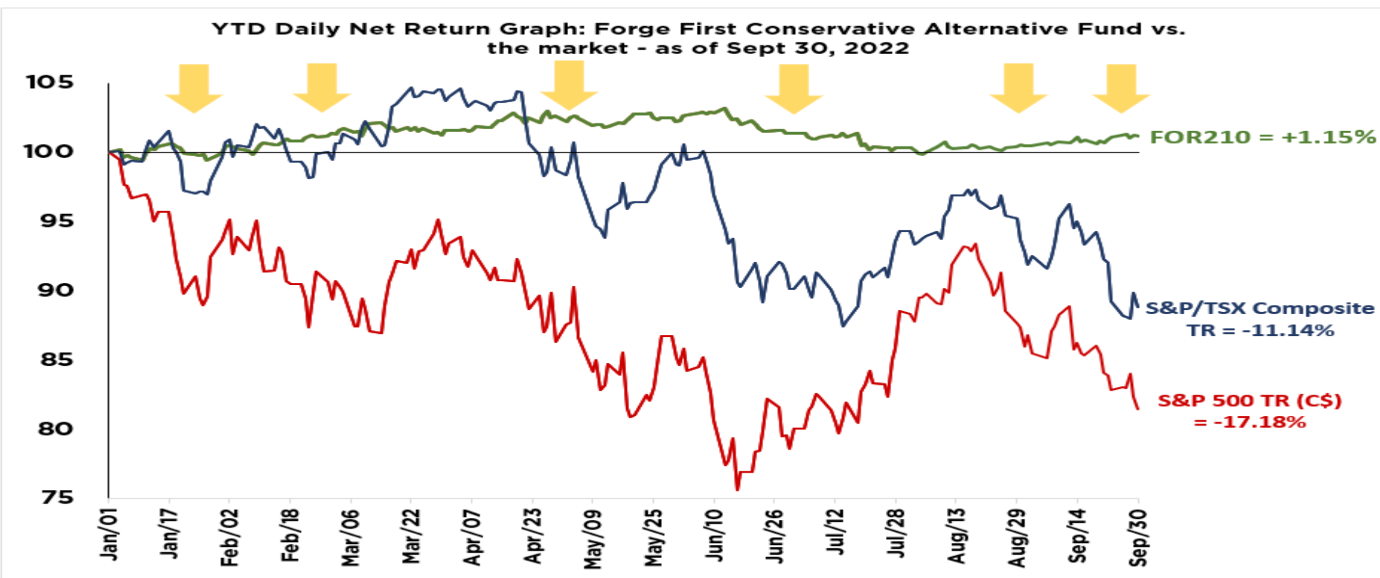
September 2022 Commentary

In light of the growing stagflationary environment, investors experienced the full brunt of the renewed downside correlation between stocks and bonds during September, historically the worst month of the year. For the first time since 1938, the S&P 500 closed the quarter with a negative return (-5.28%) after earlier rising more than 10% (+14% July through mid-August gain) as breadth turned strongly negative during the last month of the quarter. In fact, to highlight what has become a year-to-date trend, 56.4% of all trading days during 2022 have shown declines for the SPX, including 26.1% of those days featuring declines of at least 1%. Perhaps even more startling, the Nasdaq-100 and long-term US Treasuries are both down by roughly 30% since the start of January and yields on U.S. 10-year bonds hit 4% for the first time since 2010.

In fact, the disorder we've seen year to date in markets, catalyzed by the regime change in monetary policy last fall, has now entered the arena of the absurd, given the Bank of England's recent moves to hike rates, boost their inflation forecast, yet pivot from QT to QE in an attempt to save the plummeting Pound. We'll table our perspective of what all this means for investors later in this commentary, but first let's recap the performance of our funds.

