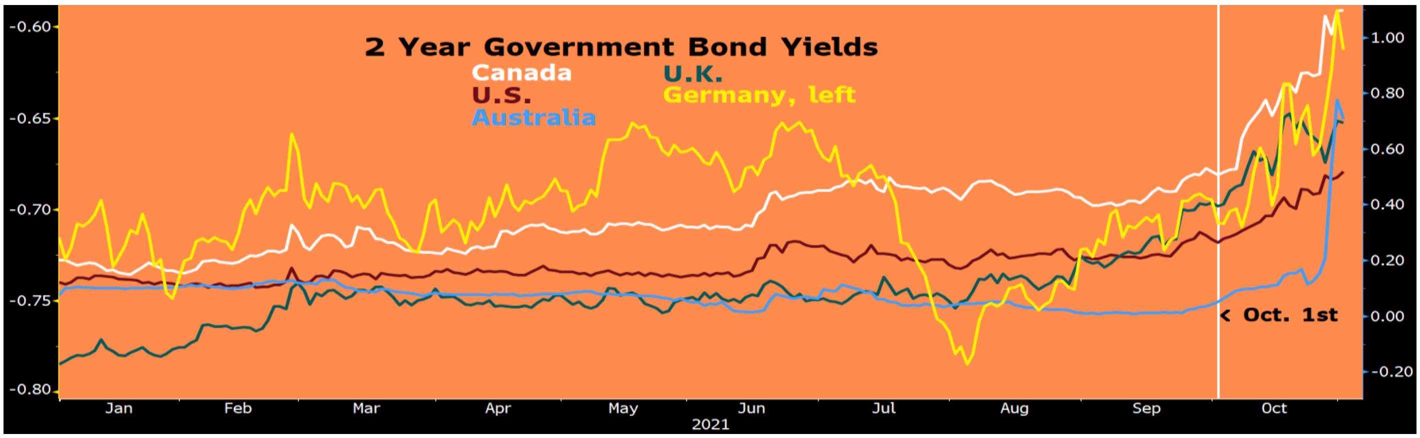
November 8, 2021

October 2021 Commentary

Equities roared back during October 2021 as markets were comforted by temporary stop-gap bills on America's debt ceiling problem, respectable U.S. economic data, improving COVID-19 trends and a generally better-than-expected start to the Q3 earnings season. While the month closed with investors enjoying the 59th all-time high for the S&P 500 year to date, two stories that dominated headlines were the stunning climb in yields on two-year government bonds and the relentless rise in the price of oil. We'll discuss oil later in this note but for now, please review the far right of the graph below, highlighting rise in yields on two-year bonds during October. German bunds (yellow line) are on the left axis, other sovereigns are on the right axis. Clearly, markets are pressing Central Banks to hike interest rates.

