FORGEFIRST
ASSET MANAGEMENT INC

September 11, 2023

August 2023 Commentary

As we've often remarked, history rhymes but doesn't repeat and sure enough, once again, markets remain convinced that the 'song will remain the same' this cycle. While both stocks and bonds 'took it on the chin' during August until the end of month rally, markets view recent evidence of a softening labour market as a precursor to Fed rate cuts during 2024. At this juncture, this scenario remains a high probability. The questions remain around the timing and extent of rate cuts, the cadence and composition of economic growth, and the subsequent impact on corporate profits and valuation of stocks. This note will delve into these questions, but first let's recap the performance of our funds.

						-----------------Annualized-----------------			
As of August 31, 2023	**YTD**	**1-mo**	**3-mo**	**6-mo**	**1-year**	**3-year**	**5-year**	**10-year**	**Inception**
Forge First Long Short LP (Class F Lead Series)	2.82%	1.58%	1.30%	2.70%	-0.23%	7.58%	9.00%	10.17%	13.00%
Forge First Multi Strategy LP (Class F Lead Series)	2.33%	0.62%	1.33%	1.57%	3.79%	8.80%	8.40%	7.82%	10.30%
S&P/TSX Composite Total Return Index	6.94%	-1.37%	4.57%	2.06%	8.49%	10.36%	7.80%	8.05%	8.35%
S&P 500 Total Return Index (C$)	18.87 %	1.26%	7.82%	13.91%	19.94%	11.93%	11.93%	15.69%	16.58%

Note: Returns for the Forge First funds are based on the August 2012 Class F Lead Series and are net of all fees and expenses. In a year, up to 12 series can be created within a Class of units. Unitholders are advised to refer to their monthly statement for the net return of their respective Class and Series. All returns are in local currencies.

Each of our two funds delivered solid, positive net returns for the month, with the short book of each fund providing significant contributions. The Class F Lead Series of our Long Short LP gained +1.58% net of fees, boosting its year-to-date net return to +2.82%. Energy, Financials and listed put options were the largest contributors for August. Losing positions included securities we'd characterize as 'bond proxies', including several REITs.

Interestingly, entering 2023, defensive sectors including REITs, Utilities and Staples were among the most consensus long ideas. Of course, they've turned out to be the largest underperformers given the move higher in yields on long maturity bonds. While we have started to pick away in the REITs space, with the intent of accumulating a position during the remainder of 2023, with hindsight we could have waited a little longer.

In Energy, we continue to stick with our now long-held preferred names including Tourmaline Oil Corp. (TOU.CA), Canadian Natural Resources Ltd. (CNQ.CA) and Athabasca Oil Corp. (ATH.CA). Shifting to Financials, we profitably covered a portion of short sales on Sun Life Financial Inc. (SLF.CA) and took partial profits on Fairfax Financial Holdings Ltd. (FFH.CA). This fund exited August with delta-adjusted gross and net exposure of 141% and 18% respectively.

The Class F Lead Series of our multi-asset, lower volatility Multi Strategy LP generated a net return of +0.62% for the month, boosting its year-to-date net return to +2.33%. Positive performance was mainly captured in Financials, the Consumer Cyclical sector, index put positions, Energy and Technology. Consumer Non-Cyclical and Materials were the principal losing sectors for this fund.

