1492 Capital Management
DISCOVERING OPPORTUNITY

MARCH 2017 • VOL. 9 • ISSUE 3

IDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY | VALUE INCOME STRATEGY

1492 Vantage Point Newsletter

Welcome to 1492 Capital Management's quarterly newsletter for the first quarter of 2017. In each quarterly newsletter, we provide a small cap perspective on the most recent quarter, preview what lies ahead and how our portfolios are positioned to capitalize on these views, and offer a bit of market trivia.

Our corporate tagline is "Discovering Opportunity" which is our daily focus for our clients with our Small Cap Growth, Small Cap Value, Small Cap Core Alpha, and Small Cap Dynamic Hedge strategies. Our investment professionals possess a tremendous amount of experience navigating the current, choppy investment waters. 1492's time-tested strategies are based on a three-step process of identifying investment themes from hundreds of meetings annually with company executives, extensive tire-kicking of the financial statements, and a rigorous valuation methodology. Our job is to know what we own so that our clients will too.

A reversal of fortune. Faster than you can say "Trump trade", the winners of 2016 quickly became the losers thus far in 2017. In 2016 small caps, value, and energy stocks were the best performers, and healthcare was the worst. In the first quarter, this leadership reversed course. Large caps, growth, and healthcare were the best, and energy was by far the worst sector. These results seem to signal a lack of confidence in the ability of President Trump to push his pro-growth agenda through Congress. Small caps' underperformance relative to large caps is equally puzzling as Trump's agenda, particularly tax reform and deregulation of the financial industry, clearly favors small caps over large. The first quarter feels eerily similar to 2014/2015 when the FANG stocks and biotech were all the rage. So far this year, the largest company in the S&P 500, Apple (+24.6% in first quarter), is driving large caps higher ahead of its widely anticipated launch of its next generation IPhone. However, the members of FANG (Facebook, Amazon, Netflix and Google) are advancing nicely as well year to date. Consequently, the tech-heavy NASDAQ Composite (+10.1%) won the first quarter performance race and put up the strongest quarterly return for the index since 2013. However, the S&P 500 saw its streak of 110 days without a greater than 1% down move come to an end in the quarter. Nevertheless, each month of the year has seen a positive return for the S&P 500, which is a tremendously bullish sign for the balance of the year. Please read on to see our unique views of what's on tap for the rest of 2017, what the hostile environment in Washington D.C. may mean to the stock market, and indulge in some stock market trivia.

For detailed performance information on 1492's strategies, please click on these fact sheet links (Small Cap Growth / Small Cap Value / Small Cap Core Alpha) to find gross and net of fee performance information and the appropriate disclosures. If you would like to discuss any of these strategies with us, please contact Tim Stracka at 414-238-3398.

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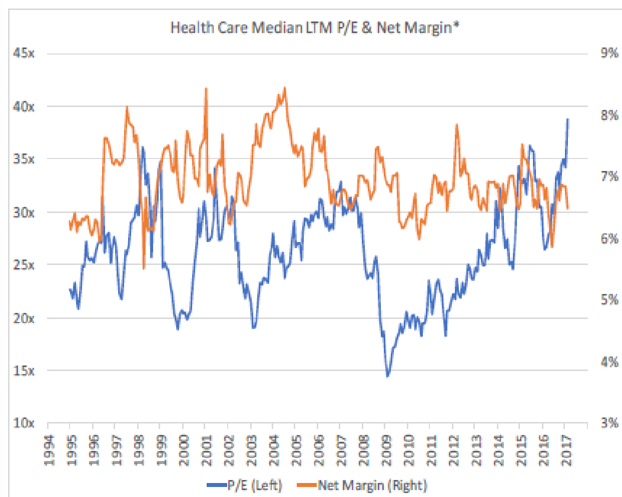
<u>A Review of the Quarter: As Fast as You Can Say "Trump Trade", Winners and Losers Flip Flop</u>

The first quarter of 2017 began with tremendous optimism as the market was riding a wave of strong returns based on President Trump's pro-growth agenda. However, something seems to have gotten lost in translation as the winners and losers from 2016 quickly changed places in the first quarter of 2017. In 2016 small caps, value stocks, and the energy sector were the best performers, and the healthcare sector was the worst. In the first quarter of 2017, we reversed course. Large caps, growth stocks, and the healthcare sector were the best, and the energy sector was by far the worst sector. This flip-flop can be seen in the table below left. This movement seems to signal a lack of confidence in President Trump's pro-growth agenda being enacted and in the reflation trade more broadly. What's particularly puzzling to us is that the Healthcare sector was by far the strongest performing sector in the first quarter due to leadership from biotech stocks. This healthcare strength occurred despite the fact that the first item on the President's agenda was to repeal and replace Obamacare which would bring uncertainty to the sector. The Republicans failure to push a replacement plan through their own party says volumes about the current state of affairs in Washington, but we don't think we've seen the last of the healthcare legislation to repeal and replace Obamacare. With the Healthcare's big move in the quarter, the sector is now in uncharted territory. *As the chart below right shows, the P/E ratio for the healthcare sector is now at the highest level in the past 25 years.*

Table 3: We saw some big shifts in performance in the first quarter

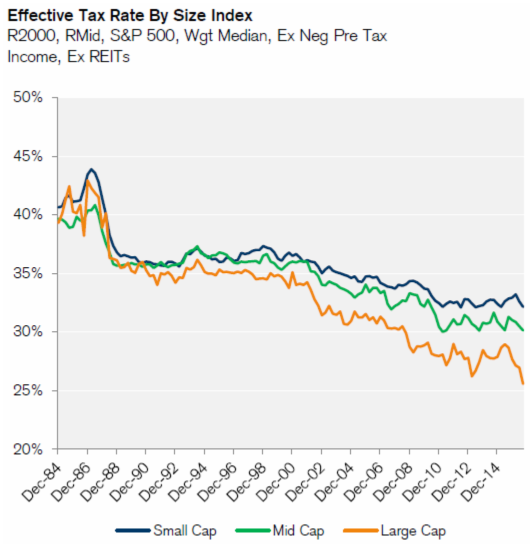
	Excess Performance	
GICS Sector	**1Q2017**	**2016**
Discretionary	-1.4	-8.9
Staples	-3.9	0.9
Energy	-13.2	7.1
Financials	-4.0	13.3
Health Care	10.1	-28.6
Industrials	-1.4	10.8
Info Tech	3.4	2.2
Materials	3.3	26.5
Real Estate	-2.3	1.1
Telecomm Srv.	-7.9	-0.6
Utilities	2.2	2.6
Size Quintile	**1Q2017**	**2016**
Q1 (Largest)	1.0	-3.8
Q2	0.4	3.8
Q3	-2.6	5.1
Q4	-1.8	4.0
Q5 (Smallest)	-3.0	5.9

Source: Jefferies



Source: Furey Research

Small caps also underperformed large caps in the quarter. This underperformance prevailed despite Trump's pro-growth agenda clearly favors small caps over large as tax reform and deregulation would have a much larger impact on the earnings of small cap stocks. Granted, small caps outperformed large caps nicely in last year's fourth quarter based on the election outcome, but we still believe there is more to come for small caps if tax reform legislation is passed. *In last quarter's newsletter, we cautioned that the biggest risk for the market is the period between the promises and the execution of Trump's legislative agenda.* We're currently in this waiting period where the worrying is probably most intense, especially given what happened with the Republican's proposed healthcare policy. Nevertheless, as the charts below show, small cap companies will benefit disproportionately to any tax cuts as their current rates are substantially higher than large caps as the chart on the left shows (32% vs. 26% currently). The table on the right highlights the impact to the current P/E ratio of the Russell 2000 Index should a given level of tax cut be implemented.



Source: Credit Suisse

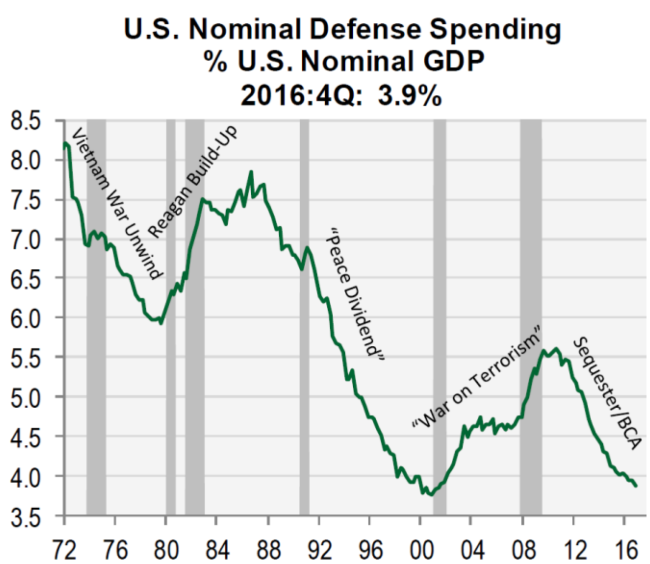
Fig 2. **P/E discount from current levels based upon varying tax rates**

