MONTHLY COMMENTARY

Risk assets had a strong September thanks to rising optimism that global economic growth was improving. The US dollar fell and equities had a strong month with the S&P500 gaining more than 3% while EM equities each gained more than 7%. Then on Sept. 17th, almost 4 months to the day that Bernanke first used the word taper, the FOMC surprised most observers by deferring their expected reduction in asset purchases. The knee-jerk positive reaction by stocks to this news faded quickly such that by the end of the first week of October, equities were roughly 3% off the record highs achieved during September.

Total Return in local currency	**September 2013**	**YTD**
S&P 500	3.13%	19.79%
TSX	1.40%	5.31%
MSCI EM	7.19%	-6.92%
GOLD	-4.75%	-16.72%
BRENT OIL	-3.52%	2.89%
FF LONG SHORT LP	2.25%	38.08%
FF MULTI STRATEGY LP	1.87%	31.99%

As can be seen in the table above, the funds at Forge First racked up another solid month with the Forge First Multi Strategy LP (“FFMSLP”) advancing 1.87% net of fees while the Forge First Long Short LP (“FFLSLP”) fund gained 2.25% net of fees. These performances increased the year to date net returns of the funds to 31.99% for FFMSLP and 38.08% for FFLSLP.

FFMSLP exited the month of September with net exposure of 33% on gross exposure of 186%. This net exposure figure included a 7% allocation to corporate bonds. During the month, our long book contributed 391 basis points (bps) of gross profits while our short book cost us 128 bps. Energy (+156 bps), Industrials (+85 bps) and Materials (+65 bps) were the top three winning sectors while Media (-119 bps) and ETFs (-60 bps) were the only sectors that cost the fund more than 10 bps.

Risk metrics remained solid for FFMSLP as the adjusted beta closed the month at 0.16, correlation to the TSX sits at a low 8.01% and alpha generation has accounted for 78% of the since net inception return of 42.22% (August 2012). The Sharpe ratio for FFMSLP is 4.38.

FFLSLP gained 2.25% net for the month of September 2013. This performance was split between a 425 bps profit in our long book and 114 bps of losses in our short book. Energy (+172 bps), Materials (+72 bps), Industrials (+66 bps) and Financials (+64 bps) were the largest contributors to profits while Communications (-145 bps) and ETFs (-49 bps) were the biggest losing sectors.

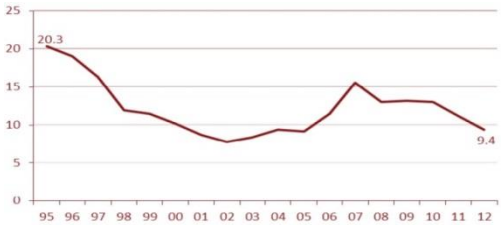
This fund, which has a mandate to always be net long, closed the month with an adjusted beta of 0.46. The higher beta of this fund arises from the fact net exposure sat at 65% at September 30th, on a gross exposure of 176%. Correlation to the TSX is 29.8% and the Sharpe Ratio of FFLSLP is 4.53.

In reviewing overall market action, having urged caution ahead of the traditionally treacherous month of September, I was surprised by the breadth and magnitude of the gains for the month. Granted major global manufacturing indices had improved without exception, yet rates of GDP growth remain tepid. Clearly there's an inconsistency between a 58 handle ISM Manufacturing number for the USA & the expected 2% four quarter real GDP number that will arise from the upcoming Q3 2013 GDP release, 4.5 years after the bottom of the last cycle.

To start with, manufacturing is only 12% of the American economy, hence the relevance placed on the ISM is overstated. Even in Germany, thought to be a manufacturing heavy country, manufacturing is only 20% of the economy. Meanwhile, moving four quarter export growth in Germany has fallen to zero.

Second, it's true that Chinese GDP growth appears to have stabilized in the mid-7s, but not without some unplanned efforts by the government. In China, the Federal government is in power for a period of ten years, hence the recently installed leaders do not have the short term focus that dictates the motives of western world leaders. Since the financial crisis, bank loans have more than doubled, as annual credit growth has averaged 35% of GDP. However, the graphs below support the argument that much of this increased leverage was all for nought. Corporate Chinese ROE, shown on the right graph below, has fallen from more than 15% in 2007 to 8.2% during 2012 while debt to cash flow, seen on the below left has climbed to an eye-popping 7.7X.

