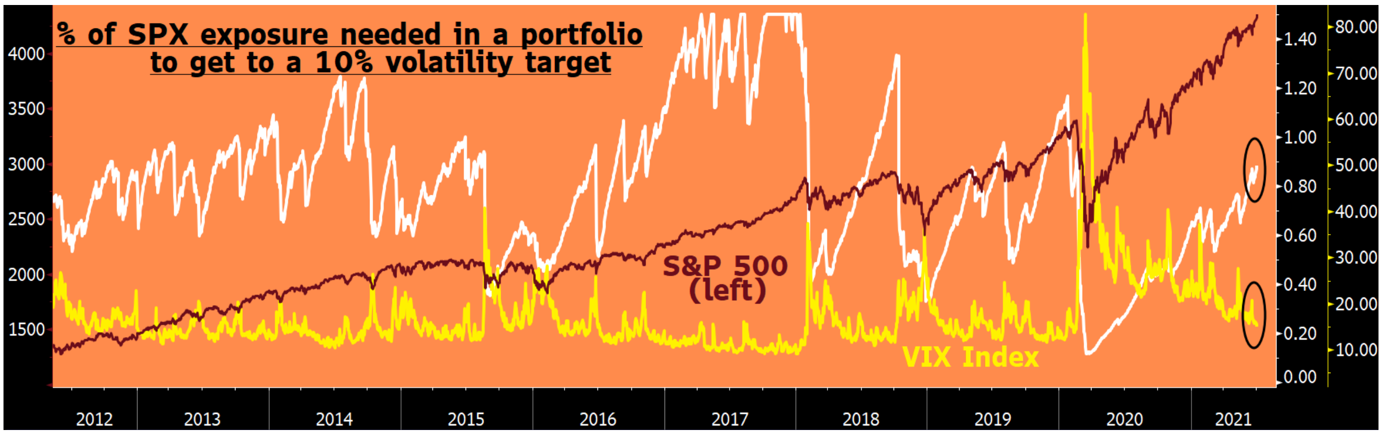
July 9, 2021

June 2021 Commentary

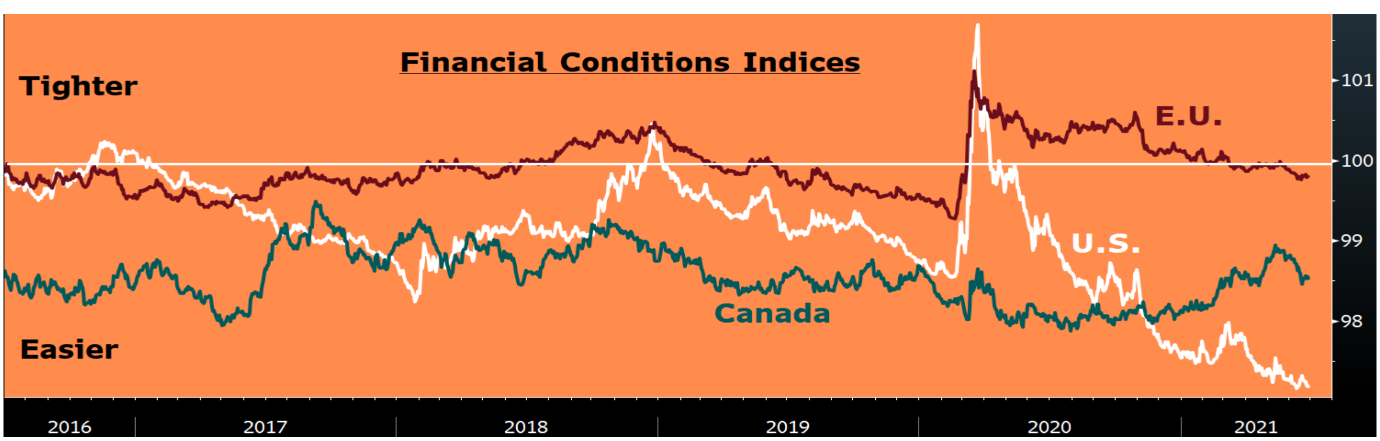
When we published our 2021 Market Lookahead commentary ([December Commentary]) in early January, it was an easy call to be bullish on stocks. The pitch was simple and the majority of buy and sell-siders shared similar outlooks. Unprecedented stimulus, albeit higher but still low interest rates and an expected flow of funds into stocks partially supported by declining volatility. With the S&P 500 having closed last week at 4,352 the outlook call gets tougher for long-only managers and especially sell-side equity strategists who have a propensity to be bullish. Interest rates remain surprisingly low and, as can be seen from the right side of the first graph, declining volatility (yellow line) continues to boost the capital allocation to stocks (white line) for traders targeting portfolio volatility of 10%.



