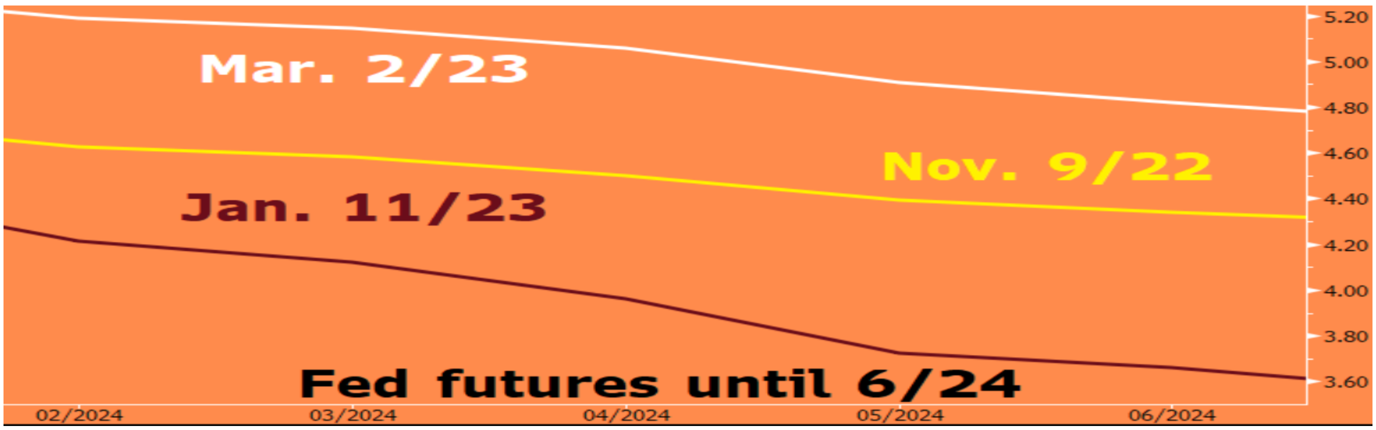
March 8, 2023

February 2023 Commentary

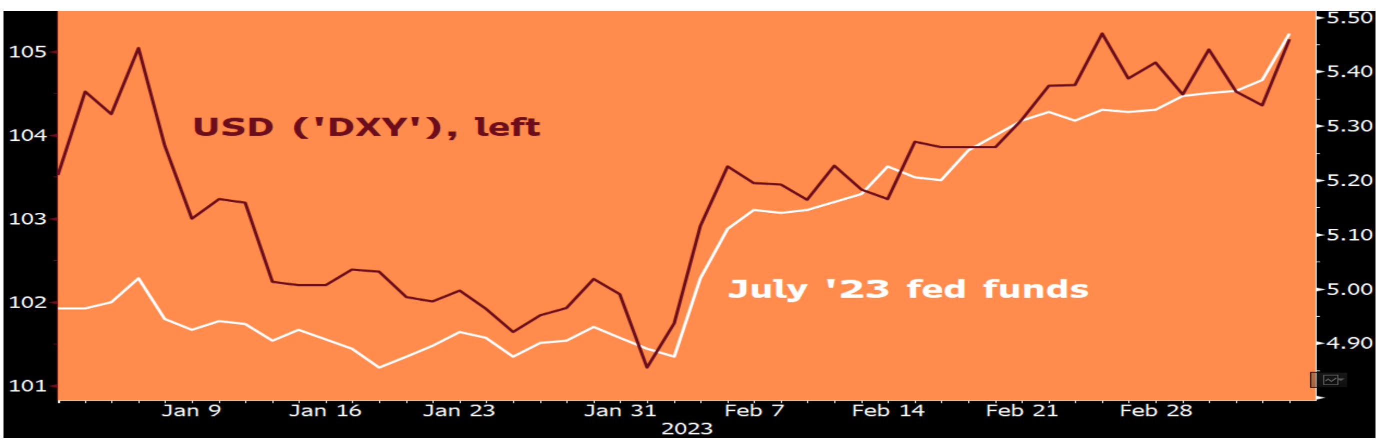
The first two trading days of February for the S&P 500 exhibited the same fear of missing out (FOMO) activity that played a significant role in fuelling the big move higher in stocks during January. Thereafter, slowing inflation (bullish), but not at a fast enough pace (bearish), provided fodder for both the bulls and the bears, keeping equities range-bound until mid-month when a stream of divergent data caused equities to ultimately succumb, giving back roughly half of their January gains.

