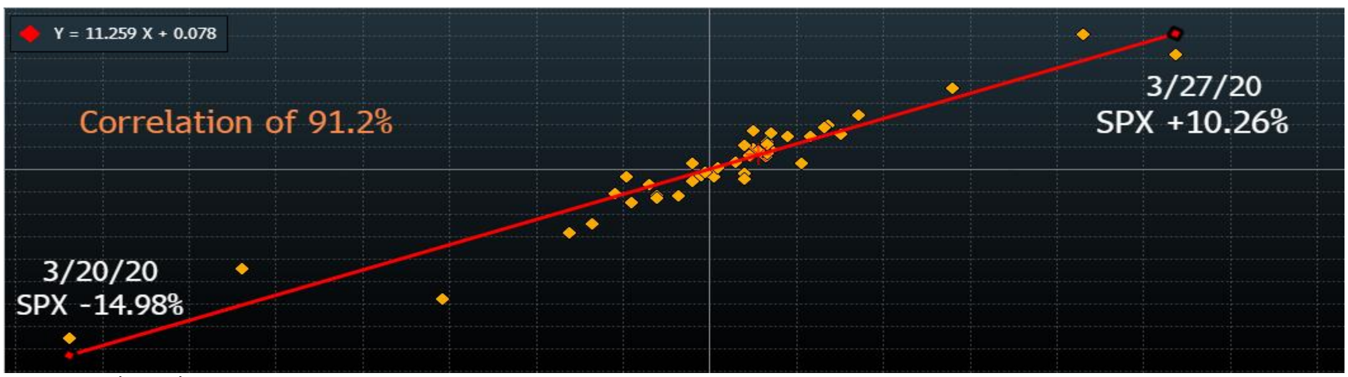
January 12, 2021

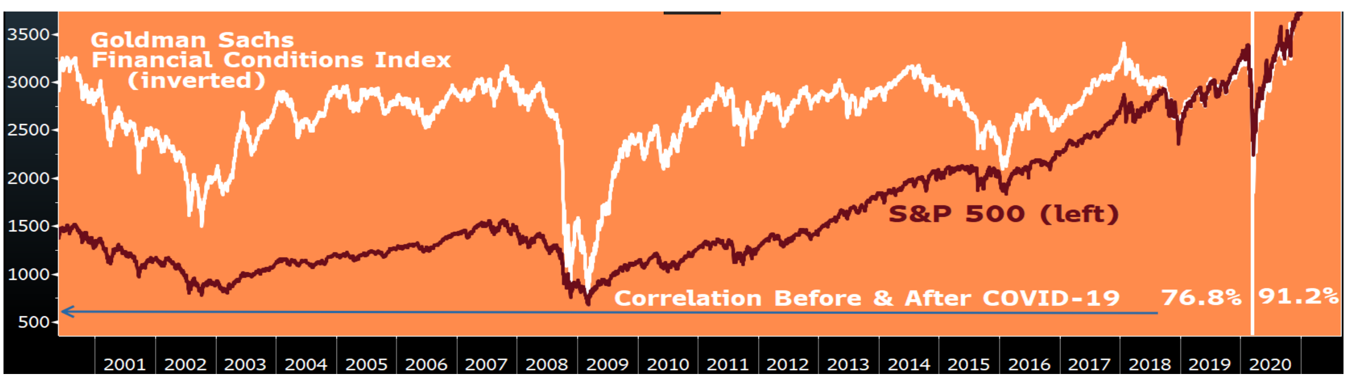
December 2020 Commentary

Happy, or should we say Hopeful, New Year has rarely seemed such an apt phrase. Obviously 2020 was a horrendous year for the majority of people, hence it's good to have the last 10 months in the rear-view mirror. Entering 2021, hope that both society and the economy will evolve towards normalization in as timely a fashion as possible is a widespread theme. Ironically, it was a record year for financial assets, as Wall Street feasted while the rest of the world suffered. Governments everywhere tabled previously inconceivable amounts of fiscal stimulus, while monetary authorities definitely delivered on Draghi's maxim of "doing whatever it takes". Almost instantaneously this combination of adrenalin, estimated by Cornerstone Macro to equal 32.9% of global GDP, transformed the outlook for financial markets. In our minds, it was monetary action that mattered most for stocks.

The graph below illustrates that from late February 2020 through last Thursday, the weekly correlation between the S&P 500 (SPX) and the Goldman Sachs Financial Conditions Index (GSFCI) has been 91.2%. We would point out that stock prices hold a 4.9% weight in the GSFCI. The next graph provides a 20-year picture of both the SPX and the GSFCI. In this 2nd graph, the area to the left of the white vertical line on the right side represents the 20 years prior to February 2020. Note the 76.8% correlation during this period vs the closer fit of the most recent timeframe.



Source: Bloomberg



Source: Bloomberg

Stimulus enabled 2020 to be a record year for stocks. From its Feb. 19, 2020 pre-COVID-19 high, the SPX proceeded to post 20 new closing highs (33 for the full year), including ending the year at a new high for the 8th time since 1928. Interestingly, the year posted both a 'bear' (Feb. 19 to Mar. 23, down -33.9%) and a 'bull' (Mar. 23 onwards, +67.9%) with both the declines and the gains being uneven, as the quick economic shift catalyzed by the virus causing many service industries to shut down while other 'at home' services and merchandise benefiting handsomely. Over time, as the recovery spread, market breadth improved, turning positive in November. Despite this shift, Apple (AAPL.US), Microsoft Inc. (MSFT.US) and Amazon (AMZN.US) accounted for over 53% of the total return for the SPX during 2020; in fact, absent the top 30 contributors, the index closed modestly negative (-0.03%) on the year. Here at home, it will come as no surprise to market watchers that Shopify Inc. (SHOP.CA), the largest market cap stock in Canada ($168.8B versus Royal Bank's at $152.1B) was the biggest driver of the TSX. Up 2% for the year, without SHOP, the price of the TSX would have declined by -1.9%. Sector-wise, Technology (fueled by SHOP) gained 80.3%, Materials (almost equally between base metals and golds) advanced 19.5%, and

