1492 CAPITAL MANAGEMENT

DISCOVERING

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1492 Vantage Point Newsletter

Welcome to 1492 Capital Management's quarterly newsletter for the third quarter of 2017. In each quarterly newsletter, we provide a small cap perspective on the most recent quarter, preview what lies ahead, and offer a bit of market trivia.

Our corporate slogan 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 through multiple market cycles. We're again pleased to announce that our **1492 Small Cap Core Alpha strategy ranked 1st out of 566 and 1st out of 173** in Broadridge MarketPlace's Best Money Managers[2] U.S. Growth & Value Equity asset class and U.S. Small-cap Growth & Value Equity asset class, respectively, for the four quarters ended June 30, 2017**.** Also, our **Small Cap Growth strategy was ranked 21st out of 460** in the U.S. Small**-**Cap equity asset class for the same period. In addition, our Small Cap Core Alpha strategy was recognized with Top Guns[1] status by Informa Investment Solutions' PSN manager database as the second best performing strategy in both their Small Cap Core Equity Universe and their Small-Mid Core Universe and the fourth best performing strategy in their Small-Mid Cap Universe all for the one year period ended June 30, 2017.

A September to remember. The month of September is historically the worst month on the calendar for the stock market, but not this year. Despite saber rattling with North Korea and three major hurricanes that are undoubtedly going to pressure near-term economic statistics, every major U.S. stock index closed the quarter at a new all-time high. Additionally, the S&P 500 continued its monthly winning streak with a positive result for the ninth straight month. Renewed hope regarding tax reform has fueled much of the optimism in the stock market recently. Recall that there was a tremendous amount of optimism for tax reform following last fall's election, and small cap stocks rallied as they were projected to be the biggest beneficiaries. However, as the year progressed, that optimism waned and small cap stocks lagged as numerous attempts at healthcare reform failed, and the market became very pessimistic that anything could be passed in a very contentious Washington D.C. Since August 21st when President Trump initiated the tax reform push, the markets have rallied with small caps rising 10% and hitting new all-time highs. While most market observers have pointed to tax reform as the sole reason for the market's push higher, they've lost focus on a surprisingly strong U.S. economy. Please read on to see our unique views of what's on tap for the rest of 2017, what the key drivers will be, 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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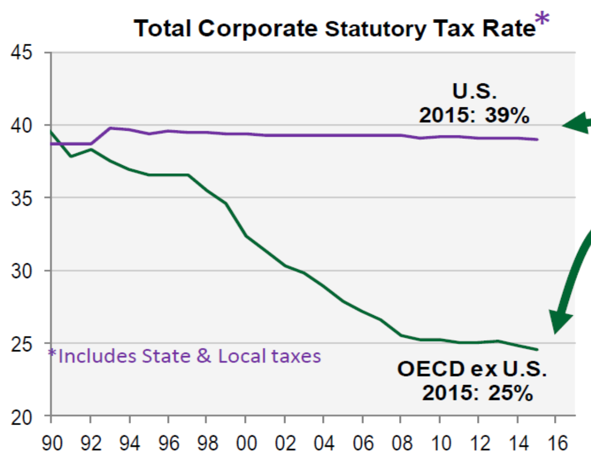
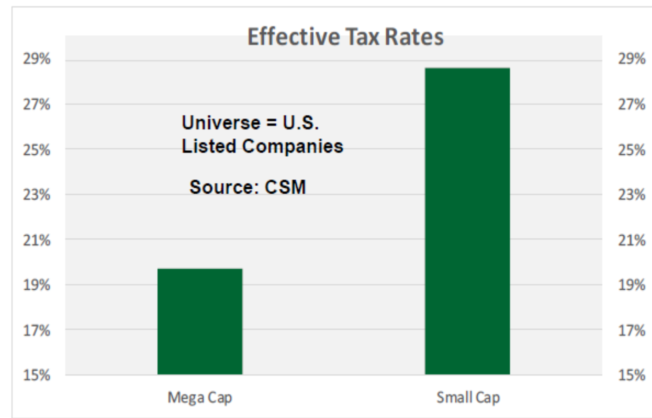
A Review of the Quarter: A September to Remember as Tax Reform Takes Center Stage

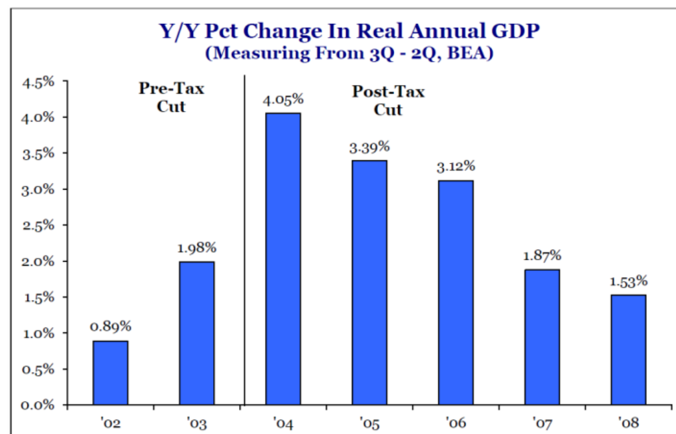
While many will remember the September quarter as the period in which saber rattling with North Korea hit a crescendo and when three major hurricanes hit the U.S. and Puerto Rico causing unheard of devastation for many in their paths, it was also a time when all the major U.S. stock indices closed at their all-time highs. Many market observers are shaking their head in disbelief and not comprehending how this is possible, particularly in light of the fact that the month of September has historically been the worst performing month for the stock market. However, one needs to pull back the curtain to see what's happening behind the headlines. First, there was renewed optimism around tax changes as some of the details around Trump's tax reform plan began to surface. If you recall, last fall following the Presidential election there was tremendous optimism around the new administration's ability to push through new tax reform legislation. On the heels of this optimism, small cap stocks rallied strongly into year-end. They were deemed to be the biggest beneficiary of tax reform as the majority of them operate primarily domestic businesses and pay taxes at the highest corporate rate. The chart below left shows just how large the tax rate gap has become between the U.S. and the OECD countries over the past few decades. The chart below right highlights the gap between the effective tax rates paid by large cap and small cap companies on average. This difference makes it clear why small caps would rally on any optimism around tax reform.





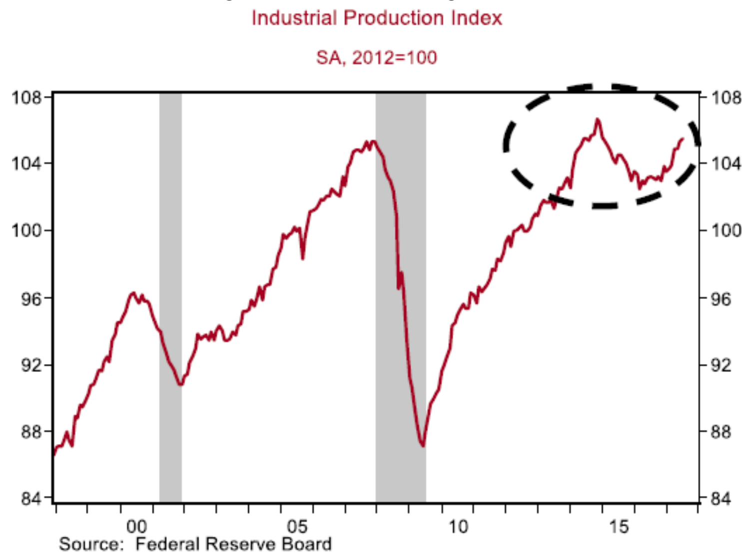
Source: Cornerstone Macro

As 2017 has progressed, small caps lost their luster and significantly trailed large caps for most of the year as it became clear that it would be difficult to get anything passed in a very contentious Washington D.C. However, since August 21st when President Trump began pushing tax reform to the front of the legislative agenda and details of his tax reform plan began to surface, small caps have surged over 10% and have significantly outperformed mid and large caps. The chart below shows how the economy surged following the last major tax reform legislation which was passed in 2003. While most talking heads are pointing to optimism surrounding tax reform as the primary reason for the stock market's surge, they are missing the bigger picture – it's the economy stupid.



