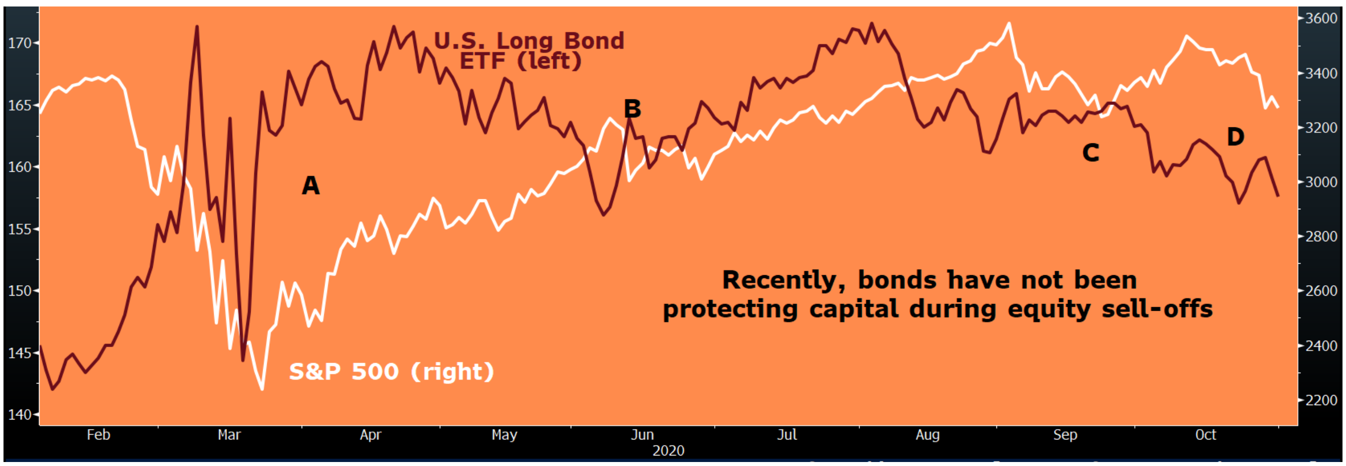
November 6, 2020

October 2020 Commentary

While U.S. election drama of the past couple of days causes last month to seem ages ago, as always this commentary will begin with a review of last month in markets and our funds.

Since its early September 2020 peak, the price of the S&P 500 had declined -8.7% through October 30th, including a -5.6% haircut last week. Catalysts for this end of month nosedive likely included the resurgence in COVID case counts, shutdowns in Europe, the lack of forward guidance from some mega cap companies, and shifts in U.S. election polling data that increased the odds of either a split government or contested election. One item that shouldn't have been the catalyst was the absence of fiscal stimulus from Washington, as who in their right mind expected a bipartisan deal right before the election? What was clear though, is that cash (and yes bitcoin!) was the only safe haven, as the graph below highlights that bond prices (red line) fell along with stock prices (white line). In fact, according to Bespoke Research, last week's action marked only the 24th time since 1962 that prices of both major asset classes have tumbled together.



Source: Bloomberg

Points A, B & C in the above graph highlight times earlier this year when bond prices rose as stocks fell. However, with markets becoming increasingly sensitive to mounting U.S. issuance, especially if there's a 'blue wave', it's possible that positive price correlation to the downside may become a more frequent event. Meanwhile, the graph on the below left indicates this recent rise in bond yields (yellow line plus white line equals red line) is being driven by higher yields on 'real' yields or TIPs (Treasury Inflation-Protected Securities, white line) as the yield on breakevens (yellow line) have been flat-lining of late. Disaggregating TIPs (yellow plus white equals red) in the graph on the right highlights that shrinking term premiums (white line) have driven the rise in real yields. In turn, these rising 'real' yields is a key reason why 'long duration' tech stocks lead last week's decline and may be in for more pain if it's a 'blue wave'.

