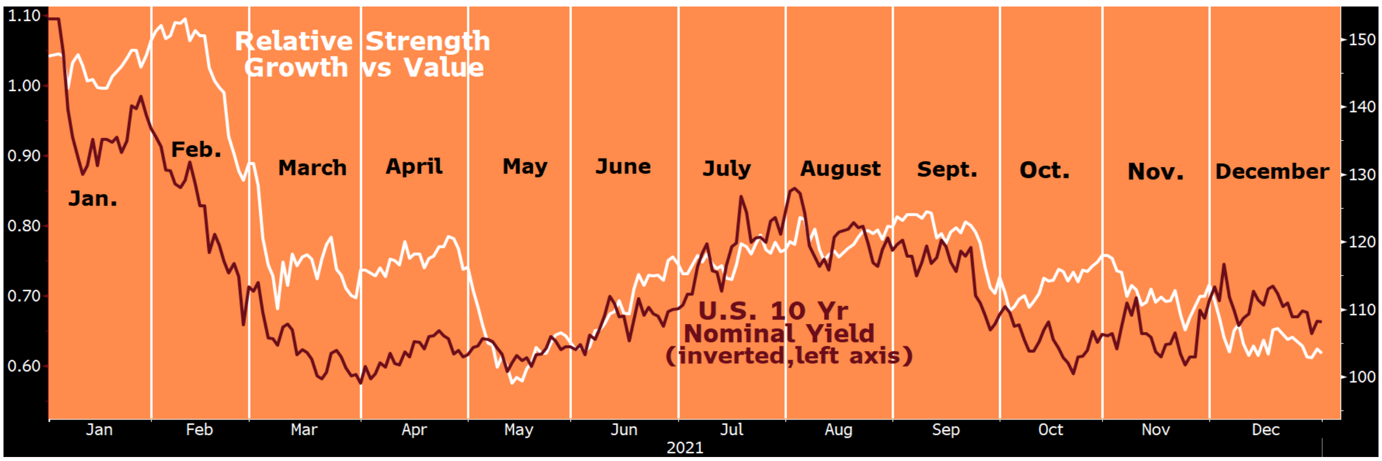
FORGEFIRST
ASSET MANAGEMENT INC

January 10, 2022

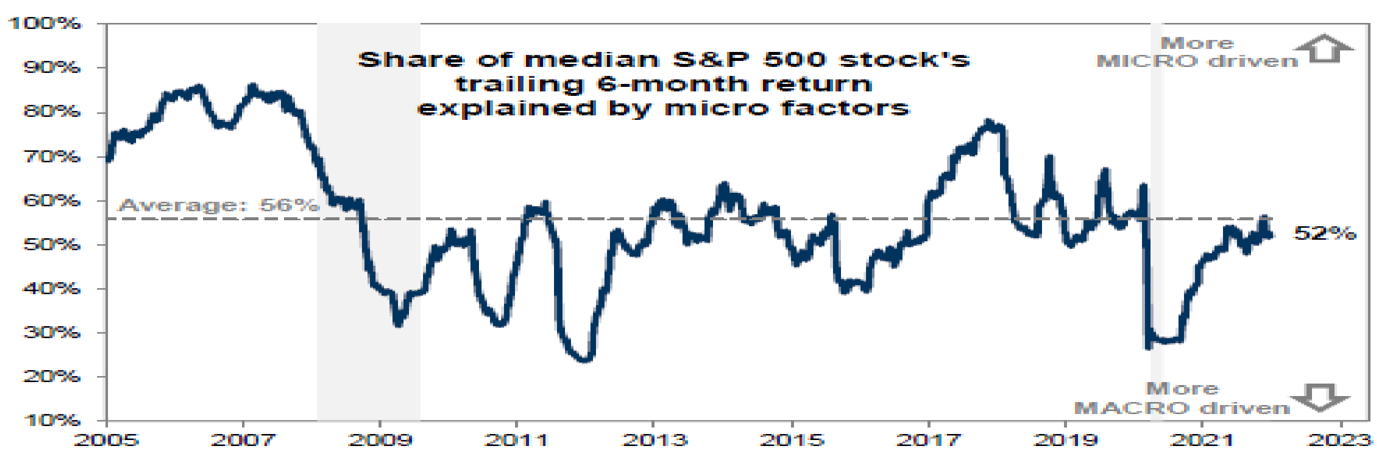
December 2021 Commentary & 2022 Outlook

December 2021 was a volatile month in financial markets, as the newly named Omicron variant entered our lexicon and FOMC Chair Powell turned hawkish, though, in the end, equities appeared non-plussed by either situation. The S&P 500 enjoyed its best December since 2010, while Canada's TSX generated a total return of 3.06%. For the full year 2021, stocks had a banner year driven by the impact of fiscal and monetary stimulus on asset prices and a strong recovery in corporate profits. In reviewing the performance of the S&P 500, 434 issues gained for the year, 96 of which climbed more than 50%, seven declined more than 25% and all 11 sectors posted double-digit gains (up from seven in 2020, five of which posted double-digit gains). The top five performers accounted for 32.6% of the total return for the S&P 500, including Microsoft Corp (MSFT.US) at 9.7%, Apple Inc. (AAPL.US) at 8.1% and Alphabet Inc. (GOOG.US) at 7.4%. The one-year graph below highlights the negative correlation between the relative outperformance of growth to value (white line) stocks against 10-year bond yields (red line; note the inversion). This correlation remained strong until Q4 when the flow of funds, words from the Fed, and Omicron combined to disrupt this relationship.