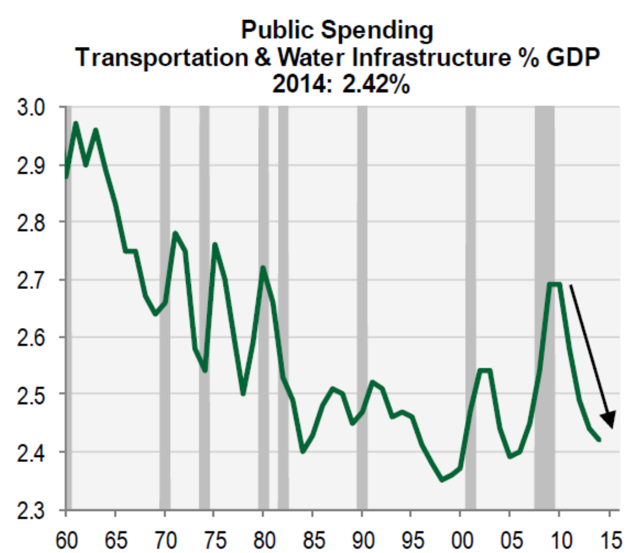
R2000 P/E Discount from Current:	'16E	'17E
Unadjusted	0%	-5%
30% Tax Rate	-8%	-13%
25% Tax Rate	-13%	-17%
20% Tax Rate	-17%	-21%
15% Tax Rate	-22%	-25%
10% Tax Rate	-26%	-29%

Source: Furey Research Partners and FactSet

Based upon current estimates, the R2000 '17E P/E could represent a 17% to 21% discount to current levels if tax rates are cut to 20-25% which is where nearly 90% of respondents believed tax rates would go according to our most recent survey. This discount does even fully discount higher growth that we think could occur due to deregulation and fiscal stimulus.

Based on the first quarter market returns, it appears that the market has seemingly lost a bit of confidence in the "Trump trade," which quite simply means that investors were betting on a reflationary environment that is generally very beneficial to the stock market in general and small caps in particular. That said, there are several components of the Trump agenda that could be particularly positive for the stock market. Tax reform, repatriation of overseas cash, infrastructure spending, and rebuilding of our military machine are on his docket. As we mentioned above, tax reform is by far the most meaningful item from a stock market perspective but repatriation likely goes hand-in-hand with tax reform. However, the defense and infrastructure spending plans could be meaningful needle movers. The charts below highlight how significant the spending reductions have been in these two areas through the years. On the left chart, you can see how meaningfully defense spending has been reduced over time as a percent of GDP. If Trump gets his spending plans pushed through, it could be a nice boost to the U.S. economy as nearly all of the spending would benefit U.S. based companies. On the right is a chart that depicts transportation and infrastructure spend over time. After a brief upswing following the 2008 recession, infrastructure spending has retreated to near its all-time low as a percent of GDP. Enacting either or both of these programs could be quite a positive for the economy and by association, the stock market.

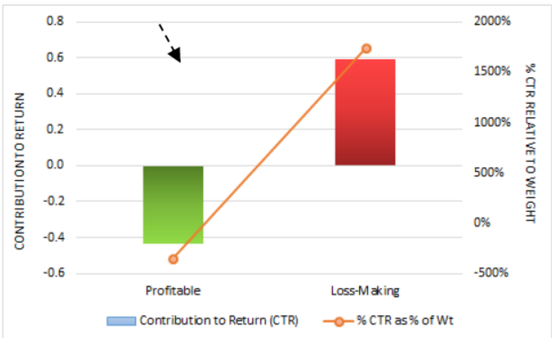




Source: Cornerstone Macro

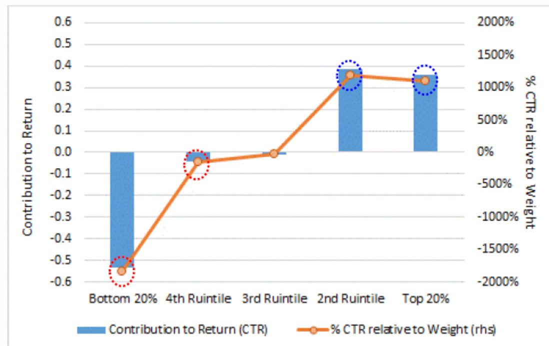
The stock market got off to a fast start in 2017, and despite all the wrangling in Washington, the first quarter was a fairly quiet period in terms of market volatility. As a sign of this calm, the S&P 500 posted 110 trading days in a row during 2016-2017 without falling more than 1% in a single session. This streak ended on March 21, 2017 and was the longest since 1993. The

S&P 500 recorded positive returns in each month of the quarter which generally bodes well for future returns for the balance of the year. However, some of the same demons that have haunted active managers in recent years reared their heads again in the quarter. Namely, the outperformance by money-losing companies (primarily biotech companies) as shown on the chart below left. As we mentioned above, the larger the market cap, the better the return achieved in the quarter. This size impact held true within the indices as well. The chart on the right shows first quarter performance by market cap quintile within the Russell 2000 index. As you can see, only the top two quintiles saw positive performance.



Source: FRP and FactSet. Data as of 3/24/17.

Fig 7. **Market Cap quintiles – YTD contribution to return**



The NASDAQ Composite index (+10.1%) was by far the best performing index in the quarter on the strength of Apple and FANG (Facebook, Amazon, Netflix, and Google) which were all up nicely in the quarter. The S&P 500 was also the beneficiary of the performance of these large cap tech names in the quarter and posted a gain of +6.1% which outpaced the Russell 2000 Index's gain of +2.5%. From a sector standpoint within the Russell 2000, the Healthcare (+12.5%) and Energy (-10.9%) sectors were at the extremes and reversed their 2016 positions. The sectors that are beneficiaries of a reflationary environment, namely Energy and Financials (-1.9%) were two of three sectors that posted negative returns in the quarter. The market may be worried about the Fed taking aggressive moves to cool the economy before it really gets going. The table below highlights the returns for the first quarter of 2017 for the popular indices.

Index Returns		
Index	First Qtr. 2017 Return	2017 YTD Return
Russell 2000	+2.47%	+2.47%
Russell 2000 Growth	+5.35%	+5.35%
Russell 2000 Value	-0.13%	-0.13%
S&P 500	+6.07%	+6.07%
Dow Jones Industrials	+4.56%	+4.56%
NASDAQ Composite	10.13%	+10.13%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Growth Index (+5.4%) significantly outperformed the Russell 2000 Value Index (-0.1%) for the quarter. As mentioned above, the financial stocks' weak performance hampered the value index as this sector has a much larger representation here than in the growth index. The two tables below highlight the performance of the Russell 2000 style indices by sector for the first quarter.

Table 5: Russell 2000 Growth's performance attribution for March 2017

	March			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	2.43	0.39	1.24	2.41	0.39	-2.94
Staples	1.22	0.03	0.04	-5.17	-0.16	-10.52
Energy	-3.06	-0.03	-4.24	-11.59	-0.13	-16.95
Financials	-0.83	-0.06	-2.02	3.19	0.23	-2.17
Health Care	1.70	0.37	0.51	13.27	2.74	7.92
Mat. & Process	2.22	0.22	1.03	6.15	0.61	0.80
Prod. Durables	-0.19	-0.03	-1.38	1.04	0.16	-4.31
Real Estate	-1.56	-0.09	-2.75	2.50	0.13	-2.86
Technology	1.83	0.36	0.64	7.03	1.35	1.68
Utilities	1.05	0.02	-0.14	1.45	0.03	-3.91

Table 6: Russell 2000 Value's performance attribution for March 2017

	March			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	2.75	0.28	3.59	-0.01	0.01	0.13
Staples	1.40	0.03	2.24	-3.95	-0.08	-3.82
Energy	-3.16	-0.17	-2.32	-10.78	-0.62	-10.64
Financials	-2.97	-0.94	-2.12	-2.98	-0.96	-2.84
Health Care	0.05	0.00	0.89	9.14	0.38	9.27
Mat. & Process	-1.90	-0.11	-1.05	2.13	0.12	2.27
Prod Durables	-0.69	-0.09	0.16	0.18	0.02	0.32
Real Estate	-0.56	-0.06	0.29	0.68	0.08	0.82
Technology	1.63	0.17	2.48	6.55	0.66	6.69
Utilities	0.48	0.04	1.32	3.58	0.24	3.72

Source: Jefferies

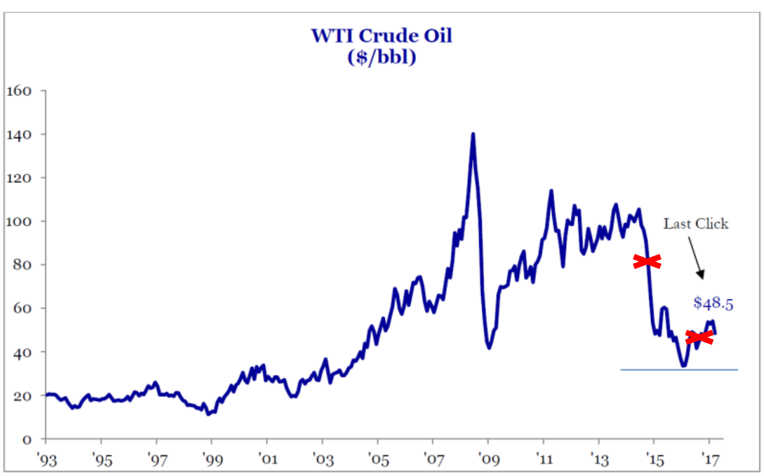
The U.S. stock market posted a strong first quarter, but most stock markets around the globe also recorded an equally strong quarter. Commodities were generally higher on the heels of economic optimism following the election of Trump, and interest sensitive investments paused as rates were range bound. Whether it's the search for yield or a stimulus-led acceleration in global growth, equity markets continue to move higher. Japan's market remains one to watch as they've been stimulating their economy aggressively; however, the stock market hasn't responded this year despite a pickup in their PMI surveys of late. One of the larger surprises below is the return that India's stock market has seen recently as their economic growth has been better than expected despite the tightening of their monetary policy. China, which is showing a strong resurgence in economic growth, is showing modest appreciation in their stock market indices. Unbelievably, volatility – which had been called out by many pundits to rise dramatically this year – has fallen dramatically and continues to bounce around near its 52 week lows. Commodities were a mixed bag as metals were mixed and energy was down after strong appreciation in 2016.

