FORGEFIRST
ASSET MANAGEMENT INC

February 9, 2023

January 2023 Commentary

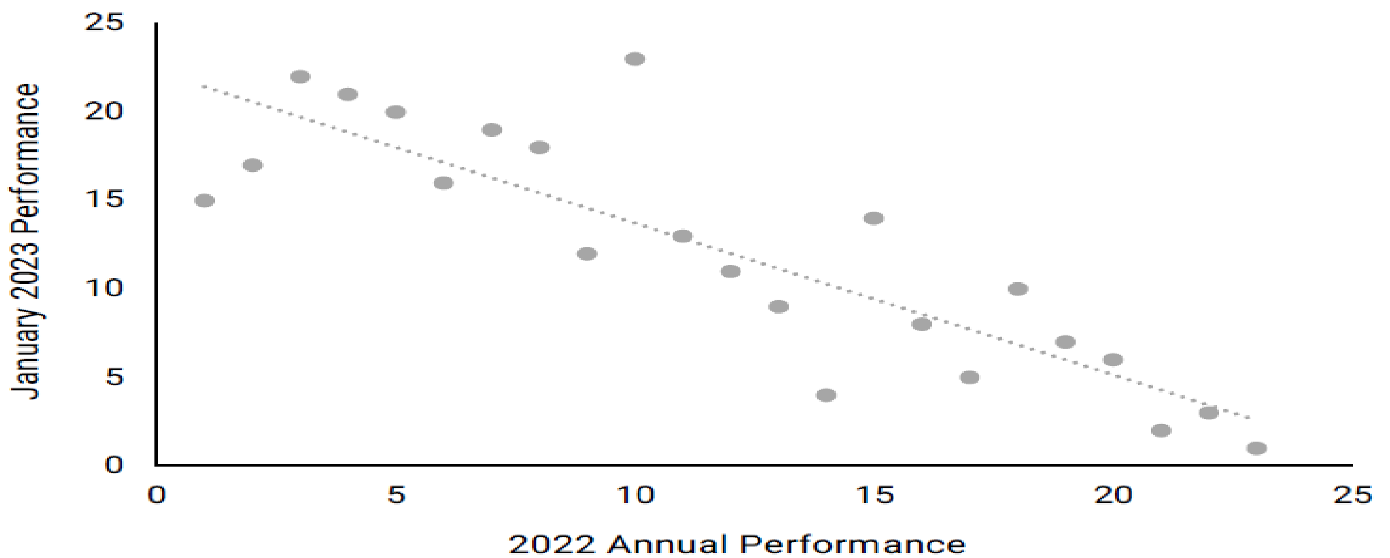
January kicked off 2023 with equity markets continuing to exhibit the same 'chop' that characterized 2022. However, unlike many months last year, likely only dedicated short sellers or investors sitting mostly in cash complained at last month's action. The price of stocks and bonds surged for three reasons.

First, not entirely unexpected, favourable comparisons enabled U.S. inflation prints for the months of October through December 2022 to be investor-friendly. Second, the Chinese government suddenly reversed course, announcing the re-opening of its economy accompanied by new, arguably modest, razor-focused spending initiatives. Third, it seems as if there hasn't been a winter anywhere!

These last two points were universally positive for the global economy, but especially helpful to the previously recession-bound Eurozone. To date, non-skiing Europeans have enjoyed their 3rd warmest winter on record. Here in my new home, Alberta, we have not experienced a significant snowfall since prior to Christmas, hence ski conditions have been lousy.

These developments convinced investors that inflation was destined to become last year's story, in turn ensuring an imminent Fed pause, rate cuts during H2 and an economy poised to coast along, not even experiencing a mild recession. Put simply, 'goldilocks' was in sight. It didn't hurt that the price of natural gas plunged, falling 40% on the month after a 35% haircut during December. This combination of events caused real yields to decline, the yield curve to bull flatten and stocks to rally or, as some sceptical observers described January's price action, a "dash for trash".

The graph from Morgan Stanley below ranks the decile performance of U.S. equity industry groups during 2022 along the horizontal axis and January 2023 along the vertical axis. You will see that the leaders of 2022 (the higher the number, the better) were the losers of January 2023, while the biggest losers of last year were the rocket ships of January (on average, up almost 40%). Companies on the verge of bankruptcy (Bed Bath & Beyond Inc., BBBY.US, among others) or close to it (Carvana Co., CVNA.US) saw their shares double and triple, while single-day call option activity went to the moon. The 'bubble' is back!