Industrials increased by +15.3%. Thanks to their end-of-year run, the price of Bank stocks only fell -1.6% on the year while dividends pushed the total return of this key group to a positive +3.58% well shy of the +8.69% return provided by the Canadian government bond index. Pot stocks and the energy index were the biggest losers, with oil and gas stocks falling -25.5%, in contrast to our energy book which has made money in each of the eight years we've been in business.

Speaking of our funds, we are pleased to report that each of our Forge First funds delivered solid risk-adjusted net returns for December 2020 and the full year. For the month of December, the Long Short Alternative Fund, Series 'F' advanced +2.77% net of fees, boosting its full year net return to +15.78%. The gross and net exposures of the Long Short fund at year-end were 125% and 53% respectively. As discussed in previous commentaries, slowly but surely over the past few months the Long Short fund has been migrating its net exposure to feature a more cyclical, value-oriented tilt. Entering 2021, the fund held a 10.3% net exposure to Energy, 10.9% to Materials and 6.5% to Industrials. The net allocation to Technology is below 10% for the first time in a long time. Meanwhile, the fund holds a healthy exposure to the "opening up, fiscal stimulus" trade given the 16.1% net long position in the Consumer sector.

	YTD	1 mo	3 mo	6 mo	1 year	Since Inception*
Forge First Long Short Alternative Fund Series A	14.67%	2.69%	10.06%	14.31%	14.67%	18.31%
Forge First Long Short Alternative Fund Series F	15.78%	2.77%	10.31%	14.81%	15.78%	20.15%
Forge First Conservative Alternative Fund Series A	16.52%	3.61%	9.98%	15.40%	16.52%	17.74%
Forge First Conservative Alternative Fund Series F	17.56%	3.70%	10.24%	15.94%	17.56%	19.54%
TSX Total Return	5.60%	1.72%	8.97%	14.13%	5.60%	10.50%
S&P 500 Total Return (US$)	18.40%	3.84%	12.15%	22.16%	18.40%	32.21%

***Inception: April 24, 2019**

Our second fund, the lower volatility Forge First Conservative Alternative Fund, Series 'F' gained +3.70% during the month of December such that for the full year, this multi asset portfolio returned +17.56% after fees to its investors. Gross and net exposure for this fund closed the year at 120% and 49%. This net exposure was split between the 37.3% net long position in the equity or capital growth sleeve, the 13.9% net exposure to credit and preferreds plus the 8.3% holding in SPACs which together totalled a 22.3% to the alternatives sleeve, and a -10.5% net positions in listed options, the asset protection sleeve of this multi asset portfolio. The net allocation to equities closed the year lower than it was at the end of November, as allocations to several positions were reduced as prices appreciated. Also, the fund increased exposure to rate-reset preferred securities last month, as besides offering attractive running yields, these instruments offer significant upside potential in the event government bond yields rise. Finally, the fund maintained its long position in high-yield credits against a short position in government bonds.

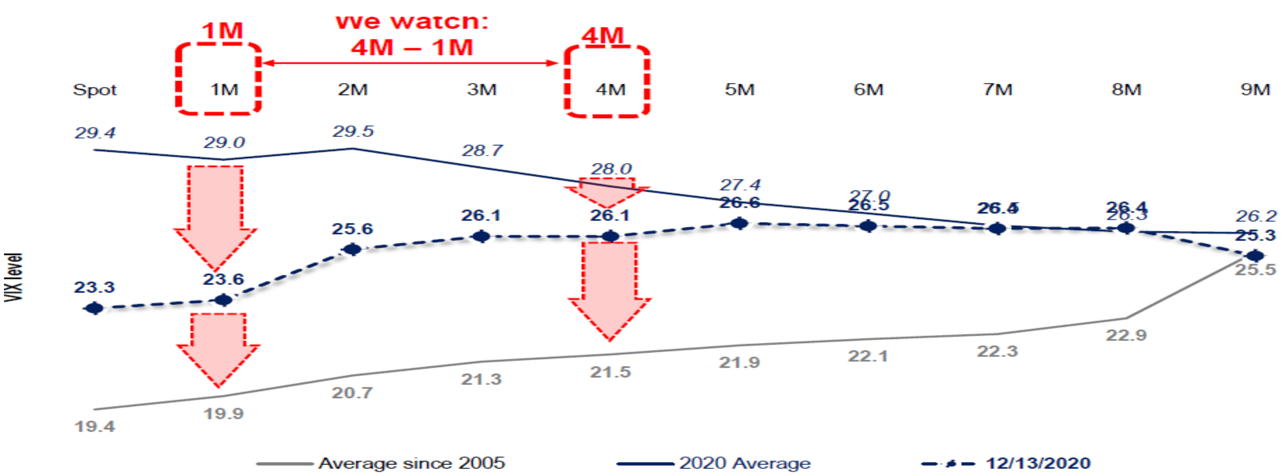
Shifting to the attribution for the funds, the somewhat counterintuitive combination of Materials and Technology were the largest contributor to the performance of the Long Short Alternative Fund and the equity sleeve of the Conservative Alternative Fund. Positions in Nuvei Corp. (NVEI.CA), Microsoft Corp. (MSFT.US) and Morningstar Inc. (MORN.US) fuelled the gains in the Tech bucket, while holdings in Freeport McMoran Inc. (FCX.US), MEG Energy Corp. (MEG.CA), Interfor Corp. (IFP.CA) and Major Drilling Group Inc. (MDI.CA) catalyzed a solid contribution from the Materials sector. Favourable consideration should also be noted to positions in the Financials, Industrials and Consumer sectors. Energy was flat for the month as gains in oil stocks were offset by hedging costs and weakness in gas stocks, while our ETF and listed index put hedges detracted from performance.

