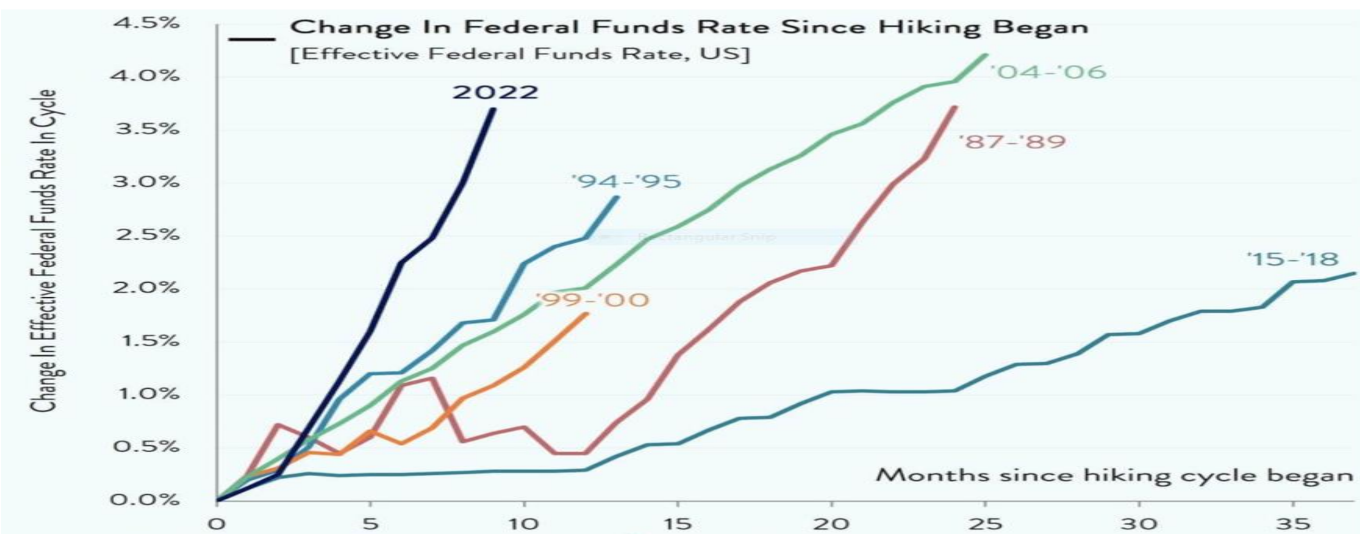
January 10, 2023

December 2022 Commentary & 2023 Outlook

For the second consecutive year, predicting the rate of inflation should prove to be the most important variable for investors to consider as we enter 2023. During the holiday season of 2021, the Fed's median projection for the upper bound of the Fed Funds Rate for year-end 2022 was 1%, with the terminal rate forecast to ultimately reach 2.5%. Investors were happy with those estimates and stocks exited 2021 trading comfortably north of 20X forward earnings. The world then changed, causing most investors to suffer sizeable losses during 2022. In this note, we will review last year, discuss the performance of our funds and table our outlook for financial markets during 2023.

The appendix at the end of this note offers excerpts from last year's lookahead commentary. Directionally, our forecasts were very good; however, our prediction that equity markets would be merely lousy, specifically either side of flat, obviously underestimated how poorly most equities would have performed during 2022. Likewise, our thinking that yields on UST10s would rise to the low 2s low-balled the eventual outcome. In fairness, the two key reasons driving those miscalculations were likely commonplace amongst investors, with both occurring after we published our report - 1) the hard Fed pivot during the 2nd week of January 2022, and 2) Russia's heinous invasion of Ukraine later that same month.

By the end of 2021, thanks to his repeated verbal missteps pertaining to policy, Chair Powell had lost credibility with investors. Hence, it was a real shock when Powell fessed up at being dead wrong on inflation (remember "transitory"?) and turned downright hawkish.



Source: Federal Reserve

As shown by the dark blue line on the graph above, 2022's interest rate hiking cycle has been the fastest and most aggressive since 1980. The horizontal axis is months from the first rate hike and the vertical axis denotes cumulative hikes during the specific rate hiking cycle. Two weeks later, Russia invaded Ukraine and resource and food supply chains came to an unexpected halt. The impact on financial markets of these two events was swift and sharply negative.