Source: Bloomberg

Yet, signs abound that we have reached the peak in the rate of acceleration in policy stimulus, economic growth and corporate earnings, hence we stick with our call that equity averages will soon take a pause and price dispersion between equities will rise going forward. Agnostic to market direction, except for large, sudden violent moves up or down, we believe H2 of 2021 will present proven long-short strategies the opportunity to shine.

June 2021 was a strong month for asset prices, with growth stocks and energy commodities leading the way. The month also featured more 'hawkish' than expected dot plots and commentary from the Fed, plus ongoing concern towards the potential for unruly rates of future inflation. However, judging from the rise in prices for stocks, bonds and energy commodities, it appears Chairman Powell did a good job appeasing the concerns of investors towards inflation. Besides, as evidenced by the Fed's gargantuan reverse repo programs and the year-to-date 10% increase in the size of its balance sheet, the fact markets continue to be awash in liquidity is one of the reasons financial conditions in the U.S. are the 'easiest' in history.



Source: Bloomberg

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	YTD	1 mo	3 mo	6 mo	1 year	2 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	11.81%	1.29%	6.24%	11.81%	27.81%	16.11%	13.24%
Forge First Long Short Alternative Fund Series F	12.29%	1.37%	6.47%	12.29%	28.93%	17.16%	14.24%
Forge First Conservative Alternative Fund Series A	8.82%	1.32%	3.22%	8.82%	25.58%	13.22%	11.64%
Forge First Conservative Alternative Fund Series F	9.32%	1.40%	3.46%	9.32%	26.75%	14.25%	12.63%
TSX Total Return	17.28%	2.48%	8.54%	17.28%	33.85%	14.43%	12.21%
S&P 500 Total Return (US$)	15.25%	2.33%	8.55%	15.25%	40.79%	23.03%	20.59%

*****Annualized | Inception date: April 24, 2019

Each of the two Forge First funds capped off a strong first half of 2021 with solid performances during the month of June. The Series F of our Long Short Alternative Fund gained +1.37% after fees, boosting its year-to-date net return to +12.29% and its trailing 12-month net gain to +28.93%. For regular readers of these notes, it will not be a surprise that the Energy sector drove performance last month. In fact, our team joked about the basis point cost of remaining disciplined with hedges when you're in a "bull market" for energy stocks. However, disciplined we will remain, as buying puts to protect large long positions is a key element of our rule book. Besides Energy, Utilities, Financial, Real Estate, Technology and Consumer stocks all contributed positively to June's performance. Losing sectors included Materials and ETFs. Our Long Short Alternative Fund exited June 2021 with gross exposure of 128% and delta-adjusted net exposure of 52%.

