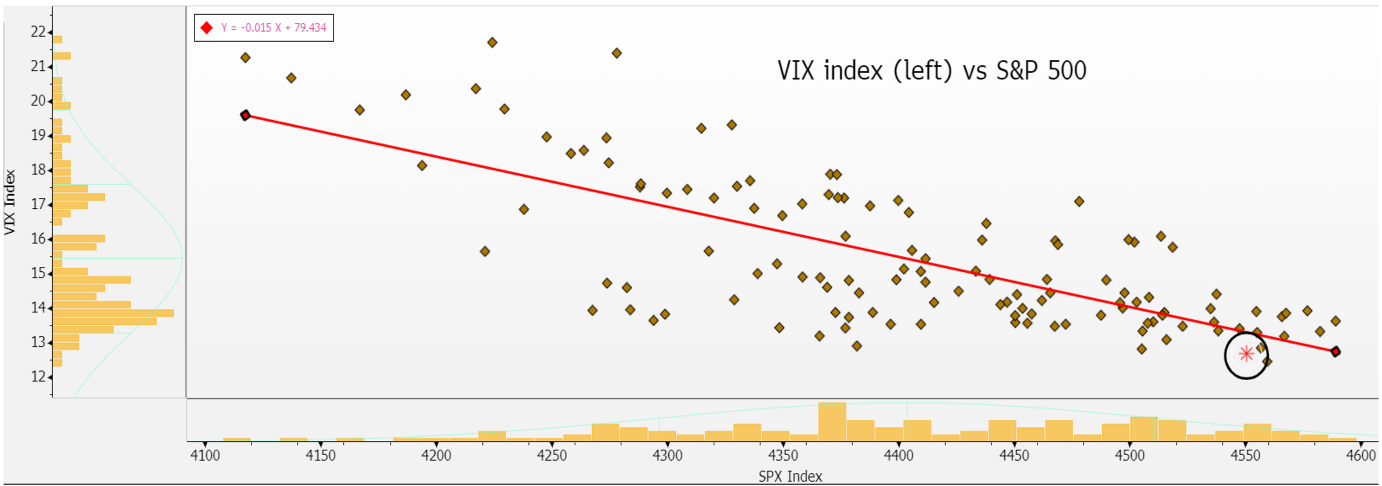
December 8, 2023

November 2023 Commentary

There's little question that last month was a clean sweep for markets (and a notable positive month for our funds as well!) as the price of both stocks and bonds gapped higher as most investors shifted their expectations to rate cuts occurring during the first half of 2024. The U.S. dollar was weaker, credit spreads narrowed to new tights, speculative stocks outperformed high-quality stocks and the VIX Index tumbled to near year-to-date lows.

The six-month scatterplot diagram below correlates the VIX Index (vertical axis) against the price level of the S&P 500 (horizontal axis). The negative correlation (the lower the VIX, the higher the S&P 500) between these two variables is a statistically significant -79.4%. The most recent data point of this series resides in the lower right quadrant of this graph and is marked by the black circle. It appears that investors have no worries at all.



Source: Bloomberg

As discussed in previous commentaries, declining volatility encourages increased use of leverage and heightened net exposure within the systematic investing community. Judging from discussions with traders, this action also caused many investors to 'throw in the towel' on hedging their portfolios. This combination of events, arguably catalyzed by hotter U.S. economic prints migrating to softer data, accompanied by the end of the bear market momentum in bond markets, generated the lack of demand for protection implied by the falling VIX Index.

Each of our two funds shared in the positive performance seen during November. The Class F Lead Series of our Long Short LP gained +2.70% net of fees, boosting its year-to-date net return to +5.22%. Positive contributions to performance were generated in rate-sensitive sectors including Financials, Consumer Cyclical, Energy and Utilities, to name a few. Improved market breadth and the use of put options vs. outright shorts to hedge market risk also helped the performance of the fund. The principal detractor to performance was the market hedges held by the fund.