Index	First Qtr. 2017 Return	2017 YTD Return
France	5.6%	5.6%
Germany	7.3%	7.3%
Brazil	7.9%	7.9%
India	12.1%	12.1%
China- A Shares	3.9%	3.9%
China- Shenzhen A Shares	0.9%	0.9%
Japan	-0.3%	-0.3%
Long-Term Treasuries (TLO)	1.7%	1.7%
Investment Grade Corp. Bonds	1.1%	1.1%
Gold	8.6%	8.6%
Volatility- VIX index	-11.9%	-11.9%
Oil	-5.8%	-5.8%
Natural Gas	-13.4%	-13.4%
Lumber	18.0%	18.0%

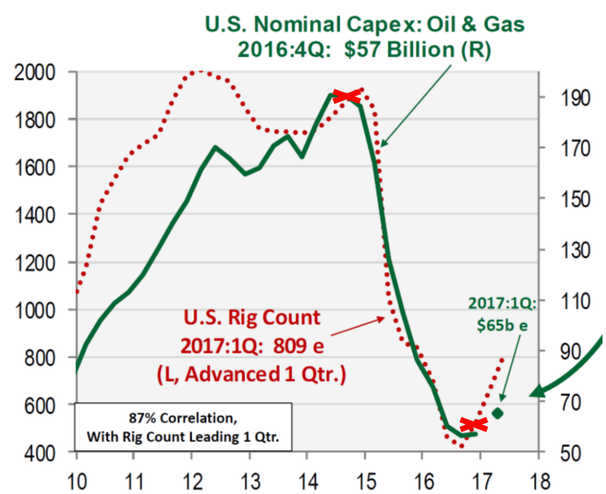
Source: 1492 Capital Management, LLC

Updated 2017 Outlook – Quite Simply, It's All About Oil

Market participants over-analyze nearly everything to search for the direction of the economy and presumably the stock market. As we'll show you through a series of charts, of late, all that you've had to look at is the price of oil and its derivative, the oil rig count in the U.S. Why has this become so important? Quite simply: the economic impact of the energy industry in the U.S. has grown since 2005 to be far more meaningful than most economists believe. The impact can be seen in railroad car loadings, sand usage, metals, rental tools, cranes, pipelines, labor, and other derivative supplies. To illustrate this significant correlation, we need to look at the price of oil for starters. After peaking at over $100 in the summer of 2014, the price of oil began to drop until the day after thanksgiving in 2014 when it was $76 per barrel. This day is normally referred to as "Black Friday" as it's normally the kickoff for the holiday shopping season. This time, in 2014 "Black Friday" took on an entirely different meaning as it was the day that OPEC decided that they weren't going to support the price of oil by reducing their output and stem the loss of market share to the U.S. shale producers which became very prolific producers in just a few short years. Following this announcement, the price of crude oil fell precipitously over the next fifteen months until it bottomed on February 11, 2016 at $26.21. *Not by coincidence, this day is the same day that the stock market bottomed and began the rally that we currently enjoy.* Then on November 30, 2016, almost exactly two years after they agreed to keep producing, OPEC agreed to begin to cut back production. Why would they do this if oil prices had already bottomed? The Saudis are preparing to bring the largest IPO in stock market history to the market in the coming months (Saudi Aramco – estimated $2 trillion market value) and needed a healthy crude oil market to get the deal done. The chart below left shows the price of oil through time and we've highlighted the points on the following charts with red X's where OPEC made their moves to take and cede share, respectively. Following the OPEC decision to take share in November 2014, the rig count peaked that week and the U.S. industrial economy basically went into a recession in the coming months. The overall U.S. economy hung in there but was only buoyed by the consumer/services components. The chart on the right shows both the rig count (red dashed line) and the oil and gas related capital expenditures (green line). The falloff in spending was precipitous ($190 billion down to $57 billion) and only bottomed when the rig count bottomed in May 2016 after falling nearly 75%.

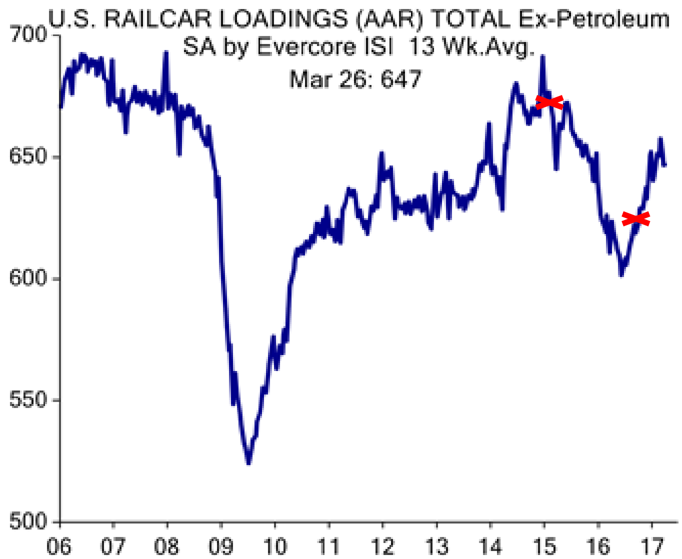


Source: Strategas Research

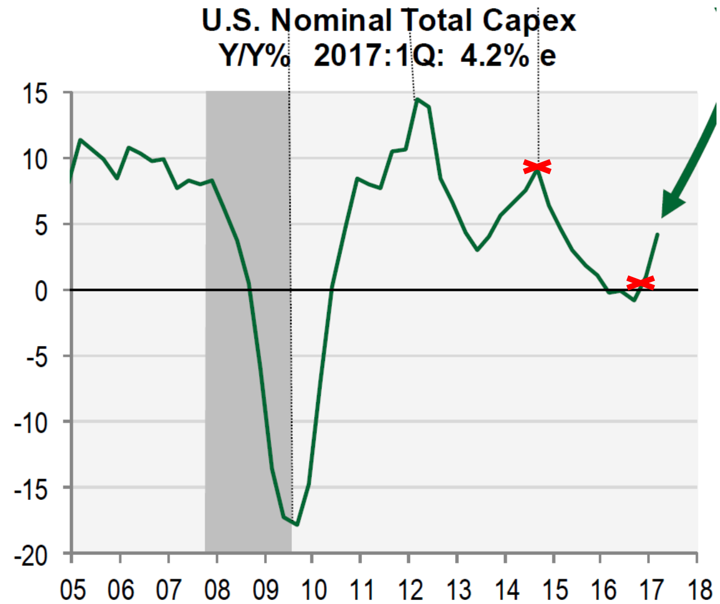


Source: Cornerstone Macro

The precipitous drop in energy patch activity was felt much wider than in just the oil and gas industry. The charts below highlight the strong correlation over the 2014-2016 period that we highlighted above. The chart below left shows the U.S. rail car loadings excluding petroleum loadings. As you can see, there was a large drop and subsequent recovery that is almost identical to the rig count peak and bottom. Similarly as seen on the chart below right, total U.S. capital expenditures was humming along in 2014 posting year-over-year growth rates in the high single digits right up until OPEC's decision to take share. Spending immediately declined in the U.S. industrial economy and went negative in 2016, and it only recently turned higher with the rig count. In our thematic investing section of this newsletter, we discuss further the economic multiplier effect of a healthier domestic oil and gas industry and one of the world class oil basins here in the U.S.



