1492 CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

MARCH 2018 • VOL. 11 • ISSUE 3

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

1492 Vantage Point Newsletter

Welcome to 1492 Capital Management's quarterly newsletter for the first quarter of 2018. 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 and with our wealth management platform. Our investment professionals possess a tremendous amount of experience navigating through multiple market cycles. This experience was demonstrated again with a number of accolades that are highlighted in the tables below for both our 1492 Small Cap Core Alpha and our 1492 Small Cap Growth strategies in Broadridge MarketPlace's Best Money Managers[(1)] and in Top Guns[(2)] designation by Informa Investment Solutions' PSN manager database.

Period Ended 12/31/2017

PSN Informa Investment Solutions

Strategy	Universe	Rank	Period
1492 Small Cap Core Alpha	Small-mid Core Universe	2-Star; Ranked 9th	One-year

Broadridge MarketPlace Best Money Managers

Strategy	Asset Class	Rank	Period
1492 Small Cap Growth	US Small-cap Equity	Rank 17 out of 467	Four quarters
1492 Small Cap Growth	US Small-cap Growth Equity	Rank 16 out of 134	Four quarters

Mileage driven was substantial but we ended up in the same place. Beginning the year, the stock market led us to believe that we were in store for more of what we saw in 2017 with January returns that were the best in 21 years on the heels of tax reform optimism. However in February, volatility, which we predicted would move higher in 2018, soared to levels that we wouldn't have imagined and that were last seen in the great recession of 2008 on concerns about rising inflation and tariffs. These concerns led to one of the 10 worst February's since 1927 which erased all of January's gains. Tariff headlines of the day and Facebook's privacy leaks which spilled over to the other members of the "FANG" consortium who also collect a lot of customer information further plagued March with a yo-yo market that saw wild daily swings. When it was all said and done, we ended up where we began the year. Small cap stocks actually outperformed large caps which is unusual when volatility spikes. We'll provide you with our take on why this is occurring. The impact of tariffs, which have dominated the headlines for much of the past few months, are substantially overblown. Please read on to see our unique views of what's on tap for the remainder of 2018, 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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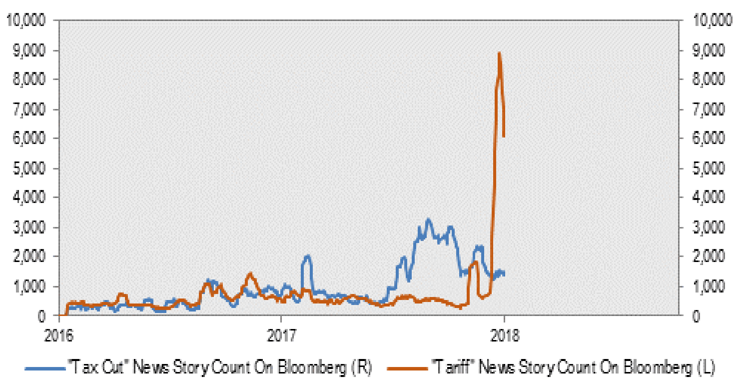
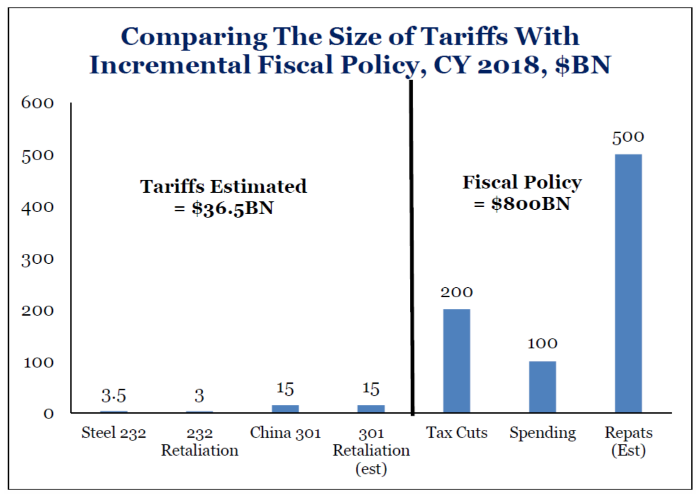
A Review of the Quarter: Mileage Driven was Substantial but We Ended Up in the Same Place

If you read last quarter's newsletter you know that we predicted volatility would pick up in 2018, but we didn't expect the hyper volatility that we witnessed in February and March. The year started with the best January performance in 21 years (+5.62%) and then recorded one of the 10 worst February's since 1927 and daily yo-yo movements in March. The culprits seem to be a mix of inflation fears, rate hikes by the Fed, Facebook privacy breaches, and tit-for-tat tariff banter. All of these concerns led to a market that traveled many miles during the quarter but ended up in the same place that we started.

Tariffs dominated the headlines for much of the first quarter and drove fears of trade wars and retaliation from trading partners around the globe. These events seemingly wiped out the optimism that was pervasive just a few short weeks before on the heels of tax reform legislation passage and implementation. The near panic from Wall Street that followed the second round of tariffs announced against China highlights the professional investor's misperception of the size and ultimate impact to the U.S. economy. The chart below left shows the surge in "tariff" related news stories versus "tax cut" related news stories. It's interesting to note that there were almost three times as many "tariff" stories at its peak than "tax reform" stories on Bloomberg. This frenzy of "tariff" related stories seemingly led to a panic by Wall Street who were led to believe the hype of these stories. The reality is that the economic impact of implementing the tariffs proposed to date would be miniscule in comparison to the benefit from tax reform and government stimulus from the recently signed budget deal in 2018 as seen on the chart on the right. *The tax reform and government spending initiatives are over 20-fold larger than the potential impact of the proposed tariffs in 2018!*

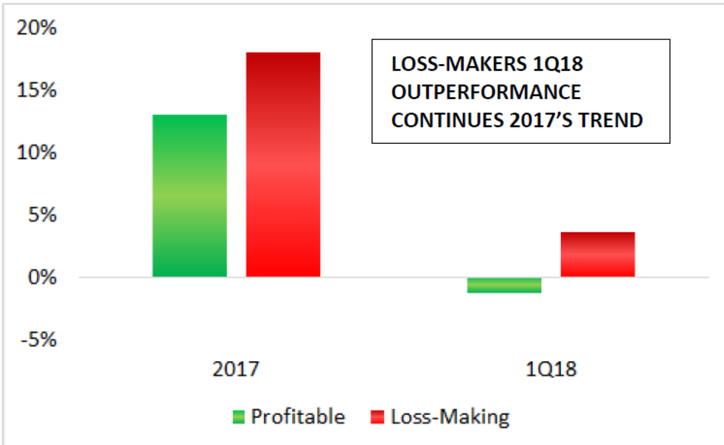


Source: Cornerstone Macro

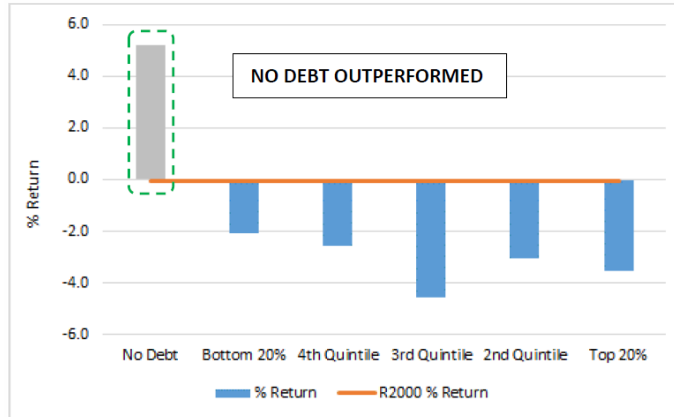


Source: Strategas Research

During the first quarter, there were a number of interesting and unique developments when you examine what worked and what didn't. First, unprofitable companies were the best performers in the quarter. Once again, we can look to biotech stocks as the key driver as there were some large profile takeovers of biotech companies in the quarter like Juno Therapeutics, which had a relatively large weight in the Russell 2000 when it was acquired. The chart below left shows that the outperformance of loss making companies is a continuance of the trend from 2017. This occurrence is quite surprising because the passage of tax reform benefits profitable companies. The second trend that is less obvious but very important is that companies with no debt outperformed companies with debt. In fact, as the chart below right shows, average companies that had any debt on the balance sheet had negative returns. Is this the market's shot across the bow implying that the best of the economy is now behind us? We'll take a further look at this idea in the next section below.