Source: Bloomberg

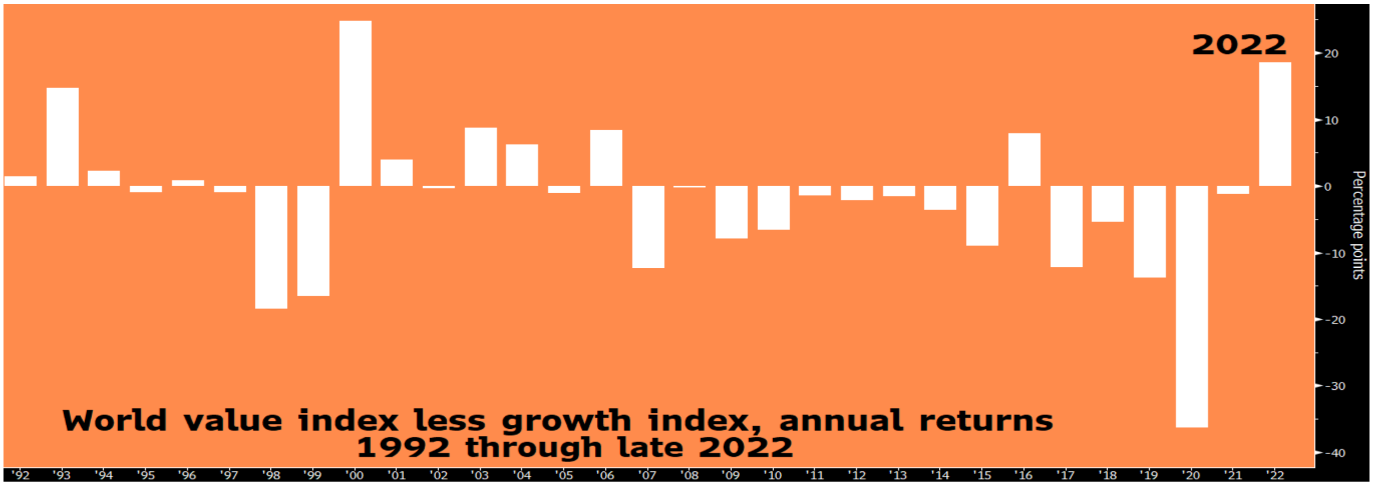
The white line on the above indexed graph of 2022 (through December 28th) compares the performance of seven macro cap (some are now just large cap) technology companies to the remaining stocks in the S&P500. The white vertical lines in this and the next graph bifurcate the four quarters of the year. As you can see from the far right of the graph above, exiting 2022, on average the big seven tech stocks had declined more than 40%, while the remainder of the S&P 500 fell 16%.

The year-to-date (through December 28th) indexed graph below compares the price changes of a U.S. long bond ETF (TLT.US) in yellow, against the S&P 500 (green), the TSX (purple), and the NASDAQ (red). Canada's TSX wins the race of the 'least ugly', thanks to its almost 18% allocation to Energy stocks; a group whose index price was still up 23% late in the year, despite the 16% price decline experienced during the final six months of 2022.

Source: Bloomberg

Needless to say, with a hawkish Fed and global supply chain issues poised to rocket inflation higher, bonds became the antithesis of safety and the '60/40' portfolio became a license to lose money. In contrast, companies producing or benefiting from the resource-dominant, war-induced supply chain issues, became the new 'safety' plays and the only winners. This dominance also marked a long-hoped-for sea change among die-hard value investors.

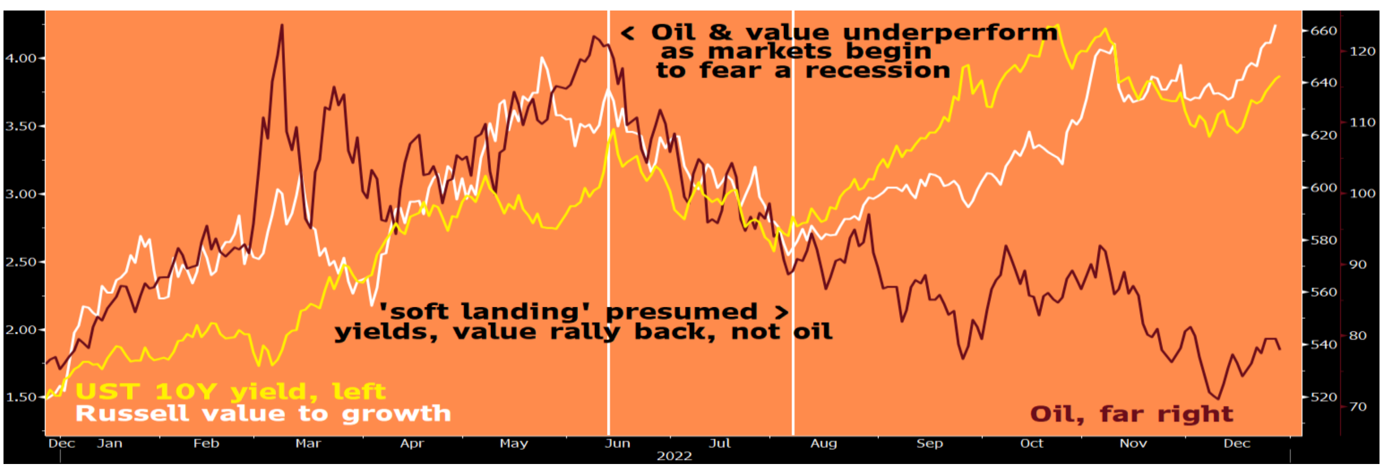
From March 2009 to the end of 2021, MSCI's index of global growth stocks rocketed by a factor of 6.4X, more than 2X the increase of the equivalent value index. In fact, the 30-year bar chart below indicates that global value stocks enjoyed their best relative year to global growth stocks since 2000. Shortages boosted the profits of these 1st half winners (energy and agriculture), but rising interest rates served to further goose the share prices of these low duration stocks. In contrast, as these higher rates were fueled by rising real yields, the decline of Cathy Woods and the rest of the speculative bubble or GAAP (growth at ANY price) crowd began to accelerate.



