1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
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IDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY | VALUE INCOME STRATEGY

1492 Vantage Point Newsletter

Welcome to 1492 Capital Management's quarterly newsletter for the second 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 as we are again pleased to announce that 1492 Capital Management has been named a Top Gun(1) by Informa Investment Solutions' PSN manager database, North America's longest running database of investment managers. The 1492 Small Cap Core Alpha strategy was recognized as the sixth best performing strategy in their Small-Mid Core Universe for the one year period ended March 31, 2018.

Tax reform, tariffs and Trump – one positive, one negative and one wild card. Tax reform benefits and optimism about a 4-handle second quarter real GDP growth sent stocks, particularly small caps, on a strong upward trajectory for most of the quarter. However, tariff talk late in the quarter stymied the rally as further tariffs were planned against Chinese imports. Many believe that these tariff threats are just that, threats. Love him or hate him, Trump remains a wild card but his economic policies are hard to argue with given the results so far. Regulatory relief for banks and businesses, while hard to quantify, has been well-received by those industries that have seen the regulatory noose loosened a bit. The ultimate outcome of his meeting with North Korea's Kim Jong-un is uncertain, but it appears that progress was made in potentially removing another nuclear threat which is stock market-friendly. The stock market hates uncertainty and the combo platter of trade tensions, the Fed hiking interest rates, and mid-term elections, has certainly injected more angst into the global markets. The U.S. stock market appears to have taken on a valuation-be-damned attitude as momentum strategies/stocks were the big winners in the quarter. Investors continue to bid up the same stocks, many of which carry valuations greater than ten times revenue, likely in anticipation of a peak in global growth and are ignoring lower valued stocks because they are viewed to be "cheap for a reason". However, we've seen this movie before, most recently in 2012, and it generally doesn't end well for those stocks that carry extreme valuations. 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.

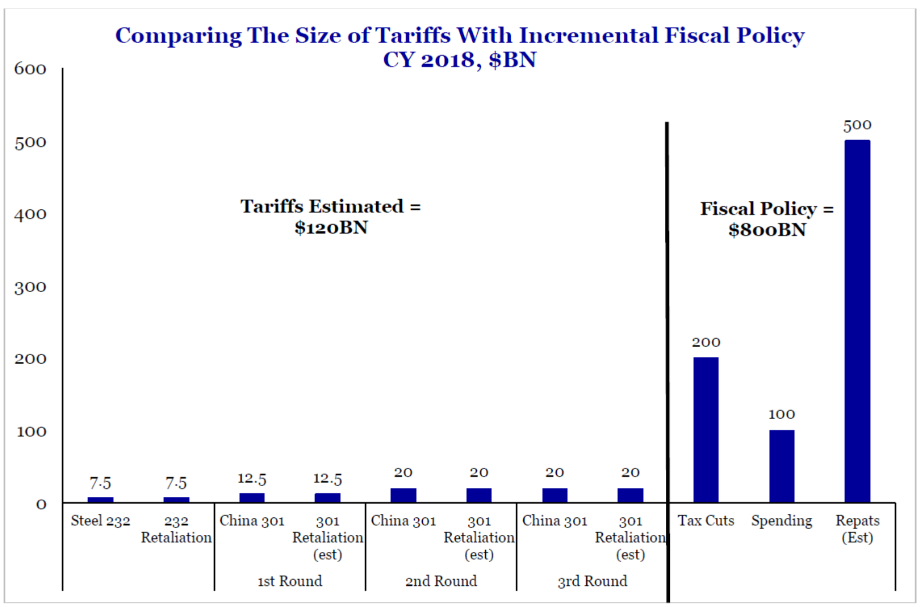
For detailed performance information on 1492's strategies, please click on these fact sheet links (Small Cap Growth / Small Cap Value / Small Cap Core Alpha) to find gross and net of fee performance information and disclosures. If you would like to discuss any of these strategies with us, please contact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

IN THIS ISSUE:

A Review of the Quarter: Tax reform, Tariffs, and Trump - One Good, One Bad, and One Wild Card

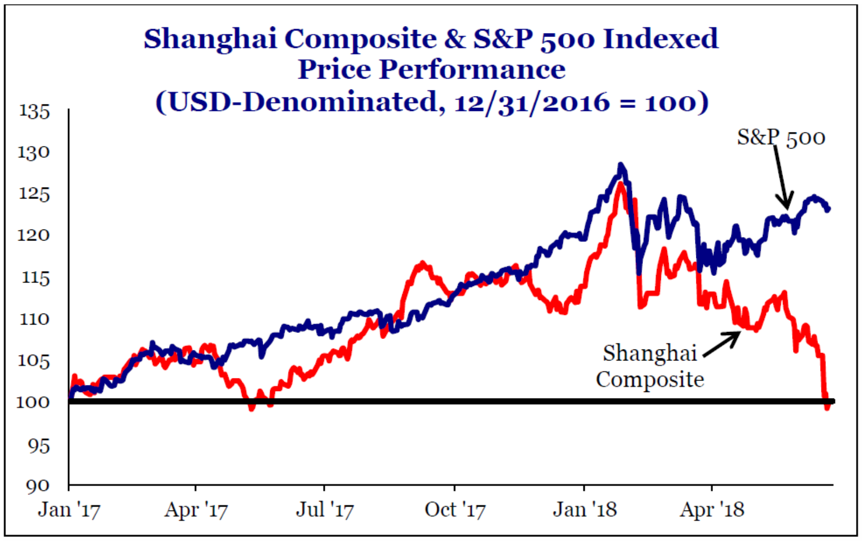
After a first quarter where the stock market launched like a rocket, only to come crashing back to earth, it appears that investors finally understand the power of tax reform and its implications for the economy. More tariff talk late in the second quarter took the shine off of what was still a very strong quarter for the stock market, in particular small caps. Whether you love him or hate him, it's hard to argue with what President Trump's economic and deregulatory policies have done for the economy. The stock market appeared to gain strength as the Atlanta Fed said that real GDP growth in the second quarter could be north of 4% based on their GDPNow forecasting tool. Their latest estimate (as of June 19th) for second quarter growth is 4.7%. *This level hasn't been seen for 14 years.* Many companies that we've met with over the past few months have said that it appears that the regulatory environment is much improved and that policies are clearly loosening up a bit, particularly for banks. Trump's initial meeting with Kim Jong-un, while short on near-term results, gave some optimism that another nuclear threat could be eliminated. Only time will tell on this one.

Tariffs continue to dominate the business news and while the ultimate imposition of the latest amped-up tariffs on China imports is unclear, the size of the positive impacts from tax reform and budgetary stimulus still massively outweigh the potential negatives from tariffs. Below is a chart we featured in last quarter's newsletter which now shows the size of the updated tariffs relative to the stimulus provided by tax reform, budget, and repatriation related stimuli. The positive implications of these stimuli still comfortably dwarf the potential negatives from the larger tariffs.



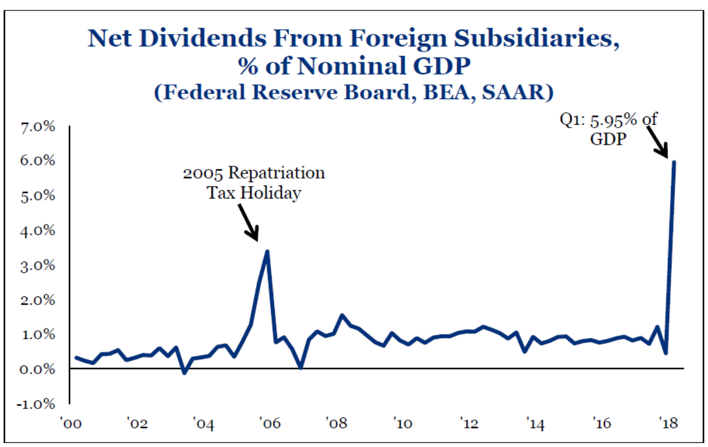
Source: Strategas Research

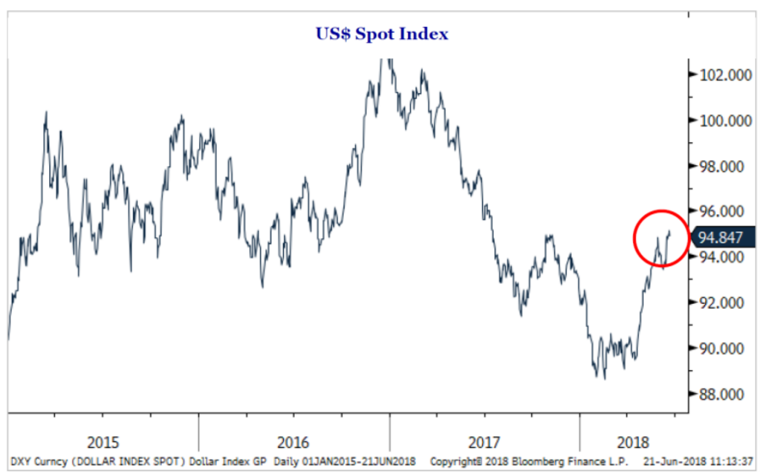
As a refresher, in 2017 the U.S. imported about $505 billion of goods from China and only exported about $130 billion of goods for a net deficit of $375 billion. The deficit has grown every year since 2000, when the trade deficit was only $83 billon, as many U.S. firms moved manufacturing facilities there to take advantage of low cost labor. That said, global stock markets appear to be picking a winner in the tariff battle. Below is a chart that shows the stock market returns for the S&P 500 relative to the China Shanghai Composite since the start of 2017. The Shanghai composite index (red line) was moving in synch with the S&P 500 (blue line) for much of the first quarter, but since the threats of additional tariffs hit, the Shanghai index has dropped dramatically. Many economists believe that China has more tools to withstand an extended tariff battle, like lowering their banks reserve requirement ratios (which they just did in late June) and depreciating their Yuan currency. However, the stock market is clearly taking the side of the U.S. for now.



Source: Strategas Research

The ability for U.S. corporations to repatriate overseas cash and pay a nominal tax, as part of the recently passed tax reform package, appears to have been a big hit for U.S. multinational companies. The amount of cash that is being repatriated to the U.S. is mind blowing. The chart below left shows that U.S. companies have received nearly $300 billion of dividends from foreign subsidiaries in the first quarter alone. This level is equivalent to nearly six percent of U.S. GDP on a run rate basis, and this repatriation program dwarfs the program that was put in place in 2005. Interestingly, much noise has been made about the strengthening U.S. Dollar and the negative implications that it has on U.S. multinational companies to sell their products overseas because a stronger dollar makes their products more expensive in local currency. However, if you notice the timing of the dollar spike on the chart on the right, it appears to be in synch with the repatriated funds from overseas. Given the size of the repatriated funds, it's entirely plausible that the movement of these funds from overseas to the U.S. has lifted the dollar's value, at least temporarily.

