FORGE FIRST
ASSET MANAGEMENT INC

December 8, 2022

# November 2022 Commentary

This year's U.S. Thanksgiving was no turkey for investors as the price of pretty much everything, other than energy commodities, moved sharply higher. There were three drivers catalyzing this fifth beta rally during an otherwise tough year for investors: October's softer-than-expected U.S. inflation data, soothing words from Fed officials, and the positioning of investors. The key question is whether this latest rally is another headfake, or does it constitute a sustainable bounce off the bottom. Before tackling this question, let's review the performance of our funds.

| | YTD | 1-mo | 3-mo | 6-mo | 1-year | 2-year* | 3-year* | Since Inception* |
|---|---|---|---|---|---|---|---|---|
| Forge First Long Short Alternative Fund Series A | -2.11% | 0.56% | -0.40% | -5.85% | -2.78% | 5.74% | 8.79% | 7.15% |
| Forge First Long Short Alternative Fund Series F | -1.22% | 0.65% | -0.13% | -5.33% | -1.83% | 6.71% | 9.81% | 8.12% |
| | | | | | | | | |
| Forge First Conservative Alternative Fund Series A | 1.39% | 1.95% | 1.49% | -0.46% | 0.46% | 6.57% | 8.97% | 7.20% |
| Forge First Conservative Alternative Fund Series F | 2.23% | 2.00% | 1.71% | -0.02% | 1.37% | 7.54% | 9.95% | 8.16% |
| | | | | | | | | |
| S&P/TSX Composite Total Return Index | -1.00% | 5.54% | 6.68% | 0.29% | 2.04% | 12.24% | 9.52% | 8.93% |
| S&P 500 Total Return Index (C$) | -7.02% | 4.78% | 7.10% | 6.71% | -4.14% | 10.06% | 11.60% | 11.49% |

*Annualized | Inception date: April 24, 2019

The Series F of our low volatility, multi-asset Conservative Alternative Fund generated a net return of +2.00% for the month of November, boosting its year-to-date net performance to +2.23%. The fund maintained modest net equity exposure and low market beta during the month, leaving alpha to drive performance. Gains were captured in the capital growth and multi-strategy sleeves of the portfolio. The asset protection segment of the fund served as a modest drag, though upside equity option exposure drove an overall positive contribution for the listed derivatives book. On a sector basis, Consumer, Financials, Technology and Industrials were the largest positive drivers of performance.

Earnings season was strong for the fund, as both long and short alpha ideas chipped in positive contributions. Names on this list include Starbucks Corp. (SBUX.US), Boyd Group Services Inc. (BYD.CA) and Canadian National Railway Co. (CNR.CA) on the long side, and Telus International CDA Inc. (TIXT.CA) and Ritchie Bros Auctioneers Inc. (RBA.CA) on the short side. Both of these short positions have been covered and we are currently evaluating the upside potential from the recent transformative transaction announced by Ritchie Bros.

As mentioned in our October 2022 Commentary, this fund increased the use of stock replacement strategies, including risk reversals, in high conviction positions to enhance upside participation in the event that equity markets continued to rally into year-end. The fund has continued to maintain upside exposure using these strategies in MSCI Inc. (MSCI.US), Visa Inc. (V.US), Starbucks Corp. (SBUX.US), Microsoft Corp. (MSFT.US) and Air Canada (AC.CA). The Conservative Alternative Fund closed November with delta-adjusted gross and net exposure of 125% and 25%, respectively. The allocation of this net exposure was approximately 13% to common equities and 12% to multi-assets.

The Series F of our more directional Long Short Alternative Fund gained +0.65% net of fees for the month, cutting its year-to-date net decline to -1.22%. Excluding the Energy sector which posted a modest loss on the month, November was characterized by moderate gains across the remainder of the portfolio. Similar to the Conservative Alternative Fund, our broad market hedges were the largest drag on the portfolio. In addition, the fairly rapid decline in market volatility, as expressed by the VIX Index, also sapped value from our option book.