Source: Bloomberg

By mid-year, the Fed had convinced investors it meant business and peak inflation was soon to be reached. Punch-drunk from the year-to-date drubbing they had taken in both stocks and bonds, investors took the Fedspeak and actions as a green light to shift their worry from inflation towards the likelihood of a recession. This change in mindset began to negatively impact many of the H1 value-oriented winners in favour of growth stocks. Hence, to have been successful at investing during 2022, investors needed to have shifted the composition of their portfolios at this juncture.

The one-year graph below displays the yield on a UST 10-year bond (yellow line, left axis) against the price of oil (red line, far right axis) and the relative strength of the Russell 1000 Value Index to the Russell 1000 Growth Index (white line, near right axis). Respectively, the two white vertical lines in the middle of the graph mark: 1) the period when markets began to worry about a recession and 2) when investors became comforted that any recession would be shallow thanks to the strong balance sheets of U.S. money centre banks, corporate liquidity, the strong labour market, and adequate personal savings.



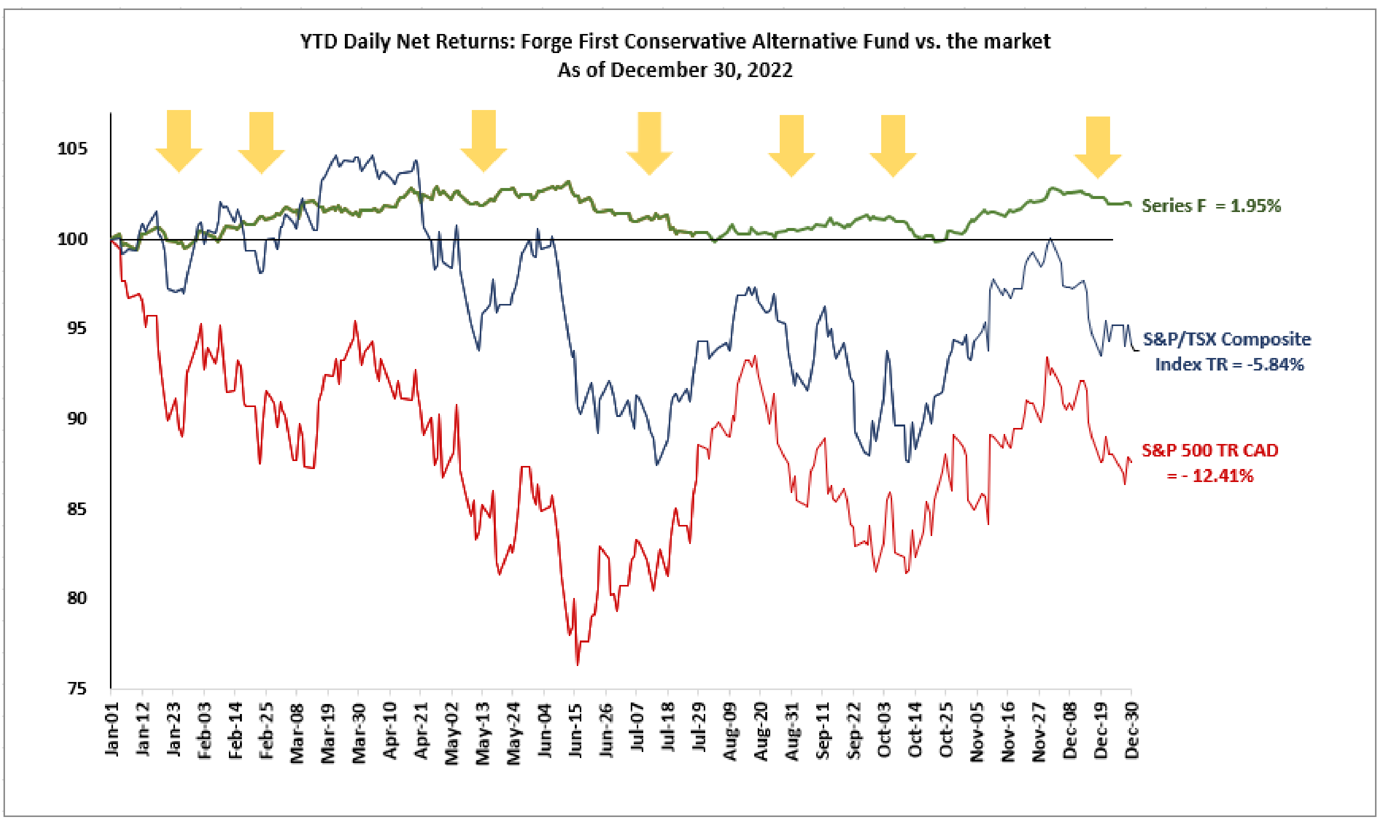
Source: Bloomberg

From the 2nd white line onwards, yields rose, value began to outperform once again, yet oil continued to struggle. It is true that the majority of this increase in yields was driven by reals versus breakevens; a situation that tends to be more pejorative to growth relative to value. However, the rise in nominal yields, confidence in a soft landing, continued supply chain challenges and still historically high price to earnings (P/E) multiples for growth stocks, aided the performance of most value-oriented securities.

The 10-year graph below compares the P/E multiple of the S&P 500 (yellow line) to each of the S&P's value (white line) and growth (red line) indices. The shaded area during 2020 highlights the COVID-induced recession, which in turn cratered profit estimates, heightening P/E multiples. Eye-balling six months ago on this graph, the P/E multiple for growth stocks was still elevated relative to the past ten years. Recently, the multiples for these three indices have converged to sharing a '17 valuation handle'.

Source: Bloomberg

