FORGEFIRST
ASSET MANAGEMENT INC

JUNE 2013

MONTHLY COMMENTARY

Markets took many prisoners during June 2013 as a combination of Fed 'tapering fears' and rising funding stress indicators in many Emerging Markets ("EM") hit virtually all assets hard. In the table below only oil saw green during the month while precious & industrial metals and EM stocks saw the most red. The TSX fell 3.76% bringing its 1st half loss for 2013 to 0.87%.

US Dollar Ex-TSX	June 2013	YTD
TSX	-3.76%	-0.87%
S&P 500	-1.33%	13.8%
Gold	-11.10%	-27.00%
Oil	6.00%	-8.10%
Japan	-0.09%	33.31%
Emerging Markets	-6.32%	-9.52%
Long Short	2.30%	17.67%
Market Neutral	3.02%	16.77%

Meanwhile both our funds at Forge First continued to deliver solid risk-adjusted returns in June. The monthly winning streak for both funds now dates back to last November.

Our Forge First Market Neutral LP ("FFMNLP") delivered a net return of 3.02% during June 2013. This performance enabled this low volatility fund to return 16.77% net to investors for the 1st half of 2013 and 25.82% since our August 2012 inception. Not only did FFMNLP handsomely trim all markets, these profits were captured by a fund that continues to exhibit great risk metrics.

The Sharpe ratio of FFMNLP is 4. The correlation of the fund to the TSX is 6.21% while annualized volatility, as measured by standard deviation, sits at 7.15%. Given the level of net returns of the fund and the adjusted beta of only 0.13, it's no surprise that the alpha is as high as it is at 27%.
FFMNLP exited June 2013 with gross and net exposures of 205% & 20% respectively. This net exposure can be further broken down to 80% in equities & 20% in bonds. Sector nets included long positions in Industrials, Energy and Financials, while our largest short exposures were in Funds (ETFs), Materials and Utilities.

The Forge First Long Short LP ("FFLSLP") generated a net return of 2.30% for the month of June 2013. Year to date, FFLSLP has earned 17.67% net for its investors, and 28.17% since our August 2012 launch.

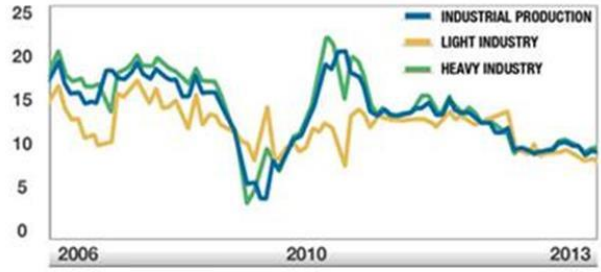
Gross exposure exited June at 188% for FFLSLP while its net was 45%. The funds' Sharpe ratio was a solid 4.0 while its adjusted beta and correlation sit at 0.30 & 17.07% respectively.

FFLSLP is a fund that will generally have net long positioning, also frequently less exposure to commodities than FFMNLP. This higher net exposure positioning in June accounts for its lower net gains than FFMNLP during the month.

While we're pleased with our net returns, we know investors care most about capital preservation. The table below compares the daily basis point change in value of each of our two funds against the market during that particularly challenging 3rd week of June. FFMNLP didn't lose money on a single day that week while FFLSLP made money on 4 of 5 days, and the losing days was a modest 14 basis points.

	Monday	Tuesday	Wednesday	Thursday	Friday
TSX	83	64	-80	-244	23
S&P 500	76	78	-139	-250	27
Market Neutral	**59**	**20**	**14**	**32**	**69**
Long Short	**67**	**32**	**10**	**-14**	**72**

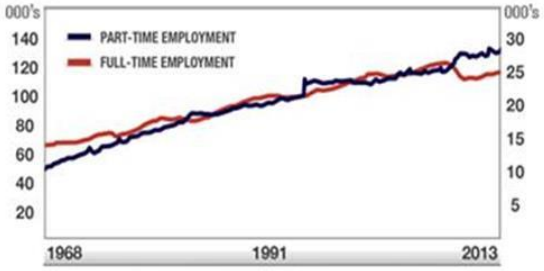
Looking ahead, I stick by my view that growth will remain tepid. Also I expect 2nd half earnings guidance from the upcoming quarterly reporting season to be muted again.
Q1 US GDP has been revised down to 1.8%. Consensus for Q2 GDP for our southern neighbours sits south of 2%. Meanwhile, it's obvious the Chinese government intends to deleverage its banking sector. While the chart below shows that Chinese Industrial Production has been slowing the past couple of years, this tightening action will serve to exacerbate the strain on China and the economies of fellow EMs. In fact some economists now call for Brazil to move back into recession.