Source: Bloomberg

According to the graph below from Goldman Sachs, last year was also a period during which macro versus micro (company-specific factors) catalyzed a majority of equity returns. As we'll discuss below, we believe 2022 will be a year where micro will matter more than macro (alpha vs. beta). Winning trades last year included energy producers, mega cap tech, mall-levered retail stores and rate sensitive financials, while losing trades included unprofitable tech stocks, Chinese ADRs and various speculative areas of the market including SPACs and marijuana stocks.



Source: Goldman Sachs

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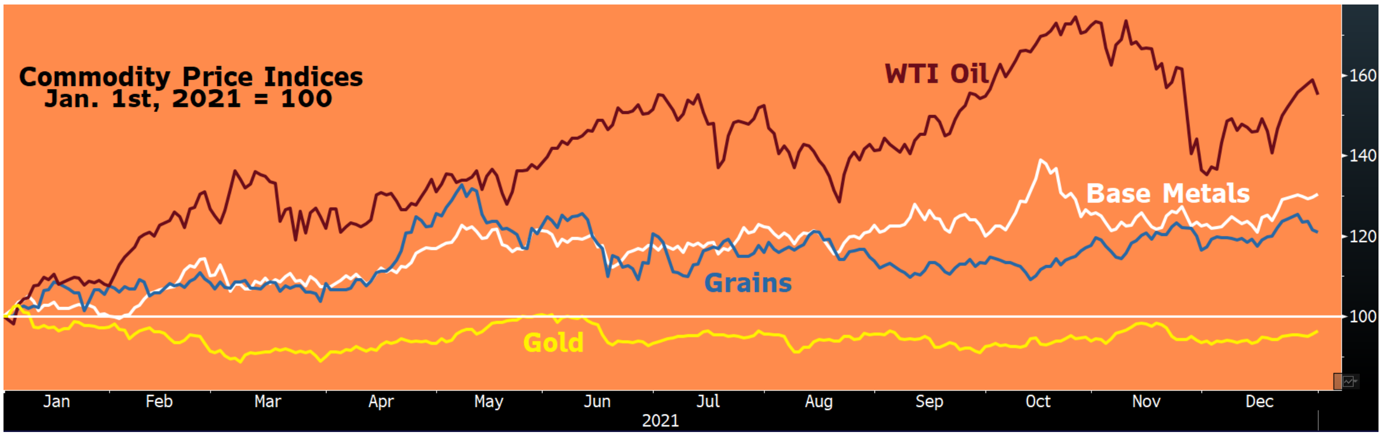
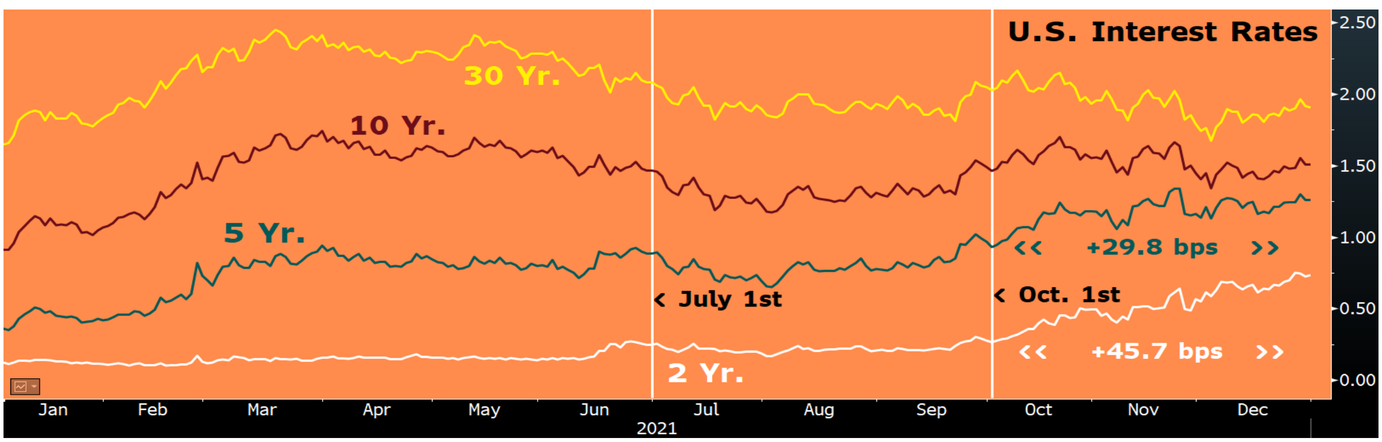
The graph below indicates that, with the exception of gold (yellow line) and iron ore (not shown), commodity prices also had a good 2021 as energy prices rose more than 50% as did a different type of "fuel", coffee. Shifting to currencies, our loonie was flattish against the U.S., the trade-weighted American dollar rose 6.4%, EM currencies fell on average another 9.3% and the surprise winner of the year, the Chinese Renimbi, gained 2% against the USD.