As for our funds, we're very pleased with the risk-adjusted net performance delivered by our Conservative Alternative Fund for two reasons. First, as shown by the 2022 daily net performance graph of the Series F of this fund (green line) versus the S&P 500 Total Return Index (red line) and the S&P/TSX Composite Total Return Index (blue line), the Conservative Alternative Fund made money last year. Second, note that each time the markets plunged (denoted by the seven yellow arrows), this fund held in like the rock of Gibraltar. The volatility or standard deviation of this fund during 2022 was a very low 3.32%.



Given the shellacking equity indices suffered during December 2022, it won't be a surprise to learn that the key to the modest loss of -0.28% net for the month posted by the Series F of our Conservative Alternative Fund, was gains generated in the short book and listed index puts. These were modestly overwhelmed by losses arising from long call option positions in the capital growth sleeve of this portfolio and holdings in the Energy sector. The fund exited 2022 with delta-adjusted gross and net exposure of 108% and 24% respectively, with this net exposure being split between an 11% net long position in common equities and a 13% net long position within the multi-asset sleeve of the portfolio.

We were disappointed with the performance of our Long Short Alternative Fund. The Series F of the fund fell -2.82% net of fees during the last month of the year. Energy was the principal culprit in December, as natural gas prices fell by 35%. After colder-than-average temperatures during October and November, forecasts for a much warmer-than-average January caused pain in gas stocks. Shifting to oil, notwithstanding the fluid COVID-19 situation in China, fears about a global recession, and higher-than-expected Russian oil production, oil stocks were much better for sale.

For the full year, the Series F of the Long Short Alternative Fund declined -4.01% net of fees. The negative shift in the performance of the fund coincided with the mid-June reversal in the price of oil and other commodities, including grains. Unfortunately, we maintained too high a weight in resource sectors including Energy during the back half of the year. The volatility of the Long Short Alternative Fund last year was 6.88% and this fund exited 2022 with delta-adjusted gross and net exposures of 112% and 36% respectively.