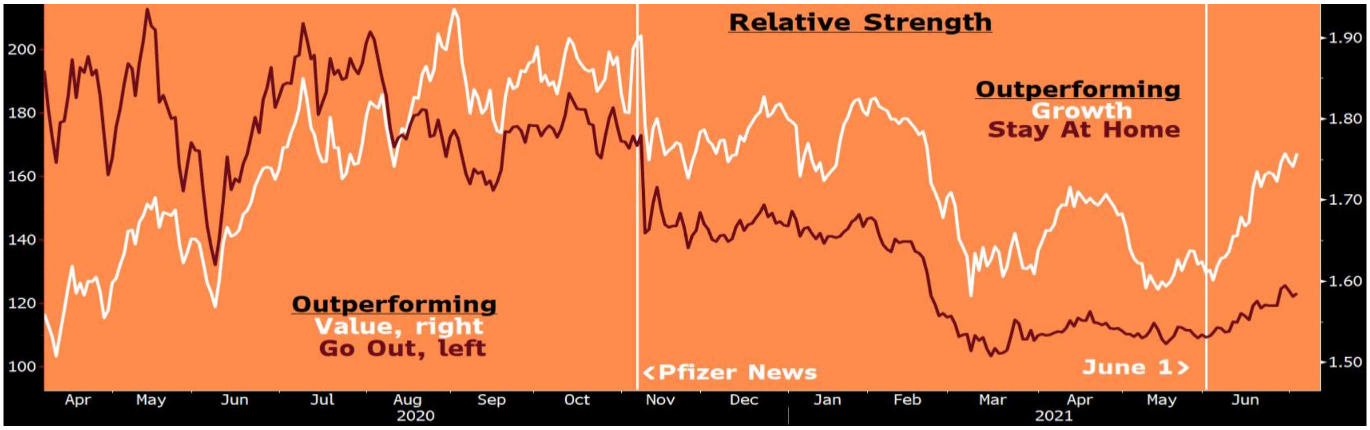
The Series F of our lower volatility Conservative Alternative Fund gained +1.40% after fees during the month, such that its year-to-date net return sits at +9.32% and its rolling 12-month net gain is 26.75%. This 15th consecutive month of positive performance was driven by contributions from each of the capital growth or common equity sleeve and the alternative strategy or multi-asset sleeve of this fund. Positive attribution in the capital growth sleeve was driven by positions in the Utilities, Energy, Financial, Technology and Consumer sectors. The 3rd sleeve of this portfolio, asset protection, detracted from performance during the month. The Conservative Alternative Fund exited the month of June with gross exposure of 108% and delta-adjusted net exposure of 45%, split among an approximate 38% in the capital growth sleeve, 14% in the multi-asset sleeve, and -7% in the asset protection sleeve.

A significant contributor to performance last month was Enviva Partners LP (EVA.US), a company we have owned in each of the funds for roughly six years. Enviva, a manufacturer of utility-grade wood pellets used in biomass power generation, is a textbook example of our buy and hold philosophy towards free cash flowing businesses. This U.S. company has grown annual distributions per unit in the low double-digit percent range, while continuing to provide unitholders with a high single-digit percentage yield. Our net CAGR on these shares has averaged more than 20% and we foresee a long runway for continued compound growth from each of Enviva's high return organic and acquisition-related investment opportunities. The shares of Enviva Partners LP continue to be a top 10 holding in each fund.

In reviewing the remaining Top 10 holdings in our Long Short Alternative Fund, aside from the very significant free cash flow generating capability of all the businesses, the balance between growth and value is striking. With the possible exception of Trulieve Cannabis Corp. (TRUL.CA), a U.S. marijuana business that our modelling shows will generate hundreds of millions of dollars of free cash flow during the next 18 months, you will recognize the names of all remaining positions.