Source: Bloomberg

Bond yields rose across the curve, though two observations from the following graph merit mention. First, notice that 10 and 30-year yields were flat point-to-point from February through December 2021. Second, during Q4, yields on 2s and 5s increased 45.7 and 29.8 bps respectively, such that the 10-2 yield curve ended 2021 at 78 bps, a measly one bp higher than year end 2020. Spreads contracted across the credit spectrum, with the greatest tightening occurring amongst the lowest quality credits.



Source: Bloomberg

We're pleased to announce that, once again, each of our two alternative mutual funds at Forge First exceeded their targeted net returns for 2021. The Series F of our Long Short Alternative Fund, which targets a net return of +8% to 10%, generated a net return of +12.18% for 2021 after posting a +15.78% net return during 2020. Last year's return includes a decline of -0.62% net in December, as losses on our portfolio hedges exceeded the gains in our equity book. This fund exited calendar 2021 with gross and net exposures of 115% and 31%.

Similarly, the Series F of our multi-asset Conservative Alternative Fund bettered its +6% to 7% net return objective, delivering a net gain of +9.10% for 2021, following its +17.56% net advance during 2020. During December 2021, the negative impact of asset protection strategies exceeded the gains in the capital growth and multi-asset sleeves of this portfolio, such that this fund declined -0.84% for the month. The gross and net exposures were 103% and 33%, respectively.

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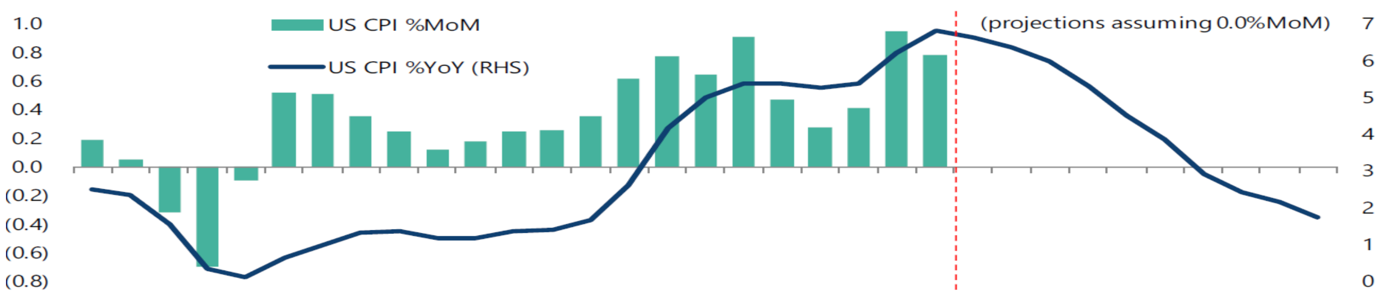
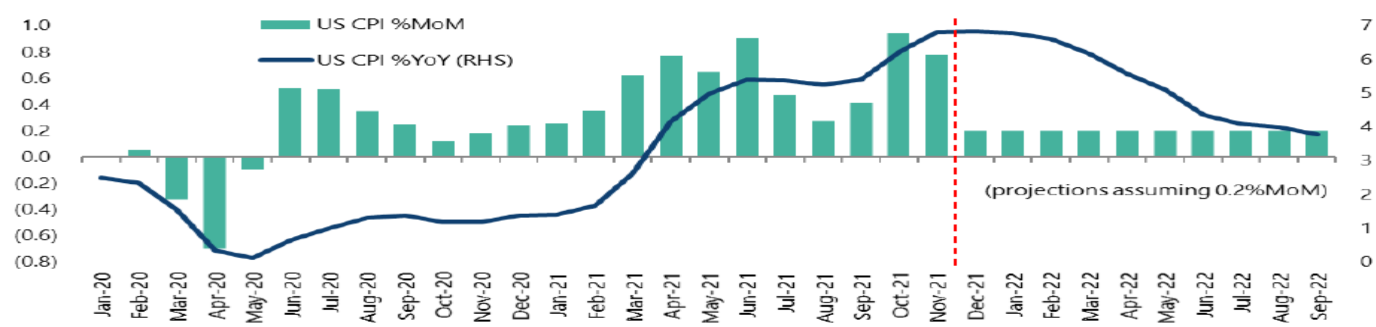
	YTD	1 mo	3 mo	6 mo	1 year	2 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	11.22%	-0.68%	-0.71%	-0.53%	11.22%	12.93%	10.50%
Forge First Long Short Alternative Fund Series F	12.18%	-0.62%	-0.50%	-0.10%	12.18%	13.97%	11.47%
Forge First Conservative Alternative Fund Series A	8.10%	-0.92%	-1.33%	-0.66%	8.10%	12.23%	9.17%
Forge First Conservative Alternative Fund Series F	9.10%	-0.84%	-1.10%	-0.20%	9.10%	13.25%	10.14%
TSX Total Return	25.09%	3.06%	6.47%	6.66%	25.09%	14.93%	12.49%
S&P 500 Total Return (US$)	28.71%	4.48%	11.03%	11.67%	28.71%	23.44%	21.33%