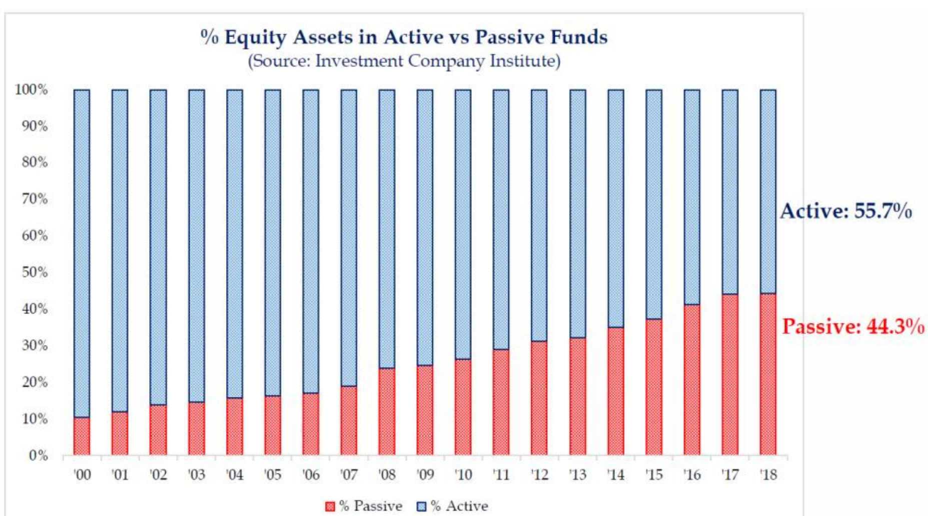


Source: Furey Research Partners and FactSet.



Source: Furey Research Partners and FactSet. Based upon quintiles set as of 12/31/17; sector neutral other than the "No Debt" grouping.

One other interesting development occurred during the first quarter. Small caps outperformed large caps. You might be asking yourself, so what's the big deal? The big deal is that small caps typically underperform large caps when volatility spikes and when there are a number of concerns overhanging the stock market. This change could be an important precursor to what may happen when we enter the next sustained downturn in the stock market. Here is our take. Passive investments, like ETF's and index based funds, have been all the rage for much of the past 10 years. Passive investments now comprise over 44 percent of equity assets as the first chart below shows and appear to be moving higher still. This trend has been a very large headwind for active investors for the following reason. ETF's and index based funds' portfolios are predominantly structured by market cap weighting. Of the $2.86 trillion invested in ETF's, $2.47 trillion or almost 87 percent are in funds that are weighted based on market capitalization of the underlying holdings. It simply means that if a stock has a larger market cap, it will have a larger weighting when compared to a stock with a lower market cap in the same portfolio. Thus, for every dollar that flows into these passive vehicles, more goes into the larger market cap stocks than the smaller ones. Virtually every ETF has been structured in this manner because it allows the ETF manager to theoretically have more liquidity in its portfolios. This structure has been a significant headwind to active managers as passive fund flows have been piling into these market cap weighted funds and flowing out of active funds that are by definition active and not investing their dollars on a market cap weighted basis like an index or an ETF. Active managers are making active bets that are presumably based on differences in company fundamentals, valuation, management, etc. However, as they say, what goes up must come down. When we saw the recent downturn in stocks this past quarter, there were large outflows from passive investment strategies which, by definition, have to sell more of the larger weighted stocks in their portfolios in reverse of what happens when they experience inflows. This pattern means that smaller caps stocks, particularly those that have market capitalizations below $1 billion and may not even be represented in the ETF, aren't sold when outflows hit. This trend is worth watching as it could be very important when the market tide goes out.



Source: Strategas Research

	Equity ETF Assets	Mkt Cap	Multi Factor	Dividend	Equal-Weight	Fundamentals	Price	Proprietary	Unknown	Single Asset
Assets ($Tril)	$2.86	$2.47	$0.12	$0.09	$0.08	$0.04	$0.02	$0.01	$0.01	$0.00
%	100.0%	86.6%	4.3%	3.3%	2.7%	1.5%	0.8%	0.5%	0.4%	0.0%

Source: Strategas Research

During the quarter, the S&P 500's run of posting positive returns for 15 consecutive months ended with a thud in February. The Russell 2000 also terminated its streak of seven positive performance quarters – but just barely – as it posted a return of -0.08% for the quarter. The Healthcare (+6.7%) and Technology (+9.4%) sectors, which were the 2017 champions, continued their winning ways in the first quarter and blew away the rest of the field. Similarly, the Energy sector (-14.3%) was the biggest loser for the quarter which is the spot it held in 2017. This finish is a bit puzzling as the price of oil rose 7.5 percent during the first quarter. Amongst the indices, the NASDAQ Composite Index was the gold medalist for the quarter with an advance of nearly +2.6% and was the only index to finish in the black. Finishing second was the Russell 2000 which fell just short of breakeven. The table below highlights the returns for the first quarter and 2018 year-to-date returns for the popular indices.

Index Returns		
Index	First Qtr. 2018 Return	2018 YTD Return
Russell 2000	-0.08%	-0.08%
Russell 2000 Growth	+2.30%	+2.30%
Russell 2000 Value	-2.64%	-2.64%
S&P 500	-0.76%	-0.76%
Dow Jones Industrials	-2.49%	-2.49%
NASDAQ Composite	+2.59%	+2.59%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Growth Index (+2.3%) trounced the Russell 2000 Value Index (-2.6%) for the quarter and continued the theme from 2017. As mentioned above, the Healthcare sector, due to a resurgence in biotech stocks, propelled the strong performance in the growth index as many of the typically defensive sectors declined on inflation concerns. Note the performance of the Real Estate sector in the month of March. The market returned to this sector when the 10-year Treasury yield dropped following the Fed rate hike in March. The first two tables below highlight the performance of the Russell 2000 style indices by sector for the month of March and the first quarter 2018. Lastly, the third table below shows that the performance within the Russell 2000 was generally mixed but slightly worse as market cap declined. This trend has existed since early 2014 with only a brief respite in the second half of 2016.

Table 2: Performance attribution for the Russell 2000 Growth through March 29, 2018

	March			Year To Date			
Russell Sec.	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
Discretionary	-0.09	0.02	-1.44	-0.03	0.04	-2.32	15.3
Staples	2.08	0.05	0.73	-6.17	-0.14	-8.47	2.2
Energy	1.94	0.02	0.59	-14.25	-0.17	-16.55	1.1
Financials	0.55	0.05	-0.79	3.55	0.27	1.26	7.4
Health Care	1.93	0.47	0.58	6.70	1.51	4.41	24.9
Mat. & Process	0.91	0.08	-0.43	-4.33	-0.35	-6.62	8.0
Prod. Durables	0.44	0.07	-0.91	-2.12	-0.35	-4.41	15.6
Real Estate	6.00	0.17	4.65	-7.99	-0.25	-10.29	2.9
Technology	2.21	0.42	0.86	9.40	1.80	7.10	20.6
Utilities	1.15	0.02	-0.20	-2.23	-0.05	-4.53	1.9

Table 3: Performance attribution for the Russell 2000 Value through March 29, 2018

	March			Year To Date			
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
Discretionary	0.68	0.09	-0.56	-1.84	-0.19	0.79	11.7
Staples	0.48	0.01	-0.77	-7.99	-0.18	-5.36	1.8
Energy	2.07	0.12	0.83	-9.07	-0.60	-6.44	6.1
Financials	1.13	0.35	-0.11	0.68	0.17	3.31	29.6
Health Care	-2.82	-0.18	-4.06	5.65	0.30	8.28	6.6
Mat. & Process	-1.57	-0.08	-2.81	-5.71	-0.34	-3.07	6.0
Prod. Durables	0.88	0.09	-0.36	-1.83	-0.24	0.80	12.1
Real Estate	5.55	0.61	4.31	-7.50	-0.87	-4.87	11.6
Technology	-0.55	-0.04	-1.79	-3.36	-0.24	-0.73	7.5
Utilities	4.63	0.28	3.39	-6.17	-0.41	-3.54	6.6

Size Quintile	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
1 (Largest)	0.80	0.45	-0.50	0.21	0.09	0.30	52.3
2	1.28	0.30	-0.02	-1.30	-0.31	-1.22	24.4
3	1.94	0.25	0.65	1.00	0.14	1.08	13.4
4	3.10	0.20	1.80	0.37	0.03	0.45	6.9
5 (Smallest)	3.41	0.09	2.11	-0.91	-0.03	-0.82	3.0

Source: Jefferies

Except for Brazil, the international equity markets generally performed worse than the U.S. markets. The two bell weather markets, Japan and Germany were the biggest losers of the major international markets. This fact is a bit disconcerting given that these economies and central banks have been key drivers to the synchronized global growth that we've experienced over the past 18 months. Interestingly, the European region ran out of steam during the fourth quarter and finished with rather pedestrian returns for 2017 as well. European markets, in our opinion, are beginning to discount the end of the ECB's quantitative easing program which Mario Draghi has recently been telegraphed. Brazil's outperformance is notable as demand for raw materials like iron ore, coal, and oil generally drives their economy. Treasury and corporate bonds lost ground as interest rates ticked up in the quarter. Amongst commodities, oil was the biggest winner in the first quarter on the heels of OPEC's extension of their output reduction. The largest mover was the volatility index, which spiked in February to levels not seen since the great recession on tariff and Trump concerns.

