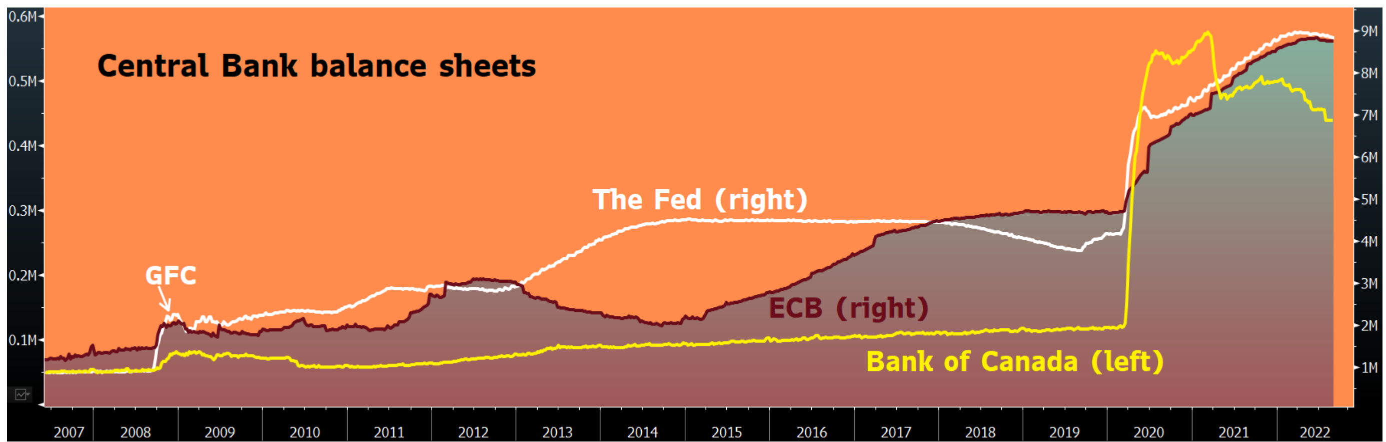


Source: Bloomberg

On the inflation front, assuming the E.U. follows through with its agreement to stop buying Russian oil (as of December 5th, followed by products in February 2023) and the U.S. doesn't renew its soon-to-expire release of oil from its SPR, we forecast energy prices to remain elevated. Further, while labour participation rates have thankfully begun to inch higher, there remains a large mismatch between the supply and demand for workers, leaving continued risk of a wage price spiral. Despite continued robust wage growth, U.S. average hourly earnings adjusted for inflation have declined on a year-over-year basis for 17 months straight; bad for growth and bad for inflation!

Second, we expect the continued tightening of monetary policy to play a role in keeping equity markets choppy. In less than two weeks, the Fed will follow the Bank of Canada and hike interest rates by 50 basis points, possibly 75. This pending hike implies the Fed will have increased rates from 0% to 3% in six months, a very fast pace. When it comes to the impact of rates on equity markets, history demonstrates that the speed at which central banks boost rates matters more than the level of interest rates.

Meanwhile, as the Fed's QE program was wildly helpful for stocks, it is easy to consider the reverse could be true for QT. The white line on the 15-year graph below confirms that since launching QT a couple of months ago, the Fed's balance sheet has shrunk by less than US$100B or 1%. As of this month, the monthly pace of shrinkage will increase to US$95B. In addition, the U.S. Treasury's TGA (Treasury General Account), equivalent to your personal chequing account, has fallen by approximately US$400B over the past couple of months, effectively injecting 4X the Fed's shrinkage into the financial system. Yet with the TGA's balance down to its targeted level of US$400B, this fiscal stimulus will stop. The bottom line is that neither the pace of rate hikes nor the pending reduction in liquidity is constructive for the valuation of financial assets.



Source: Bloomberg

The outlook for the economy and what that means for profit forecasts is the third reason why we expect markets to remain uneven. Clearly, as we first pondered in our December 2021 commentary, it appears that the U.S. economy (Canada too) remains on track to enter a recession by early 2023. While in the medium term America will benefit from the structural challenges facing Europe and the fact that it's the world's largest energy producer (22% of global supply), in the near term, the cumulative impact on consumer spending of high food, energy and rent costs, combined with rising interest rates, appears poised to trigger a recession.

On the positive side, corporate liquidity, a strong commercial banking system and the spending power of the top quintile of the U.S. population, may enable the upcoming recession to be shallow. Unfortunately, most of the countries that account for the other 76% of the global economy will contribute little to world growth.

Even prior to the recent heightened geopolitical tensions between China and the West, the forward growth rate of the Chinese economy had decelerated due to the law of large numbers, the impact of government measures to reduce financial leverage and the shift to become a more closed economy. Last and needless to say, President Xi's recently heightened COVID-19 restrictions have aggravated near-term challenges.

