1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
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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 third quarter of 2016. 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.

Last quarter we decided to forego writing our normal quarterly newsletter in lieu of a piece entitled "The Case for Small Caps" because we felt that small cap valuations, fundamentals, and balance sheets had aligned to offer a compelling opportunity for small cap outperformance. While we had conviction in our call, we certainly didn't expect it to develop as rapidly as it has. Small caps posted their best quarter since 2013 rising nearly +9.1%, far outpacing the S&P 500 return for the quarter of +3.85%. Small caps strong third quarter have pushed them into a commanding year-to-date lead of nearly +360 basis points relative to the S&P 500 (+11.46 vs. +7.84%). This advance all happened just as Brexit was supposed to cast a pall over global growth and consequently the stock market. To the contrary, markets rallied in one of the lowest volatility summers that we've seen in quite some time, powered by additional central bank stimulus programs around the globe and our own Fed leaving interest rates unchanged. However, with the U.S. election in focus, we expect volatility to fire back up as the uncertainty as to who our next President will be likely roils the market a bit in the coming month. However, this too shall pass. The one constant that has continued this year is the drumbeat of negative sentiment and record outflows from equity based mutual funds and ETF's (nearly $150 billion) which have far surpassed the total outflows during the great recession of 2008 and 2009. Despite this negative backdrop, the market continues to push ever higher. Why is this happening and will it continue? We try to shed some light on this topic in the balance of this newsletter. So please read on to see our unique views of what's on tap for the rest of 2016 and indulge in some stock market trivia regarding Presidential elections and what changes may mean to the stock market.

If you would like to discuss any of these strategies with us, please contact Tim Stracka at 414-238-3398.

Thanks to our clients and all those who have continued to support us over the past eight years as we build the best small cap investment firm in the country.

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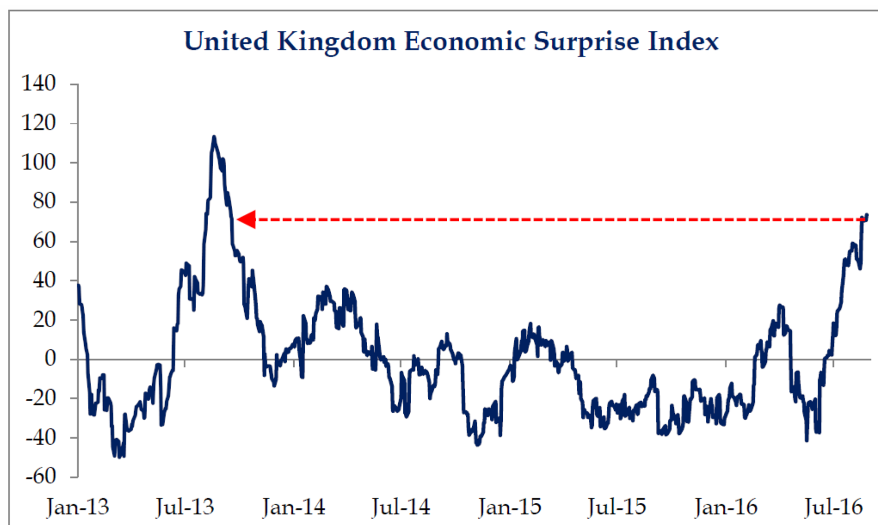
CONTACT US

1492 CAPITAL MANAGEMENT
309 North Water St. Suite 505
Milwaukee, WI 53202
Main: 414-276-1492

www.1492CapitalManagement.com

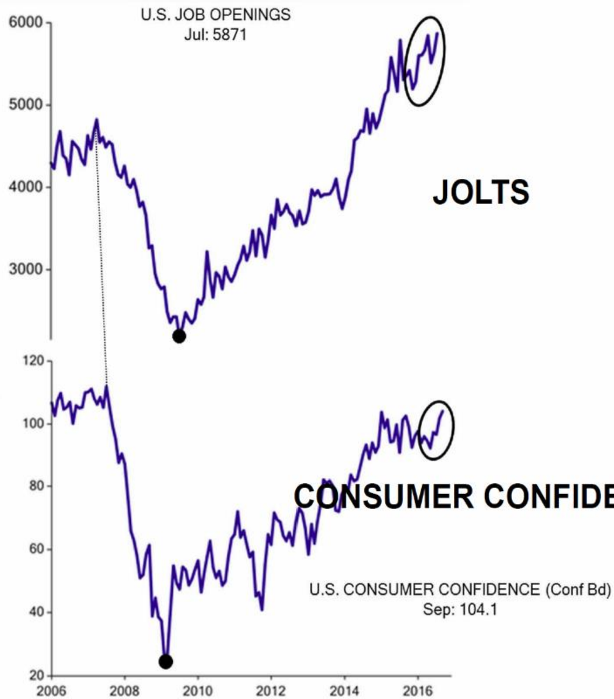
A Review of the Quarter: Second Head Fake of the Year – First Global Recession Fears, Then Brexit

2016 started with fears of a global recession that were trumped up (no pun intended) as the world economy was actually beginning to accelerate while recession panic escalated. Similarly, in the third quarter, another head fake hit with Brexit as prognosticators predicted another collapse of the global economy as Britain voted to unwind their ties with the European Union. Once again, these doom and gloom predictions proved to be incorrect and short-lived. In fact, the post Brexit stock slump lasted exactly two days and saw a quick 7% decline which was quickly recouped with most major stock indices pushing to new all-time highs near the end of the quarter. Additionally, the global economic data has improved as China and the U.K. have seen a nice uptick in their economic statistics of late. The chart below highlights the significant ramp that we've seen in the U.K.'s recent economic statistics. Similar to the first quarter market swoon, what many fear mongers forgot to put into their market calculus was that policy makers around the globe have added fuel to the economic fire over the past year with massive easing programs in Europe and Japan, huge stimulus programs in China, and an end to the fiscal austerity program here in the U.S. EU and Japan also enacted additional stimulus programs to offset any ongoing implications from Brexit. Whether you agree with these programs or not, they are stimulative at their core and should have a positive effect on the global economy with some lag.