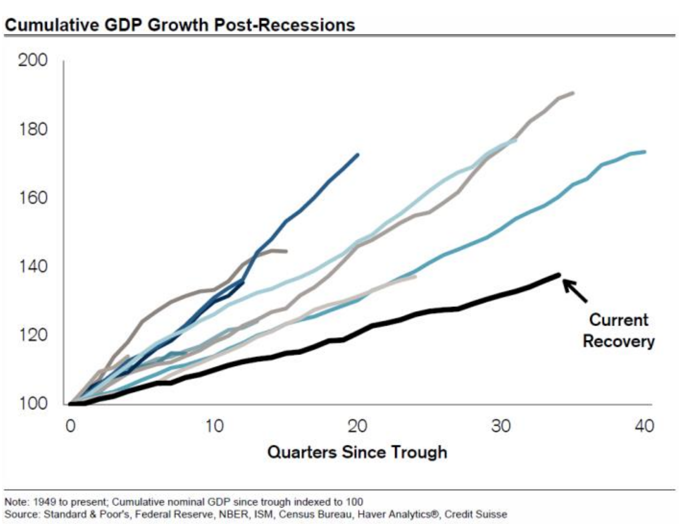
Index	First Qtr. 2018 Return	2018 YTD Return
France	-2.51%	-2.51%
Germany	-6.35%	-6.35%
Brazil	+11.73%	+11.73%
India	-4.92%	-4.92%
China- A Shares	+2.12%	+2.12%
China- Shenzhen A Shares	-3.65%	-3.65%
Japan	-6.26%	-6.26%
Long-Term Treasuries (TLO)	-4.07%	-4.07%
Investment Grade Corp. Bonds	-2.80%	-2.80%
Gold	+1.37%	+1.37%
Volatility- VIX index	+80.9%	+80.9%
Oil	+7.48%	+7.48%
Natural Gas	-7.45%	-7.45%
Lumber	+15.11%	+15.11%

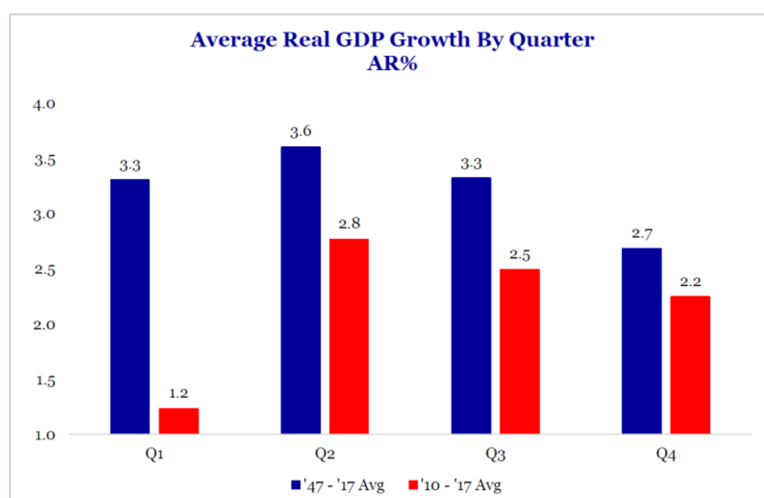
Source: 1492 Capital Management, LLC

Updated 2018 Outlook: Is This as Good as it Gets? The Tug-of-War Begins

We're getting the impression that some market participants are fearing the end of the bull market run that we've experienced since March of 2009. It seems to us that they've started to ask the question "Is this as good as it gets?" While they will point to all the standard arguments like excessive valuation, Fed rate hikes and duration of the bull market run, there are a number of subtle, less obvious drivers that could continue the run for a while longer. However, you have to be asking yourself if the market selloff in February was really all about tariffs or was it just an excuse to sell because the global economy has peaked? We contend that it really wasn't about tariffs. As we mentioned above, the size of the tariffs are tiny relative to the stimulus that tax reform, repatriation of overseas profits, and budget stimulus will have in 2018. Just to put the tariff issue into perspective, the amount of goods traded between China and the U.S. in 2017 was $636 billion. Of this total, exports to China were $130 billion and goods imported from China was $506 billion for a net goods trade deficit of $375 billion. Assuming tariffs were implemented on $60 billion worth of goods imported from China, as is being bantered about, it would still only represent a tariff on 12 percent of the dollar value imported from China annually and only 2.5 percent of the total goods imported from around the globe. The bottom line is that China has a lot more to lose in this battle than the U.S. While this tariff stuff makes for good headlines, we don't believe it is all too concerning.

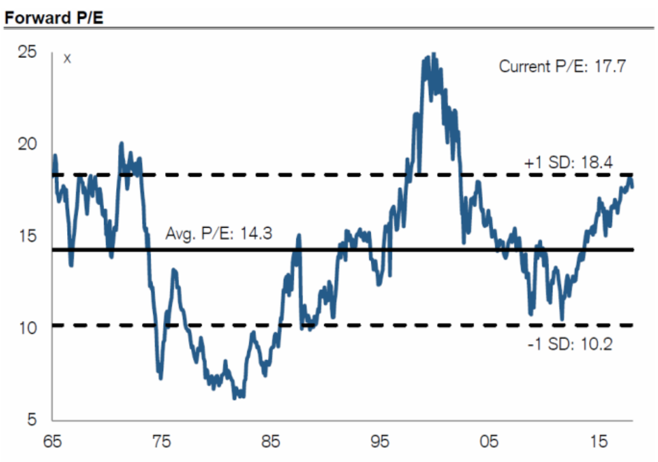
The next argument that we hear is that this rally and economic cycle are long in the tooth. It is just a poor argument all around and time has nothing to do with how a cycle ends. We always like to use time as a reference point, but other than that it's pretty worthless as a gauge for what's to come. The chart below left shows that this is one of the longer recoveries based on quarters since the trough; however, the cumulative GDP growth is one of the lowest even when compared to much shorter duration cycles of the past. Since the trough in 2009, we haven't experienced a single full year of three percent GDP growth, which may change this year. The chart below right shows the average Real GDP growth by quarter. The blue bars represent average quarterly growth by quarter from 1947-2017 compared to the red bars which represent the quarterly growth from 2010-2017. Clearly there has been a step-down in growth since the great recession. What's interesting is that a new pattern has developed since 2010 where the first quarter shows anemic growth and then steps up in the second quarter. This year, first quarter GDP is projected to be around 2.5 percent which would be double the average from the previous eight years. This start would make a 3 percent real GDP growth year attainable, particularly given that tax reform didn't even begin to kick in for individuals until mid-February. Corporations will likely accelerate their capital spending in 2018 as they get full deductibility of all capital expenditures deployed in the year. These corporations may take a little while to figure out how they want to maximize this benefit but it will be meaningful.



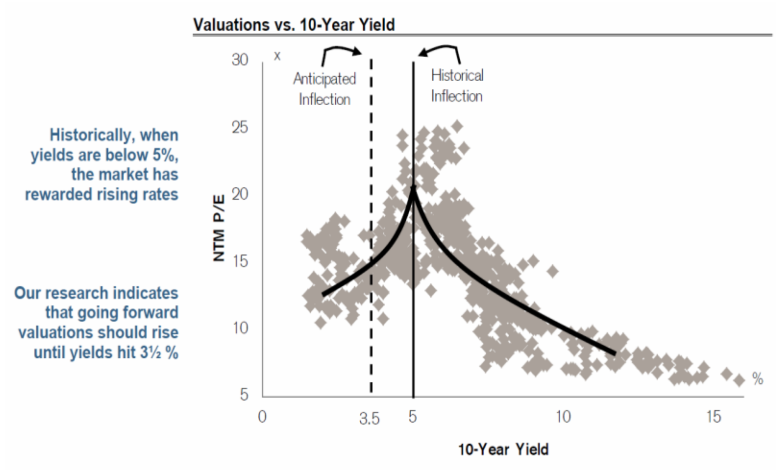


Source: Strategas Research

Valuation is an often quoted reason as to why the stock market can't move higher. When making such bold statements, many talking heads forget to take into account interest rate levels and whether there are attractive alternatives within which to invest. With current forward looking Price/Earnings ratios at 17.3 times, they are above the average over the past 50 years of 14.3 times as shown in the chart below left. That said, interest rates are still at historically low levels which would argue for a significantly higher P/E than where we sit currently. Also, if rates are going to rise as we believe, investing in the bond market, which has worked for nearly 35 years, is unlikely going to be the safe haven that it's been. There has been a lot of concern about rising interest rates over the past few months as inflation has begun to ascend. Many believe higher rates will kill the economy but despite all this angst, the yield on the 10-year Treasury is still only 2.8%, which is an extraordinarily low by any reasonable metric. We find the chart below right to be quite interesting as it flies in the face of the standard argument that higher rates cap valuation levels on stocks. Interestingly, higher interest rates, up to a point, can go hand-in-hand with higher stock valuations. As the chart shows, historically stock valuations advanced to the point of 5% interest rates. We surmise that the market isn't bothered up to this point because generally rising rates within this range implies that the economy is getting better without inflation getting out of control. This area is where we believe we sit today. Yes, inflation is rising, but it's not worrisome at this point. The economy is strong and potentially accelerating.