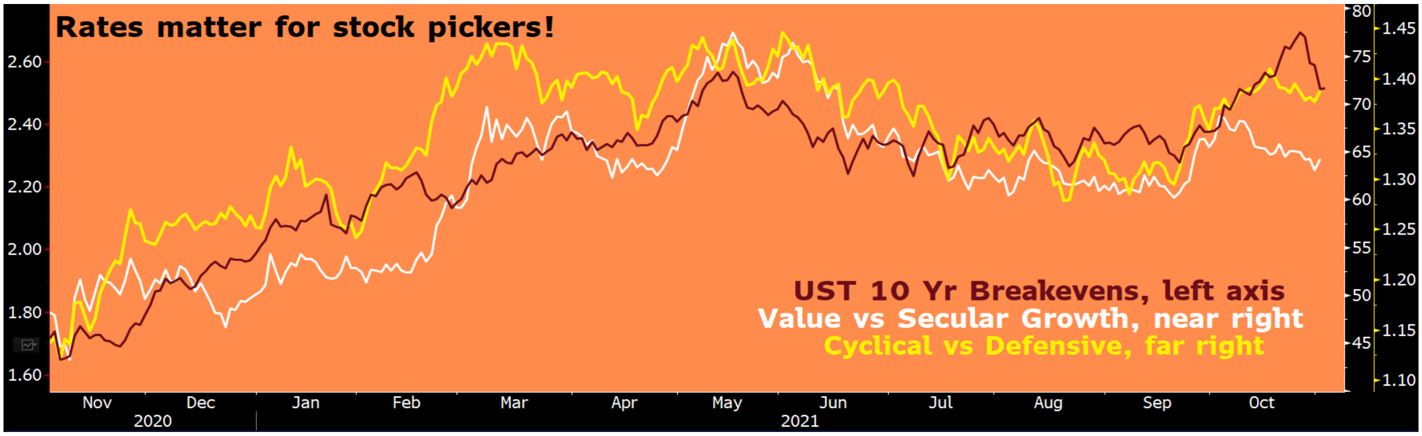


Source: Bloomberg

Despite the significant increase in two-year U.S. government bond yields to 0.50%, the graph below indicates that Eurodollar (EUD) futures are discounting two to three rate hikes in each of 2022 (white line) and 2023 (red line). Even when adjusted for FX hedging costs and the fact EUDs represent unsecured bank credit, if EUD futures are a reasonable estimation, short-term rates are likely to march much higher.

Source: Bloomberg

The direction of inflation will also have a material impact on equity markets, especially in picking the winners from the losers. For example, the graph directly below compares the relative strengths of value to secular growth stocks (white line) and cyclical vs. defensive equities (yellow line), against the yield on a U.S. 10-year breakeven bond (red line). Granted, changes in rates can be driven by breakevens or TIPs (real yields), but the point is that whether equity markets are over or underestimating the number of interest rate hikes we witness during the next 18-24 months will have a material impact on equity index averages and different factors and sectors.



Source: Bloomberg

Yet rising rates didn't hurt stocks during the month of October, as the S&P 500 delivered a total return of 7.01% and the TSX provided investors with a return of 5.02%. Cyclical equities rallied, as did both macro cap and unprofitable tech stocks. As each of our two funds entered October maintaining the low net equity exposure that served the funds so well during a rocky September, this conservatism tempered the net gains each of our two funds generated during October.

	YTD	1 mo	3 mo	6 mo	1 year	2 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	12.78%	0.68%	1.39%	4.46%	23.41%	16.85%	11.81%
Forge First Long Short Alternative Fund Series F	13.59%	0.75%	1.62%	4.92%	24.50%	17.87%	12.80%
Forge First Conservative Alternative Fund Series A	10.05%	0.46%	0.97%	2.72%	19.93%	14.53%	10.55%
Forge First Conservative Alternative Fund Series F	10.90%	0.53%	1.20%	3.19%	21.05%	15.51%	11.53%
TSX Total Return	23.38%	5.02%	4.36%	11.52%	38.77%	16.44%	12.75%
S&P 500 Total Return (US$)	24.04%	7.01%	5.13%	10.91%	42.91%	25.22%	21.11%

The Series F of our Long Short Alternative Fund returned +0.75% net last month, boosting its full year-to-date net return to +13.59%. Energy companies including Cenovus Energy Inc. (CVE.CA) and Canadian Natural Resources Ltd. (CNQ.CA), along with tech giants Microsoft Corp. (MSFT.US) and Alphabet Inc. (GOOG.US), joined long-held Enviva Partners LP (EVA.US) at the top of the leader board for the month. Given the broad strength in markets, it's little surprise that our numerous index and single stock hedge positions cost the fund money during October. As at October 31st, the gross and net exposure of the Long Short Alternative Fund stood at 129% and 45%.