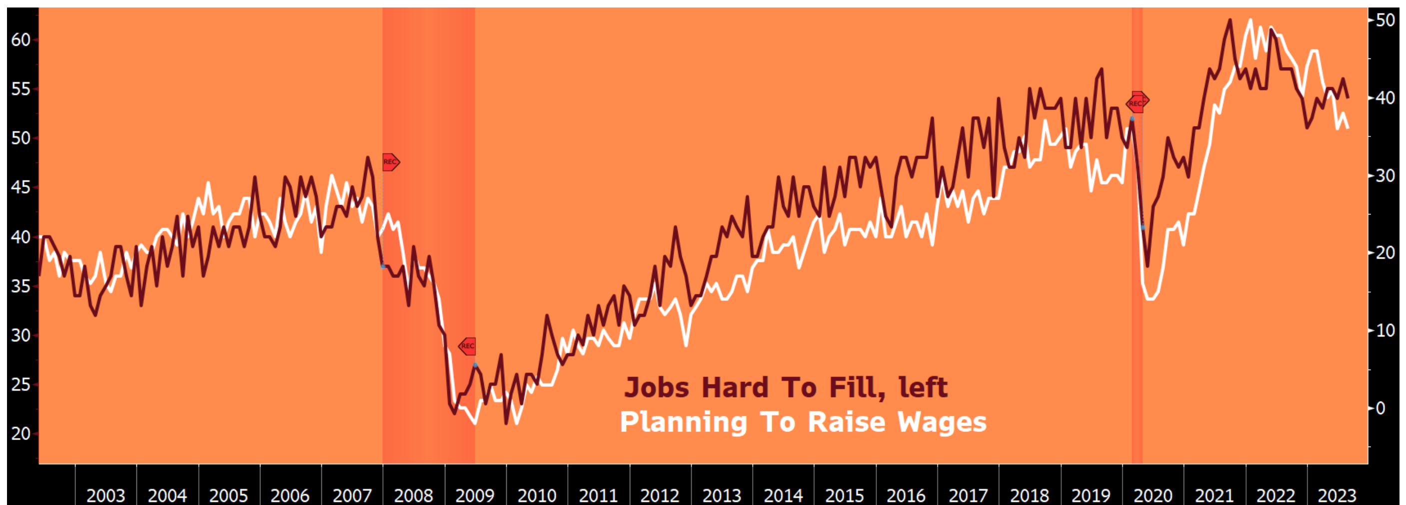
The Multi Strategy LP added to its position in RB Global Inc. (RBA.US) when the stock turned downwards at the start of August, on the surprise departure of the company's CEO. In addition, towards the end of the month, the fund allowed certain index puts to expire, so as to increase the net common equity exposure of the fund to exit August at 13% net long. However, the fund maintains significant downside protection due to ownership of put spreads expiring on each of September 29th and October 20th, as well as puts on individual securities. The net exposure of the multi-asset sleeve of the fund was 18% at month end such that overall, the delta-adjusted gross and net exposure of what we consider to be a "sophisticated balanced" fund was 111% and 31% respectively.

In last month's commentary, we tabled our short thesis on Consumer Staple stocks, for which outsized price growth since COVID-19 first appeared has caused volume growth for many companies to 'hit a wall' and collapse. In addition, the rising cost of inputs and share prices has driven the valuation of these stocks to become rich, to say the least. Take

the example of Campbell Soup Co. (CPB.US). Since the start of COVID-19, the U.S. CPI Index for soups has advanced 31%, while volumes have declined 8%. Given the increasingly challenged financial position of lower quintile North American families reducing the ability of Staples manufacturers to keep hiking prices, we foresee additional pressure on volumes, earnings, and the share prices of these companies.

Source: Bloomberg

We're sure you've all read how U.S. payroll gains have clearly shifted down, from an average of 300K in 2022 to 150K over the past three months, including 127K last month (when household employment is adjusted to match the same universe as payrolls). There's little question that interest rates are finally beginning to impact the economy. Yet, as shown in the ~25-year graph above, both wage growth (red line, left axis) and the ratio of job openings (JOLTS) to the unemployed (white line, right axis) remain elevated. Looked at from a different angle, the 20-year graph below exhibiting data from a survey of U.S. small to medium-sized businesses compares the percentages of companies finding jobs hard to fill (red line, left axis) against organizations planning to raise wages (white line, right axis). This graph also suggests that despite recent weakness, there is still lots of air in the tyres of the job market.