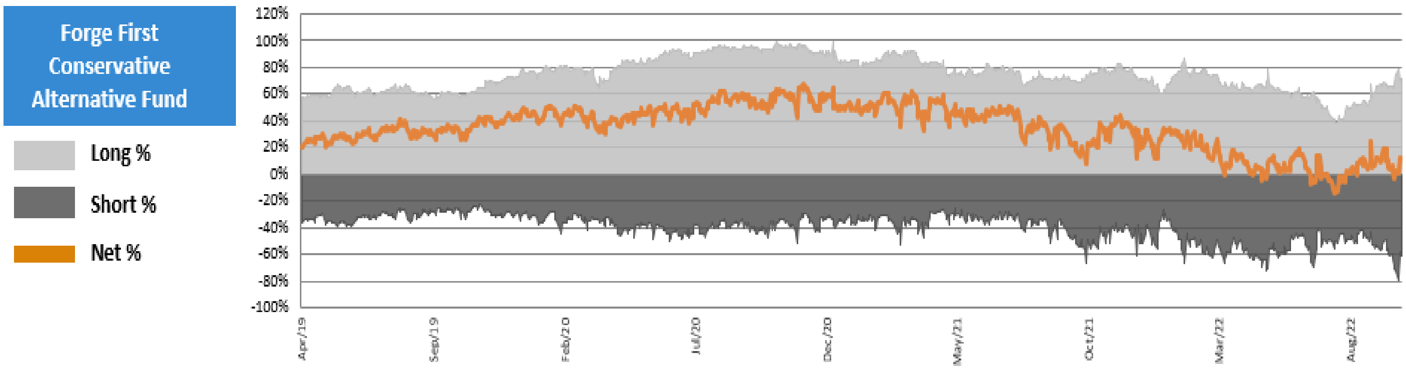
During the tumultuous month of September, one of our funds was up, one was down. The Series F of our multi-asset Conservative Alternative Fund gained +0.64% net of fees, boosting its year-to-date net return to +1.15%. The positive month was driven by gains in the asset protection sleeve, offset to a degree by losses in the capital growth sleeve of the portfolio. Viewed from the perspective of sectors, Technology, Utilities and Energy suffered losses, while the largest positive drivers were generated by positions in the Industrials and Consumer sectors. The year-to-date daily net performance graph below highlights that our Conservative Alternative Fund has not only delivered a positive net return but, as identified by the arrows, this fund has exhibited stability amidst each of the six downdrafts equity markets have experienced during 2022.



Source: Forge First

The delta-adjusted net exposure of the Conservative Alternative Fund remained consistent with the exposure levels at the end of August 2022, and now sits at approximately +11%, split between a -0.1% net short exposure to common equities and a +11.0% net long position in the multi-asset sleeve of the portfolio. It's worth noting that the fund continues to slowly increase its exposure to credit spreads, adding +2% net length during September. Given the very weak year-to-date credit performance, higher interest rates and the inverted yield curve, we foresee better performance from this asset class during 2023. Hence, we expect to gradually increase the credit exposure of the Conservative Alternative Fund through the end of this year.

Speaking of tactical repositioning, the net common equity exposure of the Conservative Alternative Fund was increased to as much as +35% net long during the Summer of 2020 (ceiling is +50% net long). The Series F of this fund returned +17.56% net during 2020. The higher net common equity exposure remained above +30% through early fall of 2021. At that time, we began boosting our gross short exposure, an allocation that has averaged -60% since then. This higher gross short exposure, represented by the dark grey area on the right side of the graph below enabled this fund to, on average, hold a dollar-neutral common equity net exposure year to date during 2022. Musing ahead to 2023, akin to the post-COVID-19 period during 2020-2021, we foresee the potential to once again boost the common equity net exposure levels markedly in early 2023.



Source: Forge First

The Series F of our Long Short Alternative Fund fell -2.73% net during the month of September, causing the year-to-date net loss to sit at -3.80%. Energy, Technology and Materials were the culprits driving this downdraft, while positive returns from holdings in the Financial and Consumer sectors only served to offset a portion of these losses. For a host of reasons, we have become even more constructive towards 'hard assets' in general, especially energy commodities. Yes, we have been positive on the outlook for energy prices for most of this year, a fact that held us in good stead during the first half of 2022, obviously less so during Q3. Regardless, the supply side of the story that has been driving our enthusiasm will shortly come to a head.