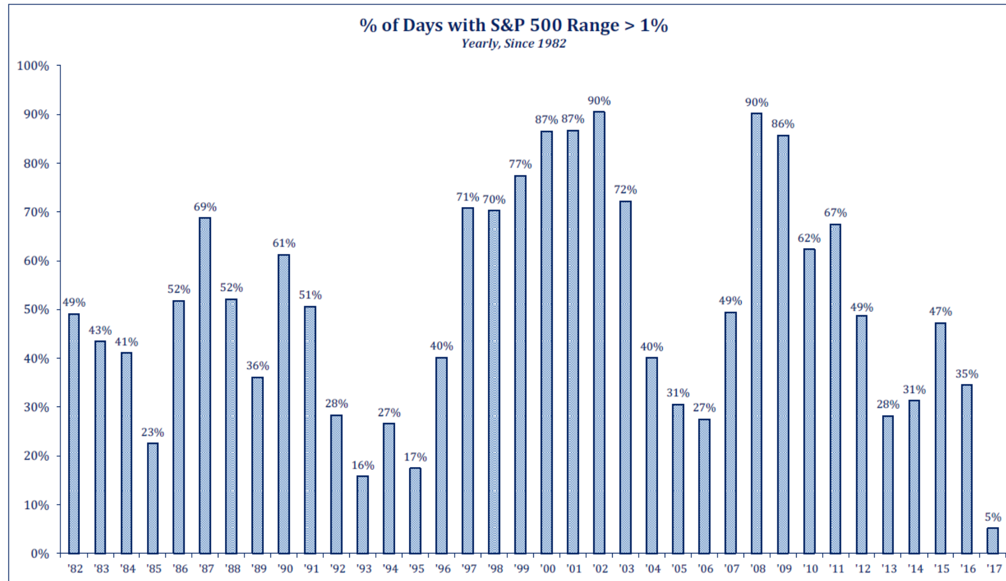
Source: Strategas Research

The devastating hurricanes will undoubtedly cause some near-term weakness and ambiguities surrounding the upcoming economic data. As history has shown us, hurricanes cause a temporary slowdown as people take time away from their jobs to pick up the pieces and attempt to put their lives back in order. However, within several months' time, insurance checks hit the banking system, causing a surge in expenditures to repair all that was damaged or lost. In fact, the last major hurricane events to hit the U.S., Katrina and Sandy, led to an economic acceleration that lasted more than a year following the disasters. Surprisingly, as we are writing this newsletter, the latest ISM Manufacturing survey registered an increase to 60.8, which is the highest reading since 2004. This advance is before any real positive impact could be felt from the hurricane related repair. The chart below shows the U.S. Industrial Production index. Note that the index fell dramatically following oil's collapse in late 2014 as the U.S. entered an industrial recession. Over the past several quarters we've highlighted that as oil goes, so goes the U.S. economy. The industrial production index has turned higher over the last eighteen months as oil has rebounded and industrial activity has risen and is now threatening to make a new high.



Small caps slightly outperformed large caps in the third quarter following the tax reform driven rally that we discussed above, but they remain behind in the year-to-date race despite a strong month of September. Large cap tech stocks showed some continued vulnerability in September as Apple's next-gen iPhone release came and went and likely created a "sell the news" event for some. Additionally, Amazon came under some scrutiny as sales tax policies on internet sales rose to the forefront again and threatened to diminish the tax advantage for internet sales. The Fed remained steadfast in their mission to normalize monetary policy and announced their intention to begin unwinding their bond purchases from the quantitative easing efforts of the past years. They also signaled that a December rate hike is in the offing. With this news, the market quickly rotated into financials and healthcare stocks, particularly biotechs, which both favor small cap indices. Last quarter we stated that "should the Trump agenda move forward, it could be a positive surprise for the stock market as there seems to be a lot of skepticism about the ability to enact meaningful tax reform and military and infrastructure spending programs". This prediction is exactly what appears to have happened as details emerged about Trump's tax reform legislation over the past month. As health care reform legislation once again failed and may be done as an agenda item for this congress, biotechs propelled Healthcare to the second best performing sector.

The stock market has posted a strong first three quarters of 2017. Despite all the wrangling in Washington, the first three quarters were an extraordinarily quiet period in terms of market volatility. *In each of the first nine months of the year, the S&P 500 recorded positive returns which generally bodes well for future returns for the balance of the year.* The chart below highlights how "quiet" the stock market has been in terms of daily percentage moves. We've only seen 5% of the trading days so far this year where the intraday percentage move up or down was greater than 1%. When compared to previous years in the bull market cycle since 2009, this stability is quite amazing. However, some of the same demons that have haunted active managers in recent years reared their heads again in the quarter, which included the outperformance by money-losing companies (primarily biotech companies).



Source: Strategas Research

Despite a retreat in technology stocks late in the quarter, the NASDAQ Composite index (+6.1%) was still the best performing index in the quarter on the strength of biotech and financial stocks which were generally higher in the quarter. The S&P 500 was the weakest major index in the quarter and posted a gain of +4.5% which underperformed the Russell 2000 Index's gain of +5.7%. From a sector standpoint within the Russell 2000, the Producer Durables (+8.8%) and Healthcare (+8.1%) sectors were the standouts in the quarter while the interest rate sensitive sectors, Real Estate (+1.9%) and Staples (+2.4%), were the laggards as interest rates increased as the quarter progressed. Energy (-23.3%) and Consumer Staples (-4.7%) are the only two sectors that have posted negative returns year to date. The table below highlights the returns for the third quarter of 2017 for the popular indices.

Index Returns		
Index	Third Qtr. 2017 Return	2017 YTD Return
Russell 2000	+5.67%	+10.94%
Russell 2000 Growth	+6.22%	+16.81%
Russell 2000 Value	+5.11%	+5.68%
S&P 500	+4.48%	+14.24%
Dow Jones Industrials	+4.94%	+13.37%
NASDAQ Composite	+6.06%	+21.67%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Growth Index (+6.2%) slightly outperformed the Russell 2000 Value Index (+5.1%) for the quarter. As mentioned above, a resurgence in biotech stocks propelled the strong performance in the growth index despite many of the traditional value sectors generally performing well in the quarter. The two tables below highlight the performance of the Russell 2000 style indices by sector for the third quarter.