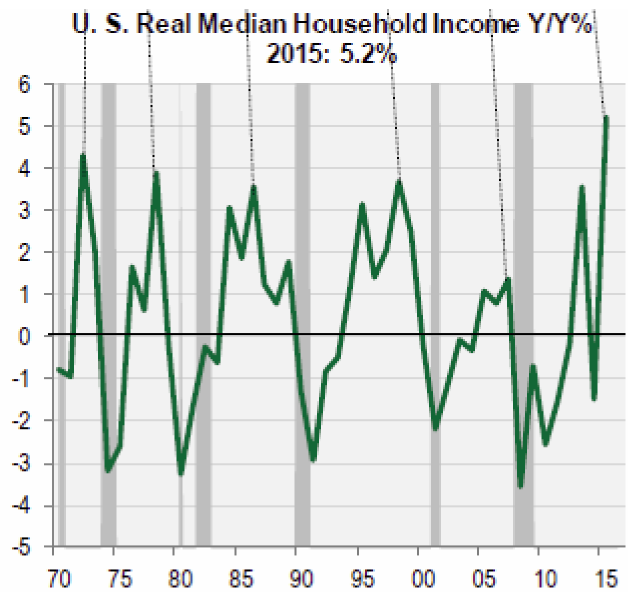


Source: Strategas Research

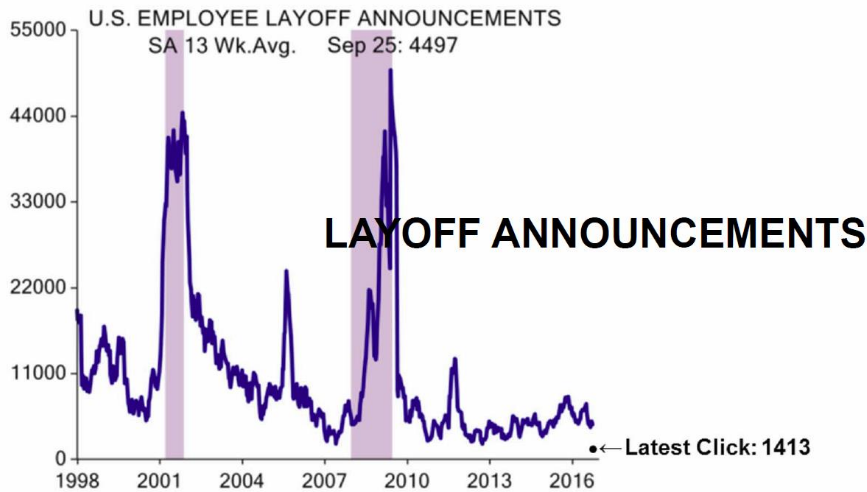
While back at home, the U.S. economy is anything but robust. Third quarter GDP should accelerate off the lackluster second quarter GDP print of +1.4% due to the end of the inventory correction experienced in many industries and an uptick in oil patch activity. One of the key drivers to improved and sustained growth that we've mentioned in this newsletter that's been missing over the past few years is the housing market. We've pointed out time and again that if the housing market could accelerate and close the gap on the precipitous drop in the number of new homes built following the 2008/2009 recession, the economy would feel a lot better. This recovery has been very slow to develop, and even seven years post the end of the recession, we are nowhere near pre-recession building levels. However, as we highlight in the charts below, there are some nice trends developing which could accelerate the building pace. In the first three charts below, you can see that most of the ingredients for a sustained uptick in housing activity are evident, including strong employment numbers (high in JOLTS (Job openings) and low in layoffs), mortgage rates at near all-time lows, accelerating household income, and strong consumer confidence readings. The one ingredient missing is bank loan availability. See our section below entitled *"**Regulations' Noose on U.S. Economy is Choking off the Current Recovery**"* where we address the impact of onerous regulations on the U.S. economy.



Source: Evercore ISI

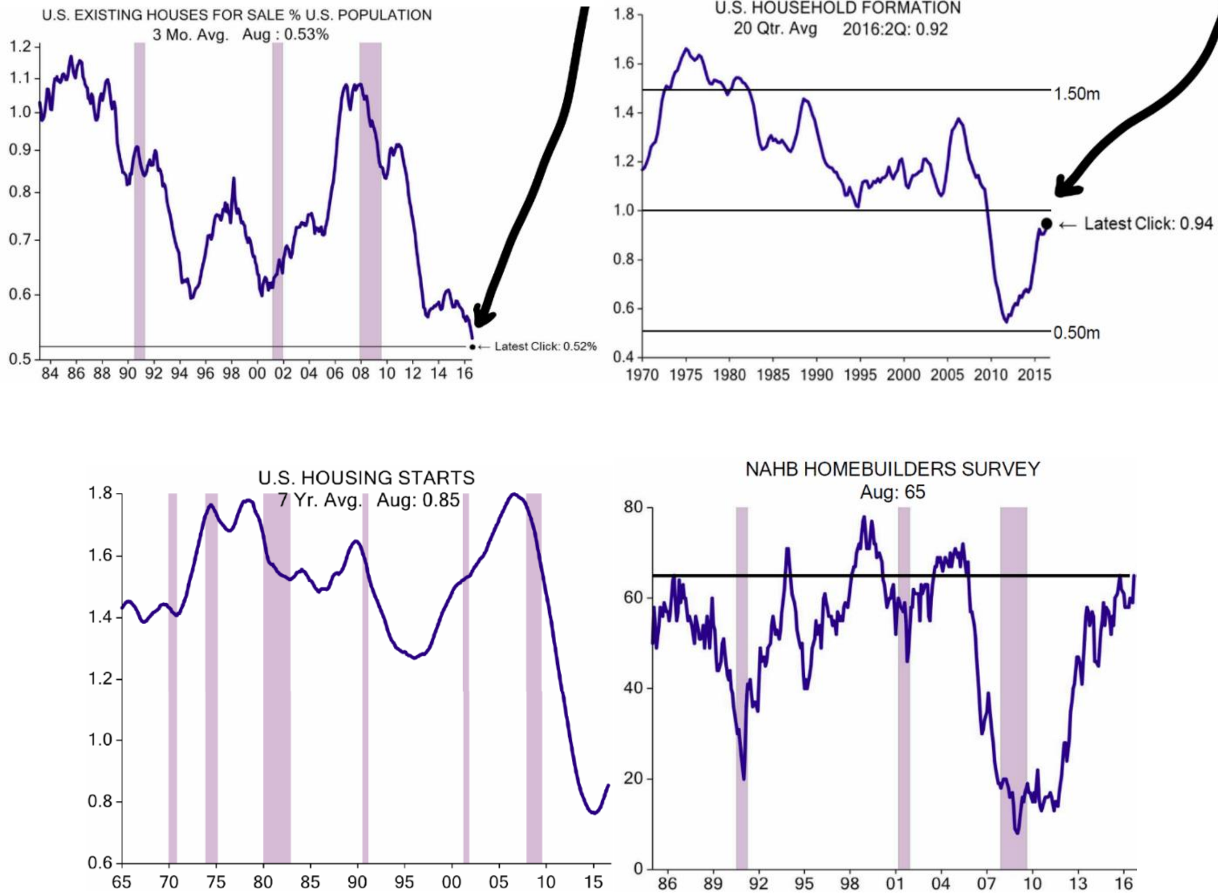


Source: Cornerstone Macro



Source: Evercore ISI

The table is set for accelerating trends in the housing market as the charts below show. Inventory of existing homes for sale as a % of the U.S. population is at an all-time low as shown in the chart below left. Household formations (below right), which were trending modestly higher, have accelerated nicely as millennials are approaching home-buying age, and boomerang children are getting back out of their parents basements. The chart in the second row below left shows the seven year trailing housing starts number. As you can see, after falling for the last seven years, the trend has turned, but the current build rate of 850,000 homes per year is well below the 1.5 million average of the previous four decades. The chart in the second row right shows that homebuilders are starting to see the demand from these pent up conditions and feel pretty good about the building environment. Over the past 50 years, housing activity has accounted for 4.5% of GDP on average, and it currently stands at 3%. Therefore, any uptick in the housing sector could have a meaningful impact on the U.S economy. In order to close this gap, the banking industry has to loosen up their lending practices which are being strangled by the regulator's noose.



Source: Evercore ISI

Despite a terrible start to the year, the market made a resounding comeback in the last six months, erasing all of the damage done in the first quarter of the year. In the third quarter, small caps posted their best quarter since 2013 rising nearly +9.1%, far outpacing the S&P 500 return for the quarter of +3.85%. The small caps strong third quarter has pushed them into a commanding year-to-date lead of nearly +360 basis points relative to the S&P 500 (+11.46 vs. +7.84%). This all happened just as Brexit was supposed to cast a pall over global growth and consequently the stock market. To the contrary, markets rallied in one of the lowest volatility summers we've seen in quite some time, powered by additional central bank stimulus programs around the globe and our own Fed leaving interest rates unchanged. From a sector standpoint, eight out of ten sectors in the Russell 2000 posted positive results for the quarter with five of them posting double digit returns. The two negative sectors were Utilities (-4.8%) and Staples (-1.9%), which reversed a long trend of outperformance for both of them. The two best performers in the quarter were Technology (+18%) and Healthcare (+13.9%). The Healthcare sector's strong performance was driven by a resurgence in biotech stocks on the heels of a few takeovers. In our opinion, active managers weren't too happy to see the resurgence in this group. The table below highlights the returns for the third quarter of 2016 for the popular indices.

Index Returns		
Index	Third Qtr. 2016 Return	2016 YTD Return
Russell 2000	+9.05%	+11.46%
Russell 2000 Growth	+9.22%	+7.48%
Russell 2000 Value	+8.87%	+15.49%
S&P 500	+3.85%	+7.84%
Dow Jones Industrials	+2.11%	+5.07%
NASDAQ Composite	+10.02%	+7.09%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Growth Index (+9.2%) modestly outperformed the Russell 2000 Value Index (+8.9%) for the quarter. As mentioned above, the strong performance by technology and biotech stocks lifted the growth index as these sectors have a much larger representation here than in the value index. The two tables below highlight the performance of the Russell 2000 style indices by sector.

