October 10, 2023

September 2023 Commentary

Clearly equity prices have finally begun to be impacted by the inevitable and now relentless climb in interest rates. The current questions are whether stocks and bonds are fairly priced and how long before interest rates decline from their two-decade highs. This note will include thoughts on these issues, but first let's discuss the performance of our funds and the attribution across the broader markets.

As of September 30, 2023	YTD	1-mo	3-mo	6-mo	1-year	2-year*	3-year*	Since Inception*
Forge First Long Short Alternative Fund Series A	2.35%	0.10%	2.44%	2.47%	1.84%	-1.73%	5.99%	5.64%
Forge First Long Short Alternative Fund Series F	3.17%	0.19%	2.72%	3.02%	2.94%	-0.73%	7.02%	6.63%
Forge First Conservative Alternative Fund Series A	2.94%	0.98%	1.65%	2.58%	3.52%	1.31%	7.33%	6.43%
Forge First Conservative Alternative Fund Series F	3.64%	1.06%	1.88%	3.05%	4.45%	2.23%	8.32%	7.39%
S&P/TSX Composite Total Return Index	3.38%	-3.33%	-2.20%	-1.13%	9.54%	1.80%	9.88%	6.82%
S&P 500 Total Return Index (C$)	13.19%	-4.77%	-0.96%	5.35%	19.50%	4.76%	10.79%	10.84%

*Annualized | Inception date: April 24, 2019

For the second consecutive month, each of our two funds bucked the declines in stocks and bonds by delivering positive net returns. The Series F of our low volatility, multi-asset Conservative Alternative Fund posted a net return of +1.06% such that its year-to-date net return exited the third quarter at +3.64%, with YTD standard deviation of 1.46%. This performance served to boost the three-year net CAGR for this fund to +8.32% at volatility of approximately one-third of the market (4.69% vs. 13.72%) and negative downside capture of -10.96%.

During September, the Conservative Alternative Fund generated positive returns in each of its three sleeves. The asset protection sleeve, a constant and disciplined feature of this fund, contributed significantly to the gains for the month. In addition, common equities chipped in positive returns despite holding a net long exposure for a majority of the month, while corporate bond exposure also positively impacted performance. At month end, the delta-adjusted gross and net exposure were 127% and 10% respectively, with the net exposure being split between a -4% net short position in common equities and a 14% net long position to securities in the multi-asset sleeve of the portfolio.

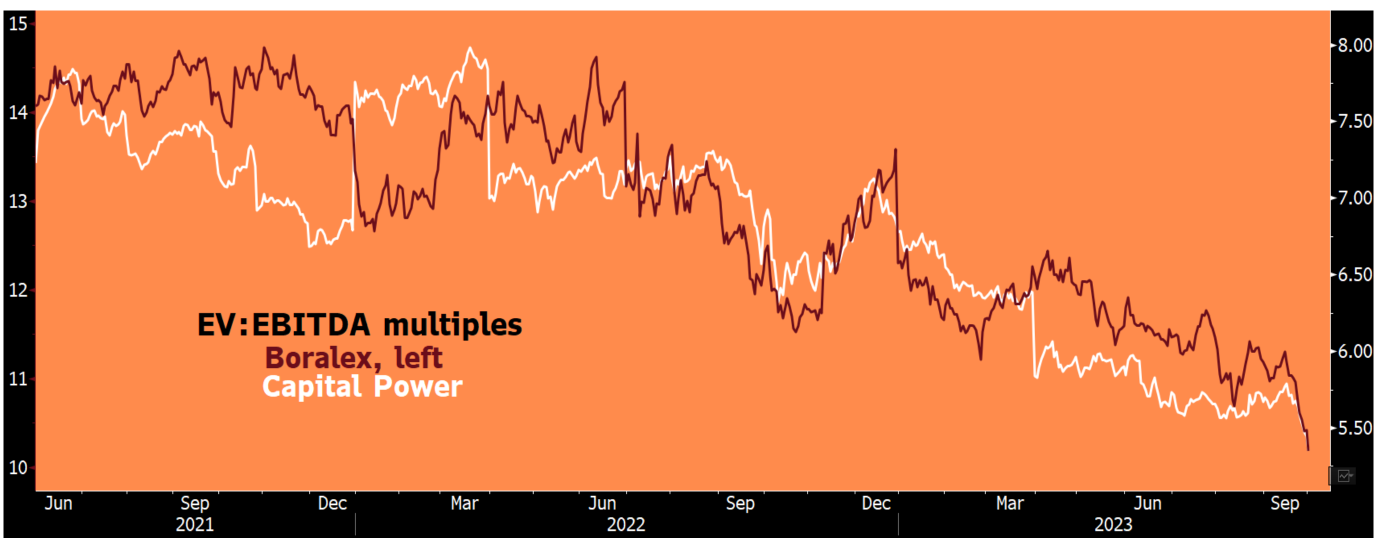
The Series F of our Long Short Alternative Fund gained +0.19% net of fees, boosting its year-to-date net return to +3.17%. Hence, the three-year net CAGR for this fund now sits at +7.02%, with volatility of 6.99% and downside capture of +18.2%. Similar to August, the short book was a significant contributor to the performance of the fund last month, as was the low single-digit net long exposure to Energy stocks. Financials, Industrials and the Consumer, Non-Cyclical sectors were also positive contributors this month.