	YTD	1 mo	3 mo	6 mo	1 year	2 year*	3 year*	Since Inception*
Forge First Long Short Alternative Fund Series A	-4.49%	-2.82%	-4.52%	-9.08%	-5.17%	8.13%	8.32%	6.75%
Forge First Long Short Alternative Fund Series F	-3.80%	-2.73%	-4.26%	-8.61%	-4.28%	9.11%	9.33%	7.71%
Forge First Conservative Alternative Fund Series A	0.47%	0.57%	-0.45%	-0.90%	-0.86%	9.30%	8.77%	7.28%
Forge First Conservative Alternative Fund Series F	1.15%	0.64%	-0.23%	-0.45%	0.04%	10.30%	9.74%	8.24%
S&P/TSX Composite Total Return Index	-11.14%	-4.26%	-1.41%	-14.41%	-5.39%	10.06%	6.59%	6.05%
S&P 500 Total Return Index (C$)	-17.99%	-4.60%	1.43%	-12.59%	-9.53%	5.08%	7.83%	6.73%

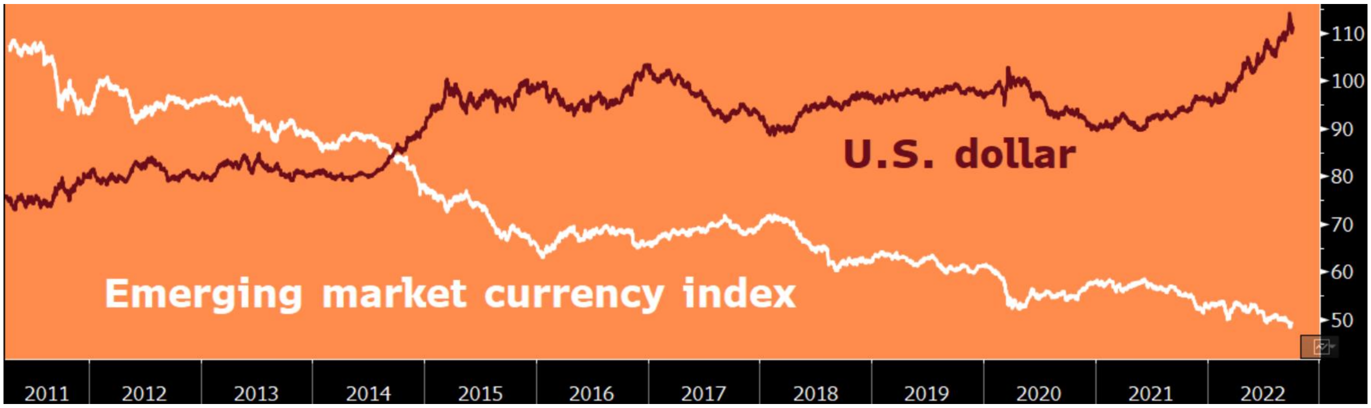
*Annualized | Inception date: April 24, 2019

The apparent intent of the European Union (EU) to follow through with both its physical embargo as well as its price cap on Russian oil will undoubtedly have a negative impact (we've seen a range of 0.6-1.5M/day) on global oil supplies. Last week, OPEC announced a 2M barrel reduction in daily quotas, which we surmise likely represents 1.2M barrels off the market as of the start of November. As for America's Strategic Petroleum Reserve ("SPR"), the current 180M barrel release (165M released so far as of last week) expires near the end of October.

As fiscal 2023 begins, it's true President Biden will have access to a further 70M barrels of future budgetary planned sales. Typically distributed over a two-year period, Biden does have flexibility on the timing of these releases plus the ability to release additional oil from the SPR as deemed "appropriate". Regardless, the bottom line is that despite pervasive and justified fears of a recession, the price of oil remains in steep backwardation; a telltale sign of a physical imbalance between supply and demand.

We maintain the belief expressed in a commentary several months ago that during 2023, oil prices will average US$95 versus the current strip of US$80 for next year. Given the lower cost structure and clean balance sheets within the industry today, even at US$80 oil, our long-term holdings in Tourmaline Oil Corp. (TOU.CA), Canadian Natural Resources Ltd. (CNQ.CA) and Meg Energy Corp. (MEG.CA) are expected to print sizeable free cash flows, most of which will be distributed to shareholders.