While a few days into a month certainly doesn't make a trend, we're pleased with how the portfolios have performed in light of last week's surprise decision from OPEC+ and the outcome of the Senate run-off in Georgia. We continue to be of the view that the near-term setup for stocks remains good given the 'market nirvana' combination of open-ended stimulus and the pending recovery in earnings. While we expect cyclical and value-oriented stocks to outperform 'high growth, momentum' stocks during the next several months, neither do we see interest rates climbing enough to cause a stampede away from these heavily weighted securities. However, assuming 'things go according to plan', by late Spring 2021 valuations are likely to have become stretched, causing price dispersion to increase during H2 of the year, forcing investors to become more discerning in their security selection. Of course, such a scenario would be marvellous for stock pickers that go both long and short.

The biggest risk facing markets is a bearish change in stance by the Fed. Such a policy shift would most likely be triggered by the economic recovery being markedly stronger than expected (triggering fears of future inflation), or less likely by a price mania in financial markets. Such a policy shift could be reflected in a couple of ways. First, the pricing of Fed Futures could shift, so as to imply that interest rate 'lift-off' would occur sooner than expected. Second, members of the FOMC could openly discuss the Fed's intent to transition from QE to QT. Neither of these events is likely for the foreseeable future. Prior to discussing these medium-term risks to markets, first let's review two incremental near-term upside drivers of stocks.

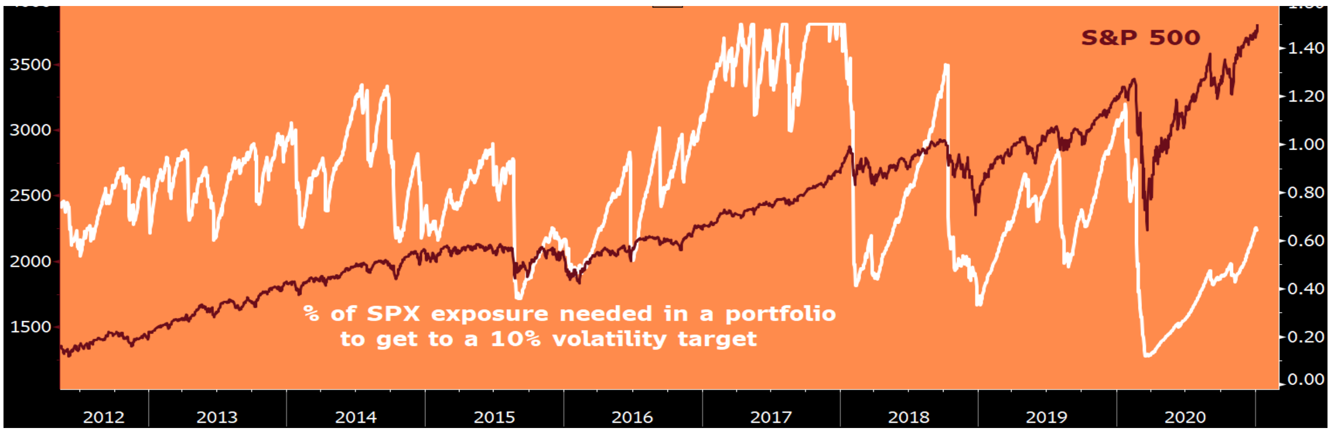
While pundits opined that a divided government in Washington would be best for markets, it strikes us that the unified government we've ended up with provides the perfect recipe ('goldilocks'). The Democrats now control the Senate, but just barely. Consequently, I'm sure the Democrats already have their sights on gaining more Senate seats in the 2022 mid-terms. Hence, it's in Biden's interest to keep his foot on the pedal of fiscal stimulus so as to ensure strong growth through that time frame. It also suggests that aside from acceptable bipartisan corporate tax hikes, it's unlikely the Democrats will seek broad, across-the-board increases in taxation. Further, be it broader tax hikes, material changes in regulation or other divisive policy issues, any such items are likely to be stymied by the 50/50 split in the Senate, as centrist Senators from either party have the power to make or break legislation. As a result, rates of economic growth under the new Administration are likely be better than envisioned under the 'divided government' scenario and the composition of growth should add fuel to the rotation towards cyclicals.

Another probable positive near-term factor for stocks relates to the flow of funds. I'm sure many of you have read that certain funds managed by high profile money managers such as Ray Dalio's Bridgewater & Associates had a tough 2020. Bridgewater is the one of the largest hedge fund companies in the world. Instead of constructing a portfolio to target a certain net return, many of these very large funds construct a portfolio that will exhibit a targeted volatility or standard deviation. This strategy implies that when equity volatility is high (and vice versa), it takes less (more) equity exposure to attain your targeted volatility. For most of the past decade, SPX volatility (when measured by the VIX Index) has been range bound between 14 and 18. But once COVID-19 hit, volatility spiked to 82, remaining elevated all year, most of the time above 25, ending the year at 22.8. As a result, these massive hedge funds, that typically utilize sizeable leverage, were forced to maintain low exposure to equities, since higher volatility meant it took less exposure to achieve their targeted volatility.