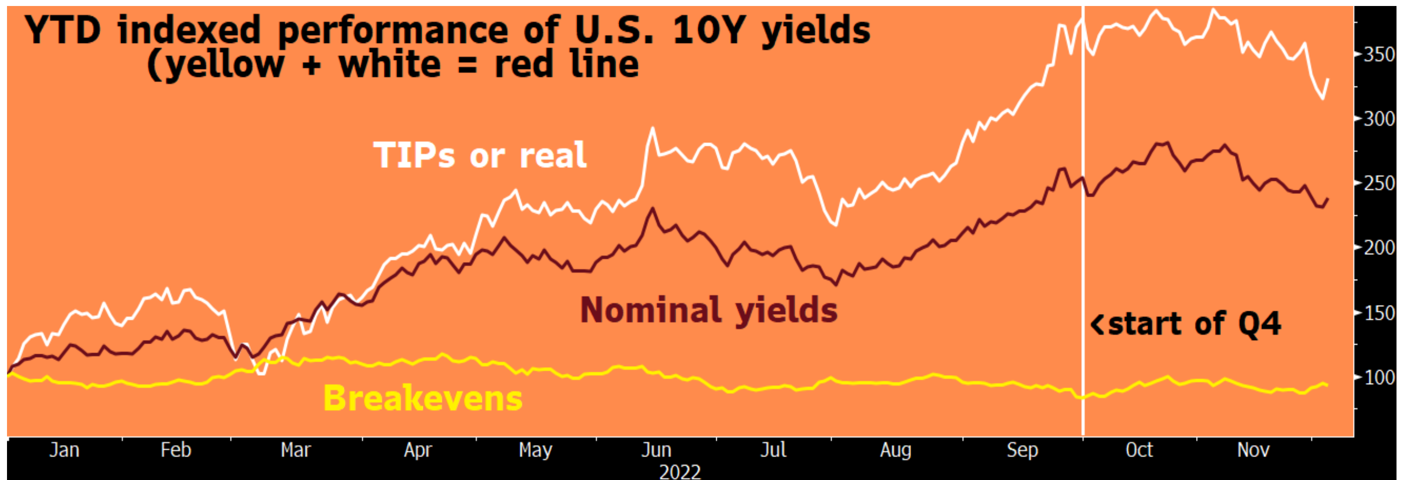
Point to point, at month-end, the net equity exposure of the Long Short Alternative Fund increased by approximately 16% from the end of October, as the fund added or increased positions in companies including Las Vegas Sands Corp. (LVS.US), Nike Inc. (NKE.US), VISA Inc. (V.US), and Freeport-McMoRan Inc. (FCX.US). This incremental net length was secured through both purchases in the

underlying securities and call spread positioning. As a result, this fund exited November with delta-adjusted gross exposure of 123% and net exposure of 49%.

Source: Bloomberg

The principal catalyst for the march higher in markets last month was the perception that the Fed will soon hit the pause button on its rate-hiking program. In fact, as shown by the graph above, between November 9th (red line), the day before the release of the U.S. October CPI print, and last Friday, December 2nd (white line), the futures market has priced in a material cut in overnight rates between late 2023 and 2024. Unless the U.S. experiences a 'hard landing', we find this view to be aggressive given our view that inflation will remain "stickier" for longer.

We continue to acknowledge that the rate of inflation will fall - thanks to improving supply chains, falling transportation costs, the impact on pricing of slowing consumer demand, and the law of large numbers, the latter of which is likely to generate 'market friendly' year-over-year headline CPI comparisons in the near term. Similarly, it is common sense that after implementing the fastest rate-hiking cycle with the greatest rate of change ever, it is only a matter of time until the Fed hits the pause button on the rate hikes. Regardless, markets clearly saw this as "new news" and responded commensurately. Of course, it helped that according to J.P. Morgan (a company we own in our portfolios), quantitative funds were short US$225B of stocks (US$150B) and bonds (US$75B) going in to the CPI print, creating a vicious short squeeze during subsequent trading sessions.



