1492 CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

JUNE 2017 • VOL. 9 • ISSUE 2

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 second 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. We're again pleased to announce that our 1492 Small Cap Core Alpha strategy has been recognized with Top Guns(1) status by Informa Investment Solutions' PSN manager database as the top performing strategy in their Small Cap Core Equity Universe for the twelve months ended March 31, 2017. In addition, the 1492 Small Cap Core Alpha strategy ranked 1st out of 571 in Broadridge MarketPlace's Best Money Managers(2) U.S. Growth & Value Equity universe for the four quarters ended March 31, 2017.

Three of a kind. This year has been strange in many ways, and the global markets for stocks, bonds, and commodities epitomize this unusualness. Rarely do you see the stock market, bond market, and gold all ascend together- three of a kind. With just a few days left in the second quarter, all three had advanced about 8% year-to-date. Which of these asset classes is fundamentals driving and where is some temporary outside force driving? We would argue that the stock market is the asset class that is most in line with its fundamental backdrop. The reversal of fortune that we spoke about last quarter continued through the second quarter as healthcare stocks, with a late surge from biotech's, are comfortably ahead in the year–to-date race and have erased their 2016 underperfromance. With the Healthcare and Technology sectors leading in performance so far this year, it's not surprising that the NASDAQ Composite is the best performing index by a long shot, despite some wobbles in the FANG (Facebook, Amazon, Netflix and Google) and technology stocks in general late in the second quarter. However, the energy sector which was the 2016 medalist, is in a distant last place. Volatility has been quite muted this year and has led to a favorable environment for stock market returns. In fact, the S&P 500 has posted a positive return in each of this year's first six months. I'm not sure the last time that happened, but I'm certain it's a rare occurrence. This consistency 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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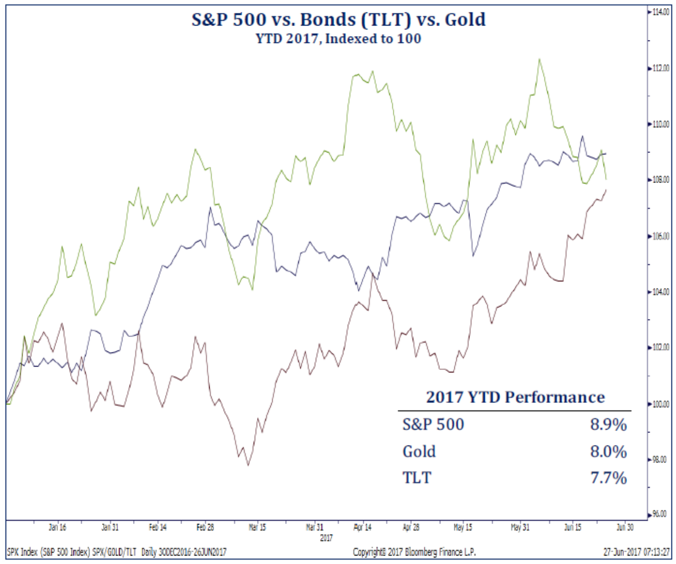
CONTACT US

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

www.1492CapitalManagement.com

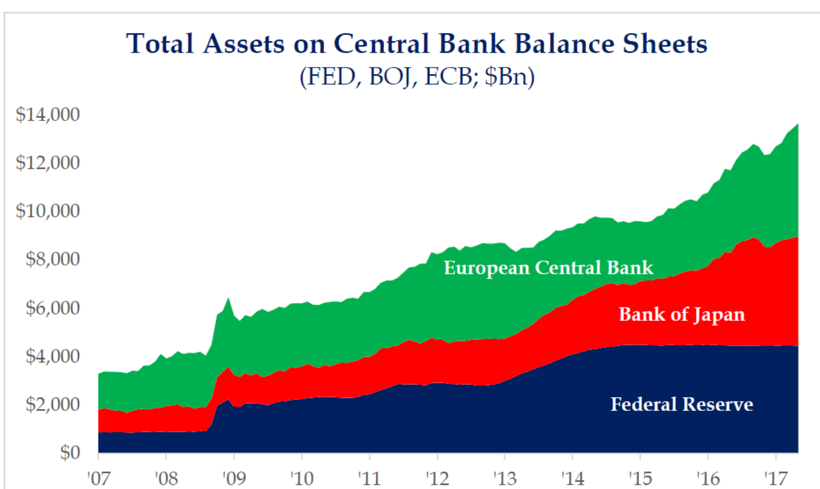
A Review of the Quarter: Three of a Kind Is a Pretty Good Hand for the Markets

With just a few days left in the second quarter, bonds, stocks and gold had all advanced about 8% year-to-date. (See the chart below) **Three of a kind**.



Source: Strategas Research

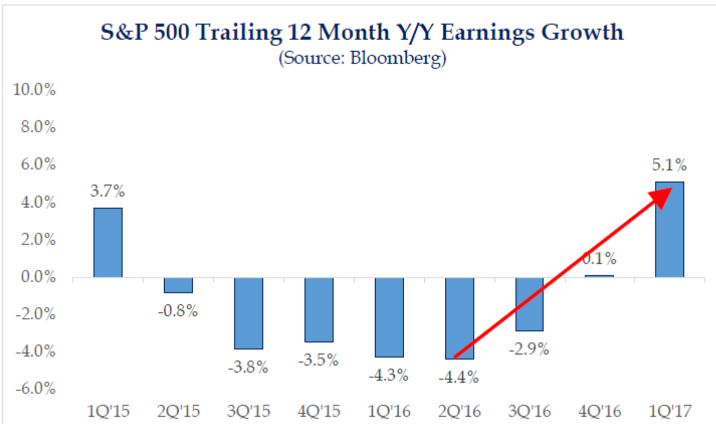
This equality is a fairly rare occurrence as the stock market typically rallies when the earnings outlook brightens; the bond market typically rallies when the Fed is cutting rates; and gold typically rallies when there is fear in the markets or when inflation is running hot. Which of these markets has it right? We believe that the stock market has it right and we'll explain in just a second. Despite recent rate hikes by the Fed, the bond market continues to be pinned down by what's happening in Europe and Japan. As the chart below shows, the Central Banks in Europe and Japan continue to intervene in their bond markets through the use of aggressive quantitative easing (buying bonds). Whereas, the U.S. Fed has stopped buying bonds and has indicated that they may begin unwinding their previous purchases later this September. You would think that the threat of the unwind would begin to put upward pressure on U.S. rates, but given the global nature of the fixed income markets, investors are seeking a higher yield in the U.S. (buying bonds) while rates overseas are near zero due to the aforementioned quantitative easing programs in Europe and Japan. The chart below shows the status of the quantitative easing programs in the U.S., Europe, and Japan.