*Annualized | Inception date: April 24, 2019

Witnessing increased volatility during the 1st half of December, post-Omicron and fears of a hawkish upcoming Fed meeting, each of our funds took actions to increase protection. Then, of course, the market experienced a sharp rally during four of the last eight trading sessions of the year. In reviewing sector performance, Technology and Real Estate led on the positive side of the ledger, while our Energy book experienced a loss for the month. Other sectors generated deminimus gains and losses.

Looking ahead to 2022, four items are noteworthy of consideration in assessing the outlook for stocks: inflation, policy stimulus, COVID and geopolitics. Inflation comes first for two reasons. If the current rise in inflation persists, Central Banks will find themselves well behind the curve; a situation likely to trigger a material increase in volatility and a tough environment for long only investors. In addition, the trend in inflation will dictate the pace at which monetary policy accommodation a.k.a. liquidity will be withdrawn from the marketplace.





Source: Jefferies & Co.

For the months of February through May of 2021, U.S. headline CPI was negative on a year-over-year basis. Then for the month of November 2021, U.S. headline CPI printed at +6.8% year over year. The base effect suggests inflation comparisons could peak on a year-over-year basis during the Spring of 2022, concurrent with the cessation of the Fed's asset purchases. Thereafter, the key question is the direction of inflation. The far, right side of each of the two graphs above, courtesy of Christopher Wood's 'GREED & Fear' publication from Jefferies & Co, indicate the projected rate of

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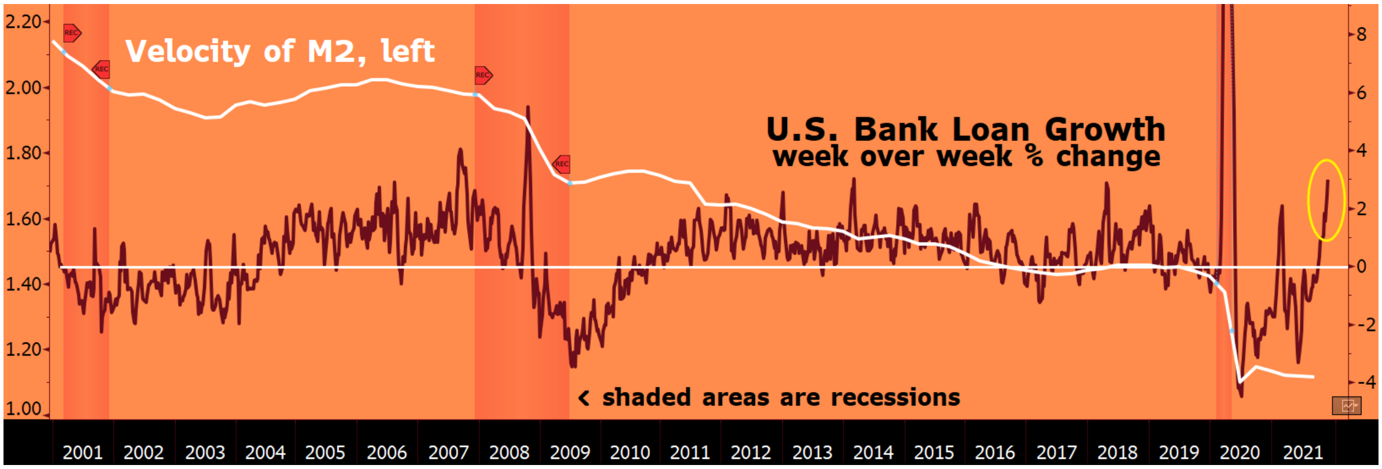
headline U.S. CPI in September 2022, assuming 0.0% (top graph) and 0.2% (bottom graph) month-over-month headline inflation prints between now (December 2021 to be released on January 12th) and September 2022. Under the generous assumption that inflation prints will be 0.0% during this time frame, U.S. CPI would hit the Fed's 2% target with the September print. Using the more realistic expectation of +0.2% prints, headline CPI would still be +3.8% the Fall of 2022.