Utilities and Consumer, Cyclical holdings, along with rate-sensitive REITs were the largest detractors from the performance of the fund, with small losses arising from holdings in Technology, Materials (gold), and Communications. In retrospect, the pain experienced from 'bond proxies' was not surprising given the rapidity of the move higher in bond yields during September (please see graph below). Being pragmatic, we reduced the allocation to this 'basket of securities', yet at the time of writing we find ourselves torn on rate-sensitive stocks.

Source: Bloomberg

For example, the 'pure' Independent Power Providers ("IPPs") are now trading at less than 10X calendar 2023 EBITDA. While there is a rate headwind on both valuations and AFFO (adjusted funds from operations) via interest expense for REITs, generally speaking Utilities only face a modest negative impact on EPS from higher interest rates. This very small impact only exists because most debt sits at the operating entity as opposed to the corporate level of the utility company and the higher expense from operating entity debt is passed through to ratepayers. We hasten to add that the share prices of companies featuring more corporate level debt, such as Emera Inc. (EMA.CA) and Algonquin Power & Utilities Corp. (AQN.CA), have been significant underperformers of late, in part because of higher exposure to corporate-level debt.

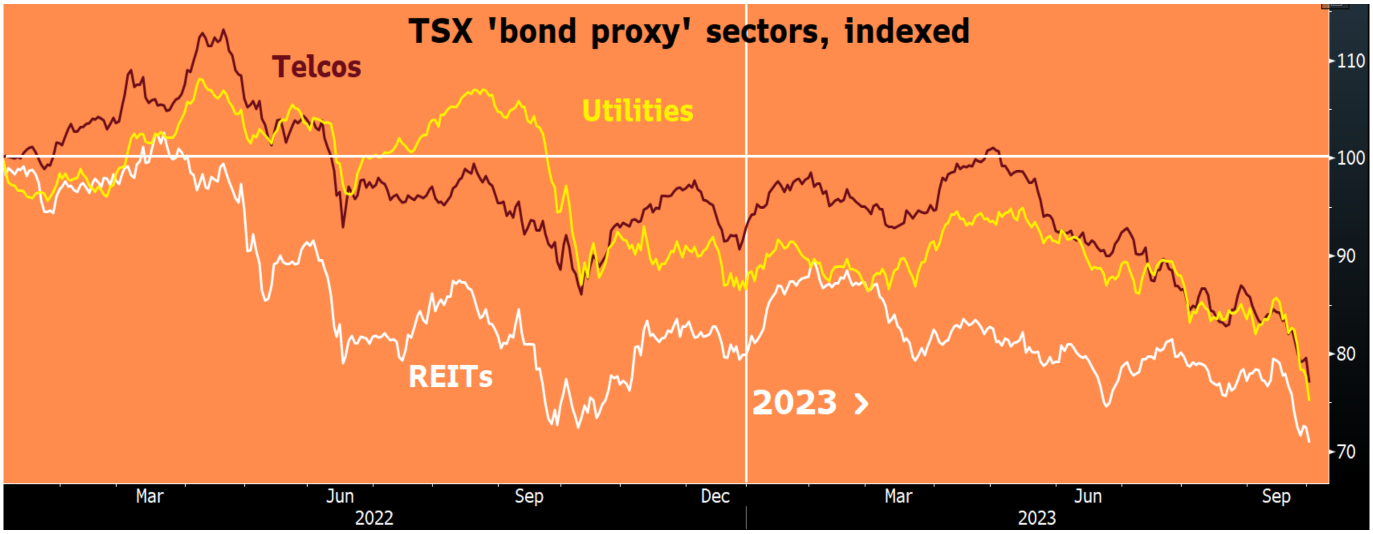
In the case of IPPs, while increases in interest expense are not subject to pass through to ratepayers, the asset-level debt almost always fully amortizes over the typical 15 to 25-year life of the PPA (power purchase agreement) with locked-in rates. This structure is the case with Boralex Inc. (BLX.CA), one of the holdings of the fund. Higher interest rates don't impact the free cash flow generation of existing operations, while prospective projects are underwritten with market-rate debt costs. Hence, the only real risk to earnings and free cash flow generation resides with the development pipeline that has yet to achieve financial close, when the cost of debt capital is normally locked in. However, with the shares now trading at a single-digit forward multiple, we question whether the market is ascribing any value to future projects.