Source: FS Insight, a Fundstrat company

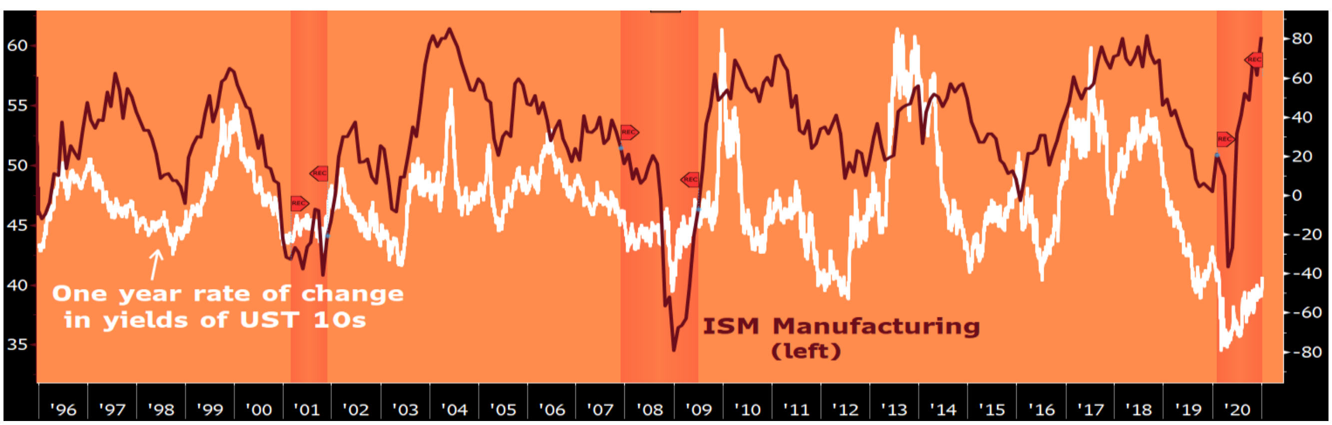
COVID-19 was the principal reason why volatility was so high last year as the pandemic materially heightened general uncertainty. As a result, traders didn't want to trade. In turn, this reduced liquidity fuelled higher volatility. Recently, as economies have begun to 'open up', volatility has been grinding lower. The graph above, courtesy of Tom Lee's FundStrat Advisors, profiles the 9-month forward curve of the VIX index for three different time frames: 1) the average since 2005 (bottom, grey line), 2) the average for 2020 (top, blue line), and 3) as of December 13, 2020 (dashed line). As shown by the grey line, on average since 2005, the shape of the forward curve has been (logically) upward sloping, in other words in contango. In contrast, note that during 2020, the average forward curve was the mirror image, downward sloping or in backwardation. Finally, the 3rd dashed line shows that by the end of 2020, the curve was beginning to normalize, in other words, shifting downwards from backwardation towards contango. A key catalyst for this downward shift would have been the reduction in uncertainty arising from the 'reopening' of the economy. It's the opinion of Tom Lee that with the further 'opening up' of the economy plus the now reduced political uncertainty in the U.S., the term structure of volatility will normalize further during the 1st half of 2021.



Source: Bloomberg

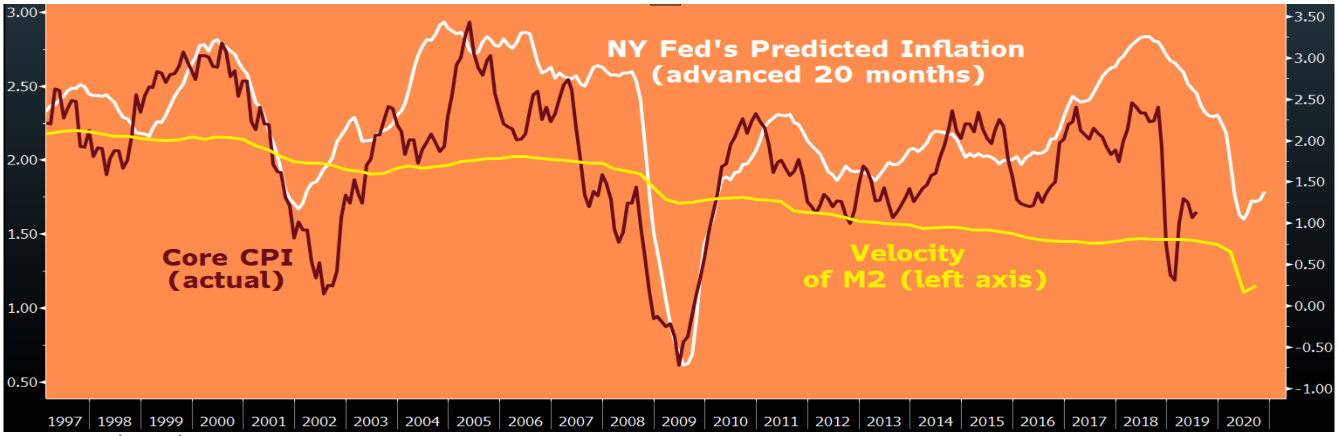
This falling volatility suggests money managers that invest with the mandate to target a specific standard deviation will need to allocate more capital to equities to attain their targeted figure. This concept is shown by the above 8-year graph. The red line on the left axis is the price of the SPX. The white line on the right axis indicates the percentage exposure to the SPX that is required to have a portfolio that exhibits 10% volatility. As volatility falls, all else being equal, the white line needs to go up. This situation increases demand for equities as fresh capital flows into the stock market, presumably helping to push stocks higher. What about interest rates?