U.S. retail sales were strong, yet quarterly commentary from both Walmart Inc. (WMT.US) and Home Depot Inc. (HD.US) awakened investors to the realization that the pace of consumer spending is destined to slow. Hotter-than-expected inflation prints then triggered the possibility of at least three more rate hikes by the Fed. Consequently, the graph below highlights that, as of late last week, the implied yield on Fed futures was well through 5% for the end of 2023 and still at 4.8% for June 2024. So much for those second half 2023 rate cuts that (we didn't believe in but) fuelled the equity market's rally off the cycle lows in October!



Source: Bloomberg

Markets should continue to be choppy over the next few months, given our expectation of persistently higher-than-desired inflation prints and weakening growth data. At the same time, near-term support may continue to arise from high institutional cash levels, an ongoing thirst amongst a segment of the retail investment community to speculate, and the persistent but 'moving target' assumption that it is only a matter of time until the Fed pivots and cuts rates. Of course, rate cuts are coming, but now from much higher levels and they still are not just around the corner. In the meantime, the direction of the U.S. dollar will remain highly correlated to the call of the markets towards the Fed.



Source: Bloomberg

For the month, each of our two daily liquidity, alternative mutual funds saw a decline in their net asset value. The Series F of our low volatility, multi-asset Conservative Alternative Fund fell 5 basis points or -0.05%, cutting its year-to-date net return to +0.68%. During the month, the fund generated profits from each of the asset protection and multi-asset sleeves of the portfolio, while experiencing modest losses in its equity bucket. Sector-wise, positive contributors included the Materials and Consumer, Non-Cyclical sectors while Energy and Consumer, Cyclical were losing sectors. As of February 28th, the delta-adjusted gross and net exposure of the fund were 105% and 10% respectively, with this net exposure split between a -3% allocation to common equities and a 13% exposure to multi-assets.

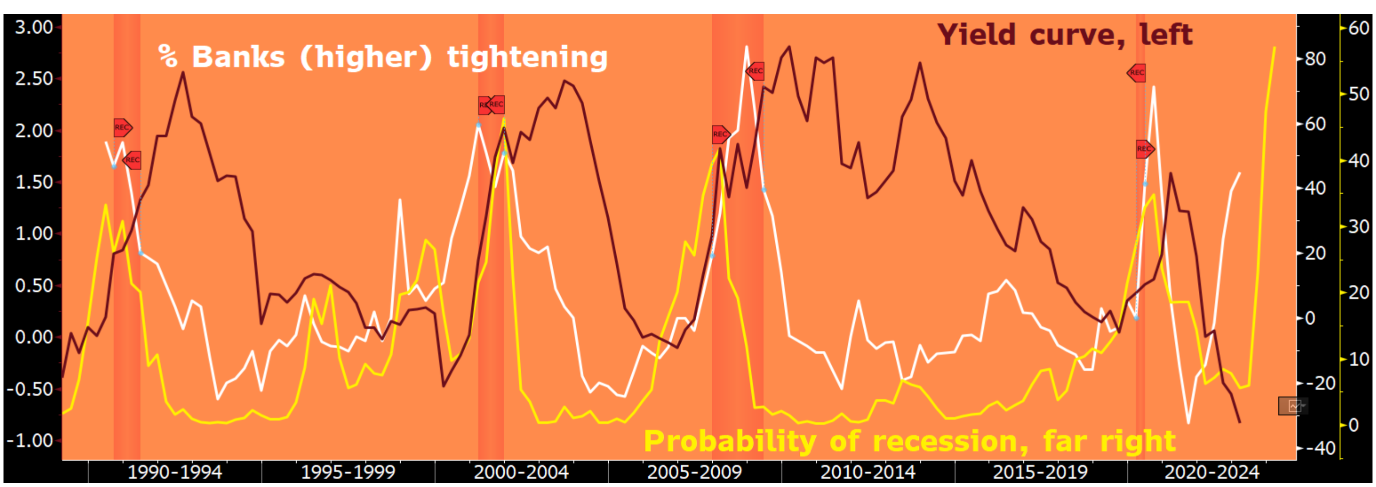
	YTD	1-mo	3-mo	6-mo	1-year	2-year*	3-year*	Since Inception*
Forge First Long Short Alternative Fund Series A	-0.04%	-1.64%	-2.95%	-3.34%	-7.69%	0.18%	7.30%	5.86%
Forge First Long Short Alternative Fund Series F	0.13%	-1.56%	-2.69%	-2.82%	-6.73%	1.13%	8.31%	6.83%
Forge First Conservative Alternative Fund Series A	0.53%	-0.12%	0.18%	1.67%	0.51%	2.41%	8.63%	6.78%
Forge First Conservative Alternative Fund Series F	0.68%	-0.05%	0.40%	2.12%	1.42%	3.35%	9.60%	7.73%
S&P/TSX Composite Total Return Index	4.78%	-2.45%	-0.35%	6.30%	-1.21%	8.92%	10.83%	8.24%
S&P 500 Total Return Index (C$)	4.36%	-0.28%	-1.68%	5.29%	-0.93%	7.28%	12.66%	10.24%