Similarly, hedging positions held back the Series F of our multi-asset Conservative Alternative Fund, yet this low volatility fund still delivered a net return of +0.53% for the month of October, boosting its year-to-date net gain to +10.90%. Always positioned with lower common equity net exposure than the Long Short Alternative Fund, this fund also holds positions in rate-reset preferred shares, various types of listed bonds, and an extra dose of listed equity index puts. Month-end gross and net exposure levels for the Conservative Alternative Fund sat at 116% and 37%.

While both tech and cyclical stocks performed well last month, the graph below showing the relative strength of the equal weighted SPX versus the market weighted SPX, illustrates that the heft of big tech dwarfs the impact of other sectors. For example, Energy represents just 2.9% of the S&P 500, while here at home it constitutes 13.5% of the TSX.

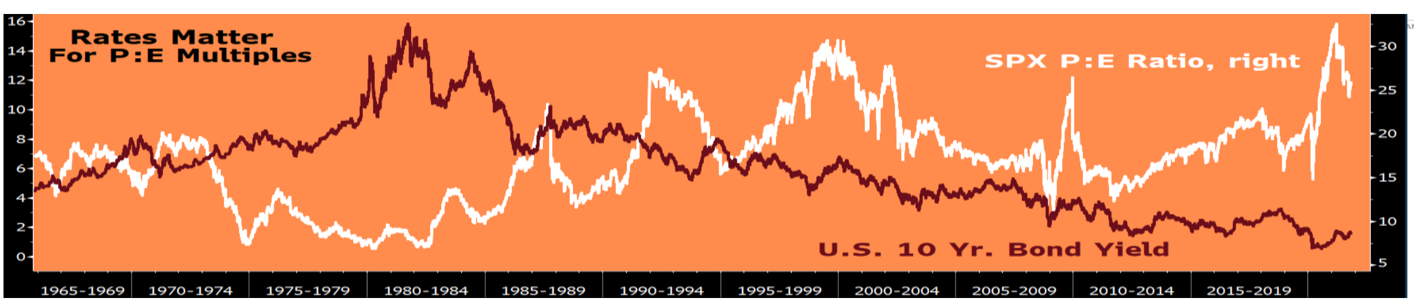
Source: Bloomberg

Looking ahead, we are dangerously authoring this note ahead of last Wednesday's FOMC and Thursday's OPEC meetings. However, we'll take the risk and presume that Chairman Powell announced the long-awaited taper and OPEC refused to budge from restricting monthly increases in oil production beyond the currently agreed to 400,000 BOE/month.

There's little question that monetary policy accommodation has been the principal driver of higher asset prices during the past few years. Unfortunately, this accommodation has now past its peak and is beginning to turn south. Interest rate lift-off has already begun in several key countries including New Zealand, Norway, Brazil and Russia. Two weeks ago, BoC Governor Macklem, a refreshing 'tells it like it is' personality amongst central bankers, essentially told investors he'll be hiking rates at least twice next year. Interestingly, Wells Fargo Economics now predicts three rate hikes from the BoC next year, while Scotiabank predicts eight before the end of 2023. Make no doubt about it, the bell has been rung and shrinking Central Bank balance sheets and rising interest rates have arrived.

