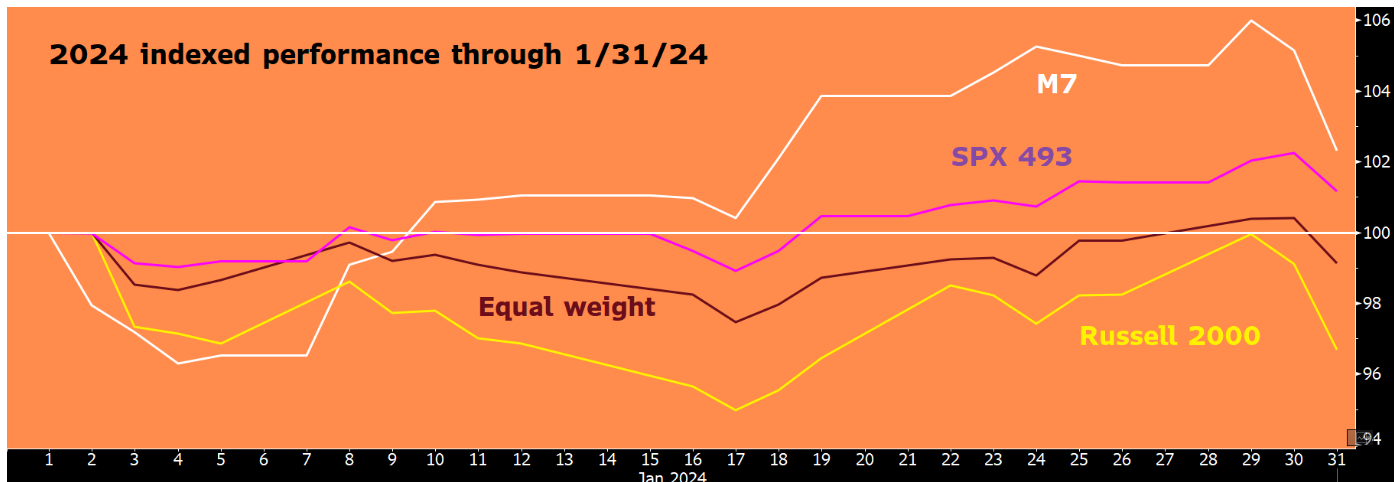
FORGEFIRST
ASSET MANAGEMENT INC

February 9, 2024

January 2024 Commentary

During the first month of 2024, analogous to a homing pigeon returning to its roost, the M7 index reverted with a vengeance to the top of the charts, surprising investors who had assumed that market breadth would continue to improve for the 3rd consecutive month. While results from Alphabet Inc. (GOOG.US) and Microsoft Corp. (MSFT.US) account for the one-day reversal shown on the far-right of the one-month indexed price graph below, subsequent earnings from Meta Platforms Inc. (META.US) and Amazon.com Inc. (AMZN.US) more than enabled the domination of market-weighted vs. equal-weighted S&P 500 performance to continue. While we foresee improved market breadth this year, we do not believe small cap stocks (Russell 2000 in yellow) will regain their lustre.



Source: Bloomberg

As can be seen from the table below, each of our funds delivered solid net results for January 2024, especially on a risk-adjusted basis. As discussed in our last commentary, into the big year-end advance in stocks, we used the availability of increasingly cheap protection as an opportunity to add and extend significant hedge positions in our funds. The January net return of +1.49% for the Class F Lead Series of our Long Short LP was achieved despite holding average net long equity exposure approximating just 12%, implying solid alpha (vs. beta) generation. This strong performance was especially evident in Financials (where net exposure averaged 5%) and Energy (4%).

					-----------------Annualized----------------				
As of January 31, 2024	**YTD**	**1-mo**	**3-mo**	**6-mo**	**1-year**	**3-year**	**5-year**	**10-year**	**Inception**
Forge First Long Short LP (Class F Lead Series)	1.49%	1.49%	7.13%	8.43%	7.88%	6.30%	9.49%	9.31%	13.14%
Forge First Multi Strategy LP (Class F Lead Series)	1.21%	1.21%	5.65%	6.43%	7.41%	6.05%	8.88%	7.44%	10.45%
S&P/TSX Composite Total Return Index	0.55%	0.55%	12.30%	3.63%	4.62%	9.91 %	9.57%	7.59%	8.50%
S&P 500 Total Return Index (C$)	3.11%	3.11%	11.95%	8.28%	21.46%	12.67%	14.72%	14.74%	16.61%

Note: Returns for the Forge First funds are based on the August 2012 Class F Lead Series and are net of all fees and expenses. In a year, up to 12 series can be created within a Class of units. Unitholders are advised to refer to their monthly statement for the net return of their respective Class and Series. All returns are in local currencies.