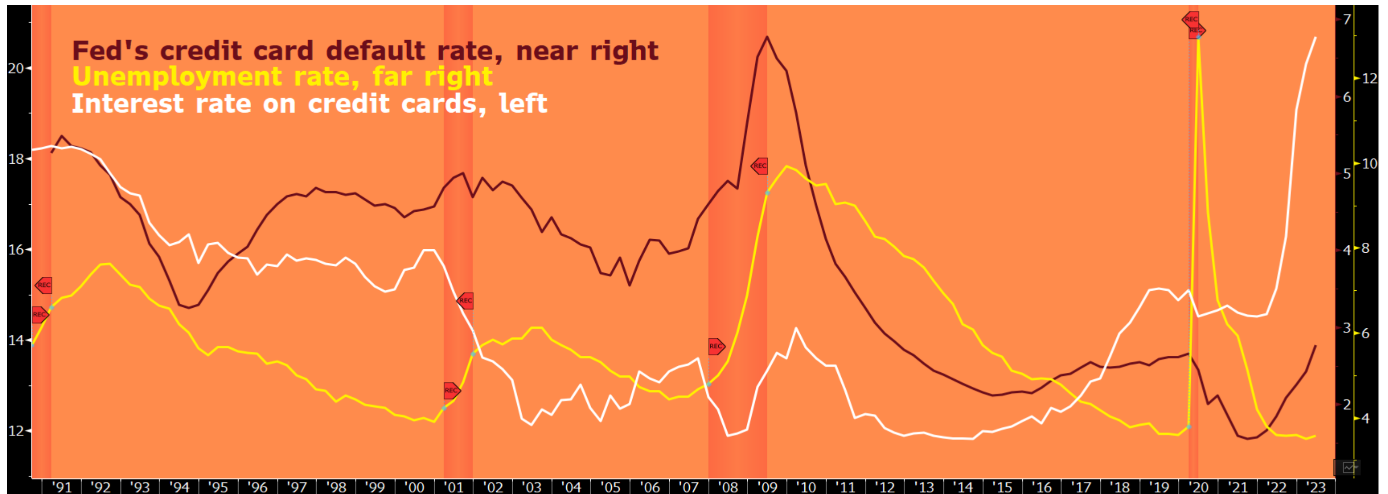


Source: Bloomberg

At the same time, a participation rate (biggest rise last month since May 2022) that is finally starting to rise implies a growing portion of the population of the U.S. needs to work! The savings rate fell to 3.5% last month, excess COVID-19 savings will be gone by the end of 2023, and the three-year forgiveness of student loan payments expired on Labour Day. Banks have begun to tighten lending standards as auto and credit card delinquencies for sub-prime borrowers now sit above pre-crisis levels.

In fact, in looking at the current rate charged on credit card debt (white line, left axis) in the graph below and the presumption of a rising unemployment rate (yellow line, far right axis), it's tough not to envision a significant rise in delinquencies during 2024. Hence, despite real wage growth having finally turned positive, consumer spending is bound to contribute little to U.S. real GDP growth next year. Fortunately, the balance sheet of the average U.S. consumer is in

much better shape than in past downturns (too bad the same can't be said about the average Canadian!) but no doubt the Fed will take notice.