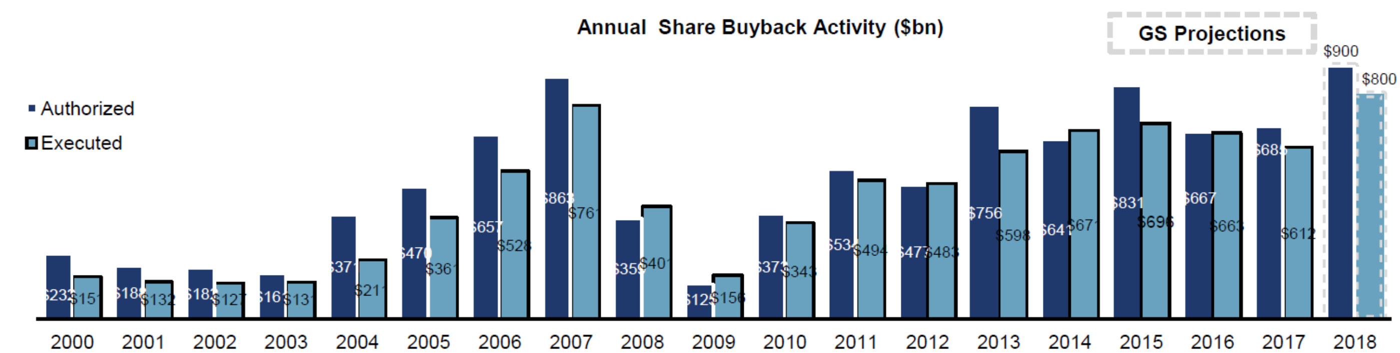




Source: Strategas Research

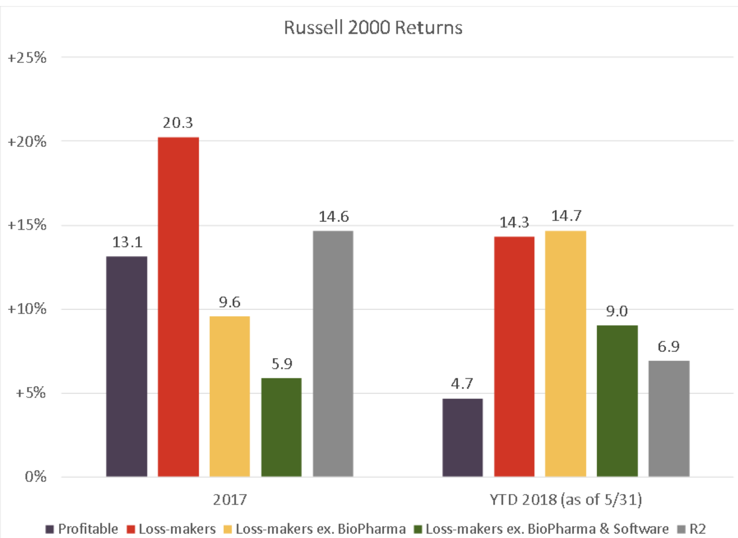
The amount of cash that has been repatriated from overseas appears to be lending support to the stock market through corporate stock buybacks. The chart below shows that Goldman Sachs predicts that stock buyback activity could approach $800 billion in 2018. This dollar volume would be an all-time record high and 30% higher than 2017 levels. Notice, too, that authorizations for buybacks are approaching $1 trillion. With repatriated funds tending to be associated with technology and healthcare companies operating overseas, it is no wonder why the Technology and Healthcare sectors are the strongest performers year to date.

Historical Repurchase Activity:



Source: Goldman Sachs

During the second quarter, there were a number of interesting and unique developments when you examine what worked and what didn't. Once again, unprofitable companies were the best performers in the quarter and year to date. We can look to biotech and software stocks as the key drivers as there were some large profile takeovers of biotech companies in the quarter and software stocks were beneficiaries of the momentum market that was prevalent for much of the quarter. 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 chart on the right shows that after a volatile first quarter, the stock market has settled into a more normalized pattern of daily market moves that put it right in line with the averages of the last 10 years.



Source: Furey Research

Daily Market Moves

	# of Trading Days		
Year	**>1%**	**>2%**	**All-Time Highs**
2009	117	55	0
2010	76	22	0
2011	96	35	0
2012	50	6	0
2013	38	4	45
2014	38	6	53
2015	72	10	10
2016	48	9	18
2017	8	0	62
2018	34	8	14
Long-Term Avg	**60**	**16**	**21**

Note: S&P 500 returns; Long-Term Avg based on 2009-2016
Source: Standard & Poor's, Haver Analytics®, Credit Suisse

During the quarter, investors' preference for domestic stocks, given all of the tariff talk, came through loud and clear as the Russell 2000 (+7.75%) significantly outperformed the S&P 500 (+3.43%), as the former has lower international exposure. The Consumer Staples sector came out of nowhere to post the second best performance in the second quarter, advancing +14.2%. We attribute the strength in this sector to investors' search for conservatively positioned, domestically exposed companies as tariffs are threatened or implemented on companies exposed to international trade. Surprisingly, the Energy sector was the best performer in the quarter as these stocks finally got some respect after trailing the market for much of the last 18 months despite significantly higher oil prices. After cutting production quotas about 18 months ago, OPEC's decision to allow more oil to come on the market didn't upset the stock market as it is being viewed that OPEC's posture will allow the price of oil to remain stable longer. Amongst the indices, the Russell 2000 Value Index was the gold medalist for the quarter with an advance of +8.3% while the Dow Jones Industrial Index lagged badly as its exposure to companies engaged in international trade as well as to General Electric's meltdown held it back. With continued strong performance from the Technology and Healthcare sectors, year to date the leaders are the Russell 2000 Growth Index (+9.69%) and NASDAQ Composite Index (+9.37%). The table below highlights the returns for the second quarter and 2018 year-to-date returns for the popular indices.

Index Returns		
Index	Second Qtr. 2018 Return	2018 YTD Return
Russell 2000	+7.75%	+7.66%
Russell 2000 Growth	+7.23%	+9.69%
Russell 2000 Value	+8.30%	+5.44%
S&P 500	+3.43%	+2.65%
Dow Jones Industrials	+.70%	-1.81%
NASDAQ Composite	+6.61%	+9.37%

Source: 1492 Capital Management, LLC and Factset

From a style perspective, the Russell 2000 Value Index (+8.30%) surged during the quarter to overtake the Russell 2000 Growth Index (+7.23%) and reverse the trend of growth over value that has been in place since early 2017. The Growth index still has a substantial lead year to date. As mentioned above, the Healthcare sector, due to a continued appetite for biotech stocks, propelled the strong performance in the growth index. However, a surge in the Real Estate and Energy sectors led the way on the value side due to a rotation out of the Technology and Industrial sectors from tariff worries. Note the performance of the Staples sector in the month of June. The market returned to this sector following the noise around tariffs as investors sought domestic company exposure that would be unaffected by tariff issues. The first two tables below highlight the performance of the Russell 2000 style indices by sector for the month of June, the second quarter, and year-to-date 2018. Lastly, the third table below shows that the performance within the Russell 2000 was generally better as you moved down market cap. This effect is a reversal of a trend which has existed since early 2014 with only a brief respite in the second half of 2016 as investors sought more domestically exposed companies due to a stronger dollar and tariff concerns.

Table 3: Performance Attribution for the Russell 2000 Growth through June 30

	June			Second Quarter			Year to Date			
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
Discretionary	4.32	0.58	3.54	10.52	1.50	3.29	10.48	1.55	0.79	17.6
Staples	7.92	0.17	7.14	19.76	0.42	12.53	12.37	0.27	2.67	2.5
Energy	0.19	0.01	-0.59	13.36	0.16	6.13	-2.76	-0.03	-12.45	2.3
Financials	-0.51	-0.07	-1.29	3.09	0.20	-4.14	6.75	0.48	-2.94	8.1
Health Care	-0.08	-0.05	-0.86	10.09	2.50	2.87	17.48	4.11	7.78	25.3
Mat. & Process	-0.41	-0.03	-1.19	1.50	0.11	-5.72	-2.89	-0.26	-12.58	8.2
Prod. Durables	0.91	0.14	0.13	2.66	0.39	-4.57	0.49	0.02	-9.20	15.4
Real Estate	3.31	0.09	2.53	10.68	0.30	3.45	1.83	0.04	-7.86	2.3
Technology	-1.47	-0.06	-2.25	6.21	1.56	-1.01	16.19	3.49	6.50	14.7
Utilities	3.85	0.07	3.07	7.03	0.13	-0.20	4.64	0.07	-5.05	1.7

Table 4: Performance Attribution for the Russell 2000 Value through June 30

	June			Second Quarter			Year to Date			
Russell Sec.	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
Discretionary	3.52	0.38	2.91	8.56	0.96	0.26	6.41	0.73	0.97	11.9
Staples	2.22	0.03	1.62	6.66	0.10	-1.64	-1.86	-0.09	-7.31	2.4
Energy	-0.62	-0.04	-1.23	21.02	1.32	12.72	11.06	0.75	5.62	7.4
Financials	-1.45	-0.31	-2.05	4.16	1.37	-4.14	4.85	1.55	-0.59	26.2
Health Care	0.63	0.12	0.02	10.93	0.79	2.63	17.18	1.11	11.74	4.5
Mat. & Process	-2.11	-0.12	-2.71	4.67	0.30	-3.63	-1.20	-0.06	-6.64	5.8
Prod. Durables	0.46	0.06	-0.14	5.67	0.68	-2.63	4.05	0.46	-1.39	11.2
Real Estate	3.18	0.38	2.58	13.63	1.56	5.33	5.11	0.62	-0.33	14.3
Technology	1.31	0.04	0.70	7.83	0.53	-0.47	4.22	0.27	-1.22	9.6
Utilities	1.35	0.08	0.75	9.06	0.58	0.76	2.49	0.14	-2.95	6.7

Size Quintile	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
1 (Largest)	0.02	0.17	-0.69	6.33	3.51	-1.42	6.56	3.61	-1.10	46.8
2	1.49	0.29	0.77	8.52	1.98	0.77	7.14	1.65	-0.52	27.4
3	1.54	0.17	0.83	9.99	1.31	2.24	11.04	1.46	3.38	14.9
4	1.19	0.05	0.48	10.78	0.70	3.03	11.22	0.73	3.56	7.6
5 (Smallest)	1.78	0.03	1.06	9.34	0.25	1.59	8.25	0.21	0.59	3.4

Source: Jefferies

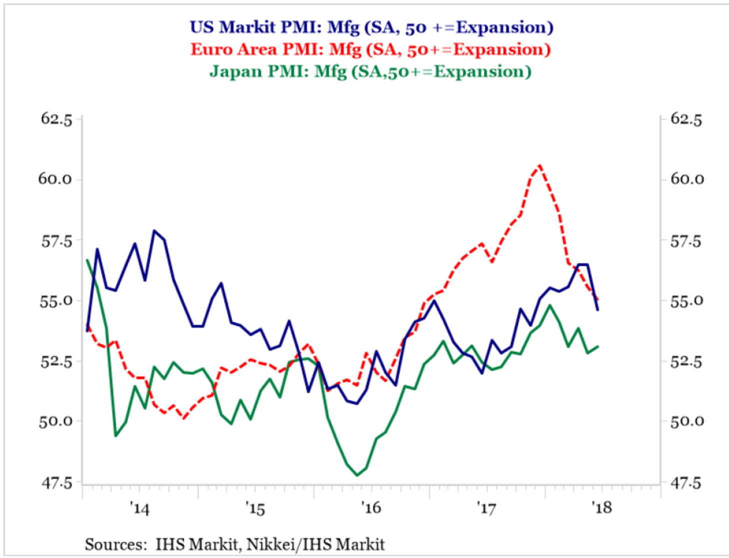
The tariff wars took their toll on international markets during the quarter, particularly those that are more exposed to the goods being used as pawns in this trade chess match. Specifically, China and Brazil were the biggest losers during the quarter as Brazil's fortunes are tied quite closely to China, which is in the crosshairs of the tariff battle. Most other international markets were up modestly in the quarter and showed some improvement after a fairly weak first quarter. Bond investments did poorly during the quarter and are in the red year to date even though interest rates retreated from their recent peak. Amongst commodities, oil was the biggest winner in the second quarter despite OPEC's decision to add supply to global oil markets late in the quarter. Despite the increased supply, oil is up nearly 23% this year. The largest mover was the volatility index which calmed down after spiking in the first quarter.