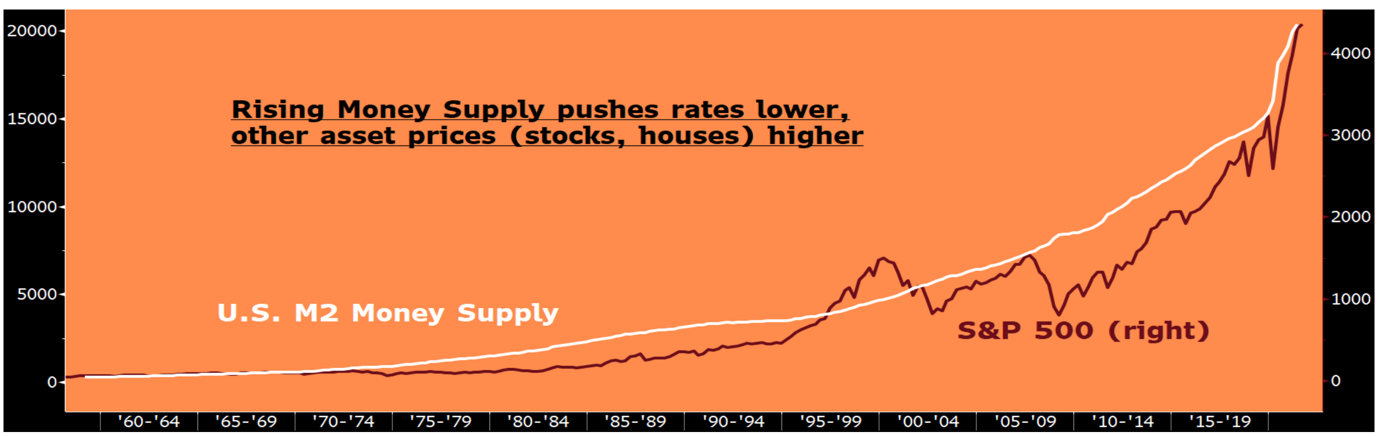
Tourmaline Oil Corp.	Canadian Natural Resources Ltd.	Enviva Partners LP
Alphabet Inc.	Facebook Inc.	Microsoft Corp.
Meg Energy Corp.	Cenovus Energy Inc.	Trulieve Cannabis Corp.
Amazon.com, Inc.		

That balance between growth and value implied by the Top 10 holdings is indicative of our style-agnostic approach to investing. It turned out to be helpful last month as we were somewhat taken aback at the degree of reversion in the value to growth rotation in markets. In fact, as shown in the relative strength graph below, each of the growth (to value) and 'stay-at-home' (versus 'go out') factors exhibited their largest outperformance since prior to Pfizer's 1st COVID-19 vaccine trial data was released on November 9th of last year. As each of these factor rotations began two weeks before Powell placated investors towards inflation, one catalyzing factor may have related to concerns that the delta variant could become problematic to the economic recovery. Only time will tell, and let's hope not!



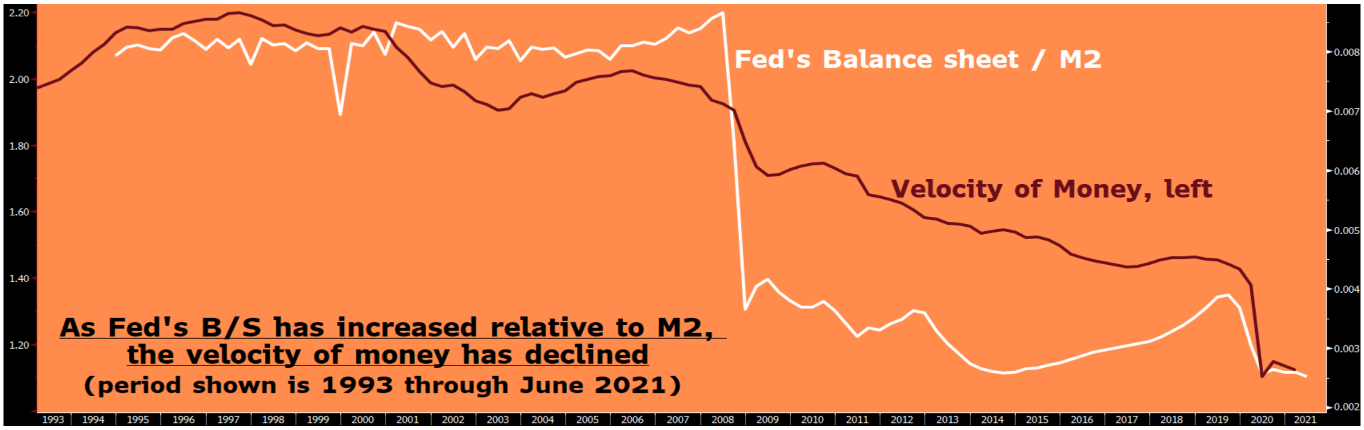
Source: Bloomberg

Looking at the 2nd half of this year, as financial markets remain awash in liquidity, all else being equal, equity indices should be able to grind modestly higher. While things in life are rarely as simple as they sometimes appear to be, the simplicity of the relationship between Money Supply (white line) and the S&P 500 (red line) in the graph below is startling. However, the greater the liquidity-driven boost in equity markets today, the lousier the mid-term outlook will be for stocks, as liquidity conditions are poised to tighten. The year-over-year growth rate in U.S. M2 money supply peaked at 27.1% in February 2021, sliding to 13.8% in May, and we expect it to decline further during the next 6-12 months as U.S. consumers are unlikely to be receiving a 4th round of stimulus cheques.



