FORGE FIRST
ASSET MANAGEMENT INC

November 8, 2022

October 2022 Commentary

Based on the aspiration that the timing of the Fed's inevitable pivot may occur before year-end, perhaps as early as last week, equities enjoyed a huge move higher during the month of October. Unconvinced that various macro variables had yet to advance from flashing yellow to exhibiting the all-green, our funds remained conservatively positioned. While frustrating to the team in light of the big bounce in equities, given our long-term net returns, we're cognizant that protecting client capital during this exceedingly rough 2022 has been top-of-mind for our investors. Hence, we will continue to aim to be the tortoise versus the hare. After discussing last month's results, this note will update our views on the outlook for markets and the positioning 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	-2.66%	1.92%	-2.10%	-6.74%	-4.00%	8.85%	9.44%	7.15%
Forge First Long Short Alternative Fund Series F	-1.86%	2.01%	-1.83%	-6.24%	-3.08%	9.85%	10.43%	8.12%
Forge First Conservative Alternative Fund Series A	-0.55%	-1.02%	-0.38%	-2.86%	-2.31%	8.24%	8.62%	6.80%
Forge First Conservative Alternative Fund Series F	0.22%	-0.92%	-0.12%	-2.40%	-1.40%	9.25%	9.57%	7.76%
S&P/TSX Composite Total Return Index	-6.19%	5.57%	-0.55%	-4.92%	-4.89%	14.88%	8.84%	7.52%
S&P 500 Total Return Index (C$)	-12.41%	6.81%	-0.20%	-0.26%	-7.48%	10.03%	9.71%	8.54%

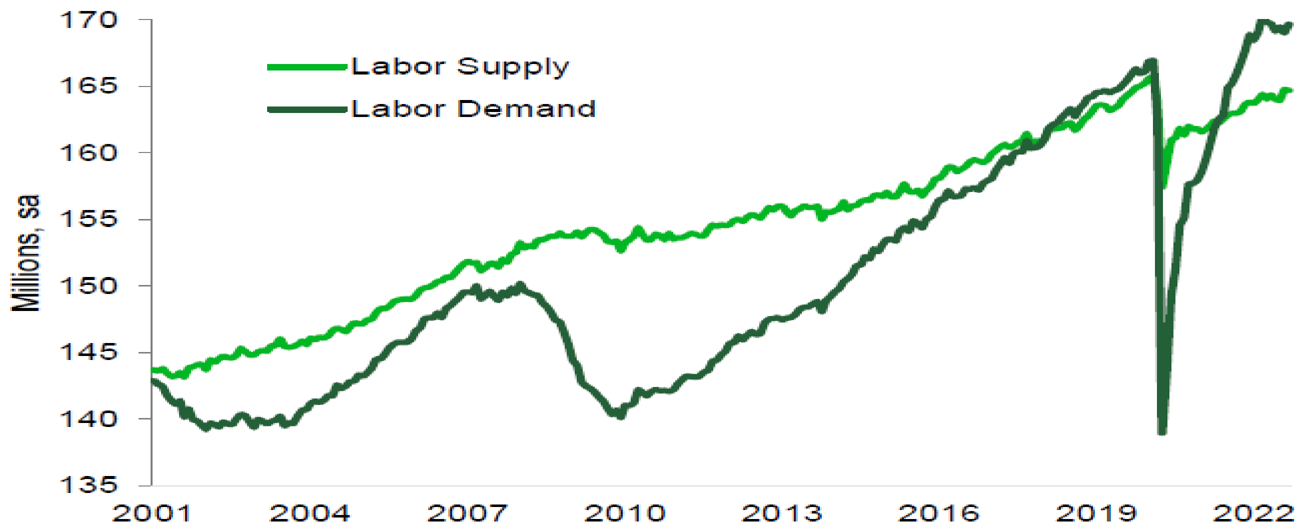
*Annualized | Inception date: April 24, 2019