Source: Bloomberg

Another holding of the fund, Capital Power Corp. (CPX.CA) does fund itself through corporate debt, but in early 2022 entered into interest rate hedges such that its next two maturities, in 2024 and 2026, have been effectively renewed and rolled at undisclosed, but likely rates that are well below current market rates. Capital Power's debt burden is also a fraction of its IPP peers and continues to benefit from above forecast power prices in Alberta, minimal outages compared to Q2, and it looks like the new Cascade facility, a key competitor, could see its start-up delayed. We await Q3 results on October 30th.

The Long Short Alternative Fund exited September with delta-adjusted gross and net exposure of 165% and 19% respectively. This exposure includes significant index put protection which benefited last month from an increase in the volatility of the held options (three-month at-the-money implied volatility was up 2.8 points). However, we note that while implied volatility appears to remain inexpensive, realized volatility continues to trade below implied volatilities; an expense that for now continues to be a necessary evil.



Source: Bloomberg

As mentioned earlier and as can be seen from the graph above, the pain across ‘bond proxies’ has been widespread. In fact, even Canadian banks have not been spared as their share prices have declined an average of 20% from the beginning of 2022. The table below suggests our southern neighbours have also shared in this pain. You’ll remember that ‘tech’ companies Alphabet Inc. (GOOG.US), Meta Platforms Inc. (META.US) and Amazon.com Inc. (AMZN.US) were transferred to the Comm. Services and Cons. Discretionary sectors respectively in September 2018, even though you likely share our view that they’re ‘tech stocks’. The table below indicates true ‘tech’ stocks as classified by S&P represented 26% of the S&P 500 at the start of 2023 (28% today) with these non-tech ‘tech’ stocks taking the ‘old tech group’ weighting back towards their previous peak in the mid-to-high 30s%’s of the broader index. Hence, now nine months into this year, when you review the basis point attribution on the far-right side of the table below, it remains true that little other than tech stocks have worked for investors.

YTD S&P 500 Return Attribution

Sector	Weight at start of 2023	YTD return	Basis points of S&P 500 return
Info Tech	**26 %**	**35 %**	**894 bp**
Comm. Services	7	40	294 bp
Cons. Discretionary	10	27	261 bp
Industrials	9	4	39 bp
Energy	5	6	32 bp
Materials	3	3	7 bp
Real Estate	3	(6)	(15)bp
Financials	12	(2)	(19)bp
Consumer Staples	7	(5)	(34)bp
Utilities	3	(14)	(46)bp
Health Care	16	(4)	(65)bp
S&P 500	**100 %**	**13 %**	**1307 bp**