As of November 30, 2023	YTD	1-mo	3-mo	6-mo	1-year	3-year	5-year	10-year	Inception
						-----------------Annualized----------------			
Forge First Long Short LP (Class F Lead Series)	5.22%	2.70%	2.33%	3.66%	2.22%	6.15%	8.86%	9.34%	12.92%
Forge First Multi Strategy LP (Class F Lead Series)	3.46%	0.99%	1.11%	2.46%	3.13%	6.44%	8.04%	7.26%	10.17%
S&P/TSX Composite Total Return Index	7.54%	7.48%	0.56%	5.16%	2.28%	8.82%	9.23%	7.42%	8.21 %
S&P 500 Total Return Index (C$)	21.29%	6.82%	2.04%	10.02%	14.27%	11.44%	12.98%	14.60%	16.39%

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.

Speaking of market hedges, due to the hedges currently included in the portfolio, in reviewing the outlook for the fund during the final month of 2023, the best performance would be expected to occur if the S&P 500 ended the year around current levels. Meanwhile, with hedging costs trading at attractive levels, we expect to layer on several medium and longer-term index hedges prior to the end of this year. The fund exited November with delta-adjusted gross and net exposure of 132% and 17% respectively.

One area of interest for us, especially in a soft/no landing scenario, is consumer credit, particularly credit card lenders. Although there is still a substantial amount of uncertainty surrounding the expected Q1/24 CFPB (Consumer Finance Protection Bureau) ruling on card late fee restrictions and the acceleration in consumer delinquencies, we believe current stock valuations and credit loss reserves give investors a more-than-adequate cushion. The credit loss reserves in particular are a somewhat misunderstood feature of the sector that deserves some explaining.

With the recent adoption of the current expected credit losses ("CECL") framework in the U.S., a lender needs to take a day one reserve for the expected loss of that loan. For many products, this reserve is relatively small, but for high-loss products like credit cards, it can be as high as 10% of the loan itself. As a result, on day one of every underwritten loan, a loss for the lender is recognized on their income statements. Naturally, this requirement hurts the perceived profitability of the lenders especially since loan growth has been high during the last couple of years.

However, the advantage now is that all card issuers are sitting on very thick reserve cushions that will shield them from when those losses actually emerge. One case-in-point is Synchrony Financial (SYF.US). This company's reserves sit at 10.5% of its total loans vs. an actual charge-off rate during Q3 of this year of just 4.6%. In other words, the business can manage a doubling of loan losses and still be highly profitable. This company's ROE during Q3 was 18.5% on Tier One Common Equity of 12.4%.

We believe this misunderstanding of CECL's impact on lender's reserving and the general view that sub-prime lending does poorly in a weak economy has unfairly punished the stocks to the point where they trade at only 6-8X earnings and material discounts to their historical multiples to tangible book value. The fund owns shares in Synchrony Financial, Capital One Financial Corp. (COF.US) and Discover Financial Services (DFS.US).

The Class F Lead Series of our multi-asset Multi Strategy LP also generated positive net returns last month, gaining +0.99%. The year-to-date net return now sits at +3.46%. Positive performance was seen in each of the capital growth (common equity) and multi-asset (fixed income) sleeves, while not surprisingly, the asset protection sleeve, a positive contributor during the correction experienced during August through October, was a source of losses. The fund's exposure in Technology, Consumer Cyclical, Financials, Utilities and Energy generated positive returns. Market hedges, along with positions in Industrials, Consumer Non-Cyclical and Real Estate detracted from the performance of the fund.

This fund continues to hold higher net equity exposure vs. its year-to-date averages, but more in line with since inception levels. The fund exited November with delta-adjusted gross and net exposure of 111% and 31% respectively, with net exposure being split between common equities of 12% and multi-assets of 19%.

Before shifting back to markets, one point about each of our funds. While earlier in this note we noted how many investors had dispensed with owning portfolio hedges during November, at Forge First, the mandate of our funds includes the use of systemic hedges at all times: it's a discipline, not a decision.