Table 2: Russell 2000' Growth's performance attribution for September 2017

	September			Third Quarter			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	8.26	1.25	2.81	5.75	0.85	-0.47	10.89	1.68	-5.95
Staples	4.35	0.10	-1.10	2.09	0.04	-4.13	-1.02	-0.06	-17.86
Energy	16.78	0.17	11.33	3.49	0.04	-2.73	-25.04	-0.34	-41.88
Financials	5.61	0.40	0.16	4.69	0.32	-1.53	6.79	0.48	-10.05
Health Care	3.20	0.78	-2.25	6.93	1.77	0.71	33.58	7.06	16.74
Mat. & Process	8.65	0.71	3.20	6.29	0.52	0.07	12.16	1.10	-4.68
Prod. Durables	8.99	1.43	3.54	9.28	1.46	3.06	12.93	1.99	-3.91
Real Estate	-0.07	0.00	-5.52	0.97	0.03	-5.25	10.62	0.62	-6.21
Technology	3.18	0.61	-2.27	5.72	1.12	-0.50	19.58	3.91	2.74
Utilities	-0.60	-0.02	-6.04	2.88	0.07	-3.34	16.25	0.40	-0.59

Table 3: Russell 2000 Value's performance attribution for September 2017

	September			Third Quarter			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	8.75	0.95	1.66	3.99	0.42	-1.14	6.52	0.71	0.72
Staples	7.37	0.18	0.29	2.56	0.06	-2.56	-9.28	-0.21	-15.07
Energy	15.59	0.90	8.50	4.95	0.31	-0.17	-22.92	-1.30	-28.71
Financials	9.21	2.57	2.13	5.35	1.45	0.23	3.18	0.66	-2.62
Health Care	7.98	0.47	0.90	13.66	0.80	8.53	30.66	1.46	24.86
Mat. & Process	7.70	0.46	0.62	6.39	0.40	1.27	5.51	0.36	-0.28
Prod Durables	9.75	1.10	2.67	8.01	0.91	2.88	14.01	1.60	8.22
Real Estate	1.74	0.24	-5.35	2.17	0.30	-2.95	4.96	0.68	-0.84
Technology	4.05	0.32	-3.03	2.42	0.19	-2.70	10.30	1.04	4.51
Utilities	-1.49	-0.11	-8.57	3.64	0.28	-1.48	9.95	0.73	4.16

Source: Jefferies

The U.S. stock market posted a strong third quarter, and the stock markets around the globe followed suit. Commodities were generally higher on the heels of the three major hurricanes and the implied demand for all commodities that is likely to ensue as repairs begin in earnest over the coming months. Interest sensitive investments were slightly higher as rates fell to start the quarter but rose as it became clear that the Fed was going to begin the unwind of quantitative easing and is likely to hike rates again in December if there isn't a dramatic slowdown. Japan's stock market remains one to watch as they've been stimulating their economy aggressively. Inflation is beginning to move higher there, and the stock market has responded favorably after a flat first quarter. Despite the tightening of their monetary policy, India's stock market continues to surprise as their economic growth has been better than expected. China's economy has regained its legs after a lull in the first half that was being blamed for the end of the reflation trade globally as the government cooled the housing boom and generally restricted credit. Brazil's stock market was the gold medalist in the quarter as they've seen a dramatic increase in demand for commodities which is key to their overall economy. Unbelievably, volatility, which had been called out by many pundits to rise dramatically this year, has fallen precipitously and continues to bounce around near its 52 week lows. OPEC extended their output cuts, and oil finally bounced back into the low $50's per barrel. Energy is still a critical area to watch going forward. See the section below entitled Updated 2017 Outlook: Quite Simply, It's All About Oil - Part Three - The Jury is Still Out.

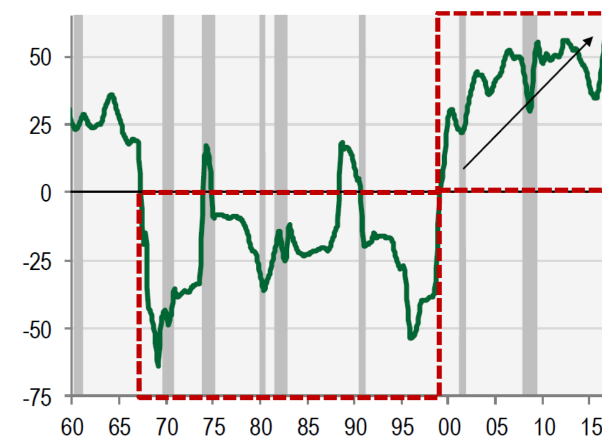
Index	Third Qtr. 2017 Return	2017 YTD
France	4.10%	9.60%
Germany	4.10%	11.70%
Brazil	19.40%	23.40%
India	1.20%	17.50%

Source: 1492 Capital Management, LLC

Index	Third Qtr. 2017 Return	2017 YTD
Japan	1.60%	6.50%
Long-Term Treasuries (TLO)	4.10%	6.30%
Investment Grade Corp. Bonds	1.10%	5.10%
Gold	3.40%	11.60%
Volatility- VIX index	-14.90%	-32.30%
Oil	12.20%	-3.80%
Natural Gas	-0.90%	-18.40%
Lumber	9.90%	27.00%

Updated 2017 Outlook: Quite Simply, It's All About Oil - Part Three - The Jury is Still Out but it's Improving

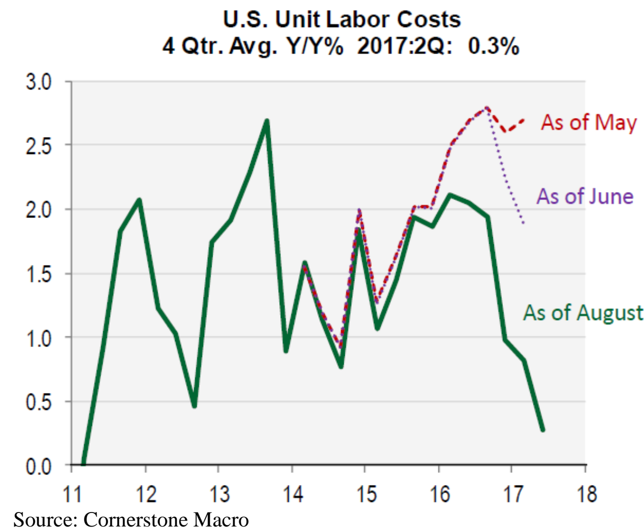
In the last two quarterly newsletters we presented the case that you didn't have to look much further than the price of oil for a sense of direction for the economy and presumably the stock market. Rather than rehash the entire premise for our argument again, you can access the prior quarterly newsletters on our redesigned website at www.1492capitalmanagement.com. Unfortunately, the jury is still out; however, the price of oil has been strengthening. Crude oil closed the third quarter trading around $52, which is down about -3% since the start of the year but up about +12% in the third quarter. It's been range-bound between $44 and $52 per barrel for much of the past six months. Our argument was quite simply that since 2005, the economic impact of the energy industry in the U.S. has grown 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. Therefore, our conclusion was that you needed to see a healthy oil market for the U.S. industrial economy to continue strengthening. So far, the economic statistics have been in synch with the direction of the price of oil. At some point, when oil is at a high enough price to sustain a reasonably strong level of drilling activity, it won't matter as much because the economy will presumably be humming along at that point and won't be so dependent on oilfield activity. The bottom line is we're not there yet as oil hasn't broken out to a new 52 week high yet and drilling activity, while up tremendously off the bottom in 2016, is still down significantly from the peak in 2014. We're not arguing that we need to return to the peak activity levels, rather we need to see confidence in the future price of oil that will support a higher level of sustained activity, which is likely something closer to $60 per barrel. The chart below shows exactly what we've been articulating- the correlation of the manufacturing activity in the U.S. (Manufacturing PMI) to the price of oil. Observe the significant increase over the last decade which coincides with the shale oil revolution. As the title of this section implies, the jury is still out on which way the price of oil will break, but it certainly will have a considerable impact on the direction of our economy here in the U.S.