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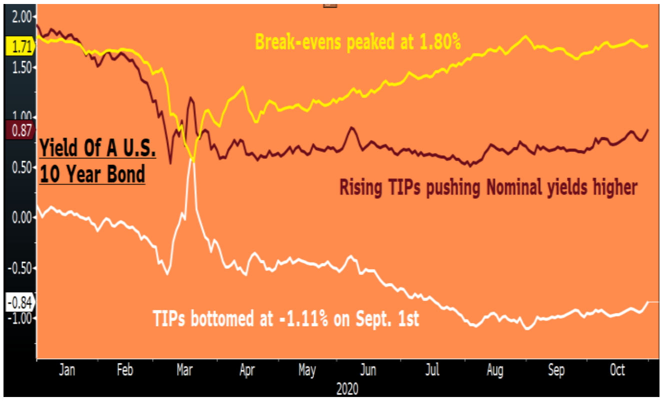

Source: Bloomberg

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Speaking of pain, the total return loss for the TSX last month was -3.11%, pushing its YTD total return loss to -6.11% versus a positive +2.77% for the S&P 500. In contrast, each of our two funds at Forge First added to their year-to-date gains with positive net performance during October.

						---------- Annualized ----------		
	YTD	1 mo	3 mo	6 mo	1 year	3 year	5 year	Inception
Forge First Long Short LP (Class F Lead Series)	6.47%	0.67%	2.02%	11.41%	13.50%	8.99%	7.51%	14.56%
Forge First Multi Strategy LP (Class F Lead Series)	8.93%	0.98%	4.71%	11.19%	11.86%	6.53%	5.56%	10.86%
TSX Total Return	-6.11%	-3.11%	-2.88%	7.13%	-2.30%	2.24%	6.07%	6.77%
S&P 500 Total Return (US$)	2.77%	-2.66%	0.37%	13.29%	9.71%	10.42%	11.71%	13.34%

Note: Returns for the Forge First funds are based on the August 2012 Class F Lead Series and are net of all fees and expenses. In a year, up to 12 series can be created within a Class of units. Unitholders are advised to refer to their monthly statement for the net return of their respective Class and Series. All returns are in local currencies.

As can be seen in the above table, the CL F Lead Series of the Forge First Multi Strategy LP (MSLP) gained +0.98% net for the month of October 2020. This multi-asset portfolio, a solid alternative for the capital preservation bucket of an investment portfolio, is now up +8.93% year-to-date, 11.86% over the past 12 months, and has delivered investors a 3-year compound annual return of 6.53%. The Sharpe ratio of MSLP sits at 1.50, while the fund features a negative downside capture of -13%.

During the month of October, two of the funds' three sleeves, capital growth and asset protection, generated positive returns, while the alternative strategies sleeve detracted from performance. Exiting the month, equity market weakness provided tactical opportunities add length to the capital growth and alternative strategy sleeves. As a result, at October 30th, the gross and net exposure of the fund were 147% and 72% respectively.

The net asset value of the CL F Lead Series of the Forge First Long Short LP (LSLP) advanced +0.67% net last month. such that its YTD return sits at +6.47%. The one-year net return of this more directional, long short equity fund stands at +13.50% while the 3-year net CAGR sits at 8.99%. Its Sharpe ratio is 1.61, while the negative downside capture of LSLP is -6%. Gross and net exposure exited October at 139% and 71% respectively.

A key contributor to the returns of both funds last month was our sleeve of listed options. As regular readers know, in addition to always including a diversified book of short positions in each of our portfolios, another ingredient of our disciplined recipe is the consistent use of index puts and other/related protective strategies.