Source: Goldman Sachs

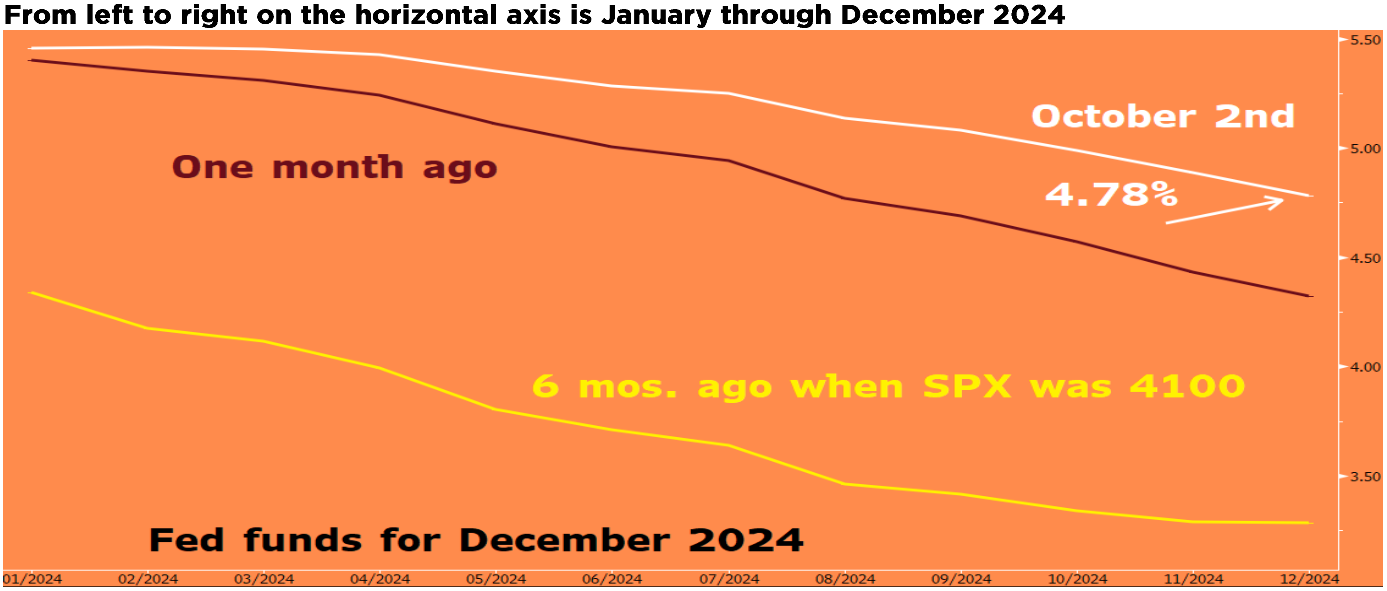
In fact, the table below highlights the lack of breadth in equities year-to-date through Sept. 30th, 2023 as the ‘bottom’ 490 stocks have only contributed 11.7% of the 11.68% total price advance for the S&P 500 through September 30th. Further, for the Russell 2000, America’s principal “small cap” index (mid to large cap in Canadian terms!), the median stock is down -6.6%. Of course, in assessing where markets go from here, it’s the valuation that matters in the context of forward earnings growth and the level of interest rates.

S&P Performers			
YTD gain	%	Percent of total SPX gain	%
Median S&P 500	0.40%	Top 10 SPX Performers	88.3%
Median Russell 2000	-6.60%	Other 490 Stocks	11.7%
Median Valuation	Trailing EPS	Top 10 stocks	
Top 10 Stocks	31.7X	4 of the 10 trade at >65X EPS and represent 32% of the S&P 500	
Other 490 Stocks	19.0X		

Source: S&P Global Inc.

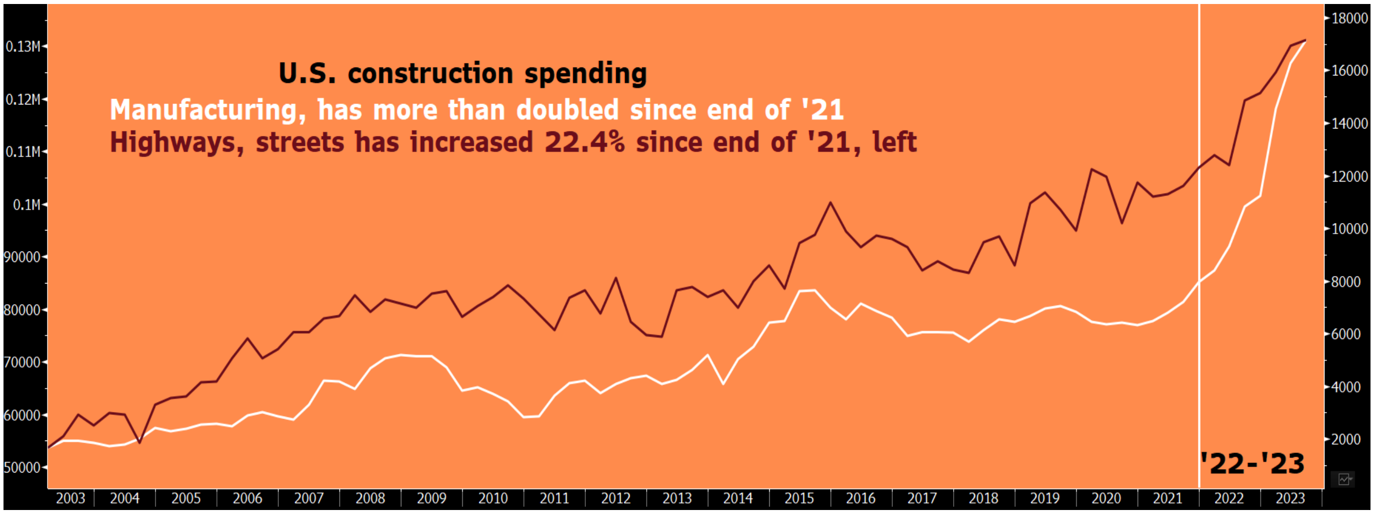
As for interest rates, the graph below suggests investors now assume the Fed Funds Rate will exit 2024 at 4.78% relative to the 3.12% level of six months ago when the S&P 500 was trading at 4100 vs. its 4288 close on September 30th. Earnings growth for 2024 is forecast at a robust 12% for the S&P 500. Disaggregating the forecast earnings of the M7 or even the top 10 stocks from the S&P 500 suggests the bottom 490 or 493 stocks in the S&P 500 are trading at roughly 17X forward earnings. Consequently, notwithstanding the 6.9% decline in the 493 since their peak in late July, we still don't find stocks particularly attractive relative to the level of interest rates. 2024 EPS growth of 12% presumably implies the U.S. won't enter a recession next year, and if the U.S. is not going to enter a recession, investors should definitely expect interest rates to stay higher for longer. Stocks excluding the M7 are not an across-the-board buy at 17X forward EPS if interest rates are to remain at or near their current levels throughout the majority of 2024. As long-only investors have learned of late, there are limits as to how long investors can have their cake and eat it too.