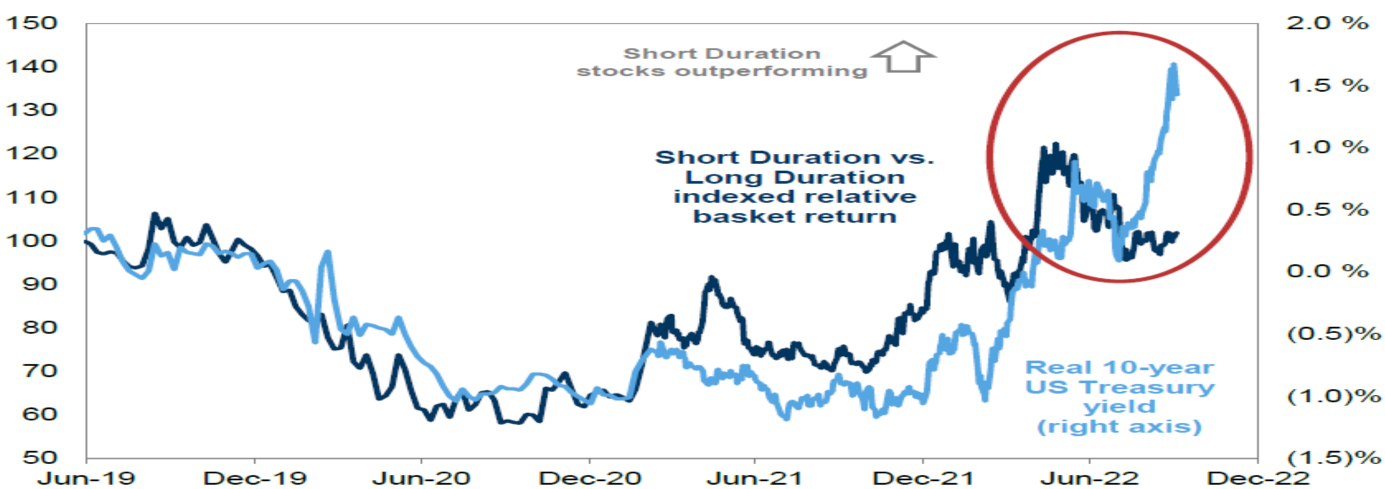
Beyond commodity-specific fundamentals, it strikes us that the recent intervention in currency markets is the start of another source of turbulence in markets. As a recent commentary illustrated the strength of the U.S. dollar against other G7 currencies, the white line on the 11-year graph below opts to highlight the J.P. Morgan Emerging Markets currency index, straight down to the right!



Source: Bloomberg

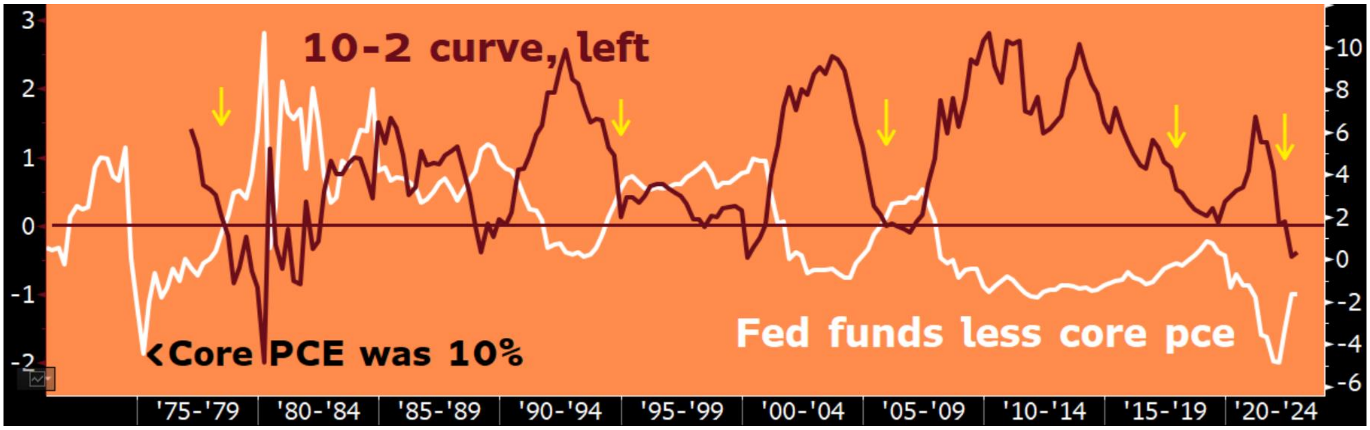
Unless the Fed backs off its most hawkish ever stance in a timely fashion, we anticipate a broadening in central bank intrusion in FX markets, actions that could ultimately represent a means to justify a higher tolerance towards inflation. Obviously, if our expectation that inflation will prove to be stickier is wrong, the perception that a Fed pivot is inevitable could prevent monetary authorities from repeating the same policy mistakes they've made during past cycles. Further, if by stroke of luck, China fully re-opened its economy and/or the war in Ukraine resolved itself in a timely fashion, it's possible financial markets could experience a gentler outcome. For now, we don't foresee either happening, hence the Long Short Alternative Fund has tactically adjusted its positioning to capture further upside from a market set-up that appears similar to the experience of the first several months of 2022.