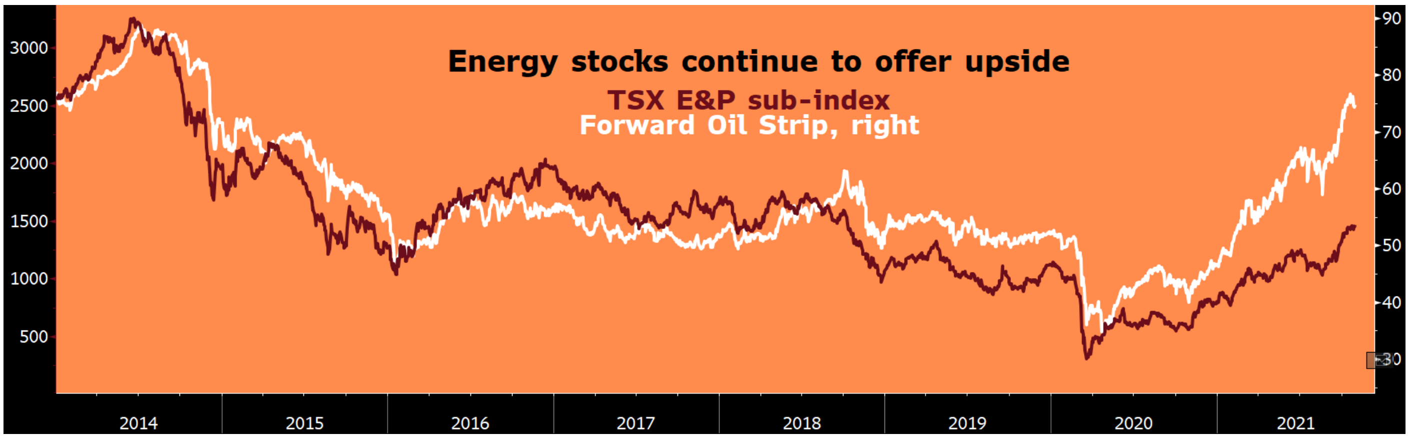
While we're aware that it is why rates rise (growth vs. inflation) and the rate of change or pace of those rate hikes that matter most to stocks, in our minds, if rates increase by 150 to 200 basis points during the next 24 months, most asset prices would be impacted in a negative fashion. For example, think about residential real estate in Canada. Prime rate is currently 2.45%. Given the not insignificant shift in the mortgage market to the unregulated, private sector, it's likely that a prime rate of 4% or 4.5% would cause problems for many homeowners. Of course, it goes without needing to say that bonds wouldn't exactly be a safe haven! At the very least, the eventual end of asset purchases by Central Banks directly reduces the support of government credit and is likely to increase volatility in financial markets.

As for stocks, it's probable that with the 10 to 2-year yield curve sitting at 1.05%, if the Fed hikes four to six times during the next couple of years, yields on U.S. 10-year bonds would likely move towards 3%. An increase of this magnitude would cause the current 1.29% yield on the SPX to appear rather paltry, likely triggering a further contraction in the P/E multiple of this key index.



Source: Bloomberg

Conversely, if markets have overestimated the rate of future inflation and interest rates fall back down, assuming the economy isn't heading for a recession, equity markets could enjoy another leg higher! Which camp is right remains the proverbial $64K question. During the next six to nine months, we believe energy markets are the most likely source of inflation being perceived as becoming problematic. That's because there are significant supply/demand imbalances in both natural gas and oil markets, as evidenced by the sharp backwardation seen in the forward curves of both natural gas and oil. Of course, with high prices being the cure for high prices, it's possible that by early 2023, the supply/demand situation could improve but for now, the 2022 forward strips of US$75 WTI oil and US$4.50 NYMEX gas suggest high prices are here to stay.



Source: Bloomberg

As a result, we foresee another leg higher in energy stocks, especially companies that generously share their gushing cash flows with investors. Tourmaline Oil Inc. (TOU.CA), the largest weight in the Long Short Alternative Fund and the largest Energy weight in the Conservative Alternative Fund, is a perfect example of this theme. After paying for its 2022 common dividends and capital expenditures plus allocating $250M to tuck-in acquisitions, at strip pricing, our modelling suggests Tourmaline could generate an additional $7.00 per share in free cash flow.

As for broader markets, two reasons enable us to be cautiously optimistic that the 'Santa Claus rally' will provide further gains for investors before the end of 2021. First, while they're in the late innings, liquidity and monetary policy remain supportive for now. Second, Q3 earnings season has been strong which, combined with gradually improving supply conditions and improving North American COVID-19 statistics, implies continued positive sentiment towards equities. Shifting to 2022, with slowing growth and policy accommodation at this juncture, we expect to hold a much more cautious view towards equities.

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Thank you,

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