From left to right on the horizontal axis is January through December 2024



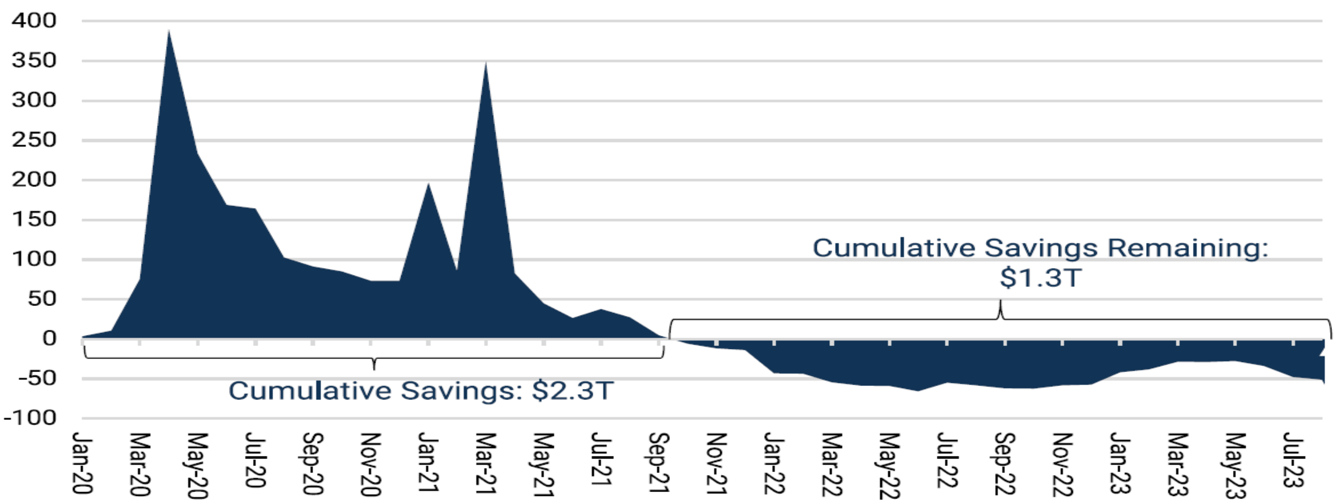
Source: Bloomberg

As to whether the U.S. will finally enter the most predicted recession ever next year, there are pros and cons to that pitch. On the 'no recession' side of the ledger, the U.S. will continue to benefit from Biden's gigantic fiscal stimulus. The graph below illustrates that construction spending on manufacturing plants (white line, right axis) has more than doubled since the start of 2022 (right of the vertical white line) and is now running at more than US$200B a year, with hundreds of billions of spending still to come (time for a big sigh and a crying emoji for Canada!). During the same time frame, infrastructure spending has grown by a not too shabby 22.4% and don't forget the housing market remains structurally short of inventory. Hence, it's an understatement to suggest capital spending will remain a strong driver of growth.