Could a further rise in rates harm the near-term outlook for stocks? Yields on 10-year U.S. government bonds have climbed a fifth of a percent during the past few days, driven by fears of even larger net issuance under the Biden Administration. However, this increase could also be attributable to investors extrapolating the historical correlation seen in the 25-year graph below between an improving ISM Manufacturing index (red line on left axis) and the 1-year rate of change in the yields on U.S. 10 years (white line on the right). Please note that the shaded vertical bars represent periods of recession.



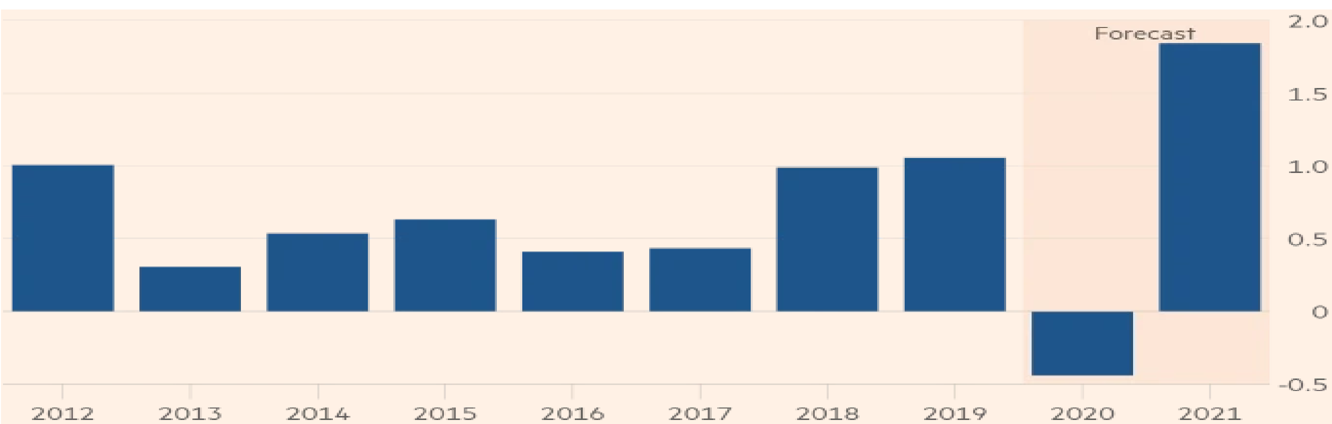
Source: Bloomberg

We knew the lagged effects of existing fiscal and monetary stimulus would fuel job growth, which when combined with the reduction in the savings rate, would ensure a strong cyclical expansion in 2021. Yet manufacturing, and as of last week's ISM Non-Manufacturing print, services too have recently surprised on the upside. Yet beyond this initial shock to rates, two factors must be considered in assessing how high rates will go during 2021. First, let's consider the outlook for inflation. Obviously, some prices have jumped markedly due to specific shortages of products or services; however, it's pretty tough to imagine more broad-based inflation happening until economies return to full employment in 2023 or later. Second, catalyzed by the volcanic adoption of 'work from home' and other digital-based disruptions to our society, improvements in productivity have been off the charts since the onset of COVID-19. While there will be some give-back, companies have learned to do more with less. These facts are supportive of the message conveyed by the 23-year graph below of the New York Fed's predicted rate of inflation (white line), advanced 20 months relative to the actual rate of core U.S. CPI (red line). The graph implies inflation isn't about to come roaring back. Nor for many reasons will the velocity of money (yellow line) bounce more than back towards its secular downward trend line. So, while I won't pretend to have a crystal ball beyond 2022, a sustainable rise in core inflation (beyond cycling easy comps this Spring) is unlikely to be a driver of incrementally higher rates during 2021.



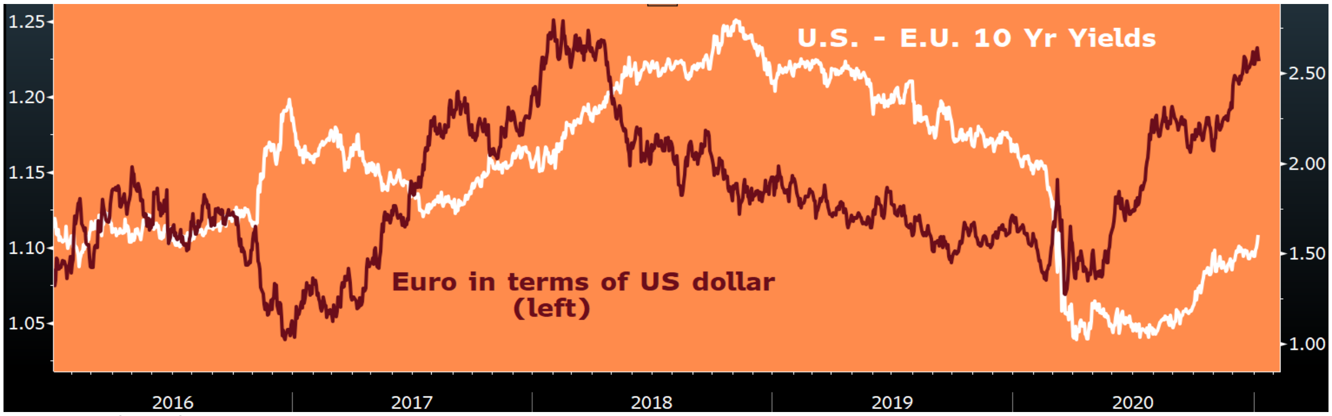
Source: Bloomberg

A second factor potentially pushing interest rates higher is the expected mismatch between the supply and demand for U.S. government bonds (USTs). The bar graph below exhibits the net issuance of USTs excluding purchases by the Federal Reserve, in trillions of dollars. According to JP Morgan, the combination of maturing T-bills and current expected deficit financing needs imply US$2.8T of U.S. bond supply this year with US$1.8T of this amount looking for a buyer. Credit analysts suggest the domestic private sector including commercial banks will remain buyers, as will the Bank of Japan, but bond bears still see a gaping mismatch; we do too. As discussed in previous commentaries, we believe the Fed will have to extend its QE program well into 2022 to ensure the U.S. can finance its deficits without pushing interest too high. That's the key reason why gold continues to merit a position in a portfolio, but more on that later.



