1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
DECEMBER 2019 • VOL. 12 • ISSUE 12
IDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY | VALUE INCOME STRATEGY

1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management's newsletter for the fourth quarter of 2019. In each quarterly newsletter, we provide our 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 strategies and our wealth management portfolios. Our investment professionals possess a tremendous amount of experience navigating through multiple market cycles. 1492's time-tested strategies are based on a three-step process of identifying investment themes from hundreds of meetings annually with company executives, extensive tire-kicking of the financial statements, and a rigorous valuation methodology. Our job is to know what we own so that our clients will too.

2018 Selloff Lowered the Bar for 2019 Gains & Tariff War Leaves More for 2020

The numbers look stellar with gains for the broader indices in the high-20% range and with the S&P 500 Index rallying to numerous new highs throughout the year. However, this outcome wouldn't have been possible without the late-2018 selloff that found the S&P 500 down over 20% from peak to trough, which provided an easy jumping off point for 2019. The math is fairly basic as following a 20% decline, you need to realize a 25% gain to break even. While the headline market returns look great, the S&P 500 will be hard-pressed to show an increase in earnings when comparing 2019 to 2018, therefore P/E expansion propelled all of the gains in 2019. As we pointed out last year, the table was set for a snapback after all of the policy missteps of 2018. The overly aggressive Federal Reserve of 2018 quickly turned into the accommodative Federal Reserve of 2019 and cut interest rates three times. Combined with stimulative policies around the globe from China and others, this Fed change managed to offset the slowing activity and uncertainty from the on-again, off-again tariff war with China.

The tariff war with China will have a long lasting impact on the global economy which we touch on in our section below entitled "China's Economic Independence Push Has Rapidly Accelerated with Tariff War". Assuming the truce in the tariff war with China lives up to the modest expectations baked into the cake currently, we believe it's at least removed a pall of uncertainty that was causing CEO's and CFO's consternation. There is nothing worse than uncertainty for managers of companies as it paralyzes their willingness to move forward on any major projects for fear that the rules will change and their decision will prove to be a poor one. However, the Phase 1 trade deal halted the imposition of future tariffs and promised to modestly roll back some existing ones. Nevertheless, it does very little to address the substantive issues that President Trump and others wanted to address like intellectual property theft and unfair competitive practices like the Chinese government's subsidization of state-owned enterprises. Nevertheless, it should cause global growth to reaccelerate, which we believe sets the table for a strong year in 2020 for small caps and international equities. Please read on to see our unique views of what's on tap for 2020, what the key drivers will be, and indulge in some stock market trivia.

We will be providing our strategy webinars and detailed performance information on 1492's strategies in a separate email in the coming week. If you would like to discuss any of our strategies with us, please contact Tim Stracka at 414-238-3398.

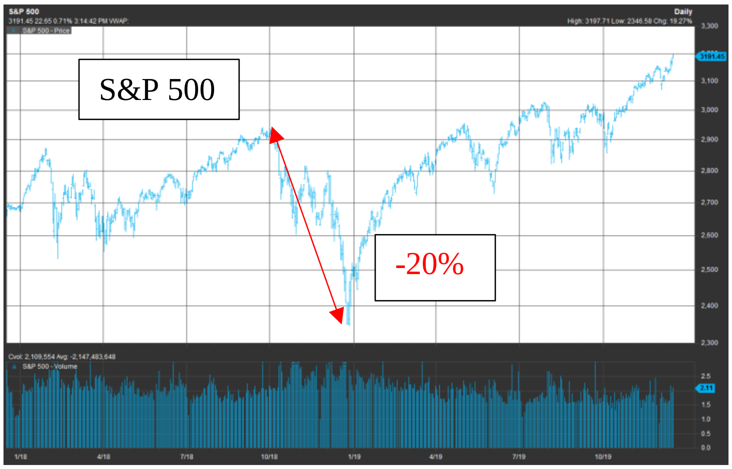
IN THIS ISSUE:

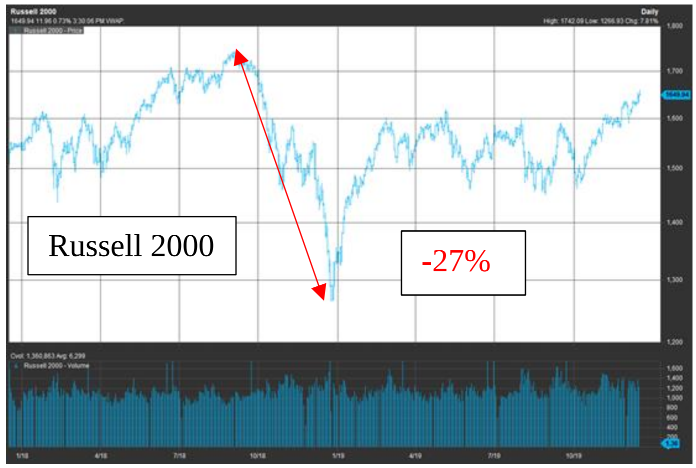
CONTACT US
1492 CAPITAL MANAGEMENT
309 North Water St. Suite 210
Milwaukee, WI 53202
Main: 414-276-1492

www.1492CapitalManagement.com

A Review of 2019: 2018 Selloff Lowered the Bar for 2019 Gains - Tariff War Leaves More for 2020

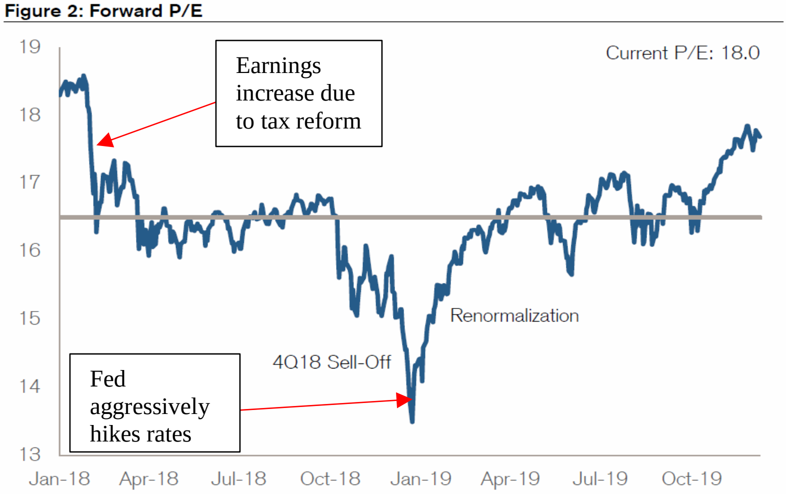
The numbers look stellar with gains for the broader indices in the high-20% range and with the S&P 500 Index rallying to numerous new highs throughout the year. However, this outcome wouldn't have been possible without the late-2018 selloff that found the S&P 500 down over -20% from peak to trough, which provided an easy jumping off point for 2019. The math is fairly basic as following a -20% decline, you need to realize a +25% gain to break even. Falling -27% peak to trough, the Russell 2000's selloff in 2018 was more severe. As seen on the 2-year charts below encompassing 2018 and 2019, the S&P 500 Index (below left) managed to post numerous all-time highs (30+) throughout the year while the Russell 2000 Index has yet to surpass its August 2018 high (below right). Much of the 2019 stock market gains were realized in the first two months of the year and the remainder of the year was spent chopping up and down due to the on-again off-again nature of the trade war. This tariff uncertainty led to a flight to liquidity and safety (i.e. The S& P 500) which favored large caps over small caps as the global economy slowed.





While the headline market returns look great in 2019, the S&P 500 will be hard-pressed to show an increase in earnings when comparing 2019 to 2018. In fact, when the dust settles on the fourth quarter earnings reports, we'll likely see full year earnings growth just fractionally above 0%. As we pointed out last year, the table was set for a snapback following all of the policy missteps of 2018. The overly aggressive Federal Reserve of 2018 quickly turned into the accommodative Federal Reserve of 2019 and cut interest rates three times. Combined with over 100 stimulative policy measures taken in China and around the globe by other countries, this change managed to offset the slowing activity and uncertainty that the on-again, off-again tariff war with China caused. Given the near-zero earnings growth, all of the markets upward movement was due to the normalization of valuations. The chart below highlights how the P/E ratio has returned to the level of early 2018 before the tariff wars began.