The Series F of our Long Short Alternative Fund gained +2.01% net of fees for the month of October, cutting its year-to-date net loss to -1.86%. In contrast, the Series F of our multi-asset Conservative Alternative Fund returned -0.92% after fees during the month, reducing its year-to-date net gain to +0.22%. This performance differential was attributable to three factors. The more directional Long Short Alternative Fund maintained a higher net long common equity exposure (~38% versus ~7% net long for the Conservative Alternative Fund), a larger allocation to energy stocks (though far less than the 18% weight in the TSX index) and less exposure to index put protection than our Conservative Alternative Fund.

Energy was the largest positive contributor to the performance of our Long Short Alternative Fund (264 gross basis points "bps"), whereas Technology was the sector that chipped in the largest gains for the Conservative Alternative Fund (58 bps). Not surprising, given the historic move in markets, the protection sleeve was painful for both funds, costing the Long Short Alternative Fund 109 bps and the Conservative Alternative Fund 184 bps. At month-end, delta-adjusted gross and net exposure totaled 132% and 33% for the Long Short Alternative Fund and 125% and 17% for the Conservative Alternative Fund. This +17% net long exposure for the Conservative Alternative Fund consisted of a +6% net long exposure to common equities at month-end and an 11% weighting to the multi-asset sleeve of this portfolio.

Source: Bloomberg

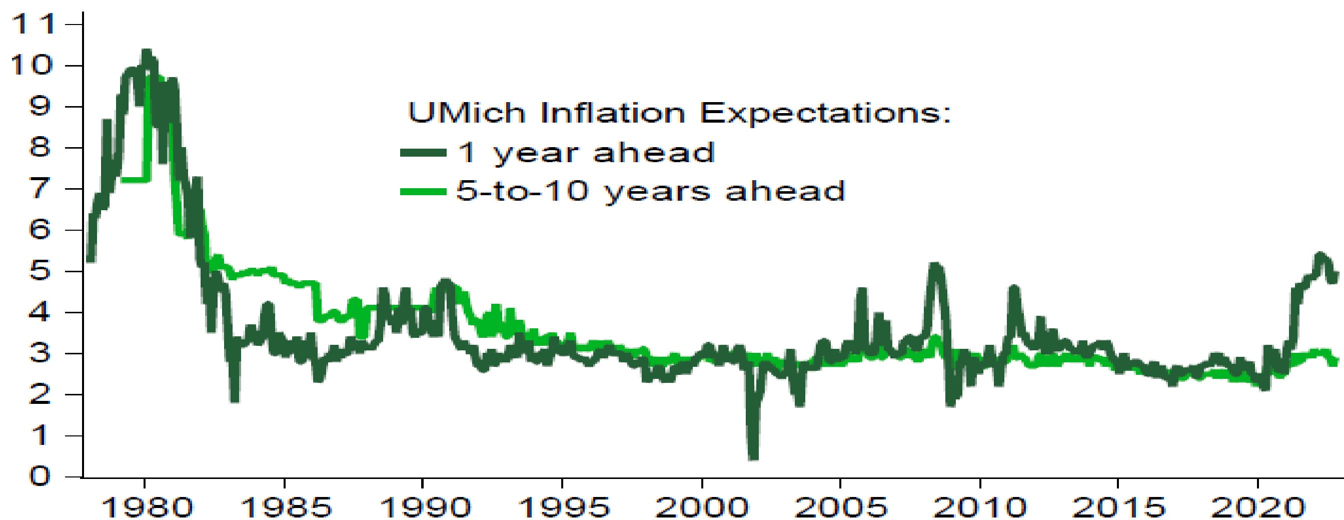
Despite the resurgent equity market optimism, our team continues to be concerned about the future impact of the rapid and unprecedented tightening in financial conditions, sticky inflation and equity valuations. The two-month graph above confirms that an expansion in the P/E multiple accorded the S&P 500 (white line, right axis), enabled stocks to move markedly higher despite the decline in forward EPS estimates (red line, left axis). Looking ahead, we foresee additional cuts in forward earnings guidance and a lower valuation multiple for corporate profits due to the impact of a recession next year and higher interest rates.