Until Fed Chair Powell caved on his previous insistence that inflation was 'transient' at December's meeting, the Fed had assumed that price pressures would abate concurrent with the normalization of the global supply chain. However, with every country having unique characteristics to its own COVID experience and the subsequent impact on its manufacturing activities, it appears that the world will continue to suffer a rolling series of supply shortages. We suspect this constant supply-demand tightening will persist until late 2022 or longer. In addition, there's the inflation embedded into the basics of life, food, rent and gasoline.

Our analysis suggests food prices are likely to increase markedly during Q1 of this year, for all the same reasons other prices keep rising: labour, transportation and supply constraints for the underlying item. While on a percentage basis, the prices of oil and natural gas may not rise markedly from current levels, our research suggests energy product prices are likely to linger at currently elevated levels long enough to be problematic for the Fed. Finally, the 'sleeper' item is rent, both the real kind and the more dubious type, the latter being the Owner's Equivalent Rent (OER) that constitutes 25% of U.S. headline CPI and 12% of core PCE. We treat OER with suspicion, given that it merely presents "the amount of rent that would need to be paid to substitute a currently owned house as a rental property". Regardless, while there has always been a lag before housing prices impact rental prices (of both kinds), in light of the hot housing market that cheap money has fuelled on both sides of the border, there's little question rental prices have more room to rise. BMO Economics forecast that rental prices can push core U.S. CPI to 4.5% during 2022.

Source: Bloomberg

While it's easy to monitor the rate of change of your spending at home or business to assess inflationary trends, two other variables to help determine whether inflation is likely to become problematic and/or cause the Fed to be materially behind the curve, are the rate of change in wages and bank lending. As discussed on page 3 of our September 2021 Commentary, if employers have to pay up for labour, the incremental cash in the pockets of employees will enable them to bid up the price paid for goods and services. There are numerous statistics economists follow to assess the likelihood that rising wage growth risks supply-driven price pressures migrating to the more insidious demand-pull type of inflation. This datum includes quit rates, job openings, participation rate and the rate of unemployment. The graph above compares the percent of companies that are planning to raise wages (white line, right axis) to ones that have job openings they're finding hard to fill (red line, left axis). If wage trends decelerate from current levels yet prices remain firm, given that consumer spending constitutes almost 70% of the U.S. economy, it's likely consumer spending would slow markedly as the average person just wouldn't have much discretionary cash after paying for groceries, gasoline and rent.



Source: Bloomberg

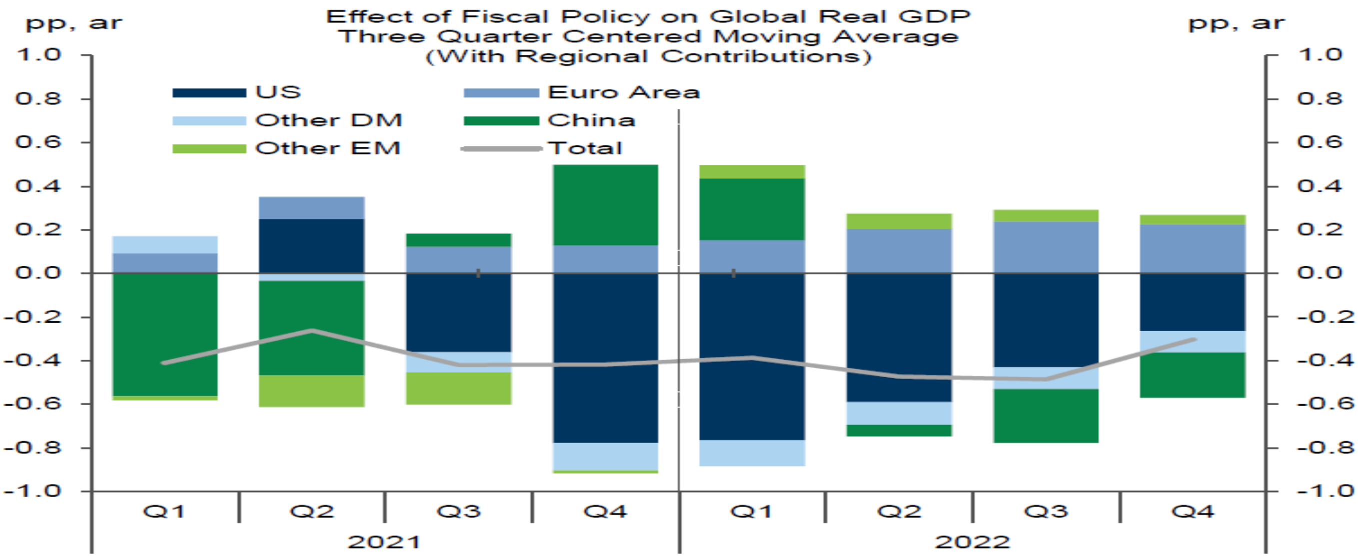
The demand for money is another measure to be followed. The yellow oval on the far right of the 20-year graph above illustrates that U.S. loan growth (red line, right axis) has begun to rise at amongst its fastest pace in years, and after years of money creation by the Fed, the commercial banks have endless amounts of cash available to lend. The velocity of money (M2, white line, left axis) or GDP divided by M2 indicates the number of times each dollar is used to purchase goods and services. The greater the velocity, the stronger the economy. Given the humungous level of excess reserves (customer deposits that banks park at the Fed) held by the commercial banks, it's probable the Fed can contract its balance sheet by US$1T before materially affecting the liquidity of markets or the everyday lending deposit model of banks. However, unless aggregate demand falters, it could only be a matter of time until velocity and bank lending contribute to a potential problem with inflation.