Figure 2: Forward P/E



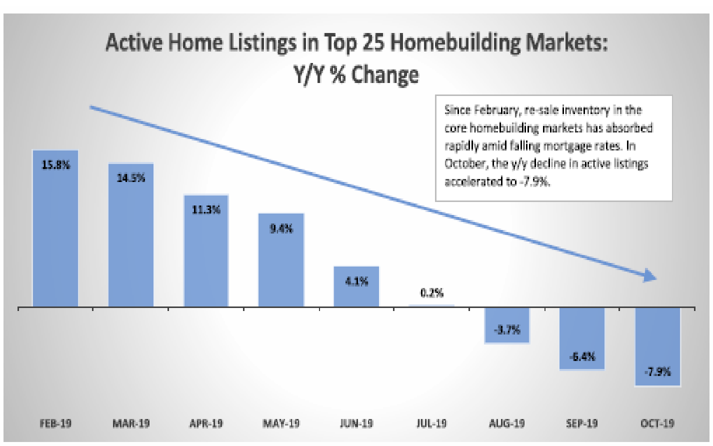
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

The tariff war with China will have a long lasting impact on the global economy which we touch on in our section below entitled "China's Economic Independence Push Has Rapidly Accelerated with Tariff War." Assuming the truce in the tariff war with China lives up to the modest expectations assumed, we believe that it's at least removed a pall of uncertainty that was causing CEO's and CFO's consternation. There is nothing worse than uncertainty for managers of companies as it paralyzes their willingness to move forward on any major projects for fear that the rules will change and their decision will prove to be a poor one. However, the Phase 1 trade deal halted the imposition of future tariffs and promised to modestly roll back some existing ones. Nevertheless, it does very little to address the substantive issues that President Trump and others wanted to address like intellectual property theft and unfair competitive practices like the Chinese government's subsidization of state-owned enterprises. The tariff-driven uncertainty caused a severe underperformance in stocks moving down the market cap spectrum. The chart below highlights the incredible disparity even within the Russell 2000 where the differential between the largest market cap quintile and the smallest market cap quintile was a whopping 11.6%. This typically happens when the industrial economy slows like it did in 2012 and 2015, but this year's disparity was enormous by any standard. Through October, the spread between the top and bottom quintiles was over 21% and the gap was only closed with a frenzied surge in biotech stocks over the last two months of the year (+32% in the fourth quarter alone). Many of these equities are money losing, early stage companies. Biotech stocks surged as a result of a couple of high profile takeovers and drug study test results and as Elizabeth Warren faded from the pole position in the Democratic Presidential race as she is pushing a Medicare For All policy which is perceived to be negative for all of healthcare.

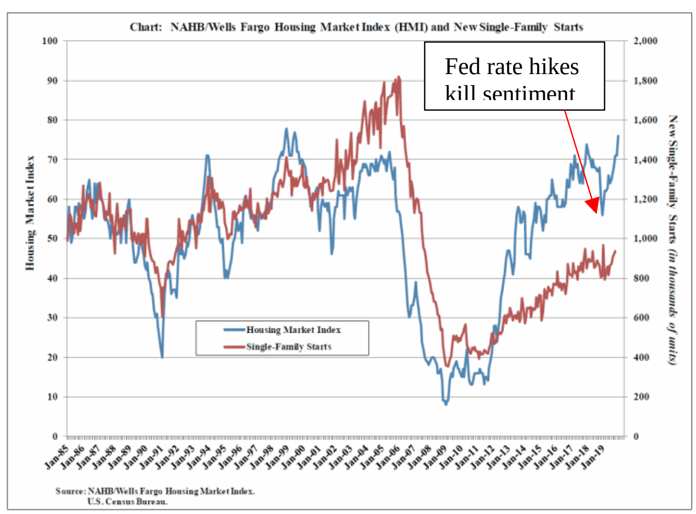
Size Quintile	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
1 (Largest)	1.62	0.88	-1.26	8.60	4.73	-1.34	26.68	14.11	1.17	53.3
2	3.50	0.88	0.62	10.82	2.68	0.88	26.78	6.73	1.28	25.2
3	4.34	0.53	1.46	10.48	1.27	0.54	20.23	2.63	-5.27	12.5
4	7.38	0.44	4.49	16.85	0.98	6.91	26.39	1.62	0.88	6.3
5 (Smallest)	6.00	0.15	3.12	10.79	0.27	0.86	15.05	0.40	-10.45	2.6

Source: Jefferies

Homebuilders was one of the best performing industries in 2019 and it helped to keep the industrial economy from slipping further into a hole. The sensitivity that this group has shown in both 2018 (to the downside) and 2019 (to the upside) has been amazing to watch. In 2018 as the Fed was aggressively hiking interest rates, 30-year mortgage rates rose to nearly 5%, which was the highest level since 2011 and homebuyers evaporated. With the Fed cutting rates in 2019, 30-year mortgage rates dropped into the mid-3% level, which forced buyers off the couch and into their bank. If this sector wasn't strong in 2019, we may have seen a full-blown recession. The rapidity in which home inventory around the country shrank over the past year has been breathtaking. The chart below left shows this phenomenon as the most recent home inventory levels are down nearly 8% versus a year ago. Are millennials finally getting out from their parents' basements? The chart below right shows the NAHB housing market index (builder's sentiment) has surged in 2019, and the orders for new single family homes have rebounded as well.

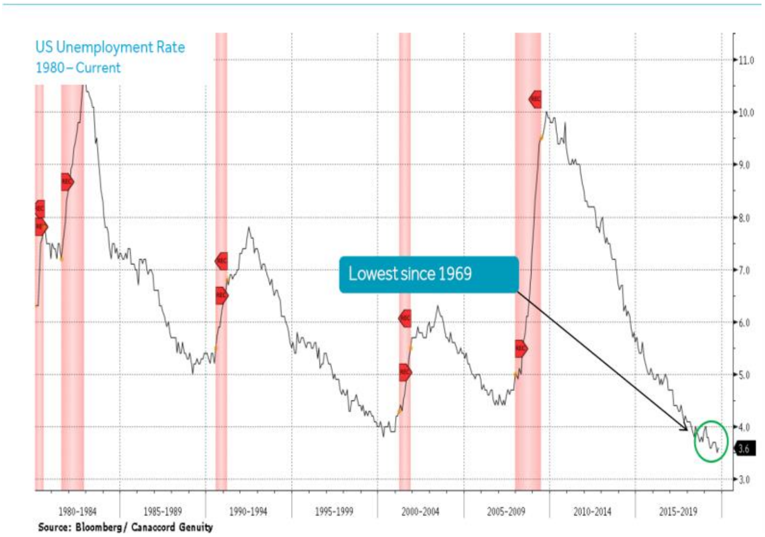


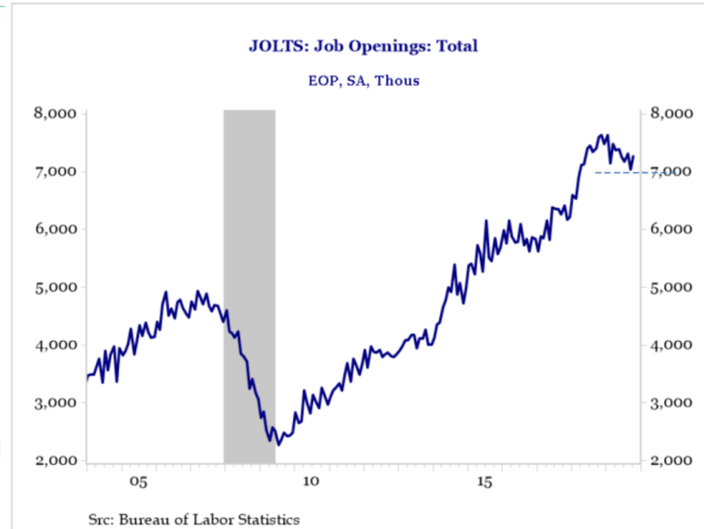
Source: Local Realtor Board Updates, National Association of Realtors, Census Bureau, BLS, and Raymond James research



The health of the U.S. consumer undoubtedly carried the day as jobs are plentiful, unemployment is low, and incomes are increasing significantly faster than inflation. As the chart below left shows, the U.S. unemployment level is the lowest since

1969, and job growth continues at a very healthy pace despite industrial weakness. The chart below right shows that the number of job openings are still at 20-year highs although down from their early-2018 peak.





Despite the tit-for-tat tariff war with China for much of the year, the stock market finished the year remarkably well. While large caps led for most of the year and were the medalist of 2019, small caps closed the gap on a late in the year surge in biotech stocks, which are now the second largest industry weighting within the Russell 2000 Index. While the markets chopped sideways between February and October, it was the tariff accord (and speculation around it) that popped the cap off the market. For a time, it appeared that the "value" indices were finally going to overtake the "growth" indices, but the falloff in traditionally value-heavy sectors like Utilities, REIT's, and Consumer Staples allowed the "growth" indices to win the annual race once again. The "growth" indices have outperformed the "value" indices in nine out of the last eleven years. The table below highlights the returns for the fourth quarter and full year 2019 for the popular indices.