Source: Forensic Asia

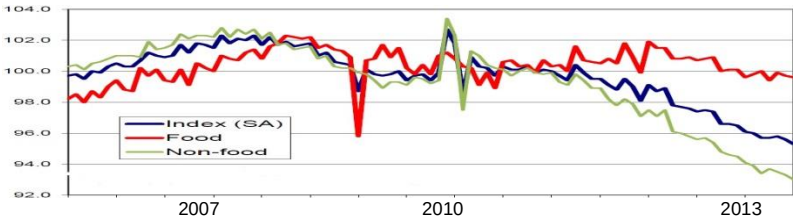


Source: Forensic Asia

Cognizant of the attendant risks to this debt explosion, earlier this year Beijing took measures to tighten up credit expansion. Sectors were ordered to shrink capacity and the late 2012 window of reverse repo liquidity to facilitate lending was closed. However, given the fragility of corporate China these moves help to trigger unintended consequences when overnight bank rates (SHIBOR) spiked to more than 20% in June 2013. Recent actions appear to have stabilized the economy. But with housing prices back to advancing at an 18% run rate, bulls have mistaken stabilization for a re acceleration.

President Xi Jinping has clearly enunciated his goals and the upcoming 3rd Plenary of the 18th Communist Party Congress in November will reaffirm his intent to focus on structural reform not stimulus. Consequently, economic growth in China will not reaccelerate in 2014.

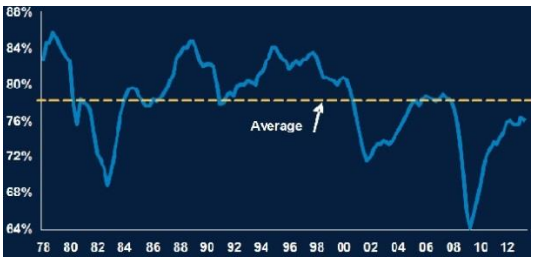
As for Europe, it's true there are many signs that a majority of economies have begun to improve. However, again, let's not get unjustifiably bullish. Private sector credit growth is currently falling at an annual rate of -2% despite having fallen for 16 straight quarters, the worst performance in almost 20 years; and the outlook is not much better. European wide loan to deposit ratios are 110%, down from 140%, but still 30 percentage points higher than their western peers. European banks still need to shed $2 trillion of assets. The impact of this deleveraging will continue to be severe.



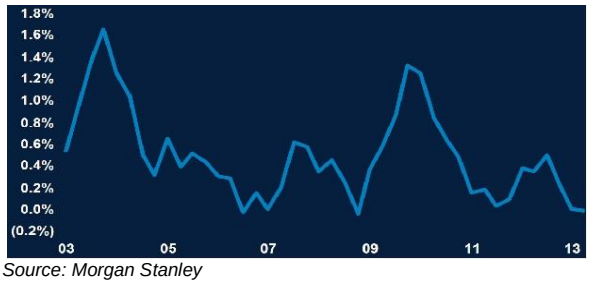
Source: Istat

As shown in the graph above, non-food nominal retail sales in Italy have now fallen 7% from the levels of 3 years ago. With a current federal government debt to GDP ratio of 132%, expected GDP decline of 1.7% during 2013, and a banking system in which non-performing loans total 9%, Europe's 3rd largest economy is obviously one of the key reasons why the European problem is far from over.

Across the pond in the United States, let's put the morass in Washington aside for a moment. I know in previous commentaries I have spoken as to how the bottom 2/3rds of the population are having a tougher time today than they were five years ago. It's great that the wealth of the USA has hit record levels, but to make one point, the top 10% of the population owns 90% of the stocks. But enough about the consumer, what about Corporate America.