	YTD	1-mo	3-mo	6-mo	1-year	2-year*	3-year*	Since Inception *
Forge First Long Short Alternative Fund Series A	-4.96%	-2.91%	-0.49%	-4.99%	-4.96%	2.81%	6.62%	6.14%
Forge First Long Short Alternative Fund Series F	-4.01%	-2.82%	-0.22%	-4.47%	-4.01%	3.77%	7.63%	7.11%
Forge First Conservative Alternative Fund Series A	1.04%	-0.35%	0.56%	0.10%	1.04%	4.51%	8.37%	6.94%
Forge First Conservative Alternative Fund Series F	1.95%	-0.28%	0.78%	0.55%	1.95%	5.46%	9.35%	7.89%
S&P/TSX Composite Total Return Index	-5.84%	-4.90%	5.96%	4.47%	-5.84%	8.53%	7.54%	7.28%
S&P 500 Total Return Index (C$)	-12.41%	-5.79%	5.57%	7.54%	-12.41%	5.68%	9.17%	9.46%

*Annualized | Inception date: April 24, 2019

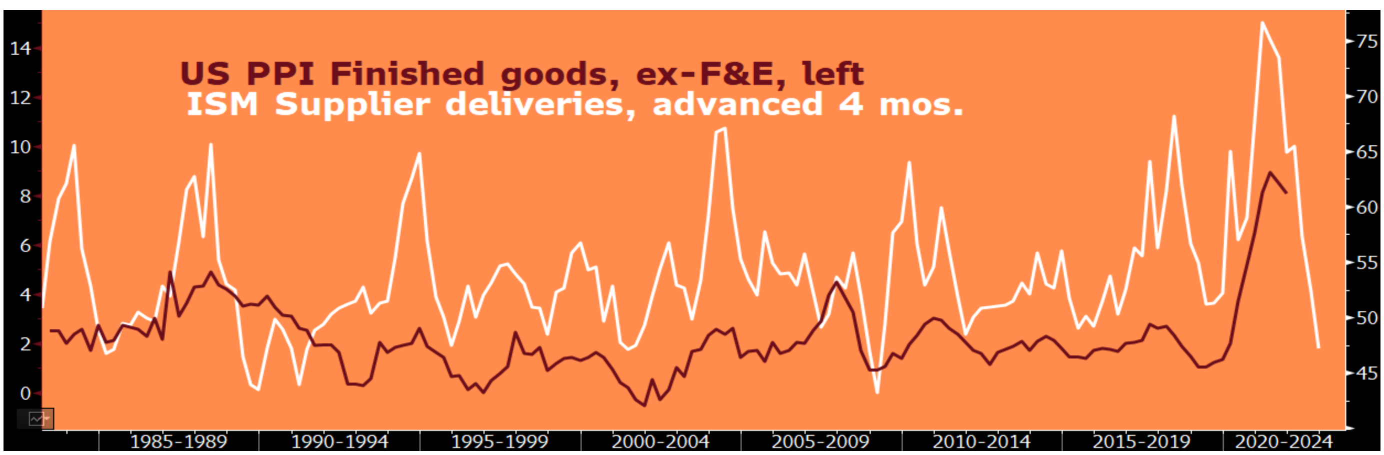
Looking ahead, we will briefly chat about the economy, followed by our outlook for markets and the positioning of our funds. We use the word briefly because there's little need to allocate much space writing about the outlook for economic growth. Sure, there are still six months of excess savings sloshing around the private sector in the U.S., but that plus a still tight labour market are the only positive items. Otherwise, with rising credit card debt, US$30T of financial market losses last year, declining housing prices, negative real wage growth, and a personal savings rate of 2.4% (lowest since September 2005), it's tough to be bullish on consumer spending. Here at home, based on the debt-to-personal disposable income ratio (183%), our consumers are even more leveraged than American consumers (100%). The bottom line is that it's a coin toss as to whether the U.S. will officially enter a recession during the next 12 months, but the 20-year graph below suggests the probability is as high as it has been since the turn of the millennium.

Source: Bloomberg

Looking at key regions in the rest of the world, previous commentaries have discussed the structurally-challenged outlook for continental Europe. Looking across the Channel, Britain has gotten itself in a nasty 'muddle', be it lack of growth, even worse inflation than the continent, and housing and labour markets that are exhibiting a lot of pain. That leaves China, and this almost 30-year graph below suggests miserable consumer confidence has led to weak retail sales and a very challenged housing market. In other words, China's 'go-go' years are over.