Table 4: Russell 2000 Growth's performance attribution for September 2016

	September			Third Quarter			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	-1.74	-0.29	-3.18	3.73	0.72	-5.49	6.41	1.61	-1.04
Staples	-2.92	-0.09	-4.36	-5.04	-0.16	-14.26	3.34	0.17	-4.11
Energy	4.84	0.04	3.40	18.04	0.15	8.83	0.86	-0.06	-6.59
Financials	-2.57	-0.17	-4.01	7.05	0.43	-2.17	2.68	0.16	-4.77
Health Care	5.60	1.27	4.16	13.46	3.03	4.24	-2.57	-2.27	-10.02
Mat. & Process	-0.51	-0.05	-1.95	9.22	0.84	0.00	22.17	1.98	14.72
Prod. Durables	-0.13	-0.03	-1.57	7.74	1.07	-1.48	14.30	2.14	6.85
Real Estate	-1.26	-0.08	-2.70	0.70	0.04	-8.52	17.38	0.79	9.93
Technology	4.07	0.79	2.62	17.64	3.18	8.43	15.90	2.83	8.46
Utilities	1.83	0.04	0.39	-3.71	-0.09	-12.93	1.93	0.07	-5.51

Table 5: Russell 2000 Value's performance attribution for September 2016

	September			Third Quarter			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	-0.58	-0.07	-1.37	7.17	0.82	-1.71	5.86	0.72	-9.66
Staples	-2.97	-0.07	-3.76	2.73	0.08	-6.15	16.93	0.54	1.41
Energy	5.66	0.26	4.87	11.13	0.50	2.25	19.65	0.76	4.13
Financials	-0.43	-0.13	-1.22	10.90	2.91	2.02	9.96	2.50	-5.56
Health Care	6.85	0.32	6.07	14.27	0.66	5.40	7.06	0.25	-8.46
Mat. & Process	2.98	0.16	2.19	12.55	0.68	3.68	41.14	1.94	25.63
Prod Durables	0.97	0.12	0.18	10.51	1.32	1.64	13.77	1.72	-1.75
Real Estate	-2.68	-0.38	-3.47	3.77	0.56	-5.11	18.54	2.96	3.02
Technology	4.51	0.47	3.72	18.58	1.77	9.71	25.75	2.45	10.23
Utilities	1.31	0.10	0.53	-5.18	-0.42	-14.06	16.34	1.71	0.82

Source: Jefferies

Within small cap stocks, there has been a trend in place since April 2014 in which the performance of small caps is linearly worse as you move down the market cap spectrum. After a very painful period for any money manager who skews smaller, this trend finally reversed in the third quarter. The two tables below highlight this phenomenon. The first table below shows the performance differential by market cap quintile for the period March 31, 2014 through June 30, 2016. The second table shows the same differential but viewing it from June 30, 2016 through September 30, 2016 as circled in red. The differential between the top and bottom market cap quintiles approached nearly 2600 basis points of underperformance as you moved down market cap over this two-plus year period. This chasm is the widest that we can remember over any timeframe. The good news is that this trend reversed in the most recent quarter and the differential declined about 660 basis points. Only time will tell if this trend has legs.

iShares Russell 2000 ETF
3/31/2014 to 6/30/2016
U.S. Dollar

Market Cap	Total Return	Port. Contribution To Return	Port. Beginning Weight
Total	**2.05**	**2.05**	**100.00**
MC Quintile 1: 1635.6 - 30151.7	5.92	3.61	49.72
MC Quintile 2: 969.2 - 1630.3	2.13	0.43	24.87
MC Quintile 3: 555.0 - 969.1	1.23	-0.07	14.08
MC Quintile 4: 296.6 - 553.7	-2.05	-0.23	7.52
MC Quintile 5: 0.0 - 296.5	-17.01	-0.77	3.75
[Cash]	0.13	0.00	0.05
[N/A]	-19.23	-0.92	0.01

Holdings Data As Of
iShares Russell 2000 ETF 3/31/2014 through 6/30/2016

iShares Russell 2000 ETF
6/30/2016 to 9/30/2016
U.S. Dollar

Market Cap	Total Return	Port. Contribution To Return	Port. Beginning Weight
Total	**9.02**	**9.02**	**100.00**
MC Quintile 1: 1582.5 - 10239.0	6.65	3.41	50.62
MC Quintile 2: 920.5 - 1582.4	10.83	2.71	25.20
MC Quintile 3: 490.0 - 920.3	10.57	1.42	13.46
MC Quintile 4: 263.3 - 489.4	14.39	1.03	7.19
MC Quintile 5: 23.6 - 262.8	13.38	0.46	3.52
[N/A]	-0.99	-0.00	0.01

Holdings Data As Of
iShares Russell 2000 ETF 6/30/2016 through 8/31/2016

Source: 1492 Capital Management, LLC and Factset

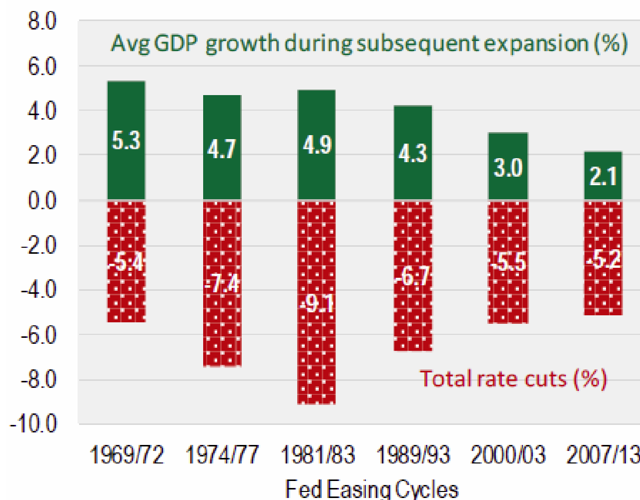
The U.S. stock market posted a strong third quarter, but most stock markets around the globe posted an equally strong quarter. Commodities and interest sensitive investments paused, but most are up nicely year-to-date. Whether it's the search for yield or a stimulus-led acceleration in global growth, equity markets continue to move higher. One of the biggest surprises below is the return that Brazil's stock market has seen just as most investors thought the country had entered a recessionary abyss. China, which is showing a strong resurgence in economic growth, is one of the biggest laggards for the year as investors there seem to be enthralled with chasing the latest housing bubble. Unbelievably, volatility, which had been called out by many pundits to rise dramatically this year, has fallen dramatically and approached levels not seen since last June. The upcoming election will likely cause volatility to pick up for a time until we know who the next President is.

Index	Third Qtr. 2016 Return	2016YTD Return
France	+5.0%	-4.1%
Germany	+8.5%	-5.1%
Brazil	+13.3%	+34.6%
India	+2.8%	+9.9%
China- A Shares	+2.6%	-15.1%
China- Shenzhen A Shares	+1.1%	-13.6%
Japan	+6.1%	+10.5%
Long-Term Treasuries (TLO)	-.4%	+14.9%
Investment Grade Corp. Bonds	+1.1%	+9.9%
Gold	-.3%	+24.2%
Volatility- VIX index	-15.0%	-27.0%
Oil	-.2%	+30.2%
Natural Gas	-.6%	+24.4%
Iron Ore	+6.8%	+43.1%

Source: 1492 Capital Management, LLC

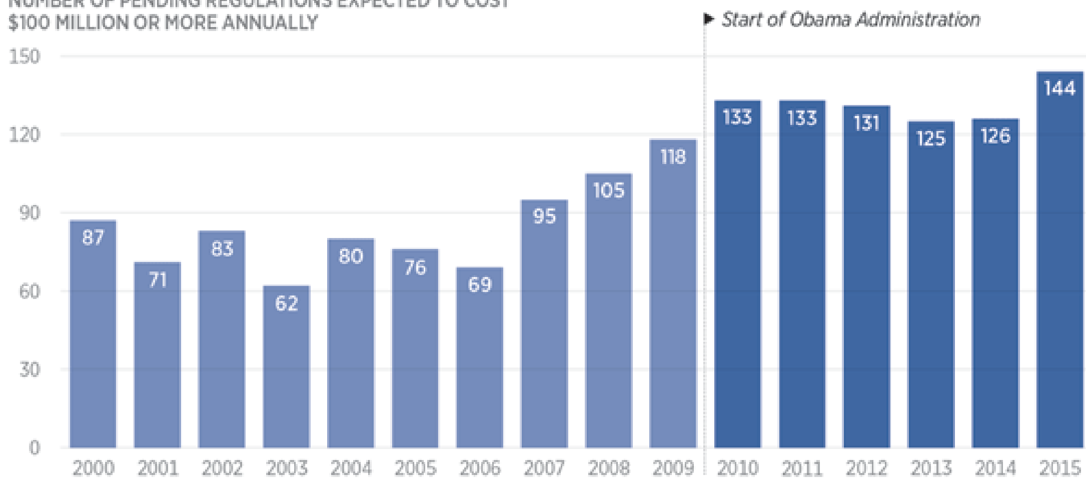
<u>Updated 2016 Outlook- Regulations' Noose on U.S. Economy is Choking off the Current Recovery</u>