Source: Morgan Stanley

Having used that pejorative phrase, it is important to acknowledge that the S&P 500 has broken out above its downtrend, as well as its 200-day moving average. Moreover, the U.S. large cap index has started making both higher highs and higher lows; the hallmark of any uptrend. The obvious question is whether this is the 8th countertrend rally during this bear market, or the beginning of a new bull market. This commentary will table some thoughts towards answering that question but first, let's discuss the performance of our two daily liquidity, medium risk-rated, prospectus-based alternative mutual funds.

Both of our funds generated positive net returns last month, though admittedly both funds markedly underperformed the market due to a) our continuing cautious stance towards equities entering 2023, and b) January's performance bias towards low versus high-quality securities, including the GAAP versus GARP factor.

	YTD	1-mo	3-mo	6-mo	1-year	2-year*	3-year*	Since Inception*
Forge First Long Short Alternative Fund Series A	1.62%	1.62%	-0.78%	-2.86%	-4.62%	3.54%	7.37%	6.45%
Forge First Long Short Alternative Fund Series F	1.72%	1.72%	-0.51%	-2.33%	-3.65%	4.52%	8.38%	7.43%
Forge First Conservative Alternative Fund Series A	0.65%	0.65%	2.26%	1.87%	1.90%	4.44%	8.48%	6.96%
Forge First Conservative Alternative Fund Series F	0.73%	0.73%	2.47%	2.34%	2.81%	5.40%	9.46%	7.92%
S&P/TSX Composite Total Return Index	7.41%	7.41%	7.81%	7.22%	1.55%	12.66%	9.50%	9.13%
S&P 500 Total Return Index (C$)	4.65%	4.65%	3.30%	3.52%	-3.71%	8.51%	10.13%	10.55%

*Annualized | Inception date: April 24, 2019

Our low volatility, multi-asset Conservative Alternative Fund continued its steady and winning ways of 2022 during January 2023. Our Series F of the fund exited the month with a net return of +0.73%. Returns were driven by gains in the multi-asset and capital growth sleeves. Equity options also contributed to positive performance, despite the obvious drag from the asset protection sleeve during last month's rally in stocks. Holdings in the Technology, Financial and Consumer sectors led performance, while holdings in Materials and Utilities lost money.

The fund has utilized the recent 52-week low in implied volatility to increase both upside exposure and downside protection; actions which have been roughly neutral to net exposure. The delta-adjusted net exposure of this fund increased modestly from year-end 2022, sitting at 25% net on a gross exposure of 108% as of January 31st. This 25% net exposure was split between equities (13%) and multi-assets (12%).

Looking ahead, during market pullbacks, we expect this fund to further increase its allocation to publicly-traded investment grade (IG) credit instruments and gross long exposure to compound growth stocks. Increased allocation to the former will occur due to widened credit spreads, high absolute rates and our expectation of the positive impact the currently inverted yield curve will have on our holdings.

January also marked a positive month for our Long Short Alternative Fund. The Series F of the fund gained +1.72% net of fees, fueled by contributions from securities aligned with the focus investment themes for this fund during 2023:

- Travel names, benefiting from China's re-opening: Booking Holdings Inc. (BKNG.US), Las Vegas Sands Corp. (LVS.US), Expedia Group Inc. (EXPE.US) and Air Canada (AC.CA).
- Securities in the Industrials sector related to our energy transition capex theme, specifically Encore Wire Corp. (WIRE.US), Quanta Services Inc. (PWR.US) and Carrier Global Corp. (CARR.US).
- Resource scarcity in geopolitically safe jurisdiction's theme, exhibiting itself via gains in both basic materials and precious metals.

In addition to the above noted gains from the Consumer, Industrials and Materials sectors, profits were captured in Technology and Financials. We hasten to add that the low net exposure we held during the month to Technology stocks represented an opportunity cost for the fund. Conversely, despite being well protected via put options on long-held Tourmaline Oil Corp. (TOU.CA), other holdings on the gassier side of the Energy sector caused the fund to lose money during January. General market hedges were also a losing proposition last month. The fund exited January 2023 with delta-adjusted gross and net exposure of 122% and 45%, respectively.