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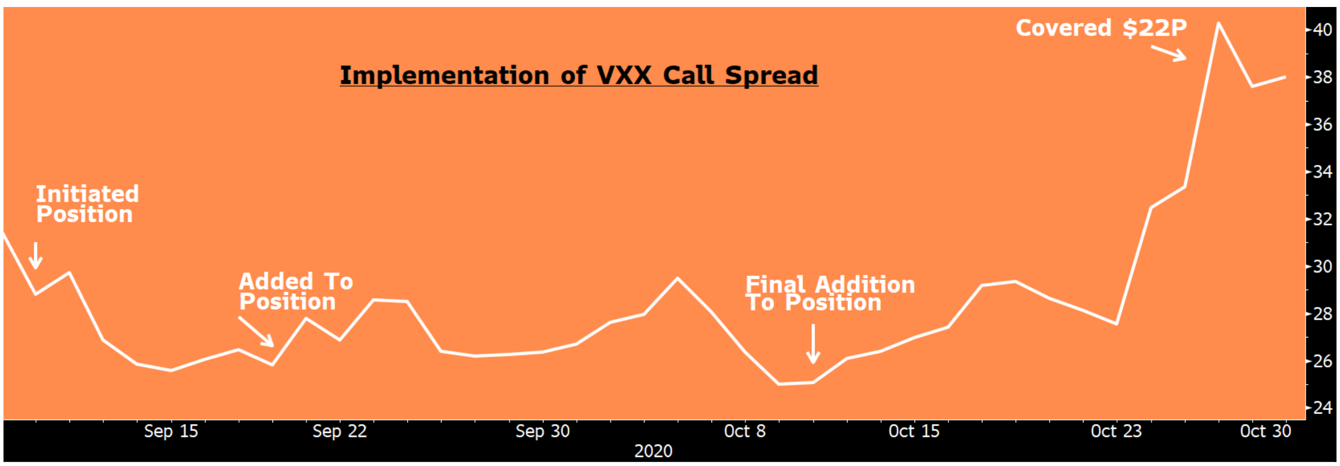
In my commentary for September 2020, I noted that our investment team believed that Fed easing was likely to remain the key medium-term driver of equities. That view, combined with our constructive attitude towards the fundamental business outlook for our largest long positions, caused us to seek alternative ways to hedge election event risk versus cutting exposure. Each fund strapped on a call spread on the VIX index that expires 2.5 weeks after the U.S. election. Let me explain why this position worked well last month.

The VIX or volatility index represents the market's expectation of 30 day forward looking volatility. Derived from the price inputs of S&P 500 index options, it provides a measure of market risk and the sentiment of investors. Expectant of the potential risk of a contested election, in early September the investment team purchased a call spread on the iPath Series B S&P 500 VIX Short-Term Futures ETN (VXX.US), the listed security that represents the vehicle to 'play' (don't think the word 'invest' is appropriate) the VIX. We purchased November $26 calls, sold November $50 calls, and shorted November $22 puts (the price of these contracts is based on the volatility on S&P 500 index options for December). Given that we used a combination of long and short positions to implement this trade, plus the fact that we opportunistically legged into this trade over time (as shown on the graph below), we were able to limit the total cost of this protection to 0.13% in contrast to the significant upside potential of this trade.