A common question that we get from investors is "Why isn't the U.S. economy growing faster given how far it fell in the 2008 recession?" The chart directly below shows each of the past Fed easing cycles and the subsequent annualized GDP growth rate following the easing cycle. As you can see, the current cycle is showing an anemic +2.1% average growth rate, which is less than half of the rate experienced in the prior five easing cycles. While the answer is probably a combination of things, it's hard to ignore the one overarching reason in our mind and that is that the regulatory environment has become absolutely stifling since 2009. However, the regulatory burden has been increasing for decades and undoubtedly the Obama administration was dealt a tough hand entering office in 2009 given the state of the banking sector and economy broadly. Nevertheless there is a clear correlation between the regulatory burden and economic growth in the U.S.

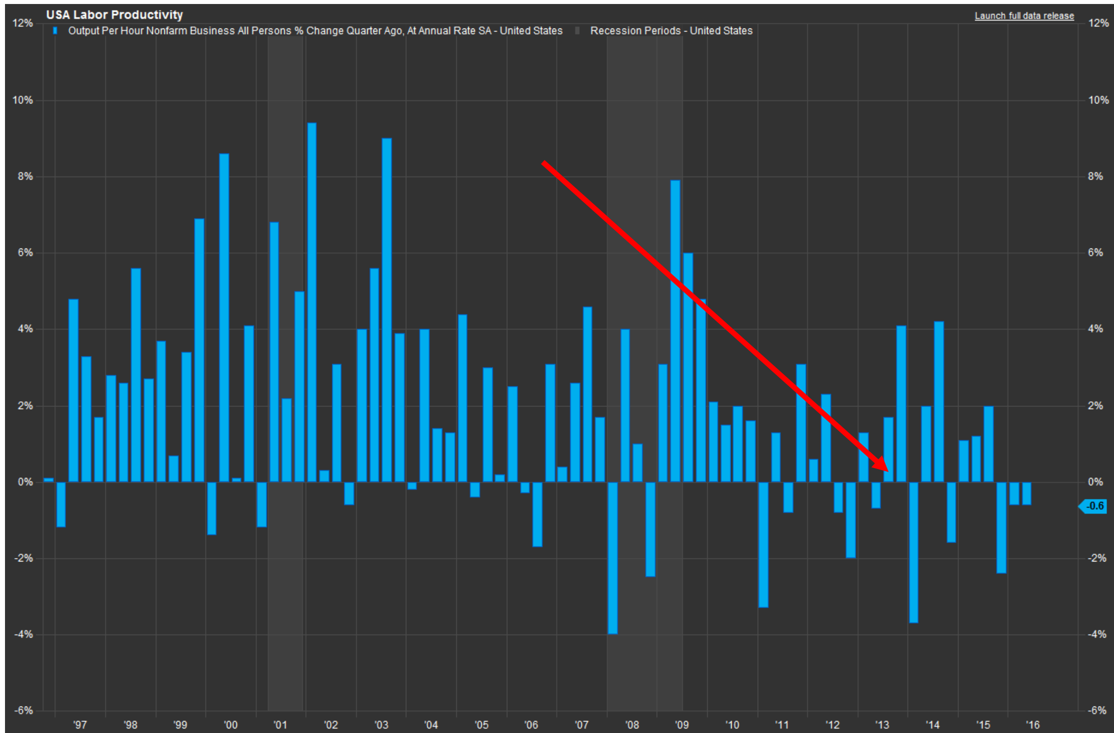


Source: Strategas Research

As support for our claim, the chart below shows the number of "economically significant" rules that have been imposed since 2009 compared to the immediately preceding Bush administration. An "economically significant" rule is one that has an expected compliance cost of $100 million or more annually. These rules have grown 40% over the previous administration! Examples of new regulations that have driven up costs to businesses and ultimately consumers are: higher utility rates resulting from the Environmental Protection Agency's "Clean Power Plan", escalating food prices due to new rules implemented by the Food and Drug Administration, tight access to consumer credit because of Dodd-Frank regulations, less access to physicians and significantly higher health insurance premiums thanks to the Affordable Care Act. In terms of numbers of regulations, the "economically significant" regulations are dwarfed by the total number of regulations enacted under the current administration, which number 2,353 in 2015 and 20,642 since Obama took office. This volume is having a distinctly negative impact on the productivity of the U.S. economy.



Below is a 20 year chart of the USA Labor Productivity statistic released by the U.S. Department of Labor. You can see a noticeable drop in annualized productivity growth since 2010 which coincides with the acceleration in regulations issued shown above. Of note, the last three quarterly readings have been negative, which is a feat we haven't seen in the last 30 years of data. A simple anecdote will shed some light on how this manifests itself in the real world. We had the opportunity to attend an investor conference focused on the banking industry last month. One of the common refrains that we heard after meeting with ten different publicly traded banks is that they've had to add a significant number of bodies to comply with all the new regulations that came into being as a result of Dodd-Frank. Additionally, they have to answer to numerous governmental bodies now like the OCC, CFPB, FINRA, SEC, and FRB, as well as state agencies. One of the banks that we spoke with at this conference told us that they have had to add over 25 bodies to their compliance staff, more than doubling it in the past three years, and this was for a relatively small bank. These added employees don't do anything but shuffle paper and fill out forms to keep the bank in compliance with current regulations. They aren't selling anything or providing anything that will enhance the activities of the bank, rather they are an added expense. This example is how productivity can turn negative in the real world.



Source: 1492 Capital Management, LLC and Factset

The federal government is open about 250 days per year. At the current pace, two major regulations will be issued every week. Regulation acts as a stealth tax on the American people and the U.S. economy that totals more than $2 trillion annually, which is more than is collected in income taxes annually and is larger than the GDP of all but 11 countries in the entire world. It is a hidden tax that amounts to $15,000 per U.S. household each year. Assuming that the economy doesn't accelerate dramatically before the end of his presidency, Obama will be the first President ever to not see a single year of 3% GDP growth. While admittedly he was dealt a tough hand coming into office in 2009, the increasing costs of regulation are acting as a noose around the neck of the U.S. economy.

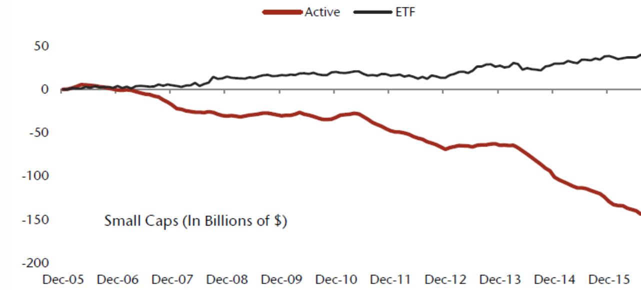
Updated 2016 Outlook: A Common Question We Hear – How is it Possible that the Stock Market is Going Higher? Answer – The Incredibly Shrinking Stock Market

We are often asked about our thoughts on the stock market and where we think it's headed. A common refrain of late has been "How is it possible that the market is going higher when there are so many negative issues in the world?" First, the context of the question tells you that they are likely in the naysayers camp which has been fed a bunch of one-liners from the talking heads on CNBC about why the market is going to implode tomorrow. Taking a step back, the stock market's direction is a function of many different inputs like fundamentals of the economy, valuation, psychology, government inputs, interest rates, money flows, etc., to name a few. To say the least, it's complicated. However, let's knock out a couple of these quickly. Psychology is probably the least tangible of the variables. Today it is negative based on investor surveys that we've seen lately and on the general tone emanating from the media outlets. This stance is probably a net positive for the market from a contrarian viewpoint as markets don't usually fall precipitously unless everyone is ebullient. Next, money flows into equity mutual funds and ETF's have been signficantly negative for a majority of the years since 2009. In fact, equity outflows from mutual funds and ETF's over the past 52 weeks is roughly $150 billion, which is more than what was drawn from the market in the 2008/2009 recession environment. As shown below right, over $100 billion net has flowed out of small cap mutual funds and ETF's since 2005. So clearly, flows have been a headwind for the stock market, yet the market's trudged higher.