Source: Bloomberg

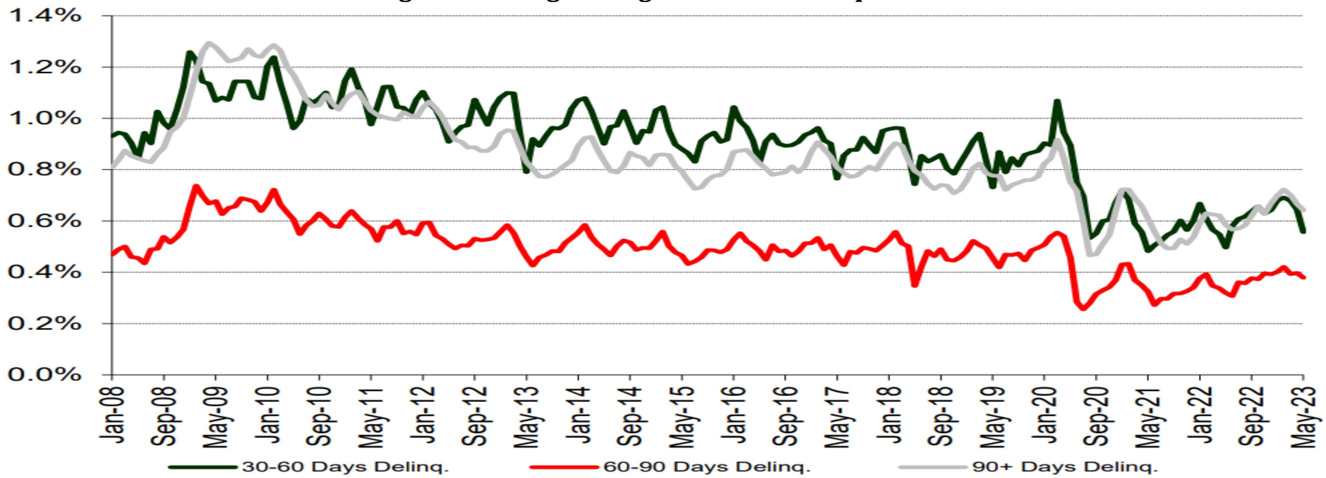
Also, on the topic of consumer spending, it's worth noting that higher interest rates will fuel higher interest income. However, the vast majority of these gains will reside with the proportion of the population that has the lowest propensity to spend. At the same time, it's estimated that real savings amongst the lower quintiles, and proportionately higher spenders, of North American consumers are lower today than they were prior to COVID-19. In addition, specific to the U.S., reductions in Medicaid spending and the return of student loan repayments will hurt spending growth. Hence, the swing factor as to how much lower 2024 consumer spending is compared to 2023 will be the jobs market.

Another sector that undoubtedly has the Fed's eye is Housing as, according to Case-Shiller, during Q2 prices advanced 15% on an annualized basis from a year ago! Meanwhile, according to the National Association of Realtors, based on the median family income and home prices, the average mortgagor now has to allocate nearly 29% of their income to cover the monthly mortgage, up from roughly 14% in 2020. Fortunately, Redfin believes 82% of mortgagors hold mortgages with rates of less than 5%. Of course, these low rates explain the limited supply of existing homes on the market; folks don't want to give up their mortgages! In turn, this lack of supply explains why prices have accelerated to the upside.

Source: Bloomberg

One sector we remain unenamoured with is Canadian Banking, as we found the recently reported quarterly results quite underwhelming. Expense and revenue growth both went the wrong way. Margins for U.S. businesses remain under pressure (cumulative NIM decline as much as 50 bps) while the stronger Canadian businesses are only now beginning to roll over. Funding mix and narrow spreads have evolved to fully offset the potential benefit of the aggregate hikes by the Bank of Canada ("BoC"). All of the banks began to lock in rates at the start of the year (Royal Bank spoke to this topic on their Q1 call and Scotiabank has been hedged since this time last year). In our view, additional hikes by the BoC will be neutral at best for the group. Looking ahead to fiscal 2024, our current assumption of flat margins next year may prove to be optimistic.

Canadian Credit Card Trusts: Weighted Average Charge-Offs and Delinquencies



Source: Company reports, CBRS, TD Securities Inc.