Index	Second Qtr. 2018 Return	2018 YTD Return
France	+5.63%	+2.97%
Germany	+1.73%	-4.73%
Brazil	-14.76%	-4.76%
India	+4.42%	+4.01%
China- A Shares	-12.14%	-16.92%
China- Shenzhen A Shares	-12.17%	-15.38%
Japan	+5.62%	-1.03%
Long-Term Treasuries (TLO)	-0.20%	-4.26%
Investment Grade Corp. Bonds	-0.27%	-1.62%
Gold	-5.48%	-4.19%
Volatility- VIX index	-19.43%	+45.74%
Oil	+14.18%	+22.72%
Natural Gas	+6.99%	-0.98%
Lumber	+10.39%	+27.08%

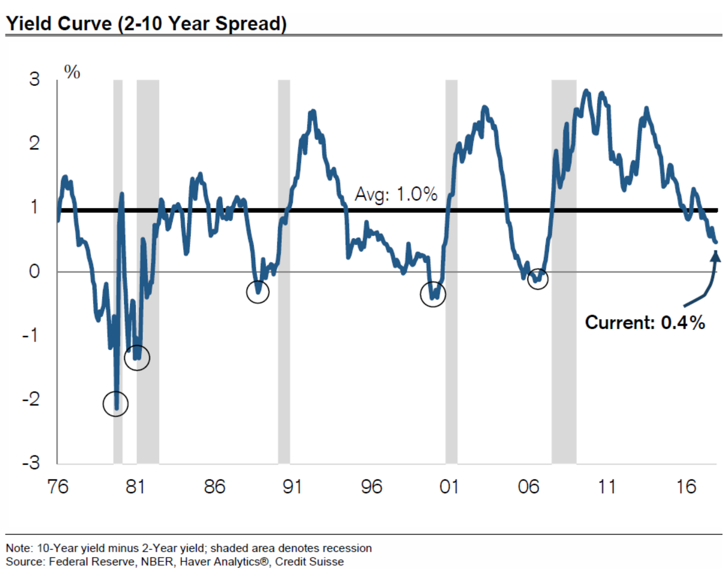
Source: 1492 Capital Management, LLC

<u>Updated 2018 Outlook: Is This as Good as it Gets? The Tug-of-War Continues</u>

Last quarter we began this discussion in our newsletter section entitled, "Is This as Good as it Gets? The Tug-of-War Begins". We anticipated that the stock market was going to take longer than a single quarter to discern what will be the driver that will take equities higher. As we mentioned earlier, it appears that accelerating GDP in the second quarter was a key catalyst, at least for small cap stocks. It's difficult to argue against the crowd who is claiming that global PMI's (purchasing manager index) have peaked, and therefore the stock market has too. The PMI levels that were reached earlier this year are rarely sustained for long. However, the PMI surveys are diffusion indices that Wall Street economists have used as a leading indicator for years. But, because they're diffusion indices, the survey respondents are simply asked if this month was better than last on a number of different variables which are cobbled together to form a composite number. However, given that they are diffusion indices, if one additional respondent replies that things are slower than last month, the survey ticks down regardless of the strength of the other respondents' replies. Nevertheless, the PMI's have clearly decelerated over the past several months from unsustainably high levels as seen on the chart below. Europe has dropped the most, but all of them are still well above the 50 level which denotes expansion. You'll notice these surveys bounce around a bit month to month, and it's easy to see why some believe the global economy has peaked. We're certainly not denying that we may have peaked, but we could remain in the +50 mode for quite some time with the amount of stimulus that is still in the pipeline globally. Admittedly, the Fed is tightening, and the ECB is expected to dial back their quantitative easing program later this year which will make things incrementally tighter. However, interest rates are still low, and the full brunt of tax reform hasn't yet hit here in the U.S. Have we seen the best numbers for this cycle? Probably but that doesn't mean we fall off a cliff either.



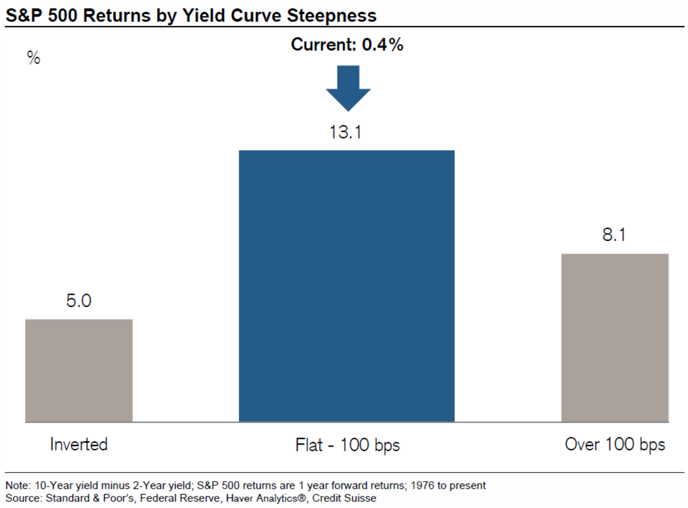
Another item that we've been watching is the yield curve. Many are looking to that for clues about when the next recession begins. The chart below shows the spread between the yields on the 2 and 10 Year U.S. Treasury notes. As you can see, the spread has narrowed significantly over the past several months and is currently about +40 basis points. When the curve has inverted in the past, it has been a precursor to a recession. The table on the right shows that after inversion, the time to stock market peak and a recession are only eight and 17 months away, respectively.

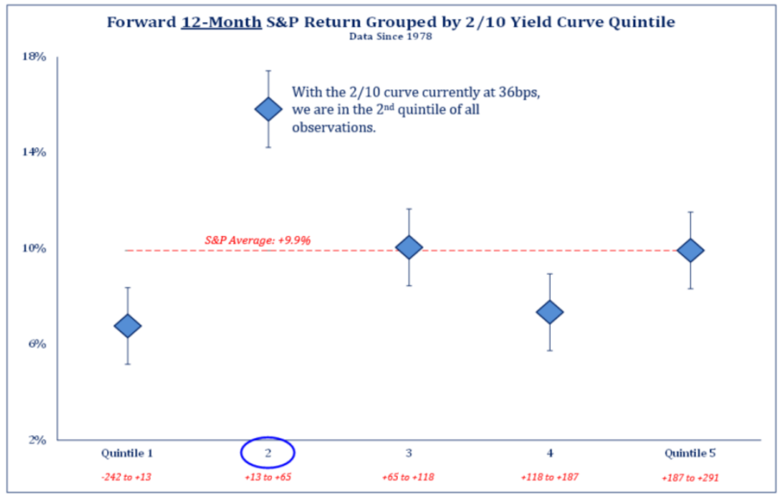


Yield Curve Inverts	Equity Market Peaks	Months to Peak	Recession Begins	Months to Recession
Sep-78	Sep-78	0	Feb-80	17
Sep-80	Nov-80	2	Aug-81	11
Jan-89	Jul-90	18	Aug-90	19
Feb-00	Mar-00	1	Apr-01	14
Feb-06	Oct-07	20	Jan-08	23
	Average:	**8**	**Average:**	**17**

Source: Strategas Research

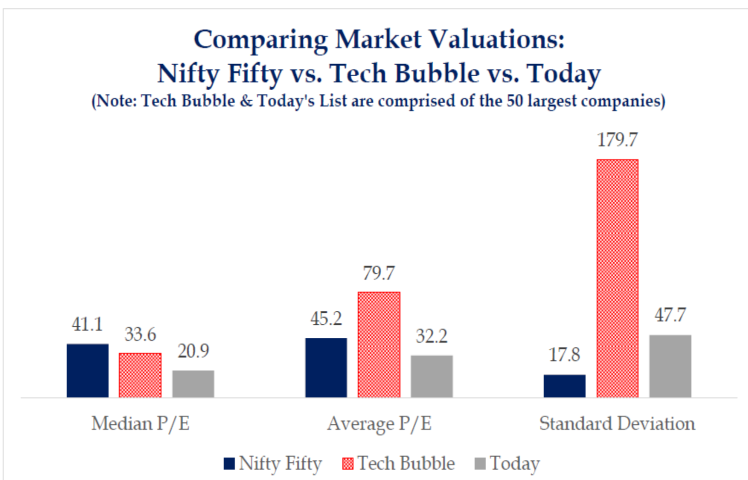
However, all is not lost. Interestingly, the chart below left shows that when the yield curve is between flat and +100 basis points, the S&P 500 has its best returns which average +13.1% annually. Similarly, the chart on the right shows the forward 12 month returns grouped by yield curve quintile. When the 2/10 yield curve falls between +13 and +65 basis points, you're in the sweet spot for forward 12 month returns. We are currently squarely in the middle of this range so don't get too depressed just yet.