Net Flows into Mutual Funds + ETFs ($BN)

Year	Equity Domestic	Equity International	Bond	Money Mkt
2009	3.3	69.2	417.2	-539.1
2010	-34.4	98.2	262.0	-525.1
2011	-86.0	28.3	163.7	-124.1
2012	-78.2	58.3	358.5	-0.2
2013	122.2	204.2	-59.0	15.0
2014	81.4	132.0	94.5	6.2
2015	-105.5	203.6	29.5	21.5
2016 YTD	-51.0	6.7	148.8	-47.1
TOTAL	-148.2	800.5	1415.2	-1192.9

Source: Strategas Research



Next we'll tackle governmental inputs. Clearly this factor has been a major support for markets worldwide with the ongoing quantitative easing programs in Europe and Japan and major fiscal stimulus in China. The U.S. is the only major government going against the grain, threatening interest rate hikes and they've already ended their quantitative easing programs. However, fiscal stimulus appears to be on the horizon no matter who is elected President. For now, governmental inputs are positive but could be less so as we enter 2017. Fundamentals of the global economy are "okay" in our opinion with global GDP hovering just under 4%. More specifically, U.S. based companies are growing earnings in the mid to high single digit range as the chart below shows. However, analysts are projecting an acceleration to the low double digit range in 2017 which feels a little lofty to us. With oil prices on the rise, earnings, however, could see an uptick as they lap easy comparisons from the last two years.

Weighted Median Yr/Yr EPS Growth; as of 8/5/2016

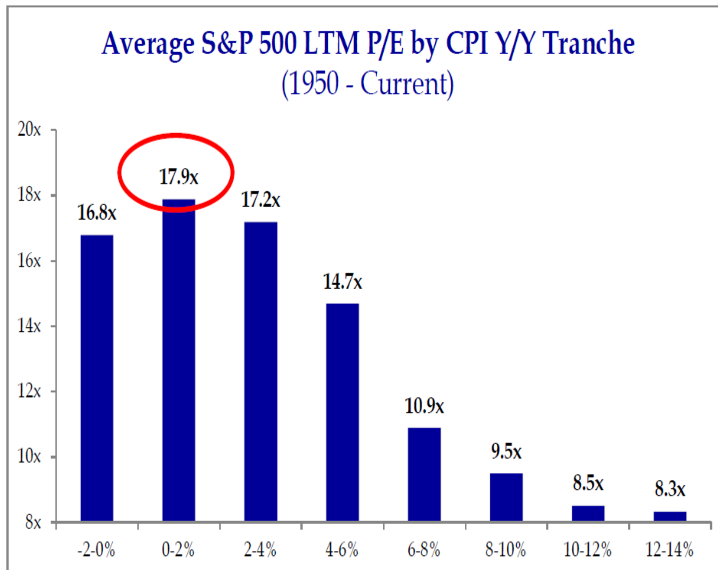
	Small Cap	Mid Cap	Large Cap
Quarterly			
1Q14	7.8%	10.0%	6.8%
2Q14	10.0%	10.7%	10.5%
3Q14	11.3%	11.3%	11.2%
4Q14	13.0%	13.2%	7.6%
1Q15	10.6%	7.2%	7.4%
2Q15	7.9%	6.7%	7.3%
3Q15	8.6%	6.9%	5.3%
4Q15	8.6%	5.3%	5.2%
1Q16	6.4%	7.1%	3.8%
2Q16E	7.5%	7.4%	5.2%
3Q16E	6.5%	6.0%	4.4%
4Q16E	7.7%	7.8%	8.2%
1Q17E	12.1%	10.3%	9.8%
2Q17E	11.8%	10.1%	9.9%
3Q17E	13.9%	11.8%	11.5%
4Q17E	12.5%	11.0%	11.4%
Annual			
2015	11.0%	6.5%	6.2%
2016E	7.3%	7.1%	6.0%
2017E	13.4%	10.9%	10.4%

Russell 2000, Russell Mid Cap, S&P 500

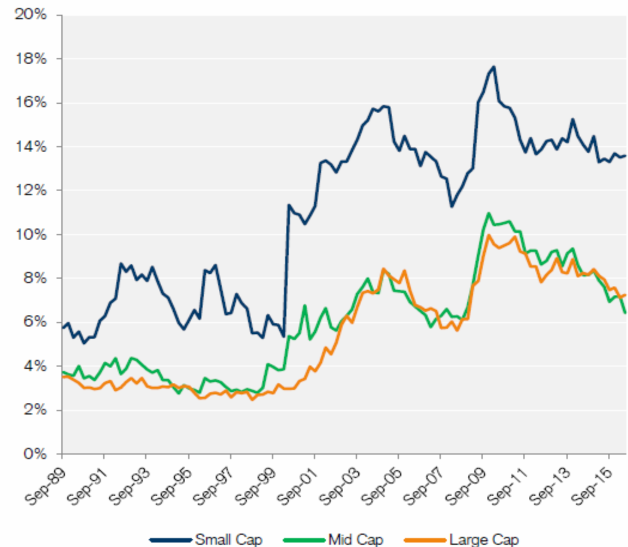
Source: Credit Suisse

Valuation metrics are a bit more nebulous because beauty is in the eye of the beholder. Certainly the stock market's valuation is near the high end of its historical range, but you can't compare valuations across time because so many variables that we spoke of already in this section change over time. For example, the S&P 500 currently trades at 16.9 times 2017 consensus earnings, but we've never seen interest rates this low, which enhances the valuation of any asset that is dependent on cash flows into the future. The chart below left shows the average P/E ratio of the S&P 500 by levels of CPI, which serve as a proxy for interest rates. Notice that when inflation is lowest, valuations are correspondingly higher and vice versa. As the chart

shows, when inflation is subdued in the 0-2% range which is where it is today, valuations average 17.9 times earnings. As the chart on the right shows, cash balances on corporate balance sheets are still at historically high levels which gives them dry powder to make acquisitions and buy back their shares. Additionally, cheap money has caused M&A activity to accelerate over the past few years as companies can borrow at tremendously low rates and pay almost limitless premiums to acquire additional growth legs to their businesses.



Source: Strategas Research



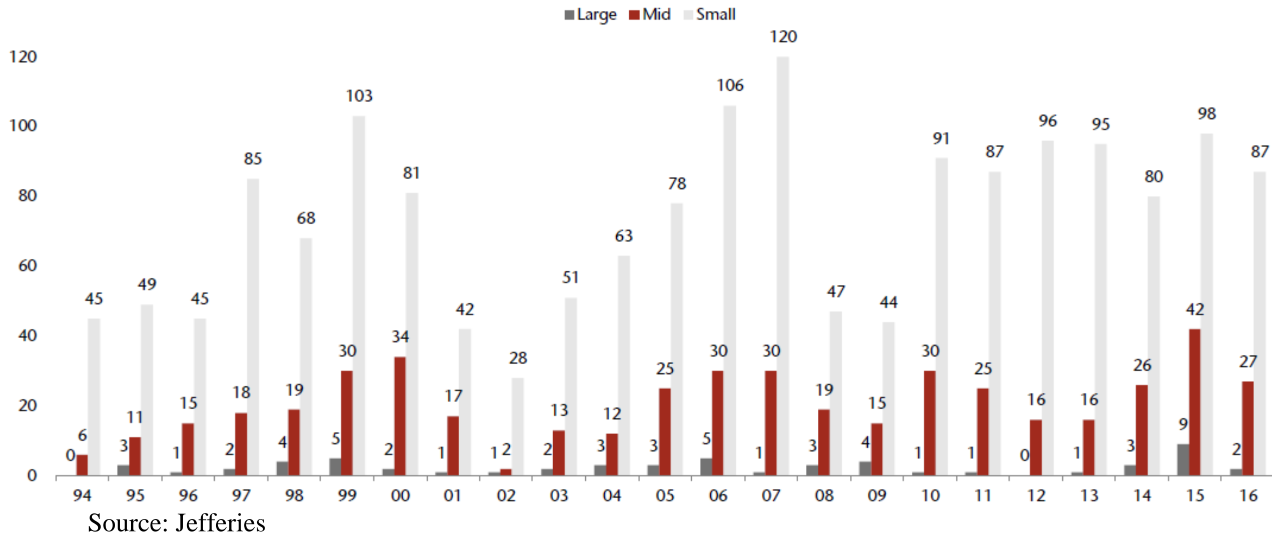
Source: Credit Suisse

We wrote about the coming M&A activity surge in our newsletter in 2014 in a section entitled "*Arb Opportunity of a Lifetime Will Debunk View That Small Caps are Expensive*". In this piece we made the following points that are still valid today and why we think we'll continue to see an elevated level of M&A activity for some time to come.