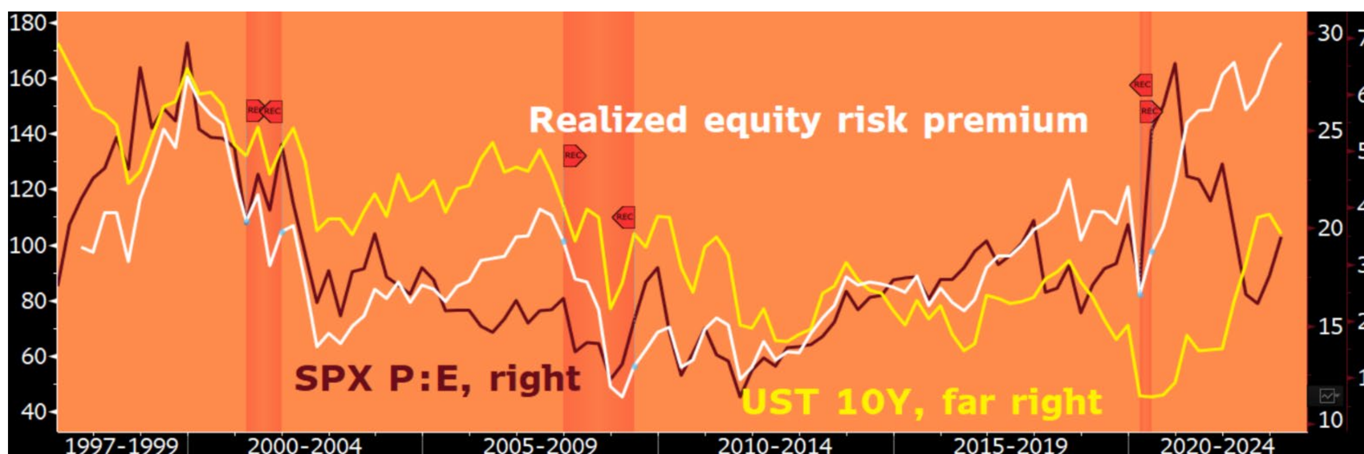
At month-end, we further adjusted the composition of our energy book to reflect the continuation of the bearish view towards natural gas equities for the foreseeable future. In contrast, we maintain a constructive attitude towards oil, especially Canadian heavy oil and oil sand assets. In our minds, numerous tailwinds should positively impact Canadian oil (Western Canadian Select or WCS) differentials throughout 2023.

In assessing opportunities in the rest of the equity market, this fund continues to see weak fundamentals across many sub-sectors of the Technology sector versus good opportunities in Industrials, Consumer and Resource stocks. Within the Financials sector, our bias continues to be long non-bank financials against bank stocks, specifically U.S. regional banks (due to deteriorating Net Interest Margin - NIM and credit stories). Positions include recently purchased Chubb Ltd. (CB.US), Fairfax Financial Holdings Ltd. (FFH.CA) and Brookfield Business Partners LP (BBU-U.CA).

Shifting to the big question of whether recent tape action is the 8th countertrend rally during this bear market or the beginning of a new bull market, we acknowledge an underinvested investor community and several near-term positives. At the outset of this commentary, we identified China's re-opening, a better-than-feared E.U. economy, and lower inflation as definite positives for stocks. In addition, the recent and swift 10% decline in the USD is beneficial for risk assets. Lastly, further to suspicions expressed in commentaries published last year, for all of the talk about the potential for reduced liquidity from the Fed's balance sheet runoff to date, rundowns in the Treasury Department's TGA fully offset QT during 2022. Put simply, in the near term, liquidity and growth conditions may continue to be supportive of risk premiums.

However, despite last Friday's apparently gangbuster U.S. jobs print, we maintain that growth will slow markedly and non-rent service inflation will remain sticky. Consequently, we foresee further reductions in earnings estimates and a Fed that does not cut interest rates during the back half of 2023. If we are correct, the outcome would likely be problematic for both bonds and stocks, especially with the S&P 500 trading at 19X forward earnings.