Fairfax Financial Holdings Ltd. (FFH.CA) was the largest single stock contributor for the month. This company's operating execution has been solid, and we expect stable to slightly better combined ratios this year compared to last year. Commercial insurance pricing is set to have yet another strong year, with renewal price increases meeting or exceeding lost cost inflation. As this commentary was 'going to press', we acknowledge the short report published on Fairfax. We note the author took no issue with the business operations or earnings power of Fairfax. In addition, we have no issues with the company's IFRS 17

accounting methodology and while we acknowledge that the company has both good and bad investments on its books, we take comfort in the approximate, current $800M mark-to-market on these non-tradeable investments. We will continue to own shares in Fairfax.

The fund also benefited handsomely from the short position it took in the Russell 2000 at the start of the year, through both an outright short position and a put spread. With respect to the latter position, both sides of the put spread made money 1) as the bottom strike eroded faster (being farther out of the money) than the closer strike and 2) because it was a ratio spread trade. Finally, Technology was also a solid contributor, owing mostly to a long position in Advanced Micro Devices Inc. (AMD.US) and a short position in Apple Inc. (AAPL.US). The fund exited January with delta-adjusted gross and net exposure of 144% and 20%, respectively.

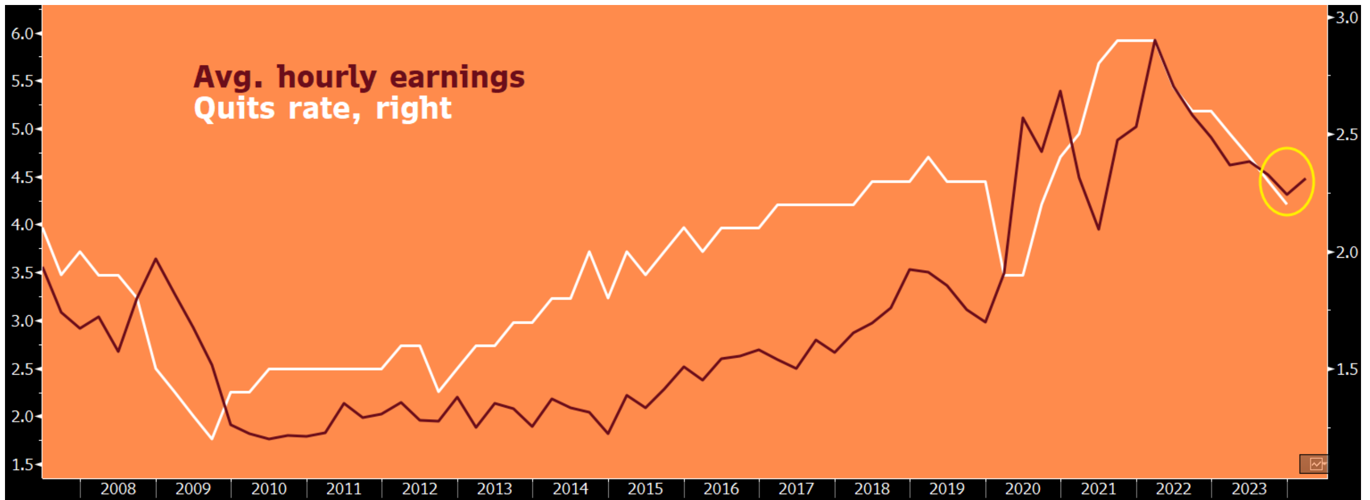
The Class F Lead Series of our low volatility, capital preservation-focused Multi Strategy LP kicked off the new year with a +1.21% net gain during January. Positive contributions were generated in each of the equity and credit sleeves of the fund, while listed options were a modest drag. Similar to the Long Short LP, Financials was the leading contributor to performance. This was then followed by equities in the Technology and Consumer Cyclical ("CC") sectors. Within Financials, the fund benefited from spread tightening in its public credit book despite the fact that GCAN five-year yields moved higher. Fairfax and CI Financial Corp. (CIX.CA) also chipped in some basis points, as did our short position (since covered) in U.S. government bonds.