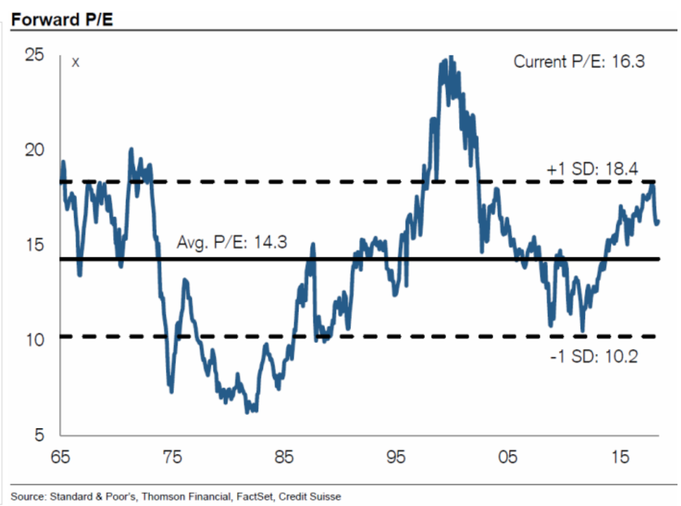




Source: Strategas Research

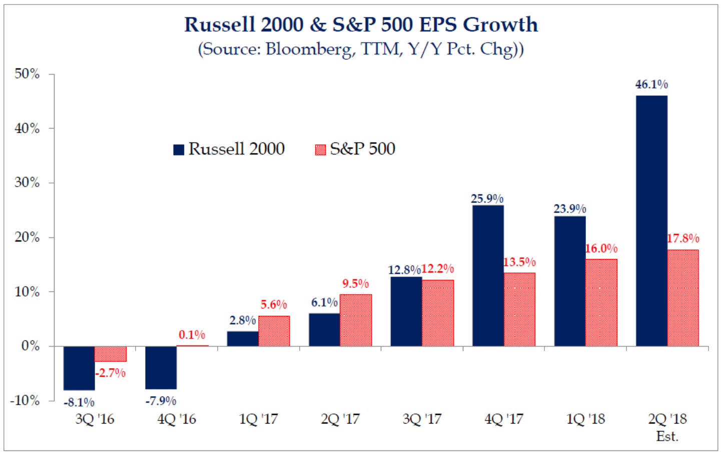
Many market prognosticators that we hear on CNBC and on other media outlets have somehow equated today's stock market valuation with lofty levels of the past and compare today's valuations with the tech bubble of 2000 and the "nifty fifty" era of the 1970's. They claim that because today's valuations are so elevated, the stock market has to have seen its peak. Nothing could be further from the truth as the charts below show.

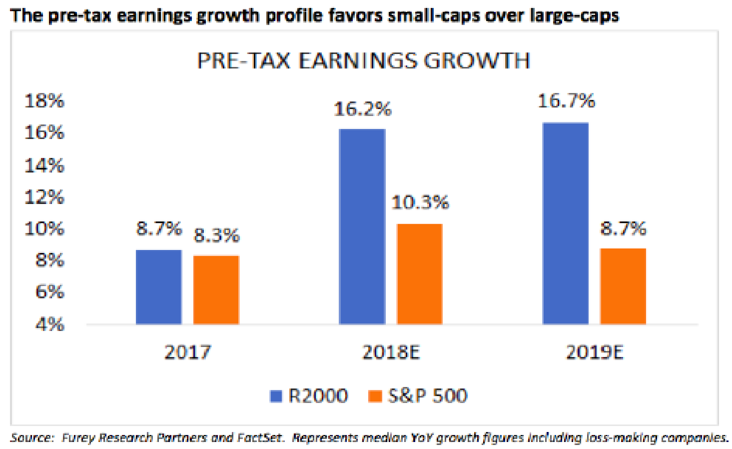




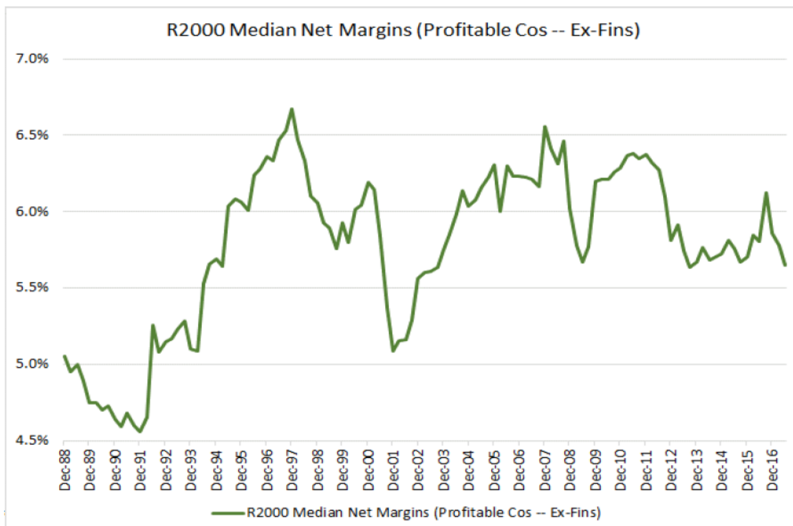
<u>Updated 2018 Outlook: Small Caps are Winning the Market Race at Halftime - Can They Hold the Lead?</u>

Small cap stocks jumped nicely ahead of large caps from a performance standpoint in the first half of the year. Many would probably tell you that it's because small caps have less foreign sales exposure than large caps, which is favorable if tariffs go into effect and the dollar continues to strengthen. That's logical and we agree in part, but there is more to it if you look under the hood. The chart below left shows that Russell 2000 earnings growth has been exceeding that of the S&P 500 by a wide margin over the past few quarters. One could argue that this outperformance is due to tax reform, and once we anniversary tax reform in 2019, this differential will disappear. However, the chart on the right takes a different tact. It looks at pre-tax earnings growth for 2018 and 2019. Interestingly, pre-tax earnings growth for the Russell 2000 is expected to accelerate relative to pre-tax earnings growth for the S&P 500 for 2018 and 2019. It seems to us that the market is sniffing out this difference and awarding small caps with better performance. The third chart below shows the net profit margins for the Russell 2000 over the past 30 years. You can see that current margins are hovering on the lower end of this long-term range which implies that there is still room for improvement. However, large cap margins are currently near their all-time highs.





Source: Strategas Research



Source: Furey Research

<u>2018 Updated Outlook: Capital Expenditures or Stock Buybacks or Both? A 1492 Internal Debate</u>

Much of our optimistic economic outlook for 2018 that we discussed in our newsletter at the beginning of the year was predicated on that the new tax reform law would help to accelerate corporate America's capital expenditures. Recall that the tax reform law put in place a mechanism that allows corporations to immediately deduct 100% of any new capital expenditures made on equipment, buildings etc. over the next several years. Initially, our belief was that with the finite window for this provision, many corporations would take advantage of this change and accelerate any expenditures they were contemplating as the economic benefit of doing so was made clearer by the new policy. However, is the incentive large enough to make companies take the plunge and shell out incremental capital on buildings and equipment this late in the cycle? Will companies instead stick to the tried-and-true stock buyback programs that help push share prices higher which can enrich company management more immediately than making capital expenditures that may take years to pay off? At 1492 Capital Management we've had this debate, and we present our positions below.

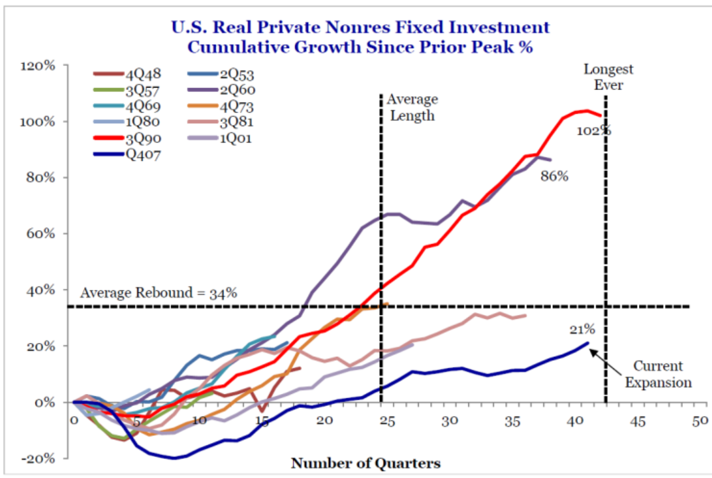
<u>The Case for Capital Expenditures</u>

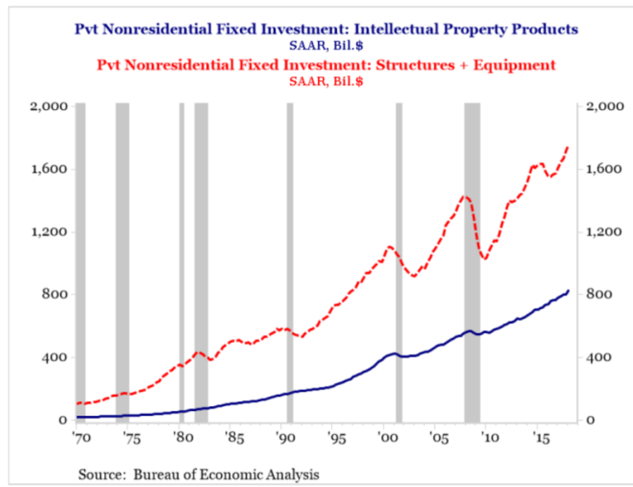
There are a slew of reasons that capital expenditures should increase in 2018 and 2019. They include the following:

1. Immediate expensing of all capital expenditures for tax purposes
2. Reshoring of manufacturing facilities to the U.S. as wage arbitrage is no longer compelling

3. Low financing rates
4. Old capital stock that needs to be brought up to current standards
5. Increase productivity as labor tightens
6. Strong profit growth
7. Deregulation

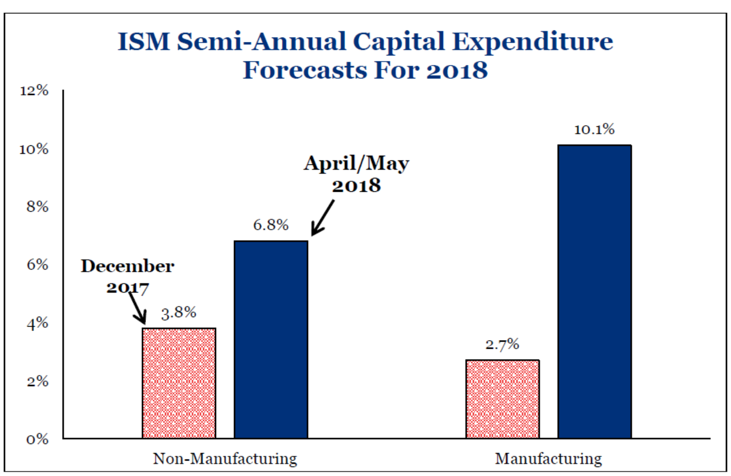
The chart below left shows a history of capital expenditures across multiple economic expansions going back to the 1940's. The current cycle is shown in dark blue. It's been a long cycle but the cumulative growth in fixed investment (i.e. capital expenditures) is only 21% above the prior peak. The average rebound is 34%. The chart below right shows a breakdown between technology capital expenditures (blue line) and structures and equipment expenditures (red line). As you can see, technology spend has been far more steady relative to the structures and equipment spending which tends to follow economic cyclicality far more closely.