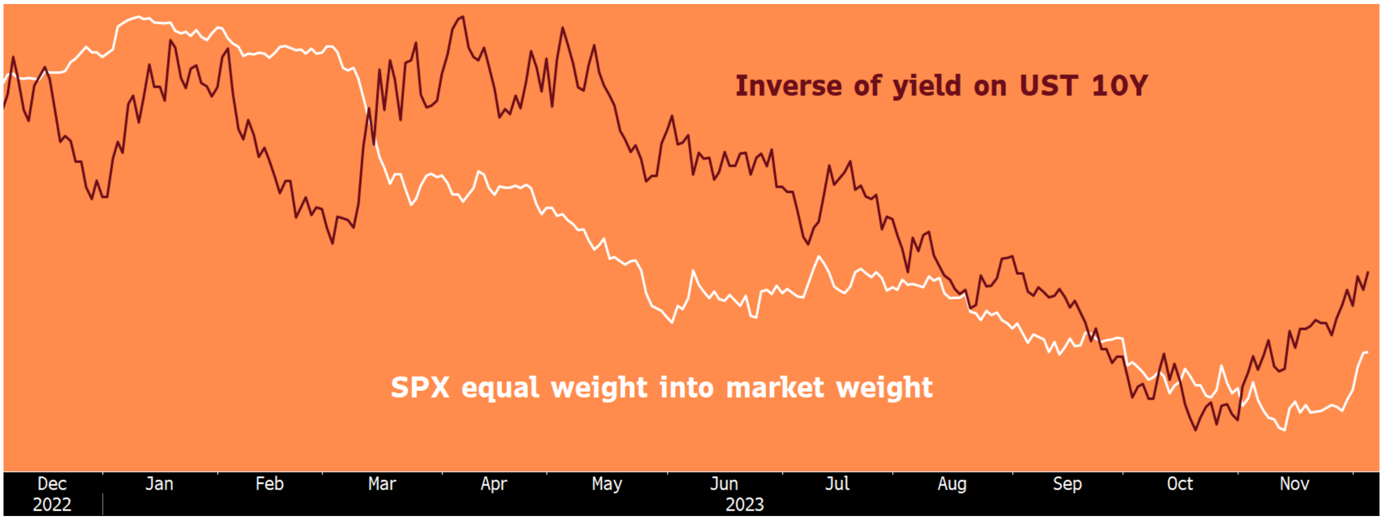
Source: Bloomberg

In reviewing the recent performance of stocks, the right side of the graph above highlights how speculative activity has become during the past four to six weeks. The red line on the left axis of this almost two-year graph highlights the yield on a U.S. 10-year government bond. The white line is the relative performance of the NASDAQ 100 Index against Cathie Wood's ARK Innovation ETF (AARK.US); the latter being a proxy for unprofitable technology stocks. On the right side of the graph, note NASDAQ's relative outperformance as bond yields went up and underperformance as yields declined the eye-popping 60 basis points they dropped during November. Arguably even more stunning about this relative performance was the fact that NASDAQ's price advance last month was its second-best month of the last three and a half years!

Source: Bloomberg

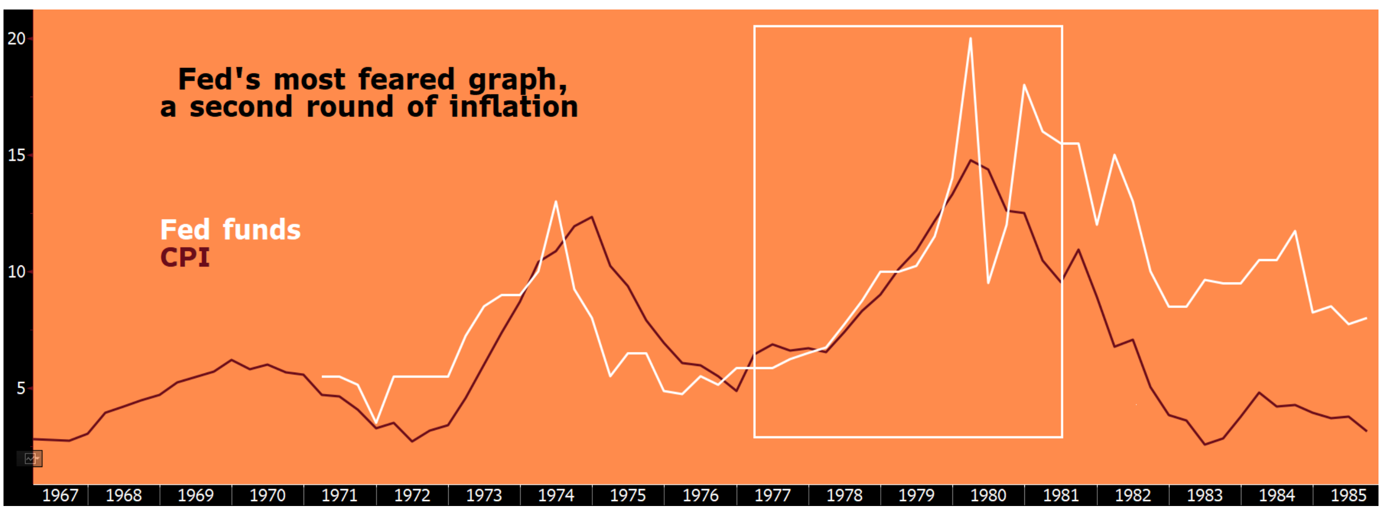
Another graph that caught our eye and is relevant to future decisions made by investors compares the local currency, indexed one-year price performance of Canada's TSX Index (red line) against the S&P 493 (white line). This graph suggests Canadian equity performance could benefit from better market breadth amongst U.S. equities. As can be seen from the far-right side of the one-year graph below, since the last few trading days of November (through Dec. 4th), the equal-weighted S&P 500 has outperformed the market-weighted S&P 500 (white line). We find it interesting that this shift in relative performance appears to correlate with the recent decline in bond yields (red line, inverted yields).