Index Returns		
Index	Fourth Qtr. 2019 Return	2019 Return
Russell 2000	9.95%	25.61%
Russell 2000 Growth	11.39%	28.47%
Russell 2000 Value	8.49%	22.39%
S&P 500	9.07%	31.49%
Dow Jones Industrials	6.02%	22.34%
NASDAQ Composite	12.47%	36.69%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (+11.39%) trumped the Russell 2000 Value Index (+8.49%) in the fourth quarter, and widened its full year 2019 lead to +28.5% versus +22.4%, respectively. As mentioned above, growth indices outperforming value indices has become a common refrain since the Great Recession, but value stocks' late-in-the-quarter rally has some wondering if the tide is going to turn in their favor in 2020. We contend that this shift will only be sustained if we see an acceleration in economic statistics which likely only comes on the heels of a China trade deal. All of the sectors within the Russell 2000 Growth Index finished with positive returns for the year and the typical "risk off" sectors of Real Estate (+3.66%) and Utilities (+0.95%) were the weakest in the fourth quarter as odds of a tariff deal increased. In an odd twist, the only sector in the Russell 2000 Growth index that beat the benchmark for the quarter was Healthcare which surged +23% in the quarter on the heels of the biotech stock surge of +32% that we mentioned above. The worst performing sector in both the Growth and Value indices was Energy. We attribute this weakness to concerns that this sector will be most affected should the Democrats win the White House in 2020 and the current slowing of the industrial economy, despite the price of oil being up +34.5% for the year. The best performing sector in the quarter was Healthcare (+22.4%) due to the surge in biotech stocks that we mentioned above. The first two tables below highlight the performance of the Russell 2000 style indices by sector for the month of December, the fourth quarter, and year-to-date 2019.

Table 13 - Russell 2000 Growth's Performance Attribution through December 31

	December			Fourth Quarter			Year 2019			
Russell Sector	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
Discretionary	2.23	0.30	-0.06	9.91	1.39	-1.48	26.79	4.70	-1.68	13.6
Staples	4.15	0.12	1.86	5.91	0.16	-5.48	17.37	0.49	-11.10	3.1
Energy	9.68	0.10	7.39	2.47	0.02	-8.92	3.56	0.13	-24.91	1.1
Financials	1.22	0.08	-1.07	7.88	0.52	-3.51	22.51	1.72	-5.96	6.3
Health Care	4.42	1.31	2.13	23.23	6.25	11.84	32.52	8.50	4.06	30.0
Mat. & Process	2.60	0.18	0.31	9.19	0.64	-2.20	34.14	2.38	5.67	6.8
Prod. Durables	1.45	0.24	-0.85	6.59	1.13	-4.80	31.14	4.89	2.68	16.0
Real Estate	0.95	0.04	-1.34	3.66	0.18	-7.73	26.25	0.92	-2.21	4.6
Technology	-0.67	-0.12	-2.96	6.16	1.03	-5.23	27.08	4.44	-1.39	16.0
Utilities	1.30	0.03	-0.99	0.95	0.02	-10.44	19.30	0.38	-9.17	2.3

Table 15 - Russell 2000 Value Performance Attribution through December 31

	December			Fourth Quarter			Year 2019			
Russell Sector	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
Discretionary	2.48	0.31	-1.02	8.13	1.01	-0.43	16.01	2.12	-6.47	12.1
Staples	5.05	0.08	1.54	6.27	0.10	-2.29	10.40	0.21	-12.08	1.7
Energy	16.61	0.83	13.10	5.91	0.28	-2.65	-7.86	-0.71	-30.34	5.6
Financials	2.34	0.67	-1.17	7.59	2.12	-0.97	22.65	6.06	0.17	27.5
Health Care	2.65	0.14	-0.85	17.79	0.89	9.23	14.59	0.77	-7.89	5.2
Mat. & Process	3.68	0.24	0.17	11.18	0.70	2.62	28.07	1.62	5.59	6.4
Prod. Durables	3.33	0.42	-0.17	11.04	1.36	2.48	27.30	3.14	4.82	12.5
Real Estate	0.45	0.05	-3.05	3.60	0.53	-4.96	27.73	3.91	5.24	13.8
Technology	6.75	0.57	3.24	22.88	1.76	14.32	54.94	4.24	32.46	8.7
Utilities	3.15	0.20	-0.35	-2.70	-0.20	-11.26	15.52	1.23	-6.96	6.3

Source: Jefferies

Progress on the trade war front sent international stock markets up nicely in the fourth quarter after a fairly slow start to the year, particularly in China. The Chinese stock markets surged later in the year as the Chinese government initiated over 100 stimulative measures over the past twelve months to reinvigorate their slowing economy. The fall in the VIX volatility measure tells the whole story for stock markets around the globe. It started at an elevated level in January after the stock market swoon late in 2018. Volatility continued to fall for most of the year as the Fed eased interest rates and progress was made on the tariff front. Treasury bonds had a decent year despite falling in the fourth quarter as uncertainty created by the tariff war began to fade. Energy markets were bifurcated with Oil up significantly for the year, whereas the natural gas market was weak as there remains a glut of natural gas in the U.S. that doesn't seem to have an end in sight. Most other hard commodities were up low double digits on the year as there was broad optimism that the global economy would reaccelerate following a trade deal.

Index Returns

Index	Fourth Qtr. 2019 Return	2019 Return
France	5.50%	30.50%
Germany	6.60%	25.50%
Brazil	10.40%	31.60%
India	6.80%	15.70%
China- A Shares	5.00%	22.30%
China- Shenzhen A Shares	8.00%	36.00%
Japan	8.90%	20.70%
Long-Term Treasuries (TLO)	-5.30%	10.90%
Investment Grade Corp Bonds	1.30%	14.80%
Gold	3.40%	18.90%
Volatility- VIX index	-15.20%	-45.80%
Oil	12.90%	34.50%
Natural Gas	-6.10%	-23.20%
Lumber	10.40%	21.90%

Source: 1492 Capital Management, LLC and FactSet

Predictions and Prognostications in 2019: How Did We Do?

While we aren't in the business of making formal forecasts on the economy or on the stock market, we thought it would be interesting to review our 2019 outlook from a year ago and see where our prognostications hit and missed the mark. Our predictions/prognostications from our fourth quarter 2018 newsletter are in italics below.

While we're not in the business of making predictions, we always present some directional views on where we think the market will trend over the next year. If, and it's a big if, the tariff war with China can be resolved in short order (in the first quarter) and the Fed backs off on rate hikes early in the year, we believe the stock market could have a sizeable move to the upside given the market selloff late in 2018 which lowered the bar to a stock market recovery. The resolution of the other policy missteps around the globe, like Brexit, will just be icing on the cake. However, at the end of the day, markets are most influenced by earnings and fundamentals. We expect fourth quarter 2018 earnings reports to be relatively good for most companies but given the turmoil of late, we expect companies to use the cover provided by the recent market downturn to lower earnings expectations for 2019 as they'll try to under promise and over deliver. As we move through 2019 and some of the major issues are clarified, growth could reaccelerate compared to dramatically lowered expectations given the stimuli we mentioned above. Many of the things that have been supportive to the economy will remain in place like historically low interest rates, low unemployment, and accelerating wages, we believe. The environment should remain supportive of M&A activity given the low relative valuations of stocks that we highlighted above. Small cap valuations relative to large caps remain below the long-term median level and are supportive of outperformance. However, the wild cards remain Trump, foreign relations, and global stimulus. Therefore, our prediction, similar to last year is that the market will likely be strong over the first half of the year and then pause as the market starts to look forward to 2020 earnings growth. The bottom line is that there is still a widening relative valuation gap for small caps and with earnings growth potentially greater than 10% (due to full year impact from tax cuts), we wouldn't be surprised to see an advance of 10-15% by year's end.

With the help of hindsight, several of our comments from a year ago were spot on, but the timing was slightly off. For example, we didn't expect the tariff agreement to take until the fourth quarter but we did caution that it was a "big if" to be settled early in the year. We were correct when we said if the Fed halts rate hikes early in the year, which they did, that we believed the stock market could have a sizeable move to the upside from the late 2018 swoon. Much of the markets move happened early in the year following the Federal Reserve's signaling that rate cuts were in the cards in 2019. While Brexit hasn't officially been completed, the recent election in the U.K. certainly makes it appear likely in short order and probably adds icing on the cake in 2020. Our expectations for earnings growth weren't met, but the reacceleration in the economy given the tariff accord has put an accelerating global economy back on track. Our prediction for a strong first half was also correct with much of the year's gains happening in the first two months of the year as the tariff war kept advances for much of the rest of the year in check. Small caps certainly didn't outperform due to the tariff-induced slowdown, but our prediction of 10-15% appreciation which was aggressive at the time, thankfully turned out to be conservative.