Source: Strategas Research

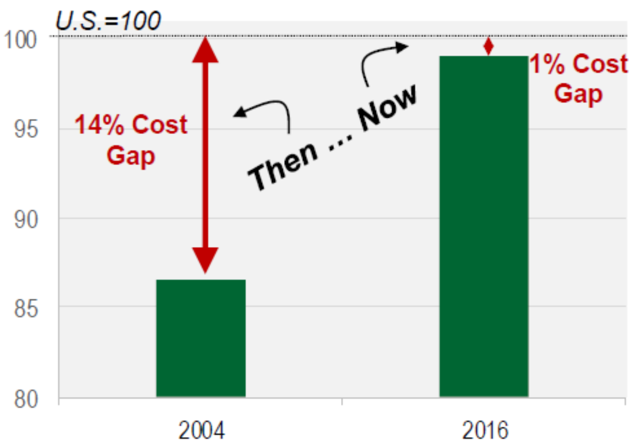
Below we show a couple of surveys of corporate CFO's and their capital expenditure intentions. The chart below left highlights how sentiment changed significantly following the passage of tax reform. The pink bars show corporations spending intentions in December 2017, prior to tax reform, and the blue bars show their spending intentions in April/May 2018. There was a huge step up in spending intentions due presumably to tax reform and the ability to expense 100% of any expenditures. The chart below right shows the NFIB survey for those who believe now is a good time to expand which is at the highest level in over 30 years and measures small business owners' intentions which is meaningful because they tend to be quite conservative typically.



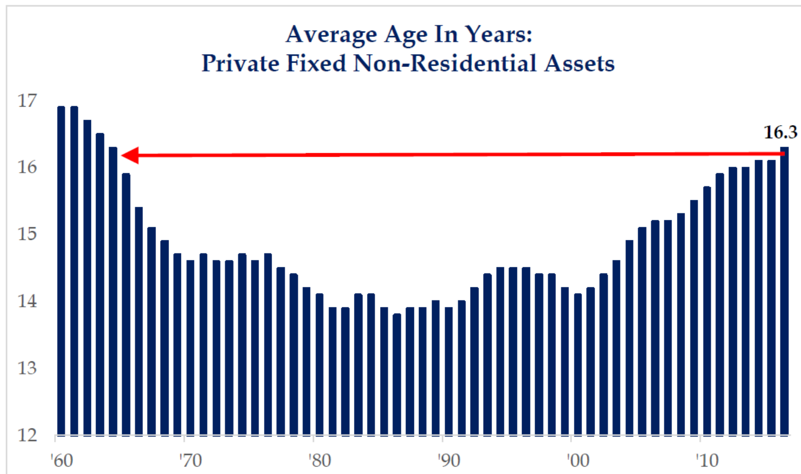
Source: Strategas Research

As we mentioned above, the wage arbitrage game, in which U.S. companies moved production over to China to take advantage of significantly lower wage rates, is likely coming to an end. China's labor rates have increased for many years, and coupled with the increased cost of shipping back and forth between the U.S. and China, the cost competitiveness of China as a go-to country for manufacturing has diminished greatly. The chart below left shows how China's cost competitiveness has shrunk from 2004, which was during the boom time for moving production abroad, to the current time where the cost gap has essentially been closed. This shrinkage makes the case for reshoring back to the U.S. much more compelling. Additionally, the average age of our fixed asset pool in the U.S. has increased to the highest level since the 1960's. To bring our plants up to speed and generate the type of productivity growth that will be required to move production back to the U.S., companies will have to invest in plant and machines that will return our production capabilities back to par. This aging trend can be seen in the chart below right.

Global Mfg Cost Competitiveness Index: China % U.S.



Source: The Boston Consulting Group



Source: Strategas Research

Thus, based on the rationale provided above, we believe that we'll see a marked acceleration in the amount companies expend on equipment, buildings, etc. The one concern that we have is the data contained in the chart below. This chart shows what spending behavior that the stock market has rewarded for different spending initiatives for pre- and post-recession timeframes. As you can see, making capital expenditures was the worst performing attribute since 2010. Whereas, share buybacks as a way to deploy capital was the second best performing attribute. Therefore, the stock market will likely have to change their reward system in order to incent corporate executives to bite the bullet and increase expenditures. The real question is, are incentive systems in place in corporate boardrooms to reward executives for thinking long term? Only time will tell, but we believe that the fundamentals are in place to encourage an acceleration in spending.

Chart 7: Pre- vs. post-crisis annualized relative total return performance of cash deployment factors (1986-2017)

Source: Factset, BofA Merrill Lynch US Equity & US Quant Strategy
Note: based on total return performance of top quartile of S&P 500 companies by each factor, relative to the equal-weighted S&P 500. Dividend payout ratio growth excludes negative earners.

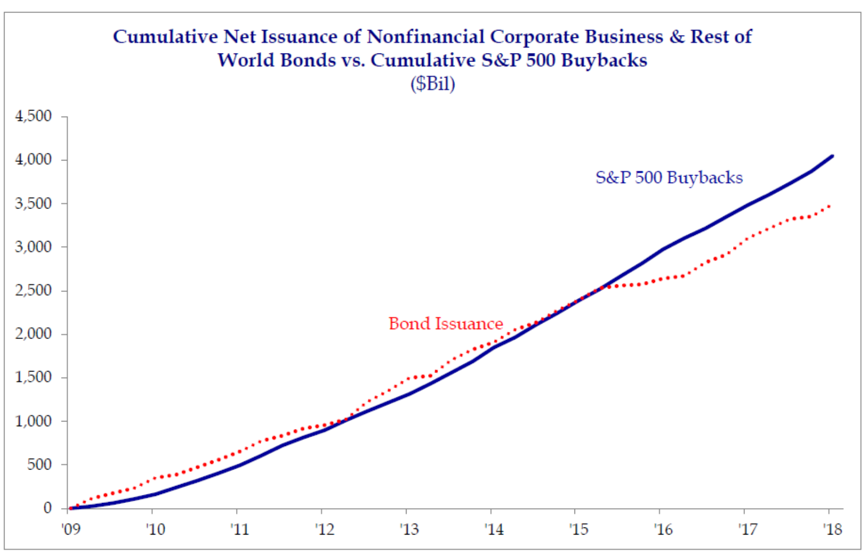
<u>The Case for Stock Buybacks: Corporate America Will Stay the Course and Focus on Short-term Metrics</u>
(by Tim Stracka)

Having been in the business for over 25 years, I have spent the majority of my career working for major Wall Street firms through multiple cycles including the stock market boom in the late 1990's and early 2000's. I have traveled with hundreds of corporate managements on road shows and due diligence trips. It was not uncommon for senior management teams to check their stock price every hour after each meeting presentation. One thing in common with all of the corporate management teams is their focus on micro or the short term performance of their stock price.

With an estimated 50-75% of senior management's yearly compensation coming from stock options and their underlying stock ownership, it's no wonder that they are so focused on the short term performance of their stock. A study done by researchers at Temple University and the University of Missouri showed that of 365 U.S. companies between 2000-2010, the average CEO held office for 7.6 years, but the optimal tenure length was 4.8 years. Specifically, they discovered that the longer the CEO tenure, the more likely they were to stop reacting to market conditions and customer desires, and ultimately hurt the firm's performance. If this research is correct, it is not surprising that CEO's and top management teams are hyper-focused on short term gains in their underlying stock price.

Today, the markets are flooded with private equity firms and activist investors who scour the markets daily for companies and management teams that are not focused on the opioid high of short term gains and that are instead attempting to build the proverbial Swiss Watch. As a CEO you are forced to do the things that generate short term profits or they are likely to have unfriendly consequences from these two groups.

With the average tenure for a corporate CEO of 7.6 years and with 50-75% of his or her annual compensation tied to the underlying stock price and as long as Corporate America continues to focus on quarterly earnings estimates, why would CEO's focus on capital expenditures that don't bring short term appreciation to the stock price? President Trump's corporate tax breaks, capital expenditure deductibility, and the repatriation of dollars from overseas were all planned to stimulate a major avalanche in corporate capital expenditures which is just not happening! The growth in stock buybacks has dwarfed the capital expenditure gains of roughly 9% in the first quarter 2018. According to Goldman Sachs, stock buybacks rose 38% in the first quarter of 2018 to a record $189.1 billion, which exceeded the fourth quarter 2017 level of $137 billion and also displaced the prior record of $171.9 billion set in the third quarter of 2017! The chart below shows the cumulative stock buybacks and bond issuances for the S&P 500 since 2009. Stock buybacks are approaching nearly $4 trillion cumulatively since 2009, and bond issuances are closely correlated, which implies that management teams have been incented to borrow cheap money and deploy it through stock buyback programs aimed at increasing their stock price in the short run.