Source: Cornerstone Macro

Updated 2017 Outlook: Economists Throwing in the Towel on Inflation Just as it's About to Turn

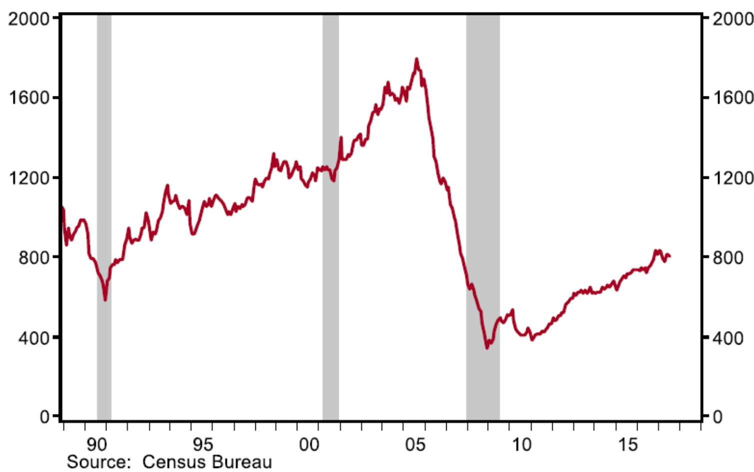
Many economists are throwing in the towel on their "higher inflation" predictions. A 10-Year Treasury note yield that plummeted to 2.01% in early September following yet another North Korean missile launch and war of words spooked many. If you recall, the "reflation" trade following Trumps election was a very popular topic. The playbook goes something like sell your utilities and REIT's and buy financials, cyclicals, and commodities. However, since the beginning of the year, the reflation trade hasn't worked as financials, namely banks, have lagged badly, and cyclicals have generally underperformed except for the past few weeks. Oil, the most meaningful commodity, was down through September about 3% even after a 12% move higher in the third quarter. We believe economists are looking in the wrong places for inflation because it's coming. Most of them must be looking at a chart that is similar to the one directly below which shows the percentage change in labor costs that are dropping year over year. How is this possible with unemployment pushing lower to 4.4%, and the JOLTS index (a measure of the number of job openings in the U.S. monthly and is indicative of how easy it is to get a job and implicitly get paid more money to move) is at an all-time high? By almost all accounts in our interactions with hundreds of companies over the past nine months, labor costs are increasing at a 3-4% pace on average. One would expect this sort of increase in a full employment situation that exists today in the U.S.

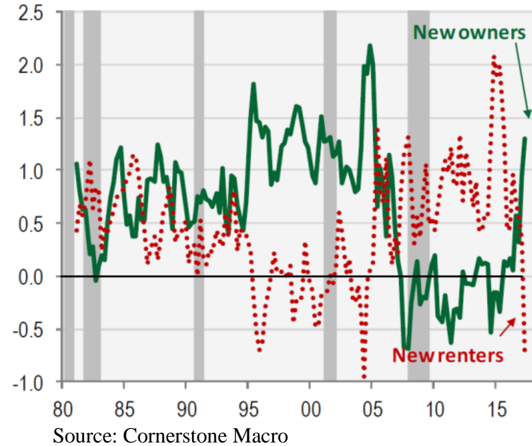


Source: Cornerstone Macro

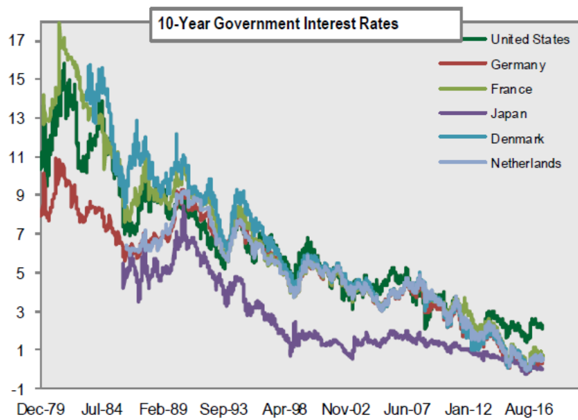
The U.S. Dollar index has fallen about 9% so far this year, which makes imported goods more expensive in U.S. Dollar terms. The chart directly below highlights this phenomenon. Commodities are generally up and some significantly so over the past year. For example, copper is up +34%, Zinc +35%, steel +19%, wheat +11%, hogs +41%, lumber +21%, Corn +4%, and even oil is up +6% even though it's down year to date. The reparation of hurricane damage is going to push commodities and labor costs higher as the areas most damaged by the latest hurricanes don't have a labor pool in the trades that is big enough to satisfy demand. This shortage is going to cause people to leave lower paying jobs to maximize their opportunity in the building trades for example. Many of these folks leave less desirable jobs like truck driving where they aren't paid particularly well and can be at home every night. Wallboard and lumber prices are already increasing in anticipation of much higher demand in Florida and Texas. Companies are announcing 15% price increases in the wallboard market for example as demand exceeds supply in the coming months. While these moves may be a little more transient, there are other signs of inflation that are going to be much stickier.

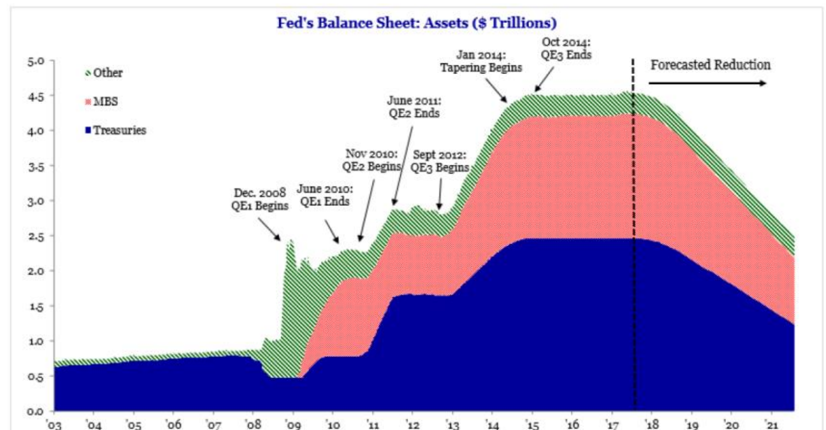
The cost of shelter is one of the biggest expenditures for any individual. The price of homes is going up, and not just because of the commodity increases we mentioned above. There is a true lack of housing supply as the industry has underbuilt the number of homes when compared with the number of household formations. According to the Urban Institute, currently we're building six homes for every ten new households formed in the U.S. The chart below left shows the number of single family homes built over the past thirty years. The industry is currently on a pace to build about 800,000 homes annually versus the peak of nearly 1.8 million in 2005. The chart below right shows this phenomenon is being exacerbated due to a shift in the number of households that want to be owners instead of renters. Simple economics would tell you that when demand exceeds supply, prices are going higher and that's what is happening.





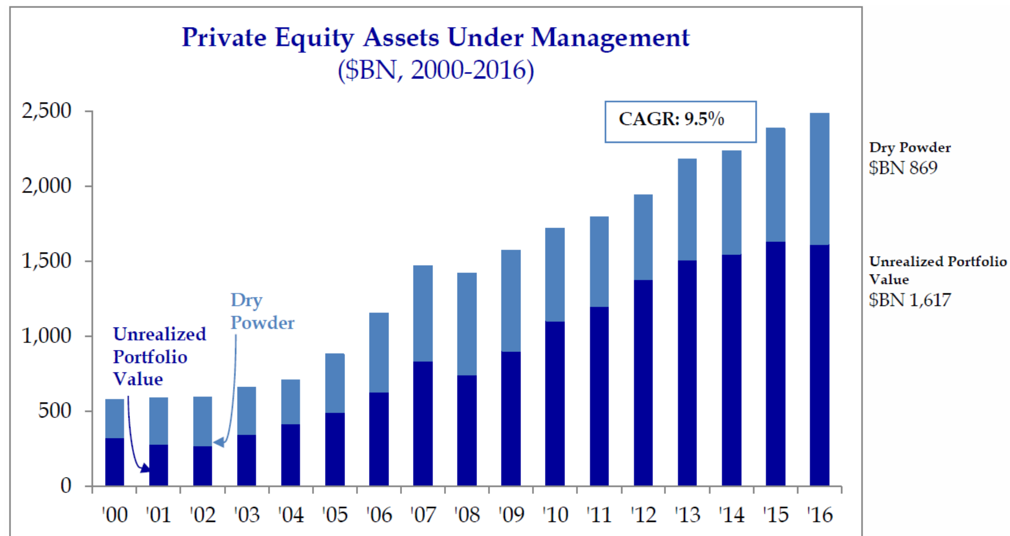
One cost that many don't take into their inflation calculus is the cost of money. Inflation partially determines interest rates, so it's a bit of a circular argument. However, if we're right in our assessment of inflation, interest rates will begin to move higher. As we all know, the central banks around the globe who were trying to provide stimulus to their respective economies since the great recession in 2009 kept interest rates artificially low. As can be seen on the chart below left, U.S. rates have been pinned down by the Fed's quantitative easing programs and by the global investors' search for yield above a negative rate that they could earn in Europe and Japan. The quantitative easing programs of the U.S. Fed are about to begin the process of unwinding. The Fed has stated that they will begin to reduce the amount of bonds that they hold by about $10 billion per month beginning this month and accelerate over time. As the chart below right shows, the Fed's balance sheet grew nearly $4 trillion since 2008 as they bought in bonds of all types and maturities. Again, if supply comes to the market through the Fed's unwinding, rates should rise to soak up that extra supply and make money more expensive to borrow over time.