Installed Building Products Inc. (IBP.US) was a winner in the CC sector as the fund added a 'risk reversal' options trade after IBP shares fell in sympathy to the results from homebuilder D.R. Horton Inc. (DHI.US). Industrials was the key losing sector for the fund, as positions in Bombardier Inc. (BBD.B.CA) and RB Global Inc. (RBA.US) bucked the rising tape. This fund exited January with delta-adjusted gross and net exposure of 133% and 37% respectively, with the net exposure being split between equities (14%) and credit (23%).

Source: Bloomberg

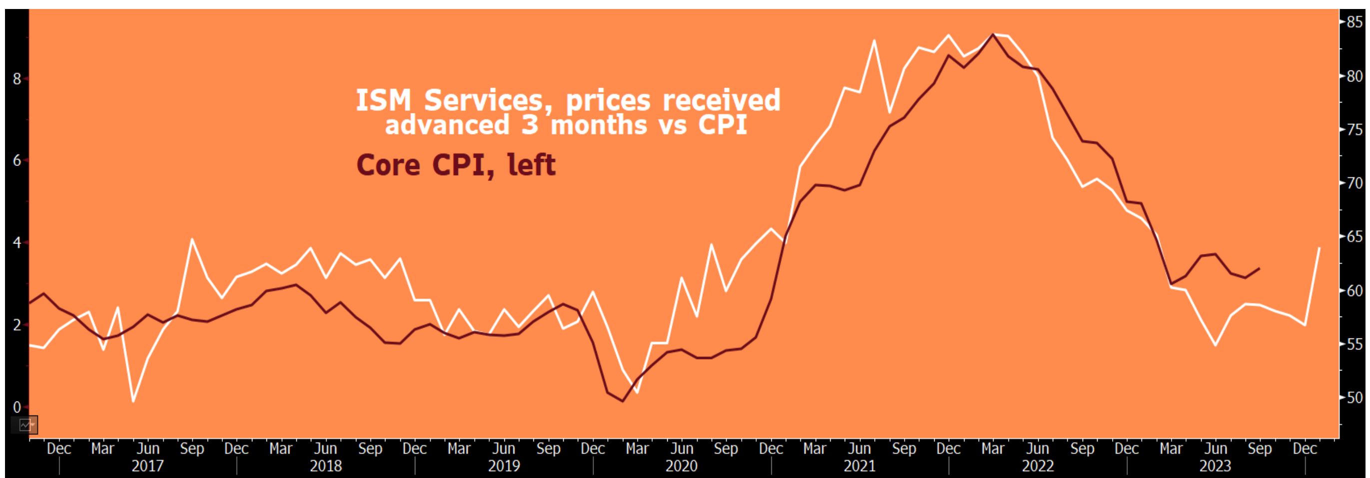
In reviewing the Canadian market, the indexed price graph above starts from January 2022 with the vertical white lines marking the ends of calendar years. Hence, the far-right side indicates the January 2024 performance of Resources (red line), Banks (white line), 'safety' stocks defined as grocers, REITs, and Utilities (green line) and the 'rest of the TSX, excluding Shopify' (yellow line). Banks and Resources, roughly half of the Canadian market index, actually fell during January, while the remaining segments of the market generated positive returns.

Looking ahead, supposedly the big driver for markets is the timing and rate of change in governed interest rates. We use the word supposedly because 14 months ago, three rate cuts were priced in for H2 of 2023 but of course rates increased another 100 basis points instead, yet stocks didn't care. Late last year, there was talk about a rate cut by the Fed in January 2024, followed by additional cuts in March, May and several others during the year. Obviously, nothing happened in January. At his most recent press conference, Chair Powell pretty much said no rate cut is coming in March and odds for a cut in May have started to recede. Hence, once again, the question is whether equities will care if the Fed doesn't cut soon enough nor as frequently as has been priced into markets.