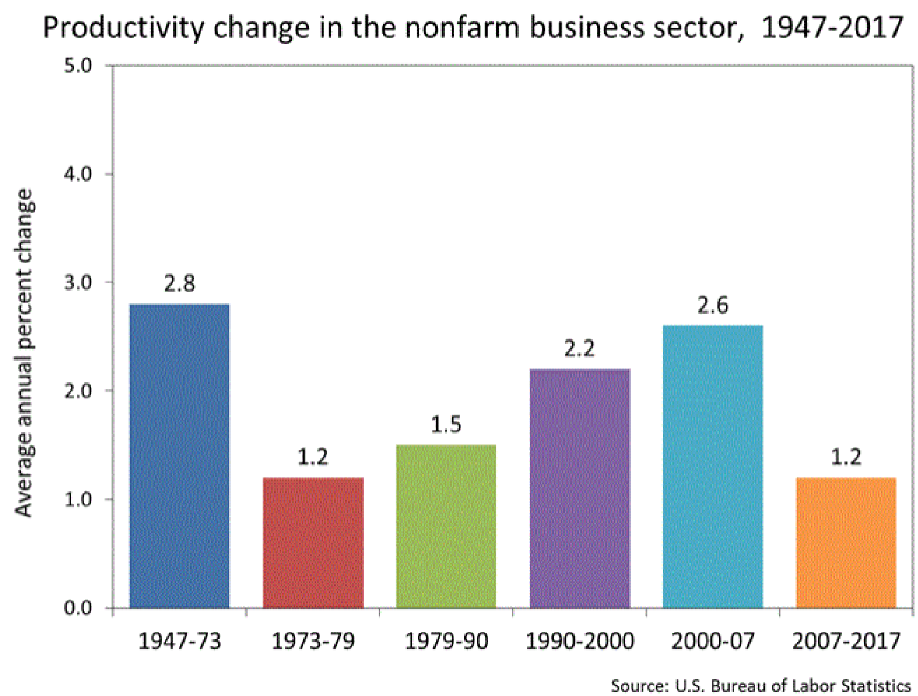


Source: Strategas Research

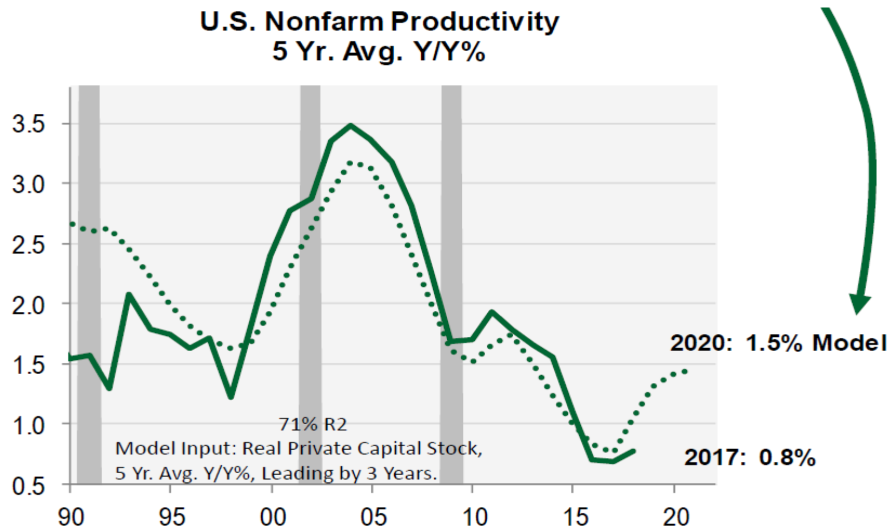
Thus, a more moderate uptick in capital expenditures is the likely outcome as Corporate America continues to focus on the short term. So from my perspective, you will see a continuation of the large corporate stock buybacks, accretive acquisitions, increased dividends and the continuation of the "great shrinkage" in available shares to purchase in the public market place!

U.S. Productivity Growth is Back to Life

In the comedy Monty Python and the Holy Grail movie, a man and a cart move through a plague ridden town collecting the dead, and as one townsperson tries to load an elderly man from his shoulder on to the cart, the "dead" man hilariously remarks that he is not dead yet, that he's feeling much better and that he thinks that he might go for a walk. This scene parallels well with the story of U.S. productivity which, as seen in the chart below, after being nearly catatonic for the last decade (2007-2017) at less than half the previous decade's level, as seen in the chart below. However, U.S. productivity is actually feeling much better in 2018 and out for a walk higher.

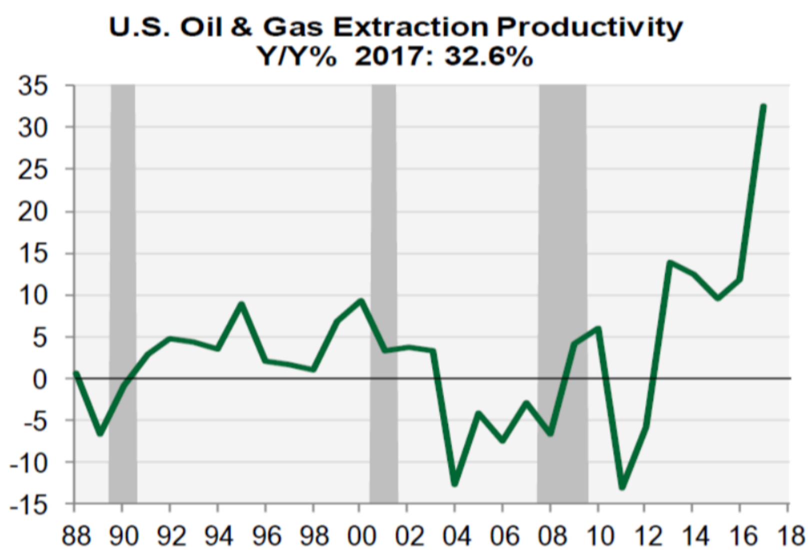


This reacceleration in productivity is a result of an increase in capital spending beyond maintenance levels as full depreciation of capex, lower, now competitive, U.S. tax rates, reduced government regulation, and low natural gas prices that create highly competitive industrial electricity prices provide the tailwinds. In addition, according to Strategas research, the average age of the U.S. private fixed non-residential assets has not been this high or this old since the 1960's. With these tailwinds blowing, capex in the first quarter 2018 was recently revised higher to 9.2% from 6.1% year over year growth. As seen in the chart below, productivity generally rises with a lagged effect from increases in the capital stock or spending, and based on Cornerstone Macro's modelling, the five year average year over year change in U.S. nonfarm productivity should nearly double from 2017 to 2020. This trend is important in that rising productivity helps to offset wage inflation and to keep unit labor costs (ULC), the largest component of the U.S. corporate cost structure, in check. Consequently, this effect should generate stronger GDP growth and an extended economic upcycle with generally tame core inflation, in our opinion.



Source: Cornerstone Macro

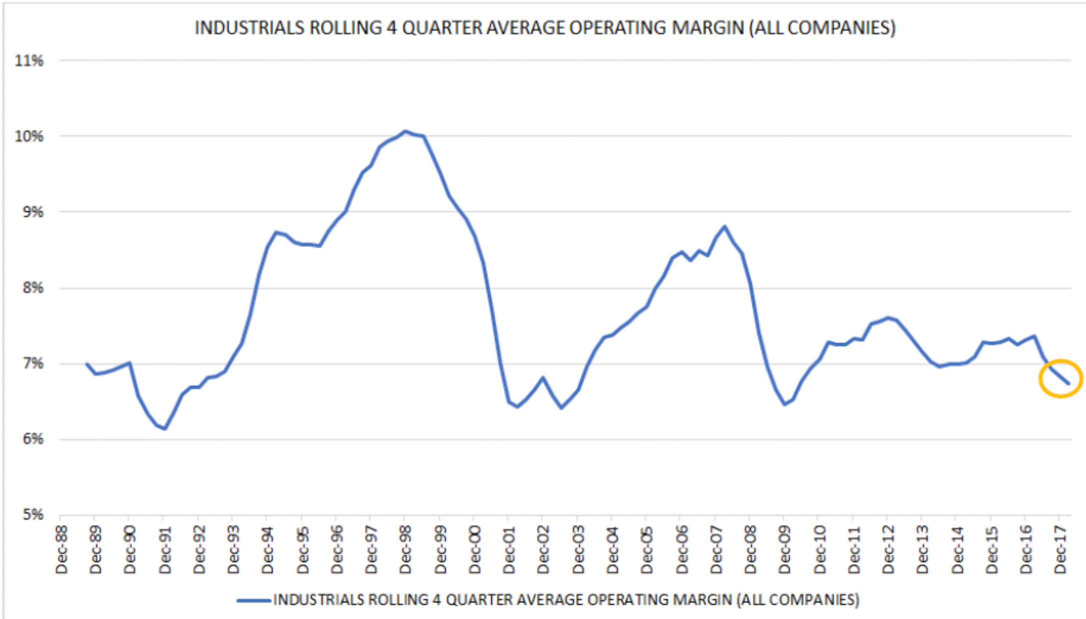
We have written in the past about the importance of healthy oil prices on the U.S. economy as the multiplier effects of higher oil and gas drilling across the transportation, construction, and chemicals drive industrial growth. The oil and gas industry, which was also incorrectly pronounced dead back in early 2016 at $26 per barrel oil prices, is the poster child for improved productivity as seen in chart below. There are literally dozens of charts in publicly traded oil and gas production companies' corporate presentations that highlight how much faster they are drilling than a year earlier and how changes in well fracking have increased the amount of oil and natural gas being produced from their new wells compared to wells drilled a year or two ago. This sector is a key driver for overall productivity growth in the U.S.



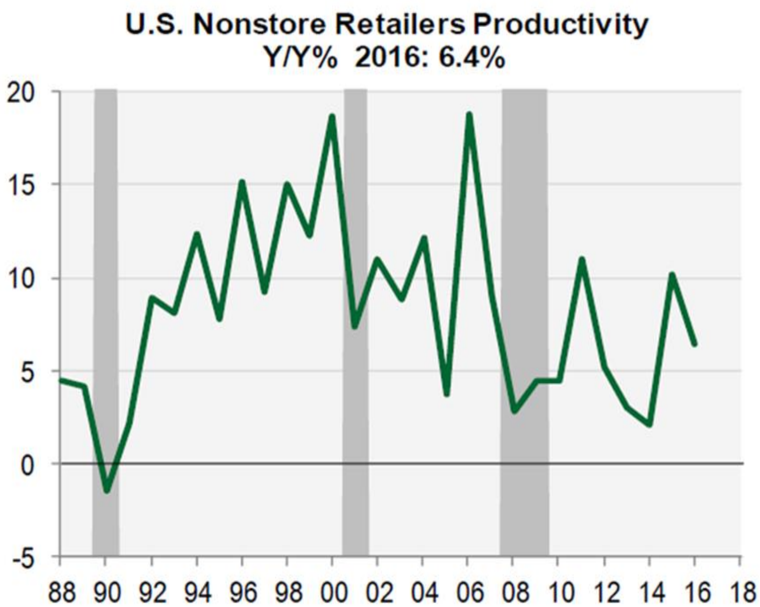
Source: Cornerstone Macro

As we have previously mentioned in past newsletters, the multiplier effects of a strong domestic oil and gas business should positively impact industrial America. Across the 1492 Capital Management investment strategies, we have deployed our industrial automation theme which benefits from the key driver of productivity growth which is higher capital spending to create greater efficiency at the plants or on the factory floor. There is plenty of opportunity throughout our U.S. industrial base to upgrade aged equipment. As seen in the chart below, there is also plenty of runway for greater productivity to stimulate higher industrial operating margins, which are stagnating near their lowest levels since first quarter 2010 among Russell 2000 Industrials.

Fig 15. **R2000 Industrials Operating Margins**



Source: Furey Research Partners and FactSet



Source: Cornerstone Macro

Lastly one can see in the chart above the proverbial Amazon or e-commerce effect on nonstore retailer productivity which has served as bellwether for multiple years for strong productivity gains. As you can see in the chart below, the markets like productivity as it has rewarded Amazon over three times the market cap of Walmart for its operations that employ less than a fourth of the number of Walmart's employee base.

Source: Strategas

With the e-commerce productivity strength expected to continue and other areas of the economy reaccelerating in productivity with the higher capital spending underway, the U.S. is poised for an extended period of relatively low core inflation and improved GDP growth. It is well positioned to reap these productivity gains as lower taxes, less regulation, cheap power, repatriated funds and aged equipment bolster the economics of higher capital spending. These conditions generally precipitate healthy returns in the stock market, and we continue to maintain our forecast for 5-10% appreciation in small cap stocks in 2018.