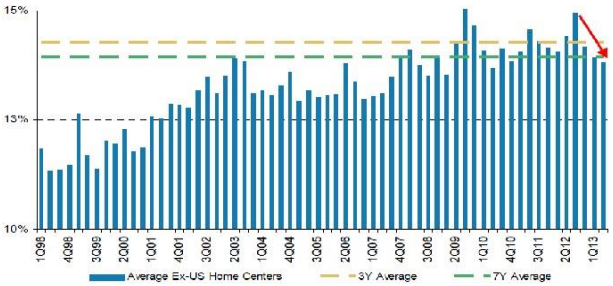


Source: Morgan Stanley



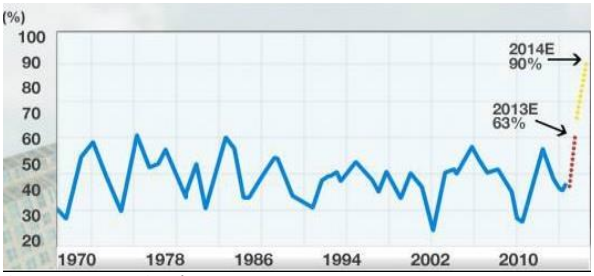
Source: Morgan Stanley

The graph on the above left shows that the moving four quarter average of US capacity utilization remains below its 35 year average while the picture on the right shows running four quarter labour productivity sits at zero. Last, the chart below indicates while global inventories declined in August, they're still not exactly lean. Even if I accepted the views of the more bullish economists that capital spending will add 75 bps or more to GDP next year, corporate tax reform is likely to ensure this doesn't occur. Surveys indicate that corporate tax reform is the single most important variable influencing investment decisions in America. Given what's going on in D.C. I suspect it's highly unlikely there'll be any movement on that front prior to the mid-term elections next November; and this spending gridlock doesn't bode well for accelerating corporate profits.

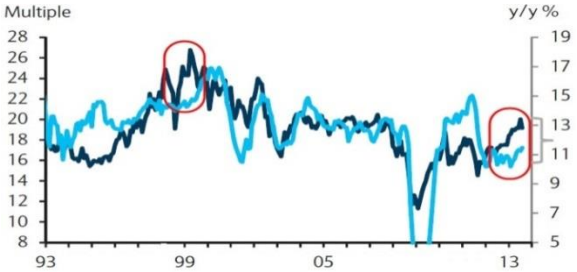


Source: Morgan Stanley

Despite a negative to positive earnings revision ratio of 5.2 entering the Q3 earnings season that begins this week, analysts expect EPS growth approximating 4.5%, the 4th consecutive quarter of lousy growth. More importantly, despite easy comps, consensus for Q4 calls for an unrealistic 12% rate of growth. Achieving Q4 consensus would put 2013 EPS at $110 for the S&P 500. Next year, analysts expect EPS to climb to $122. The graph on the below left shows that attainment of this number is unrealistic.



Source: Morgan Stanley



Source: Barclay's

For 2014 consensus S&P 500 earnings to be met, the graph on the above left indicates that 90% of the top 1500 companies in the USA must have higher net margins next year, a level well in excess of historical averages. In turn,

unless economic growth picks up markedly from the current range, so as to aid earnings growth, a decently higher stock market in the next 12 months means the valuation needs to go higher. Having risen 3X points this year, the graph on the above right shows today's market is only modestly above historical averages. So it's possible multiples could climb. However, how much do you want to pay for mid-single digit earnings growth in the face of a FOMC that clearly is moving closer to taking away the punch bowl.

You'll note that I've yet to discuss the DC morass that I earmarked last month as being a likely source of concern for the market. Of course, such consternation is only happening as I write this commentary. While common logic would cause a sane person to think that an elected official will put their country ahead of their ego, of course, politics and power have long defied common sense. It's pointless to speculate on what will happen in another couple of weeks, but suffice it to say, if the parties did not work out a compromise, the impact on the markets would not be good. For my money, any chance greater than zero is too high a number. Now's not the time to be fully invested. Buy some insurance. Hopefully you won't need it; but in the slight chance you do, it'll be well worth the price. Better yet, buy a real hedge fund, one that runs a big short book.

As always should you have any questions or comments, please contact me at 416-687-6771 or amccreath@forgefirst.com. Follow me on **TWITTER @CEDARBUSH**

Thanks very much,

Andrew McCreath