Source: Bloomberg

One additional thought on monetary policy - the graph below displays how the velocity of money (GDP/M2 = Velocity) has fallen as the size of the Fed's balance sheet has increased relative to the total money supply (falling white line). A key reason this trend has happened is that a growing portion of the money supply has been invested in financial assets, as implied by the previous graph. If you don't change this dynamic amidst a decelerating economic environment, authorities may just end up creating that much talked about 'asset bubble' that we've yet to see in the broader equity markets of the current cycle. Without doubt, such an event could harken society back to 2008 with a 'balance sheet recession'. Unfortunately, today, excluding the top 10% of the population and the top few hundred global companies, the world is mired in debt. Hence, for financial markets, it's tough not to ponder the chess term, 'checkmate'.

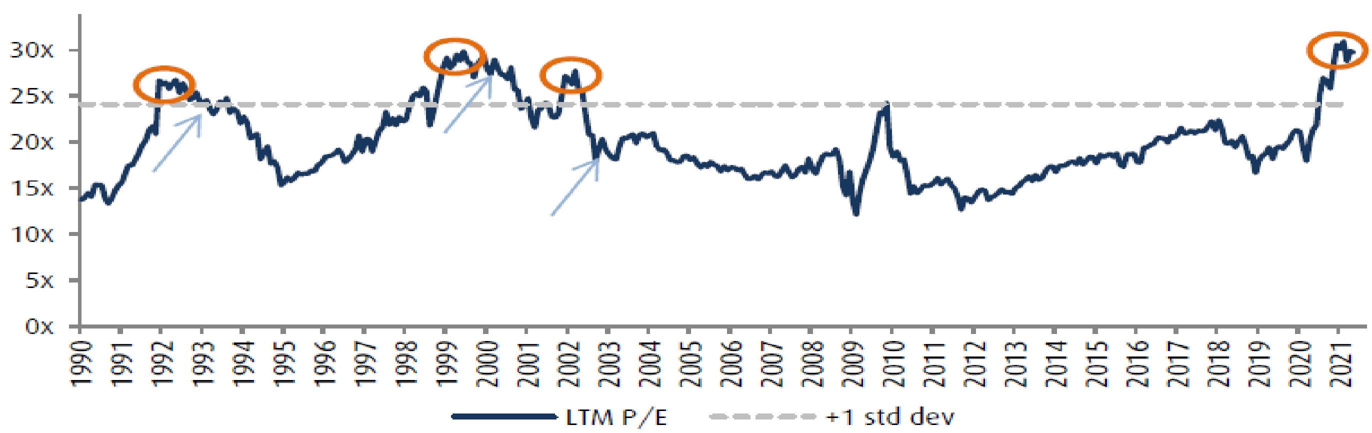


Source: Bloomberg

Alternatively, if continued accommodation doesn't create a bubble and the U.S. economy closes its output gap during early 2022, the Fed could risk the need of an abrupt tightening cycle, causing a spike in interest rates just as borrowers return to markets. So, for all the soothing talk from Powell, it's likely there is a very active debate around the FOMC's Boardroom table between officials that prefer the new 'outcomes-based' process versus the traditional 'forecast-based' approach towards monetary policy. Cognizant of the lag between policy and outcomes, the hawks know the stakes are too high for the Fed to be wrong. Be thankful that the Fed has at least begun talking about talking!

As for inflation, labour market uncertainties likely dictate that it will be late Q1 2022 before we can ascertain the future path of inflation; we continue to believe that a majority of the inflation is transitory (supply chain issues and the 'internetization' of the economy). Turning to growth, the fiscal component of stimulus is also expected to slow down, but for stocks there's an additional factor at play.