- The earnings yield (inverse of P/E ratio) is substantially above all bond alternatives.
- The S&P 500 dividend yield is greater than the yield on the 10 year Treasury note.
- Corporate profits are at all-time high.
- Cash on balance sheets as a percent of enterprise value has rarely been higher.
- Biotech stocks and non-earners inflate the P/E ratio of small cap stocks.
- Small cap profit growth is faster than large caps and deserves a premium.
- Valuations on a P/E basis are on par with the median value over past 40 years.

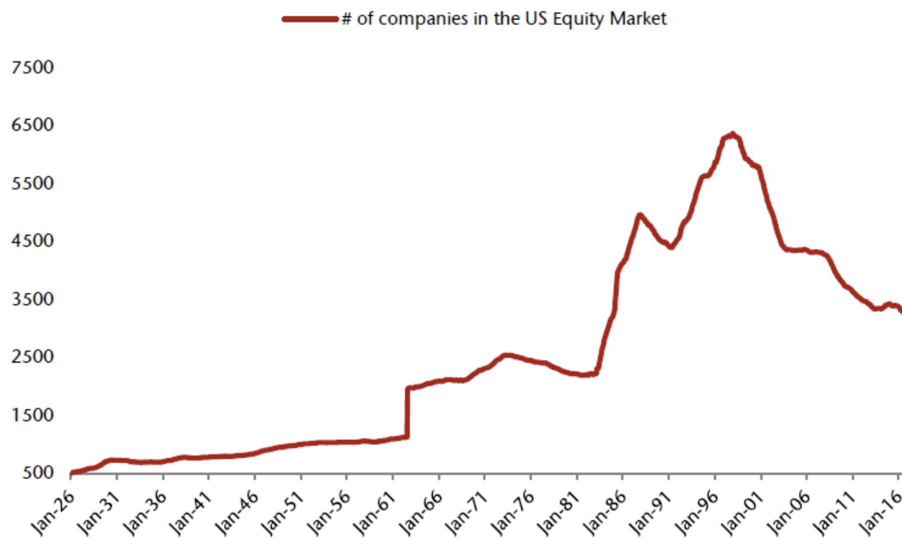
As you can see in the chart below, deal activity accelerated in 2014 and 2015, and the numbers in the chart for 2016 are only through May and will most definitely surpass the 2015 levels.

Deal activity really picked up and on pace to hit new records in small caps



Source: Jefferies

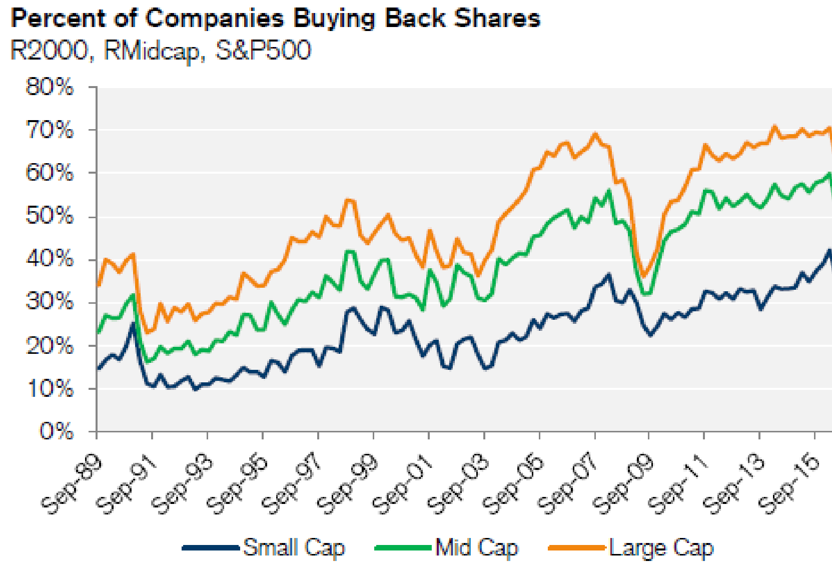
We've addressed all the generally observable data points that speak to why the stock market is at its current level. However, the one variable that most market participants don't factor into their market calculus and is generally not observable daily unless one does some digging, is that of the "incredibly shrinking stock market". Simply put, there are fewer publicly traded stocks available for purchase today than at any time in the last twenty years. As the chart below shows, the number of publicly traded companies has nearly been halved over the past twenty years for the reasons that we've highlighted in this newsletter. Regulations like Sarbanes-Oxley and Dodd-Frank have made being a public company quite onerous from a compliance standpoint and expensive. M&A activity has been accelerated over the past twenty years as shown above.



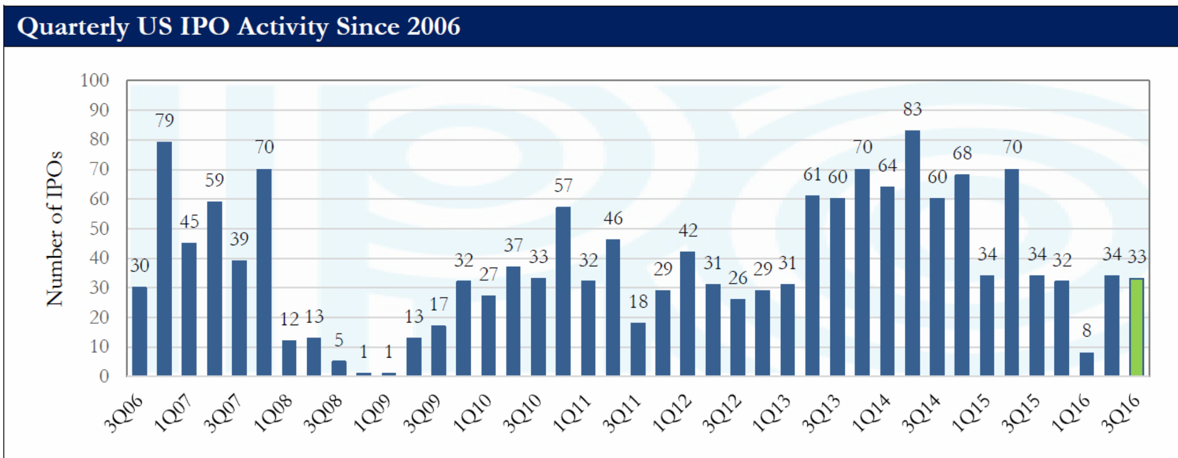
Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies.

Source: Jefferies

Lastly, adding fuel to the fire of the shrinking stock market are the corporate buyback programs that have increased over the past twenty years and have reduced the number of publicly available shares. A slowing IPO market has also added fewer new companies to the list. See charts below.



Source: Credit Suisse



Source: Renaissance Capital. Includes IPOs with a market cap of at least $50 million and excludes closed-end funds and SPACs.

Thematic Investing: Update on our "Regional Bank-Tax Haven States" Investment Theme

In our third quarter 2015 quarterly newsletter, we communicated with our clients that we had deployed a regional bank - tax haven states theme (previously named Florida/Texas bank theme) that focused on bank franchises in states with zero state income tax. After meetings with several bank management teams that were headquartered in the robust economies of Tennessee, Florida and Texas, we selected our investments for this theme. It was our belief, at the time and it still is, that the tax haven states would have the best inbound migration of people and job growth. Over the last couple of months, we have digested the banks' second quarter earnings reports and were recently fortunate to again meet with several bank management teams from tax haven states at a conference.