Source: Bloomberg

Now to the $50M question! Will the rate of inflation cooperate with the desires of central bankers and march towards the 2% number that they all claim to be targeting? Of course, the apparent question is which inflation statistic do you want to talk about; is it headline consumer price index (CPI), core personal consumption expenditures (PCE) or the Fed's latest core service inflation excluding housing. Use of the word 'core' means it is an inflation statistic that excludes food and energy prices. Simply put, that leaves the pricing of goods and services. The almost 40-year graph below advances ISM supplier delivery times (white line, right axis) by four months, against U.S. producer price index (PPI) for finished goods, excluding food and energy (red line, left axis). It's pretty obvious that goods pricing is likely to exhibit negative year-over-year prints during 2023. Services is a different story and presents a very mixed bag when it comes to inflation.



Source: Bloomberg

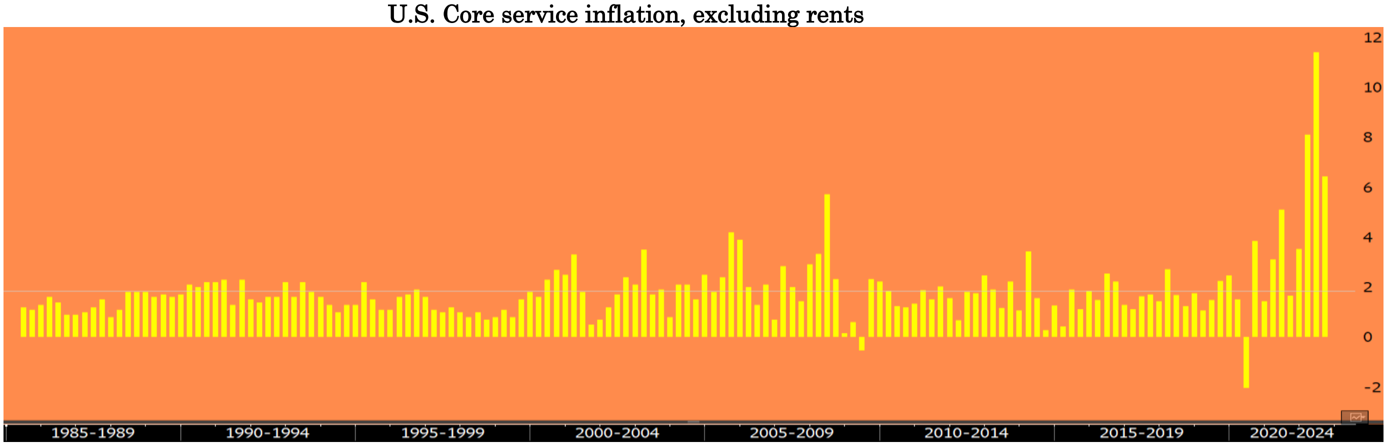
Diffusion indices for service inflation, the number of service prices that are increasing minus decreasing, still shows significant inflationary pressures. A key reason is that wages play a major role in the pricing of services. The following 20-year graph compares U.S. wage growth (red line, left axis) against the ratio of job openings ("JOLTS") to the total number of unemployed people. These two correlated lines have started to decline, yet with wage growth printing at 5.1% in November, labour cost pressures must recede significantly before service price inflation is likely to help the Fed.

Source: Bloomberg

Economists suggest that wage growth of 3.5% is consistent with 2% inflation. The jobs-workers gap sits at more than 2X the historical 2M level that implies this more sustainable rate of wage growth. At the same time, we acknowledge that the cumulative loss of tens of thousands of high-paying tech jobs will reduce spending, helping to balance aggregate demand with supply. In addition, history suggests the now negative year-on-year growth in money supply (M2) correlates with declining inflationary pressures. Yet, overall, we believe it will take longer to reduce stubbornly high wage growth because employees have simply suffered too much pain from the cumulative price hikes of food, rent and utilities. In addition, if oil prices move back to our 2023 forecast price level of US$95, after a lag of a few months, such an advance would exacerbate inflationary pressures.

Shifting back to Powell and company, in deciding whether services inflation is improving, months ago the Fed started chirping about core service inflation excluding housing. Rental pricing has been running very hot for the past couple of years, with price hikes of 20% to 30% considered common. Historically, rent pricing has lagged the growth rate of selling prices for single family homes by 12 to 15 months. The almost 40-year graph of U.S. core service inflation, excluding rents shown below indicates the growth rate of this price measurement has levelled off in recent times. Combined with slowing rental price trends observed during the past four months, developments in service inflation will become helpful to central bankers by late spring of 2023. Once again, the question is how far and how fast.