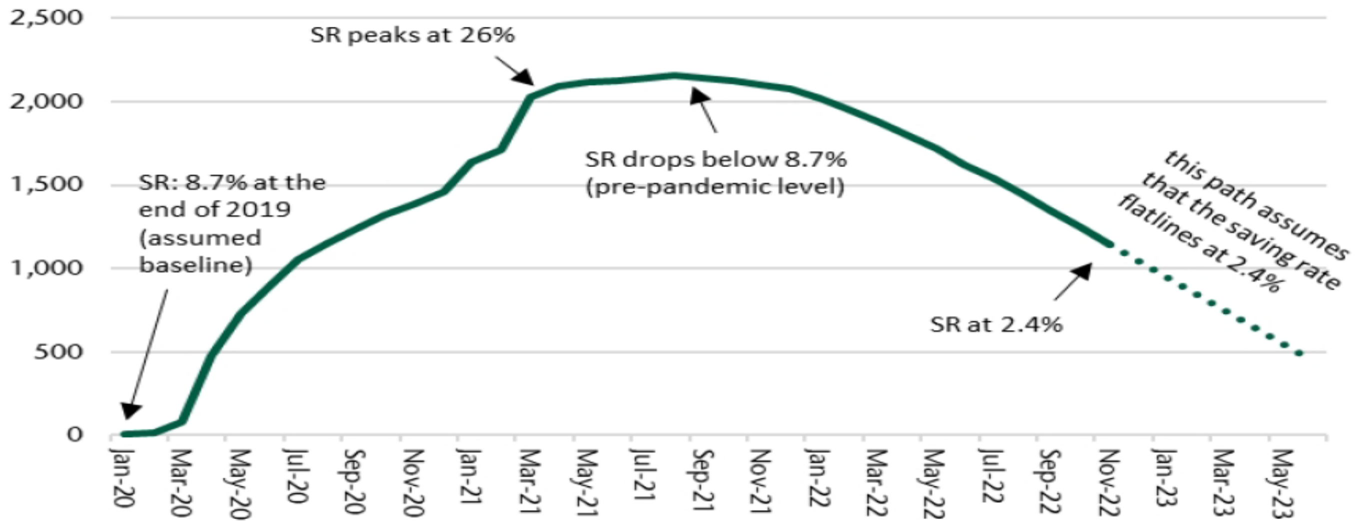
Another datapoint we look to is the spread in returns between equities and treasuries, otherwise known as the equity risk premium ("ERP"). The ERP (white line) is displayed in the 25-year graph below against the yield on a U.S. 10-year bond (yellow line, far right) and the P/E multiple of the S&P 500 (red line, near right). As you can see from the right side of the graph, this spread is at an all-time high, suggesting to us that equities are not cheap on either an absolute or relative basis and the risk is to the downside for equities regardless of the next move in yields. So, stocks aren't cheap, what about the fundamentals?



Source: Bloomberg

First, let's tackle growth. As regular readers know, it is our view that China is no longer the engine of global growth and, while it's true that the E.U. got lucky, '23 GDP numbers may now be positive but tepid. We have agreed with consensus that North American consumer spending, two-thirds of the continent's GDP, is poised to decelerate noticeably this year. Weakening excess cash is a key reason supporting this view.

The graph below, courtesy of Jefferies Group Inc., illustrates the total value of excess savings in the U.S. The unit value of the vertical axis is in billions, meaning that excess savings peaked at more than US$2 trillion during the Spring of 2021. According to Jefferies, if the personal savings rate holds at its current 2.4%, excess savings will revert to pre-COVID-19 levels by this spring.



Source: Jefferies Group Inc.

The following table highlights disposable income growth of 3.1%, combined with a 5% reduction in the savings rate last year to facilitate an 8.1% gain in nominal consumption. Subtracting PCE inflation of 4.9% from this tally implies that real consumption grew by 3.0%. For 2023, Jefferies economist, Aneta Markowska, predicts an improvement in income growth to 5.6%, lower PCE inflation but an increase in the savings rate of 2.0% (to 4.4%) such that real consumption will only grow by 1%. To be clear, we present this table more for illustrative purposes, to gain insight into the dynamic driving consumption, than an expression of support for her specific forecast. The bottom line is that consumer spending is unlikely to be the engine of growth during 2023 that it was last year.

	Disposable Income Growth	**+**	**Change in Saving Rate**	**=**	**Nominal Consumption**	**=**	**PCE Inflation**	**+**	**Real Consumption**
2022:	3.1	+	5 ppts	=	8.1	=	4.9	+	3.0
1H '23 ann. (est):	5.6	+	-2 ppts	=	3.4	=	2.4	+	1.0

Source: Jefferies Group Inc.