From our banks headquartered in Texas, we learned once again why groupthink can be dangerous. Despite plummeting energy prices throughout 2015 which was supposed to have had all the inhabitants of the Lone Star State curled up in the fetal position in fear, the state managed to report the nation's third best rate of growth, according to 24/7 Wall St., which shows the balanced

nature of their once oil-centric economy. In the second quarter 2016, our two Texas banks in the theme posted double digit, annualized linked quarter loan growth and improved credit quality. Both management teams are also excited about merger and acquisition activity to expand their banks. It is interesting to note that one CEO commented that now is an opportune time to make new energy loans as pricing has improved 75 to 100 basis points with significant private equity behind many companies. The lender can also demand 75-90% of oil and gas production be hedged as some of their banking peers have retreated from the energy arena. After meeting with both management teams at this September conference, we believe that our holdings have weathered the energy downturn well, and we remain positive about the long-term prospects for these high performing Texas bank franchises.

Our conversations were also very positive with one of our Tennessee based banks as Chief Executive Magazine recently ranked the state #4 in the nation for places to conduct business. Ranked by Forbes Magazine also in the four spot on its "The Best Big Cities for Jobs 2016" list, Nashville's job growth was ten points higher than the U.S. average from 2010-2015, which, along with the data below, is obviously a nice tailwind for robust loan growth.

SUMMARY DEMOGRAPHIC AND OTHER MARKET DATA

Geographic Area	Total Population 2016 (Actual)	Population Change 2010 - 2016	Projected Population Change 2016 - 2021	Median Household Income 2016	Projected Household Income Change 2016 - 2021	Unemployment Rate*
Nashville MSA**	1,840,320	10.14%	6.87%	$ 55,922	9.41%	4.0%
State of Tennessee	6,623,654	4.37%	3.82%	46,781	7.13%	4.1%
Southeast Region of the United States	82,419,986	5.43%	4.43%	52,942	6.13%	4.7%
United States	322,431,073	4.43%	3.69%	55,551	7.77%	5.1%

* Unemployment data as of June 2016

** The Nashville MSA includes Davidson County (Nashville) and 13 additional counties.

Source: SNL Financial, Bureau of Labor Statistics

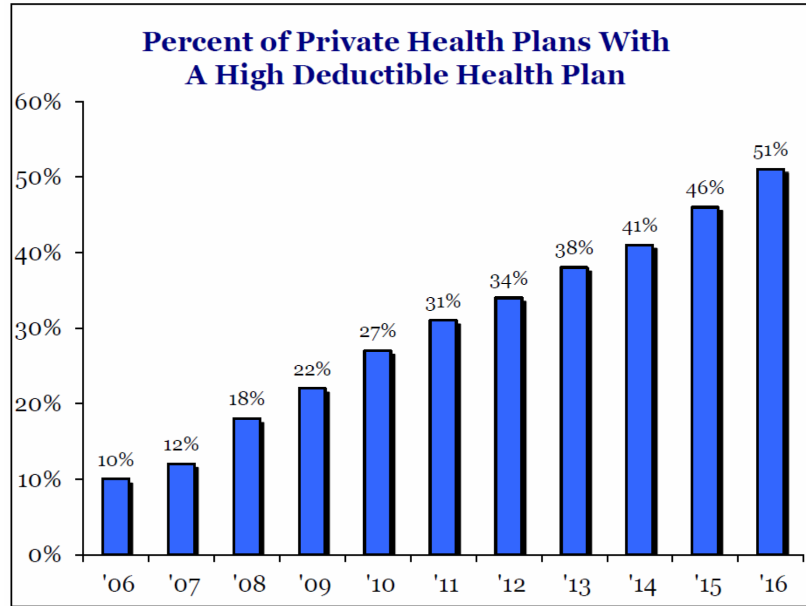
In addition, two September IPOs have added to the pool of Tennessee focused banks, and the opportunities for bank merger and acquisition activity to augment robust organic loan growth are numerous, in our opinion, as there are roughly 150 banks in the state with less than $1 billion of assets.

Lastly, we were able to meet with several bank CEOs with operations in Florida, which according to the U.S Census Bureau, is the number one state for net migration of people. As in Tennessee, there are numerous small banks, and the expectation is that growth through mergers and acquisitions will heat up after a subdued first half of 2016. While we did detect some concerns over multi-family and hotel lending in south Florida, the management teams are focused on adding lenders and growing in the Orlando, Tampa and Jacksonville markets. All in all, we believe the regional banks - tax haven states theme remains well positioned in 1492 Capital Management's strategies with the tailwinds of better than the U.S average economic and population growth rates driving healthy loan growth and franchise value for future banking consolidation.

Updated 2016 Outlook- A Picture is Worth a Thousand Words

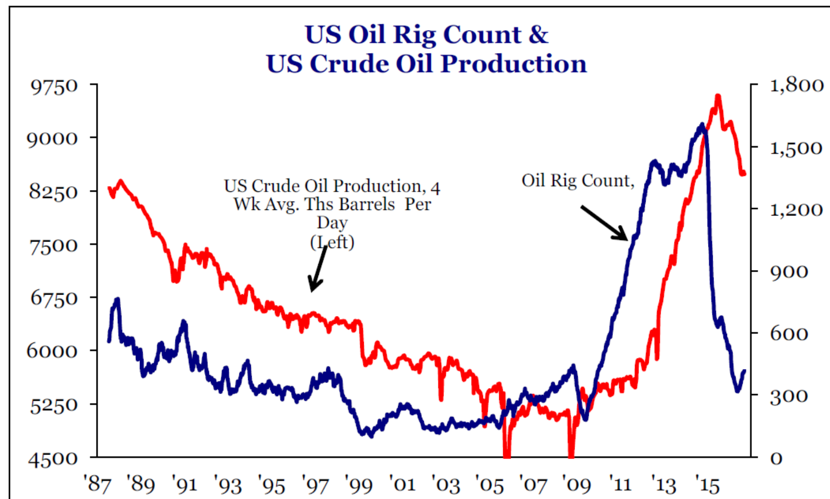
Above we laid out our case for the balance of 2016 and the key issues and drivers for the stock market. However, we believe there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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.

Obamacare promised affordable care for everyone, but it appears that it just accelerated the push to have employees pick up a bigger percentage of the bill.



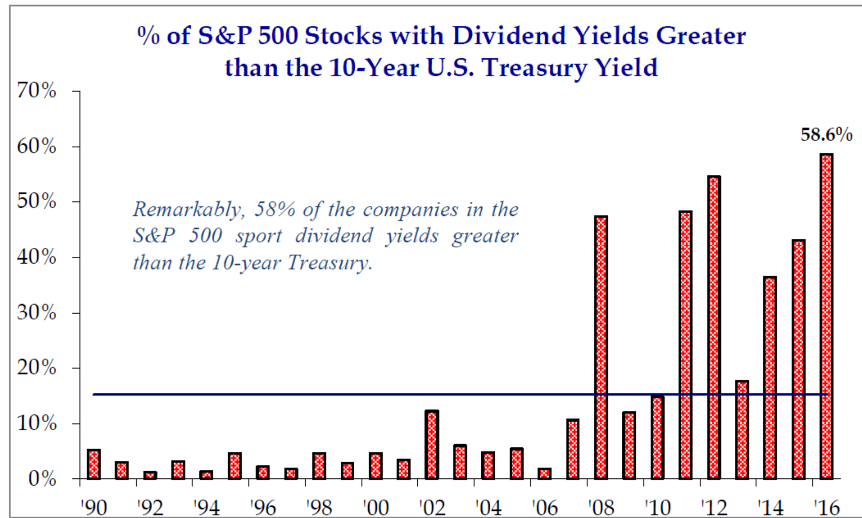
Source: Strategas Research

If the rig count is a reliable precursor to the amount of oil produced in the U.S. which it has been in the past, the collapse in the number of rigs working in the U.S. is and continues to result in a fairly significant reduction in oil produced in the coming year.