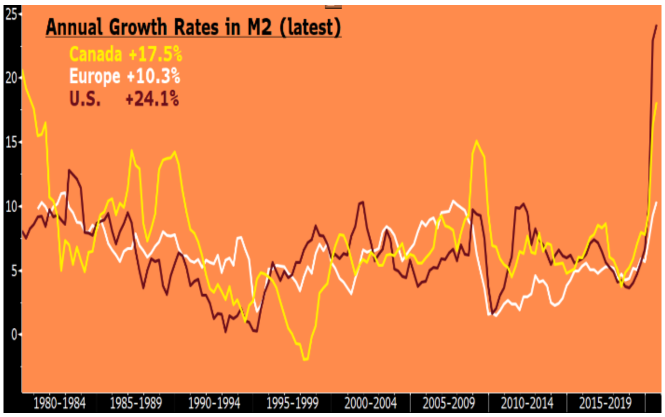


Source: Bloomberg

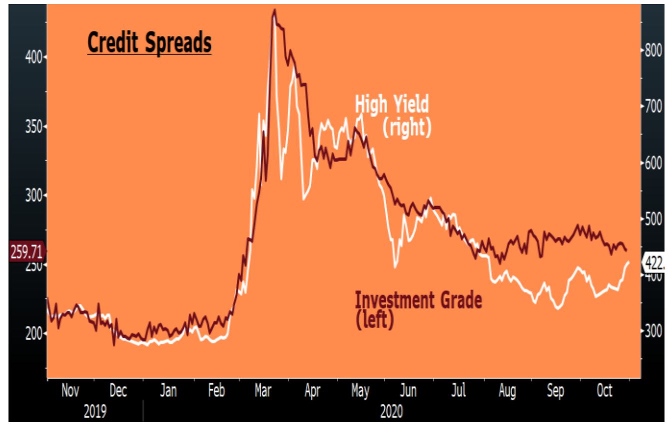
Then last week, pricing action in equities exhibited a rising absolute level of volatility as the VIX climbed from 25 to 40. This spike in volatility enabled us to reduce our cost in the trade by covering the $22 put at a profit, while maintaining the other two legs of the trade. Clearly FOMO sentiment had given way to an appetite to hedge against the virus, in addition to uncertainties towards the election and the economy. Even on November 1st, a strong day for equities, the VIX remained elevated at 37, suggesting conviction was low and the chances of being wrong, whatever one's politics or positioning, was viewed as being higher than 'normal'.

Other significant positive contributors to the performance of the funds were holdings in the Consumer and Utility sectors. For example, our largest position, and longest held holding I might add, at five years and counting, Enviva Partners (EVA.US), a master limited partnership, continues to benefit from its visible, double digit growth and environmentally friendly profile. On the consumer side, our longest held position in the marijuana sector, the highly profitable U.S.-based Trulieve (TRUL.CA) moved higher on election hopes and in response to a nicely accretive acquisition.

On the other side of the equity ledger, Industrials, that mixed bag sector of businesses, clipped the funds for some basis points while the Materials sector generated the largest loss, as gold equities endured continued selling after September's large sell-off in the shiny metal. Speaking of that shiny metal, in last month's commentary I attributed much of the selloff in gold to the lack of news on the Fed's plans for QE at its September meeting. I remain of the mind that it's only a matter of time until the Fed extends QE, shifts its buying out the curve and further expands money supply (M2).