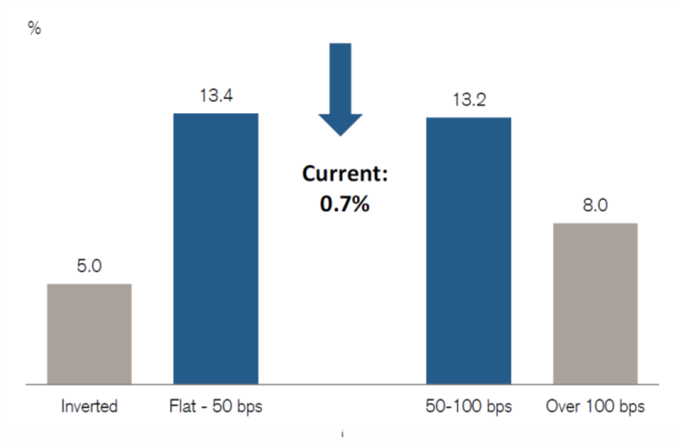
Note: As of Feb. 2, 2018
Source: Standard & Poor's, Moody's, Thomson Financial, FactSet, Credit Suisse



Note: 1965 to present
Source: Standard & Poor's, Federal Reserve, Thomson Financial, FactSet, Haver Analytics®, Credit Suisse

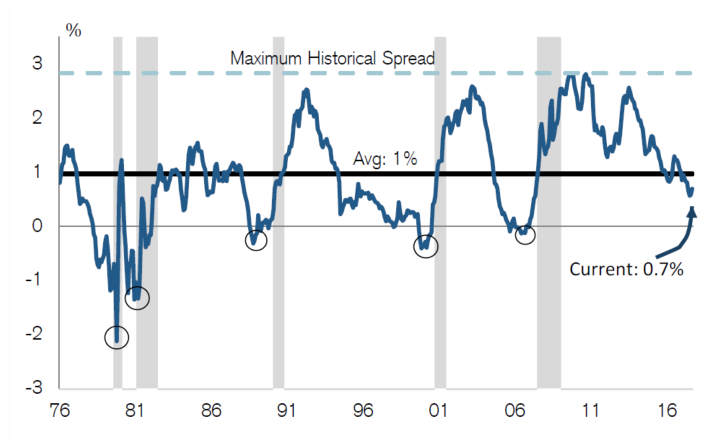
The two charts shown below offer a bit of a dichotomy. On the one hand (see chart below left), when the yield curve is between zero and 100 basis points as measured by the difference in interest rates between the 2- and 10-year Treasury Notes, this range offers the best probability for outsized stock returns that have averaged about 13% annually. As we write this newsletter the spread sits at 50 basis points, which is right in the middle of the preferred range. The chart on the right is arguably the scariest chart that exists for economists and stock investors alike. This chart shows that every time the yield curve has inverted, it's signaled that a recession was right around the corner. Given the trajectory of the current yield curve spread (downward), many analysts are assuming that we continue on the current path and that the curve inverts relatively soon. We disagree with the assumptions being made on a number of fronts. The first disagreement is that the yield on the 10-year Treasury continues to be pinned down by the quantitative easing programs that are ongoing in Europe and Japan. While it's always dangerous to say it's different this time, this effect is a major difference from any prior period. We would argue that the 10-year rate isn't reflective of a normal period and would likely be higher if not for the QE programs overseas. Second, if the Fed continues on their projected pace of three plus rate hikes this year and the 10-year doesn't move, we'll almost certainly be close to inversion. However, the Fed likely wouldn't continue to raise rates if the economy begins to show signs of slowing and would only continue on this path if all signs pointed to continued prosperity. The Fed is moving glacially if you compare their current pace of hikes with prior periods when six or more rate hikes in a year was considered slow.

S&P 500 Returns by Yield Curve Steepness



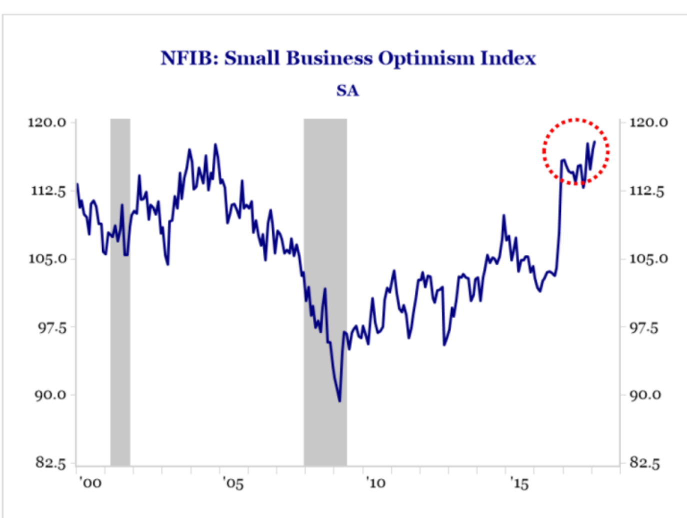
Note: 10-year yield minus 2-year yield; 1976 to present. S&P 500 returns are 1-year forward returns. As of Feb. 2, 2018
Source: Standard & Poor's, Federal Reserve, Haver Analytics®, Credit Suisse

Yield Curve (2-10 Year Spread)

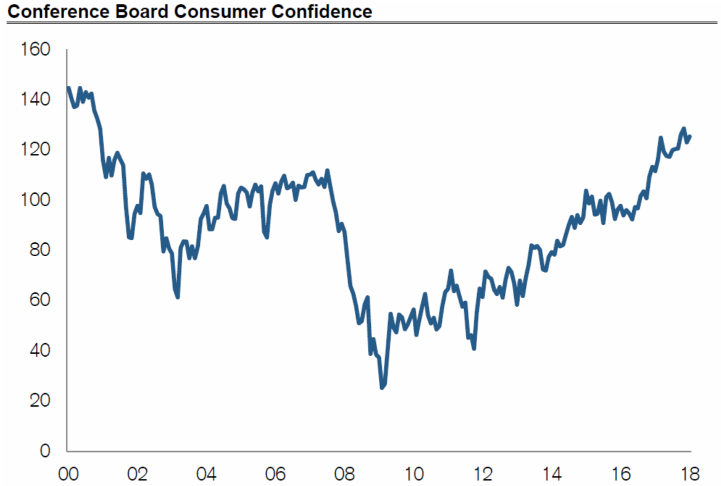


Note: 10-year yield minus 2-year yield; shaded area denotes recession. As of Feb. 2, 2018
Source: Federal Reserve, NBER, Haver Analytics®, Credit Suisse

Now we'll address what gives us pause. As we said in last quarter's newsletter, the market has become conditioned to stimulus as every year since the great recession we've had one form of stimulus program or another. 2018 will likely be the first year that won't have an incremental stimulus program deployed. We count tax reform as a 2017 stimulus program as it was proposed and approved in 2017, and the stock market discounted the inevitable implementation of the program. All the while, the Fed will likely be hiking interest rates in 2018 and the quantitative easing programs in Europe and Japan will likely be throttled back. Additionally, we are in a mid-term election year and as we show in our "Market Trivia" section below, these years aren't the kindest periods to the stock market. The following set of charts is what gives us pause and takes us back to the title of this section *Does it get any better than this?* We'll move clockwise starting with the top left chart below. Small business optimism is at an all-time high. Consumer confidence is at a level we haven't seen since 2000. Global PMI's are at levels where they've typically peaked. Global PMI's through January were all up sequentially and greater than 52 (expanding). It is a difficult quandary because history would tell you that it doesn't get any better because we are now entering a period of tighter monetary conditions as the Fed hikes, as money growth slows, and as quantitative easing is slowly withdrawn overseas. However, there are offsets as tax reform benefits kick in, as deregulation continues on a number of fronts, and as capital expenditures accelerate as if we were closer to mid-cycle than late-cycle. These conditions provide the perfect backdrop for an epic battle of tug-of-war. The problem is we won't know if we are at a peak until we're able to look back at history. In this environment, we think it is prudent to think about what a slowdown may look like (not a recession) and begin to focus our investments in secular growth themes and slowly retreat from the cyclical ones.



Conference Board Consumer Confidence



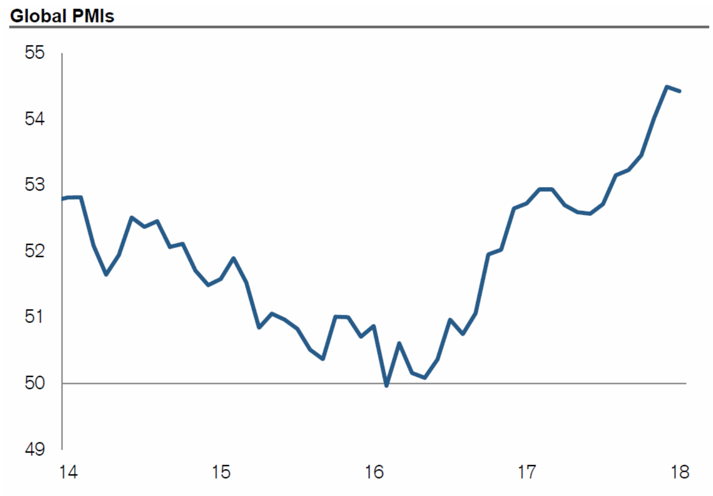
Source: The Conference Board, Haver Analytics®, Credit Suisse.