Updated 2017 Outlook: PE Funds Are Key Reason Stock Prices Going Higher - Not Likely to Change Anytime Soon

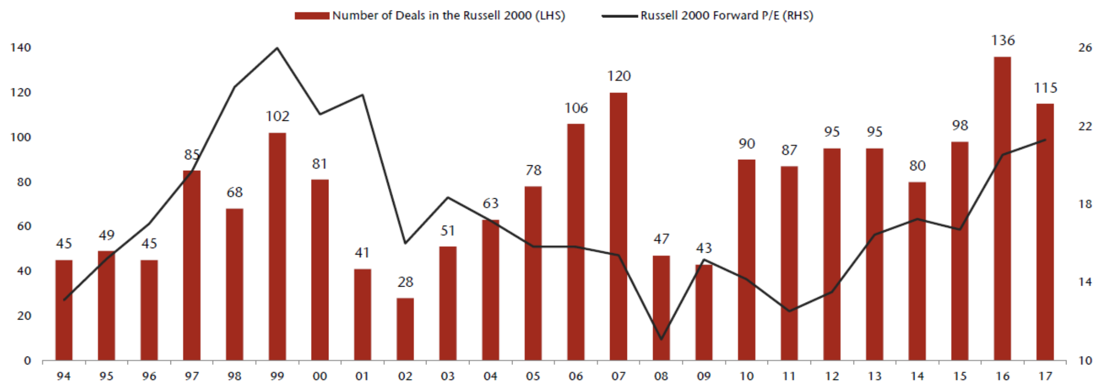
The private equity (PE) asset class has undergone extraordinary growth over the past fifteen years. According to a study by the "Economist", the number of PE firms has ballooned from 100 in 2000 to over 4,000 today, and 95% of them reside in the U.S. The chart below shows that PE fund assets have grown from just over $500 billion in 2000 to almost $2.5 trillion at the end of 2016. While the attractiveness of the asset class is undeniable, those who are flooding these firms with huge sums of money may have been sold a bill of goods that can't be achieved when a downward trending market occurs.



Source: Strategas Research

Private equity funds raise assets in their funds which typically have a set duration of between seven and ten years. The assets that are gathered are levered as high as six to seven times or more of the equity contributed for a given deal. Now here comes the trick. Many PE funds don't mark-to-market the assets in their funds daily like a mutual fund is required to do. This protocol gives them the appearance of being much more stable than they truly are. For example, the Wall Street Journal recently ran an article about Uber's valuation. The company has never had a down valuation round so investors simply marked their position to the value of the latest round of funding. There were no market blips or up and down motions in the valuation chart, just simply a stair step, or elevator increase in this case, that went up and to the right. Who wouldn't be attracted to obtaining equity exposure with no possibility of volatility or disappointment? To monetize their holdings as the fund reaches end of life, these funds must find a buyer. Historically, the portfolio companies were sold to the public markets through an IPO or sold to another PE fund who was looking to invest their funds. Recently, about 60% of PE fund exits were sold to another PE firm. This process is a function of their burgeoning assets under management that need to find a home within a defined

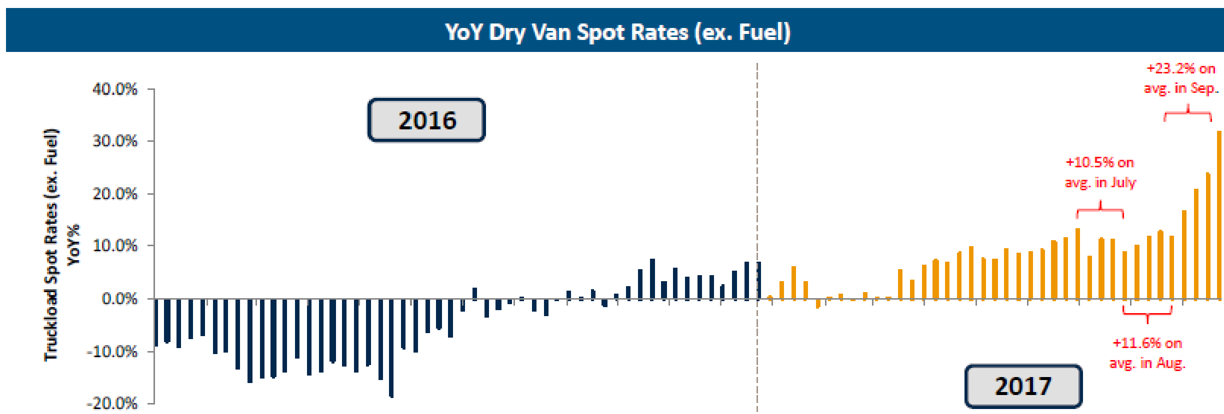
timeframe. The chart above shows the "dry powder" that these funds cumulatively hold. It is a whopping $869 billion and that is before leverage is applied. So, the buying power is extraordinary and this asset class growth is why the number of publicly traded stocks has been cut in half over the last fifteen years as they've been targets for PE funds. The chart below shows the number of buyout deals each year within the Russell 2000 universe of companies. The only slowdowns over the past two decades were during the last two market meltdowns, but they generally are trending higher over time. Additionally, the IPO market has been amazingly slow as many of the companies that would have historically come to market through an IPO are being bought by PE funds long before they can ever hit the public markets. We don't think this ends anytime soon given the asset growth in PE funds. However, watch out below if there is another major market downturn as these assets will have to find a home somewhere at a valuation that is likely below where they were purchased.



Note: 2017 is through October 1st.
Source: FactSet; FTSE Russell; Jefferies

All Things Freight!

As we have mentioned in past quarterly newsletters, we have deployed our trucking theme across the 1492 Capital strategies. After a sluggish first half for many of these truckload and less than truckload operators, the proverbial worm has turned in the second half of 2017 as the market absorbs the positive datapoints emerging. Based on the research from Trans4cast and Stephens Inc. featured below, the growth in truckload dryvan spot rates, excluding fuel, accelerated through the third quarter with a 10.5% year over year increase in July, 11.6% in August and 23.2% increase in September.



Source: Trans4cast and Stephens Inc.