Source: Bloomberg

Shifting to the positive, the segment of the economy economists have underestimated the most is the persistence of consumer spending. In turn, this reality is attributable to a lack of appreciation as to how large the cash cushion both businesses and households were working with heading into the Fed's tightening cycle. Recently, the Bureau of Economic Analysis (BEA) released its annual revisions to the National Income and Product Accounts and GDP, which implied consumers had an even larger than previously believed cushion of cash on a much lower than formerly held base.



Source: Jefferies Financial Group Inc.

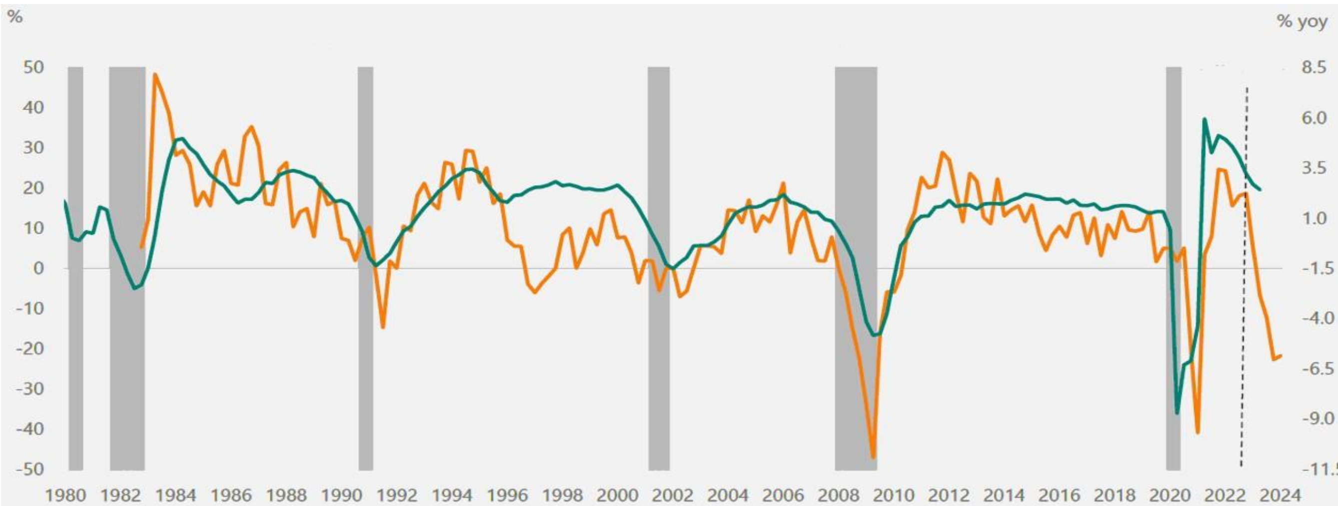
Hence, according to economists at Jefferies, consumers not only have more cash to spend, but also a lower base savings rate to potentially spend down to. This Wall Street dealer calculates that consumers have roughly US$660B left of what turns out to have been US$2.3T (vs. US$2.2T) of peak savings, and likely speaks to why consumer spending has yet to fade. Having said that, and despite the fact real earnings have finally turned positive, the historical correlation between the tightening availability of credit and payrolls growth (along with now almost 8% mortgages, food prices, gasoline, etc.) does suggest consumer spending is destined to slow during 2024.