Unfortunately, the downdraft in energy pricing and equity markets overwhelmed the protective put positions held by the fund. During September, the price of WTI oil and NYMEX natural gas fell 11.2% and 25.9% respectively; consequently, the Energy book cost the fund more than 200 basis points. In addition, despite rising real yields (light blue line, right axis), the dark blue line on the left axis of the following three-year graph illustrates that short duration stocks have recently underperformed long duration stocks. This action hurt our positioning in the Technology sector, as our short position in the ARK Innovation ETF (ARKK.US) outperformed long-held positions in "GARP-tech" including Microsoft Corp. (MSFT.US) and Alphabet Inc. (GOOG.US). Wins in United Natural Foods Inc. (UNFI.US), The Clorox Co. (CLX.US) and Magna International Inc. (MG.CA), all shorts, and long positions in securities including the Royal Bank of Canada (RY.CA) were not large enough to offset the near-term headwinds experienced in the remainder of this portfolio.



Source: Goldman Sachs

Our view is that the Fed will proceed with the remainder of the rate hikes that have been communicated for 2022. These moves would lift the Fed Funds Rate to 4.25% by Christmas. Once we move into 2023, there's no question in our minds that the Wall Street-friendly Chairman of the Fed would love to stop hiking rates. It's true and logical that the Fed should consider taking a pause to see whether the historical 6 to12-month lag of monetary policy's impact on the economy will serve as the standard once again this cycle. Whether a pause is justified or not will depend on what's happening with inflation. In fact, it's your call on inflation that should dictate the positioning of your investment portfolio.