Rising rates of bank loan growth can easily offset the impact of any reduction of liquidity by the Fed. Hence, if the rate of bank lending accelerates and inflation prints remain resilient despite lapping the abovementioned easy year-over-year comparisons this Spring, it will become incumbent on the Fed to expedite its withdrawal of liquidity. If this scenario were to happen post that first US$1T of withdrawal by the Fed, there is little doubt that market volatility would pick up and equities, especially long duration and 'bond proxy' stocks, plus bonds would be in for a rough ride. While this scenario is not our base case, it is definitely is a possibility during H2 2022. We suspect few investors are positioned to withstand the tail risk of this storyline.

To summarize our discussion on inflation, we'll table three scenarios: 1) inflation becomes problematic, wage growth picks up, the Fed is seen as being markedly behind the curve, and as a result, the pace of rate hikes and withdrawal of liquidity accelerates, and the price of bonds and stocks fall, 2) A more matched supply chain stems a further rise in inflation and wage hikes, though price pressures remain stubbornly above the Fed's target, receding wage hikes slows consumer spending during late 2022, in turn causing the Fed to push pause on rate hikes, bonds rally, factor and style rotation amongst stocks pushes equities higher, the more growth oriented U.S. indices outperform Canadian equities, and 3) inflation levels show signs of reverting towards Fed's 2% target this summer, wages stop climbing, quiescent inflation enables consumer spending to remain strong, bonds rally, equities trade to new all-time highs led by macro cap tech stocks.

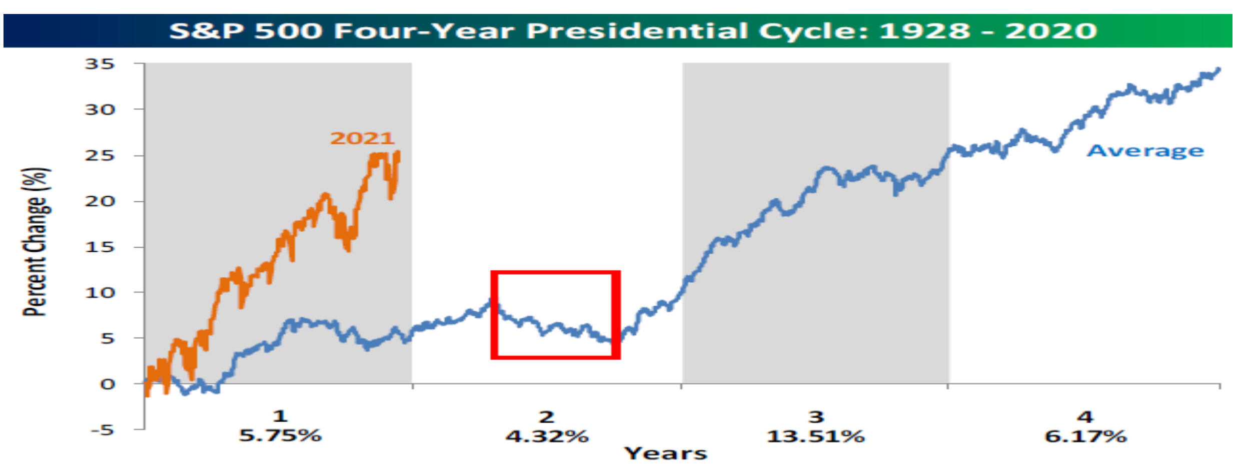
Policy stimulus was the most important driver of financial market performance during 2021. Which scenario is correct on the outlook for inflation will determine whether the withdrawal of monetary stimulus is accelerated, in line with current Fed thinking or more dovish if there's a material reduction in the rate of inflation or economic growth. While it's possible that Omicron could cause the Fed to delay interest rate lift-off by a meeting or two, we suspect the Fed will move quickly to begin reducing the size of its balance sheet once its bond buying concludes during March 2022. Step one for shrinking the balance sheet would see the Fed cease reinvesting the proceeds from maturing securities, followed by an active reduction in holdings. Besides inflation, a caveat to this hawkish view is that by Spring 2022, new appointees will reposition the composition of the FOMC to a more dovish orientation.