Source: Evercore ISI

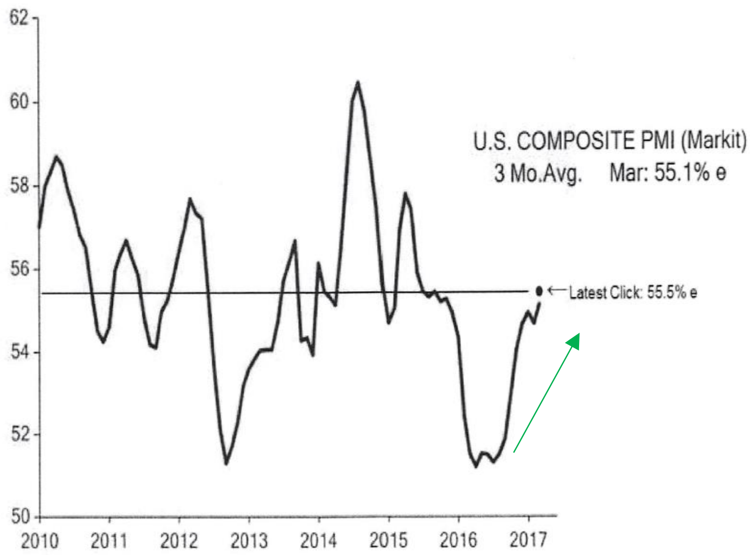


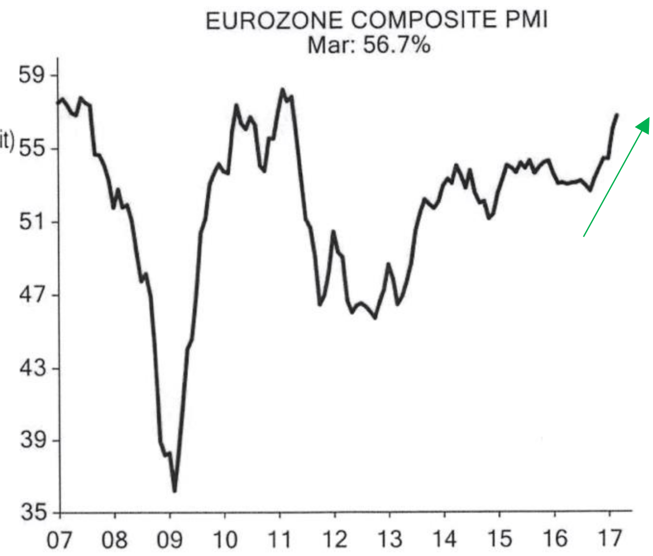
Source: Cornerstone Macro

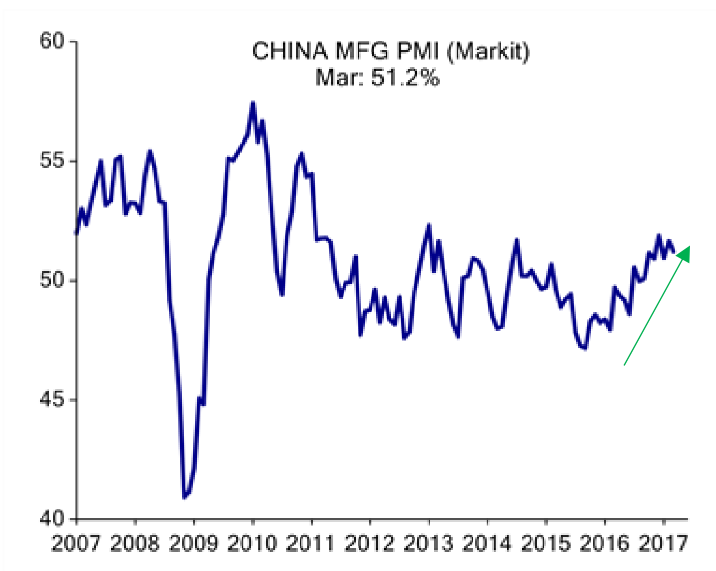
Several prominent economists are projecting that GDP growth has peaked in the U.S. We disagree with that assessment currently, particularly if the Trump administration is able to push through tax reform and the other pro-growth policies that we discussed earlier. In our opinion, given the above correlations between oil and industrial activity, the economists better pay attention to the price of oil as it's far more material than it's ever been to the U.S. economic outlook. So far this year, oil is down about 6% and is hovering around $50/barrel, but it is off its year-to-date low of $47.70. A key driver for the oil market is whether or not OPEC extends the production rollbacks that are scheduled to expire at the end of June. We believe that it still comes down to the Saudi Aramco IPO and the desire to get that deal done in a favorable commodity environment. If oil can reclaim the $55/barrel mark, the reflation story isn't over like many are pontificating currently. The next section highlights one of the reasons we don't believe the global growth story/reflation story is dead.

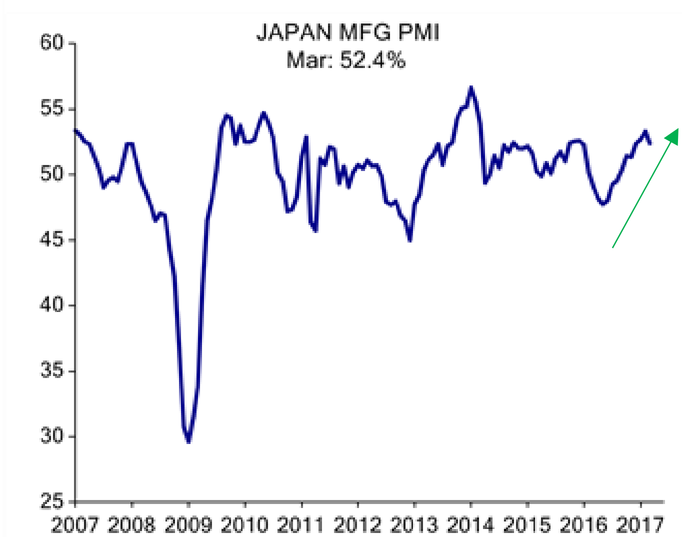
Updated 2017 Outlook – The First Synchronized Global Growth Episode in Nearly 15 Years Isn't Being Appreciated

It's been nearly fifteen years since we have had the big four economic powers (U.S., China, Europe, and Japan) all growing at the same time, yet economists and investors don't seem to appreciate this significance. The last time that we had synchronized global growth was 2003, which followed the tech bubble bursting and the 9/11 terrorist attack which ultimately sent the U.S. into recession. Yes, one could argue 2010 was the last time, but that period was very short and was almost all stimulus driven. The series of charts below highlight this synchronized phenomenon that began in early 2016 when commodities like oil bottomed. (See the section above: Quite Simply, It's All About Oil) Additionally, the table below also highlights numerically where we've come in just the last year. The improvements are impressive and widespread.









Source: Evercore ISI

Global PMIs

	Feb-17	Jan-17	Aug-16	Feb-16
Global	52.9	52.7	50.7	50.0
U.S.	57.7	56.0	49.4	49.7
Canada	54.7	53.5	51.1	49.4
Japan	53.3	52.7	49.5	50.1
U.K.	54.6	55.7	53.4	50.9
Euro Area	55.4	55.2	51.7	51.2
France	52.2	53.6	48.3	50.2
Germany	56.8	56.4	53.6	50.5
Italy	55.0	53.0	49.8	52.2
Spain	54.8	55.6	51.0	54.1

Expanding ≥ 52 52 > Neutral ≥ 50 Contracting < 50

Source: Markit, ISM, Haver, and RBC Capital Markets Note: U.S. ISM PMI, Markit PMI for all others

A sustainable growth cycle is usually commodity driven which causes some inflation as demand increases. This demand then causes an investment cycle to capture this demand and creates loan growth which is ultimately used to increase productive capacity and becomes a positive feedback loop. This process can go on until things overheat from an inflationary standpoint, until there is an exogenous shock, or until policy tightens. China's renaissance and drive to be a global economic player precipitated the 2003 cycle. Consequently, U.S. companies ramped investment significantly in a race to capture a piece of the China growth engine. The emerging market economies soared for a time as commodity prices of all types rose due to China's insatiable demand. It ultimately came crashing down as the U.S. housing market became tremendously over-leveraged, and the Fed stepped in to quell inflation. Since 2009, the global economy has been focused on balance sheet repair, and central banks have been fighting deflation. The U.S. recovery is well ahead of Europe and Japan, which are still in the midst of their quantitative easing programs while the U.S. Fed is already starting the interest rate tightening cycle. This timing difference highlights the difficulty in getting a synchronized recovery. The U.S. and China have been the most consistent growers since 2009, but China's growth has been decelerating since 2010. However, it has recently reaccelerated and appears to be running at a very robust +7% growth rate. Meanwhile the U.S. has been meandering around the 2% growth rate for several years and is probably the biggest risk for a shortened cycle. This vulnerability heightens the importance of turning the Trump pro-growth ideas into action. In this cycle, emerging markets are finally getting their feet under them again, and with modest to moderate inflation, it appears that they have stabilized and have a runway for growth.