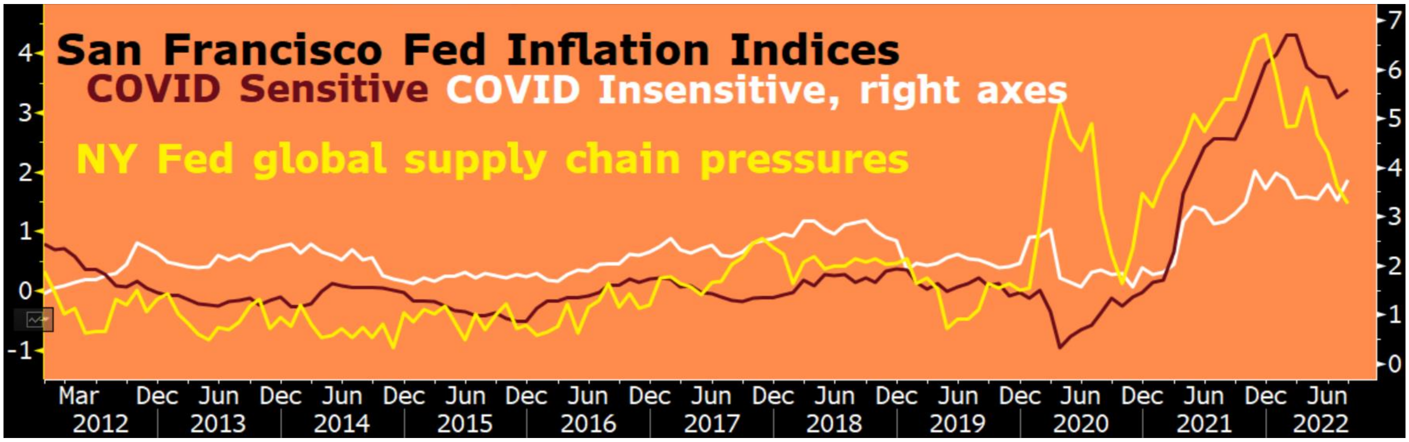


Source: Bloomberg

The 50-year graph above compares the Fed Funds Rate less the Core Personal Consumption Expenditures Price Index ("PCE") (white line, right axis) against the 10-2 Year Treasury Yield Curve (red line, left axis). The yellow arrow highlights periods when the curve is flattening or inverting and the Fed Funds Rate less the Core PCE is rising. Unless inflation recedes markedly in a timely fashion, this historical relationship is supportive of additional rate hikes by the Fed.

Is inflation going to march back down to the low 2s by late Spring of 2023? There's little question the law of large numbers will shortly begin to kick in, enabling inflation to march lower. We're not economists, but for several reasons our instinct remains that nine to 12 months from now, it will still be in the mid to high 3s. First, we believe energy prices will move higher from current levels. Assuming we're correct, the pricing trajectory of utilities is unlikely to abate plus, post a three to six-month lag, given the pervasive use of energy commodities, higher energy prices should catalyze a renewed push higher in economy-wide pricing.

Rents and food prices are likely to remain sticky into the second half of next year. Remember, rising rates hurts housing affordability, in turn increasing the demand for rental properties. Further, meetings our team has held with the senior management of grocery and restaurant chains have us thinking food prices will continue to climb by the high single digits into the back half of next year. It's true that labour markets are showing modest signs of loosening up, but at 5.0% in the U.S. and 5.6% in Canada, there's yet to be any slowdown in wage hikes.



Source: Bloomberg

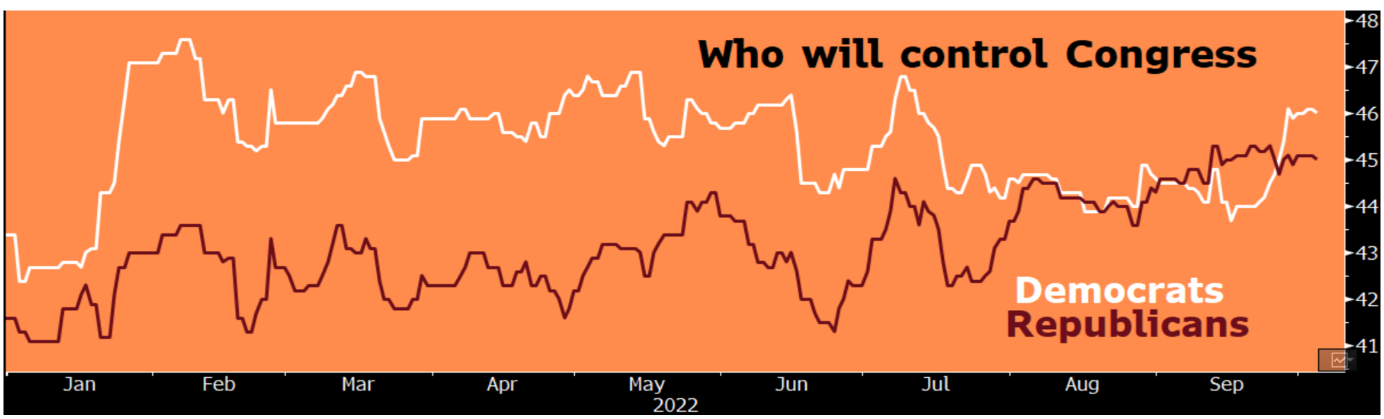
Finally, the above graph helps us to understand the inflationary impact of the current state of supply chains. August is the last data point in the above 10-year graph, so perhaps September will have shown further improvement. The yellow line on the left axis is the NY Fed's Global Supply Chain Pressure Index (GSCPI), while the red and white lines on the right axis are the San Francisco (SF) Fed's price indices for COVID-Sensitive and Insensitive Contributions (products and services) to Inflation, respectively. Note how the COVID-insensitive index has flatlined at higher-than-historical levels for all of 2022. Further, the decline in the COVID-sensitive price index has markedly lagged the improvement seen in the supply chain index. Collectively, these factors explain why nine to 12 months from now, our hunch is that inflation will stay in the 3s vs. the targeted 2s, making it tougher for central bankers, especially since neither the Chinese, European, or North American consumers (U.S. savings rate now sits at just 3.5%) will fuel a resurgence in the economy during 2023.