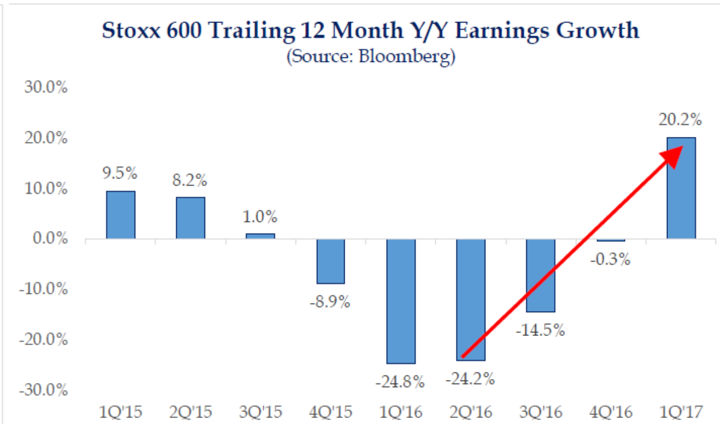


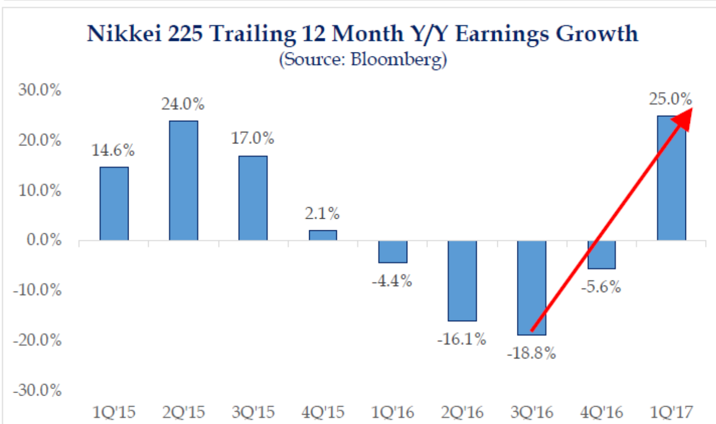
Source: Strategas Research

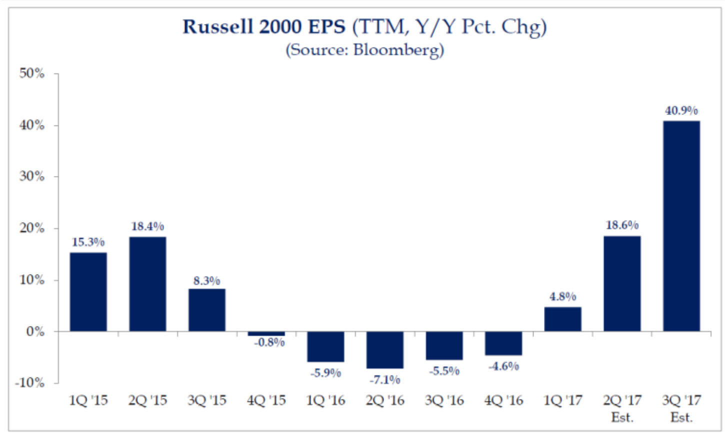
As for gold, we've never been able to figure out what the key drivers are except for fear and inflation. Both of these elements seem to be tempered for the time being, and consequently, have a hard time explaining the rise in gold prices so far this year.

As we stated above, we believe that the stock market has it right. It's the one market that seems to be tracking its historical fundamental drivers of appreciation- earnings growth. As the charts below show, earnings growth is inflecting in the U.S. (S&P 500), Europe (Stoxx 600), and Japan (Nikkei 225). The Russell 2000 small cap index is also seeing a major earnings acceleration. However, we have some concern about the magnitude of growth expected in the third quarter. This growth expectation will likely retreat as we move through second quarter earnings reports.









Source: Strategas Research

Small caps slightly underperformed large caps in the second quarter and remain behind in the year-to-date race despite a strong month of June. Large cap tech stocks showed some vulnerability in June as several Wall Street analysts noted that the popular large cap FANG trade was nearing its end. The market quickly rotated into financials and healthcare stocks, particularly biotech, which both favor small cap indices. Despite the lack of any real progress on healthcare and tax reform in Washington, we've been surprised at the market's resilience so far this year. Maybe the market's telling us that no change is a good thing. If progress is made, we believe that small caps will be the major beneficiaries as regulation and tax reform would disproportionately help small caps over large. Based on the year-to-date market returns, it appears that the market has seemingly lost a bit of confidence in the "Trump trade" as investors were betting on a reflationary environment that is generally very beneficial to the stock market in general and small caps in particular. This change is quite evident when examining sector returns where the Energy and Financial sectors are two of the three sectors that are negative so far this year. Nevertheless, 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 in Congress.

The stock market has posted a fast start in 2017, and despite all the wrangling in Washington, the first half was a fairly quiet period in terms of market volatility. *In each of the first six 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 logged three days so far this year where the 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).

Exhibit 3: Number of Trading Days with 1% and 2% Moves

Year	# of Trading Days >1%	# of Trading Days >2%
2009	117	55
2010	76	22
2011	96	35
2012	50	6
2013	38	4
2014	38	6
2015	72	10
2016	48	9
2017	3	0
Long-Term Avg	**61**	**14**

Source: S&P, Bloomberg, and RBC Capital Markets

Despite a retreat in technology stocks late in the quarter, the NASDAQ Composite index (+4.2%) was still the best performing index in the quarter on the strength of Apple and FANG (Facebook, Amazon, Netflix, and Google) which were all higher 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 +3.1% which slightly outpaced the Russell 2000 Index's gain of +2.5%. From a sector standpoint within the Russell 2000, the Healthcare (+9.1%) and Energy (-17.9%) sectors were at the extremes and reversed their 2016 positions. The sectors that are beneficiaries of a reflationary environment, namely Energy and Financials (-1.4%) were two of three sectors that have posted negative returns year-to-date. 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 second quarter of 2017 for the popular indices.

Index Returns		
Index	Second Qtr. 2017 Return	2017 YTD Return
Russell 2000	+2.5%	+5.0%
Russell 2000 Growth	+4.4%	+10.0%
Russell 2000 Value	+.7%	+.5%
S&P 500	+3.1%	+9.3%
Dow Jones Industrials	+3.3%	+8.0%
NASDAQ Composite	+4.2%	+14.7%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Growth Index (+4.4%) significantly outperformed the Russell 2000 Value Index (+.7%) for the quarter. As mentioned above, the energy and financial stocks' weak performance hampered the value index as these sectors have 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 second quarter.