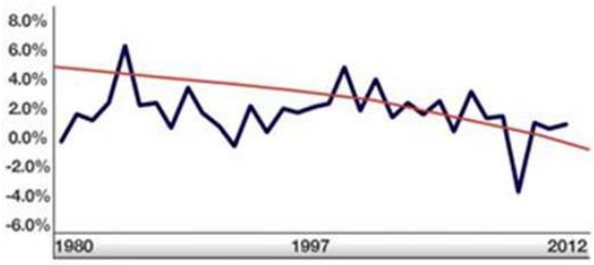
Source: Morgan Stanley in the flow report

Yesterday, the IMF cut its forecast for EM & global growth, again. Of course this will impact 2nd half revenue growth for S&P 500 companies, who as a group capture 34% of their revenues from outside North America, including 20% from EM countries. Meanwhile, the US dollar has climbed 5% since May 2013. That won't help the revenue growth for the components of the major index either. Nor do these trends bode well for the Basic Materials sector, which of course explains why we remain net short this space.

As for the US consumer, no question things have gotten better but let's not get carried away. The chart on the below left shows the U.S. economic recovery has been about part-time not full-time jobs. While a part-time job is better than no job, this trend is one of the reasons why real personal disposable income growth, shown in the chart below on the right, continues its long term downward spiral, despite falling inflation.



Source: US Bureau of Labour



Source: US Bureau of Labour

Rising housing prices have definitely been a positive, but the recent hike in interest rates may stall this trend. According to the Mortgage Bankers' Association, the U.S. mortgage applications Composite Index declined for a 4th straight week (now 8 of the past 9 weeks) such that the Composite Index is at the lowest level since July 2011. Average household income in the USA approximates $50,000. This figure drives the rule of thumb that a family allocates $2,000/month for a mortgage payment. Interest rates two months ago implied the average household could afford a house in the low $400,000s. Today that figure is in the mid $300,000s.

With the Fed frequently acknowledging the key role played by housing in the healing to date of the US economy, the Fed will watch housing trends like a hawk. While the impacts of either systemic leverage (carry trades, derivatives) & convexity hedging (selling treasuries to adjust portfolio duration given lower volumes of mortgage refinancing) can shock interest rates higher at any time, I don't think the Fed will allow them to rise further on a sustainable basis. The Fed can't since the US recovery remains fragile.

So while I'm offside on my call for US 10 year bond yields to not sustainably rise above 2.2% during 2013, the chart below suggests that either the positive carry favouring US bonds over German Bunds must shrink or else the US dollar has further to rise. In my books, either scenario leads to falling yields and a tougher environment for stocks.

Source: Bloomberg

My view can be wrong for at least two reasons. Given the relative lack of equity supply in the US, modest incremental foreign demand for US stocks can push prices higher, despite the fact trading volumes remain lousy. Alternatively, I could be dead wrong on my economic call. Regardless, in early July 2013, non-resource equities appear to be a one way trade, up, as both good & bad news pushes stocks higher.

Based on the S&P 500 at 1,650 & consensus earnings of $108 for 2013, the markets' trading at 15.3X 2013 EPS, not cheap but not too expensive either. Let's call it 'no man's land'. The bet is whether the consensus is right on earnings. According to Thomson Reuters, analysts expect S&P 500 year over year EPS to grow at 8.5% and 12.8% respectively for Q3 & Q4 of 2013 but I don't buy it. I think earnings growth will be lower than that. The answer may come during the next 3 weeks when 75% of the S&P 500 companies report Q2 and provide 2nd half guidance. I will wait with bated breath & prudent net long positions in our portfolios.

As always should you have any questions or comments, please contact me at 416-687-6771 or amccreath@forgefirst.com. Follow me on **TWITTER @CEDARBUSH**

Thanks very much,

Andrew McCreath