Tightening credit implies that a slowdown in job growth is forthcoming

Total Non-farm payroll, y/y %, right axis

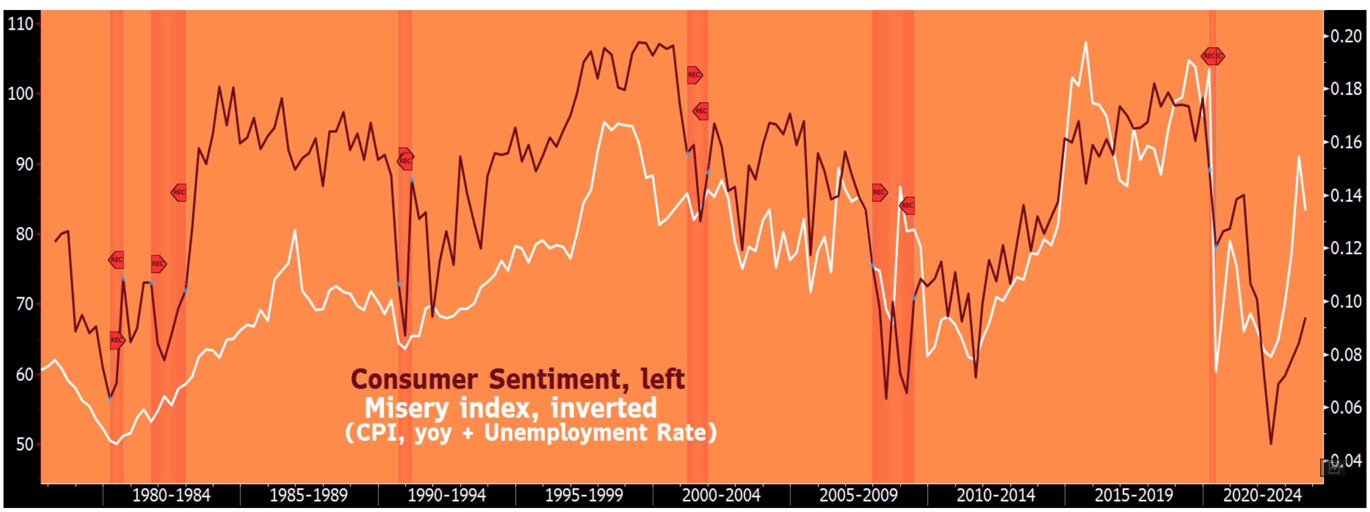
Willingness of loan officers to lend to consumer, %, left axis, leading by 6 months

- - - - When Fed started to hike rates



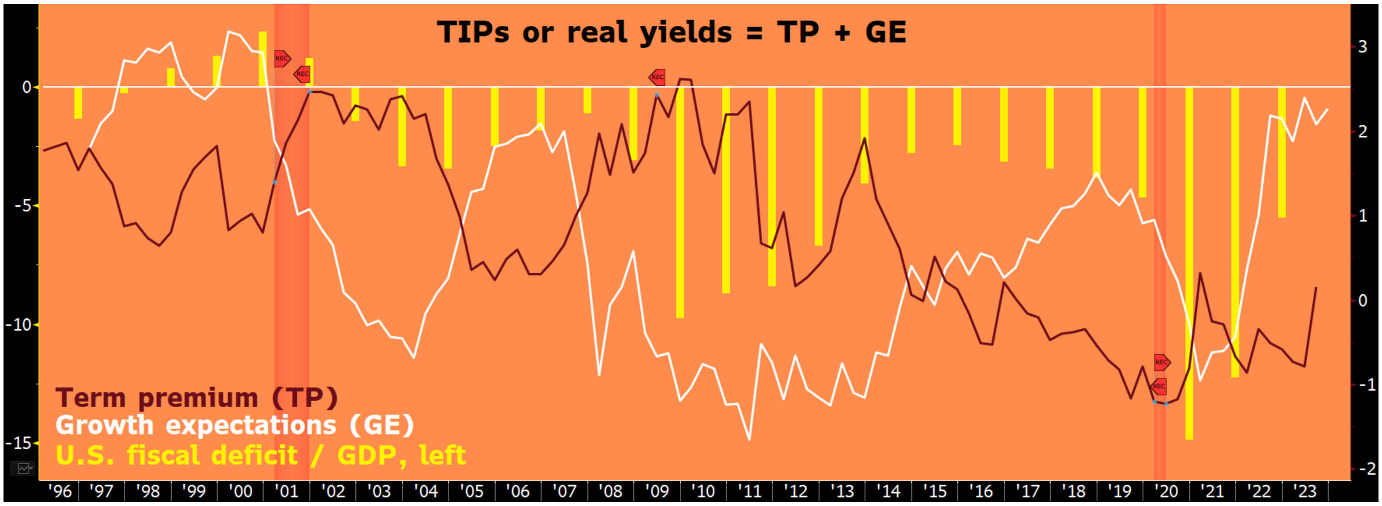
Source: Apollo Group

The almost 45-year graph above compares the willingness of loan officers to lend money to the consumer (orange line, left axis) against U.S. payrolls growth (green line, right axis). The shaded vertical bars mark recessions, the dashed vertical line on the right marks when the Fed began to hike rates and note the orange line is advanced six months against the green line. There's a solid logic and fit between these two lines that suggests the jobs market will finally slow down during 2024.