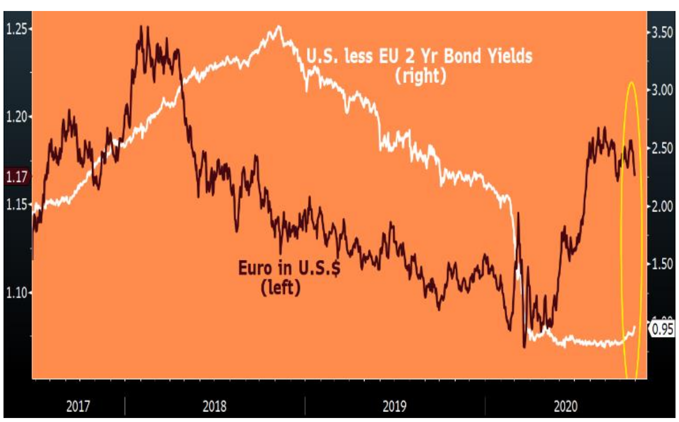


Source: Bloomberg



Source: Bloomberg

To that end, Fed Governor and potential future Treasury Secretary, Lael Brainard, recently stated that it was "important" to commit to a path of "lowering borrowing costs along the yield curve". I doubt a Central Banker could be more overt in indicating their intentions that the printing of money will continue. Consequently, with a strong manufacturing and housing recovery, incremental fiscal stimulus being inevitable, and the Fed 'all in' (see M2 growth rates in the graph on the above left), it's not surprising that Investment Grade (IG) credit spreads continue to narrow. That's shown with the red line in the graph on the above right while the white line highlights that high yield spreads are widening, albeit only marginally. But continued Fed largesse implies that a) the FOMC will draw a 'line in the sand' as to how high they'll let yields on UST 10s go, plus b) yield differential versus Eurobonds won't widen that much. As a result, the white line in the graph on the below left, which represents US 2-year yields less the EU equivalent, is likely to stay low relative to the past few years and explain why FX traders believe the Euro in terms of the USD, the red line inside the yellow oval, can grind even higher. I've got my doubts on that one for two reasons.



Source: Bloomberg

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First, in contrast to the euro bulls, I've always questioned how strong the resurgence in European growth and inflation had been in the first place, but the recent resurgence in COVID-19 will certainly push sequential quarterly growth substantially negative in Q4. The underperformance of the Euro Stoxx 50 index (white line) in the graph on the above right against the S&P 500, excluding the 'big 6' stocks, is discounting Europe's latest recession. Further, with government support now less generous and funds from the much ballyhooed EU750B recovery fund still quarters away, significant job cuts are likely and of course, once again, the ECB will attempt to come to the rescue.

At last week's press conference, ECB Chair Lagarde made it quite clear she's opening the ECB's floodgates (once again) at the December meeting. Societe Generale expects her to table an additional EU2T of 'alphabet soup' credit programs (APP, PEPP, TLTRO). However, the question is whether this latest round of stimulus will even matter. While the graph below is

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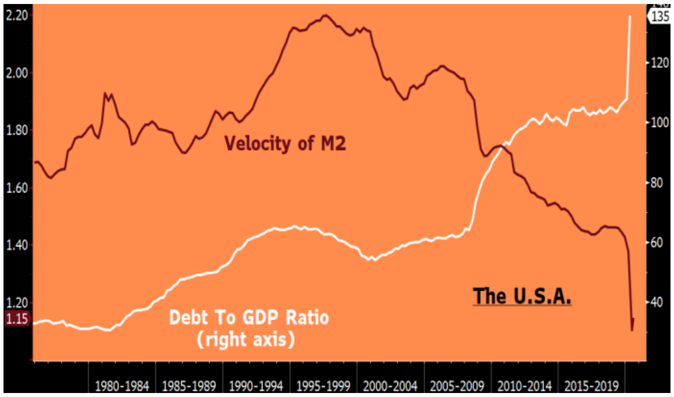
of the U.S. not the EU, the picture looks the same for both economies, falling money velocity (GDP divided into money supply) and a rising debt to GDP.



Source: Bloomberg

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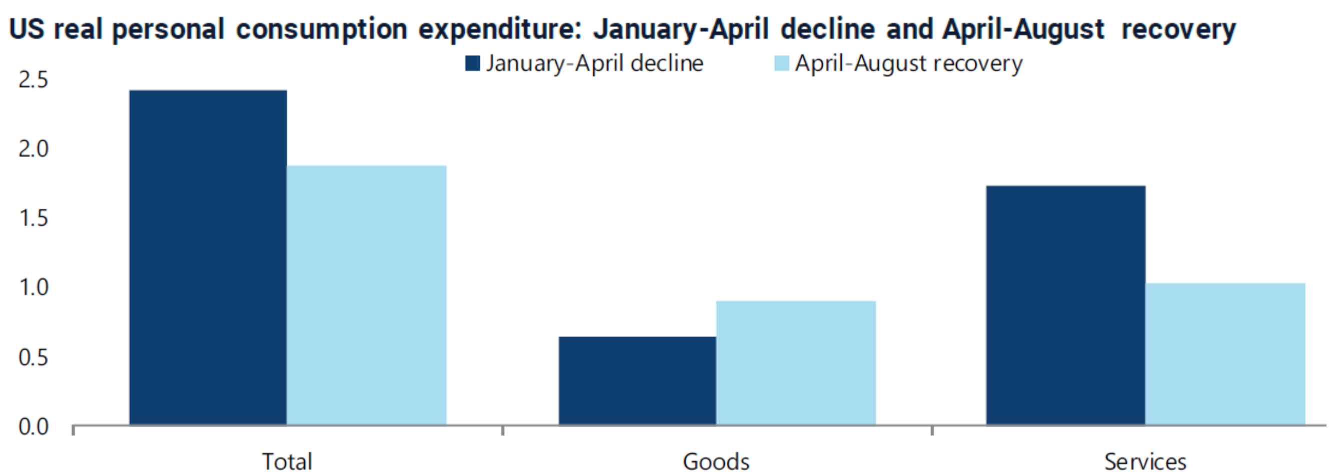
Consequently, while I acknowledge the logic of another leg down in the USD, I believe such a continued decline is more likely against north Asian currencies whose economies have largely recovered from the virus, especially China and its RmB, as shown in the graph on the above right, as opposed to currencies such as the Euro.