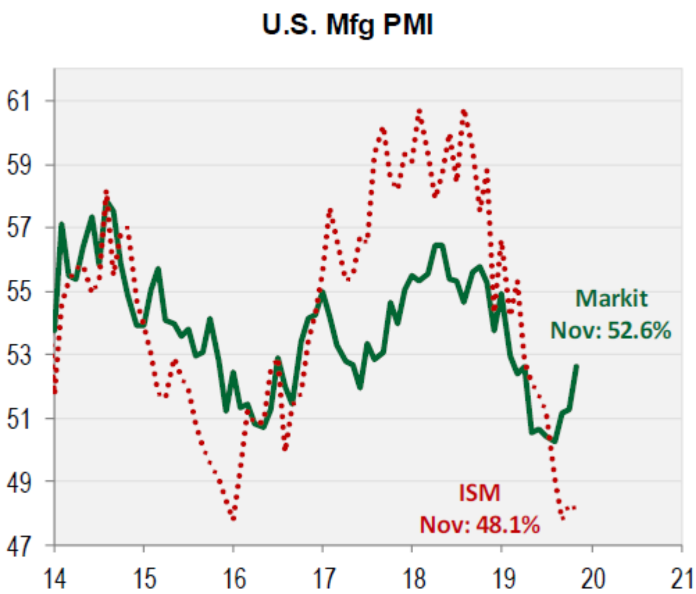
2020 Outlook: The Deck Looks Stacked in Favor of Small Caps

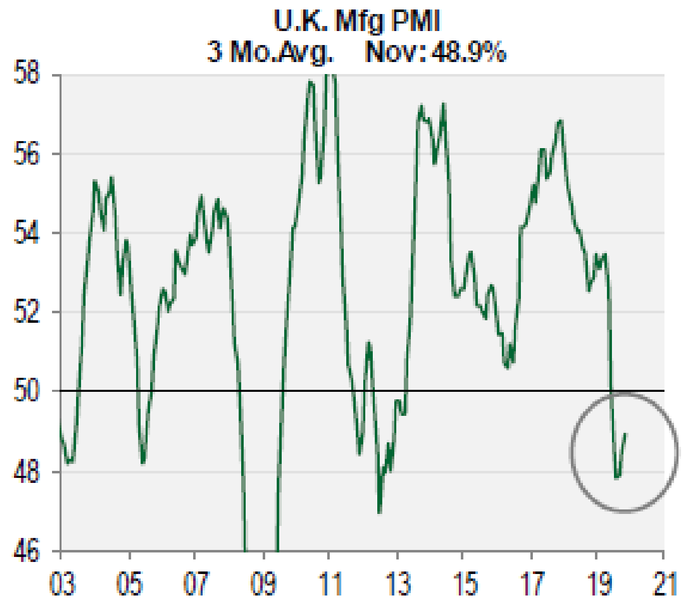
While it's certainly self-serving as small cap specialists to predict a strong small cap market, we believe that the weight of the evidence is clearly leaning in their favor. First, if you simply deconstruct the returns of the S&P 500 in 2019, the two heaviest hitters in the S&P 500 index, namely Apple and Microsoft, soared 89% and 58%, respectively, and accounted for nearly 20% of the S&P 500's returns for the year. These trillion dollar mega cap stocks are unlikely to repeat this feat in 2020. We're not predicting any major swoon for these stocks in 2020 as they are still very well positioned, but their returns are likely to be much more muted. Before we make the case for small caps over large, we'll present our views for 2020 from a broader market perspective.

The Economic Outlook

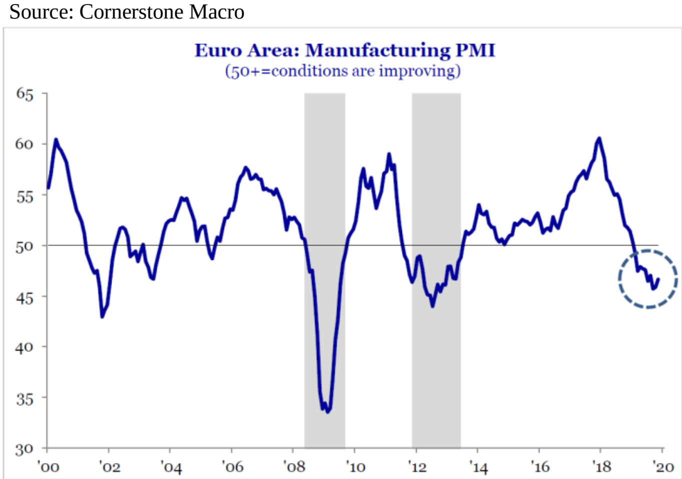
Now that the tariff war appears to be receding, it certainly removes a significant roadblock to escalating GDP growth rates in 2020. In addition, Brexit's overhang on the European economy appears on track to be imminently removed with the mandate that Boris Johnson's party received in the recently completed British elections. While it's difficult to quantify the Brexit overhang, it undoubtedly created uncertainty in Europe as companies froze major initiatives for fear that the rug would be pulled out from under them. These developments, the Fed's three rate cuts in 2019, and China's stimulative measures that now total more than 100, set the table for accelerating economic growth in 2020. The green shoots are starting to pop up as PMI's (purchasing manager's index) are starting to bottom, if not, bounce. Below, we show the PMI indices for the major economic powerhouses around the globe. Below left, is the U.S. PMI. There are two measures shown; the Markit which is more U.S. centric and the

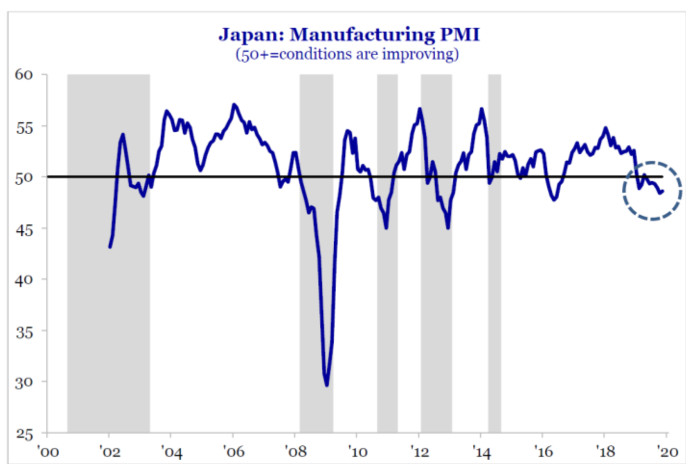
ISM which weighs international activity more heavily. Both of them appear to have bottomed in September with modest bounces in the latest reading in November. Below right is the U.K. PMI reading which also appears to be bouncing. The two far below represent the Euro area and Japan. While neither of these data points are that convincing, there appears to be stabilization.





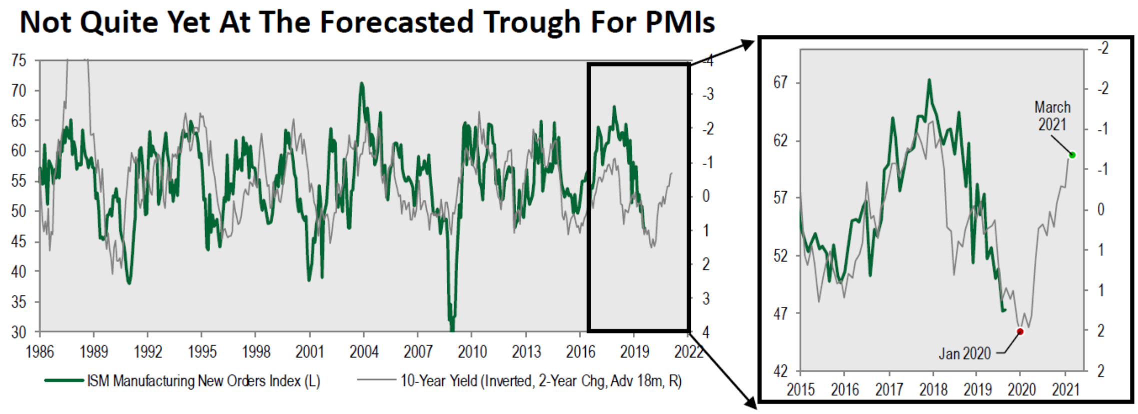
Source: Cornerstone Macro





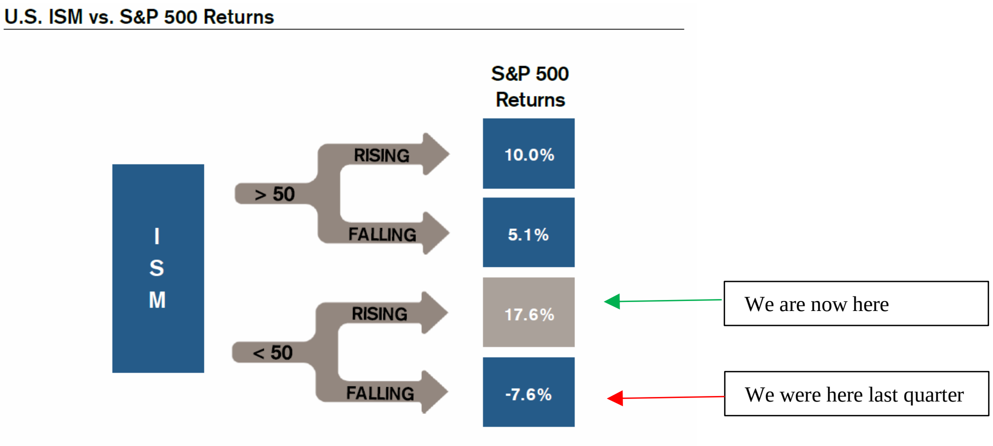
Source: Strategas Research

This analysis leads us to one of our favorite charts for identifying turning points in the global economy. The chart below, which we've shown in the past, compares the two year change in the 10-year yield advanced 18 months. The advancement of the series 18 months makes sense because it takes time for rate cuts to work their way through the economy and provide the intended stimulus. The long-term chart is shown on the left pane, and the last five years is shown on the right pane. As the right pane shows, we're getting close to the bottom in the PMI as the change in rates predicted, but the actual bottom may have already occurred in September.