At their current yield of 4.17%, we question how much lower yields on U.S. 10-year government bonds can go, especially if the U.S. avoids a recession and the Fed does not cut interest rates until the back half of 2024. In fact, it's possible that if the Fed follows the market (March 2024 cut odds at 60%) and begins to cut interest rates during the spring of 2024, yields on long bonds actually increase as investors become concerned the Fed has not completed its task of ensuring inflation recedes to targeted levels. Having said that, there's little question inflation has followed the script, marching lower to the 'now it becomes tougher' levels in and around 3%.



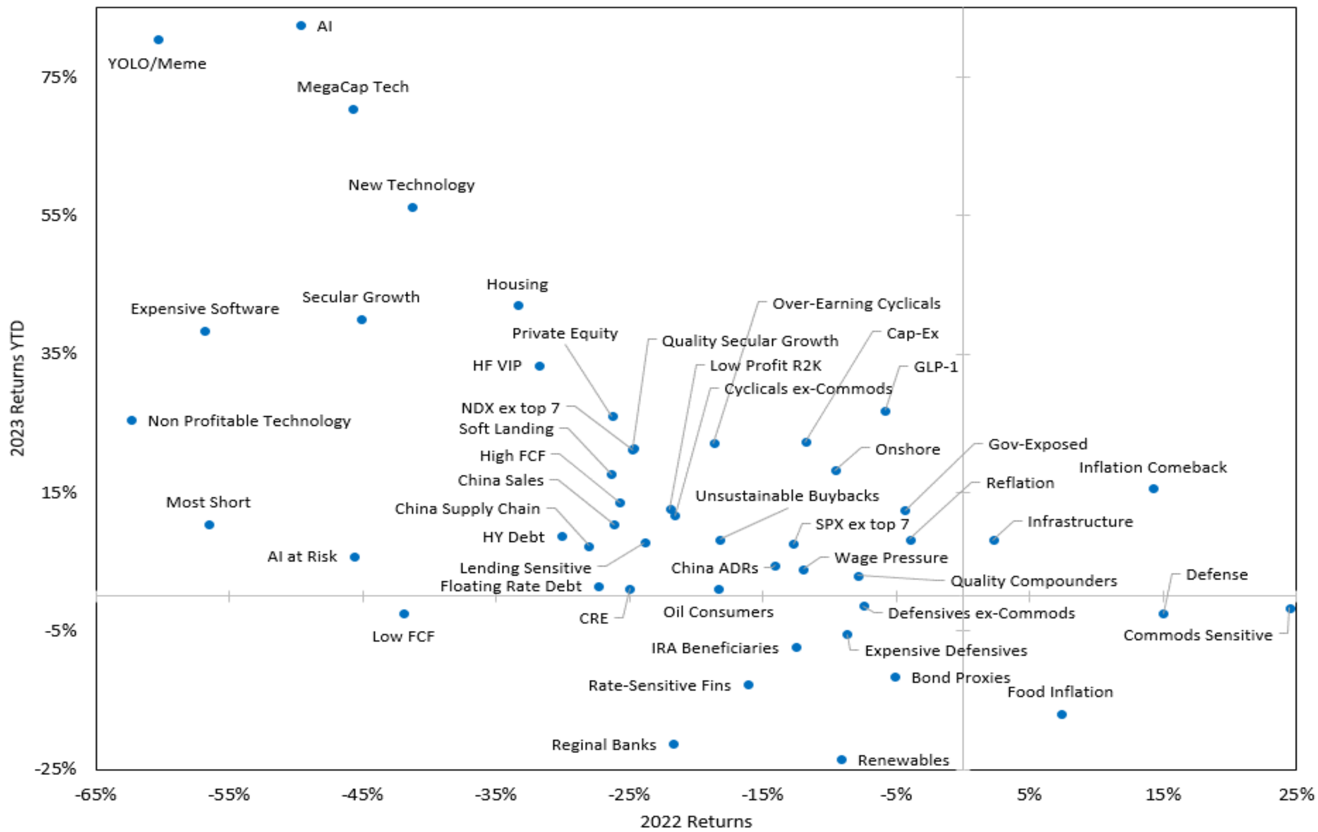
Source: Bloomberg

With product pricing expected to remain dormant, the inflation question becomes whether the recent slowdown in labour markets, to still pretty robust levels, is enough to nudge wages low enough such that service inflation legs lower from the still too high levels for the Fed to declare victory. You'll note that while the Fed has confirmed it won't be adjusting interest rates next Wednesday, December 13th, Chair Powell has yet to waver from the long-held "not even thinking about cutting" stance towards interest rates. The reason he repeatedly made this statement during 2022 is due to his determination to not repeat the mistake made by Fed Chair Charles Burns during the 1970s. As can be seen in the graph below that ranges between 1967 and 1985, the Fed arguably cut interest rates before the cinders of inflation were cold and as shown inside the rectangle, inflation marched to new cycle highs after two to three years.



Source: Bloomberg

As you know, occasionally we include a graph that intrigues us vs. one that is particularly relevant to our discussion. The graph below fits this bill and yes, we acknowledge that it's crowded relative to the allotted space. Left to right, worst to best, the horizontal axis marks the performance of various U.S. equity sectors, factors, or themes during 2022. Similarly, bottom to top, the left vertical axis denotes the same year to date during 2023.



Source: Goldman Sachs