Regardless, it's this largesse that continues to explain why our funds continue to own gold stocks, the latest 'kids on the blocks' when it comes to dividends.

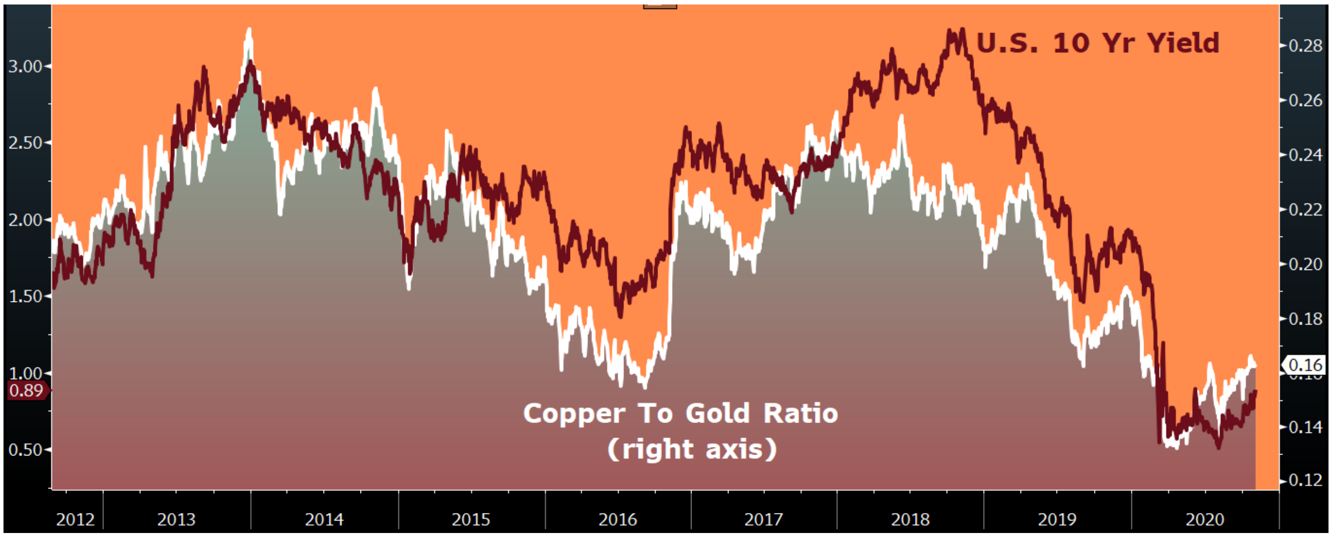
As for the economic recovery in the US, previous commentaries have discussed our bullishness towards US housing and the consumer, with the table below explaining why our holdings continue to be biased towards the goods economy. Portfolio holdings in the consumer sector include Home Depot (HD.US), Best Buy (BBY.US), Aritzia (ATZ.CA) and recent additions Tapestry (TPR.US), the owner of Coach, and Molson Coors (TAP.US).