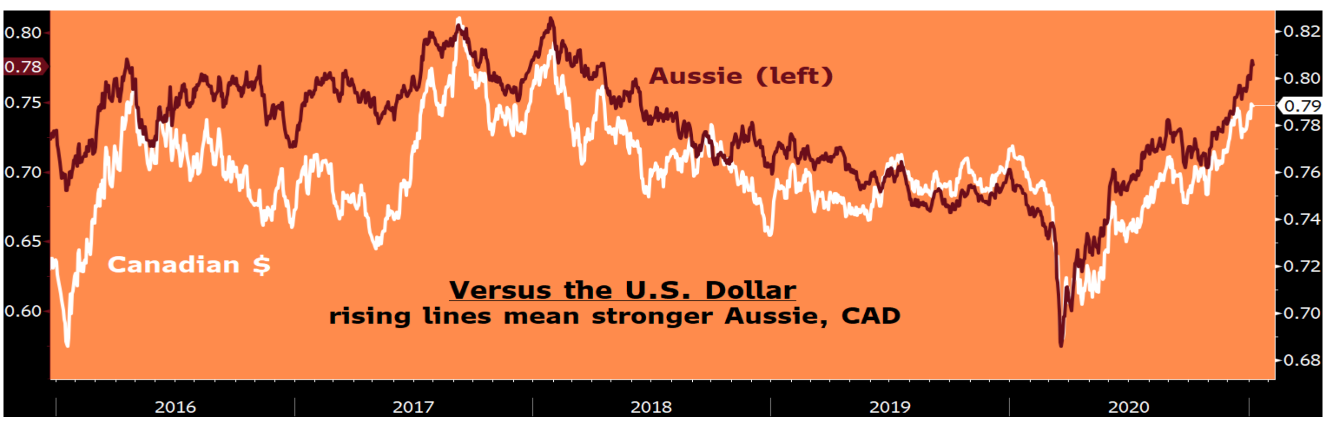
Source: J.P. Morgan

At the same time, the Fed, which remains the key driver for stocks, has caused the investing public to become addicted to stimulus, pushed equity valuations very high, plus the Fed's own analysis shows that equities are back at record highs as a percentage of private sector assets. Notwithstanding recent comments from several voting members of the FOMC to the contrary, we don't believe the Fed will shift gears from QE to QT during 2021 or H1 2022 for two reasons. First, the Fed cannot, will not risk bursting the 'bubble' in financial assets this year plus, as stated in the previous paragraph, there's a risk that there may not be enough buyers of U.S. debt at an acceptable clearing price. Hence, if climbing rates show signs of hindering equity markets or the economy, the Fed will intervene. As a result, we don't expect rising rates to kill the current 'equity bull' during the next several months. At the same time, the bottom right of the 5-year graph below shows that the correction in relative U.S./E.U. rates, be it at the 2, 5 or the 10-year (white line) tenor, has moved a long way back from the mid-2020 bottom that was catalyzed by the barrage of policy announcements by the Fed, though as you can see the Euro (red line) has kept rising versus the now beaten-up U.S. dollar.



Source: Bloomberg

With the ECB on tap to buy the vast majority of net issuance in the E.U. during 2021, the ECB definitely won't be pushing long rates higher. Hence, it's entirely possible the Fed's happy to have helped the dollar fall 10% since Summer, figuring the combination of a weaker currency and rising rate spreads will entice foreign capital to buy more Treasury securities. Sure, as global rates converged during the past year, the use of the dollar as a funding currency picked up markedly. In addition, the dollar's market share of FX reserves of Central Banks fell from 61.8% to 60.5% by last Fall, with the Canadian dollar being one beneficiary. But while the short U.S. dollar became a 'pile-on' trade as 2020 was wrapping up, its recent rate of decline is unsustainable. According to Morgan Stanley, the impact on growth of expansive fiscal accommodation during the next 12 months will trump the Fed's monetary stance, enabling the U.S. dollar to breathe higher before a potential next leg lower. I've been surprised and wrong at the pace of the recent decline in the U.S. dollar.