Source: Cornerstone Macro

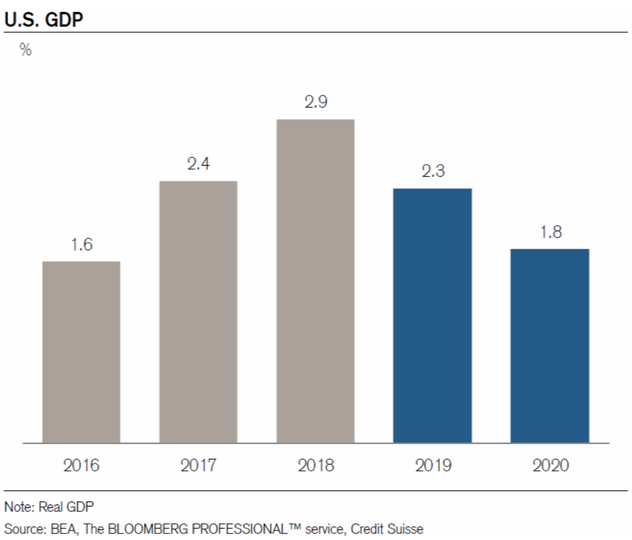
Despite the recent month's ISM readings being below 50 (50 is the line of demarcation between a growing and shrinking industrial economy), it generally is the best when examining forward returns in the stock market. We showed the chart below last quarter but we were in the ISM <50 and falling category. Based on the latest reading as shown above, it now appears that we're in the <50 and rising category. This level has historically resulted in average forward 12-month returns of +17.5%.

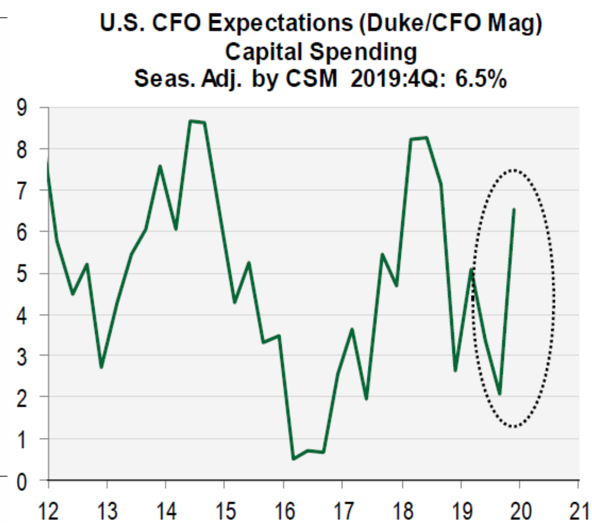


Note: 1970 to present, forward 12-month returns based on ISM change
Source: Standard & Poor's, Institute for Supply Management, Haver Analytics®, Credit Suisse

The last two industrial slowdowns in the post-recession recovery, in 2012 and 2015, were precursors to strong years in the stock market the following year. The chart below highlights the prior two industrial slowdowns and the current one in 2019. Interestingly, the year following these troughs the S&P 500 was up +32.4% and +12%, in 2013 and 2016, respectively. Similarly, the Russell 2000 advanced +38.8% and +21.3%, in 2013 and 2016, respectively. While those performance figures are pretty heady, and it's tough to forecast the same magnitude of returns going forward, we believe that they are directionally instructive.

The conspiracy theorist in us thinks that President Trump saw the global slowdown unfolding and realized that if he settled the trade dispute with China too early, the economy would peak and be in a slowing mode or worse come mid-2020, which is right before the presidential election. In order to avoid this outcome, he used delay tactics in structuring any deal with the Chinese. In the meantime, the uncertainty that ensued following these tactics sent U.S. industrial statistics to levels not seen since the 2008 recession. This decline has caused the U.S. GDP growth to decelerate to around 2% in the fourth quarter. It could have been far worse if the consumer wasn't so strong. In the chart below left, you can see that the forecast for 2020 GDP is another step down from the 2019's level. Capital expenditures in the second half of 2019 have been very weak as many new projects were likely halted as escalating tensions with the Chinese caused uncertainty. The timing of the deal with China was required in order for the economic statistics to begin accelerating again before the 2020 elections. There is likely some pent up demand from companies that deferred projects in 2019 and from those that accelerated inventory shipments into the earlier part of 2019 in order to avoid the projected tariff hikes. As inventories normalize in the coming months, we're likely going to see an uptick in buying patterns. The chart below right shows how CFO expectations of capital spending have waned since the beginning of the tariff war. The notable bounce in the last month is a major positive for 2020 as CFO's are in the midst of budgeting for 2020. The combination of the higher capex, increased corporate confidence, and normalized buying patterns could actually turn 2020 into a decent growth year from a GDP perspective.

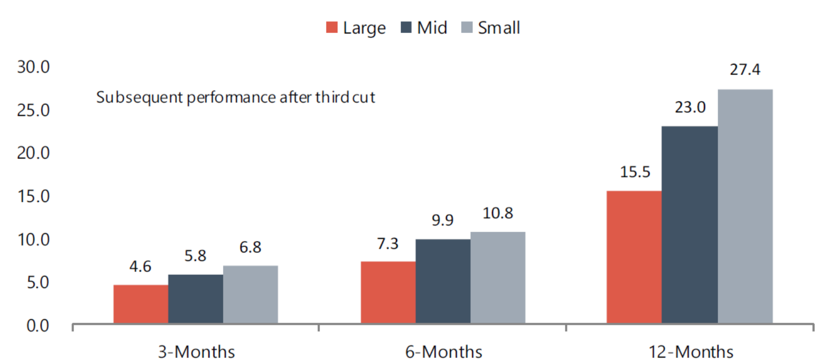




Source: Cornerstone Macro

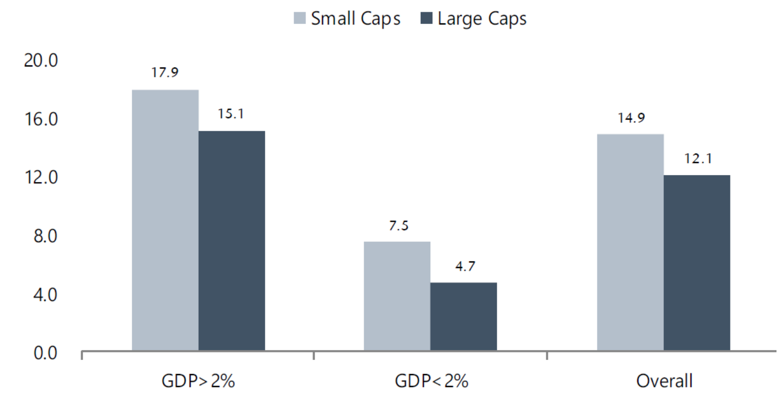
2020 Setup for the Stock Market Has Some Nice Tailwinds

The economy is starting to show some green shoots as we've discussed above due to the Fed's three rate cuts and China's aggressive stimulus programs. There is a fine line between how the stock market acts following three rate cuts versus more than three. Interestingly, the stock market likes the "policy correction" mode that three or fewer rate cuts implies versus the "policy mistake" mode that more than three rate cuts depicts. The chart below shows the performance of the stock market in the twelve months following the Fed's third rate cut. It's quite positive if September marks the Fed's last rate cut. It's particularly positive for small caps.



Note: Used Fed Funds from 1954 until 1963, then used the Discount rate from 1963 until 1994 and Fed Funds rate after that. The performance was calculated (or Derived) based on data from 2016 CRSP cap-weighted database.
Source: Federal Reserve Board; Haver Analytics; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

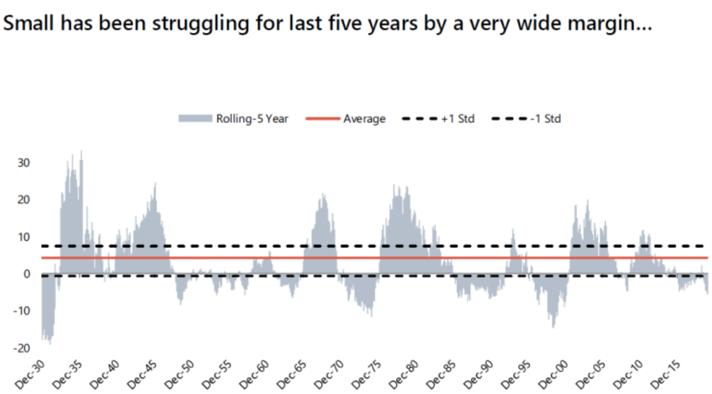
If U.S. economic growth can manage to grow north of 2% in 2020 compared with the current consensus of +1.9%, the implications from a stock market standpoint can be quite stark. As shown in the chart below when GDP growth is greater than 2%, the stock market returns are quite a bit better than when growth slows below 2%.