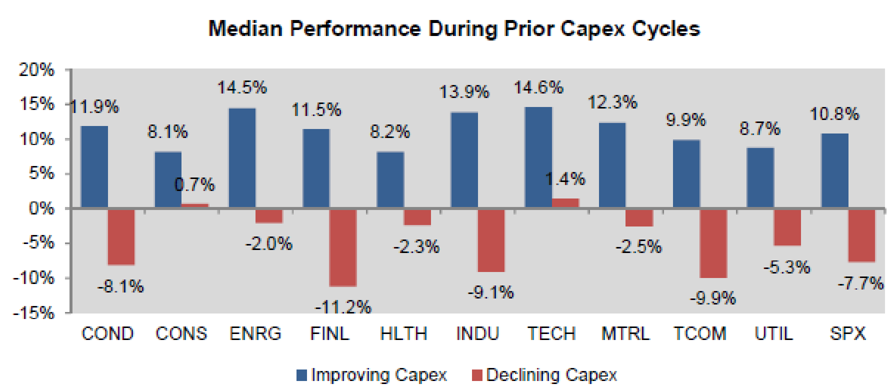
When China was in its glory days of double digit GDP growth, it couldn't help but drag the rest of the global economy along with it. However, now China is growing around 7%+ on a much larger base with Europe and Japan finally seeing growth accelerate after massive quantitative easing and stimulus measures to kick start their economies. In Europe in the first quarter of 2017, GDP growth outpaced the U.S. for the first time since 2008. Synchronized growth is important because it has the best chance of turning short term cyclical growth fueled by policy initiatives into self-sustaining longer term growth. This impact removes some of the pressure on the passage of Trump's pro-growth agenda as the only game in town for growth.

The bottom line is that synchronized growth will slowly lead the world's central banks away from their ultra-accommodative policies over the next year or so without the risk of implosion. It will return us to more normalized business cycles with its inherent cyclicality and not the muted growth and suppressed volatility that we've experienced for the past seven years. In an odd way, it will return the focus to company fundamentals and valuations and away from indiscriminate investing through ETF's that has made active managers lives most difficult since the recession.

Updated 2017 Outlook – Surveys are an Opinion but Capital Spending is a Fact

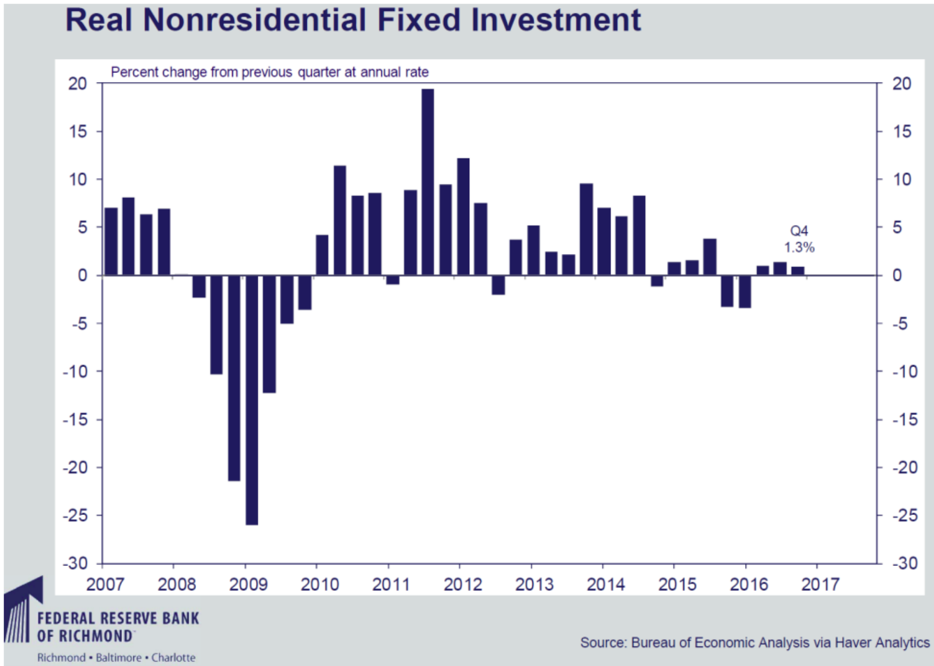
Is real capital spending important to the financial markets? While it's often difficult to predict macro-economic indicators and more importantly pinpointing the inflexion point, there's no denying that there is a correlation between capital spending cycles and stock market performance. The chart below shows that periods of improving capital spending correlate with higher stock market returns.

Exhibit 3: Stock Market Performance Is Much Stronger When Capex Improves



Source: BMO Investment Strategy Group, FactSet, CompuStat, IBES.

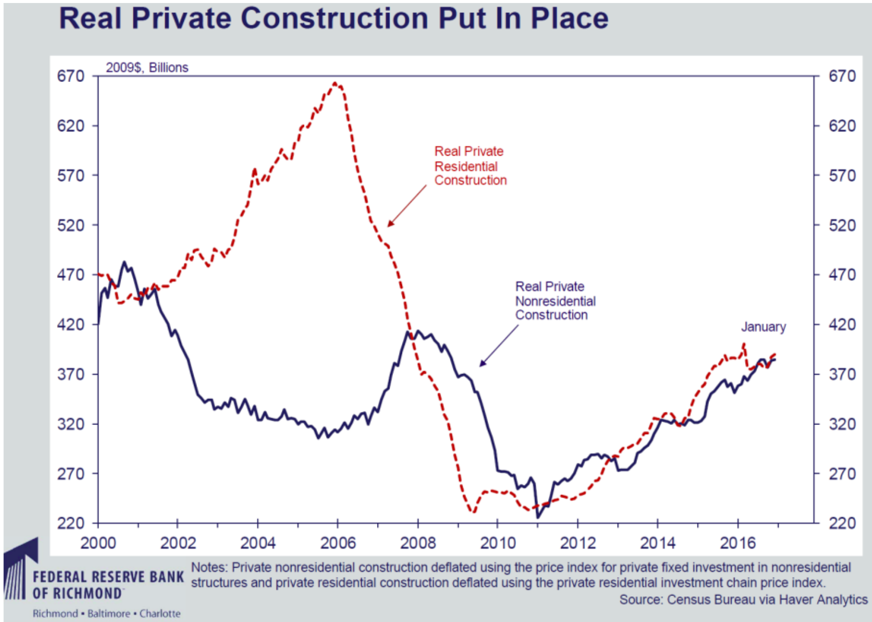
In the chart below we can clearly identify when capital spending growth plummeted during the Great Recession in 2008-2009. What is less noticeable is the slowdown and eventual downturn that occurred in the 2015-2016 timeframe. While the economy did not go into a technical recession over the last two years, there was a significant curtailment in capital spending when the oil commodity price crashed from over $100/barrel in late 2014 to under $30/barrel in February of 2016.



When the price of oil dropped so precipitously, most of the drilling for new wells ceased in the U.S. At the time, economists downplayed the overall impact of the lack of capital spending in the oil patch and cited that this activity was a relatively small percentage of GDP growth. What we learned in hindsight however is that the lack of spending in the oil patch had reverberations that were felt widespread in the economy. Again with 20/20 hindsight, it's not surprising that GDP growth slowed to a snail's pace over the last two years while the stock market muddled along up until the presidential elections last fall.

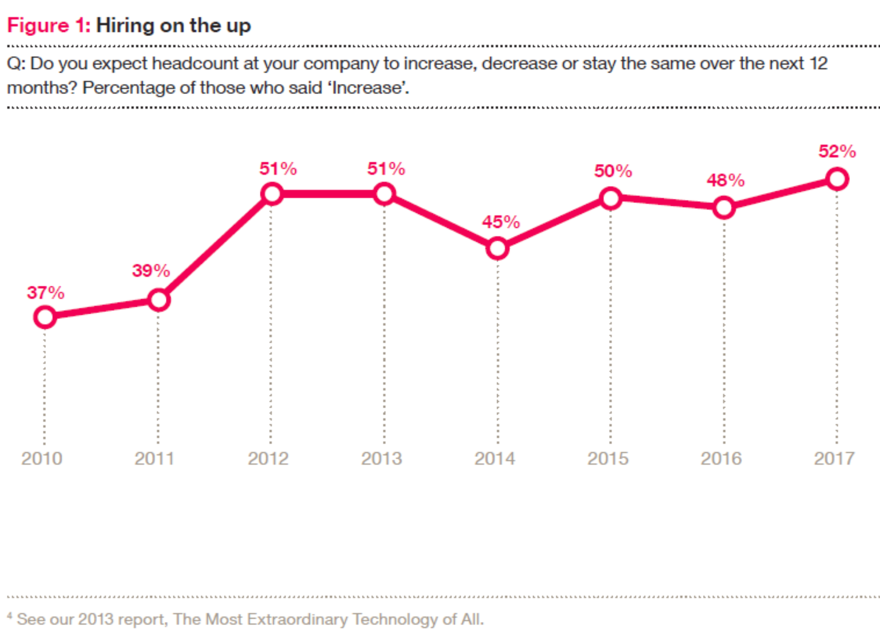
The silver lining is that we've now had three consecutive quarters of growth in capital spending, and from discussions with company CEO's over the past few months, it appears that growth in projects are moving forward at an accelerating pace to start 2017.

One of the questions that concerns investors as this economic cycle reaches beyond seven years in duration, is how much longer can GDP expand without a recession. In the chart below, we see that construction trends for both residential and commercial clearly bottomed between 2010-2012 and have been trending up since. Yet for the residential side, absolute spending levels still have not reached the trend-line of roughly $450 billion annually that existed prior to the housing bubble between 2004-2006. Commercial construction spending is just now returning to what appears equilibrium, which is still below peak levels prior to the dotcom bust in 2000.