To assess the probable shift in fiscal accommodation, the bar chart below suggests the degree of fiscal retrenchment will remain static Q4 2021 through Q1 2022 (note Chinese expansion in green, U.S. reduction in dark blue) then increase through the remainder of the year. No surprises with respect to the change in direction of fiscal stimulus, and its importance is dwarfed by actions taken by the Central Banks.



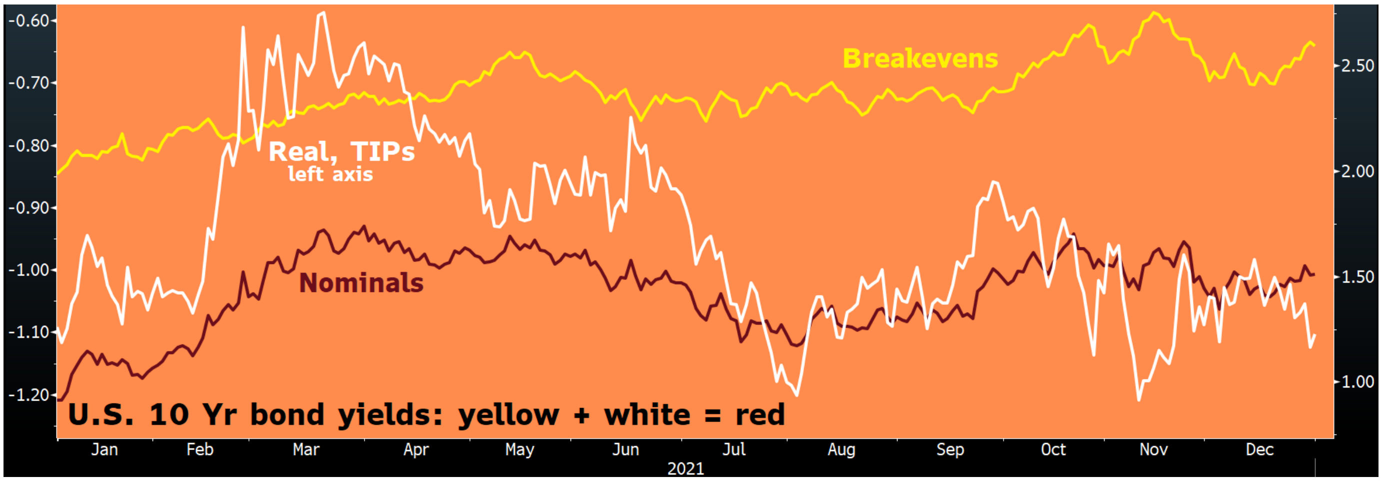
Source: Goldman Sachs

Next up on the list is COVID and let's all keep our fingers crossed that the optimists are correct in suggesting with Omicron, COVID will migrate to becoming a materially less virulent virus. Our health care system can't withstand any incremental stress, governments shouldn't be running up even more deficits and our economies can't cope with another major disruption in the supply chain. Hopefully we'll exit 2022 with a line of sight to having a combined COVID and flu vaccine. The final variable making the list of items that could impact markets during 2022 is a perennial favourite, but this year it seems more pertinent, and that's geopolitics. This list seems to be growing: 1) Russia /Ukraine, 2) Iran (39% inflation, debt-to-GDP now 60% & climbing), 3) China vs. the U.S. / R.O.W, 4) U.S. mid-term elections, and 5) the impact of the newly formed left wing coalition governing Germany. While we will leave it up to you to ponder what impact any of these situations could have on financial markets, below please find a nifty graph suggesting the 2nd year of a U.S. Presidential cycle typically generates skimpy returns.