*Annualized | Inception date: April 24, 2019

The Series F of our Long Short Alternative Fund fell -1.56% for the month of February, reducing its year-to-date net gain to +0.13%. Holdings in Energy and Gold were the largest contributors to the loss, with Precision Drilling Corp. (PD.CA) and Agnico Eagle Mines Ltd. (AEM.CA) being the principal culprits. Small losses were also experienced in the Technology sector. Winning sectors included Industrial and Financial Services. It is important to note the fund adopted a much more defensive posture during the month. As a result, the delta-adjusted net exposure of the fund was cut from +45% net long at the start of the month to a mere +1% net long at the end of February, on a gross exposure of 125%. This shift included adopting net short positions in Technology, Materials and Consumer Non-cyclicals.

As you can deduce from the positioning of each of our funds, we remain unconvinced that this bear market is over. One reason is that we have never seen a bear market end amidst heightened speculation instead of despair. Further, unless inflation falls dramatically in a timely fashion, and without yielding a recession, we believe there needs to be a re-pricing of risk assets. Until that time (or the facts change), lower net equity exposure is warranted.

This re-positioning includes our placement in the sub-sectors of Resources. While acknowledged inflation hedges, such as commodities, seem logical given our view that inflation will remain sticky, we believe that it is late in the cycle to be increasing exposure to deep cyclicals. In fact, if one believes in the resolve of the Fed to tame inflation, we may consider increasing our short exposure to all cyclicals rather than net length. In addition, there remains a high probability of a U.S. recession (hence, inevitably Canada too); an event likely to further reduce corporate earnings.