Economic Expansions Don't Die of Old Age

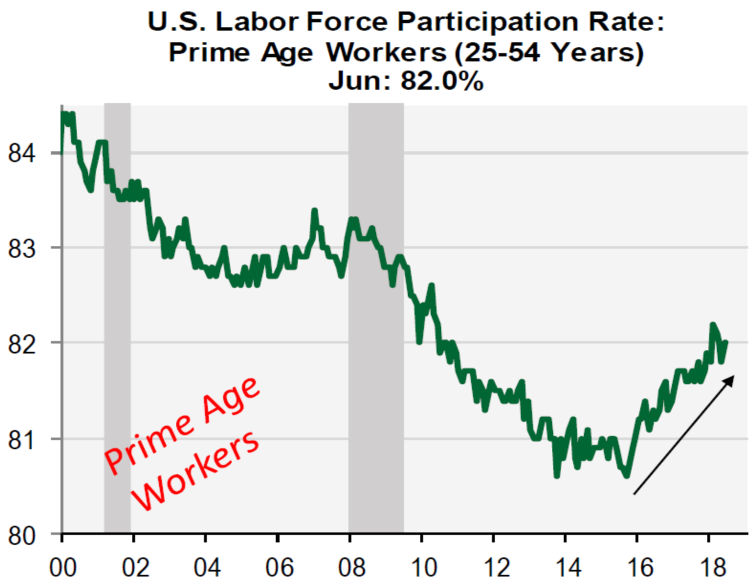
When the duration of an economic expansion period extends as long as this one has, it's natural to expect a plethora of skeptics to prognosticate a pending recession. But is past prologue the appropriate catch phrase for today?

Economic expansions don't die of old age; policymakers' mistakes usually choke them. In fact there is precedent for expansionary periods with similar durations as the current one, 1982 to 1990 and 1992 to 2000. Historically, it's often difficult to pinpoint the root cause that sets off a recession until after the fact. Generally an excess amount of capital floods an asset class that causes valuation to be over-inflated. An exogenous event follows that causes a panic and a stampede for the exit.

In 1990 an overly restrictive Federal Reserve policy coupled with the first Gulf War's oil shock sent consumer confidence in the tank, and the economy ultimately spiraled into recession. The mini-crash of 1997 foreshadowed he Recession of 2000, but the full onslaught occurred with the piercing of the dotcom bubble and was exacerbated by the terrorist attacks of 9/11. Lax lending standards for subprime home mortgages which created a real estate bubble of epic proportions setup the Great Recession in 2008. Market pundits also pointed the finger at Alan Greenspan's overly accommodative monetary stance in the early part of the decade and his overly aggressive hawkish stance in the face of a slowing economy immediately prior to the recession.

The current market expansion began June 2009, and we have just eclipsed nine years. So we must be due for a recession, right? Not so fast. Like we mentioned earlier, recessions are typically brought about through policy missteps, which create an environment for heated asset inflation. While we have seen a number of companies talk about pricing pressure, and there have been pockets of commodity inflation, the absolute price levels are still in very manageable ranges. While percentage gains in prices such as steel and other commodities are up strongly over the last year, the absolute prices are still nowhere near the peaks prior to the Great Recession. Copper for instance is up 8% over the past year, but at $2.86/lb. it is still far below the peak of $4.45/lb. over the past decade. Crude oil is up 21% since the beginning of the year, but at $73/bbl it is well below the pre-Great Recession peak of $145/bbl.

One key inflationary indicator that we track is the labor rate. While much of the focus over the past couple of years has been on the demand side of the equation, we believe that there is an argument to be made that labor supply is on the rise. Post the Great Recession and despite growth in the economy, both consumer sentiment and business confidence lacked firm conviction. While unemployment rates recently ticked below 4%, skeptics are quick to point out that the labor participation rate is also low. Yes we have had a number of discussions with companies over the past few quarters where management teams have commented that it is difficult to find skilled labor and that wages are going up. However, we believe that there is potential for good news on the horizon as business and consumer confidence are at all-time highs which has created an environment for idle workers to re-engage in the workforce. This trend reversal should supply the needed workers to help alleviate wage inflation over the next year.



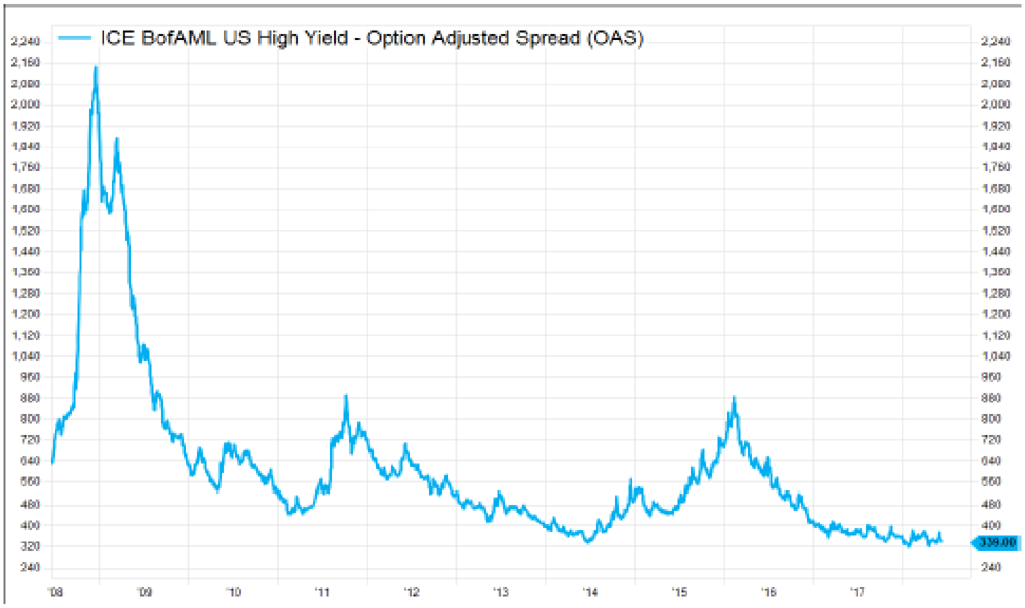
Source: Cornerstone Macro Research

Wage inflation historically been a key driver behind overall inflation due to its trickle-down effect on the purchase of goods and services. If wage inflation can be kept in check with this increase in the labor pool, we could expect to see this economic expansion reach 10 years and beyond.

<u>2018 Updated Outlook: A Picture is Worth a Thousand Words</u>

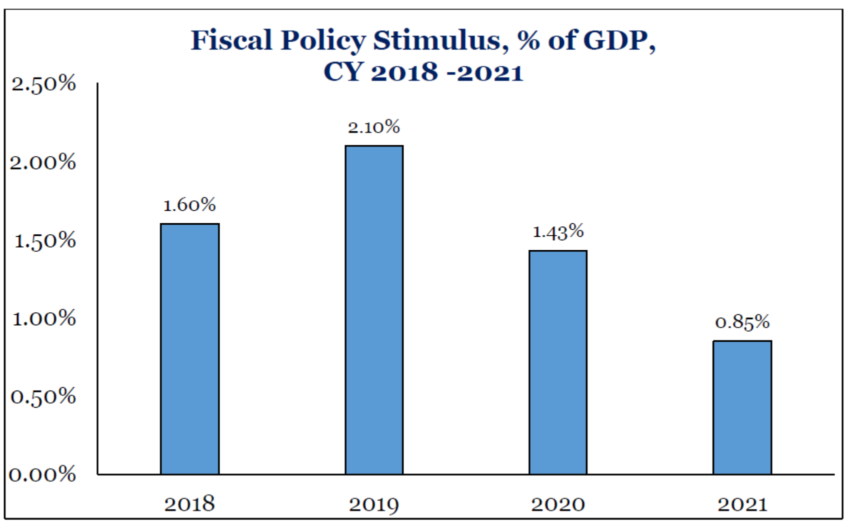
Above we articulated our updated 2018 outlook and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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.

Despite much angst around tariffs and potentially slowing growth, high yield spreads remain quite suppressed. They usually are a good predictor of trouble.



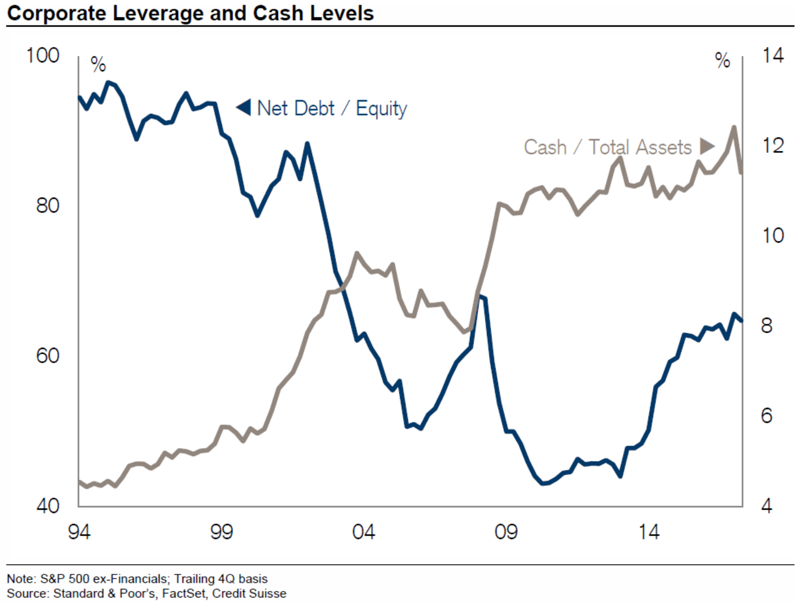
Source: Credit Suisse

With real GDP growth expected to push near 4% this quarter, many talking heads are predicting peak growth in 2018. Nevertheless, with the way tax reform and budget spending is planned, 2019 will have 50 basis points of added stimulus compared to 2018.