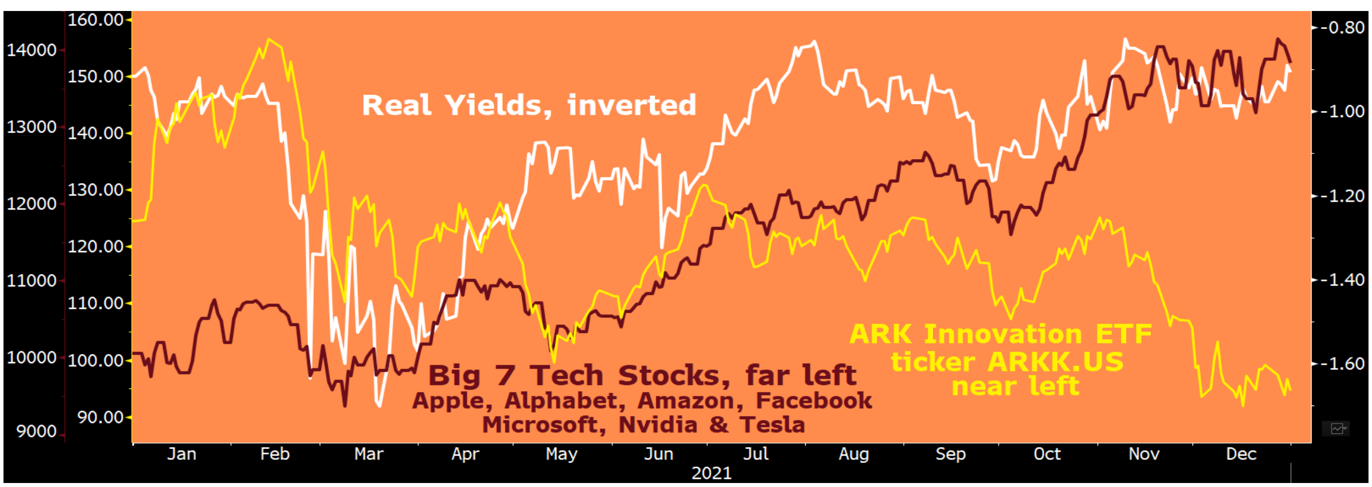
Source: Bespoke Investment Group

We note that we haven't discussed currencies, rates of GDP growth or corporate profits, otherwise we would be writing a book not a commentary. We assume that (hopefully) post-Omicron, GDP growth will accelerate through mid-year before slowing during H2 2022. Chinese growth will be unspectacular, Europe will once again be unimpressive in its economic performance and Canada will generally tag alongside the U.S. outlook albeit featuring some provincial rebalancing (Alberta up, Central Canada down) and a slowing housing market during the second half. The U.S. dollar should remain well bid, unless the E.U. surprises to the upside, while our Canadian dollar should have another uneventful year. Bond yields should rise with UST 10s featuring a handle in the low 2s before year end. Bonds in the belly of the curve should underperform shorter term bonds and the yield curve is expected to remain historically unexciting for banks. The one year graph below highlights where it gets interesting for bonds.



Source: Bloomberg

If inflation reverts towards the Fed's 2% target, breakeven yields (yellow line, right axis) will decline. In contrast, as the Fed shrinks liquidity, real yields (white line, left axis) or TIPs (treasury inflation protected securities) should be expected to rise. Our belief that nominal yields (red line, right axis) trade with a two handle this year presumes breakevens don't fall markedly from current levels but real yields move higher. The graph below compares real yields (white line, right axis, inverted) against seven mega cap tech stocks (red line, far left) and the Ark Innovation ETF (yellow line, near left), a proxy for GAAP stocks (growth at any price). If real yields rise, large cap tech stocks are likely to come under pressure and expect an even more pronounced decline in the GAAP stocks.



Source: Bloomberg

Shifting to our view of 2022, further to the previous sentence, the investment team at Forge First believes markets have just begun to reverse several of the market trends witnessed during the past few years. We expect predictable earnings growth will become of increasing importance as rising real rates triggers a further contraction in P/E multiples. We also believe the withdrawal of policy stimulus will create a market that favours stock pickers over market beta. Overall returns are likely to be lower, serving to increase the importance of limiting drawdowns. Stock-wise, our team expects quality growth or GARP equities and several of the sectors typically associated with value, to outperform. While cautious in the short term, we are getting increasingly bullish on oil prices, as we expect supply issues will more than offset any demand destruction resulting from COVID. For example, Russia's oil production failed to increase last month despite holding an increased quota. With valuations having normalized, banks are viewed as solid though unspectacular investments for the next 12 months. Securities often characterized as 'bond proxies' should struggle to deliver any capital appreciation.

While tactically adjusting exposure levels as the team sees fit as the year evolves, the strength of our process has driven the consistency of our returns over the years. Hence, we'll continue to strive to offer a competitive net return and protect capital when markets get rougher by sticking to our rule book:

- Buy and hold, free cash flowing businesses in North America
- Always include a diversified short book complemented with a book of listed put options
- Limit small cap stocks (market cap of <$1B) to no more than 10% of a portfolio.

Thank you for your business and interest in our funds. The team at Forge First hopes that you and your loved ones share a healthy and happy new year. 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	Daniel Lloyd	Keenan Murray
President and CEO	Portfolio Manager	Portfolio Manager