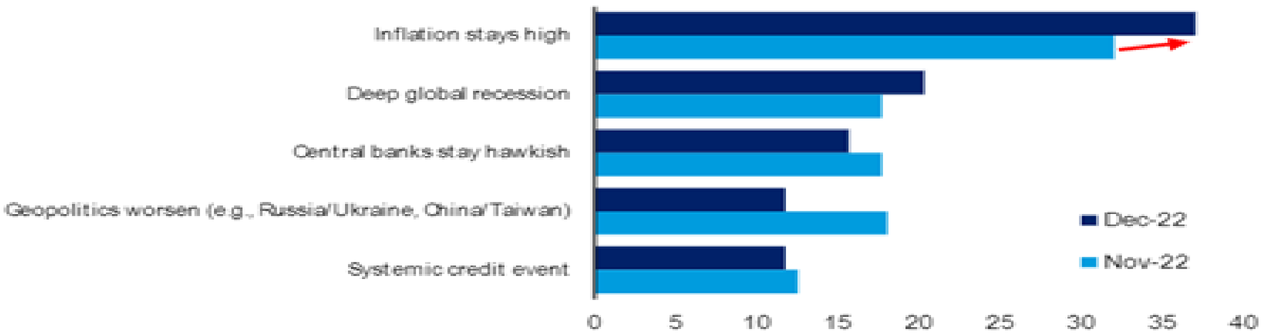
U.S. Core service inflation, excluding rents



Source: Bloomberg

Regardless, unless the U.S. experiences a hard landing, we expect that inflation will stay stickier for longer, forcing Central Banks into tough decisions if payroll growth turns negative during 2023. Remember, the Bank of Canada has the single mandate of inflation, whereas the Fed is also tasked with targeting maximum employment. To that end, a recent Bank of America Fund Manager Survey asked investors what they considered to be the greatest 'tail risk' for markets and, as shown below, the answer was inflation staying too high.

What do you consider the biggest 'tail risk'?



Source: Bank of America Fund Manager Survey

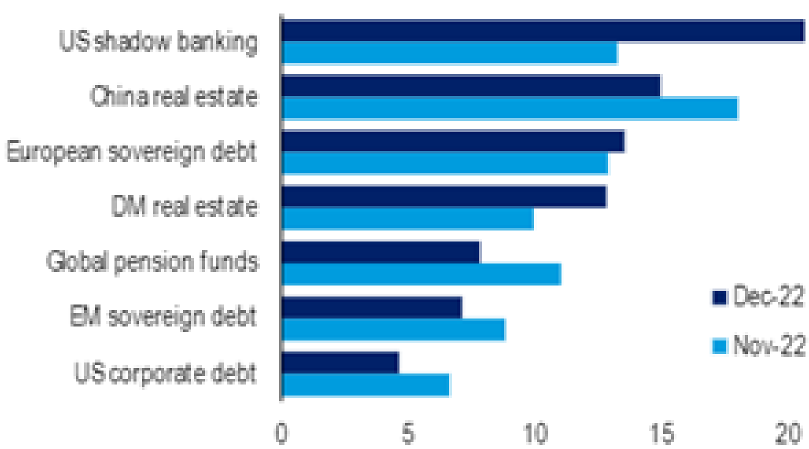
The next big question is how determined is the Fed to keep its terminal rate in place for an extended period of time. The longer the Fed keeps rates at terminal levels, the greater the risk of a hard landing. Yet, if we're right on wage growth and inflation staying stickier for longer, the Fed is likely to keep rates at terminal levels into 2024. We are aware that markets are pricing in cuts during H2 of 2023; time will tell who is right and the answer will come down to inflation. Getting US inflation towards 3.5% should be straightforward but forcing it toward 2% will be a challenge. Regardless, there's little doubt that the era of free money is over.

G7 Central banks printed US$11T of new money post COVID-19. In turn, this enabled American firms to sell US$486B of high-yield debt during 2021. Post the Fed tightening, that number fell by 75% during 2022, a year featuring the leanest IPO market since 1990. While 2022 was the big year for rate hikes, we believe reduced liquidity will be the rate of change story during 2023. The Fed pulled nearly US$400B out of the financial system during 2022. This year they're expected to almost triple that reduction (US$95B/month * 12 mos. = US$1.14T).

A natural progression when talking rate of change is what could be the source of the next credit event. According to that same Bank of America Fund Manager Survey, the U.S. shadow banking system is at the top of the heap for such an ugly event.

Chart 13: US shadow banking the most likely source of a credit event

What is the most likely source for a systemic credit event?