In a recent meeting with the management team from a flatbed truck carrier, they are seeing rates accelerate even faster which has been aided by the year over year increase in oil and gas activity. What is particularly interesting is that we are seeing this reacceleration well in advance of the mid December 2017 start of the electronic logging device (ELD) mandate. This mandate should substantially curtail the drivers that manipulate their paper logs for more hours on the road and thus further tighten truckload supply to the tune of a 2.5% productivity decrease according to FTR, a transport intelligence firm. With industrial freight improving and with tighter truckload capacity shifting additional loads to the less than truckload operators, asset-heavy trucking firms are finally seeing the wind at their backs. All of these positives are in addition to the incremental freight loads that hurricane rebuilding efforts in two of our country's fastest growing states, Texas and Florida, should precipitate.

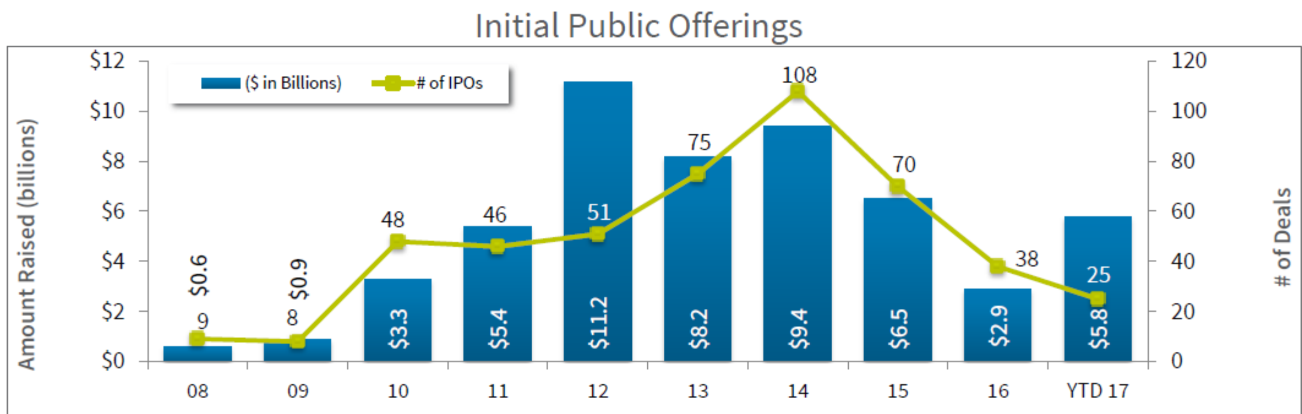
Will there be coal in the stocking this Christmas for the transports? There are no signs yet that they are on the naughty list as this holiday season sales are forecasted to rise 4.5% year over year, which is up from 3.6% growth for each of the last two years according to Deloitte & Touche. It also forecasts e-commerce sales to climb a healthy 18-21% this holiday season versus 14.3% in 2016. The holiday season should also benefit from a colder winter than a year ago, less political angst over election results, and the potential of some form of tax reform. While only one data point in what could be a challenging seasonal hiring, Target is adding 100,000 holiday workers which is a 40% increase from a year ago.

Throughout history, people have referred to certain time frames as the golden age of science, art or literature. Wikipedia has defined a golden age as "a period in a field of endeavor when great tasks were accomplished." In our opinion, we now reside in the golden age of expedited freight where anything taking longer than two days to arrive feels like carrier pigeons or dogsleds delivered it. Team drivers in truckload operations and efficient airfreight are pivotal in this freight market. As an example of this golden age, we recently learned that airfreight carrier DHL is requesting 17 planes for the peak holiday season versus a normal peak request of 5 to 6 aircraft. According to research from Seaport Global, airfreight traffic across the major markets has grown 10-15% year over year. We have also seen truckload carriers with team drivers that specialize in expedited freight services receive peak season capacity requests earlier than normal in 2017. Two day delivery from the 800 lb. gorilla that is Amazon Prime or its competitors is, in our opinion, accomplishing a great task that requires great transportation resources for all things freight. Welcome to another golden age.

Updated 2017 Outlook: A Picture is Worth a Thousand Words

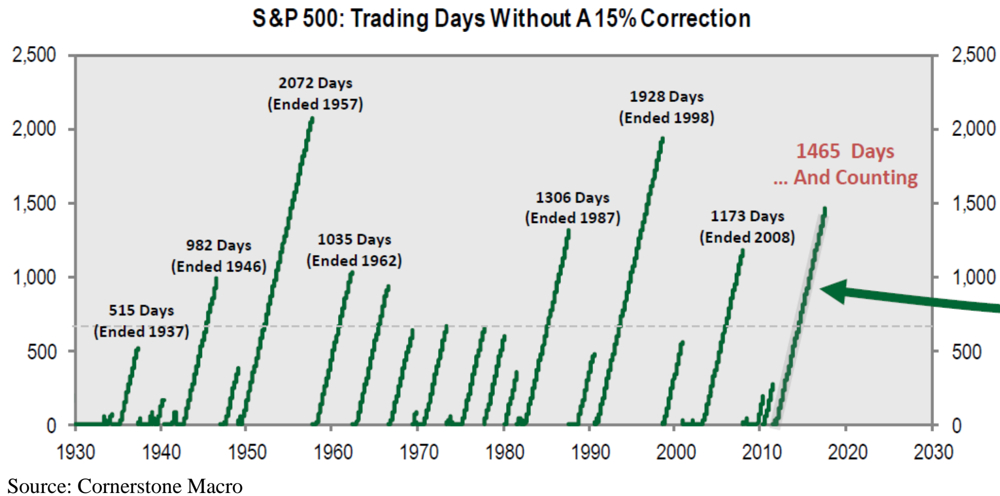
Above we articulated our updated 2017 outlook and the key issues and drivers for the stock market. However, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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 number of IPO's is on track to roughly match the activity level of 2016, but this level is still way below the peak of 2014. This low activity level is contributing to the shrinking number of publicly traded companies here in the U.S.



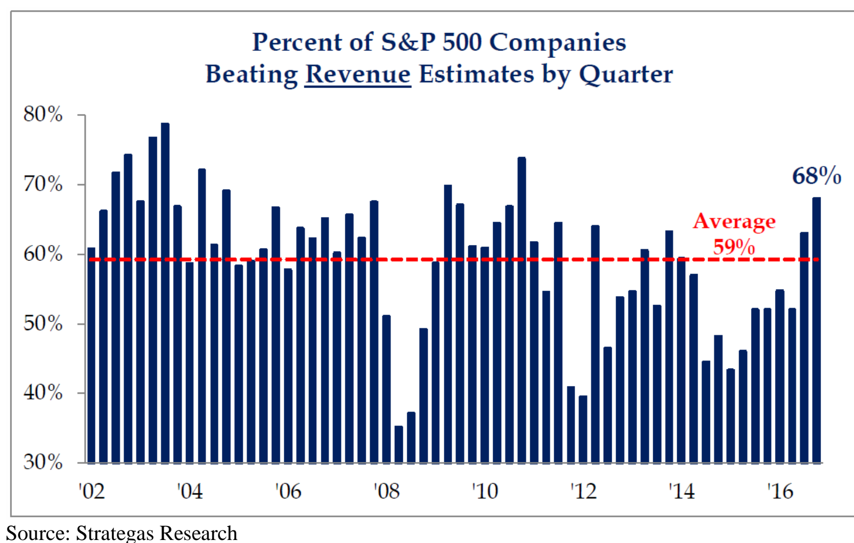
Source: Hercules Capital

We're in the midst of the third longest period in stock market history without a 15% correction in the S&P 500. Let's hope we break some records.