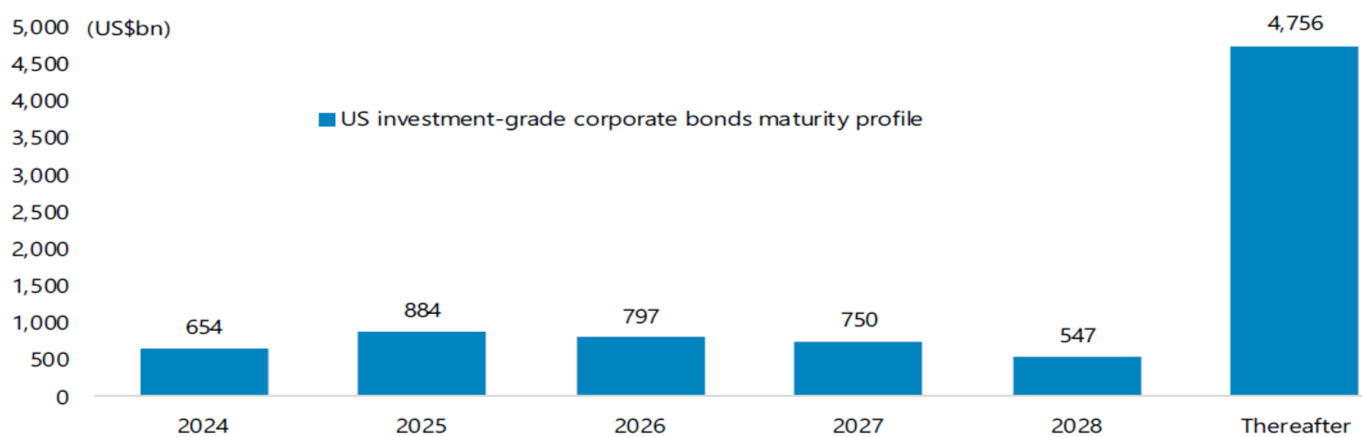
Source: Bloomberg

The 30+ year graph above compares the percent of U.S. banks that are tightening lending standards (white line, near right axis), the New York Fed's probability of a recession (during the next 12 months) gauge (yellow line, far right) and the yield curve comparing U.S. 10-year bonds less 90-day T-bills. Please note that the shaded vertical bars mark recessions. Scrutinizing this graph, it's tough not to conclude that a recession is on the horizon.

However, it's not all doom and gloom in the U.S. economy. Despite accelerating weakness in 'job openings' data from non-governmental (3rd party) sources in the U.S., the jobs market remains strong (even if there's a negative revision to January's data tomorrow). In fact, anecdotal evidence suggests as many as half of the employees affected by layoffs in the tech sector are finding new jobs in a timely fashion, often at improved compensation. While sales, marketing and HR personnel may be finding it tough acquiring a new chair, the surge in demand for AI/ML skills is driving a much lower-than-publicized net decline in headcount.

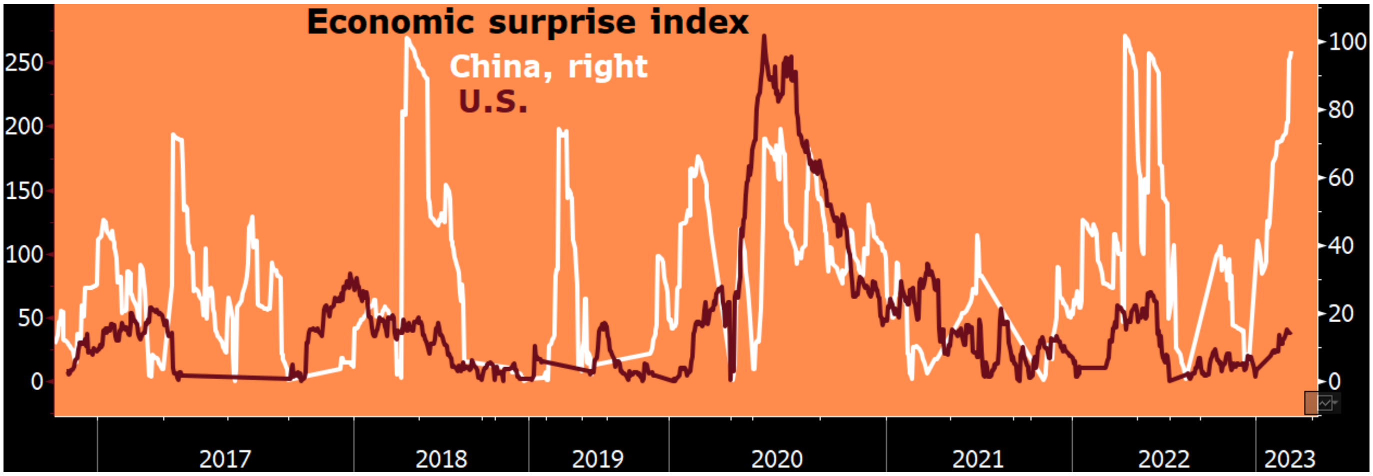
Further, January retail sales demonstrated that there was 'gas still left in the tank' of the U.S. consumer. Several annual government inflation adjustments drove a +2% gain in disposable personal income (expectations of +0.4%) and an 8% decline in tax payments. In addition, we must note that January was the warmest on record, plus the personal savings rate was revised considerably higher. Originally reported as an almost two-decade low, the savings rate for December 2022 was revised upwards to 4.5% followed by a 4.7% print for January 2023. Not too much of a surprise that reported advance retail sales for January were 3% versus the expectation of 2%. We don't believe that this strength can continue due to the lagged impact of last year's rate hikes and the continued negative real earnings growth that is bound to hurt spending once savings normalize during the second half of 2023.