There are numerous other economic indicators that we could point to that might give us insight in to how the stock market might react going forward, but we believe that capital spending projects, including construction projects, are a great harbinger of future growth plans. It also validates CEO and business owner sentiment. It is one thing to ask a CEO or business owner what he/she thinks about the economy and their outlook, but I'd rather place more credence in what they are doing with real dollars in their capital allocation.

Capital projects are usually long term in nature, require extensive planning and budgeting and are typically not dependent on near-term swings in market sentiment. Another indicator of overall business sentiment is plans for hiring new employees. As you can see in the chart below, the prospect for new hires has been fairly mundane since 2010, despite the gradual improvement in economic growth. The current 52% reading is the highest level in the last seven years, which we believe bodes well for continued expansion of the economy for the foreseeable future.

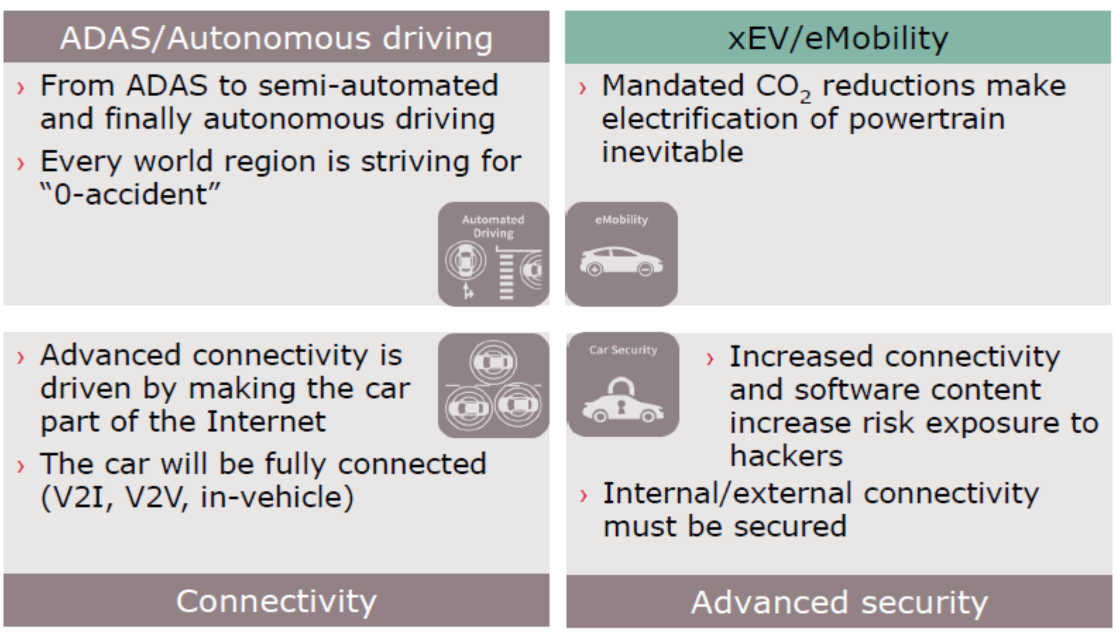


Source: PWC 2017 CEO Survey

<u>Thematic Investing: The Technology Super Cycle - When It Rains It Pours</u>

After collecting a bevy of data points from our meetings with management teams in the technology arena, we believe that 2017 is the start of a technology super cycle with a variety of growth drivers that as a whole put the internet focused 1999-2000 technology expansion period to shame. Overall semiconductor industry sales are forecasted to grow 3-4% per year according to International Data Corp, but we are focused on the pockets of strength within the industry that are experiencing growth at rates that are multiples to the overall semi industry. In the consumer space, we will see new smartphones from Apple and Samsung this year which offer a variety of new features such as organic LED or OLED screens for better viewing quality. 3D sensing in new smartphones will be a hot technology item as it is unveiled across both iPhone 8 and other brands in 2017 to improve virtual and augmented reality applications. The ramping of one standard connector for all of the myriad devices called USB-type C and the chips associated with this growth begin to ramp this year as well. For the better part of 2016 and on into 2017, we have deployed a fiber optics theme in our 1492 Capital Management investment strategies, and we remain excited about the semiconductor demand for fiber optic equipment for fiber to the home and for fiber in data centers this year.

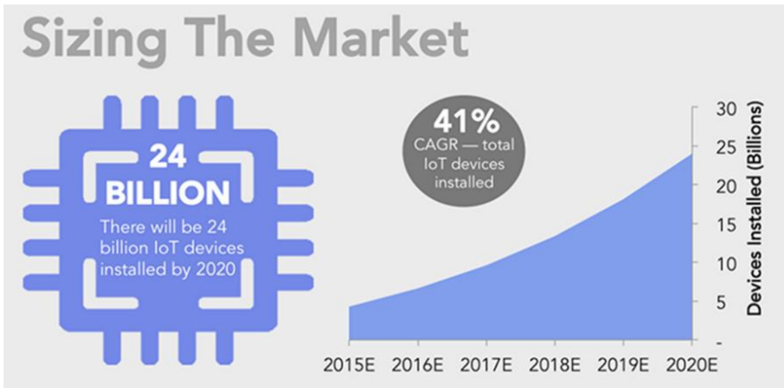
On the automotive and industrial side, we are particularly excited about the expanding semiconductor chip content in automobiles and on the factory floor with the Internet of Things or IoT that promotes interconnectivity within industrial automation. We recently listened to an analyst day webcast for one of our semiconductor holdings which highlighted compound annual growth rates for 2016-2021 within the auto area that ranged from 7-16.5% or two to four times overall semiconductor industry growth rates. As seen in the chart below, whether it be in a car's instrument cluster, its body electronics, Wi-Fi connectivity, rear seat infotainment or advanced driver assistance systems (ADAS), semiconductor content is on the rise in the automobile industry.



Source: Infineon

Apparently gone are the days of looking out the window as rear seat entertainment offerings strive for the "Airplane Plus Experience." This push toward Wi-Fi in your car is forecasted to result in a six fold increase in Wi-Fi chip products from 2016 to 2021 in this addressable market. In our opinion, NOR flash will also experience "hockey stick" growth through 2021 as these chips are key components in the ADAS systems expanding into the mid-market auto market to proliferate state of the art automobile safety.

Lastly, this previously mentioned analyst day featured a slide with the headline "Welcome to the IoT Era, the Biggest Opportunity Yet." The demand for semiconductor chips for smart homes, wearables, smart healthcare and industry applications is forecasted to dwarf the chip shipments from the computer and smartphone upcycles and to do so over a shorter period of time. According to International Data Corp. analysis, the IoT market is forecasted to nearly triple from $656 billion in 2014 to $1.7 trillion in 2020. Fasten your seatbelts folks as chipmakers with Wi-Fi and Bluetooth offerings will be in the driver's seat to offer high-speed, secure, low power units to fulfill the needs of a burgeoning number of IoT devices as seen in chart below.

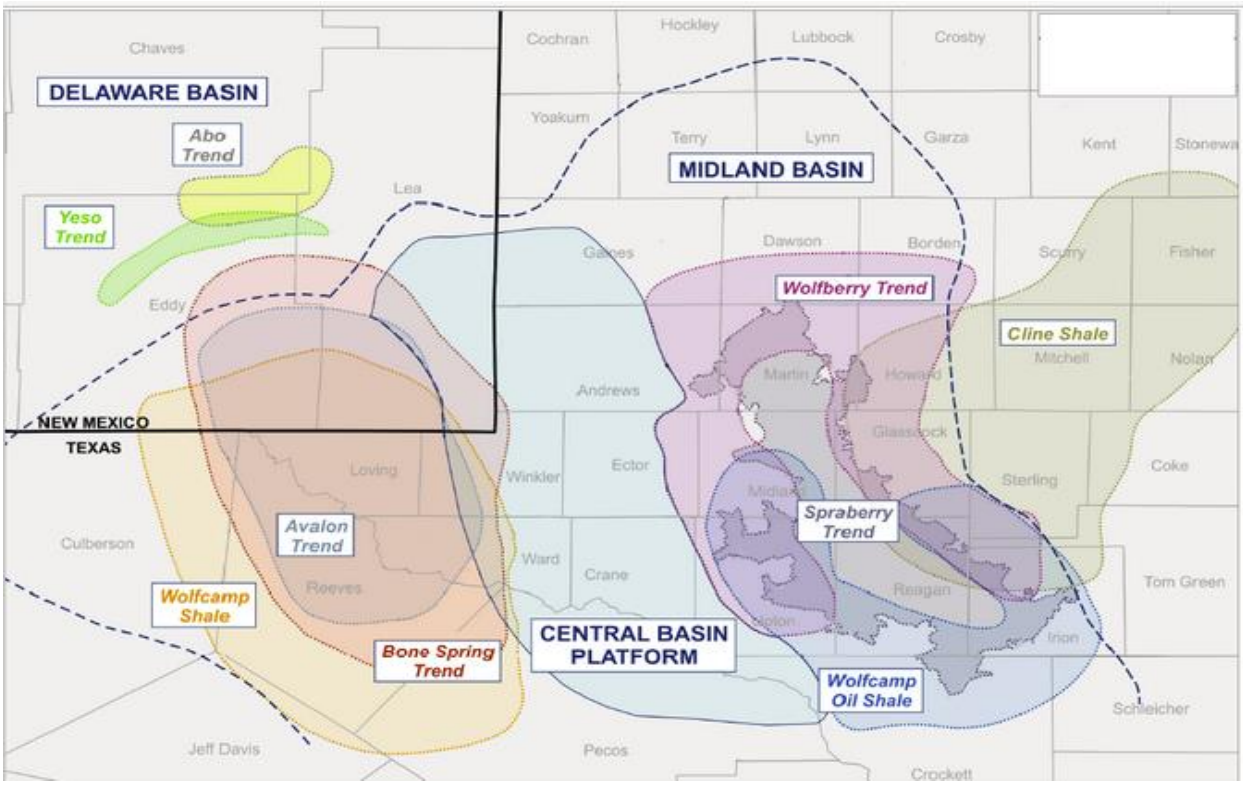


Source: Business Insider

IoT is often referred to as the next Industrial Revolution, and we are on the lookout for the companies that are best positioned for this significant tailwind of growth and for the other growth avenues emerging in this technology super cycle.