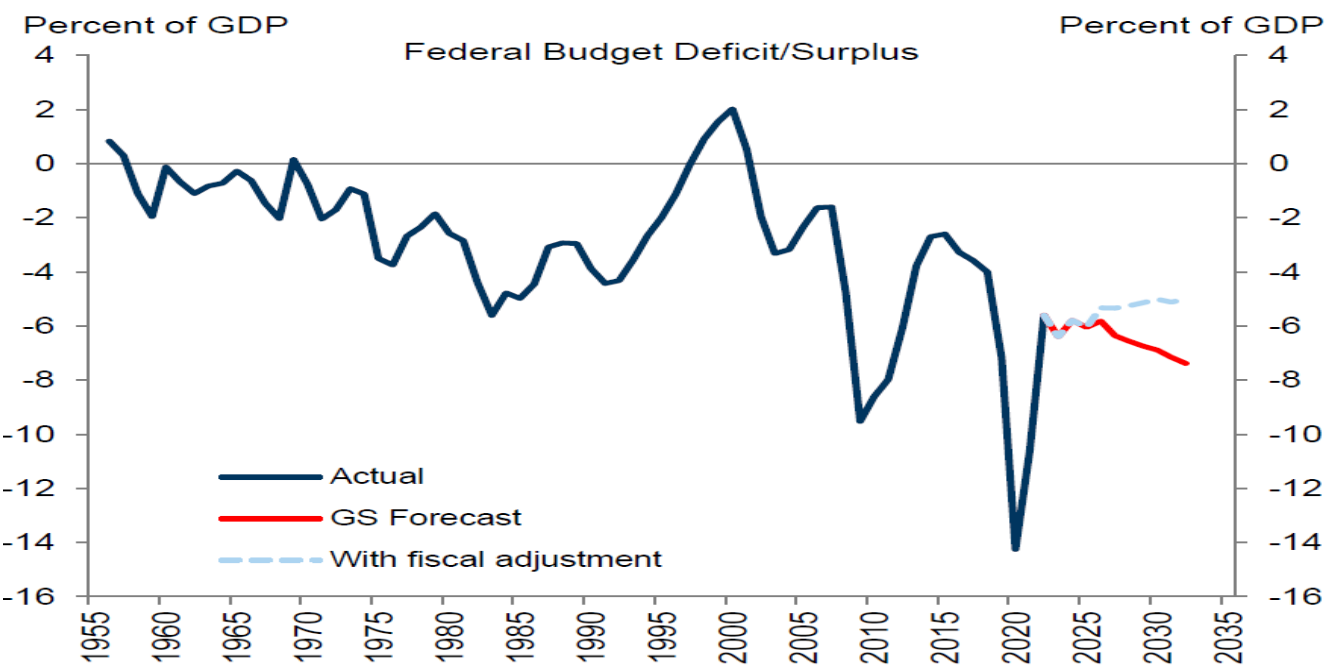
Source: Bloomberg

If that's the case, it's likely that consumer sentiment (red line, left axis) and the misery index (white line, right axis, inverted) in the almost 50-year graph above will both reverse course and serve as a precursor to reduced consumer spending. Consumer spending is upwards of 70% of the U.S. economy, whereas booming capital spending constitutes just 10% and real estate just 5%. Hence, unless consumer spending surprises markedly to the upside during 2024 (and don't expect any help from China or the E.U.), it's possible that only the lagged effect of Biden's fiscal stimulus could enable the U.S. to avoid a technical recession. Yet, even if a recession is avoided, the 'higher for longer' structure of interest rates is likely to persist and reverberate through financial markets via higher 'cap rates'.



Source: Bloomberg

With U.S. fiscal deficits pushing 6% next year (please see graph below) in a non-recessionary environment and the duration of America's US$33T of federal debt sitting at just over five years, we believe the supply vs. demand of bonds will keep interest rates on longer maturity bonds higher for longer. While the fit is crude to say the least, we believe this supply-demand issue plays a role in determining the 'black box' term premium ("TP") on USTs. In the above graph, notice how the TP (red line, right axis) moved higher when Washington went from surplus to deficit (yellow line, left axis) during 2000-2001 and again when the deficit skyrocketed during 2008-2009. Given the 'sea of red' expected into the fiscal future of the U.S, we expect the TP to be the key driver of 'higher for longer', long-term rates.



Source: Goldman Sachs

Nominal long rates will fall when the Fed ultimately cuts rates due to the slowing economy; however, the days of 2% to 3% yields on 10-year USTs are long gone. In turn, the valuation of all assets must be reassessed. The graph below clearly suggests equity valuations (red line, inverted) are out of whack with real rates (white line, right axis). At Forge First, our job is to generate a competitive net return AND protect your hard-earned capital when markets get rougher, and our recent results prove that's exactly what we're doing.

Source: Bloomberg

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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