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

	Last Month			Last Three Months			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	2.18	0.34	-1.25	2.39	0.38	-2.00	4.86	0.79	-5.12
Staples	-0.92	-0.02	-4.36	2.24	0.07	-2.16	-3.05	-0.09	-13.03
Energy	-2.57	-0.02	-6.00	-16.93	-0.19	-21.33	-27.57	-0.36	-37.55
Financials	4.73	0.32	1.29	-1.14	-0.09	-5.54	2.01	0.15	-7.97
Health Care	10.82	2.27	7.38	9.95	2.08	5.56	24.83	4.97	14.85
Mat. & Process	2.79	0.25	-0.65	-0.59	-0.09	-4.99	5.52	0.54	-4.46
Prod. Durables	1.32	0.19	-2.12	2.28	0.33	-2.12	3.34	0.50	-6.64
Real Estate	3.37	0.21	-0.06	6.89	0.41	2.50	9.56	0.55	-0.42
Technology	-1.06	-0.16	-4.50	5.68	1.20	1.29	13.11	2.62	3.13
Utilities	1.57	0.04	-1.87	11.39	0.27	6.99	13.00	0.31	3.02

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

	Last Month			Last Three Months			Year To Date		
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**
Discretionary	4.47	0.47	0.97	2.44	0.26	1.75	2.43	0.28	1.86
Staples	-4.88	-0.10	-8.37	-8.88	-0.20	-9.57	-12.49	-0.28	-13.07
Energy	-3.21	-0.10	-6.71	-18.06	-0.93	-18.74	-26.55	-1.53	-27.13
Financials	5.58	1.59	2.08	0.94	0.22	0.25	-2.06	-0.75	-2.64
Health Care	10.77	0.49	7.27	5.13	0.23	4.45	14.74	0.62	14.16
Mat. & Process	1.96	0.12	-1.54	-2.90	-0.16	-3.58	-0.82	-0.03	-1.40
Prod Durables	4.17	0.50	0.68	5.27	0.62	4.58	5.46	0.64	4.88
Real Estate	3.02	0.37	-0.48	2.04	0.27	1.35	2.73	0.36	2.15
Technology	1.44	0.20	-2.06	1.07	0.15	0.39	7.70	0.81	7.12
Utilities	-1.33	-0.10	-4.83	2.36	0.18	1.67	6.03	0.41	5.45

Source: Jefferies

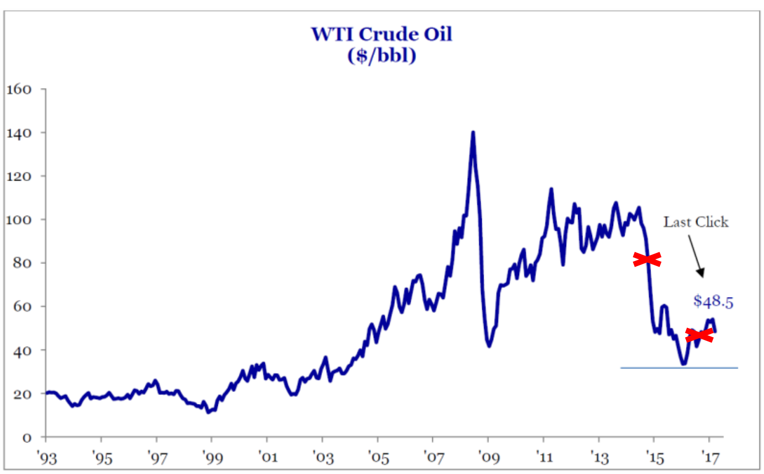
While the U.S. stock market posted a strong second quarter, the stock markets around the globe were quite mixed. Commodities were generally a touch lower on the heels of waning economic optimism following the election of Trump, and interest sensitive investments were higher as rates fell and as inflation data was generally muted. 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 is being blamed for the end of the reflation trade globally as the government has cooled the housing boom and generally restricted credit of late. The Chinese stock market is one of the few that is down year-to-date. 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. Despite OPEC extending their output cuts, energy commodities were down after strong appreciation in 2016. Energy is a critical area to watch going forward. See the section below entitled Updated 2017 Outlook - Quite Simply, It's All About Oil, Part 2: The Jury is Still Out.

Index	Second Qtr. 2017 Return	2017 YTD Return
France	2.40%	8.10%
Germany	0.80%	8.10%
Brazil	-4.20%	3.30%
India	4.40%	16.10%
China- A Shares	-0.90%	2.90%
China- Shenzhen A Shares	-4.50%	-3.70%
Japan	6.10%	5.80%
Long-Term Treasuries (TLO)	4.10%	5.80%
Investment Grade Corp. Bonds	1.80%	2.90%
Gold	-0.80%	7.80%
Volatility- VIX index	-9.70%	-20.40%
Oil	-8.70%	-14.00%
Natural Gas	-5.00%	-17.70%
Lumber	-4.30%	15.30%

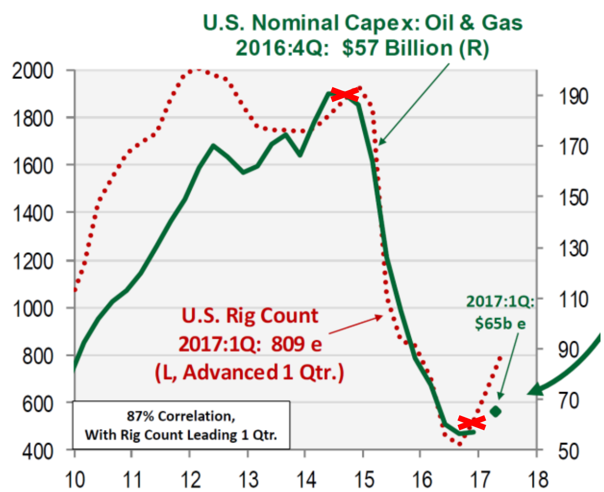
Source: 1492 Capital Management, LLC

Updated 2017 Outlook – Quite Simply, It's All About Oil, Part Two: The Jury is Still Out

In last quarter's newsletter 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. Unfortunately, the jury is still out. Crude oil is currently trading around $47, which is down about 12% since the start of the year, and has 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. To illustrate this significant correlation, we need to examine the price of oil for starters (See the first chart below left). This chart 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 market share, respectively. 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" had an entirely different meaning. It was the day that OPEC decided that they weren't going to support the price of oil by reducing their output and would stem the loss of market share to the U.S. shale producers which had become 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 date 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 need a healthy crude oil market to get the deal done. In May 2017, OPEC agreed to extend the production cut for another nine months. 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%.