<u>Thematic Investing: Welcome to Delaware – the Basin not the State</u>

During the first quarter, we had the opportunity to meet with several oil and gas executives at a conference during a field trip to several headquarters in Denver, Colorado and Dallas and Midland, Texas. We continue to deploy a domestic shale oil theme in the 1492 Capital Management strategies and, as previously mentioned, believe that growth in this sector is vital to the overall growth in the U.S. economy. One of the key drivers to this now reinvigorated sector is the highly economic, horizontal drilling for oil in west Texas in the Permian basin (see map below). During 2016, the industry was pouring resources into drilling for oil on the east side of the Permian basin called the Midland basin. This capex upswing helped to pull the domestic rig count off of the floor of 380 rigs in May and to bring people and materials back to work. Later in 2016, the western part of the Permian basin called the Delaware basin came quickly into the drilling spotlight, and activity there has helped propel the domestic rig count to 802 land rigs, according to Baker Hughes, which is a 26% increase from year end 2016 alone. Similar to Clark W. Griswold's jelly of the month club gift in Chevy Chase's Christmas Vacation movie, the Delaware basin, in our opinion, appears to be that "gift that keeps on giving." With each passing quarter, a new oil and gas producing zone is tested in the Delaware that adds to an oil and gas producer's future drilling inventory. A key takeaway from our field trip is that there are over nine different producing zones in the Delaware with several of the zones being so thick that the industry will drill parallel horizontal wells within the same zone to effectively drain the oil. Drilling and thus economic activity will continue to accelerate as several large oil companies such as ExxonMobil, Marathon Oil and EOG Resources have acquired operations in the northern part of the basin recently. If companies of this size are writing checks to enter or increase their stake in the play, we view that exercise as a very positive endorsement of the Delaware basin.



Source: Shaleexperts.com

Simply put a higher drilling rig count translates into more oil wells that need to be completed or fracked. From our data points from the field trip, not only are their more wells to frack but the horizontal length of each well is increasing from 4,500 feet out to as much as 10,000 feet which necessitates larger fracks. Larger fracks mean more diesel engine horsepower, more crew, and more sand per foot of horizontal well to conduct an efficient frack. The sand is pumped into the well to create fractures for better oil flow into the wellbore. More sand translates to more sand mining activity, more rail traffic as this sand can come from as far away as northern Wisconsin and more trucking to get the sand from its rail stop to the wellsite. A flowing oil and gas well also needs a series of gathering lines, tanks and processing facilities to prepare it for its trip through a pipeline to a refinery. Lastly in order to keep oil production growing, additional reinvestment in drilling, fracking and related services is constantly required as the first year production decline from a west Texas horizontal oil well can easily be in excess of 50%. Growth translates to a perpetual need to place more oil wells on production, and the tentacles of the oil and gas industry consequently lubricate a wide variety of economic engines.

Updated 2017 Outlook – A Picture is Worth a Thousand Words

Above we articulated our updated 2017 outlook and the key issues and drivers for the stock market. However, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided to express it in pictures. As they say, a picture is worth a thousand words, and we'll let you interpret what we view as some compelling charts. We'll provide a bullet point or two of explanation as to why we think the chart or graphic is important.

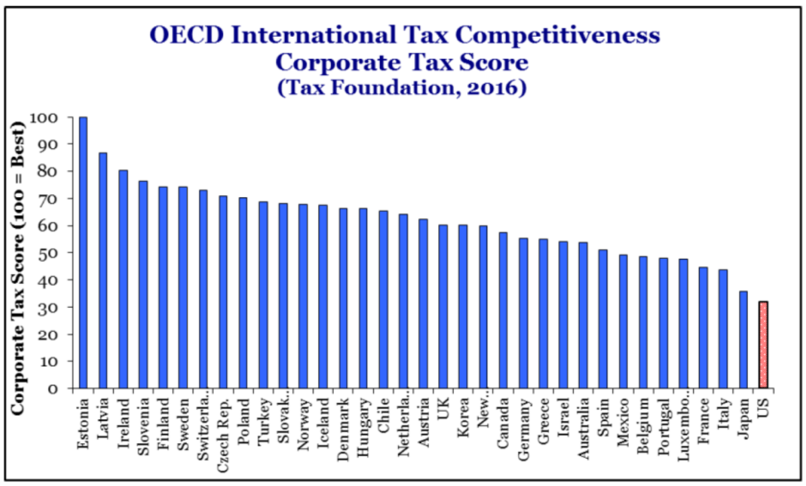
The level and direction of GDP growth is quite important when it comes down to stock returns. The current U.S. GDP growth of 2% puts us on a very precarious precipice between strong and very weak market returns.

Forward 12 Month Market Returns for Given GDP Levels

Real GDP	R2000		S&P 500		R2 Less SP5	
Range	Avg	% Up	Avg	% Up	Avg	% Beat
Above 5%	-10%	0%	1%	100%	-11%	0%
4% to 5%	16%	71%	18%	86%	-2%	71%
3% to 4%	10%	78%	10%	89%	0%	44%
2% to 3%	**19%**	**88%**	**14%**	**88%**	**5%**	**75%**
1% to 2%	**-3%**	**20%**	**1%**	**40%**	**-3%**	**40%**
0% to 1%	**1%**	**100%**	**-13%**	**0%**	**14%**	**100%**
-1% to 0%	14%	67%	5%	67%	10%	100%
Below -1%	23%	100%	19%	100%	4%	100%

Source: Furey Research

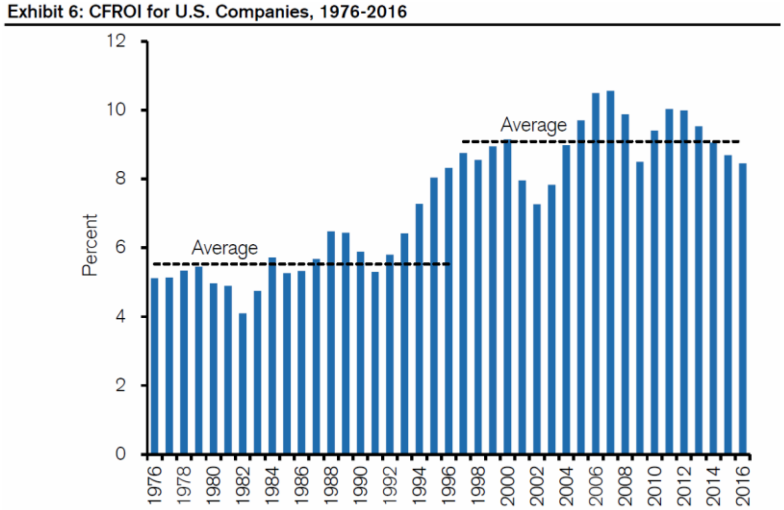
So do you think we need tax reform?



Source: Strategas Research

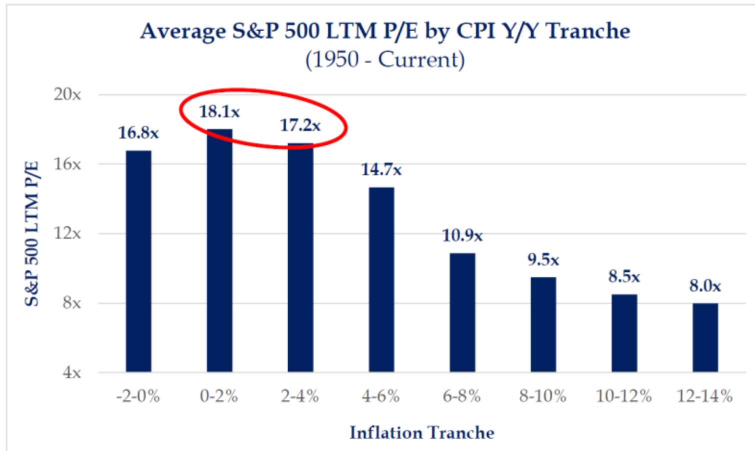
Maybe there's a good reason why the stock market should be trading at above average historical P/E multiples.