North American, COVID-driven fiscal stimulus has been dedicated to immediate consumption, as opposed to spending capable of catalyzing generative or productivity-boosting economic activity. It is this twin-barrelled reduction in stimulus that will cause rate of economic and profit growth to fade slowly through 2022, with that cadence picking up in 2023. Meanwhile, in the graph below, courtesy of Brian Belski of BMO Capital Markets, the P/E multiple for the S&P 500 appears vulnerable to a further contraction over the next 12 months.



Source: BMO Capital Markets

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Putting all this together, while decelerating, U.S. growth should remain firmly above trend for the next two to three quarters, hence a reduction in accommodation by the Fed is appropriate. Yet this reduction in accommodation is likely to impact financial markets in two ways. First, beyond the near term, the risk/reward offered by equity indices should become less favourable during the next 6-12 months. Second, investors should expect continued volatility between styles and factors. In fact, recently we've noticed the time between these factor cycles has been getting shorter.

However, companies that can continue to grow earnings and cash flow in this tougher environment should continue to be rewarded, while remaining companies will probably not be so lucky, as the 'rising tides lift all boats' investing climate is past its due date! It is our view this dispersion will provide fertile ground for the bottoms-up stock picking style of the investment team at Forge First.

Shifting to the energy sector for a moment, the oil market has tightened considerably over the last month with global inventories drawing at an alarming clip. The rate of this draw will continue for at least another month, causing inventory headlines and real-time supply/demand data to remain bullish, as the market remains short roughly 2.2M to 2.4M bbls/day.

As for last week's OPEC meeting, we admit surprise at its outcome but let us step back at look at the backdrop. OPEC has 20 members and roughly 6M bbls/day of total spare capacity. Approximately, 5M bbls/day of this spare capacity is held by five producers, with half of this 5M sitting with OPEC's chief coordinators, Saudi Arabia and Russia. The UAE holds roughly 850K of spare capacity, but remember, their demand is to boost the reference number used for their production capacity, not raise production by this number of barrels. The other two of these five countries are Iran (currently still sanctioned) and Iraq, with the Iraqis supportive of the Saudi's decision. The bottom line is there are several countries which are not capable of producing at their current quota let alone at a higher rate based on their spare capacity. Hence, in our books, the bearish scenario requires the Saudis and the Russians to pump as much oil as they can. We doubt either player is desirous of blowing up the oil market for the second time in two years, though we will admit the chances of that are not zero.

Also, it is possible that vaccine-hesitancy and/or the delta variant torpedo the oil market, but we also note that the vaccine situation has begun to improve markedly in EMs. Finally, we are aware that longer data oil prices, i.e., 2025 have not increased anywhere near as much near-dated contracts; however, it remains our view that oil producer equities are inexpensive. We continue to own our favoured producers and hedge the expected choppiness at this point in the cycle via listed options.

The sometimes-forgotten molecule, natural gas, has seen prices move materially higher for a few reasons. First, heightened demand from the persistently warmer than average weather in North America. Second, U.S. LNG exports have remained buoyant and, third, inventories are not being replenished at a rate the market deems sufficient to ensure adequate supply for Winter 2022. A cold upcoming winter would undoubtedly spike gas prices and likely lead to outperformance in gas-focused equities within the energy market, yet in the near term we urge caution just in case early forecasts show a warm winter on the horizon. We would also note that the AECO gas is showing itself to be the price-advantaged market we assumed it would become, albeit not as quickly as it has happened.

Similar to our view that the marketplace for energy equities has entered a period of choppiness, this note has tabled our reasoning why the next 12+ months are likely to be stormer for equity markets (bonds too, given the yield on a 10-year bond sits at just 1.30%!). The Forge First team has delivered an almost nine-year track record of delivering competitive net returns and protecting capital when markets get rougher.

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.

Thank you,

Andrew McCreath	Daniel Lloyd	Keenan Murray
President and CEO	Portfolio Manager	Portfolio Manager

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