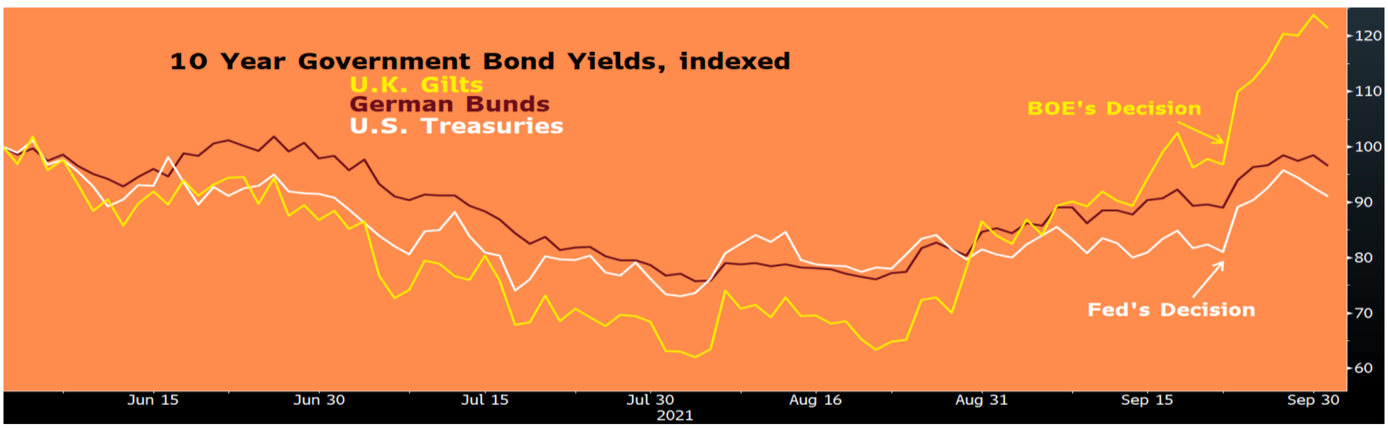
October 7, 2021

September 2021 Commentary

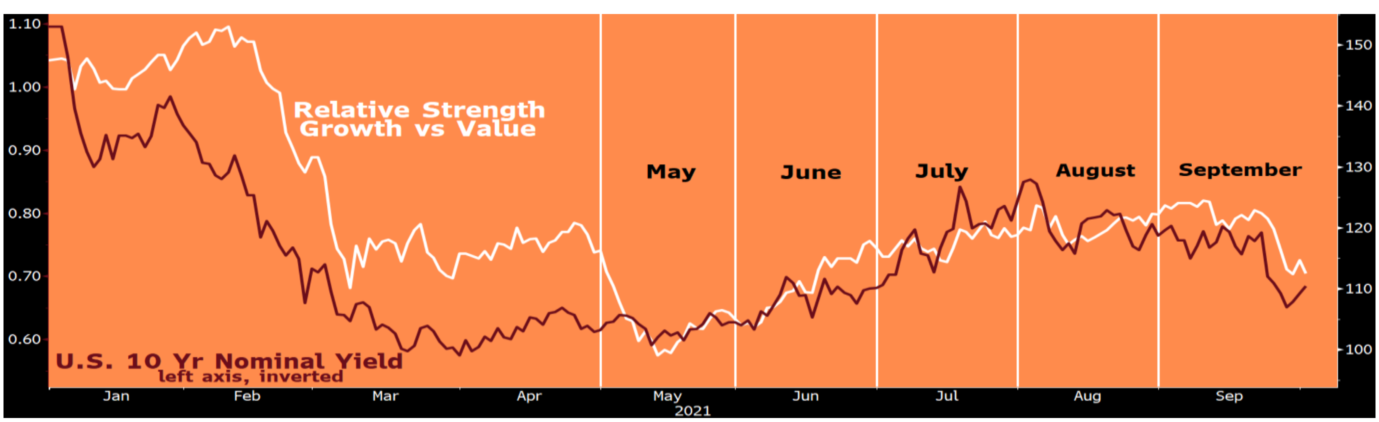
Last month's commentary stated that "we now view markets as being expensive, with an increasingly asymmetrical risk/reward outlook when peering out over the next 12 months". The S&P 500 had been trading comfortably north of 20X forward EPS amidst signs that monetary accommodation had peaked and a material retrenchment in fiscal stimulus was forthcoming. Our investment team proceeded to tactically reduce the net exposure of each of our two funds, resulting in solid net gains for the month of September.