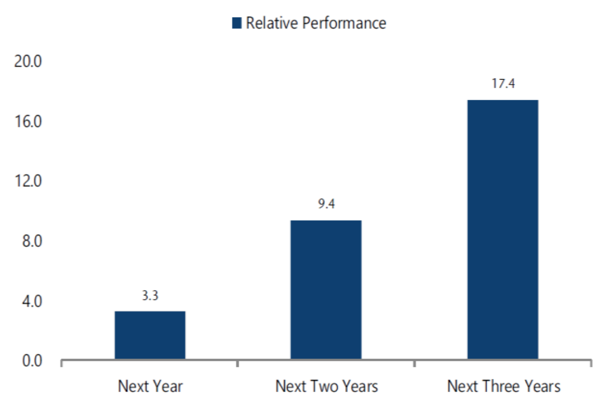
Source: FactSet; FTSE Russell; Jefferies

Bringing It Back to Small Caps

The setup for small cap stocks in 2020 is quite compelling, especially if the economy shows some signs of acceleration. Frankly, part of the positive setup into 2020 is due to their significant underperformance over the past few years. For example, as the chart below left shows, small caps have been struggling relative to large caps on a rolling 5-year basis. The good news is that this lag is in the rear view mirror. The chart below right shows that following these periods of small cap underperformance, small caps show strong relative performance to large caps over the next three years.



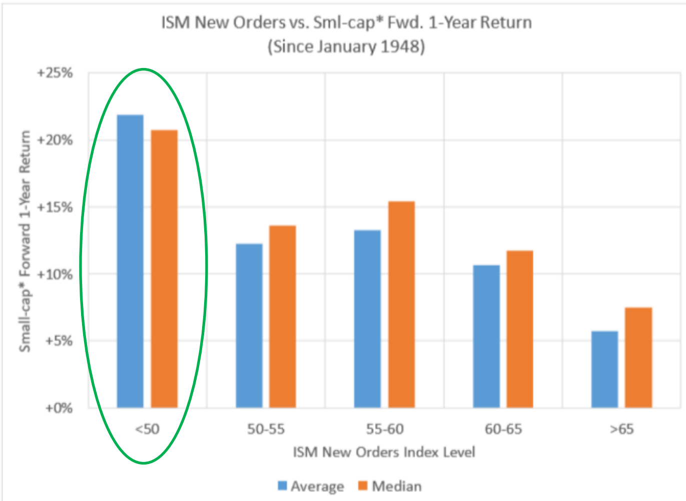
Note: Data as of 11/30/2019.
Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies



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

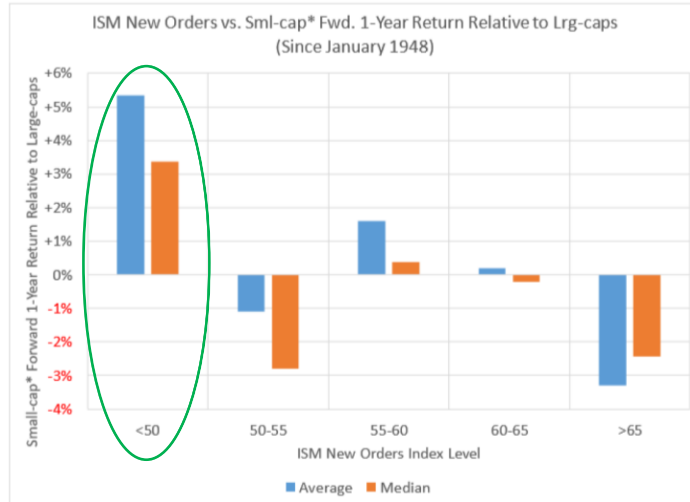
As we mentioned earlier, our thesis of small caps outperforming large in 2020 is predicated on an economic acceleration. The latest reading for the ISM new orders index is 47.2 in November, which is the lowest reading since April 2008. However, when the new orders index is below 50, the stock market broadly and small caps in particular, have the best average performance. This event is due to the perception that negative readings portend an imminent bottom in the economy, and stimulus measures are generally being taken to reinvigorate economic activity. The below charts highlight this phenomenon. The chart below left shows the forward one year returns when the ISM New Orders index is below 50. The average forward one year return is greater than 20%. The chart below right shows small caps relative returns versus large caps on a one year forward basis. The average outperformance is greater than 5% for all observations going back to 1948. The ISM New Order index fell below 50 for the first time since the great recession in August 2019. We expect that the China and USMCA trade deals should cause upward momentum in this index imminently.

Fig. 6. **When ISM New Orders falls below 50, forward small-cap returns are strong on average…**



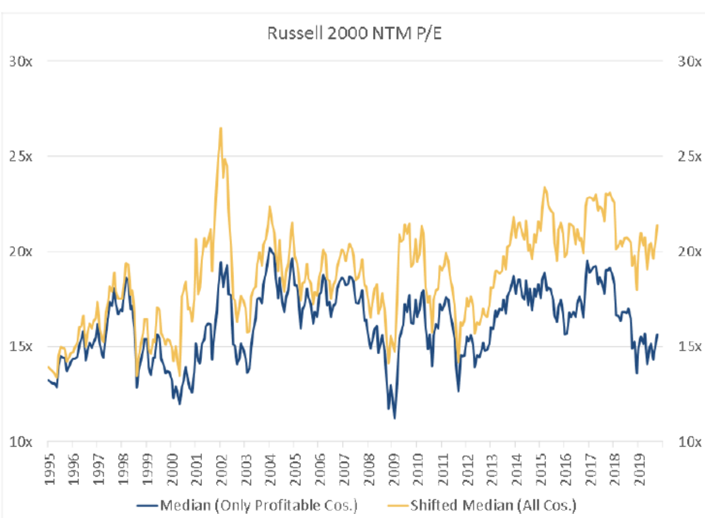
Source: FRP, FactSet; as of 11/30/19

Fig. 7. **…as are forward small-cap returns relative to large-caps**

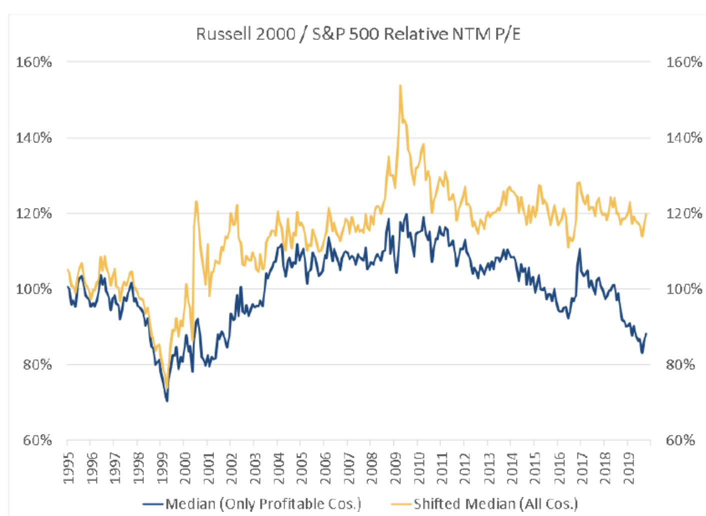


Source: FRP, FactSet; as of 11/30/19

The performance gap between small and large caps over the past few years has led to a pretty dramatic valuation disparity between large and small caps. The Russell 2000 Index of small caps has become littered with non-earners that tend to make its valuation seem quite high when compared with the S&P 500 for example. The Russell 2000 Index as currently constructed has nearly 40% of its constituents that don't make any profit, which is primarily a function of the hundreds of biotech stocks that have come public over the past decade and that have been added to the Russell 2000 Index. Nearly all of them are early stage companies that don't earn money. If you exclude these companies from the index and simply look at profitable companies, the valuation for small caps is quite compelling. The chart below left shows the P/E ratio for the Russell 2000 Index through time. The blue line shows only profitable companies and the yellow line shows all constituents. As you can see, the blue line hovers just around the 15 P/E level, which is one of the lowest levels in many years despite interest rates at historically low levels. The chart below right shows the relative valuation of the Russell 2000 versus the S&P 500. Again, the blue line shows only the profitable copmanies whereas the yellow line shows all constituents. The relative valuation for profitable small caps has been in decline since 2016, which is when small caps had their last significant year of outperformance relative to large caps. The relative valuation levels are the lowest since 2002. With all of the capital on the sidelines at private equity firms, we bet that the market's or private equity's M&A activity will close this valuation gap. In any event, the setup is quite compelling.