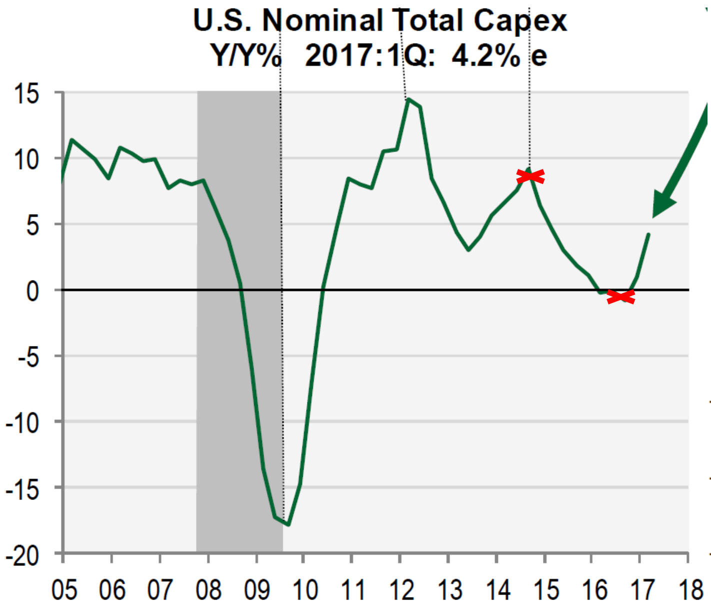


Source: Strategas Research

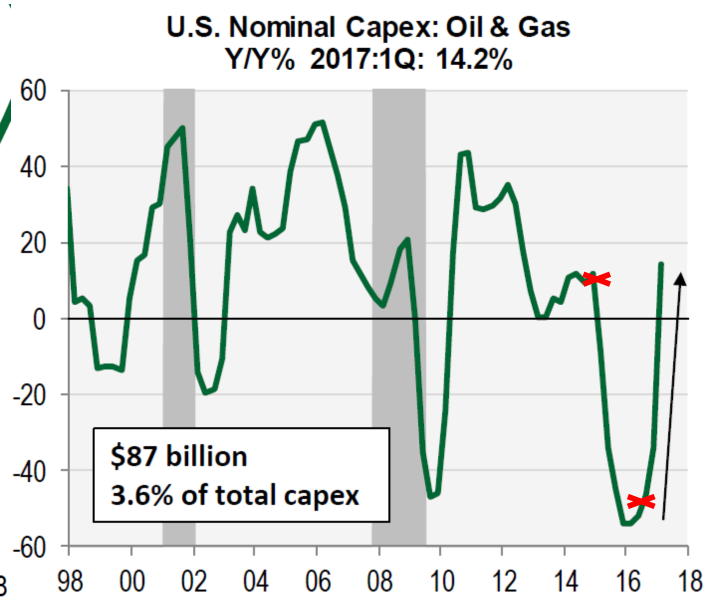


Source: Cornerstone Macro

The precipitous drop in energy patch activity impacted more than just the oil and gas industry. The charts below highlight the strong correlation that capital expenditures have with the price of oil over the 2014-2016 period that we highlighted above. The chart below left shows total capital expenditures in the U.S. were humming along in 2014 with 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. This only recently turned higher with the rig count. The chart below right shows oil and gas related capital expenditures. Note the strong recovery in spending on a year-over-year basis as the rig count has dramatically increased over 100% in the last year to 915 rigs. However, the last week of rig count data was flat and broke a 23 week streak of increasing rig counts. Stay tuned.

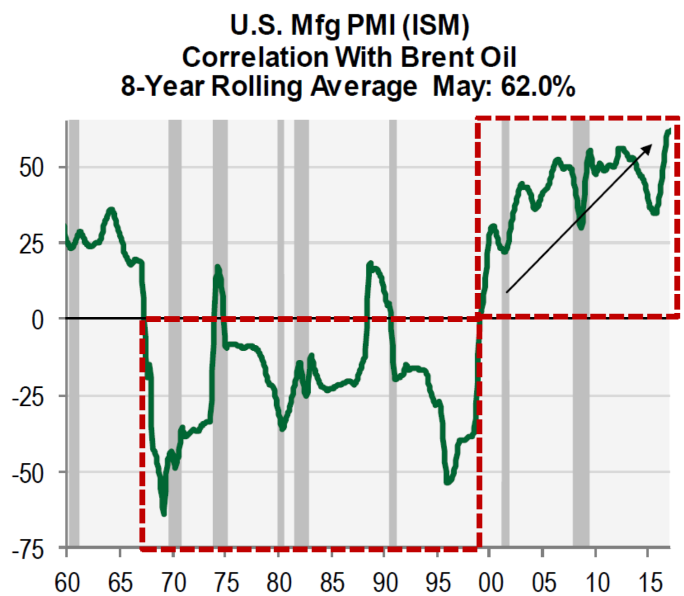


Source: Cornerstone Macro



Source: Cornerstone Macro

Lastly, someone must have been reading our newsletter last quarter as 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

<u>Thematic Investing: Tech Trends of the Future- Look No Further than the Next-Gen Apple iPhone</u>

Technology trends haven't been this strong since the internet boom/bust of the late 1990's. At 1492 Capital Management, we're always scouring the tech landscape for investment opportunities. However, if you want to know what particular trends may be worth investing in down the road, look no further than the next-generation Apple iPhone. The smartphone market globally is expected to double from 2.5 billion units in 2017 to over 5 billion in 2020. According to numerous tech publications, analyst reports, and leaks from suppliers, the next-gen iPhone is likely to contain many new innovations that will likely spawn new applications and pave the way for lower cost devices that will take this new technology and place it in new form factors. Apple is supposed to release their next phone in September, and it should contain a bevy of new technologies like OLED screens, 3D sensing capabilities, USB-C adapters, and potentially wireless charging. These offerings are in addition to other technologies that are pushing forward in other form factors like autonomous driving, internet of things, home automation, wearables, artificial intelligence, and virtual reality.

OLED (organic light emitting diodes) screens are low power, high clarity screens that will be far superior to current LED screens. The screens will be able to go right to the edge of the phone, which increases the amount of viewable surface area for the same size case, consume much less power, and give the viewer a much more pleasant viewing experience. LG and Samsung are spending billions of dollars on new OLED fabs that will produce the screens for the next-gen smartphones. Smartphones are just the beginning, as the bigger market is the TV market which has much larger screen sizes. It's in its infancy of adoption as the cost of OLED TV's is still too high for mainstream consumers. Additionally, OLED screens can be folded or rolled up, and this technology is being pushed ahead for interesting applications. The investment opportunities brought about by OLED screens will include the manufacturers of the equipment used to make the screens and the emissive compounds used to create the colors you'll see on the screen. At 1492 Capital Management we're investing in companies with exposure to this robust trend.

3D sensing technology is expected to make its debut in the next-gen iPhone too. Quite simply, it will allow your phone to interpret depth. This technology will allow for biometrics and facial recognition to be used for security, and it will also allow for some very practical uses. For example, if you want to buy a couch from an e-commerce site, you'll be able to use your phone with 3D sensing technology to have a visual of how that couch may look in your living room and whether it will fit in the space that you're trying to fill. Apple's rationale for installing this technology is much more self-centered. We understand that they want to use the facial recognition or retinal scanning capability to insert themselves as the new middleman for all types of financial transactions that will be able to be done over a smartphone, and realize a toll charge on each transaction. Other applications of 3D sensing include gaming, as Nintendo's WII Nunchuks were one of the first "primitive" uses of the sensing technology. Virtual reality applications will also use this technology. Some of the best ways to invest in this technology is through the fiber optic component manufacturers which have VCSEL technology as the basic building block of 3D sensing solutions.