Exhibit 6: CFROI for U.S. Companies, 1976-2016



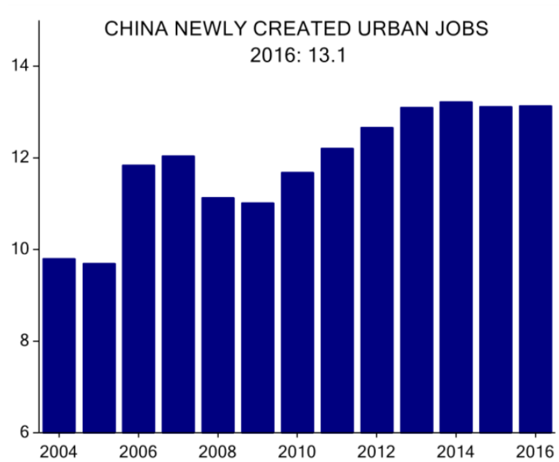
Source: Credit Suisse HOLT®.
Note: U.S. industrial firms, weighted by net assets.

Not too hot and not too cold, but just right provides the highest multiples when it comes to inflation. This chart lends support for current market multiples as CPI is around 2% currently.



Source: Strategas Research

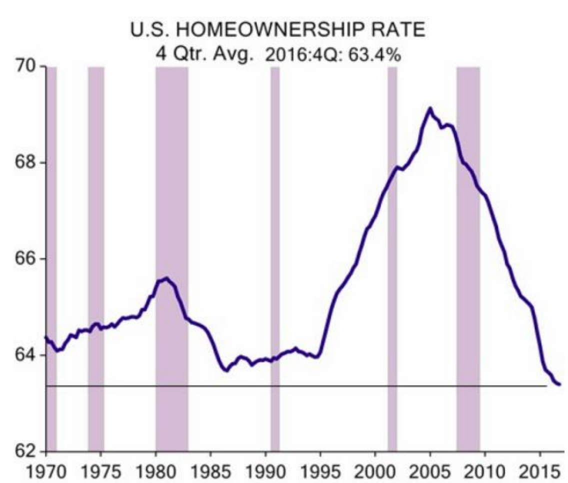
The chart below puts China's enormity into perspective.



China is massive! Employment in China increased +13.1m in 2016. Employment in the US increased +2.2m in 2016.

Source: Furey Research

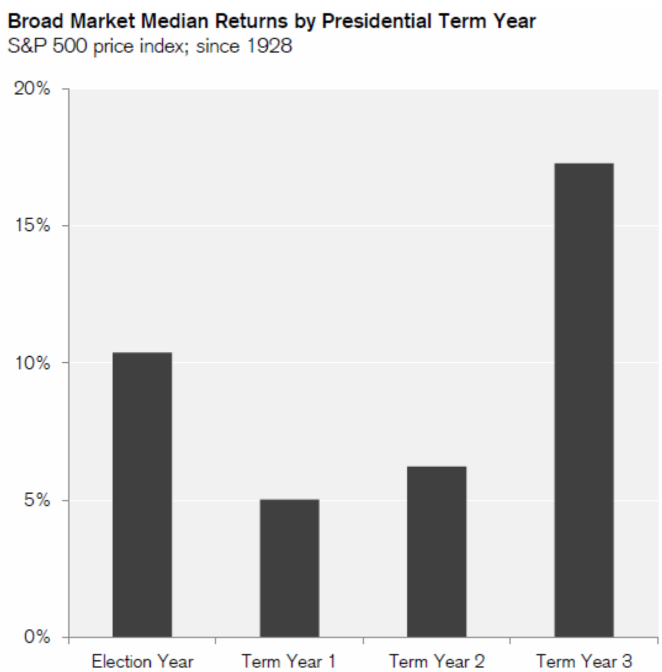
Housing supply is tight. What happens if the Millennials want to start buying homes?



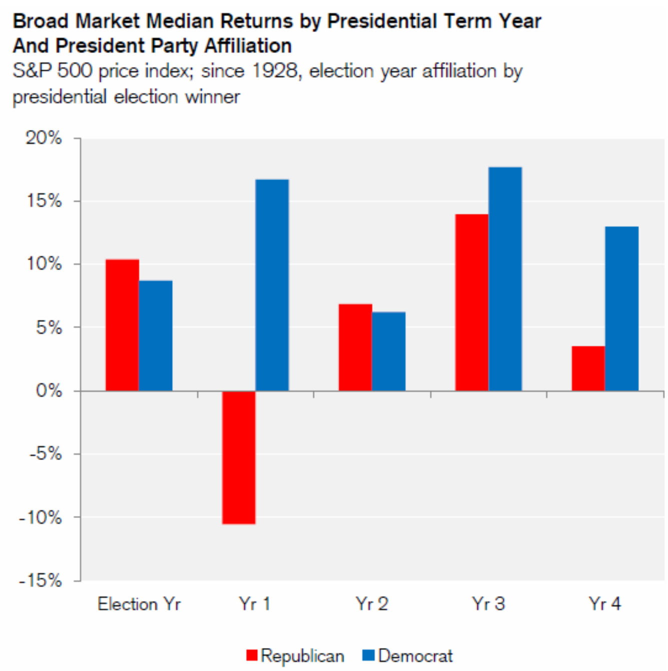
Source: Evercore ISI

Market Trivia

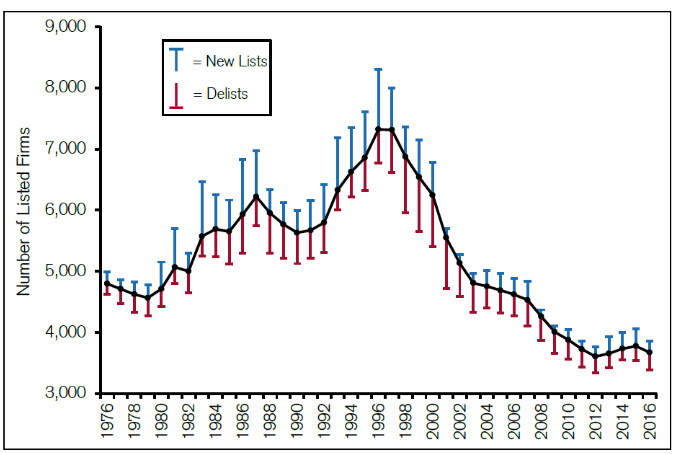
Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. By now you're probably sick of Presidential talk. However, we thought that one more reference to returns in a given year of a Presidential term was appropriate. By the looks of it, year one is the one to watch out for, particularly if it's Republican.



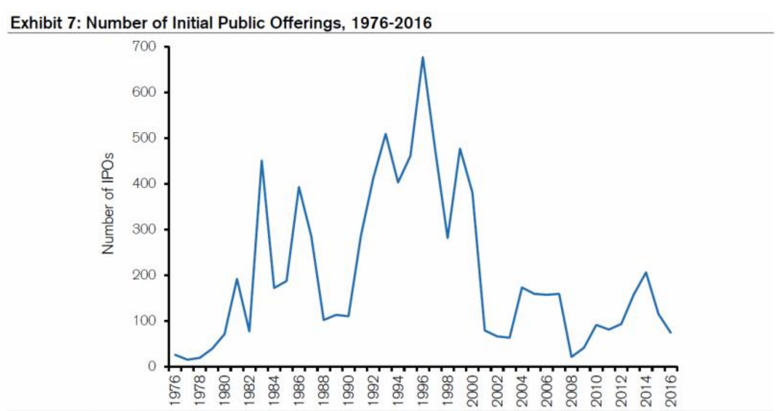
Source: Credit Suisse



In last quarter's newsletter we had a piece called the "Incredibly Shrinking Stock Market" which highlighted how the number of publicly traded companies has shrunk from almost 7,500 to about 3,500 currently. The chart on the right shows this phenomenon with the new listings offset by the delists. The IPO's are the biggest source of new listings, but as shown on the right chart, the number of IPO's which peaked in 1996 has declined precipitously and is approaching all-time lows. The delists are a primary function of buyout activity which has accelerated as private equity fund assets have ballooned over the last several decades.



Source: Doidge, Karolyi, and Stulz, "The U.S. Listing Gap" and Credit Suisse estimates.



Source: Jay R. Ritter, see https://site.warrington.ufl.edu/ritter/ipo-data/.
Note: Data for all years exclude IPOs with an offer price below $5.00, ADRs, unit offers, closed-end funds, REITs, natural resource limited partnerships, small best efforts offers, and stocks not listed on the New York Stock Exchange, the Nasdaq Stock Market, or the American Stock Exchange (currently NYSE MKT); Data for 1980-2016 also exclude IPOs from banks and savings and loans.

We hope that you found our first quarter 2017 and updated 2017 outlook newsletter insightful and interesting. Should you have any questions about anything discussed herein or would like more information about 1492 Capital Management, please call us at 414-276-1492.

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