September opened well, with the S&P posting its 54th new closing high of the year, yet ended the month with its first losing month since January and worst month since March 2020. While investor concern towards the supply chain and D.C. debt ceiling issues that we discussed last month continue to linger, a hawkish shift by Central Banks was the principal catalyst pushing stocks lower during September. During the afternoon of September 22nd, the FOMC tabled a potential schedule for tapering, late 2021 through mid-2022, and interest rate 'lift-off' in late 2022. The market initially accepted the two schedules with a slight decline, until the next day when the Bank of England (BOE) issued a downright hawkish decision.



Source: Bloomberg

With the British economy more structurally geared towards supply chain issues and energy shortages than most major economies, post the UK's Monetary Policy Committee's decision on the morning of the 23rd, as seen by the yellow arrow on the right side of the above graph, markets promptly moved forward its expectation for the first interest rate hike to occur in February 2022. The response in U.S. markets was swift, with the yield on a U.S. 10-year bond climbing 25 basis points (white line), from 1.30% to 1.55% in four trading days. The rapidity of this spike higher in yields spooked equities. Throw in the upward reacceleration of energy prices and the graph below highlights that cyclical stocks outperformed growth stocks amidst rising yields (inverted red line) and a very weak September equity tape.



Source: Bloomberg

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						---------- Annualized ----------		
	YTD	1 mo	3 mo	6 mo	1 year	3 year	5 year	Inception
Forge First Long Short LP (Class F Lead Series)	15.06%	1.59%	0.38%	7.92%	29.28%	13.67%	11.62%	16.14%
Forge First Multi Strategy LP (Class F Lead Series)	11.80%	1.25%	0.97%	4.78%	25.04%	11.87%	9.12%	12.31%
TSX Total Return	17.48%	-2.22%	0.17%	8.73%	28.02%	11.07%	9.64%	9.35%
S&P 500 Total Return (US$)	15.92%	-4.65%	0.58%	9.18%	30.01%	15.99%	16.90%	15.52%

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 displayed in the above table, the Class F Lead Series of our multi-asset Multi Strategy LP delivered a net return of +1.25% for the month of September, boosting its year-to-date net gain to +11.80%. Investors that share our concern about a shifting risk/return outlook for equities may find appeal in the stability of this fund.

Profits during the month were generated in each of the three sleeves of the fund: capital growth, multi-asset and asset protection. Equity index puts are a staple holding of the Multi Strategy LP; however, early in September, the notional exposure to index puts was increased. As a result, sector and index protection contributed handsomely to the profits earned during the month. These same option positions reduced the net common equity exposure of the fund at month end to 15%. At the time of writing this exposure, it was closer to 10%. Energy stocks fuelled gains in the capital growth sleeve of the portfolio, while rising interest rates boosted the value of the rate-reset preferred shares held in the multi-asset sleeve of the fund. Total gross and net exposure of the Multi Strategy LP exited September at 128% and 28% respectively.