Shifting to Europe, putting it politely, the EU is challenged, both cyclically and structurally. In the near term, the worst drought in 500 years is already damaging the Eurozone's economy. Longer term, Germany, accounting for 25% of total EU GDP and the 3rd largest exporter in the world, faces a high risk of losing its competitive advantage in advanced manufacturing due to the twin blows of the supply chain and energy crises.

However, to quote the title of a Paul Simon song, "one man's ceiling is another man's floor"! In this case, that other "man" is the U.S. as partially thanks to being the largest energy producer in the world (22% of global production), the U.S. is well positioned to benefit from the challenges facing Germany (and the rest of the E.U.). Given our skilled, educated, multilingual workforce, Canada could also be a beneficiary, but sadly our governments have not encouraged the export of our energy resources, especially natural gas. In contrast, U.S. LNG exports increased by 12% year-over-year during the first half of 2022, averaging 11.2 BCF/day and of course the U.S. is a net exporter of energy. Shifting to sectors for a moment, notwithstanding recent price action, we remain constructive towards the price of energy commodities, in our minds, 'ground zero' for inflation, and energy stocks. Further, as we move into 2023, we foresee this sector benefitting from a flow of funds away from the Canadian banks. Following fiscal Q3 results and their recent sell-off, our stance towards the Canadian banks has become modestly more constructive. However, we would point out that during calendar 2023, shareholders should expect a marked slowdown in dividend growth and share buybacks.

Rolling back the clock, heading into 2022, the story as to why you needed to own the bank stocks was driven by the billions of excess capital that was going to be returned to shareholders. This theme, along with the perceived benefit in earnings from higher rates, drove sector share prices to all-time highs in February. Since then, the market has been brought back to reality on both counts.

Pro-forma the announced acquisitions of Bank of Montreal (BMO.CA) and the Toronto-Dominion Bank (TD.CA), the group sits at an average CET 1 ratio of 11.9%, only modestly above the 11.5% that we would use as a good baseline level. With the prospect of having to rebuild credit reserves and the potential for higher risk-weights as delinquencies rise, we doubt the conservative management teams of the banks will remain keen on aggressive capital allocation. It is very telling that only Royal Bank of Canada (RY.CA) and the Bank of Nova Scotia (BNS.CA) bought shares back last quarter, with BMO and TD going as far as to institute DRIP discounts last quarter.

Further to our view that buybacks will be a non-factor for at least the next year, our analysis also foresees a deceleration in the pace of dividend hikes. At this juncture, the bank group sits right in the center of its 40% to 50% payout ratio range. We expect banks will continue to face an earnings headwind from their capital markets divisions. Looking ahead to 2023, we believe the looming credit cycle associated with an even shallow recession will make it difficult for EPS growth to exceed 3% to 5%. Our base case is that annualized dividend increases end up coming in at a similar level, and well below the double-digit pace set last year after OSFI removed their capital restrictions on the group.

In contrast, generally cleansed of debt by year-end 2022, we expect the energy sector will gush cash back to shareholders during 2023. By way of example, we estimate that on current strip, current holding Canadian Natural Resources Ltd. (CNQ.CA) will generate $18B of operating cash flow and return ~$10B of this pile to shareholders next year, implying a ~13% base return at the current stock price, comfortably above the bank group which will struggle to reach 5%.

Even more powerful is the cash flow story at Tourmaline Oil Corp. (TOU.CA), the largest position in our Long Short Alternative Fund and a company that, despite its name, is 80% weighted towards natural gas. At strip pricing, this company foresees approximately $6.5B of operating cash flow during 2023. Capital spending next year is estimated to be $1.6B, leaving $4.9B or greater than $14/share in free cash flow, a 19% FCF yield, the majority of which management expects to return to shareholders. Energy has been a painful sector to own the past quarter, but as free cash flow-focused investors, we view these large cap stocks as compelling opportunities.

Looking ahead, three key questions worth considering are:

1. What level of interest rates will enable the Fed to cut demand enough so as to outweigh the inflationary impact of ongoing supply chain issues?

2. Recent U.S. election results suggest there has been a noticeable shift in voter sentiment away from the Republican party. How would the market react if the Democrats exited the U.S. mid-term elections with a 'true' majority in Congress?

3. What's the six-month outlook for the U.S. dollar? Can sentiment get worse for the Euro, the Yen and the U.K. Pound?

Amidst this rough macro environment, we will continue to work towards achieving our twin goals of generating a competitive net return and protecting capital when markets decline.

As we look forward to October 2022, please join us for a quarterly update. We will review the third quarter of 2022, discuss key economic themes moving forward and have a conversation with Keenan Murray, Portfolio Manager of the Forge First Conservative Alternative Fund. Details for our webinar, including registration link, are below for your reference:

Wednesday, October 19, 2022
11:00 AM – 11:45 AM EST
Please note this webinar is for investment advisors only
REGISTRATION LINK

Thank you for your business and 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.

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