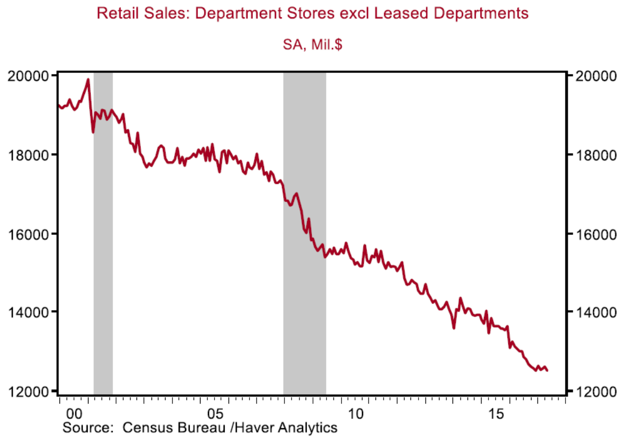
USB-C adapters are going to replace the traditional inputs for headphones and for power on a smartphone. The technology allows for the transmission of data, video, and energy alike, and eliminates separate connections for each. Requiring a single input jack will reduce the cost of the phone and it will accomplish numerous tasks. There are investment opportunities in semiconductor companies that manufacture the chips that allow for this technology to happen. This technology will also finds its way into laptops, computers, TV's, etc.

Lastly, wireless charging, which Samsung has already adopted in their smartphones is rumored to debut in the next-gen iPhone. The technology makes all the sense in the world. Who wouldn't want to rid themselves of a slew of tangled charging cords? Count me in. Investing in this technology is primarily achieved through a couple of semiconductor companies who have perfected this technology. As we mentioned last quarter, 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.

Thematic Investing: It Works In Reverse Too- Avoid Being Amazoned

Thematic investing is our hallmark investment strategy that we deploy in our portfolios here at 1492 Capital Management. In its simplest form, thematic investing involves identifying an industry or sector that has the wind at its back. Then we identify a number of companies that will benefit from that trend and invest only in those companies that we believe have the best fundamentals, valuation, and management. However, it works in reverse, too. When we identify an industry or sector that has the wind in its face, we avoid it and such is the case with companies that are competing with the very formidable Amazon.

It's been well documented that Amazon has been giving traditional retailers fits. The mall-based retail model is no longer a winning proposition when consumers can shop with their mouse or mobile phone from the comfort of their couch. Historically consumer stocks, like mall-based retailers, were well represented in our portfolios at 1492 Capital Management as they were generally viewed as growth stocks with large runways for expansion. In today's world, thanks to Amazon, this is no longer the case. Only those retailers with differentiated product and the ability to run an efficient and profitable omni-channel model are considered for our portfolios. Therefore, our portfolios are underweight companies that are located in malls or that are dependent on mall-based traffic. Macy's has been the poster child for this Amazon phenomenon over the past several years as its profits have been pressured, and the stock has been cut by two-thirds over the past two years. The two charts below highlight the dilemma of mall-based retailers. As you can see by the chart on the left, retail sales by department stores have fallen nearly 40% over the past fifteen years. Along with the falling sales, the number of employees at department stores have dropped precipitously as can be seen on the chart on the right.

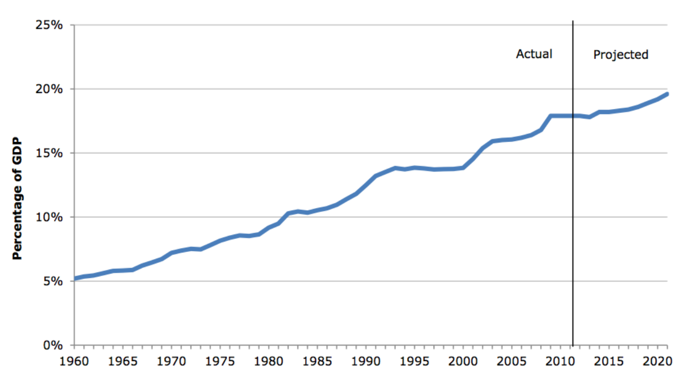


Amazon's recent purchase of Whole Foods, the natural and organic grocery chain, may signal the next battle ground- the super market industry. While it's too early to know how Amazon is going to use its brute force and innovative thinking to change this industry, it's probably not a place we'd want to be making investments given their track record. However, all is not lost. There are industries that stand to benefit from Amazon's success. We've written in the past about our transport investments that have exposure to Amazon through jet leasing (cargo planes) and through trucking given the number of packages being shipped to residences. Others that could benefit include cardboard manufacturers, mom and pop businesses that are able to gain more exposure on their platform, online media companies, and a host of tech companies that help to build out their datacenters and networks.

<u>Updated 2017 Outlook-- Health Care Issues for 2017 And Beyond</u>

As our nation celebrated Independence Day this past weekend, we as Americans have many reasons to be proud. We live in one of the most prosperous and dominant societies that has ever existed, and the United States leads the world in many categories. Unfortunately, it doesn't mean we're always the best at everything. One lagging category is health care expenditures as a percentage of Gross Domestic Product (GDP). Here in the United States 17.1% of our economic output is spent on health care. For comparison, the world average as of 2014 was 9.9%. As you can see in the chart below, health care expenditures have been on a steady rise for several decades and are showing no signs of slowing down, especially as the average age of the U.S. population continues to rise.

Figure 2: U.S. National Health Expenditures as a Share of GDP, 1960-2021



Source: Centers for Medicare and Medicaid Services.

Recognizing that spending on health care cannot continue to garner an ever larger share of total economic output, there has been a shift to Value-Based care. In simple terms, this shift means that health care providers, such as doctors and hospitals, will be reimbursed based on the actual health outcomes of the patients that they treat. Driven by Centers for Medicare and Medicaid Services (CMS), this disruptive shift in the approach to reimbursement for services has spurned several other behavioral changes by both consumers and providers, and has fostered investments in the field of medicine.

The other secular shift that has been occurring is the increasing amount of out-of-pocket expenses that the individual bears. Following the Great Recession much of the new job creation in our nation has been driven by small start-up companies that often lack the scale and resources to provide comprehensive health care insurance coverage for employees. With health plans trending towards higher deductibles that cover only catastrophic or emergency visits, the need for individuals to cover more of their health care costs has sharpened consumer acuity which has in turn forced providers of health care services to adopt more consumer friendly practices. This change in mindset for doctors and hospitals is nothing short of revolutionary for an industry that is still dominated by non-profit networks that had previously been more focused on garnering donations from wealthy benefactors to expand facilities, regardless if there was patient demand from the market.