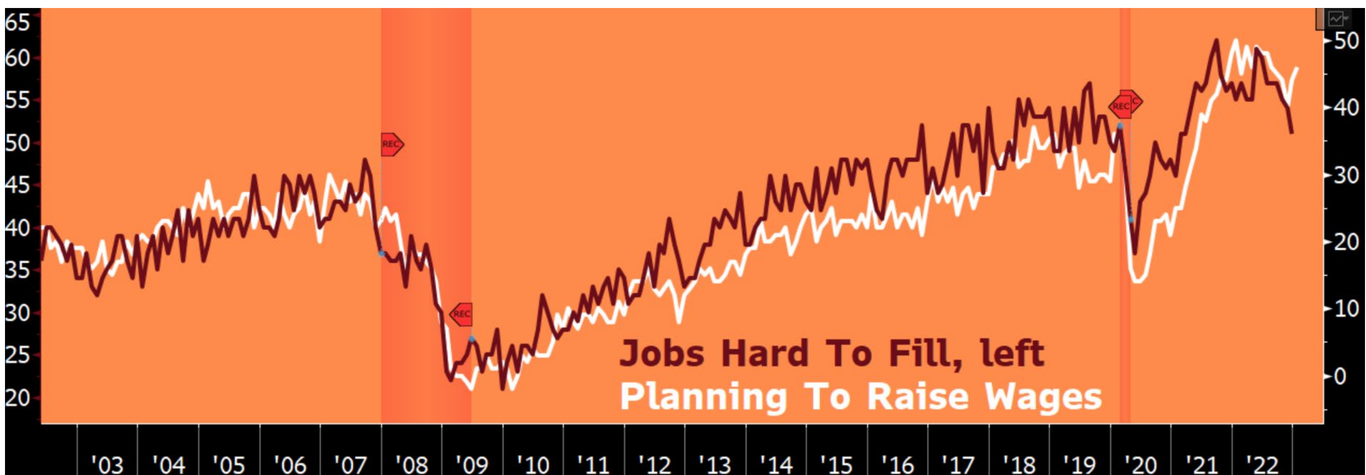
Shifting to inflation, we are on board with the belief that the prices of goods will exhibit negative year-over-year prints this year. Our rationale for the potential of inflation staying ‘stickier’ for longer rests entirely on the services side of the economy; a sector in which wages dominate the expense line. Let’s walk through our logic.

Starting from 1996, each of the two graphs below compares ISM Services (white line) against ISM Manufacturing (red line). The first graph compares new orders, the second graph prices. Note the yellow oval on the far right of each graph. Extreme cold weather during the month of December negatively impacted the order book for Services, but note that it bounced back hard, to trend during January; no weakness there! Meanwhile, prices have softened markedly for the Manufacturing sector, partially explaining why goods inflation should print negative this year, but there is no weakness in service pricing. Service demand and pricing power remains strong at this juncture.

Source: Bloomberg

Source: Bloomberg

The following 20-year graph illustrates two variables from the National Federation of Independent Business (NFIB) survey in the U.S. The jobs hard to fill (red line, left axis) data point is compared to the percent of businesses that are planning to raise wages (white line, right axis). Note how, despite the dip in jobs hard to fill on the right of the graph, the percent of businesses planning to raise wages has increased.



Source: Bloomberg

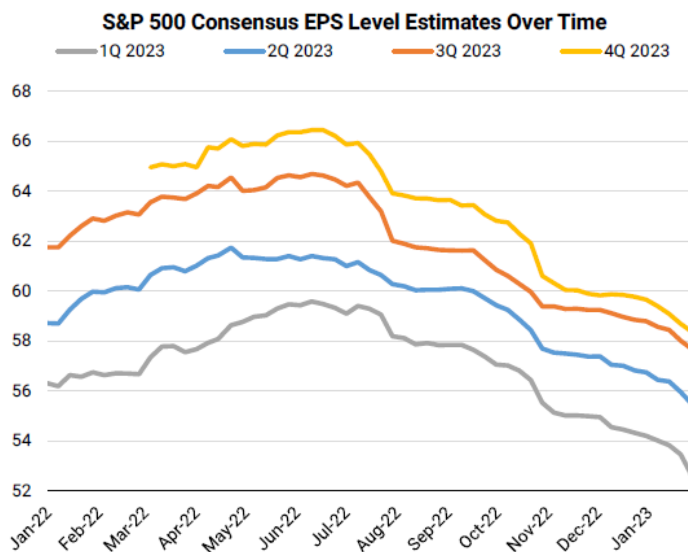
Within last week's barnburner U.S. jobs report, inflation doves jumped on the fact that wage growth had slowed to 4.4% (despite the heightened bar from a revised higher 4.8% for December). We have read reports attributing this below forecast print to industry mix shifts and a longer work week.