Source: Bureau of Labor Statistics, TD Securities

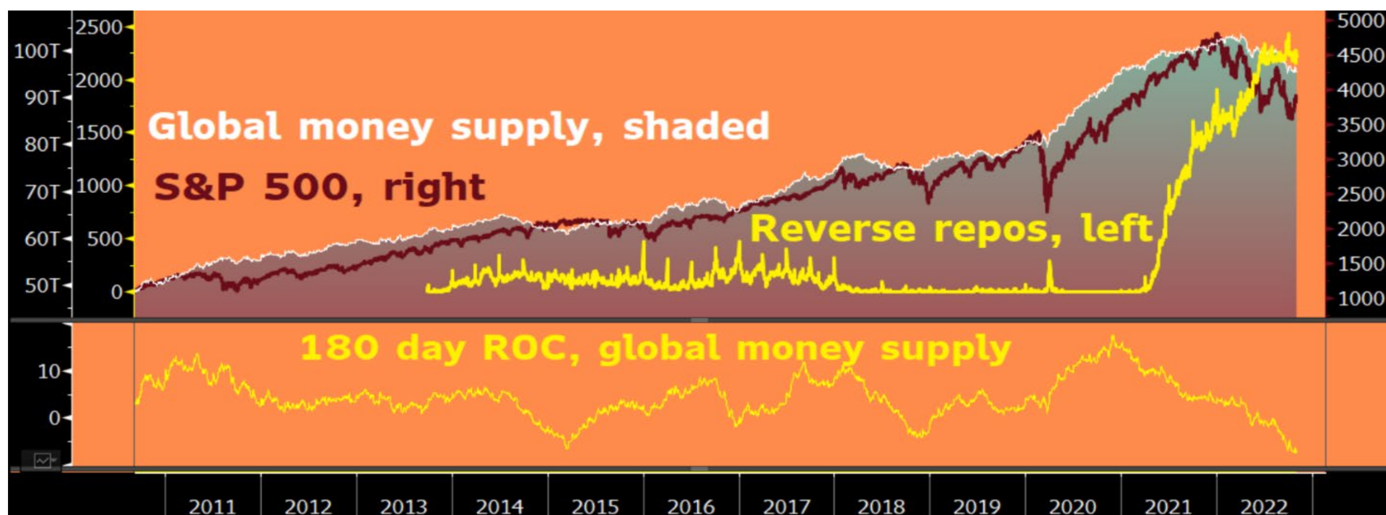
At last week's press conference, Fed Chair Powell made it quite clear that labor demand (dark green line on graph above) continues to uncomfortably exceed labor supply (lighter green line). The Fed remains concerned that the degree of this imbalance may cause wage growth to stay dangerously high. Rationale for this belief is supported by the graph below, which highlights that one year ahead, inflation expectations have yet to recede.

Combined with recent hotter-than-expected inflation prints, Powell's comments imply that the Fed now fears a growing risk of higher, longer-term inflation expectations becoming engrained in the minds of the consumer. Hence, he enunciated the Fed's intent to keep rates higher for longer, meaning the eventual pivot is most likely to be a cessation in rate hikes versus the mid-2023 rate cuts that were priced into markets ahead of last week's Fed meeting. The bottom line for markets is that the Fed's terminal rate is now expected to be higher than investors had anticipated and that rate is expected to stay at that higher level for a longer period of time.