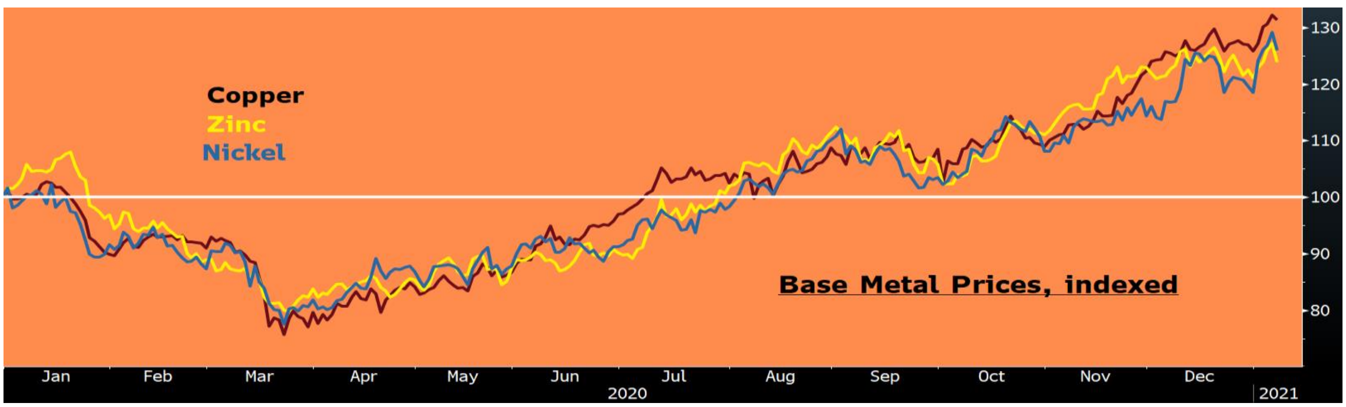


Source: Bloomberg

We have fielded many questions about the sustainability of the strength in the Canadian dollar relative to the U.S. buck. In the past, either 2-year rate spreads or the price of oil was the key catalyst driving the loonie. This time around, neither seems to be playing much of a role. Instead, it's another example of the 'risk on' trade as shown by the correlation between the rise in the dollars of each of Australia and Canada. Given our bullish view on oil (see below), it's likely our dollar hits US$0.80 for the first time since September 2017 during 2021. To summarize, we believe the equity setup is good for the next few months, with a bias towards cyclicals, as there appears to be little to upset the proverbial apple cart. However, there are many items beyond the Fed, growth and inflation that investors must consider as the year progresses.

The most obvious story to monitor is the success of the rollout of vaccines against COVID-19. While the launch has been rocky, let's hope authorities fix the logistics of this unprecedented immunization program. It's also imperative that the initial hesitancy of some to be vaccinated is addressed such that 'herd immunity' can be achieved before the end of this year. Further, it's widely assumed that the E.U. will implement and begin to distribute the €750B COVID-19 bailout plan that was agreed to last year. Second only to the agreement to mutualize debt, this program of which countries such as Italy are the biggest beneficiaries, was a spark that triggered the Euro's ascent from the sub-1.10€/USD basement last Summer. If the E.U. finds a way to mess this up, look down below on the Euro. Staying in Europe, next Fall will see Germany's Federal election. Chancellor since 2005, Ms. Merkel, is not expected to seek another term. It's possible that the Green Party could play a pivotal role in determining which party forms the next government. Of course, here at home many political observers believe Canada could also have a Federal election during 2021.

Finally, as always, China bears watching. With their economy largely back to normal and expected to print positive real GDP growth for 2020, it's as if China is on a different cycle from other countries. While recent commentary has appeared to be less hawkish than previously feared (ahead of the annual Central Economic Work Conference), it's widely expected that China's relatively modest, infrastructure-focused COVID-19-related fiscal stimulus plan will be allowed to wind down in early 2021. In addition, the PBOC, China's monetary authority, is expected to remain attuned to the liquidity needs of the country's banking system, yet otherwise embark on a slow and modest monetary tightening program as this year progresses. Consequently, it's unlikely China will be a major growth driver for the global economy, nor will its demand play a role in pushing the price of base metal and bulk commodities higher from current levels; however, this view does present an excellent segue back to our outlook for markets.



Source: Bloomberg

Resource stocks are the epitome of cyclicals and, along with the recent run-up in banks stocks, enabled the TSX to trade at a new all-time high last week. We continue to have a constructive outlook on base metals, copper in particular, but the share prices of base metal stocks are running a little too hot of late. As regular readers of these commentaries will know, our preferred base metals equity has been Freeport McMoran (FCX.US). We also continue to see good upside in small cap mining driller, Major Drilling Group (MDI.CA). Staying with metals but shifting to the shiny variety, our funds continue to hold several gold stocks, specifically Barrick Gold Corp. (ABX.CA) and Teranga Gold (TGZ.CA), soon to become part of Endeavour Mining Corp. (EDV.CA). The new EDV, having acquired SEMAFO Inc. (SMF.CA) and TGZ during 2020, is poised to enter the top tier of gold producers during 2021, generating material amounts of free cash flow.

Shifting to energy, while warm weather in Central North America hampered natural gas prices for the past couple of months, gas draws through the withdrawal season have been larger than last year, as every other country in the northern hemisphere is experiencing a much colder than normal Winter. This weather-related demand has ensured that North American LNG export capacity has been fully utilized, running at 11 bcf per day vs. a more typical 6 bcf per day last year, implying that on a weather-neutral basis, the North American gas market is 5 bcf per day tighter than a year ago. In fact, LNG demand has been so strong that last week, a tanker of LNG bound for South Korea that sold for $20.80/mmbtu! Meanwhile, winter is expected to come to Central North America by the end of January, hence the setup is strong for US$3+ gas pricing during 2021. Our favourite natural gas equities are Tourmaline Oil Corp. (TOU.CA) and Storm Resources Ltd. (SRX.CA). The funds also own shares in Trican Well Services Ltd. (TCW.CA), a company poised to benefit handsomely from an even modest pick-up in capital spending in energy.