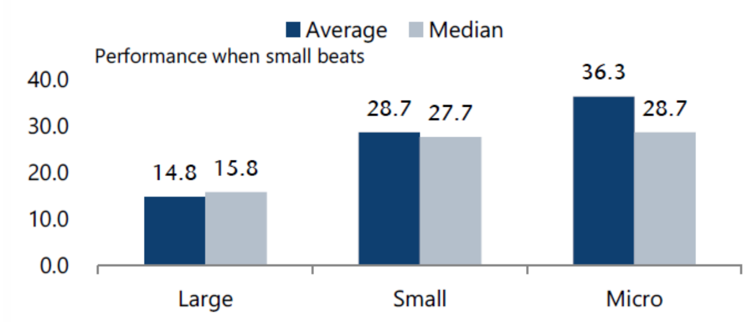
Source: Furey Research Partners, StockCharts.com as of November 18th, 2019



Source: Furey Research Partners, StockCharts.com as of November 18th, 2019

Lastly, when small caps outperform large caps, they ususally do so in grand fashion, and the returns are linearly better moving down the market cap spectrum as shown in the chart below.

Chart 4 - When small beats large, smaller small really works



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

Our Fearless Forecast for 2020

While we're not in the business of making predictions, we always present some directional views on where we think the market will trend over the next year. We expect 2020 will get off to a slow start from an economic standpoint due to an earlier Chinese New Year and remaining uncertainty about the go-forward rules around trade (although this should quickly be resolved with China). Another headwind is the uncertainty around Boeing and their production issues related to the ongoing 737-Max jet saga. While it is just a single company, Boeing's issues have a disproportionate impact on certain economic statistics and resonate through its huge supply chain. Based on the latest forecasts, Boeing should be back up and producing at more normalized rates late in the first or early second quarter of 2020. The GM strike, which was a headwind to the economy late in 2019, should turn to a tailwind in 2020 as production normalizes. We also face easy comparisons in the first half of 2020 in many industries due to the excessively wet weather that much of the country experienced in the first half of 2019. It's hard to imagine that the weather impact could be much worse in 2020 but it, as always, is a wild card. Lastly, we'll have to endure a year of intense political noise as we approach the November Presidential election. Election years can be very interesting from a stock market perspective, and I don't imagine 2020 will disappoint. See our Market Trivia section below which highlights trends from prior election years. The individual who rises to the top of the chart of Democratic candidates for President will likely impact the outlook for significant portions of our economy, like healthcare if Elizabeth Warren gets the nomination, etc.

It's likely that the Brexit saga comes to an end which could unleash a torrent of activity in the U.K. and Europe which has been suppressed as companies were unsure of how it would end and what the rules would be. This improvement is likely another tailwind to go along with the tariff agreements in China and the new USMCA agreement between the U.S., Canada, and Mexico. As we've highlighted in the earlier parts of this newsletter, the economy has slowed dramatically but central banks' stimulative measures have already come to the rescue. It's interesting to note that the price of copper and oil, two of the best historical predictors of economic activity, have recently rebounded. In fact, oil is now up 32% year to date. Consistent readers of our newsletters know that we've long professed that U.S. economic activity is highly positively correlated with higher oil prices. As we work through some of these issues mentioned above, the first half of the year may not be much to write home about, and we'll also need to digest the significant gains that were tallied in 2019. The earnings comparisons that we'll face in the second half of the year will be quite easy given the economic weakness that we've just experienced over the past several months. However, it's the rate of change that matters, and we should see nice year-over-year growth in the second half of 2020 as a result. Many of the things that have been supportive to the economy will remain in place like historically low interest rates, low unemployment, and accelerating wages with subpar inflation. This environment should be supportive of M&A activity given the low relative valuations of small caps as we mentioned above. The wild cards remain Trump, the election, and China. Therefore, our prediction is that the market in the first half of the year will likely digest gains and assess the trajectory of the second half recovery before putting in another strong upside move in the second half. If our assessment is right, we should see accelerating earnings growth that approaches the high single digits in the second half of the year. This acceleration will lead the market higher as we move toward the end of the year and as the Presidential election is behind us. The bottom line is that there is a larger gap between small and large cap valuations that we haven't seen in almost 20 years. This gap leads to small cap outperforming large caps and an advance approaching 10% for the broader market and potentially more for small caps.

2020 Outlook: China's Economic Independence Push Has Rapidly Accelerated with Tariff War

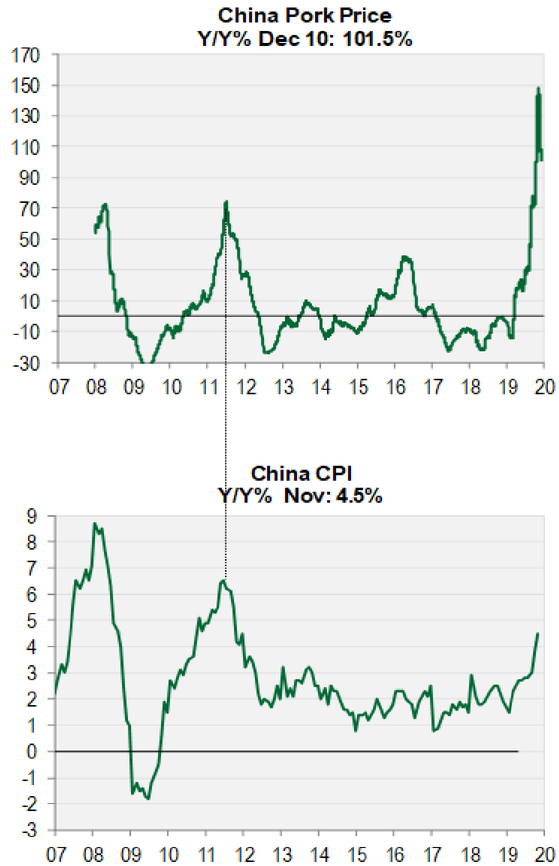
The consequences of the tariff war with China have become painfully obvious as you examine how the global economy has slowed substantially since the outset of the war in early 2018. It has affected hundreds, if not thousands, of U.S. companies that have had to pay tariffs on goods imported from China and rejigger their entire supply chains to move into other low-cost labor countries to avoid a potentially protracted tariff war. However, the one item that President Trump didn't put into his calculus was that he may have just awakened a sleeping giant. China is certainly a giant, and they may not have really been sleeping given the fast paced growth that they've experienced for much of the past twenty years. However, Trump's plan to go after China for economic abuses was long overdue given their history of intellectual property theft and subsidized state owned enterprises that made competing against them on a global scale difficult. He prohibited U.S. suppliers from providing components to blacklisted Chinese companies like Huawei and numerous others. China is a proud country and they do things their own way. The ban on U.S. companies doing business with Huawei, one of the largest technology companies in the world, may be the straw that broke the camel's back from China's perspective.

Huawei is viewed as China's crown jewel, and this ban on them and others likely accelerated the "made in China 2025" initiative. China has long been a fertile market for many U.S. technology companies to sell due to the rapid pace of growth and the sheer magnitude of their ever-growing middle class. The China 2025 initiative was a public declaration as was the directive to all Chinese government and public-facing offices to replace any equipment (i.e. Computers) featuring foreign components. The so-called 3-5-2 policy which derived its name due to the plan's timeline of replacing 30% of foreign equipment in 2020, 50% in 2021, and 20% in 2022. Analysts estimate this initiative equates to nearly 30 million computers and has unfortunately created a technological cold war that is unlikely to improve any time soon. Through discussions with the many companies we invest in and interview, it's become clear that a private mandate has been issued to Chinese companies, in particular technology companies, to avoid using U.S. company components such as our all-important semiconductors. This change will drive significant market share loss for U.S. companies as many Chinese manufacturers have already started using non-U.S. components that clearly aren't best of breed but will do. Huawei just recently announced a new line of smartphones, the Mate 30, that don't have a single dollar of U.S. content in them. This move is just the tip of the iceberg. China has already spent tens of billions of dollars acquiring semiconductor technology over the past decade as they viewed this technology as a key linchpin to control their destiny and to grow their economy rapidly. In October the Chinese government created a new $29 billion fund to invest in the semiconductor industry. There is already ample evidence that U.S. companies are losing share in China, and if they lose 5-10% share per year, analysts predict this will lead to a 1- 3% growth headwind each year for the U.S. companies with exposure. While some of the tariff discussions are aimed at averting an all-out technology cold war, we worry that we've already reached the point of no return.

2020 Outlook: A Picture is Worth a Thousand Words

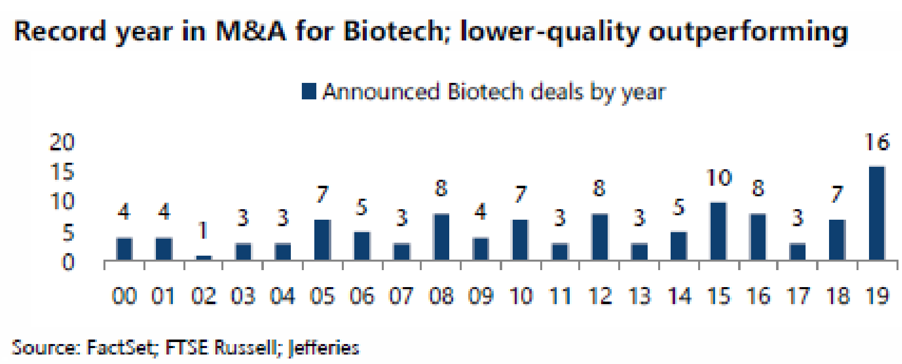
Above we articulated our 2020 outlook and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided to express 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.