Source: Macrobond, TD Securities

Declining forward earnings estimates, sticky inflation and higher-for-longer rates leave liquidity as the principle positive factor supporting stocks. The yellow line in the bottom panel in the graph below indicates that the 180-day rate of change (ROC) in global money supply now sits at -8%; good for the outlook on inflation, bad for the valuation of stocks. Yet, the yellow line in the top panel highlights that reverse repurchase agreements (reverse repos, "RRP") between U.S. commercial banks and the Fed continue to exceed US$2T per day. Bank reserves have fallen 29% from last December's all-time high of US$4.28T to US$3.04T, roughly US$500B within what's likely an acceptable run rate. Once reserves have normalized, RRPs will be the final source of excess liquidity to shrink as new treasury issuance pushes yields up relative to the RRP rate, catalyzing money market participants to switch. We've long expected the reduction in this source of liquidity for financial markets to be a 2023 event, one unlikely to be helpful for stocks.



Source: Bloomberg

Shifting to the economy, several commentaries ago, we suggested that the final shoe to drop that would signal a pending recession would be a reduction in the capital spending plans of corporate America. Last week, Powell confirmed the Fed has now seen a decline in business CAPEX. Combined with a U.S personal savings rate poised to fall below 3% during the next few months, a degree of leverage in the U.S. commercial real estate sector that is bound to cause problems, and a Fed which has now explicitly stated rates will stay higher and for longer ("rates will stay high for some time") than expected, at 17.3X forward earnings, the risk/reward trade-off for stocks is not favourable.

To assess where equity prices could decline to, let's review three methodologies. First, 2023 earnings estimates for the S&P 500 have so far declined 9% from $245 to $223, suggesting a further $12 or 5% of additional downside risk if this cycle's decline in EPS is to match the average 14% reduction in EPS that has marked the typical recession's impact on profits since WW2. As for what investors will pay for each dollar of earnings, historically P/E multiples have bottomed out at 10X to 14X, suggesting $211 times say 12X = 2,532. However, it is important to note that three items are likely to protect investors from such a severe outcome.

First, the health of the various components of the U.S. economy. For example, while we suspect leverage-related risks reside within the private equity sector, the balance sheets of the U.S. banking system are strong. Further, corporate liquidity remains solid, as corporate America raised trillions of dollars of cheap debt during the past few years, with few maturities during the next 24 months. Finally, labor markets are tight and, generally speaking, consumer balance sheets remain strong despite the roughly US$20T year-to-date loss in the public's portfolios of stocks and bonds.

Second, unless the world goes into a deep recession, a 2023 pivot by the Fed, even if it's just to a 'pause', is likely to signal a relative shift in monetary policy to other countries that finally enables the USD to weaken. In turn, such a reversal should be beneficial to corporate profits.

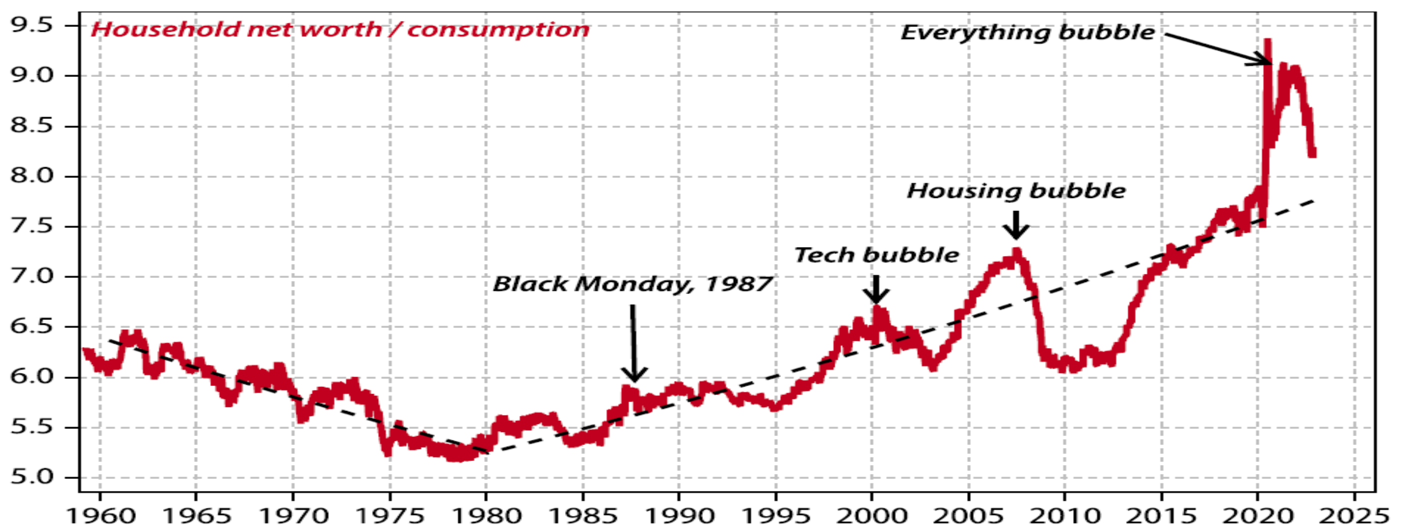
Third, from the perspective of economic growth, the U.S. is poised to be a relative outperformer in the medium term for three reasons: as the world's largest energy producer, American manufacturing is assured a significant competitive advantage to other countries, it dominates the fast-growing technology sector and it's poised to benefit from insourcing from Asia and Germany's probable increasingly challenged competitive position in advanced manufacturing as a result of the war in the Ukraine.