Recalculating average hourly earnings ("AHE") using fixed industry weights, implies that wages would have increased 4.6%. On top of that, as you can see from comparing AHE (red line, left axis) against hours worked (white line, right axis) advanced by two months, on the 15-year graph below, there was a distinct increase in hours worked (+0.9% month-over-month). As AHE is calculated by dividing total weekly pay by the number of hours worked, it is likely that hourly earnings were also modestly and negatively effected by this calculation. In addition, the leading relationship of hours worked suggests that rising wages may be a story a couple of months down the road.

Source: Bloomberg

Obviously, the next few wage prints will tell the tale. We may be right or wrong, but that explains the logic behind our thinking. The cumulative, negative impact of high inflation for too long a time has forced workers to seek higher wages in an environment where there is a structural mismatch between the supply and demand of workers.

Next up in our assessment of markets is the outlook for earnings. Q4 S&P 500 EPS estimates have unfolded weaker than had been expected exiting 2022. Reported earnings, plus estimates for the roughly 50% of companies that have yet to report, project a Q4 decline in earnings of 5.3%; the first decline since Q3 of 2020. Consensus SPX earnings growth for 2023 were reduced a few months ago from the high single digits to +3% growth, with estimates envisioning a return to year-over-year EPS growth during the back half of 2023. For the reasons discussed on the last couple of pages, we believe that the call for a return to growth during the second half is optimistic.



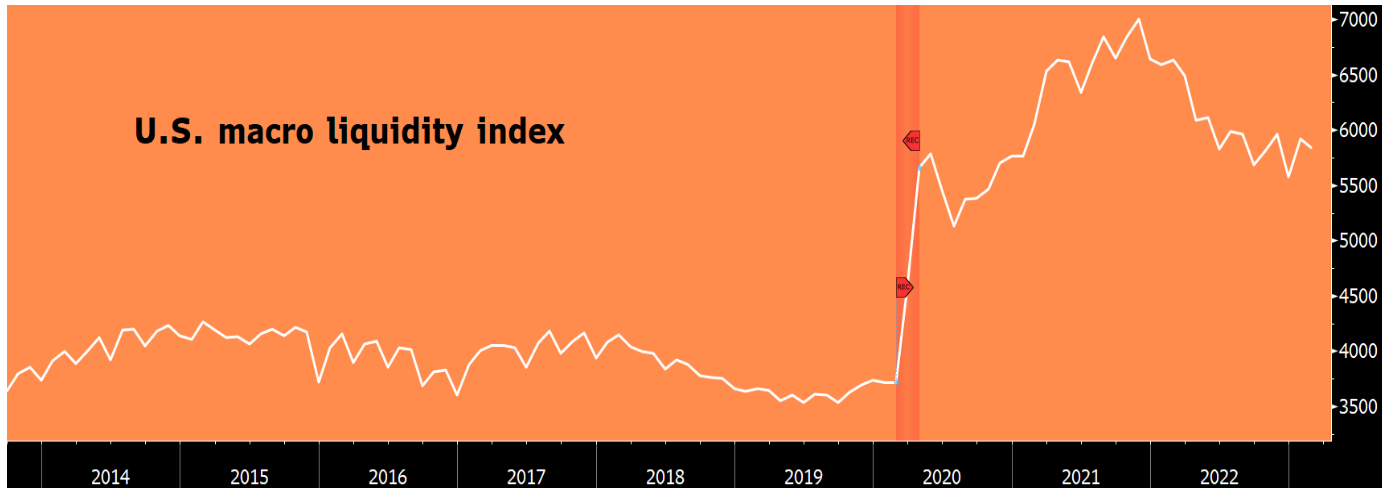
Source: Morgan Stanley

In fact, we expect EPS estimates to be reduced further as lower inflation hinders revenue growth, while ongoing wage pressures and lingering supply chain issues cause profit margins to suffer their 2nd consecutive annual decline. The above graph from Morgan

Stanley tracks the progression of quarterly 2023 EPS estimates for the S&P 500, starting from January 2022 on the left side of the horizontal axis. Note how the existing optimism towards 2nd half results is gradually fading.