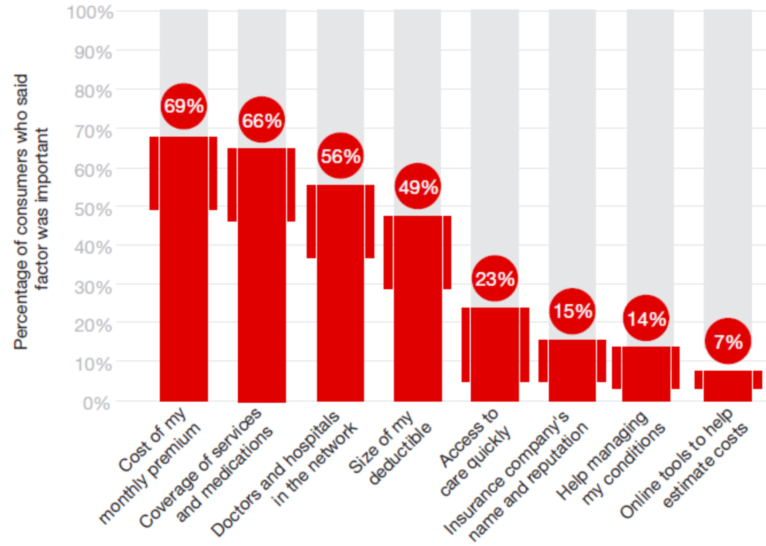
When I started covering the health care industry as an analyst back in 1994, the common statistic that we used was that there were roughly 5,000 acute care hospitals in the U.S. operating at about 50% of capacity utilization. In other words the industry was extremely over built with hospitals. However, since 90% of the hospitals at the time were owned by not-for-profit organizations, there was not a strong incentive for them to run facilities at optimum levels of efficiency. There was absolutely no transparency on pricing of services to the consumer mainly because the consumer didn't care. Most anyone working for a corporation at that time was part of a Health Maintenance Organization (HMO) that had negotiated wholesale prices from providers in exchange for patient volume. Since individuals had little to no out of pocket expenses so long as they stayed "in-network", they freely used the benefits. Consequently, it should not be surprising that health care expenditures have nearly doubled as a percent of our economy during this period.

The other demographic factor that is exacerbating the stress on health care spending is the "greying of America". Health care analysts have known for several years that the aging of the Baby Boom generation would create opportunities for investors. After many years of watchful waiting, we are now at the tipping point of that reality; roughly 8,000 to 10,000 Baby Boomers are turning 70 years old every day. Intuitively, we know that as we age we tend to consume more health care services. Our bodies naturally break down, and we are more susceptible to disease. Fortunately, since we live here in America where we outspend every other country on health care, we should have the world's best longevity. Wrong! We aren't even a "country mile" close. In fact the U.S. ranks 31st globally in average life expectancy at 78.8 according to the Centers for Disease Control (CDC). Number one is Japan at 83.7. What is more shocking is the average life expectancy fell in 2015 for the first time since the height of the AIDS epidemic. It is very rare for life expectancy to drop in a developed nation. Bottom-line, we are no longer getting healthier as a nation but in-fact regressing due to a myriad of factors including sedentary lifestyles and a high fat diet.

These three major trends occurring in 2017 and beyond, Value-Based Care, Consumerism in Health Care and Greying of America will shape will shape our investment strategy for this sector for the next several years. Beneath these over-arching trends are several sub-themes such as artificial intelligence in medicine, repeal of the Affordable Care Act, smart phone app technology, population health management and holistic/nutraceutical integration into wellness programs. We will address a few of these topics briefly below.

The fate of the ACA, or Obamacare, is still uncertain as the Senate has delayed its vote on an alternate bill until after the July 4th recess. At center stage is what happens to the roughly 20 million individuals that have been added to the Medicaid roles over the past few years and whether hospitals will take a major hit if left un-reimbursed for these patients. Even if there is a partial reform to the ACA that is passed, there most certainly be a transition period for insurance companies so the only shocks to the system will be merely headline risk. One of the key points that Republicans want repealed immediately is the excise tax currently levied on medical device companies. The most important item to keep in mind obviously is that consumers are most concerned about the cost of their monthly insurance premium. Longer-term, consumers also want to be able to effectively budget for health care costs and not be surprised every year with double-digit percentage increases to premiums.

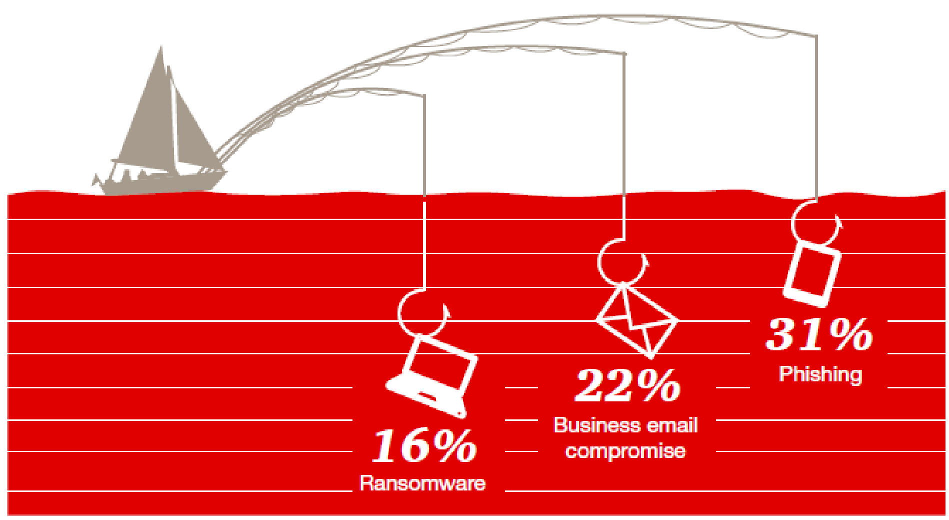
Consumers pointed to the cost of their monthly premium, coverage of services and medications, and provider network as their most important considerations when choosing a plan from a health insurance company.



Source: *PwC Health Research Institute Consumer Survey*, 2016

Consumerism in health care is leading to more credit card transactions which are currently estimated at 5% of provider revenue. This volume is expected to double over the next few years. As a result, hospital systems need to upgrade to the existing payment networks as well as fortify security against cyber-attacks.

Percentages of payers and providers reporting each type of security incident



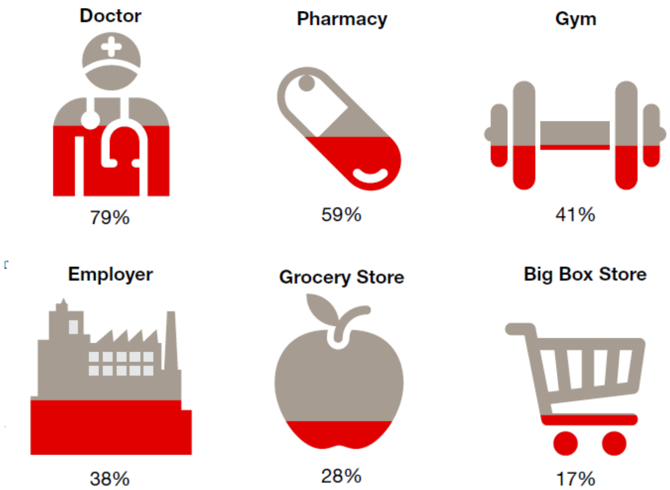
Source: *PwC The Global State of Information Security Survey* 2017

Accountable Care Organizations (ACO's) is the new term that hospital networks are branding to reflect the value-based reimbursement being implemented by CMS. Most ACO's have now implemented technology for capturing electronic medical records (EMR's) with the help of government incentives. We believe investment in technology will continue in areas such as cyber-security, remote patient monitoring apps, and population health management.