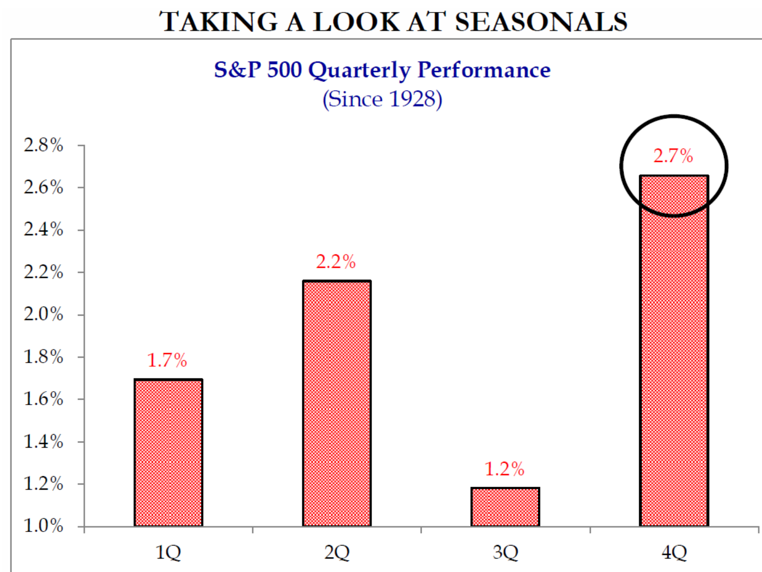
Source: Strategas Research

Nearly 59% of the stocks in the S&P 500 sport a dividend yield greater than the 10- year U.S. Treasury Bond. This metric could be an ongoing boost to the stock market given the lack of yield elsewhere.



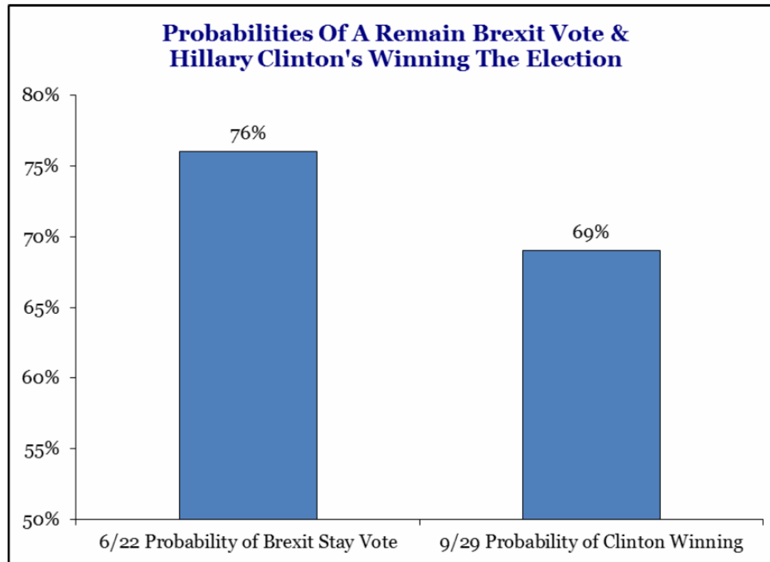
Source: Strategas Research

Despite the concern for what lies ahead in the U.S. Presidential election, we are entering the seasonally strongest quarter of the year for stock market gains.



Source: Strategas Research

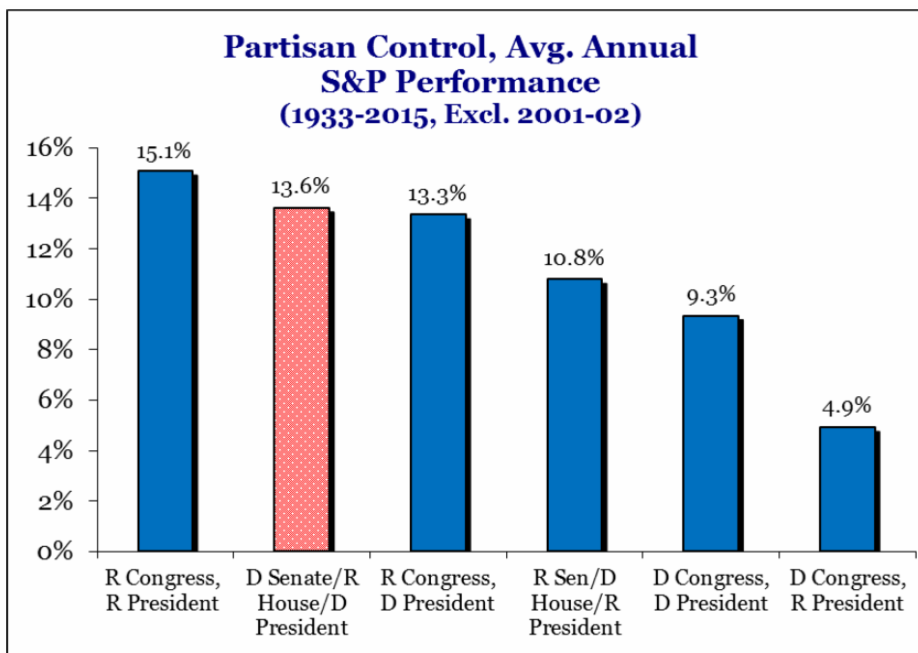
Below are the betting odds that existed just prior to the Brexit vote in June, contrasted with the current betting odds of Hillary Clinton winning the Presidential election. We all know how the Brexit vote turned out.



Source: Strategas Research

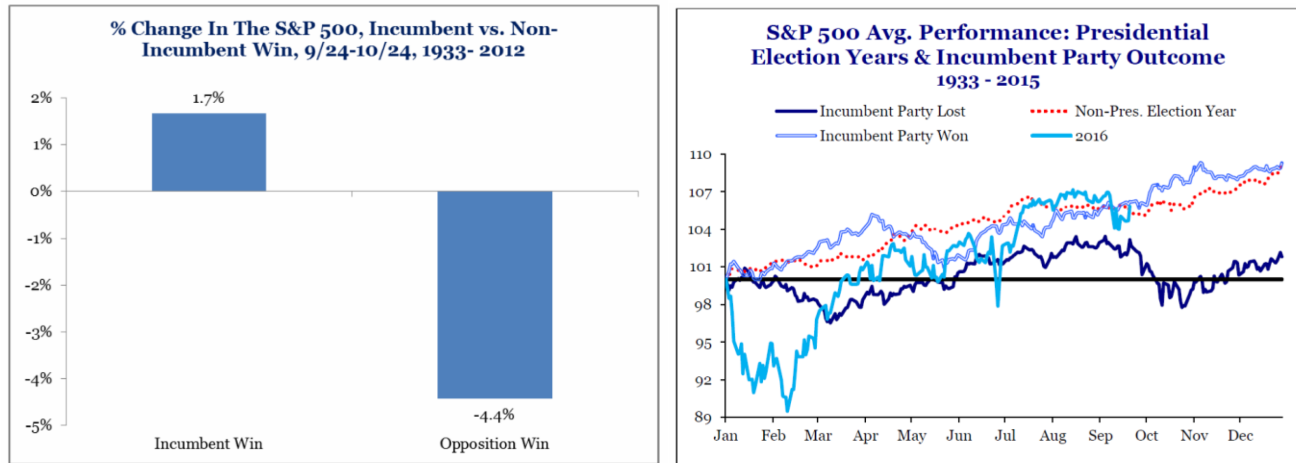
Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. Given that the Presidential election will likely remain center stage for the next month, we thought it made sense to publish a piece on stock market returns depending on which parties control the Presidency and Congress. The chart below shows the percentage returns in each instant where the given party control applied. The best average annual returns were generated when the Republicans controlled both the Presidency and Congress. Whereas the worst performance occurred when the Republicans controlled the Presidency but the Democrats controlled Congress. Neither of these outcomes seem likely at this point so we'll probably end up somewhere in the middle.



Source: Strategas Research

The next two charts below are correlated. The chart on the left shows what the stock market has done in the month leading up to the Presidential election depending upon whether the incumbent or opposition wins. The chart on the right shows the typical path of stock market returns as we approach the November election. As you can see, when the incumbent is projected to win, the market has smooth sailing and mirrors the non-election year returns. However, when the incumbent party lost, there is a market pullback to account for the uncertainty that a new regime brings to the table. The bottom line is that the market hates uncertainty.



Source: Strategas Research

We hope that you found our third quarter 2016 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.

Joe Frohna Rodney Hathaway Adam France Tim Stracka

CONTACT US

1492 Capital Management, LLC
309 North Water Street
Suite 505
Milwaukee, WI 53202
Main: 414-276-1492
Fax: 414-224-9158

www.1492CapitalManagement.com

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