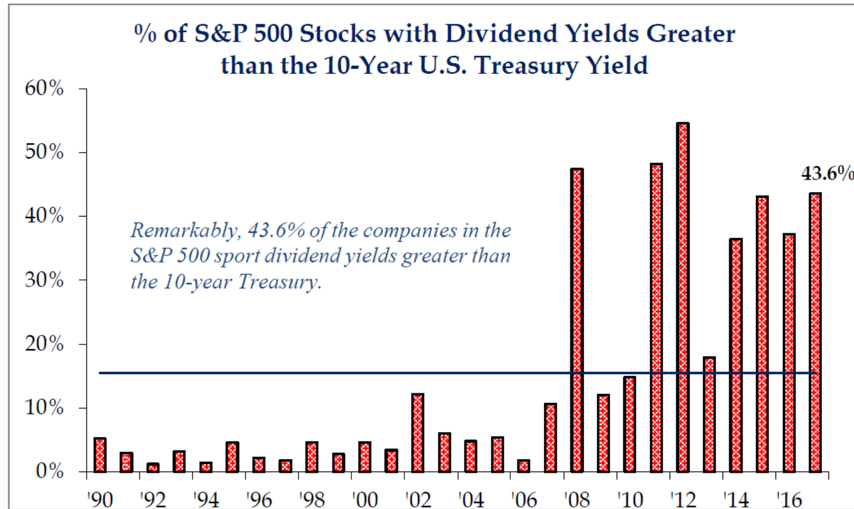
Source: Cornerstone Macro

No wonder the stock market is hitting new highs nearly every week. The number of companies beating revenue expectations has reached a cyclical high of 68% in the June quarter.

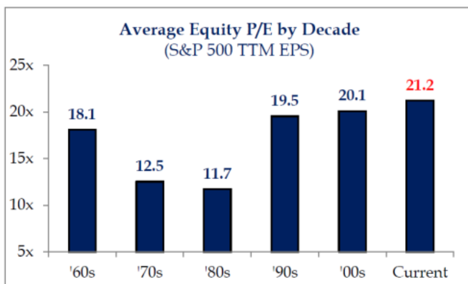


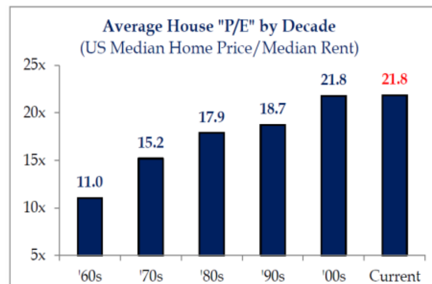
Source: Strategas Research

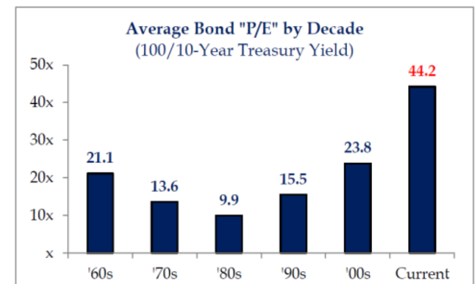
The thirst for yield is driving interest rates to record low levels globally. However, this thirst can also be satisfied in the stock market as 43.6% of S&P 500 stocks have a dividend yield greater than the 10-Year U.S. Treasury yield. This search for yield is likely one of the factors driving the U.S. stock markets to record highs.



The stock market always seems to get the most discussion regarding being overvalued. But is it based on historical valuations of other asset classes? You be the judge.







Source: Strategas Research

<u>Heard at 1492 Capital Management</u>

As a matter of investment process, our research team at 1492 Capital Management meets with hundreds of companies throughout the year to gain insights on business trends. This bottom-up process is how we derive our investment themes that are deployed across all the portfolios.

There are certain industries that are considered leading indicators and certain ones that tend to be lagging, in terms of what part of the economic cycle in which they participate. Our comments below are a sampling of some of the company meetings that we've held over the past quarter to give you an idea of how business is trending from our vantage point.

One of the secular shifts that has been occurring is within the Technology sector. Heretofore, the enterprise clients advanced capital spending cycles with technology companies. Corporations would upgrade servers, for instance, to gain faster computing speeds or to increase data storage. Over the past five years however, consumer spending in electronics, primarily for mobile as well as video streaming and broadband applications, is driving more of the capital spending cycle. In fact, strategists are now viewing technology like a consumer staple sector considering none of us can live without our smart phones!

A meeting back in August with a company that designs and manufactures instruments for the semiconductor capital equipment market confirmed the consumer driven spending cycle mentioned above. The other key change over the past decade is the focus on lean manufacturing which has significantly shortened lead times for customers. A combination of shorter lead times as well as consolidation in the customer base has muted the boom-to-bust cycle for the industry. In previous cycles, customers would over-order to ensure they had adequate supply which exacerbated the boom-to-bust cycle. This company also sees significant growth opportunity over the next few years as a result of the increasing demand for OLED displays and 3-D wafer architecture in semiconductor manufacturing designs.

As we see signs of an economic acceleration, you would assume freight volume for the trucking industry would increase which should improve pricing power for the carriers. In fact, we have seen pricing firming for the truck-load segment of the market. This trend should continue as the new ELD (Electronic Logging Device) regulatory mandate is implemented this December which should further decrease available trucking capacity. The new ELD mandate requires carriers to closely monitor electronically the number of hours drivers are on the road in an effort to improve safety by reducing driver fatigue. In a recent meeting with a specialty truck-load carrier, management shared that pricing inflected in the first quarter of 2017 and is trending up 7%-8% compared to the same period last year.

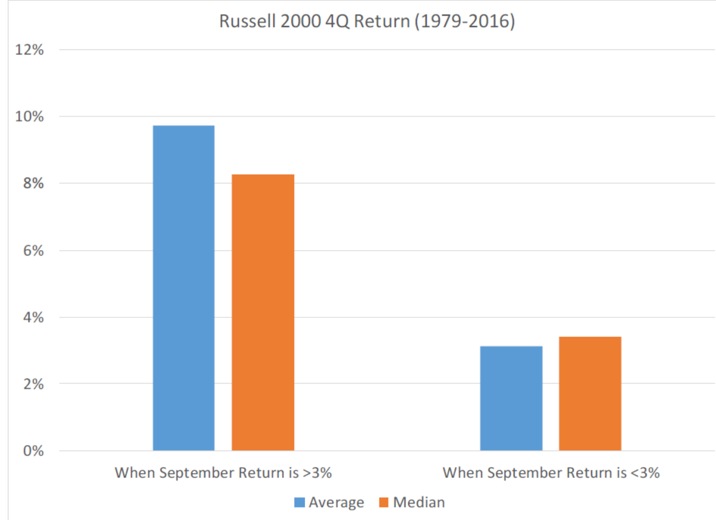
When oil commodity pricing plunged in the fourth quarter of 2014, most companies that had exposure to the energy sector went through a deep recession that lasted through 2016. When speaking to companies that have all or part of their business dedicated to providing equipment or services to the oil exploration and production industry, it appears that demand has finally bottomed. The count for drilling rigs has inched up in recent quarters and there appears to be a slight recovery forming for the industry. We had a meeting back in August with a manufacturer/lessor of rail cars, which often move oil and oilfield related products like frac sand. According to management, lease rates which had declined for the previous eight straight quarters have now flattened. Book-to-bill was a strong 1.4 in the second quarter and build rates for the second half of 2017 are up significantly versus the same period in 2016.