Global PMIs

	Jan-18	Jan-17	Jan-16	Jan-15
Global	54.4	52.7	50.9	51.6
U.S.	59.1	55.6	47.8	53.9
Canada	55.9	53.5	49.3	51.0
Japan	54.8	52.7	52.3	52.2
UK	55.3	55.4	52.3	52.4
Euro Area	59.6	55.2	52.3	51.0
France	58.4	53.6	50.0	49.2
Germany	61.1	56.4	52.3	50.9
Italy	59.0	53.0	53.2	49.9
Spain	55.2	55.6	55.4	54.7

Expanding ≥ 52 | 52 > Neutral ≥ 50 | Contracting < 50

Note: ISM PMI for U.S., Markit PMI for all others.
Source: Markit, ISM, Haver Analytics®, Credit Suisse



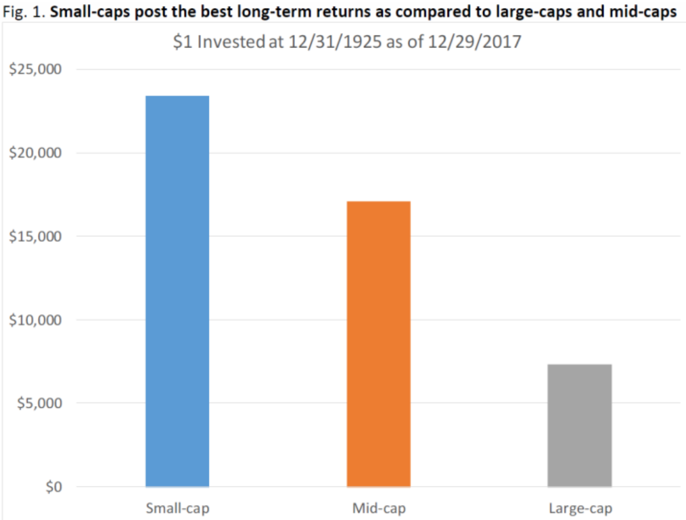
Source: Markit, Haver Analytics®, Credit Suisse

<u>The Case for Small Caps: A Short Refresher</u>

In the "what have you done for me lately" world in which we live, sometimes we forget to take a step back and look at the big picture – for small-caps – that is. The last few years have been challenging for the small-cap asset class due to the tremendous flows into ETF's and the break out of sexy, large-cap bell weather stocks like Facebook, Amazon, Apple, Netflix, and Google, or the "FANG" stocks as they're collectively known. Stock index returns are generally viewed on a calendar year basis and large caps (as measured by the S&P 500 index) have outperformed small caps (as measured by the Russell 2000 Index) in three of the last four years (2014, 2015, and 2017). Interestingly, the small-cap asset class has outperformed large-caps since the date of Trump's election in November 2016.

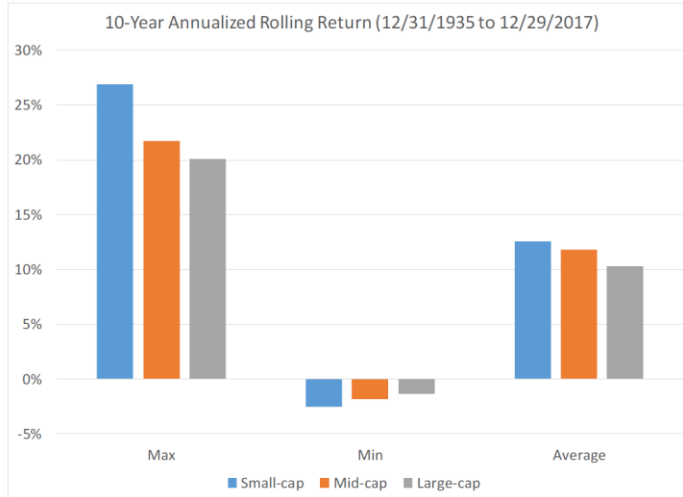
Taking a step back and looking over many years, the small-cap asset class has easily outperformed both mid and large caps by a sizeable margin as shown in the chart below left. One dollar invested in small caps back in 1925 would have grown to over $23,000 by the end of 2017 versus approximately $17,000 and $7,000 for mid and large caps, respectively. The immediate push back to this argument is that small caps only outperformed in certain decades or that they were significantly more volatile. However, the data doesn't prove this out. If an investor has a long-term investment horizon of at least 10 years, investing in the small cap asset class will likely benefit them. The chart on the right shows the best, worst, and average rolling 10 year period returns comparing small, mid and large caps. The outcome is likely surprising to most of you. *Small caps were a clear winner in the best 10 year period by nearly 7% annually* (a near doubling of your money over this 10 year period by investing in small caps instead of large caps). The worst 10 years for small-caps versus large-caps shows that small caps lagged by about 1% annually. But on average, across all periods, small caps outperformed large-caps by about 2.3% annually. The "higher volatility" myths aren't born out in the data.

Fig. 1. **Small-caps post the best long-term returns as compared to large-caps and mid-caps**



Source: FRP, CRSP, FactSet; as of 12/29/17

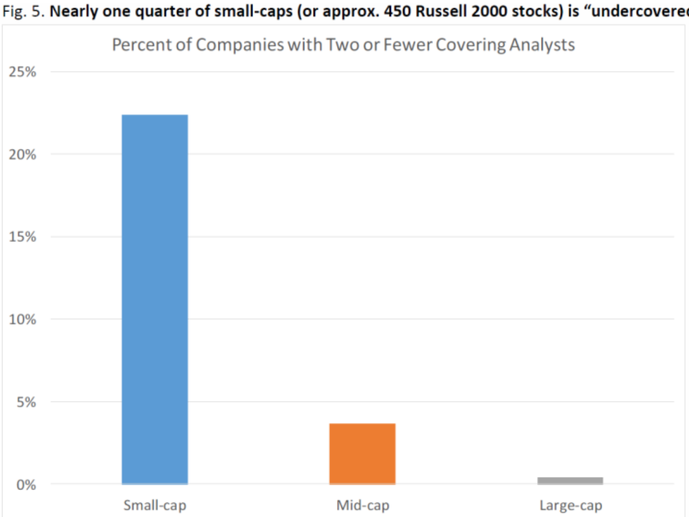
Fig. 2. **The small-cap average annual return is approximately +2.3% higher than large-caps**



Source: FRP, CRSP, FactSet; as of 12/30/16

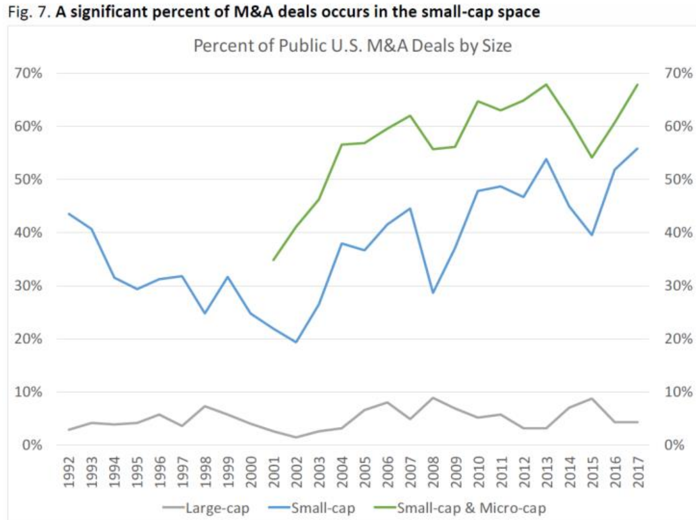
For fundamental investors like 1492 Capital Management, a major benefit of focusing on small caps is that they are less exposed than large caps from a research perspective as there are fewer “Wall Street” analysts researching these small cap companies. Therefore, there are potential benefits to those willing to do the work. Our corporate slogan at 1492 Capital Management is “Discovering Opportunity”, and it implies that we’re doing the digging to discover these small-cap gems before the rest of the investment community finds them. The chart below left shows that nearly 25% of small-cap stocks have two or fewer Wall Street analysts following the company. In contrast, a whopping 52 Wall Street analysts follow Amazon.com Inc. Another benefit of the small-cap asset class is that they tend to be the targets for a bulk of the M&A activity in the public markets. The chart below right shows that small and microcap stocks were nearly 70% of the M&A deal targets announced in 2017. We recently heard a statistic that private equity funds have nearly $1 trillion in assets that need to be deployed. This should keep the small-cap space on the private equity radar screen for years to come.

Fig. 5. **Nearly one quarter of small-caps (or approx. 450 Russell 2000 stocks) is “undercovered**



Source: FRP, FactSet; as of 12/29/17

Fig. 7. **A significant percent of M&A deals occurs in the small-cap space**



Source: FRP, FactSet; as of 12/29/17

<u>Thematic Investing: See it on the Big Screen</u>

Economic cycles come and go, but if there’s one thing most Americans enjoy it’s a good movie. The motion picture industry along with the exhibitors have gone through transformation over the years like most other industries. The studios have experimented with the timing of new releases throughout the calendar year as well as shortening the time from theater release to on-demand release. For example, movie studios used to think September was a dead month for movie releases until *IT,* a feature film based on Stephen King's book, was released last September and turned out to be a blockbuster. Springtime also used to be considered a bad time for a release until Marvel Studio's *Black Panther* exceeded expectations this year. Executives at the studios are realizing that Americans are willing to go to the movies throughout the year if there is good product to see. Obviously this multi-season approach will help smooth out production bottlenecks as well as limit head-to-head competition between blockbusters.