Loan growth has also been a drag, with monthly OSFI data suggesting loan growth settling out in the 3%-5% range (including growth in mortgages of 1%-3%) markedly below the mid-to-high single digit estimates held by analysts. One bright spot is Canadian credit, an example being the benign trends in credit card securitization data shown in the graph above that begins in 2008. Both Royal Bank and TD Bank tabled good results on delinquencies and impaired loans, even surprisingly delivering a partial inflection towards quarter-to-quarter improvement. Other banks exhibited some disappointments on the credit front such that on a total bank basis, PCLs were 32 bps for the group, up four bps from the previous quarter, and now sit in the upper/middle of the normal range. Almost all of the deterioration is driven by non-Canadian business units.

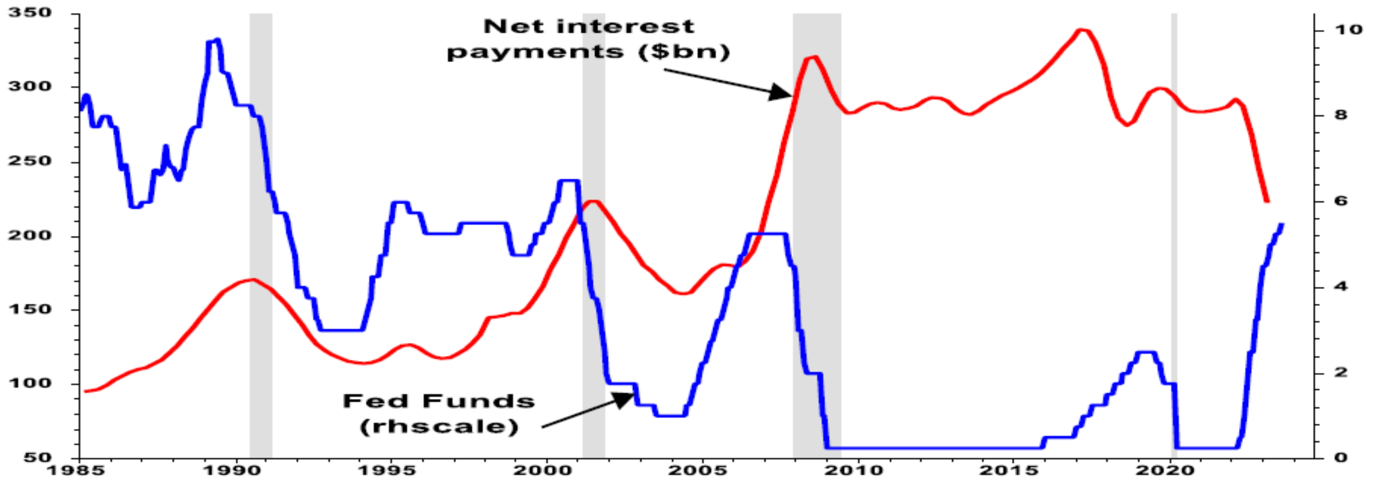
Looking over to China, it's an understatement to say there are no 'green shoots' in that economy, where ground zero is the real estate market. Whether it is consumer confidence, exports/imports, the appetite for credit, or capital spending, no metrics in the Chinese economy are inflecting upwards. Given the importance of the property market to their economy, arguably Gavekal's year-to-date graph below says it all. Relative to the same period prior to COVID-19, daily property sales are continuing to deteriorate even though interest rates have been going down, not up, in China! The bottom line is that while most pundits, including ourselves, expected the U.S. economy to be in deteriorating shape by now, it remains the 'best house on a bad street'.