In general the health care industry has lagged other sectors in terms of information technology investment. This shortfall has been due in large part to factors that we've already discussed such as the dominance of the non-profit hospitals, destination visits driven by HMO's, and lack of transparency to consumers. As health care delivery becomes more remote, mobile and virtual, providers will be required to update practices and technology to accommodate the increased demands from patients.

Lastly, the need for Americans to get healthier is real. Drug and medical device companies spend billions of dollars every year in research and development to find cures to disparate diseases. In reality these cures however are merely a Band-Aid fix to the bigger problem which is a lack of wellness. Diabetes looms as the next nationwide epidemic and is primarily a lifestyle disease. Considering they are the most trusted source for health advice, health care providers need to do a better job in educating patients on what they need to do to develop a more healthy lifestyle regimen.

Consumers were asked whether they would take advantage of free advice for weight management or help with diet-related medical conditions from a nutritionist or dietitian from each of these entities. Percentage of respondents answering yes:



Source: *PwC Health Research Institute Consumer Survey*, 2016

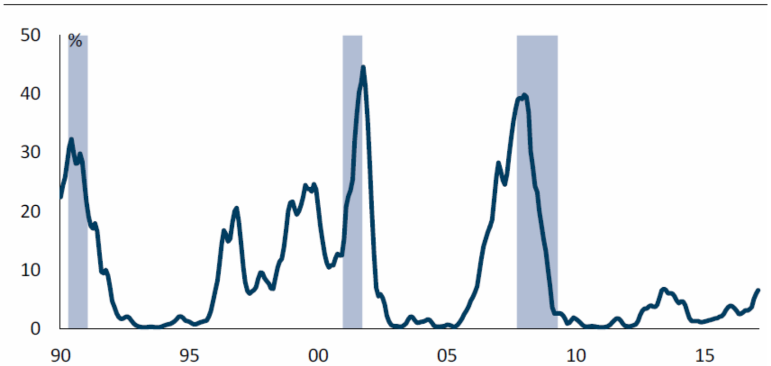
While there looms much uncertainty around the health care sector in 2017 due to mainly potential regulatory changes, we believe that there will be a plethora of investment opportunities in the years to come as we witness these secular changes that are occurring in our country.

<u>Updated 2017 Outlook – A Picture is Worth a Thousand Words</u>

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.

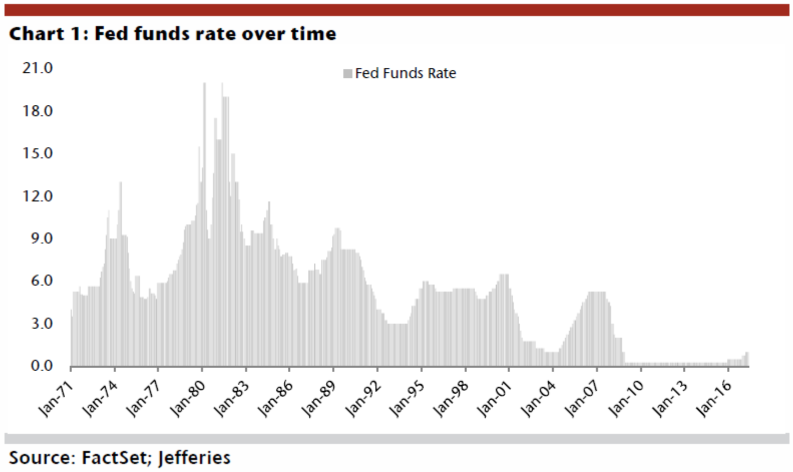
At this point of the cycle, the number of Wall Street economists calling for the end of the cycle is increasing. However, according to the NY Fed, the odds of a recession in the next 12 months are quite low.

Exhibit 7: NY Fed Probability of Recession in Next 12 Months

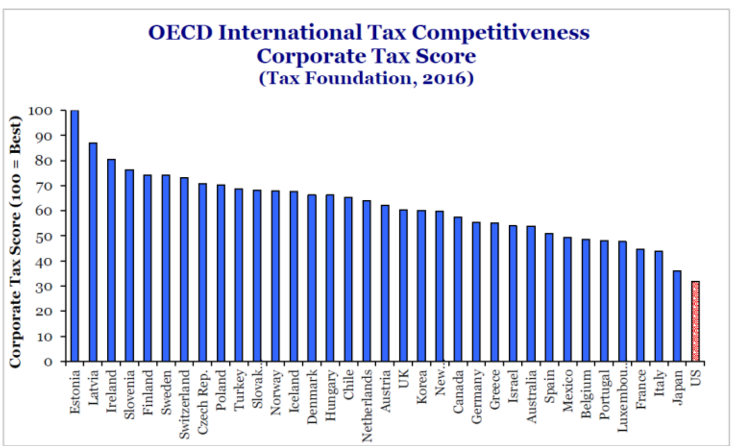


Source: Federal Reserve Bank of New York, NBER, Haver, and RBC Capital Markets

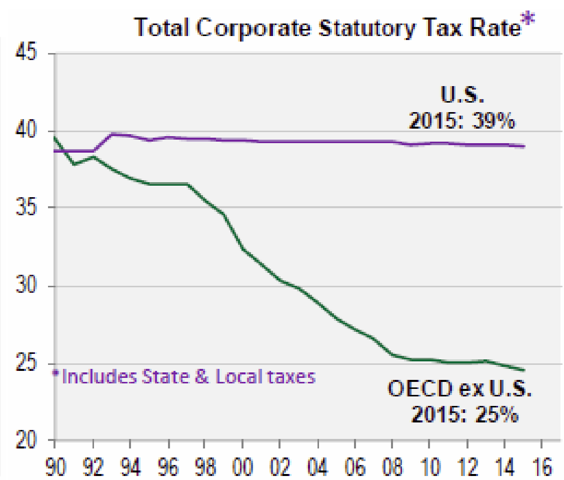
The chart below puts the recent Fed rate hikes into perspective- we're a long way from normal.



More support for tax reform in the U.S.- we're clearly an outlier now.