Source: U.S. BEA

Notwithstanding this continuing bullish stance towards the consumer, over the past couple of months, our funds have begun to gradually shift their equity mix to hold a more cyclical bias, though I'd note this adjustment has been more pronounced in the LSLP than the MSLP. With China printing economic statistics that are back to or above 2019 highs, the Fed's foot remaining on the pedal plus presumably some level of fiscal stimulus to come, we see upside in resource and industrial securities. Also, in the case of copper, we see supply challenges crashing into the incremental demand arising from the push towards alternative energy and transportation. The copper to gold ratio looks poised to climb higher.

Freeport McMoran (FCX.US) has been our 'go to' name to date, but we've started to increase our allocation to the metals space.



Source: Bloomberg

Of course, the funds continue to hold a healthy cohort of secular growth stocks including Microsoft (MSFT.US), VISA (V.US), Home Depot (HD.US), MSCI Global (MSCI.US), Best Buy (BBY.US) and Nuvei Corp (NVEI.CA), to name a few. In contrast, the capital growth sleeve of the Multi Strategy LP also owns shares in Amazon (AMZN.US).

Looking ahead, COVID continues to be a tail risk for markets though our analysis has made us hopeful that shortly we'll hear news of a proliferation of rapid-testing and announcements on vaccines. Don't get me wrong, we're aware availability, especially of vaccines, doesn't guarantee rapid availability and utilization; however, both should facilitate the start of a swing back towards normalcy and outperformance by 're-opening' related securities including the Air Canada (AC.CA) convertibles that are held in the funds.

As for the U.S. election, there's little question that Tuesday's results delivered each of the 3 wildcards that investors had been thinking could happen: 1) the potential for a contested election, 2) a split Congress and 3) the potential of a Trump win.

As I'm writing this commentary, the race for the Presidency sits at 264 for Biden versus 214 for Trump. It appears Biden could win the White House, yet with the GOP maintaining control of the Senate and the current composition of the Supreme Court, Biden might have a darn tough time getting much done. If a split government is the outcome, Biden will have to carefully select which files he'll go to the wall for so as to attempt to position the party to win control of the Senate two years from now. This party goal suggests he won't aggressively target America's strength (versus China) in tech, but will focus on health care. Action in financial markets during the past couple of days appears to acknowledge that substantive change in taxation and regulation is unlikely. As for Canadian-US relations, while Mr. Biden is undoubtedly a more predictable individual to negotiate with versus Mr. Trump, but like Trump, Biden's very much a 'Buy America' person, hence our Federal government will have its work cut out for it.

Shifting to markets, regardless of the size of the U.S. fiscal stimulus that ultimately gets tabled, U.S. debt issuance will remain enormous, forcing the Fed to step in so as to keep long rates low. Hence, other than the occasional tactical trading opportunity, cash is preferred to bonds or GICs. As for stocks, 15 months from now when GDP growth normalizes, debt and demographics is likely to cause the rate of growth to be at or below pre-COVID levels. During the interim period, we foresee a tactical, sector rotation driven trading opportunity with cyclical stocks arising from this combination of a hyper-cooperative Fed, fiscal stimulus, and the high probability of gridlock in D.C. As mentioned, we're positioning the funds to benefit from that prospect. However, further out, a return of inflation and accelerating earnings growth isn't obvious, hence the leadership of growth stocks is likely to return. But with those valuations already rich, it's tough to get excited about the potential returns offered by equity indices. That's why owning proven hedge fund strategies featuring high Sharpe ratios and negative downside capture make so much sense.

Thank you for your continued interest in our funds. Please visit our website at www.forgefirst.com for information on our funds or contact us at 416-687-6771 with any questions.

Thank you,

Andrew McCreath
President and CEO

Daniel Lloyd
Portfolio Manager