Speaking about the lagged impact of rising interest rates (Fed Funds only crossed 4% in December 2022), it is important to differentiate between large companies and small to medium sized businesses. Large businesses are able to push their debt into the public markets at fixed rates of interest and maturities that are typically well into the future. To this end, the data displayed in the bar chart below indicates that more than half of all corporate investment grade debt in the U.S. does not mature until after 2028. This fact is supportive of companies having ample liquidity to maintain spending and may account for the recent decoupling of IG credit spreads from equity prices.



Source: Jefferies Group

Unfortunately, this is not the case for small and medium sized businesses (up to 250 employees) which have accounted for nearly 78% of all job openings in the U.S. and nearly 90% of the post-pandemic increase in the demand for labour. Rarely do these companies have the option to term out their debt. Consequently, they tend to be much more exposed to moves in short-term interest rates. Speaking of this cohort of companies, the following quote from last week's S&P Global US Services PMI release struck us as worthy of mention. On pricing, "Despite a softer increase in cost burdens, service providers raised their selling prices at a sharper pace in February. The rate of charge inflation was the quickest since October 2022 and strong overall. Survey respondents commonly noted that higher output charges were due to the pass-through of greater costs to clients".

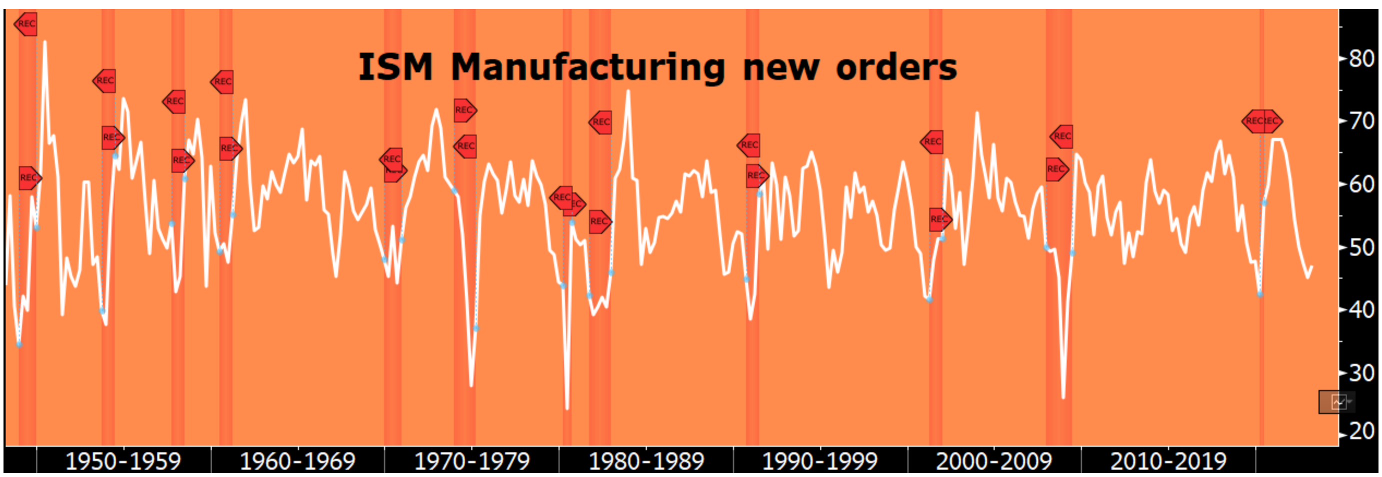