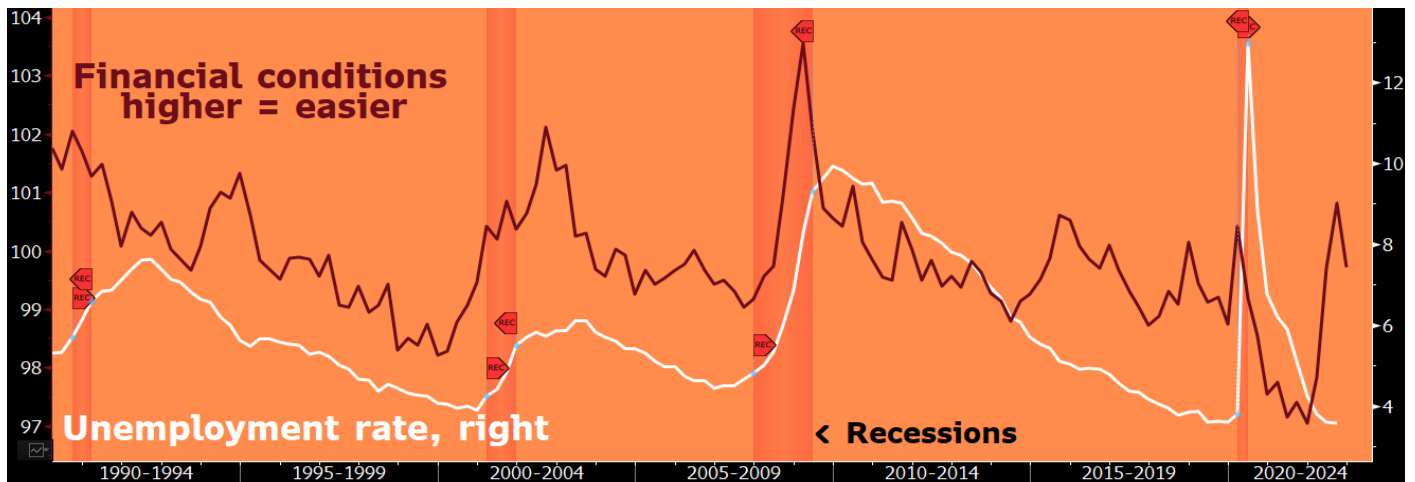
Source: Bloomberg

During November, yields on UST10s fell 45 basis points, with 30 basis points of this decline being attributable to falling TIPs or real yields. As evident from the year-to-date, indexed, disaggregated graph of yields on the US 10-year government bond (red line) above, breakevens (yellow line) have traded sideways lately, hence the majority of the decline in nominal yields has been attributable to the movement in real yields.

Source: Bloomberg

The yellow oval in the graph above highlights the strong negative correlation between real yields and the P/E multiple of the S&P 500 over the past five years; in other words, when real yields are rising, P/E multiples decline and vice versa. The far right side of this graph indicates that this relationship has reversed since mid-October 2022, as P/E multiples (red line) have been increasing (falling line) as real yields (white line) kept rising prior to the decline of the past few weeks. Credit spreads have also narrowed in concert with the rise in equity valuation.

During this same period, the 32-year graph below indicates that the Goldman Sachs US Financial Conditions Index (red line) has been rising, implying easier financial conditions in the U.S. The Goldman Sachs US Financial Conditions Index is effectively the same financial conditions index watched by the Fed. Easing financial conditions is not what the Fed wants to see right now, especially given that the rate of unemployment (white line, right vertical axis) in the U.S. hasn't budged off the bottom. Once again, notice the decoupling in the relationship between these two variables.