Source: Bloomberg

It's true the U.S. labour market is not as hot as it was last year, but last week's data suggests it's still in pretty darn good shape. Sure, average hours worked declined the most (outside of COVID-19) since 2010, serving to fully offset the +0.6% month-over-month print (double the estimate) in average hourly earnings such that average weekly earnings were flat. Yet, job growth was far better than expected (and yes, despite being inconsistent with the Household Survey) and while the Quits rate (white line, right axis) in the above graph has fallen markedly, you can see average hourly earnings (red line, left axis) remains well above historical averages and resides at a level considered to be inconsistent with 2% inflation.



Source: Bloomberg

While we are not economists, the reason we argued 14 months ago that there would be no rate cuts during 2023, was due to our belief the general population needed to be paid more money to pay for their basic needs. We still believe that's the case and ultimately explains why wages remain elevated. Wages still have a way to fall before Powell and team can declare victory against inflation. Granted, price pressures have fallen far enough that he's admitted his most likely next move is to cut rates. Yet, given the disastrous move by Fed Chair Burns in the 1970s and the surprising strength in much of the U.S. economy, we remain in the camp that the first rate cut is several months away, and the number of cuts this year is more likely to be three or four vs. the assumed six. Of course, also under his watchful guise will be corporate America's pricing plans. The above graph compares Core CPI (red line, left axis) against the ISM Services Prices Received Index (white line, right axis), with the latter advanced three months against the former variable. ISM Services pricing has clearly turned higher, lock step with an increase in the order to inventory ratio for U.S. Manufacturing companies.

The bottom line on the Fed is that the current stability in growth and employment affords Powell and company a significant degree of flexibility to allow them to guard against rebounding inflation. As a result, we believe the Bank of Canada will cut rates before the Fed.

Source: Bloomberg

Beyond trends in inflation and interest rates, the amount of liquidity in the system also merits consideration. The recent Quarterly Refunding Announcement (QRA) by the U.S. Treasury Department was in line with estimates and risk positive, with future coupon issuance not expected to increase for several quarters. However, with reverse repo balances (RRP) expected to approximate zero as early as the end of March (please see graph above), the FOMC will deliberate balance sheet runoff plans at their meeting in March.

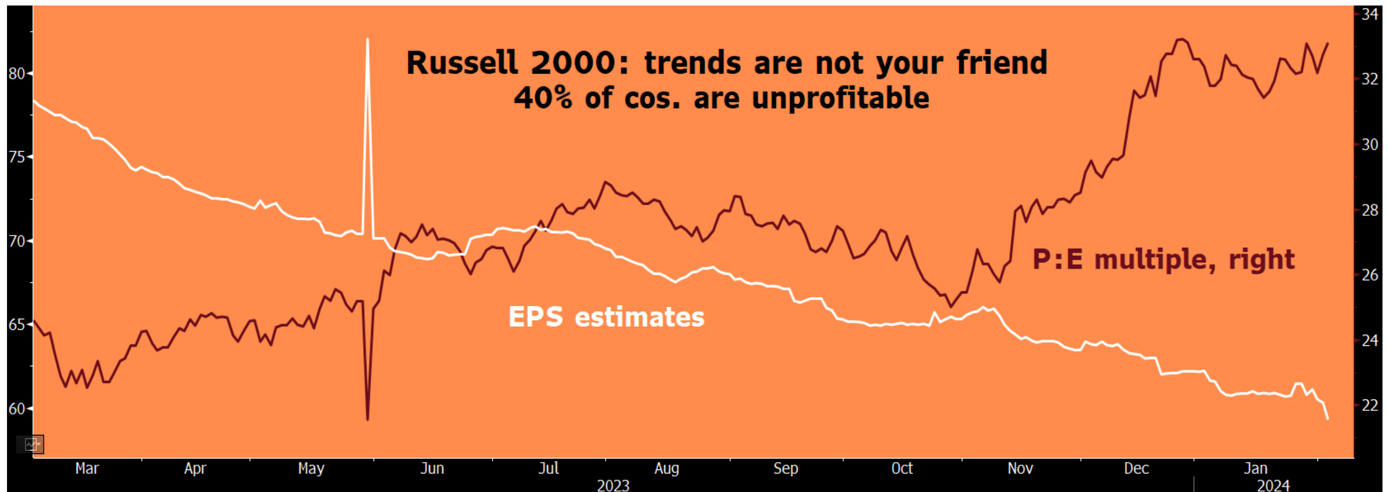
We would not be surprised to see QT taken off the table as with no RRP 'piggy bank', Yellen will be forced to start issuing coupons again and extending term (because liquidity to buy bills can really only come from RRP and Bank Reserves in the near term). Once Yellen starts issuing coupons in size and we experience some shaky auctions (think last October but many in a row), Powell will have to step in, signal QT tapering and eventually end the program. We expect to hear concrete talk about tapering QT at the March 20th press conference, followed by a roadmap for its conclusion tabled this summer.