On November 16th, members of the G20 will meet in Bali, Indonesia. Market chatter has already begun of the potential for members to reach an accord on currencies akin to the Shanghai Accord of February 2016 and the Plaza Accord in September 1985. Such an agreement would see the Americans strike a deal with other G20 members to devalue the U.S. dollar (currently at its highest level since May 2002). Some observers believe the dollar is now as much as 35% overvalued on a purchasing power parity basis. Achieving sustainable success with such an agreement would be tough if the Fed remains full throttle hawkish. Yet, there's little doubt that taking the air out of the soaring dollar would cause a vicious rotation among asset prices and equity sectors, plus a general ramp higher in markets.

Another factor to consider with respect to portfolio positioning is the impact of forward guidance from companies that we'll hear about during the Q3 earnings season due to start shortly. Many companies have recently issued disappointing business updates of various stripes including Apple, Tesla, Nike, Micron and Fedex. Q3 estimates for the S&P 500 have already declined 7% and the whisper numbers imply there is more downside. The larger concern (than the actual numbers for Q3, when consumers were still spending) is the guidance for Q4, as consumers have pulled back, inflation continues and the Fed's "adjustments" to date are likely to have more of an impact. Remember, according to Goldman Sachs, on average since WW2, EPS has declined 14% during a recession. At the time of writing this commentary, the SPX was 3,783 or 16.8X a 2022 EPS estimate of $225. Shaving even 10% off this $225 estimate gives you $202 in 2023 EPS, implying a current P/E of 18.7X; not exactly cheap given the likely level of interest rates next year.

Hence, we continue to believe it is probable there is another leg lower in stocks, especially highly-valued growth stocks and most 'bond proxies'. If we're correct, it's likely that credit spreads would continue to widen, providing that constructive set-up for 2023 discussed earlier in this commentary. In contrast, we foresee upside in energy, other low duration equities and stocks that we'll generously categorize as supply chain issue-driven securities. Each of our two funds will continue to hold a sizeable short book to complement significant market hedges.

Finally, at the conclusion of our last commentary we posed the outcome of the U.S. mid-term elections as a question for investors to ponder. We're not making any predictions, but highlight that if the Democrats gained solid control of the Senate, investors should ponder whether Biden would attempt to embark on additional stimulus, even if financed with higher taxes and how the markets may react to such a scenario.



Source: Bloomberg

This year has presented investors with a rude awakening to the consequences of a regime change from easy money, low inflation, a relatively peaceful geopolitical environment, the continuing accrual of the benefits of globalization and mostly friendly fiscal regimes. We have now climbed over to the other side of this fence. It's naïve to think that the pain is going to be "one and done". We are likely to be in a recession next year and remember history rhymes, but it doesn't repeat. This statement implies that investors should forget the euphemisms of soft versus hard landing because a recession is a recession. Real estate prices will drop, issues will arise within the private credit space and equity markets won't bottom with a P/E of 17X.

Once we get that next leg lower in stocks, that next move higher in credit spreads and hopefully, a pause by the Fed which in turn would cause the USD to deflate, there's likely to be a solid trade in financial assets. However, don't be fooled, the significance of the regime change that we have undergone suggests it is probable the investing climate is going to be tough for longer than you'd like.

Fortunately, there are disciplined long/short managers including Forge First whose funds have exhibited an ability to generate competitive net returns and protect capital when markets get tougher.

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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