Source: Bloomberg

Shifting for a moment to the global economy, while we continue to believe that China will no longer be the engine of global growth, the above five-year graph suggests their re-opening is evolving better than expected as positive surprises are dominating the Chinese Economic Diffusion Index (white line, right axis) in contrast to similar data for the U.S. (red line). Two commentaries ago, in our [2023 Outlook], we identified China's re-opening as a favoured theme in our Long Short Alternative Fund; that view remains the case today.

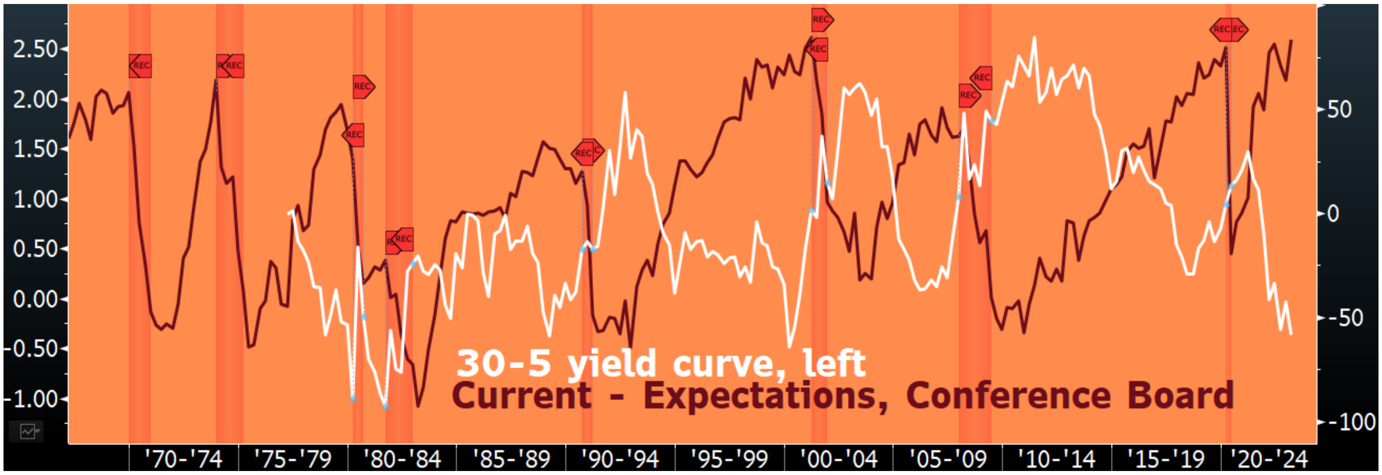
It is the constructive nature of these variables that explains why we are not big bears, just value-oriented long short managers who believe the market is at the high end of the fair value range. Further, our thinking suggests that earnings estimates are going lower, stagflation will continue to best describe the economic environment and monetary tightening will cause cap rates (inverse of price to free cash flow multiple) to grind higher over time.

In looking at the challenges that backstop our view on markets, let's start with the manufacturing sector in the U.S. As you can see from the more than 70-year graph below, the order book for U.S. manufacturing businesses is downright lousy and plunges this deep have rarely not preceded a recession. It is true that manufacturing doesn't dominate the economy the way it used to during the front years of this graph, but manufacturing has continued to exhibit an uncanny track record at being representative of trends in the broader U.S. economy.



