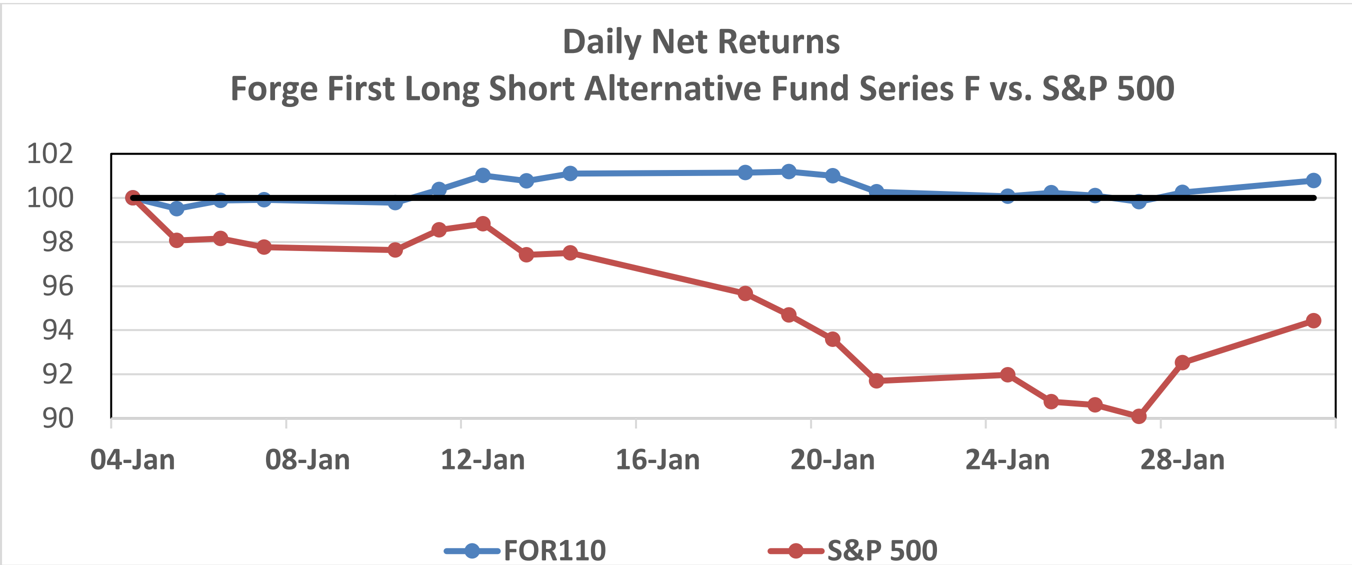
FORGE FIRST
ASSET MANAGEMENT INC

February 9, 2022

January 2022 Commentary

Last Fall, we suggested policy accommodation had peaked and this inflection would catalyze a prolonged unwind of the multi-year outperformance of growth stocks versus value-based equities. This gradual process continued during the month of January. Then in last month's commentary, we suggested inflation would be the key variable driving the outlook for the price of assets during 2022; an item that definitely remains the case today. Before delving into these stories and revisiting our outlook for 2022, let's recap the tumultuous month of January.



As can be seen from the daily net return graph above for January 2022, the Series F of our Forge First Long Short Alternative Fund (blue line) exhibited stability amidst the volatility in markets (red line), plus the fund generated a solid net return. We attribute this performance to our portfolio hedging and net long exposure to the Energy sector. For example, while the S&P 500 Technology index declined 6.48% during the month, our GARP versus GAAP (growth at any price) net positioning within tech enabled this sleeve of our portfolio to generate a positive return. Of course, given the pervasive losses experienced for the month, our discipline of always owning put options to protect conviction long positions plus holding index puts as market hedges, paid off handsomely. Our ongoing constructive stance towards Energy also made a positive contribution towards performance. Losing sectors included Real Estate, Industrials and positions in the Materials sector. This fund closed the month with delta-adjusted gross and net exposure of 118% and net long exposure of 45%; net having been boosted by 13% during the last week of the month.

	YTD	1 mo	3 mo	6 mo	1 year	2 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	1.26%	1.26%	-0.14%	1.25%	12.40%	13.92%	10.66%
Forge First Long Short Alternative Fund Series F	1.33%	1.33%	0.08%	1.69%	13.38%	14.95%	11.63%
Forge First Conservative Alternative Fund Series A	-0.20%	-0.20%	-1.97%	-1.02%	7.04%	11.93%	8.81%
Forge First Conservative Alternative Fund Series F	-0.11%	-0.11%	-1.73%	-0.54%	8.05%	12.95%	9.78%
TSX Total Return	-0.41%	-0.41%	0.97%	5.37%	24.98%	13.71%	11.94%
S&P 500 Total Return (US$)	-5.17%	-5.17%	-1.61%	3.44%	23.29%	20.23%	18.40%