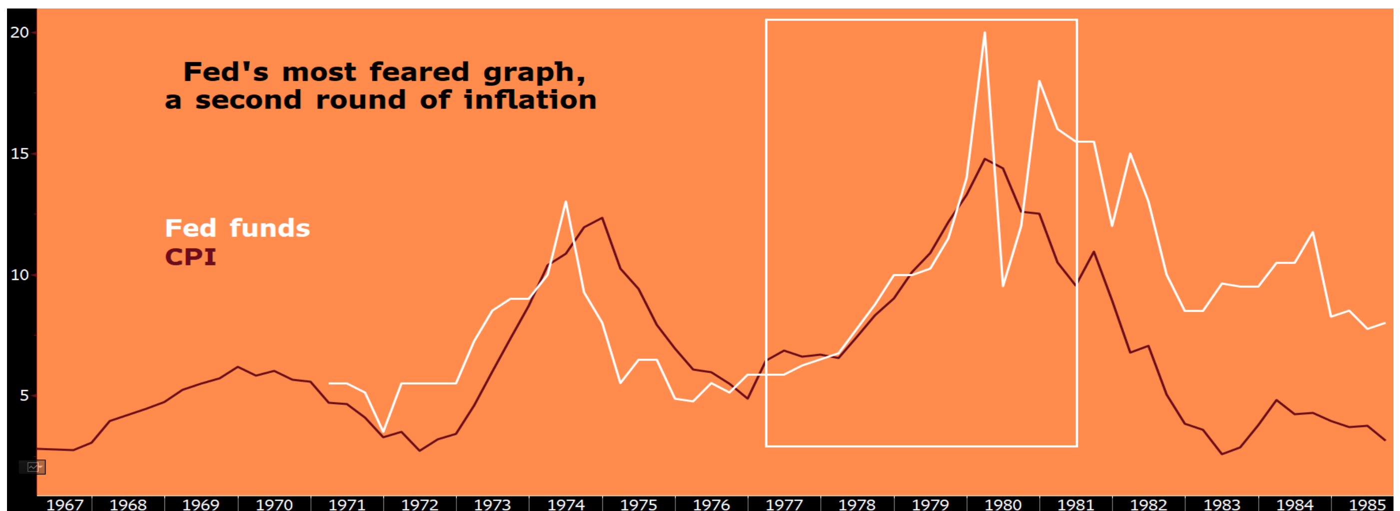
Sure, we would have liked to have captured more of January's upside in markets. But due to the combination of our style, being disciplined buy-and-hold investors with a value orientation, and our view on the risk/reward offered by markets, we had yet to be convinced it was time to significantly increase our net exposure. What if we are wrong on our views? Well, first and foremost, our funds are never dogmatically positioned. The team's marching orders are to drive down the centre of the road! Having said that, the investment team constantly debates the rationale for our investment positioning.

We acknowledge that the mismatch in the jobs market may cause the U.S. economy to be stronger than we have previously thought to be the case. In addition, the graph below displays our calculation of the still ample liquidity available in U.S. financial markets. Combined with the still easy financial conditions, a strong jobs market would likely maintain the Fed's resolve to sustain its terminal rate into 2024.



Source: Bloomberg

If, at the same time, inflation cooperates and marches lower, our hunch is that growth stocks would rip higher and credit spreads would narrow, ensuring financial conditions become even easier. The lower inflation may be supportive of lower rates, but the Fed's fear of repeating the mistakes of the 1970s once again causes us to think that they will maintain their resolve. The rationale for this fear is displayed in the following graph. Note how during 1974, the Fed cut rates before inflation peaked, with inflation raising its head again a couple of years later.



Source: Bloomberg

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.

Two last points - first, be prepared to read notes from market commentators on how recent market and economic action mirror the experience of 2000. At that time, NASDAQ rallied hard in the spring/summer of 2000, only to give up the ghost as stronger economic data pushed short-term yields to new highs even though the Fed was finished hiking rates. NASDAQ gave back its rally gains, and more. Second, all analysis of future market action must consider the potential for the war in Ukraine to end. Clearly, such an event could have a market-moving impact.

In the meantime, the team at Forge First will stick to its disciplined methodology of managing client capital, buy-and-hold, free cash-flowing North American large capitalization stocks, always complemented with a diversified short book and listed put options to hedge single stock and systemic risk.

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.

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

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