The top right quadrant would exhibit variables that performed well during each of 2022 and 2023 but note it's blank! In similar fashion, the bottom left quadrant would display the variables that performed poorly in each time frame, but it also is devoid of content. Note the consistently worst performer has been companies with low amounts of free cash flow while only two variables have delivered positive returns in both years (infrastructure and 'inflation comeback' stocks).

Which brings us to the question of what's in store for the economy and investors during 2024. Is the U.S. economy going to slow, take a deep dive or not slow down at all? We'll delve deeper into our outlook for economies and markets for 2024 in the year ahead commentary we will release during the second week of January, but here's a quick snapshot of our thinking:

- No U.S. recession during 2024.
- Fed won't cut rates until H2 of 2024.
- Bank of Canada will cut before the Fed.
- 4% will be the floor for yields on U.S. 10s.
- Stocks will outperform cash and bonds.
- Performance of non-M7 tech stocks will outperform the M7 during 2024.
- Equal-weighted S&P 500 Index will outperform the market-weighted S&P 500.
- Average price return will be in the single digits.
- Successful navigation of factor and sector rotation will outweigh net market exposure in generating investor returns.
- U.S. market averages will outperform the TSX.
- Natural gas will experience a lousy H1 and better H2 while WTI oil will experience the reverse, though remain rangebound between US$75-$90.
- U.S. dollar will remain well-bid while the Canadian dollar tumbles several pennies from current levels against the greenback.

Based on our belief, interest rates will stay 'higher for longer' because the U.S. won't experience a recession, we expect that a) valuation will constrain the upside in the markets, b) security selection or alpha will matter more than beta or net market exposure and c) participation will broaden out with the M7 underperforming market-weighted averages.

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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