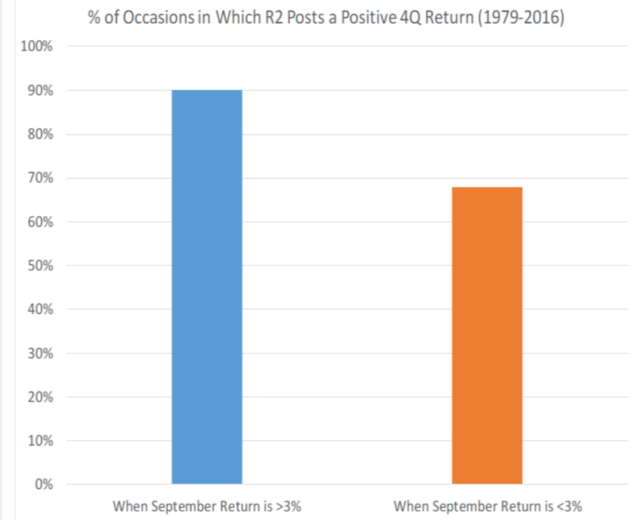
One of the major growth themes occurring in the telecom industry is the proliferation of super high speed, broadband internet access. The major wireless carriers, cable companies and telcos are investing billions of dollars in upgrading fiber networks and wireless antennae to meet the seemingly insatiable demand for data. Engineering and construction (E&C) companies that specialize in installing the infrastructure will stand to benefit from this capital spending that will take place over the next 3-5 years. There are multiple drivers beyond just consumer applications that will drive the capital spending which gives us comfort that this will be a sustainable investment theme. For example, FirstNet, which will be a dedicated frequency and equipment network for first responders, is scheduled to begin construction next year. We had multiple meetings last month with different E&C companies that shared a strong optimism for a growing backlog of business for at least the next two years based on these spending initiatives mentioned above.

The general sentiment amongst most of our company meetings over the past few months is that business trends are improving. Capital spending projects are moving forward following a lull since 2014. Many industrial companies went through a fairly severe recession unbeknownst to the general public. This lack of capital spending is one of the main culprits behind the stagnant productivity trends that we have seen recently in the macro-economic reports. However, with the prospects of a more-friendly regulatory environment, a potential tax cut and possible repatriation holiday for overseas cash reserves, it appears that company owners and executives are feeling optimistic enough to make investments in their businesses.

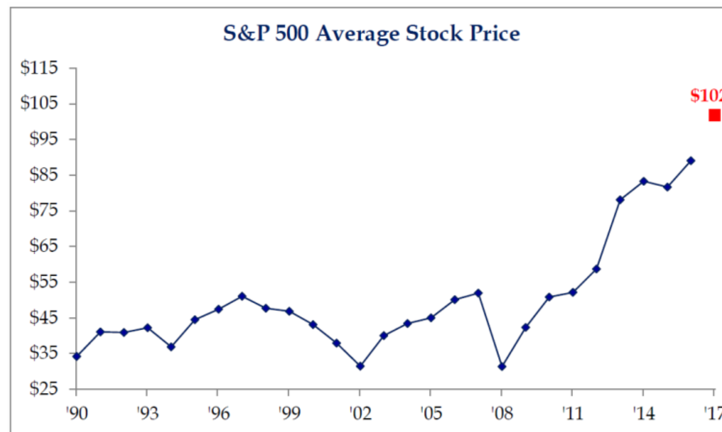
Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. Earlier in the newsletter we mentioned that a strong stock market in September is generally a precursor of good times ahead. Below is the evidence. The chart on the left shows that when the stock market is up more than 3% in September, which it was this year, the fourth quarter returns average about 10%. While we're not endorsing a 10% return in the fourth quarter, it's nice to know that history is on our side. The chart on the right shows that in years when September was up more than 3%, in 90% of these occurrences the stock market was positive in the fourth quarter.





The price of an average stock in the S&P 500 has never been higher than it is today at $102 per share. While market appreciation has been a contributor to this move, it isn't the only reason. Corporate America is no longer selling stock to the widows and orphans who are numerically "price sensitive." They now are catering to the institutional buyers who don't care about the numerical price but do care about the valuation. Additionally, some ETF's and indices which make up a very large part of the buying pool these days, have price-weighted indices, which provides a disincentive for companies to split their stock.



Source: Strategas Research

We hope that you found our third 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.

Joe Frohna Rodney Hathaway Adam France Nancy Frohna Tim Stracka

Important Disclosures:

(1) Utilizing a proprietary blend of Informa Investment Solutions' top priority performance screens, PSN Top Guns ranks products in six proprietary star categories in over 50 universes. This is a highly anticipated quarterly ranking and is widely used by institutional asset managers and investors. Top Guns receive a star rating in the range from one to six. The stars

indicate the continued performance over a length of time. 1492 Capital Management was named a Top Gun with a star rating of 2-Stars for its 1492 Small Cap Core Alpha strategy as a second best performing strategy in both their Small Cap Core Equity Universe and their Small-Mid Core Universe and the fourth best performing strategy in their Small-Mid Cap Universe all for the one year period ended June 30, 2017.

The complete list of PSN Top Guns and an overview of the methodology can be located on http://www.informais.com/resources/psn-top-guns. For more details on the methodology behind the PSN Top Guns Rankings or to purchase PSN Top Guns Reports, contact Ruth Calderon at ruth.calderon@informais.com. **About Informa Investment Solutions:** A market leader in intelligence and software solutions for investment professionals and financial institutions of all sizes, Informa Investment Solutions offers a robust set of analytics and tools to help you grow and retain your business. With a nearly 40-year history, Informa Investment Solutions is part of Informa PLC, a leading business-to-business knowledge provider serving International markets. Informa Investment Solutions has set the standard for providing turnkey and customizable applications for performing manager searches, building wealth plans, and producing client reports and investment marketing materials for companies worldwide. For more information, please visit http://www.informais.com/ and follow https://twitter.com/InformaInvest

(2) The minimum criteria for inclusion in ***Best Money Managers***: Performance must be calculated "net" of all fees and brokerage commissions. This means after all fees have been deducted. This standard is somewhat controversial, as the SEC requires that only "net" of fees numbers be presented publicly, while GIPS (Global Investment Performance Standards) prefers that "gross" numbers be presented along with a fee schedule. Since the SEC is a regulatory authority, and since complete fee schedule presentation would be impractical in this "ranking" format, we require "net" numbers. Performance must be calculated inclusive of all cash reserves. To explain, any given investment portfolio will hold some level of cash over a particular reporting period. Even equity portfolios which specifically seek to be fully invested in the market at all times will temporarily have dividend payments and other ordinary cash flows which cannot instantaneously be invested in the market. These cash holdings obviously will have an effect on the performance of the overall portfolio – negative when cash returns are low relative to returns of the asset class, and positive if the opposite is true. While presentation of "equity-only" (for example) returns may provide a valuable insight into the security selection skills of the manager, we require for comparability's sake that performance results be inclusive of cash reserves for consideration in the rankings. Performance results must be calculated in U.S. dollars, that is, from the perspective of a U.S.-based investor. Currency holdings can have a very significant impact on the performance of a portfolio with international holdings. While this will always be the case (as we do not make distinctions between hedged and unhedged portfolios), we require that performance must be translated into U.S. dollars to ensure comparability to the point where these are all returns that would be seen by a U.S.-based investor. Performance results must be calculated on an asset base which is at least $10 million in size for "traditional" U.S. asset classes (equity, fixed income, and balanced accounts) or at least $1 million in the case of international and "alternative" U.S. asset classes. This minimum ensures that the firm and product are somewhat established. The goal is to not taint the rankings with "flashes in the pan" while also not excluding promising emerging managers. The minimum asset base requirement, therefore, is set at a level which balances these objectives. The classification of the product must fall into one of the categories which we rank. We only publish rankings for categories/time period combinations for which we have at least 20 contenders.

Comments and opinions expressed in this document regarding individual securities, markets, strategies and case studies are not recommendations or predictions, and thus should not be acted upon. They are based only upon the judgments and opinions of 1492's professional staff. The use of any investment strategy does not guarantee that an investment return will be achieved, or that a loss will not occur from the advice provided. Past performance does not guarantee future results. No investment firm, including 1492 Capital Management, guarantees gains or that losses will not occur from the strategies applied to managed portfolios. You are encouraged to contact us with your questions.

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