*Annualized | Inception date: April 24, 2019

The Series F of our Forge First Conservative Alternative Fund lost -0.11% net during the month of January, as gains in the asset protection sleeve were offset by losses in the capital growth sleeve. In addition, gains from equity positions were held

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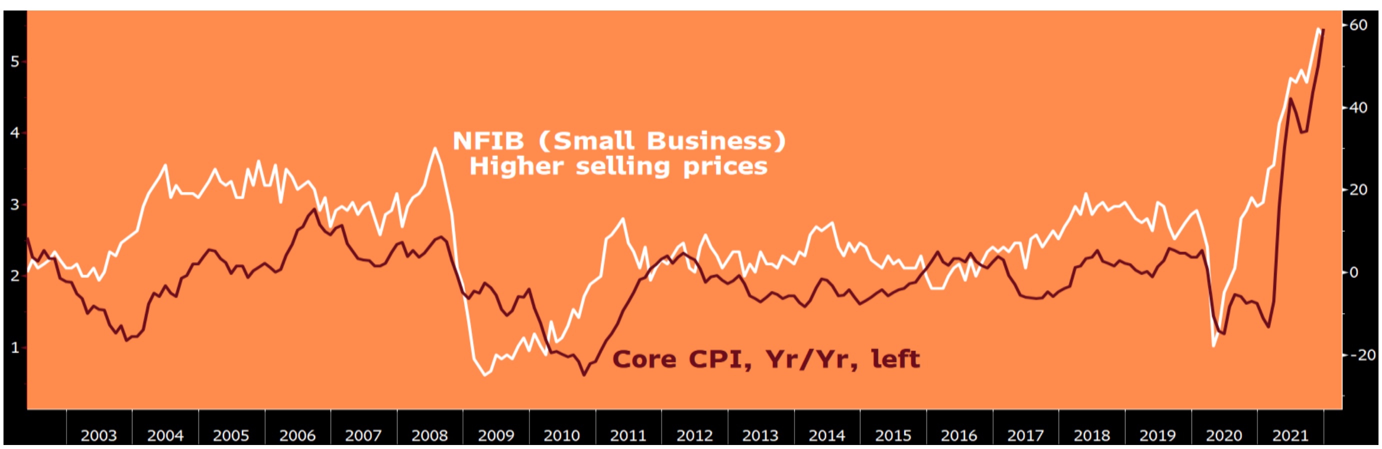
back as given its low volatility mandate, this fund will always hold a lower net exposure to securities in the more volatile resource sectors, including Energy. Similar to the Long Short Alternative Fund, losses were experienced in sectors including Financials and Industrials. Exposure-wise, the fund exited January with a delta-adjusted net exposure of 30%, lower than at the end of December, and a gross exposure of 126%.

Source: Bloomberg

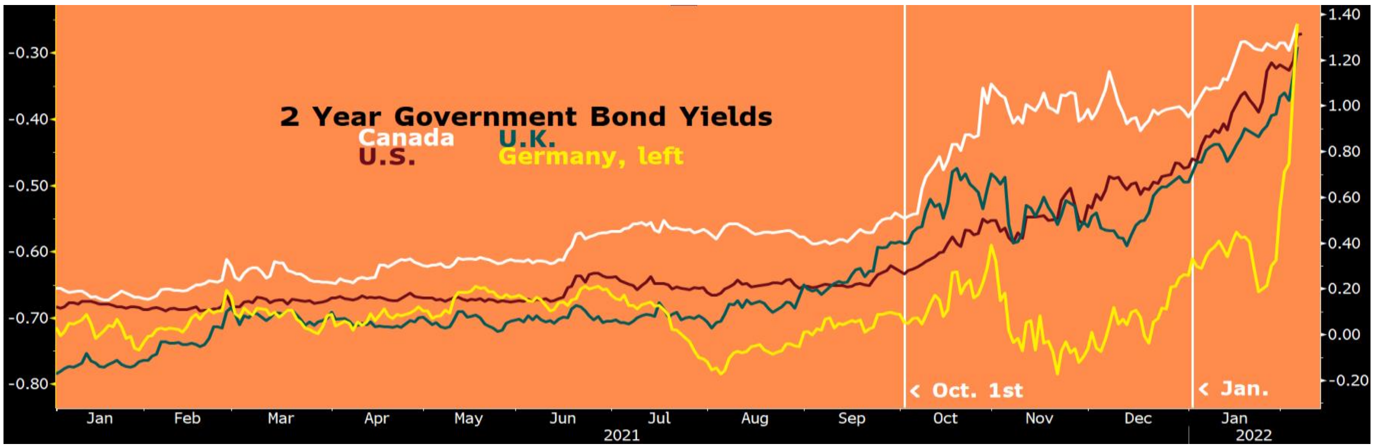
January's volatility began early in the month, post-remarks from Fed officials indicating the FOMC may halt the reinvestment of maturing securities (QT), so as to shrink the central bank's US$8.87T balance sheet. This pronouncement sparked a substantial back-up in nominal yields (+1.50% at 12/31/21 to +1.91% at 2/4/22) driven by real yields (from -1.10% at 12/31/21 to -0.71% at 1/31/22 and -0.51% at 2/4/22) and simultaneously drove equity risk premiums higher, most notably for long duration, unprofitable equities (GAAP). Morgan Stanley estimates that between May 2022 and May 2023, G4 central banks will collectively shrink their balance sheets by US$2T, 4X the previous largest decline ever in a 12-month period.