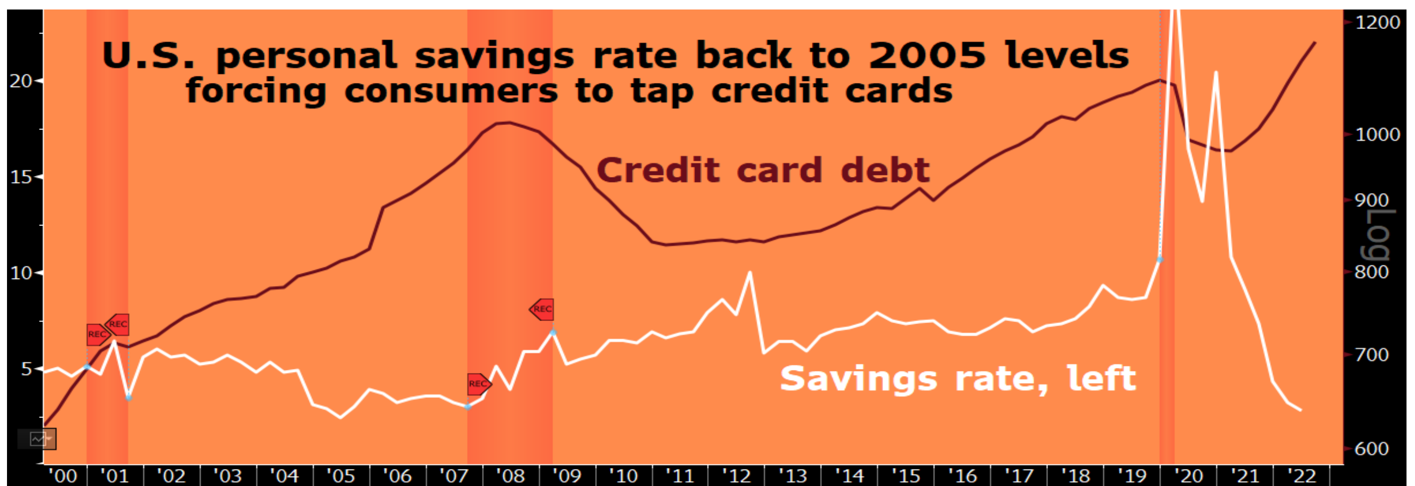
Source: Bloomberg

Markets almost appear to have taken a 'victory lap' on the Fed having won its fight against inflation, hence discounting big rate cuts starting in late 2023. We believe it is premature to assume that the battle has been won and expect the Fed to remain more vigilant for longer in their battle against inflation. Yes, the health of the U.S. is quickly deteriorating (as is Canada's!), hence, our expectation for the Fed is to hint at or outrightly announce a pause in rate hikes at its February 2nd meeting. Also, unlike the Bank of Canada which has a single mandate, inflation, remember that the Fed has the twin mandate of unemployment and the economy alongside inflation.

Source: Bloomberg

However, the 21-year graph above is equally supportive of the previous graph that implies the U.S. labour market remains strong, just a tad less hot than it was six to 12 months ago. The white line on the right axis is the ratio of job openings to the number of unemployed persons, in other words the total of job openings per person in the labour force but out of work. The red line on the left axis displays wage growth. The fit is obvious, as is the logic for the fit.

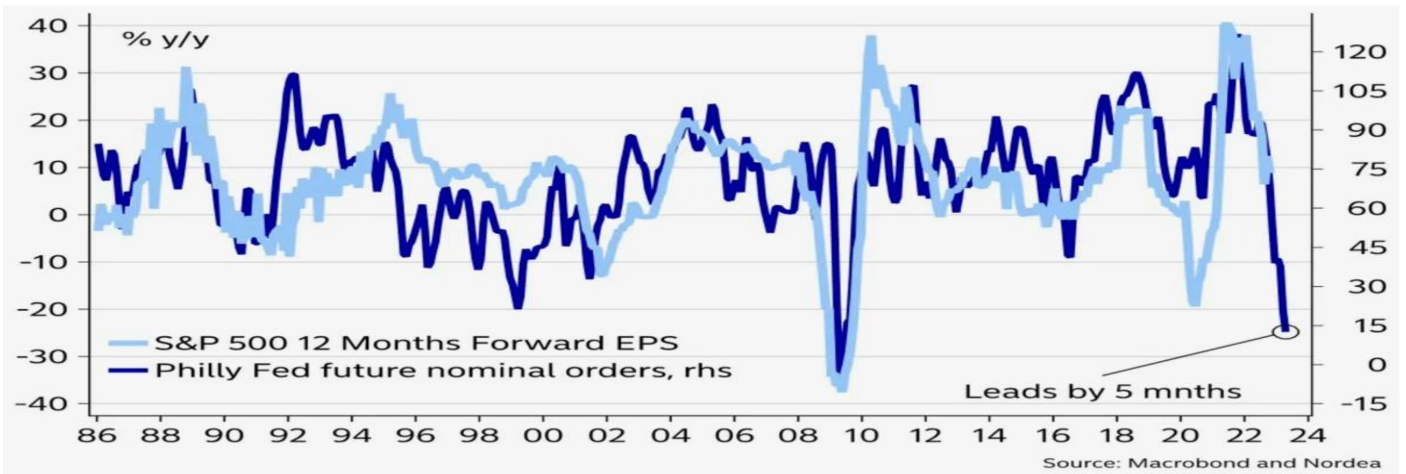
We believe inflationary pressures have hit consumers hard enough for long enough that even as the job market increasingly falters, wage hikes will stay stubbornly higher for longer than usual. In turn, this development would force the Fed to remind investors that a pause is not necessarily a prelude to a near-term cut in rates. This tight labour market will serve to limit the Fed to engage in a dramatic easing of financial conditions and monetary policy, effectively creating a ceiling on equity valuations.