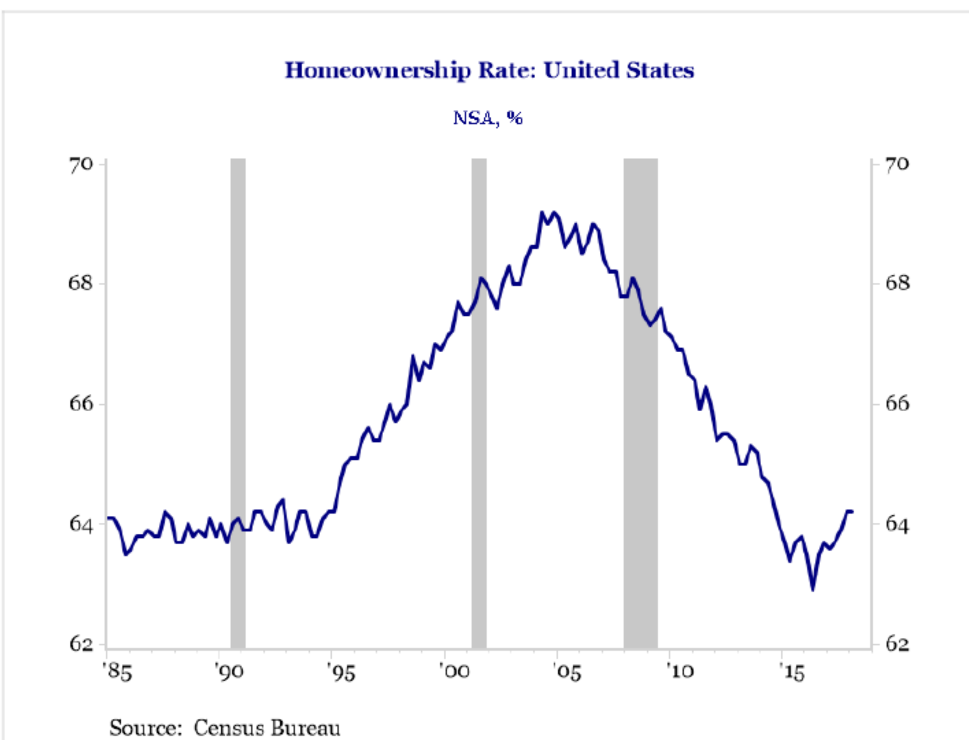


Source: Strategas Research

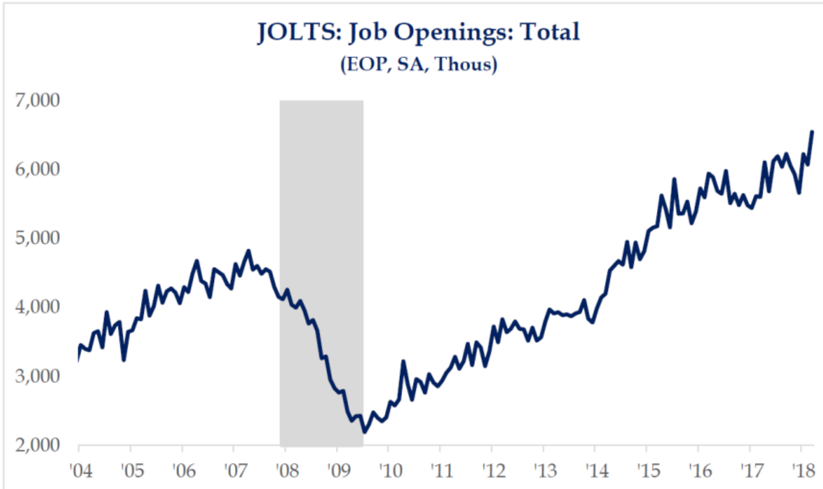
Despite massive stock buybacks, cash on the balance sheets of companies has continued to climb. Debt has been raised to fund some buyback programs, which is prudent with rates at current levels, but debt levels still remain well below long term averages.



Home ownership rates have started to increase after a 12 year slide as millennials have finally entered the home ownership market.

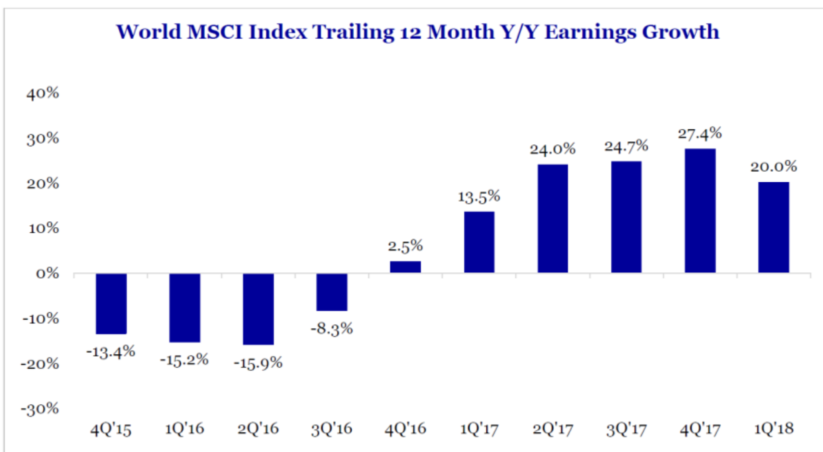


The JOLTS index, which measures the number of job openings in the U.S. labor market, is now greater than the total number of unemployed workers in the U.S. This gap has occurred for the very first time this has occurred since they started tracking the data in 2000.



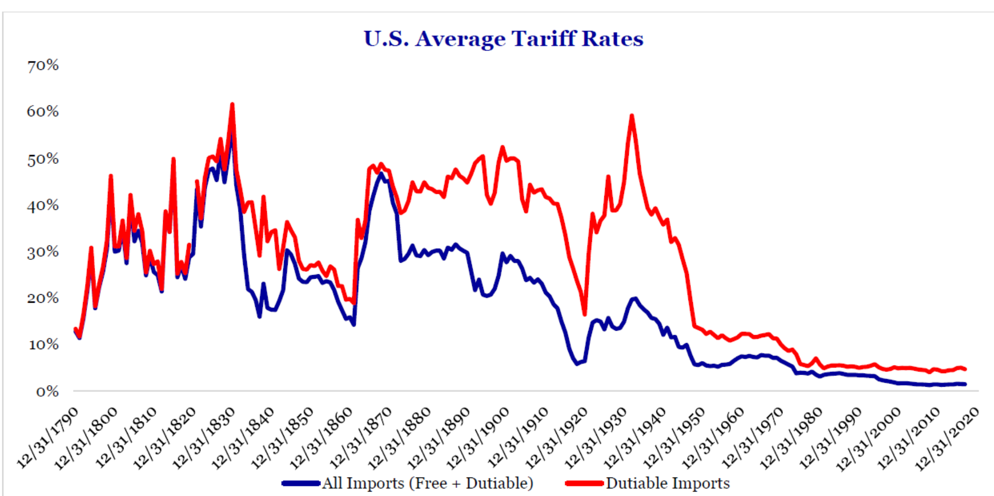
Source: Strategas Research

Yes, world earnings growth is slowing, but 25% earnings growth wasn't sustainable. European growth appears to be slowing the most currently.



Source: Strategas Research

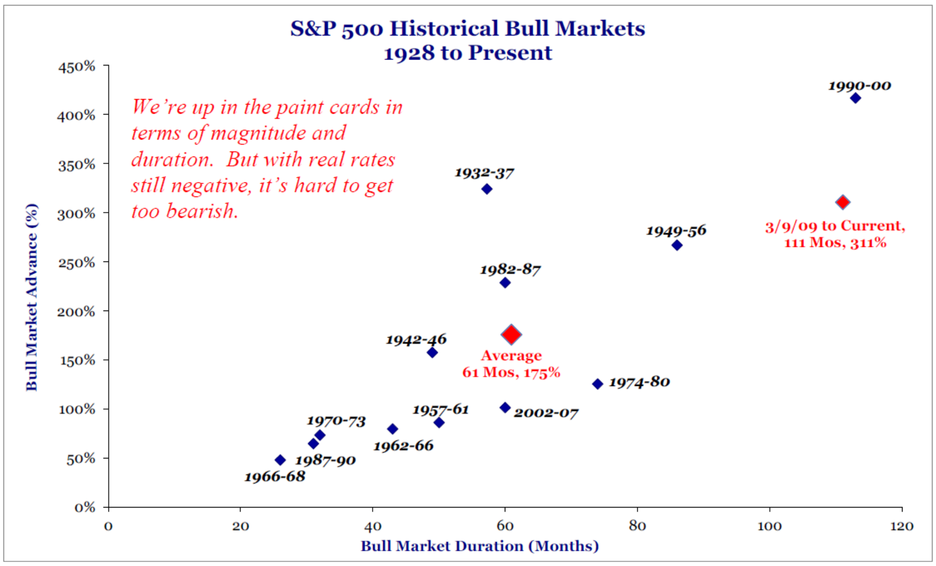
Despite all the noise around tariffs, U.S. tariff rates are at an all-time low.



Source: USITC, Statistical Abstracts of U.S. 1971-88, Historical Statistics of the U.S. Colonial Times to 1970, Douglas Irwin's New Estimates of the Average Tariff of the U.S. 1790 – 1820

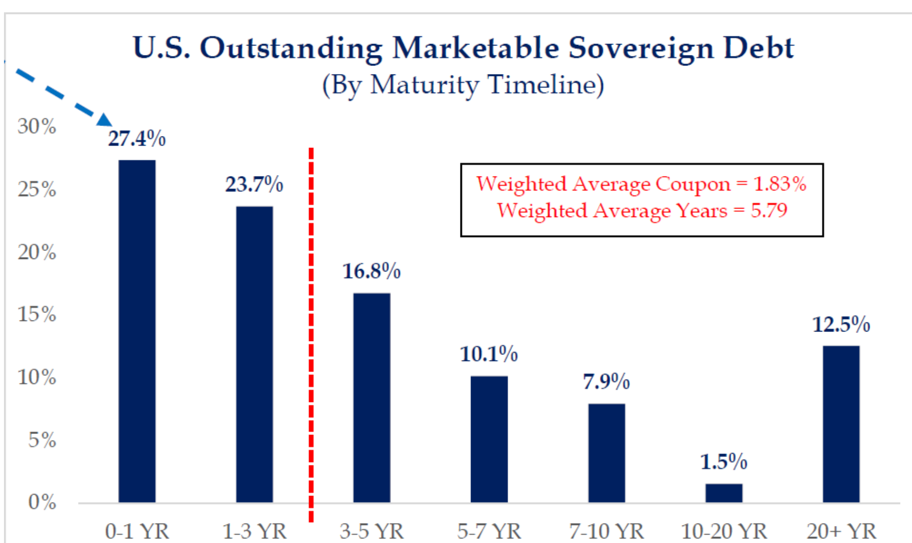
Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. The graph below shows the duration and magnitude of all prior bull market runs for the S&P 500. You can see that the average run lasts about 61 months, and the S&P 500 appreciates about 175% over this timeframe. The current cycle has now reached 111 months and appreciated 311%. This advance is now challenging the all-time greatest run of the 1990's. Part of this cycle's durability stems from where we started from, coming out of the great recession, and that we've had tremendous global stimulus for much of this time.



Source: Strategas Research

As we know, the Fed has been hiking interest rates recently removing some of the massive stimulus that has been injected into the U.S. economy over the past decade. However, the treasury better start watching the mix of debt instruments used to finance the U.S. budget deficit. As can be seen below, the current weighted average coupon on their borrowings is only 1.83%, which is in line with the current Fed Funds rate. Nevertheless, over 50% of this debt will have to be refinanced over the next three years. With the Fed predicted to raise rates two more times in 2018, irrespective of what happens in 2019, the interest costs of financing our burgeoning deficit will be escalating quite rapidly.



Source: Strategas Research

We hope that you found our second 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)) 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 Star in the Small-Mid Core Universe based on the Small Cap Core Alpha strategy's return for the year ended March 31, 2018. It also received 1 Star rating for the 1492 Small Cap Core Alpha strategy's return which ranked seventh for the quarter ended March 31, 2018 in the Small-Mid Core Universe.

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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