Source: Bloomberg

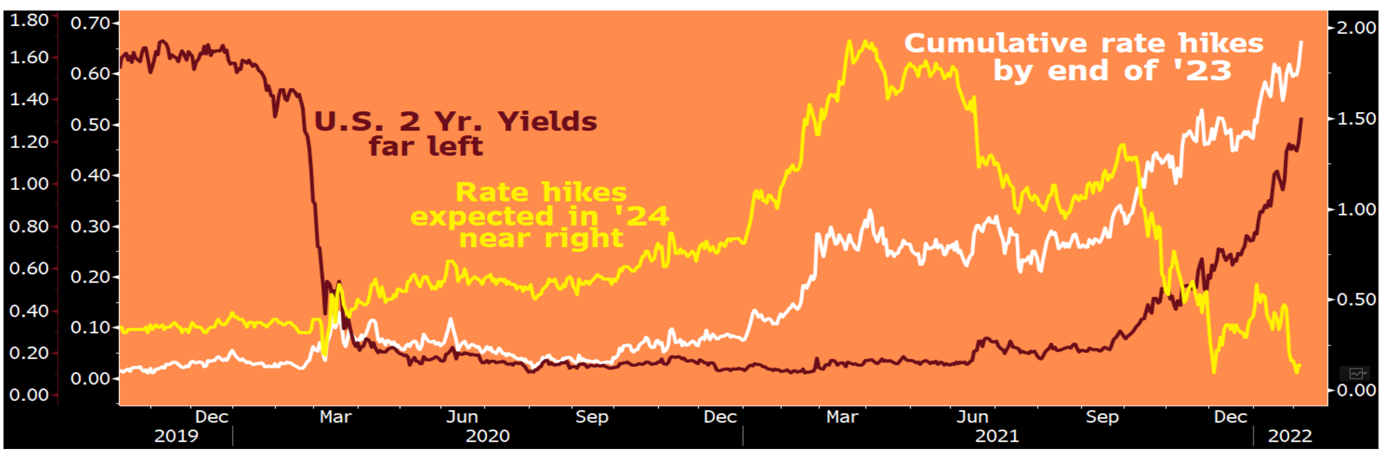
Then, after witnessing the highest year-on-year change in headline U.S. CPI since 1982, Wall Street economists and market participants were quick to ratchet up FOMC tightening expectations for 2022 and beyond. These moves furthered the rotation from high multiple growth equities into low multiple value stocks (white line in above graph). January marked a quick repricing of policy tightening expectations for 2022 and brought with it elevated levels of equity volatility.

Hence, the question becomes what's the outlook for inflation, as price trends will drive the outlook for consumer health, earnings and valuations. If inflation persists and central banks hike interest rates six to eight times over the next 20 months, plus accelerate the pace of shrinkage in the size of their balance sheets, there's little question in our minds that long-only investors in stocks and bonds will be in for a very rough ride. If the reverse is true and January marked the peak in central bank hawkishness and inflation recedes, it's fair to believe equities can move higher. However, while it's easy to presume U.S. CPI is peaking right now in the 7s, what if inflation bases closer to 3.5% compared to the Fed's hoped-for number in the low 2s. Given price trends with rent, food, transportation, wages and 'everything energy', plus our view that supply chain problems will not heal until 2023, this outcome is a distinct possibility. Such a scenario would necessitate a very different Fed path than what is even priced into markets today.