Source: Bloomberg

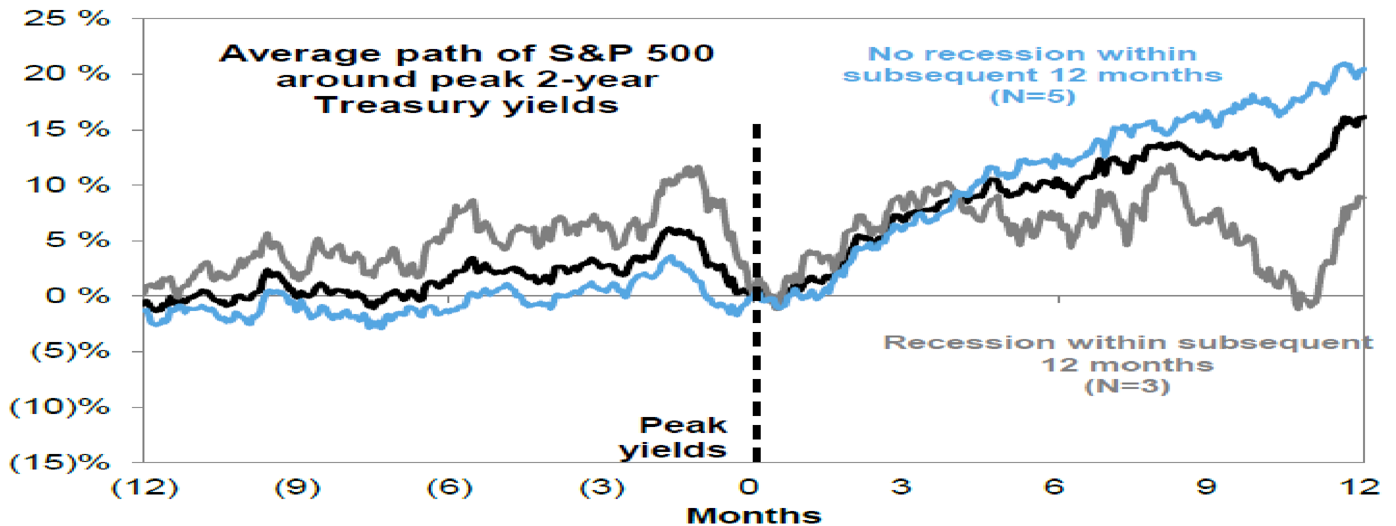
Speaking of U.S. consumers, still high housing and equity prices have kept their balance sheets strong, yet the white line on the 22-year graph above indicates their personal savings rate (left axis) is at its lowest level since 2005. Meanwhile, the red line on the right vertical axis, credit card debt, has moved markedly higher as consumers increasingly use credit cards to pay for consumption.

Low growth, an increasingly challenged consumer and sticky inflation create an outlook that is particularly tough for corporate margins. Inflation boosts revenue lines but as we've seen year to date, this can be tough on margins. We foresee further deterioration in corporate margins during 2023. The long-term graph below compares the forward 12-month expected percentage change in EPS for the S&P 500 (light blue line, left axis) against the Philadelphia Fed's future nominal orders book (dark blue line, right axis), the latter being advanced five months to the former. The obvious fit between the two lines suggests that current estimates of $220 in EPS for next year are too optimistic.




Source: Macrobond, Nordea Financial

Having outlined our concerns that in light of low growth, sticky inflation and deteriorating corporate margins that the market is expensive at >18X forward EPS, we acknowledge that equities have historically been a good buy when yields on U.S. 2-year Treasury bonds peak. This point is illustrated in the graph below from Goldman Sachs, with the dashed vertical line marking the peak in 2-year yields. The left of this line marks the 12 months before the peak in rates and to the right, the 12 months after the peak. Since 1980, the S&P 500 has rallied by an average of 7% during the three months following a peak in 2-year Treasury yields. Over a 12-month investment period; however, returns have varied dramatically depending on whether the economy subsequently entered recession or continued to grow. As Mark Twain used to say, "history never repeats itself, but it does often rhyme".




Source: Goldman Sachs

The objective of the team at Forge First is to: 1) generate a competitive net return and protect capital when markets get rougher and 2) be pragmatic, not dogmatic, in managing client capital. Consequently, each of our two funds has cautiously increased net exposure during the past few weeks, much of it being done via low risk reversal option strategies*. At the same time, we have added to our gross short exposure via a basket of U.S. trucking companies which are facing growing volume shortfalls and rising costs.

*The risk reversal options trading strategy consists of buying an out of the money call option and selling an out of the money put option in the same expiration month. This is a very bullish trade that can be executed for a debit or a credit depending on where the strikes are in relation to the stock

From the entire team at Forge First, we hope that you and your loved ones can experience a healthy and happy holiday season.

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 |
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| CEO, CIO | Portfolio Manager | Portfolio Manager |



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