Consequently, let's say 14X times $215 or 3,010 is a reasonable downside target for the S&P 500.

Let us be clear - that is not a prediction, but our downside scenario. As we wrote in our last commentary, when the SPX is trading in and around 3,600, for the reasons mentioned above, we continue to expect the market to reach new lows. At that time, it would be our intent to deploy additional capital towards quality, liquid, free cash flowing businesses and increase our exposure to credit spreads.

US household net worth, in years of consumption

Net worth based on flow of funds data, adjusted for recent equity and house price changes



Source: Gavekal Research

A second method to ascertain the potential extent of additional downside in the pricing of stocks is based solely on macro. The 60-year graph above is courtesy of Gavekal. It divides household net worth into consumption and as you can see, the red line peaked north of 9X during the past few years and appears to be headed back to below 8X. Given its history of overshooting and undershooting, between house prices and financial assets, it would not be a stretch to envision an additional 10% to 15% decline in values using this metric.

The third method we'll consider is normalized, cycle analysis. Each line in the graph below represents a different post-1970s cycle, with the day the S&P 500 peaked being represented by the 0 on the left side of the horizontal axis. The horizontal axis denotes the number of days from each peak. The current cycle peaked on January 4, 2022 (dark blue line). In studying these lines in concert with the outlook for the economy, interest rates and inflation, it's not difficult to predict additional downside in stocks.

Source: Macrobond

While we believe stocks are vulnerable to another leg down, into the 3600s and likely lower during the next few months, there are near-term catalysts that can potentially move markets in a big way:

- U.S. mid-term elections this week - in contrast to two months ago, it appears increasingly likely that the Republicans will sweep Congress. Such an outcome would likely be good for the energy sector and bad for sectors that benefited from the significant fiscal stimulus that has occurred during the past few years.

- The December 3rd date after which Europe has stated it will no longer purchase Russian oil - while various 'games' are likely to be played to circumvent the full impact of such a reduction in Russian barrels reaching the market, at a minimum, if the EU proceeds it's likely to tighten up an already tight oil market.

As stated previously, our funds will continue to be conservatively positioned in the near term. Our Long Short Alternative Fund, the 'torquier' (in a relative sense) of our two funds, will continue to be structured with a bias towards value-oriented and resource-based securities. This fund has also added several call spreads on large cap U.S. companies with Q1 2023 maturities. In contrast, our lower volatility Conservative Alternative Fund continues to feature a much lower net exposure than our Long Short Alternative Fund, partially driven by its greater listed index put exposure.

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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