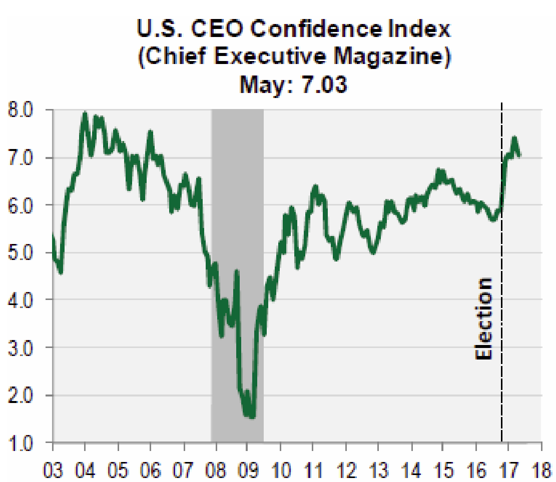


Source: Strategas Research

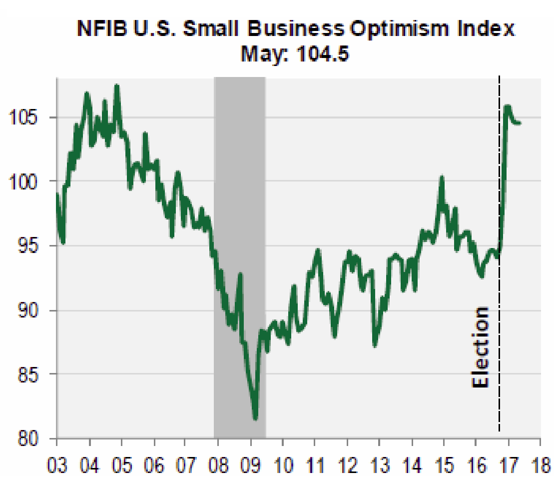


Source: Cornerstone Macro

Both CEO's and small business owners remain quite optimistic post the Trump election, despite little tangible legislative movement.

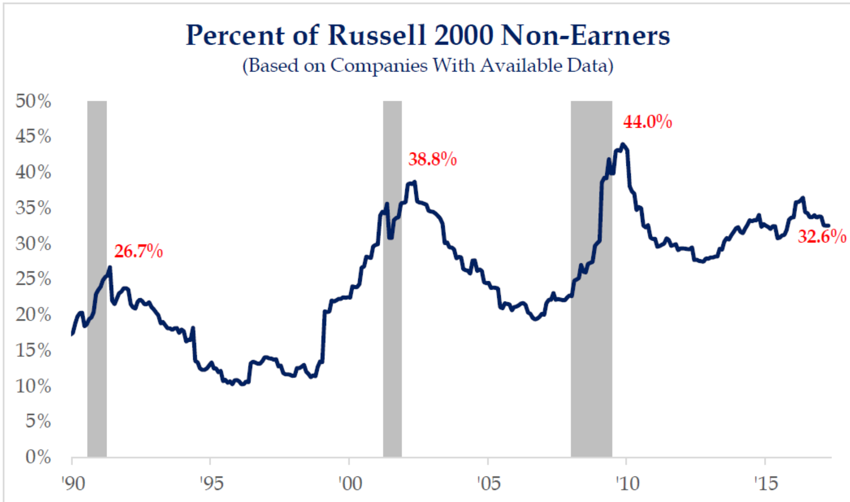


Source: Cornerstone Macro



Source: Cornerstone Macro

The percent of money-losing companies is at an all-time high (non-recession) within the Russell 2000 index. Biotech's are a key driver of this phenomenon. Low interest rates have allowed weak players to stay in the game.



Source: Strategas Research

Market Trivia

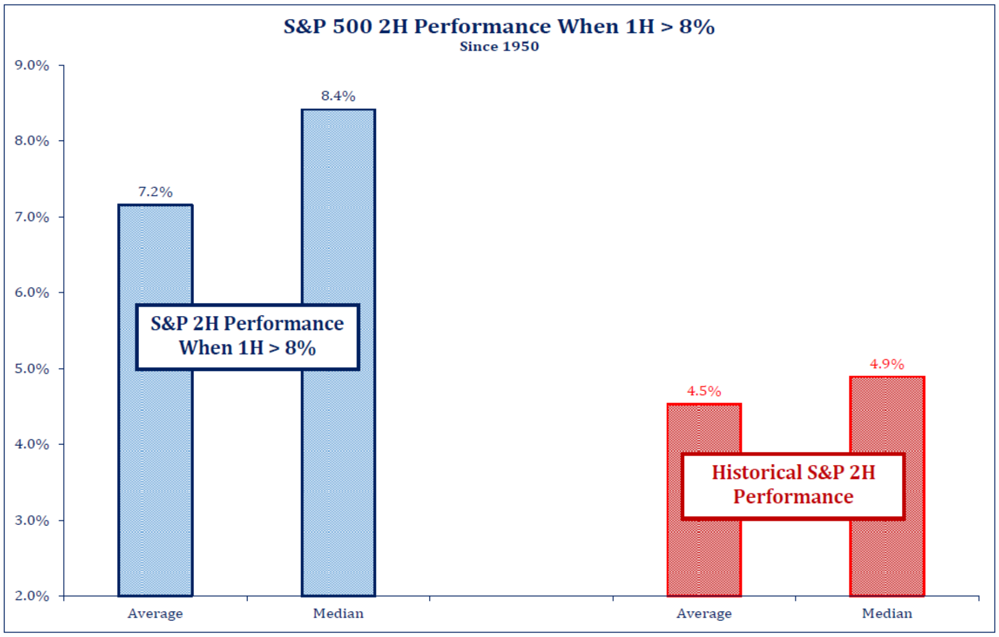
Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. The U.S. Fed appears to be hell-bent on raising interest rates several times in 2017. They just hiked for the third time this cycle in June and have indicated a fourth and fifth time are likely by year end. Tightening cycles are generally viewed as negative for stock market returns. However, as the chart below shows, on average the market is higher in the twelve months following the fourth rate hike. Interestingly, small caps outperform large caps by a wide margin in the twelve months following both a fourth and fifth Fed rate hike.

Table 1: Performance tends to be weak about a fourth and fifth hike

	4th Hike Subsequent Performance			5th Hike Subsequent Performance		
	Small	**Large**	**Relative**	**Small**	**Large**	**Relative**
1Mo	5.16	1.67	3.43	4.95	1.88	2.92
3Mo	4.98	3.86	1.07	12.30	3.83	8.12
6Mo	1.09	2.10	-1.13	-2.37	-0.84	-1.44
12Mo	8.17	5.15	3.22	3.43	-6.39	10.62

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

Earlier in the newsletter we highlighted that the S&P 500 posted positive returns in each of this year's first six months. Undoubtedly this performance is a rare feat. The S&P 500's first half return was +9.3% and bodes well for the rest of the year if history holds. In years when the S&P 500 is up more than +8% in the first half of the year, the median performance for the second half of the year is +8.4%, which is almost double the historical median return for all second half's for the S&P 500.



Source: Strategas Research

We hope that you found our second 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 top ten performer within the Small Cap Core Equity universe, based on return from the 12 months ended March 31, 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.

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.

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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