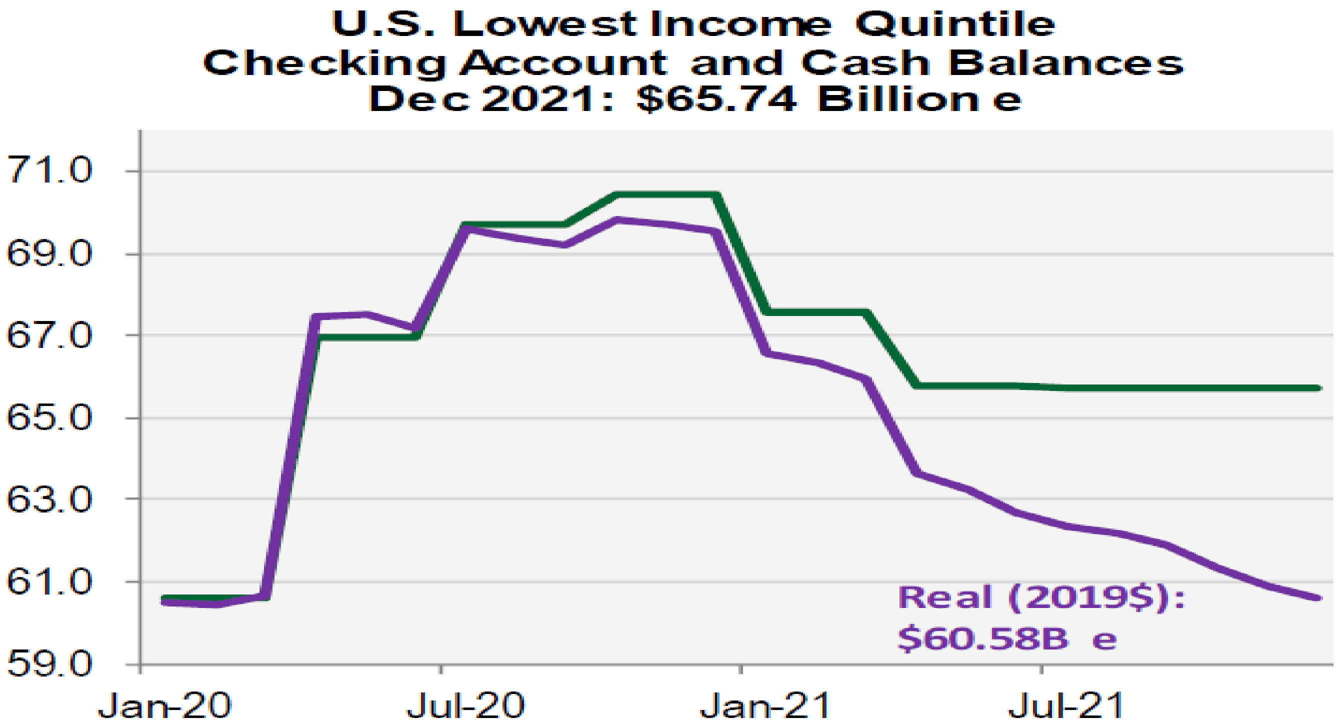
Source: Bloomberg

Further, last week witnessed a 180-degree turn by the ECB, as President Lagarde acknowledged 'unanimous concern about inflation data'. In fact, Goldman Sachs now predicts the ECB will implement two 25-basis point rate hikes before the end of 2022! So much for the anchor on North American interest rates of negative yields in Europe! As a result of these data points, the white line (right axis) in the graph below, Eurodollar futures, discounts seven rate hikes from the Fed by year end 2023. Then, as shown by the yellow line (right axis), markets have recently priced out additional rate hikes in 2024, suggesting investors are concerned that the Fed's aggressive pace could push the U.S. economy towards a recession.



Source: Bloomberg

If inflation does recede and rates fall, stocks would likely rally with growth-oriented U.S. indices outperforming Canada's value-heavy TSX. Beyond rate-induced factor rotation, the question would become whether the rally is sustainable and why inflation and interest rates fell back down. If prices and rates fell because wages have lagged inflation and the consumer is out of spare change, expect a marked slowdown in growth and the potential for an abrupt shift in the Fed rate-hiking cycle. The graph below, courtesy of Cornerstone Macro, suggests that the real cash balances of lower end consumers, the quintile with the highest propensity to spend, is already back to pre-COVID-19 levels. Presumably, the Fed would act so as to attempt to fend off a recession; hardly a recipe for sustained outperformance by equities. Instead, if wage hikes remain high, the consumer may have extra spending power, but the Fed would likely be forced to act meaningfully and quickly in raising rates, again not a good scenario for stocks.



Source: Cornerstone Macro

Our investment team will manage amidst this conundrum by not being dogmatically-positioned for a single inflationary outcome. Our 'buy and hold', free cash flow focused portfolios will continue to hold a balance of GARP and cyclically-oriented value stocks, complemented with the ever present hedge positions. Further, we believe that:

- Withdrawal of stimulus will push PMIs lower, creating more downside versus upside in profit estimates,
- Oil prices could exceed US$100 during 2022, hence we continue to favour energy equities,
- Stock picking, or alpha not beta, will be the key to returns during 2022, and
- 2022 will provide greater opportunity to short single stocks.

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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