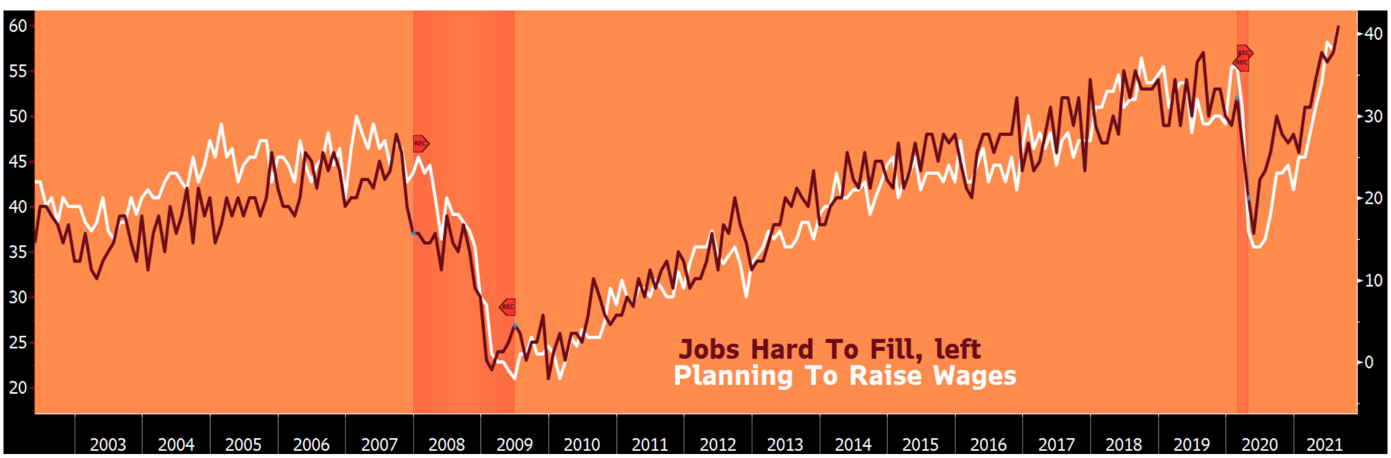
Our Multi Strategy LP is tasked to exhibit low volatility, running at 4.94% annualized on a year-to-date basis, and hence holds lower exposure to cyclical stocks than our more directional Long Short LP. For example, during the month, the Multi Strategy LP held a roughly 4% net exposure to energy stocks versus the 10%-11% net exposure held in our Long Short LP.

In fact, speaking to the long-held constructive nature towards oil and gas stocks that regular readers will be familiar with, that level of net energy exposure in our Long Short LP constituted almost one-half of the fund's end of month overall net exposure. As a result, it will be no surprise that equities in the E&P sector accounted for the majority of +1.59% net return for the Class F Lead Series of our Long Short LP last month. September's performance boosted the year-to-date net return of the Class F Lead Series of our Long Short LP to +15.06%. A review of other sectors shows small losses in each of Technology, Materials and the Consumer sectors. This fund exited the month with gross and net exposure of 140% and 22% respectively. Two months ago, that net exposure was 50%.

Both of our funds remain conservatively positioned, due to our belief that several factors will continue to fuel near-term choppiness in equities. Short-term considerations include the debt ceiling issues faced by Washington, with October 18th being pegged, by Treasury Secretary Yellen, as an important date. While one assumes the two parties will resolve this vital issue, the implicit tail risk is too high to hold anything shy of a prudent stance. Also, with quarter end out of the way, it's probable that supply chain and profit margin issues will raise their ugly heads, as more companies warn about upcoming earnings reports.