Chinese daily property sales, relative to same period of 2019

Source: Wind, Gavekal Dragonomics, Macrobond

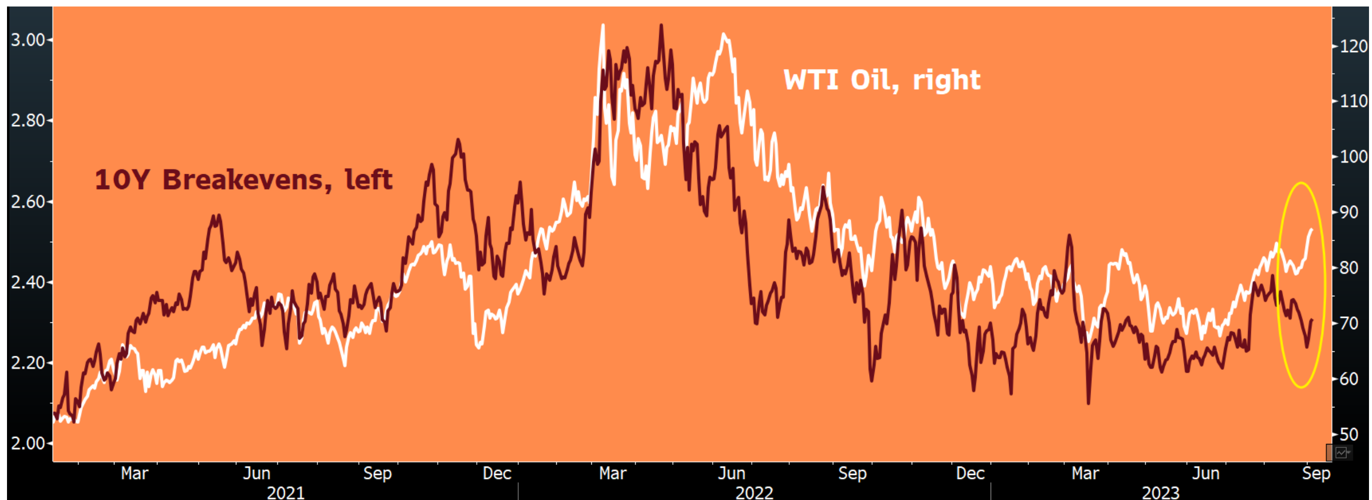
Going back to the topic of interest income for a moment, we found the graph below to be surprising and of particular interest. We all know interest rates have increased significantly and that the U.S. corporate sector is an enormous borrower of funds. Consequently, one might assume net interest expense for Corporate America has skyrocketed. In fact, as shown on the far-right side of the following four-year graph, courtesy of Societe Generale, the opposite has happened. Companies have borrowed long at 2%-3% and deposited the funds in short-term instruments yielding 5%+, resulting in collapsing net interest expense. According to Societe Generale, this tactic has added 5% to profits over the last year instead of deducting the usual 10%+ from profits. As an aside, don't be absurd and ask why 31% of the U.S. Treasury's

debt matures within 12 months when they had ample opportunity to extend the duration of their book at interest rates a fraction of where they are trading today!



Source: Societe Generale

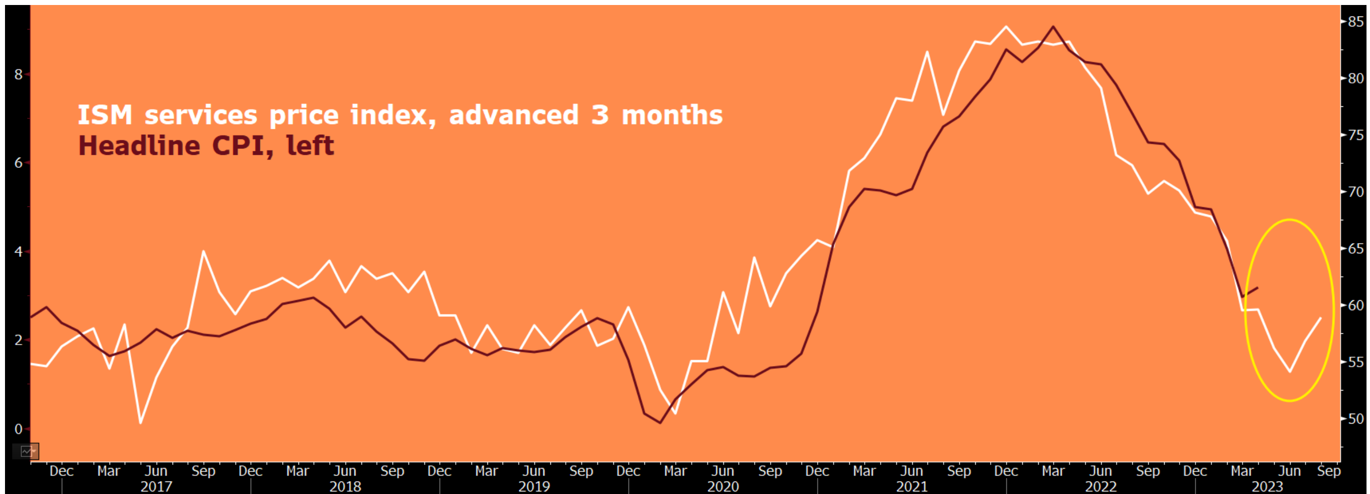
Speaking of interest rates, the historical correlation between oil prices (white line, right axis) and the yield on U.S. 10-year break-even bonds suggests if WTI stays near current levels, yields could move 20-25 bps higher. The 2024 forward strip on WTI currently sits above US$80 for the first time since June 2022. The similar strips for NYMEX and AECO natural gas are exhibiting less buoyancy, sitting at $3.42 and $3.02 respectively.