The movie exhibitors have also worked diligently to improve the movie going experience over the years through innovations in stadium seating (20 years ago), digital and 3-D projectors, and improved sound systems. The most recent innovation has been the conversion of seating to recliners. All of these investments over the years has helped the exhibitors to remain relevant during a time when consumers are bombarded with a plethora of choices for entertainment. The prevalence and growth of mobile media on phones and tablets as well as the YouTube phenomena occupy increasing eyeball time. However, we believe there is an entertainment experience that is unique to seeing a motion picture on the big screen that cannot be duplicated outside the theater.

There have been a number of bear cases stipulated against the movie theater industry over the years which have all turned out to be nothing more than headline grabbers. Twenty years ago investors speculated that movie exhibitors would be put out of business when large suburban homes were being built with in-home theaters. Currently, there is fear that premium video on-demand (PVOD) will materially dampen enthusiasm for consumers to see movies on the big screen. Throughout all of these bear cases, box office volume has continued to grow and ticket prices have risen. Bottom line, until someone can figure out how to put a 70 foot screen in a home or another venue more economically than the movie exhibitors can, we believe this is a significant barrier to entry.

In addition to the size of the screen and the sound system, there are other intangible benefits to seeing a movie at the theater. You're not bothered by someone ringing the doorbell, you can turn your phone off for a couple hours and just relax uninterrupted and now the whole family can recline in luxury lounge chairs while enjoying food and beverages during the movie. The luxury lounge chair innovation has been a wild success for the theaters on a number of fronts, despite the theater's seating capacity is cut in half. When theaters first began converting screens to luxury loungers, they targeted underperforming locations. They found that the lounge chairs immediately attracted more moviegoers throughout the week and not just the weekend. It also attracted new customers that had previously not been regular moviegoers. Since seating capacity with the loungers is cut in half, most all of these screens now sell the seats on a reserved basis. This policy has changed the buyers' behavior and made the movie a planned destination versus a spur of the moment decision. Because of this change in behavior, theaters are now selling more tickets during the weeknights and thus balancing out the weekend rush to non-peak times. The net result has been increased ticket sales as well as incremental customers that had not previously been inclined to see a movie at the theater. The success of the lounge chairs has enabled the theaters to convert not only underperforming screens but to convert flagship locations that already had good attendance. Most of the national movie exhibitors have now converted over half of their screens to the luxury loungers.

The most recent theater innovation is the concept of a full-service food and beverage screen with the luxury loungers. Customers can order food and beverages, and in some cases alcohol, from the comfort of their reserved lounge chair. These theaters don't have a traditional concession stand in the lobby. The moviegoer will typically arrive a little early to order food and drinks before the movie begins. This early arrival helps to reverse the trend of arriving right before the movie which the reserve seating precipitated. Since the moviegoer is now once again arriving early, they will be viewing all the pre-movie advertising on the screen.

While the entertainment industry will continue to be very competitive, we believe that the experience of going to the movies remains a unique offering. The economics remain very favorable for the theater industry, and we expect that these companies will continue to find innovations that will keep them relevant with consumers. This is a category that has also historically done well despite softness in the economy. The concept of a two hour "stay-cation" for the family is still very affordable. While GDP growth appears to be accelerating currently, there will inevitably come a time when that ends. In that scenario, movie exhibitors should be somewhat insulated. We have deployed the movie theater investment theme across all of our strategies over the past quarter and expect the fundamentals for this group of companies to improve throughout the year.

Thematic Investing: Ladies & Gentlemen, Boys & Girls – Welcome to the Trade Circus!

With President Trump and Xi lobbing daily soundbites to the market over tariffs, we thought that we would take a deep breath and discuss what we think we may know so far and whether there is a potential investment theme buried in all of this rhetoric. The latest greatest has President Trump countering with a $100 billion of currently undefined goods to receive tariffs after President Xi matched the initial $50 billion of goods to have 25% tariffs administered from Trump's initial salvo. These trade measures followed the steel and aluminum tariffs that the Chinese met with tariffs on roughly $3 billion of U.S. imports that included 25% tariffs on pork, pork products and recycled aluminum. Imagine Trump holding a "Made in China 2025" policy handout (ten priorities listed below) and Xi with an Electoral College voting map of the U.S. as they attempt to pummel each other with tariffs.

Ten Key Sectors for Made in China 2025 Initiative

1. Advanced information technology
2. Automated machine tools and robotics
3. Aerospace and aeronautical equipment
4. Maritime equipment and high-tech shipping
5. Modern rail transport
6. Energy-saving vehicles and equipment
7. Clean power equipment
8. Agricultural equipment
9. New, advanced materials
10. Biomedicine and advanced medical products

Source: Raymond James

The most recent trade actions started with allegations of China's intellectual property (IP) infractions which placed Trump into an interesting predicament of trying to help IP centers like Massachusetts and California (two states that he will win in the 2020 election when hell freezes over in our opinion) while risking setbacks where he did so very well in 2016 (agricultural states – OH, IA, WI, IN, and NC for tobacco). All of this back and forth has made for a volatile stock market but what does it all really mean?

Per U.S. Census data, the 2017 trade deficit with China was a record $375 billion with $130 billion of U.S. exports to China dwarfed with roughly $506 billion of imports from China. These figures compare to a deficit of $347 billion (116/463) in 2016. Based on the $50 billion of each country's goods that are being hit with 25% tariffs, Cornerstone Macro research estimates that both the U.S. and China will lose roughly 0.1% of GDP. This impact is relatively immaterial and assumes no negotiations to a middle ground which is highly unlikely, in our opinion, as President Trump dangles technology transfers at China with its list of 1,300 Chinese products subject to a 25% tariff. Interesting headlines that have the investment community buzzing are items like tariffs on U.S. auto exports (China produces most U.S. branded autos in country) or Boeing aircraft. Reading the fine print on the aircraft tariffs, we find that the measures are for 15,000-45,000kg aircraft weights. This weight range impacts legacy aircraft and not China's orders for 737 MAX 8-10 aircraft models which comprise almost all of Boeing's narrow body delivery schedule through 2025 according to Goldman Sachs research. The damage China wants to inflict is in the agricultural area but that may translate more to shifting of trade flow versus a loss of business for U.S. farmers. As an example, China is estimated to import 98 million tons of soybean for crop year 2018 (Sept-Aug) according to Goldman Sachs, which includes 35 million tons of U.S soybeans. Where can they replace 35 percent of their needs quickly with Brazil already forecast to export 58 million tons of soybeans to China or 78 percent of their total soybean exports? Export volumes to China may increase from other countries with the U.S. likely filling the voids left from shifting trade flows.

At this time, we do not know how all of this trade war rhetoric will end. However, we would be willing to bet that there will be a negotiated result that keeps both presidents from the proverbial "cutting off your nose to spite your face." As always, the 1492 Capital Management research team is searching for themes that may reveal themselves as the market convulses over the next round of trade soundbites. One theme that we are interested in is the secular growth of U.S. exports where a U.S. industry has transformed to ramp volumes significantly to serve the global market. As previously articulated, we have deployed our domestic shale oil theme as technologies such as horizontal drilling and hydraulic fracturing have combined to position the United States as an energy powerhouse in oil, natural gas liquids (NGL), and natural gas. Production of these hydrocarbons has expanded beyond our domestic consumption needs and is now creating export opportunities in oil, refined products, liquefied natural gas (LNG), ethane and ethylene. As the table below left indicates, the United States accounts for roughly 60% of the new global LNG capacity additions over the 2017-2020 period, which is a direct result of rising domestic natural gas production. Significant volumes of U.S. natural gas will be cooled to become LNG, will be loaded on specialized ships, and will be exported.

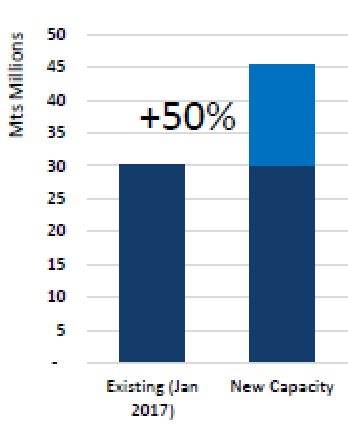
Global LNG Projects Under/Near Construction (2018-2020)

Country	Project	Capacity (bcm)	Capacity (Mmtpa)	Online dat
Cameroon	Golar Go FLNG Hilli	1.7	1.2	2017
USA	Dominion Resources Cove Point	7.2	5.2	2017
Australia	Ichthys LNG Train 1	6.2	4.5	2018
Australia	Prelude LNG	4.9	3.6	2018
Australia	Wheatstone LNG Train 2	6.2	4.5	2018
USA	Elba Island LNG 1-6	2.1	1.5	2018
Australia	Ichthys LNG Train 2	6.2	4.5	2018
Russia	Yamal Train 2	7.6	5.5	2018
USA	Freeport LNG Train 1	6.9	5.0	2019
USA	Cameron LNG Train 1	6.2	4.5	2019
USA	Freeport LNG Train 2	6.9	5.0	2019
USA	Corpus Christi LNG Train 1	6.2	4.5	2019
USA	Cameron LNG Train 2	6.2	4.5	2019
USA	Elba Island LNG 7-9	1.4	1.0	2019
USA	Sabine Pass Train 5	6.2	4.5	2019
USA	Freeport LNG Train 3	6.9	5.0	2019
USA	Cameron LNG Train 3	6.2	4.5	2019
USA	Corpus Christi LNG Train 2	6.2	4.5	2019
Indonesia	Tangguh Train 3	5.2	3.8	2020
Equatorial Guinea	Golar Go FLNG Gandria	3.0	2.2	2020
Russia	Yamal Train 3	7.6	5.5	2020
Malaysia	Petronas FLNG 2	2.1	1.5	2020
Total		**119.3**	**86.5**	

Source: Jefferies

In addition, the U.S. has also experienced higher natural gas liquids production from shale drilling, which has resulted in healthy supplies of ethane. As seen in the chart below, new plants are being built to convert ethane into ethylene, which should result in a 50% increase in U.S. ethylene capacity by 2022.