Source: Bank of America Fund Manager Survey

Putting this mix of growth, rates, inflation, and liquidity together implies further near-term challenges for stocks. The below 2022 graph disaggregates the movement in the S&P 500 between a change in P/E multiple (white line, right axis) and expected EPS (red line, left axis). As noted in the bottom right hand corner of the graph, the P/E multiple of the S&P 500 fell five points last year, while forward EPS estimates have been declining since mid-year. We reiterate the view we expressed in our November 2022 Commentary that equity markets don't typically bottom at 17X forward earnings, especially when yields on UST10s are 3.8%. In addition, we predict EPS estimates will decline another 5% to 10% due to the weakening ability of companies to pass through further price hikes to cover rising wage costs. This development is expected to further pressure profit margins as inflation will no longer boost the revenue line, which in turn masks cost pressures.

Source: Bloomberg

The real world rarely works out as simply as planned. We believe that EPS estimates will bottom out with the Q1 2023 reporting season. In addition, that is likely to approximate when the Fed will have attained its targeted terminal rate and when China's re-opening begins to have an impact on the global economy and related commodity markets. If this scenario played out as discussed, equity markets could bottom this spring , followed by a decent rest of the year. We say decent because several reasons suggest the 'other side' of this bear is likely to be uninspiring.

Central bankers suggest rates will stay higher for longer. Earnings are unlikely to rocket back upwards. China won't be juicing its system as per how the rest of the world had become used to China doing when it wanted to invigorate its economy. Finally, valuations won't be cheap relative to forward rates nor the level of earnings growth.

It's true the USD is likely to peak (if it hasn't already) since the ECB appears to be a few quarters behind the Fed in its rate-hiking cycle. This situation, plus the demand impact of a re-opened China, should be helpful for the already tight supply/demand balance of commodity markets. We also believe credit spreads will become incrementally attractive when the Fed's hiking cycle peaks. Aside from commodity stocks, we suspect GARP stocks will continue to outperform GAAP stocks; the latter of which continue to be expensive.

Source: Bloomberg

As for bank stocks, we expect them to be market performers at best due to credit headwinds and a continuing pressured outlook for net interest margins. As an aside, the five-year graph above suggests, on a local currency basis, Canadian bank stocks (red line, left axis) outperformed U.S. bank stocks during 2022.

With respect to the expected positioning of our funds, we are excited about the opportunity to once again successfully pivot the portfolios for the benefit of our clients. Our Long Short Alternative Fund foresees a rich opportunity set amongst equities as interest rates peak, the USD softens, and China re-opens its economy. Attractive sectors include Industrials, Materials, Consumer stocks and Energy. Under the right scenario, we foresee that the delta-adjusted net exposure of this all-equity fund could range from between 50% and 60% net long.

Our lower volatility, multi-asset Conservative Alternative Fund foresees big opportunities amongst listed credit, institutional preferred shares issued by Canadian banks and North American compound growth stocks. We would expect this fund to boost its delta-adjusted net exposure to between 40% and 45%. In contrast to the equity mandate of the Long Short Alternative Fund, we can envision the Conservative Alternative Fund holding as much as half of its net long position in listed credit. Also in contrast to the more cyclical bias of the equity holdings in our Long Short Alternative Fund, the common equity names in our Conservative Alternative Fund are likely to be more growth-oriented with a GARP-bias.

In assessing the potential surprises of 2023, of course there are many. Unfortunately, it is tough to see a short-term end to the war in Ukraine; an event that could have profound implications for the price of stocks and bonds.

Looking at politics, it's the 3rd year of the Presidential cycle in the U.S., a year that is typically good for stocks. This historical fact could line up well, given our current thinking towards the potential set-up for equities during the back half of 2023. Also, if we are wrong on inflation and it marches right back down towards the Fed's 2% target, and especially if the U.S. economy also hangs in there, rates could fall and stocks could rocket. At the same time, if the U.S. experiences a harder-than-expected landing, still elevated valuations would suggest much greater downside risk to stock prices.

One item you can count on is that the team at Forge First will stick to its disciplined and, now well-accepted, effective methodology for managing client capital. Each of our two funds has a solid, proven track record, something for which we hold a lot of pride in sustaining and will continue to work hard to maintain.

Thank you for your business and we hope that 2023 brings you health, success and happiness. Please let us know if you have any questions.

Andrew McCreath CEO, CIO	Daniel Lloyd Portfolio Manager	Keenan Murray Portfolio Manager

APPENDIX

2022 Outlook thoughts from our December 2021 market commentary

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.

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.

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.

As the Fed shrinks liquidity, real yields should be expected to rise. Our belief that nominal yields 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.

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.

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. 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.

Overall, while we nailed several of our predictions, we underestimated how high 10-year bond yields would reach and, how bad a year it was going to be for stocks. We predicted a lousy year, but not as lousy as it has been.