Source: Bloomberg

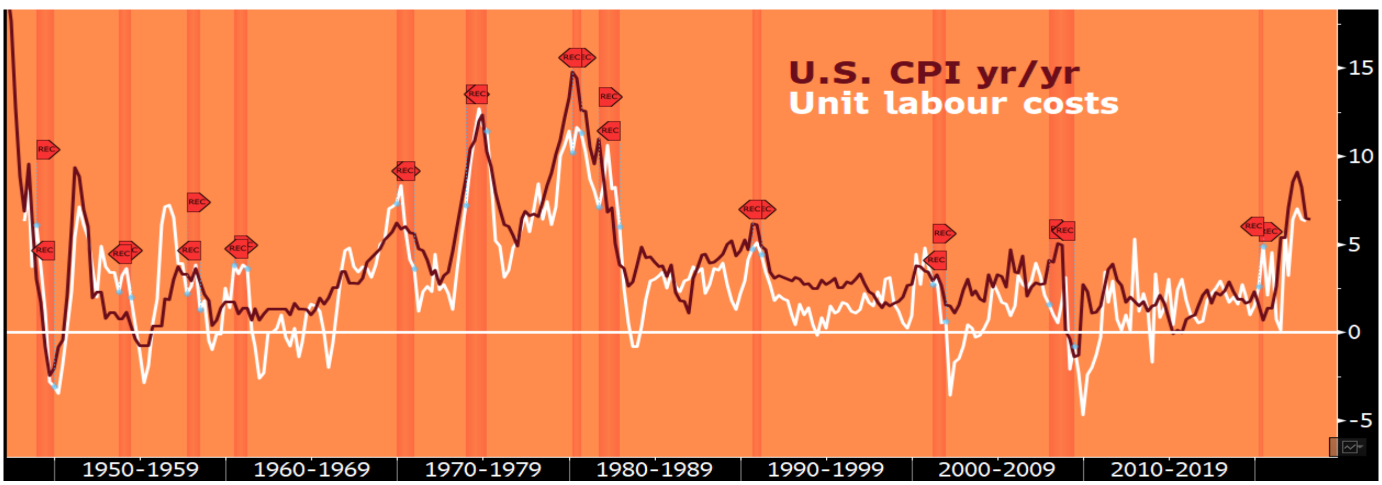
Shifting to the U.S. consumer, on the previous page, we suggested the early year strength was unlikely to continue into the back half of 2023. Below, the more than 50-year graph compares the 30-year less five-year U.S. yield curve (white line, left axis) against one method to assess consumer confidence from the Conference Board. This method subtracts future expectations (the outlook by the consumer towards their future) from current conditions (red line). For context, we note that confidence towards current conditions by itself has flat lined since mid-2021. Hence, the rising red line on the far-right of the graph indicates the consumers' confidence in the future has been steadily deteriorating since mid-2021. This trend lines up with our view that the only way for Central Banks to reduce inflation towards their targets is through a much weaker labour market. In turn, this development would imply a weakening in consumer spending.