Source: Bloomberg

Further, the trends seen within the price index of the ISM Services print last week remains supportive of our long-held belief that service inflation will stay higher than desired. Wage trends, medical costs and auto insurance are just three of the culprits generating another leg to the inflation story. The five-year graph below compares Headline CPI (red line, left axis) against the ISM Services Price Index (white line, right axis) and please note, this latter variable is advanced three months against the former metric.

A jobs market that has softened but remains far from weak (read last week's Beige Book), rising oil prices, an upturn in service pricing (led by transportation costs), the expectation of a solid Q3 GDP print and an ongoing supply imbalance in the U.S. treasury market all suggest to us that while bonds may be oversold (huge short positions) in the short term, yields are unlikely to decline markedly from current levels.



Source: Bloomberg

We had a cautious view towards stocks entering 2023, given our expectation that inflation would remain 'sticky' and interest rates would not be going down. While both views have proven correct, contrary to conventional wisdom, the P:E for the S&P 500 has proceeded to rise from 17X at the start of the year to the recent 21X, despite a roughly 50-bps increase in yields for both 2s and 10s. In addition, as of month end, most sectors are trading above their 50-day moving averages. Excluding the 'M7' names, the rest of the S&P 500 is up approximately 5% YTD at the time of writing. Hence, we'd humbly submit that a time limit is pending on the breakdown in the relationship between real 10-year yields (white line, right axis) and the P:E ratio of the S&P 500 (red line, inverted) shown in the five+ year graph below.

Source: Bloomberg

Looking ahead, we find it tough to believe markets can 'have their cake and eat it too'. If GDP growth takes a deep dive, the pace of the reduction in inflation will quicken but structural imbalances in the supply and demand for labour and some commodities should be expected to keep inflation uncomfortably high relative to nominal growth. This scenario implies shrinking demand, falling profit margins and hence, earnings that print far lower than the consensus 12% currently predicted for 2024 by analysts. In turn, if growth proves more resilient, a degree of slack in labour markets that facilitates timely rate cuts is not the intuitive outcome. (For the record, we do not expect the Fed to hike rates on Sept. 20th).

Take your pick of these scenarios, but to us neither set-up implies a favourable risk-reward for long only strategies or positions predicated upon tightening credit spreads. In the meantime, our funds will continue to stick to their discipline of holding sizeable, diversified short exposures designed to hedge a collection of long positions that are value-oriented securities generating significant levels of free cash flow. Each of our two funds intends to maintain conservative net positioning until market pricing is better aligned with the underlying macro data.

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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CEO, CIO	Portfolio Manager	Portfolio Manager

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