It is not practical for a government to post 7% deficits financed by issuance in the trillions without central bank monetization (and certainly not QT). Hence, while liquidity could get tighter during the next few months, it's entirely possible that once again the Fed comes to the rescue; and some companies need that help! One challenge for markets this time around is valuation, as the S&P 500 currently trades at 21.2X forward 12-month EPS estimates while the P:E for the Russell 2000 sits at 24.4X.

Russell 2000 vs. S&P 500 - YoY Earnings Growth		
Q4 Earnings to date	Russell 2000	S&P 500
All Securities	-3.65%	7.05%
Materials	5.99%	5.34%
Industrials	26.07%	6.27%
Consumer Staples	-4.68%	6.17%
Energy	15.72%	13.42%
Technology	9.69%	4.95%
Consumer Discretionary	3.80%	13.33%
Communications	-21.29%	2.51%
Financials	-13.94%	9.18%
Health Care	41.88%	9.91%
Utilities	6.41%	3.82%
Real Estate	-13.58%	1.28%

Source: Bloomberg

Earlier in this note, we wrote of our expectation for a continuance of small cap underperformance and our short position against the Russell 2000. The table above compares the quarter-to-date sector earnings growth of companies listed on the S&P 500 to those in the Russell 2000 Index. While the above table is only based on partial data, as companies are still reporting Q4 results, we find the divergence between small and large cap stocks in the same sectors to be startling. For example, the negative comparisons for the two indices in Consumer Staples, Communications, Financials and Real Estate are good starting points. In fact, 40% of companies listed on the Russell 2000 are unprofitable and just think, that's with a good economic backdrop! To that end, the following graph compares the falling EPS estimates (white line, left axis) for the Russell 2000 against the rising P:E multiple (red line, right axis). The trend with this combination is not your friend.



Source: Bloomberg

While we find U.S. small to mid-cap equities unattractive, the debt is particularly interesting. Credit spreads for levered loans, senior secured 'B' loans, and CLO 'BBB' (and lower) paper have not compressed nearly as much as credit higher up the curve (such as 'BBB'). One of our preferred trades to capitalize on this opportunity is to own the Invesco Senior Loan ETF (BKLN.US).

Below is the BKLN yield as a spread to the UST12M (best proxy since BKLN loans are floating with a little embedded duration). Note the spread is back to pre-COVID-19 highs. We believe structuring this trade whereby the funds own BKLN delta-hedged against the Russell 2000 (via the IWM.US ETF) will generate both a significant positive carry (8.5% to 9% depending on the number of rate cuts) and a gain on both sides of the ledger.

Source: Bloomberg

The risk of this trade is a persistent, mega risk-on move with strong breadth (think November to December 2023). We believe the combination of owning quality Russell-listed Industrial stocks in the funds plus the ratio structure of this trade, mitigate this risk. In addition, history suggests that a big expansion in credit spreads would be more than offset by the erosion of equity value. For example, from February 15th to March 15th, 2020, BKLN fell 8.6%, while IWM fell 28%.

To conclude, we remain cautiously optimistic towards equities due to recent trends in U.S. growth and inflation, plus the 'rate of change' element emanating from monetary policy at this juncture. Having said that, we are not constructive on sovereign bonds, we foresee accelerating reinvestment risk with GICs (as the BoC cuts sooner and more often than the Fed), and we note equity valuations aren't cheap. Consequently, we expect a choppy year in stocks and are very constructive on the ability for equity-based limited partnership funds to boost the positioning of client portfolios on the efficient frontier.

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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