US Ethylene expansions 2017 – 2022



	2017	2018	2019	2020-22
Oxy	1,200			
Westlake Calvert	100			
Dow Freeport	3,300			
Formosa	300			
CP Chem	3,300			
Exxon Baytown		3,300		
Indorama		800		
Formosa		2,500		
Sasol			3,300	
LACC			2,200	
Shintech				1,100
Shell				3,300
TOTAL/Nova				2,200

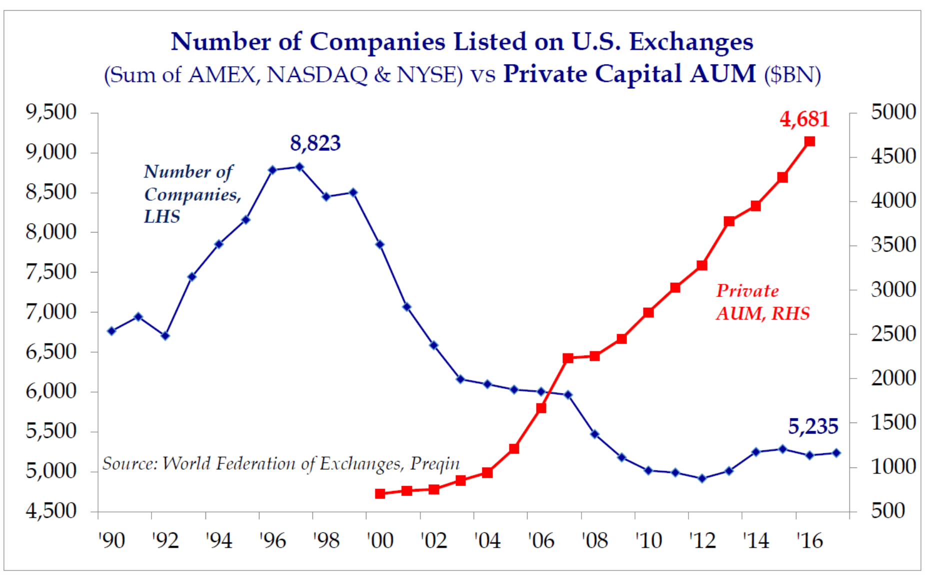
Source: Navigator Holdings, Inc.

Additional export ethylene export terminals are also being built as the U.S. moves to export this widely used, organic compound. Both ethylene and LNG are examples of the secular growth of U.S. exports theme that we are researching for the companies that are best positioned to benefit from these tailwinds.

2018 Updated Outlook: A Picture is Worth a Thousand Words

Above we articulated our updated 2018 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.

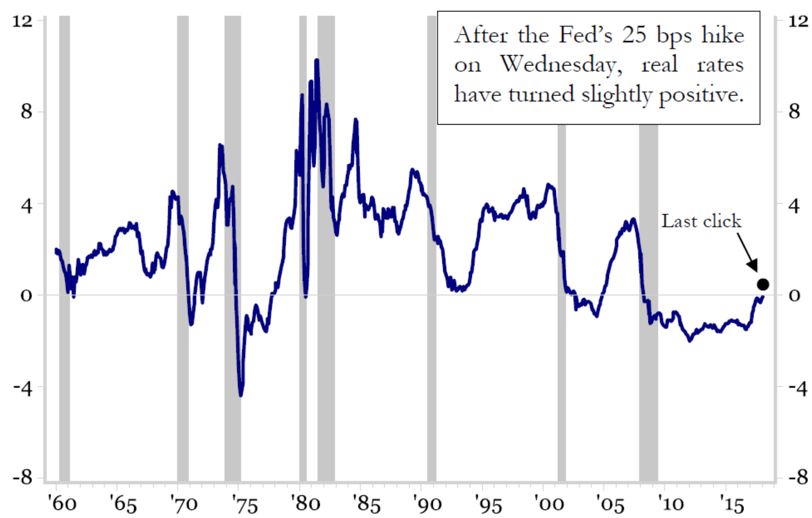
As the amount of private equity assets ballooned and were deployed over the past 15 years, there has been a contraction in the number of public companies remaining on U.S. stock exchanges. There doesn't appear to be an end in sight.



Source: Strategas Research

Following the latest Fed interest rate hike, real rates have turned positive for the first time since the Great Recession. As you can see by the chart, negative real rates have been a rarity over the past 60 years.

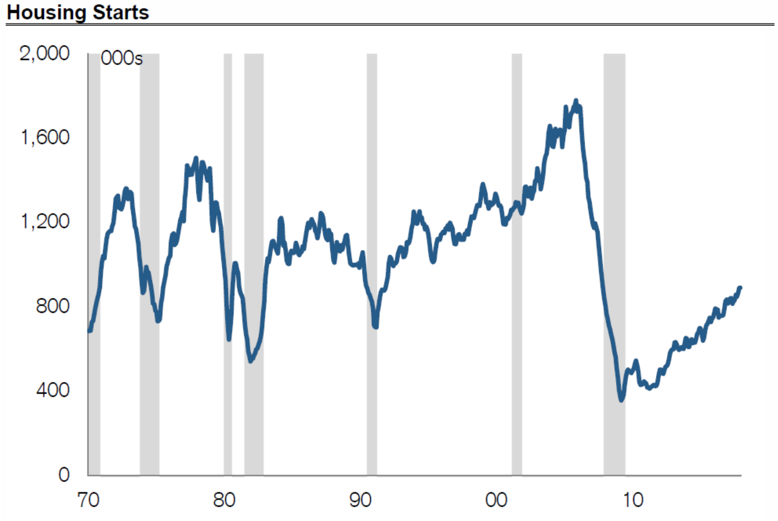
Fed Funds Rate Minus Core PCE YoY%



Source: Haver Analytics

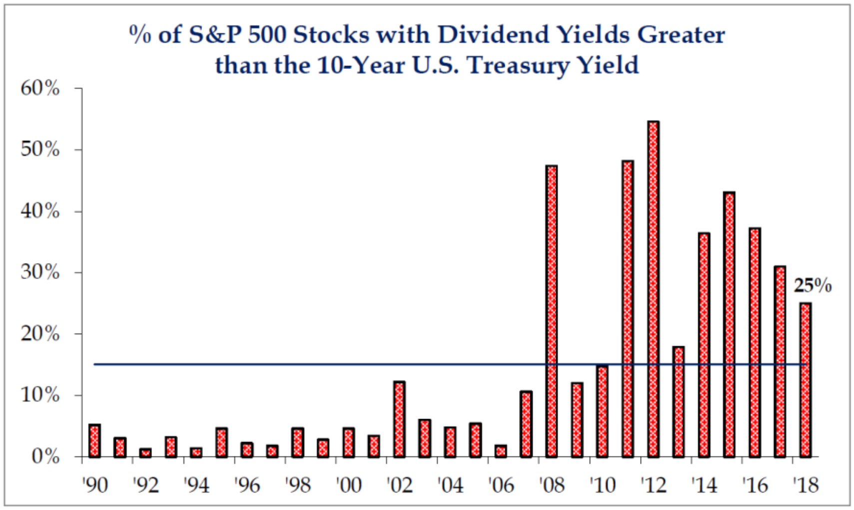
Housing starts continue to steadily increase but still remain well under the normalized rate of starts for the past 50 years despite a much larger U.S. population today.

Housing Starts



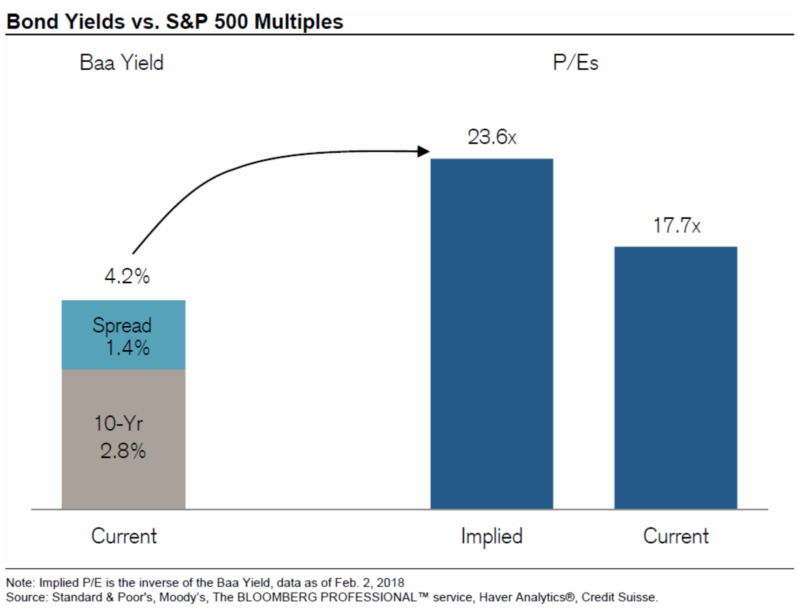
Note: Single family; 3-Month Moving Average; shaded area denotes recession
Source: Census Bureau, NBER, Haver Analytics®, Credit Suisse

Twenty-five percent of S&P 500 stocks sport a dividend greater than the 10-year U.S. Treasury Yield. This figure is still at a historically high level despite the decline over the past few years as stocks have appreciated.