Source: Bloomberg

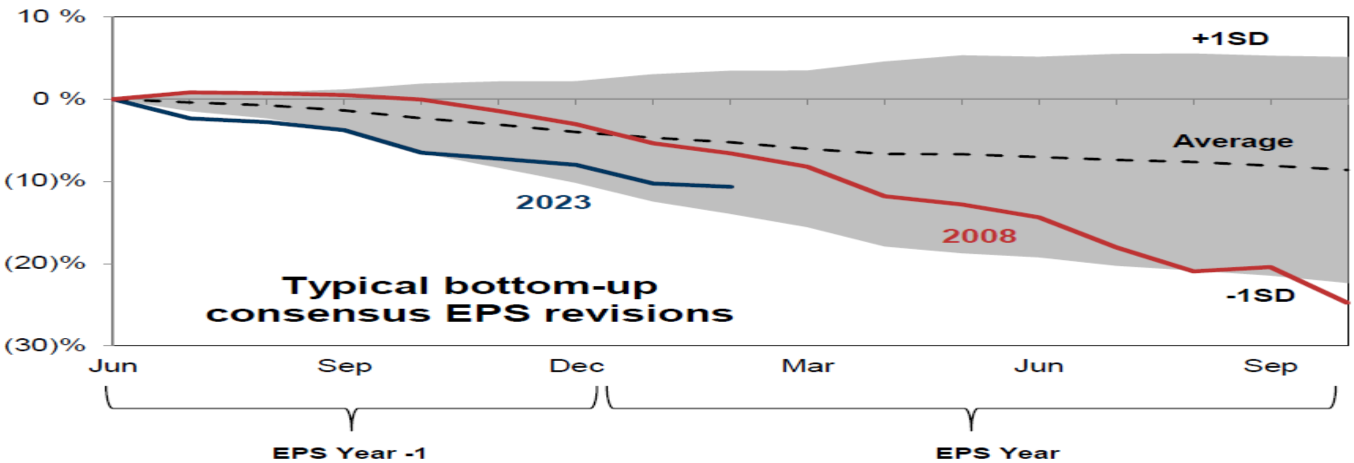
In summary about the consumer, the housing sector already has a marked turn downwards. We believe that data points from the recent quarterly releases by the Canadian banks suggest that the negative impact on consumer spending from credit cards, auto loans, and residential mortgages (greater proportion of cash flow to pay interest) will become more pronounced during H2 of 2023 and into 2024.

In previous notes, we suggested that if we're wrong and the economy stays stronger than expected, then central banks will keep interest rates higher for longer. The catch to this pitch would be if inflation marched back down towards the 2% targets of the central bankers. We continue to maintain this is unlikely to happen. Just last week, we saw that the 15,000 pilots of Delta Airlines secured a 34% pay increase over a four-year time frame, including an 18% immediate pay raise retroactive to the beginning of the year, a 5% increase next year followed by 4% raises in each of the two years thereafter. Continuing wage pressures is one reason why unit labour costs were hotter than expected last week. As you can see from the 70-year graph below, unit labour costs (white line) tend to serve as a floor for CPI. Hence, our question is how can service inflation come down without the central banks continuing to crush demand by additional tightening, both hikes and quantitative tightening (QT).



Source: Bloomberg

These views toward growth and inflation drive our belief that earnings estimates for the S&P 500 will continue to fall throughout the course of this year. The following graph indicates that earnings revisions for 2023 have so far been running more negative than those seen during 2008, and almost one standard deviation below the average over the longer time frame displayed in this graph. We believe that companies in the consumer, financial and real estate sectors are amongst the most vulnerable to additional reductions in their financial outlooks.



Source: Goldman Sachs

The next question is, what do you pay for these earnings? The S&P 500 is currently trading at 18.4X forward EPS. In last month's commentary, we suggested that stocks were expensive relative to their historical equity risk premium (ERP), let alone risk-free rates. Another way to assess the valuation for stocks is the ratio of their price to the forward expectations for earnings growth. The 35-year graph below indicates the price earnings to growth ("PEG" ratio) is currently the highest it has been with the exception of the COVID-19 recession. We suspect this higher PEG is due to investors extrapolating the big COVID-driven EPS jump enjoyed by large cap tech stocks (remember the SPX is cap-weighted) versus seeing them mostly as a one-time event. In addition, the weight of tech stocks in the S&P 500 has fallen from 30% to roughly 25%.

Source: Société Générale

Our bottom line is simple - our job is to protect capital when markets get rougher and generate a competitive net return. There's little question that choppy markets are able to make you feel like a fool one day, then on track the next. Unfortunately, until there's clarity on growth and inflation, hence the intentions of central banks, these vicious bear market rallies are bound to continue. But as we believe the Fall of 2021 marked the peak in policy accommodation, especially on the monetary side, bear market rallies continue to be what we view these intermittent market moves higher to be. We believe that the Fed will be reluctant to cut rates until employment is weaker, or financial conditions are much tighter. The status quo affords the Fed the room to press to achieve their targeted inflation objective - a scenario that is not good for the price of bonds or stocks. We will remain disciplined in maintaining our short books and market hedges, while selectively adding to IG credit and quality equities on pullbacks.

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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