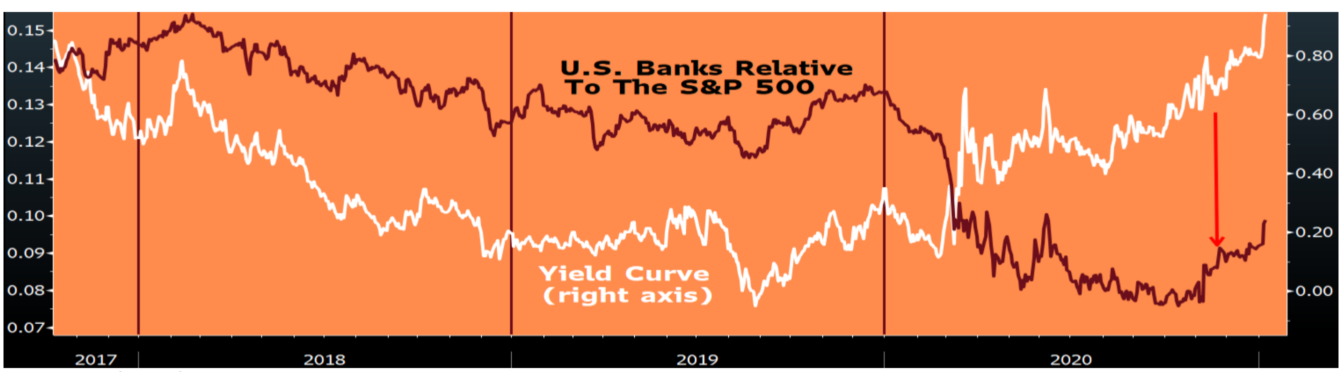
Shifting to oil markets, we foresee a very strong recovery in oil demand during the 2nd half of 2021. Broadly speaking, we expect U.S. producers to continue to struggle relative to Canadian producers due to their especially high decline rates and inferior economics. In addition, Canadian egress issues will soon be in the rearview as

Enbridge's Line 3 replacement pipeline comes into service later this year and the TransMountain expansion starts flowing next year, together adding about 1mmbbls per day of export capacity. In fact, we'd argue this incremental capacity makes Keystone XL a nice-to-have as opposed to a must-have. Our preferred oil stocks are Canadian Natural Resources (CNQ.CA), MEG Energy Corp. (MEG.CA), and Parex Resources Inc. (PXT.CA).

To quickly review other sectors, we believe stocks referred to as 'bond proxies' are 'dead money' at best this year for a couple of reasons. First, we expect most money currently allocated to growth stocks will stick with growth stocks, hence the fresh money invested in cyclically-sensitive stocks will be funded by the sale of bonds and 'bond proxies'. We include telecom, REITs, consumer staples and traditional utilities in this category. Second, while the yield differential favouring 'bond proxies' will remain very wide, we foresee consistent dividend increases from many large cap technology and gold stocks, introducing more competition for the dollars of the investor who is looking for a growth-oriented source of dividends.

As for the technology sector, by the mid-point of 2021, we'd expect investors to become more discerning between macro cap cash machines such as Microsoft Corp. (MSFT.US) and Alphabet Inc. (GOOG.US), two long-held names in our portfolios, and unprofitable 'growth at any price' securities. It goes without saying that these richly valued securities are extremely sensitive to interest rates. As previously stated, during the next several months, we don't expect rising rates to be the catalyst for pain to either group of companies. However, post this next leg up in equities, many of these loss-making momentum stocks will trade at 'nose bleed' levels and during H2 of 2021, we expect the looming spectre of the Fed is likely to cause investors to become more discerning in assessing reasonably valued, high-quality growth equities versus momentum-driven growth stocks valued at any price.

Source: Bloomberg



Source: Bloomberg

Speaking of reasonably priced securities, bank stocks have been rallying hard of late, thanks to the twin beliefs that credit has turned the corner and interest rates are on the rise. The indexed graph (first one above) compares the non-FX adjusted price performance of U.S. bank stocks (red line) against Canadian bank stocks (white line). While having tracked each other quite closely over the past several years, on the right side of the graph you can see that early Q4 outperformance by Canadian bank stocks has more recently given way to U.S. banks outperforming Canadian banks. In a cyclical recovery, we expect Canadian banks will be market performers, partially because we don't see interest rates rising that much. However, during the past couple of months, the red arrow pointing to the red line on the 2nd graph above illustrates that U.S. bank stocks have outperformed the S&P 500 as the yield curve (white line) has doubled.

Summarizing our view on the prospect for the equities beyond the next several months, we believe the outlook for H2 of 2021 is a bit of a coin toss. As valuations will be rich by late Spring, even on 2022 EPS (4000 on SPX = 20X * $200E), the market will have a very tight needle to thread to keep moving higher. Any of the variables highlighted in the earlier part of this note could tip the scales the wrong way for stocks. In fact, given the relentless move higher stocks have had since late March 2020, 70% for the SPX and 60% for the TSX, it's only a matter of time until equities take a breather, to work off overbought conditions. It's that thinking that is driving our view that while the runway looks good for the next several months, that's what it is, the next few months. If that correction is deep enough, if vaccine treatments have overtaken viral spread and closures, and the Fed's resolve has been shaken such that they extend the term and duration of their QE program, then the 2nd half could be great for stocks. If not, the 2nd half could be tougher for stocks. Hence, investors should increase their focus on managing risk and acknowledge the utility of active advice and management.

At Forge First, aside from an unexpected massive rapid move up or down in equity markets (April 2020), we are agnostic to the direction of stocks and hence pay little attention to prognosticating future levels. That's because our investment process is built around a proven discipline, a formula based on:

Security selection centred around the free cash flow generating capability of a business,
A focus on mid & large cap North American stocks to ensure a repeatable process,
Maintain a broadly diversified portfolio with no 'big bets' to limit volatility,
Always include a sizeable & diversified short book
Use listed options to further hedge market risk.

We wish you all the best in 2021 and like you, hope that entering 2022 we can all live life to the fullest once again.

For more information on our funds, please visit our website at www.forgefirst.com or call us at 416-687-6771.

Thank you,

Andrew McCreath	Daniel Lloyd	Keenan Murray
President and CEO	Portfolio Manager	Portfolio Manager