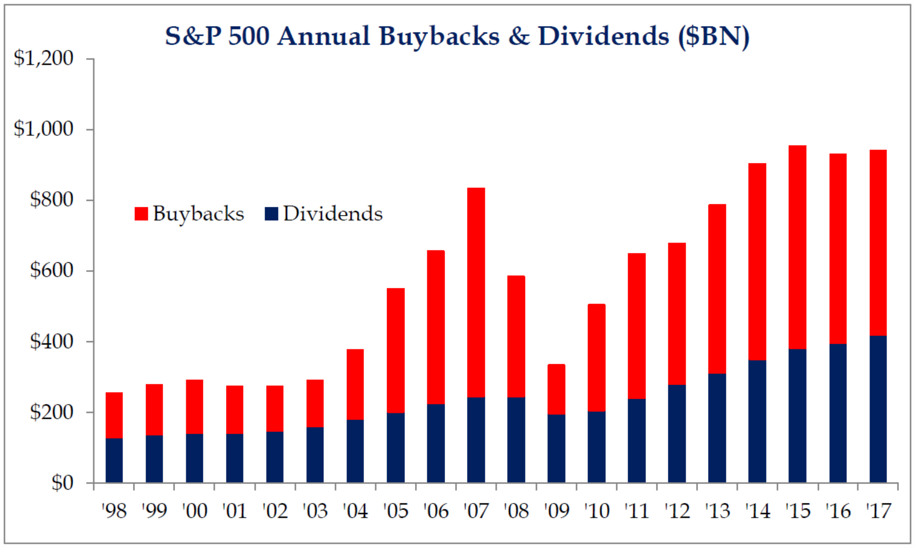


Source: Strategas Research

Many market commentators continue to say that stocks are overvalued. If that is the case, what are bonds?

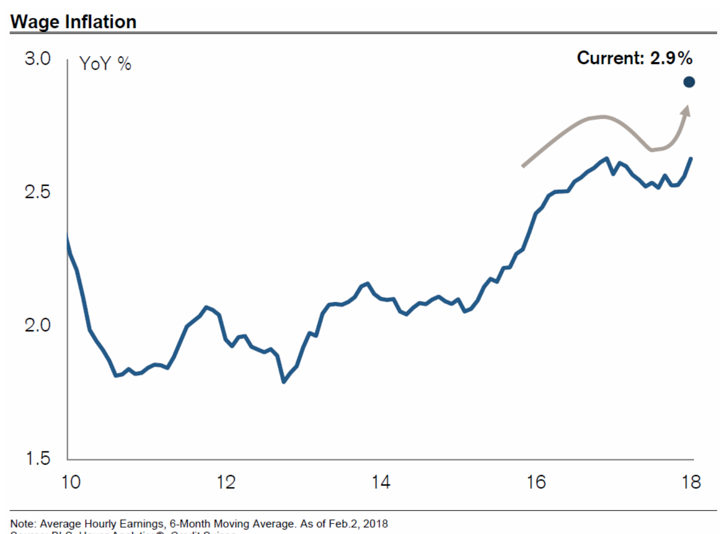


The combined total of corporate buybacks and dividends have plateaued in recent years at historically high levels. However, repatriation of overseas cash as part of tax reform is likely to accelerate the buyback component. We've been hearing year-over-year increases of greater than 20 percent during the first quarter.



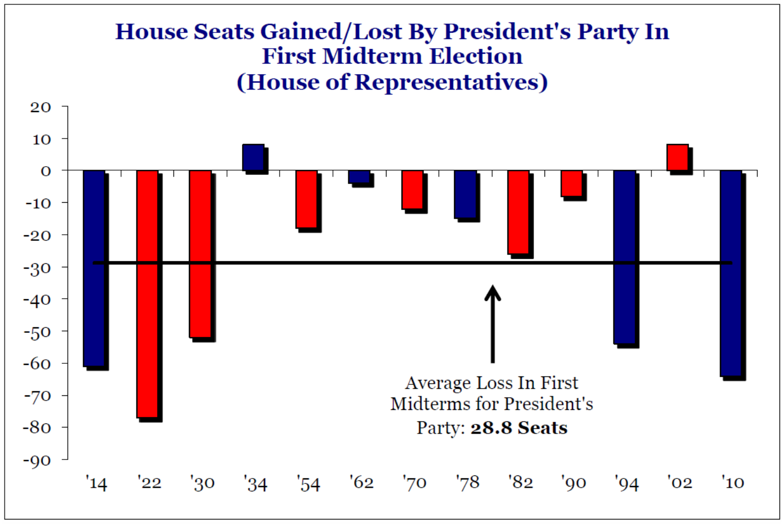
Source: Strategas Research

The Jolts index on the left is a measure of job openings and health of the jobs market. We expect that this trend implies wage inflation is moving even higher than what we've seen to date on the right.



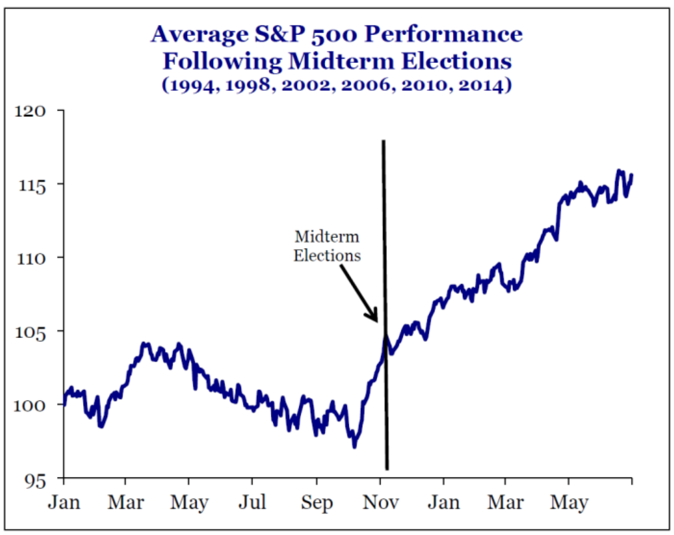
Market Trivia

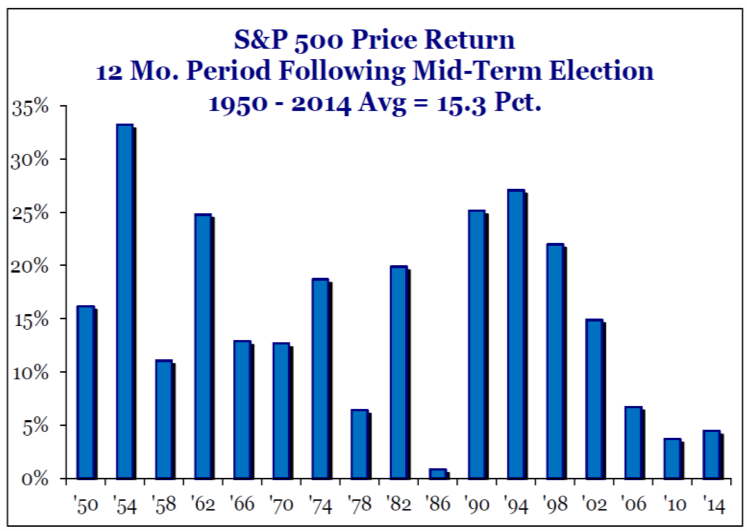
Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. Earlier in the newsletter we mentioned that mid-term elections could be a risk for the stock market as it creates uncertainty. Below is a chart that shows the average number of seats gained or lost in the House by the President's party in the first mid-term election. The average is a loss of nearly 29 seats. So far we've seen predictions that Republicans are at risk of losing around 23 which is pretty close to average.



Source: Strategas Research

With the mid-term elections comes good news and bad news. We'll start with the bad news as seen on the chart below left. The S&P 500 generally drops in the months leading up to the election as there is maximum uncertainty about the outcome of the election. However, the good news as seen on the chart below right, is that the market has averaged a +15.3% gain in the year following mid-term elections without a single down year.





Source: Strategas Research

We hope that you found our first quarter 2018 and updated 2018 outlook newsletter to be 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)] 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.

(2) 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 rating of 2-Stars in the Small-Mid Core Universe based on the Small Cap Core Alpha strategy's return for the year ended December 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

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