Source: Bloomberg

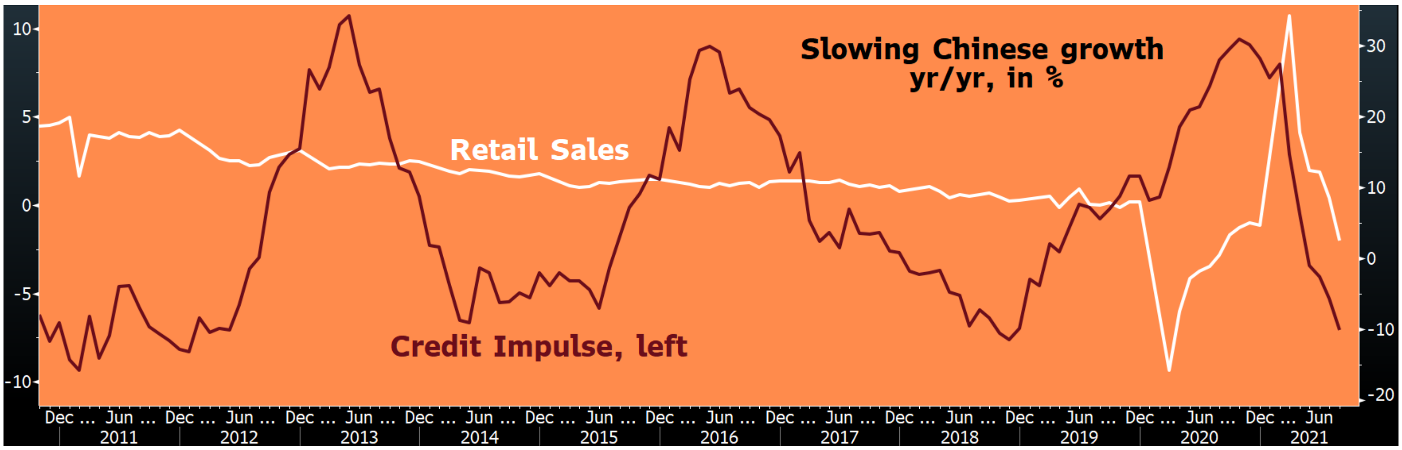
During the past couple of weeks, each of the Sherwin-Williams Co. (SHW.US) and FedEx Corp. (FDX.US) revised earnings guidance lower due to their continuing inability to hike prices enough to offset the rising cost of inputs. Past commentaries have described our concern that, among other issues, the 'internetization' of the economy will make it increasingly difficult for companies that are not monopolists, duopolists or oligopolists to maintain profit margins in the current environment. Albeit a crude proxy for future profit margins, the far right side of the red line in the above graph identifies that CPI less PPI, both ex-food and energy, is deeply negative, meaning input costs are running at 273 basis points higher than output prices. In addition, the white line on the same graph indicates that U.S. companies are receiving new orders but can't produce the products, confirming that supply chain issues continue to hold back the revenue line of many companies. Less revenues at lower margins implies rising earnings risk, which in turn suggests rising price dispersion between equities; a fertile environment for proven long short equity managers.



Source: Bloomberg

While supply chain issues are likely to remain more stubbornly persistent than most observers expect, it's the labour market that holds the key to whether the Fed's 'transient' inflation migrates into the more dastardly 'demand-pull' inflation. If employers have to up the wage ante more than expected to hire workers, that extra income could cause aggregate demand to rise faster than productive capacity, creating the type of inflation that would cause markets to realize the Fed is far behind the curve! We suspect it will be late Spring 2022 before we learn whether this happens to be the case. However, and while we're not trying to be alarmists, the 20-year survey graph right above is worrisome. The red line suggests 60% of companies are experiencing the most difficulty in hiring workers this century. Likewise, the white line indicates that 40% of companies intend to boost wages. We're hopeful that a rising participation rate will prevent a wage spiral from happening. Yet, it's important to remember that demand-pull inflation is a tail risk that few investors we speak to are taking into consideration when structuring their portfolios.

As for the likely market impact of the start of the Fed's tapering process during November, three points merit consideration. First, while the pace and sizing of the expected program remains unknown, in the grand scheme of liquidity, this reduction should be a manageable amount. Of course, assuming the debt ceiling issue gets resolved, investors should expect the U.S. Treasury to issue up to US$750B of bonds (coupon securities) in short order with one less, big buyer not being at the table. Finally, where along the curve the Fed chooses to act could generate rate volatility depending upon the hedging programs held by mortgage and municipal bond investors. Our view is that the near-term uncertainty described earlier could cause bond yields to retrace part of their recent increase; however, the amount of forthcoming net issuance is likely to push yields to new highs. We would add that the majority of that increase is likely to be seen in real yields versus breakeven yields; a potential challenge for growth stocks relative to value-based equities.



Source: Bloomberg

Given the declining trajectory of U.S. growth, a final issue for markets to contend with is the slowing rate of economic growth in China. While we expect additional monetary accommodation and a degree of fiscal stimulus prior to the Beijing Winter Olympics, it's crystal clear that China's days of massive fiscal stimulus are in the rear-view mirror. As a result, readers should not get overly optimistic that the slowing credit growth (red line) and retail sales (white line) shown in the graph above are destined for sharp rebounds in the near term.

At the same time, what's mattered most for stocks is the sea of liquidity, a variable that will remain ample into 2022. Hence, while the funds are defensively positioned at this juncture, our team will remain vigilant of the potential for improving market conditions as we move towards that latter part of October.

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.

Thank you,

Andrew McCreath
President and CEO

Daniel Lloyd
Portfolio Manager

Keenan Murray
Portfolio Manager

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