The African Swine Fever, which is highly contagious, has ravaged China's pig population over the past year. Pork is by far China's largest source of protein in their diet. Below are charts that show pork price inflation and the effect on the overall inflation rate in China. This outbreak may be one reason that the Chinese government is willing to do a larger agriculture deal as part of the tariff war.



Source: Cornerstone Macro

Biotech stocks surged late in 2019 on an accelerated pace of takeovers that was the fastest pace in history.



The chart below is a heat map for global manufacturing PMI (Purchasing Manager Index) for 2018 and 2019. We added a series of arrows to highlight the imposition of tariffs. The global economy has clearly slowed with each successive tariff hike. You can see the heat map transitioned from green (strong) to yellow (slowing) to orange (shrinking) as the tariff war intensified.

Tariffs on appliances and steel implemented

Tariffs on $200 billion of goods at 10%

Tariffs on $200 billion of goods raised to 25%

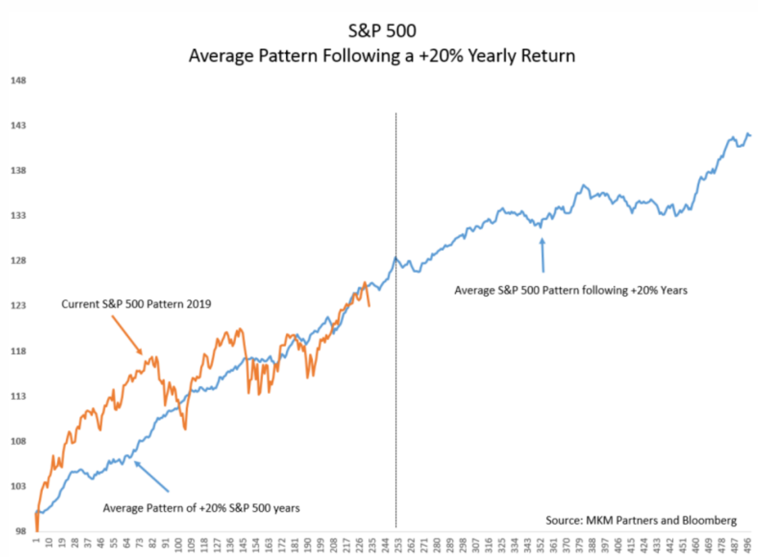
Tariffs on $300 billion of added goods at 10%

Global Manufacturing PMI Table

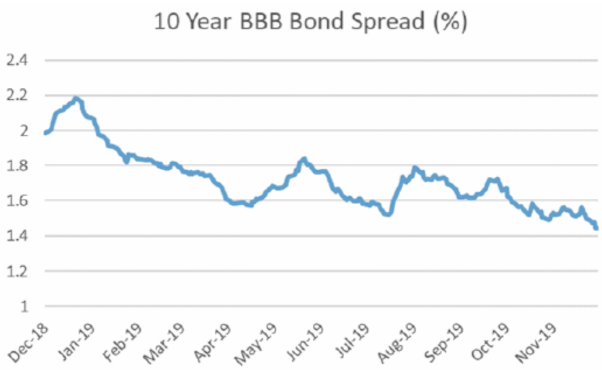
Region/Country	2018 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2019 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Global	54.3	54.0	53.2	53.3	53.0	52.9	52.7	52.5	52.1	52.0	51.9	51.4	50.7	50.6	50.5	50.4	49.8	49.4	49.3	49.5	49.7	49.8	50.3
DM	56.3	55.7	54.8	55.1	54.7	54.4	54.0	53.8	53.6	53.2	52.8	52.3	51.8	50.3	49.9	50.2	49.2	48.9	48.7	48.7	48.6	48.6	49.6
EM	51.8	51.9	51.3	51.3	51.1	51.2	51.0	50.8	50.3	50.5	50.7	50.2	49.5	50.6	51	50.5	50.4	49.9	50.1	50.4	51.0	51.0	51.0
US	55.5	55.3	55.6	56.5	56.4	55.4	55.3	54.7	55.6	55.7	55.3	53.8	54.9	53	52.4	52.6	50.5	50.6	50.4	50.3	51.1	51.3	52.6
Canada	55.9	55.6	55.7	55.5	56.2	57.1	56.9	56.8	54.8	53.9	54.9	53.6	53	52.6	50.5	49.7	49.1	49.2	50.2	49.1	51.0	51.2	51.4
Japan	54.8	54.1	53.1	53.8	52.8	53.0	52.3	52.5	52.5	52.9	52.2	52.6	50.3	48.9	49.2	50.2	49.8	49.3	49.4	49.3	48.9	48.4	48.9
UK	55.2	55.3	54.8	53.8	54.3	54.0	53.9	52.9	53.7	51.1	53.3	54.3	52.8	52.1	55.1	53.1	49.4	48	48	47.4	48.3	49.6	48.9
Eurozone	59.6	58.6	56.6	56.2	55.5	54.9	55.1	54.6	53.2	52	51.8	51.4	50.5	49.3	47.5	47.9	47.7	47.6	46.5	47	45.7	45.9	46.9
Germany	61.1	60.6	58.2	58.1	56.9	55.9	56.9	55.9	53.7	52.2	51.8	51.5	49.7	47.6	44.1	44.4	44.3	45	43.2	43.5	41.7	42.1	44.1
France	58.4	55.9	53.7	53.8	54.4	52.5	53.3	53.5	52.5	51.2	50.8	49.7	51.2	51.5	49.7	50	50.6	51.9	49.7	51.1	50.1	50.7	51.7
Italy	59.0	56.8	55.1	53.5	52.7	53.3	51.5	50.1	50.0	49.2	48.6	49.2	47.8	47.7	47.4	49.1	49.7	48.4	48.5	48.7	47.8	47.7	47.6
Spain	55.2	56.0	54.8	54.4	53.4	53.4	52.9	53.0	51.4	51.8	52.6	51.1	52.4	49.9	50.9	51.8	50.1	47.9	48.2	48.8	47.7	46.8	47.5
Greece	55.2	56.1	55.0	52.9	54.2	53.5	53.5	53.9	53.6	53.1	54	53.8	53.7	54.2	54.7	56.6	54.2	52.4	54.6	54.9	53.6	53.5	54.1
China	51.5	51.6	51.0	51.1	51.1	51.0	50.8	50.6	50.0	50.1	50.2	49.7	48.3	49.9	50.8	50.2	50.2	49.4	49.9	50.4	51.4	51.7	51.8
Indonesia	49.9	51.4	50.7	51.6	51.7	50.3	50.5	51.9	50.7	50.5	50.4	51.2	49.9	50.1	51.2	50.4	51.6	50.6	49.6	49	49.1	47.7	48.2
South Korea	50.7	50.3	49.1	48.4	48.9	49.8	48.3	49.9	51.3	51	48.6	49.8	48.3	47.2	48.8	50.2	48.4	47.5	47.3	49	48.0	48.4	49.4
Taiwan	56.9	56.0	55.3	54.8	53.4	54.5	53.1	53.0	50.8	48.7	48.4	47.7	47.5	46.3	49	48.2	48.4	45.5	48.1	47.9	50.0	49.8	49.8
India	52.4	52.1	51.0	51.6	51.2	53.1	52.3	51.7	52.2	53.1	54	53.2	53.9	54.3	52.6	51.8	52.7	52.1	52.5	51.4	51.4	50.6	51.2
Brazil	51.2	53.2	53.4	52.3	50.7	49.8	50.5	51.1	50.9	51.1	52.7	52.6	52.7	53.4	52.8	51.5	50.2	51	49.9	52.5	53.4	52.2	52.9
Mexico	52.6	51.6	52.4	51.6	51.0	52.1	52.1	50.7	51.7	50.7	49.7	49.7	50.9	52.6	49.8	50.1	50	49.2	49.8	49	49.1	50.4	48.0
Russia	52.1	50.2	50.6	51.3	49.8	49.5	48.1	48.9	50.0	51.3	52.6	51.7	50.9	50.1	52.8	51.8	49.8	48.6	49.3	49.1	46.3	47.2	45.6

Source: Bloomberg, Jefferies

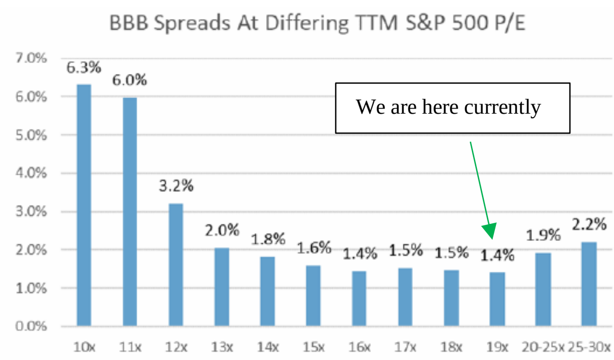
A Yogi Berra-ism- A trend is not a trend unless it continues. This chart below bodes well for 2020.



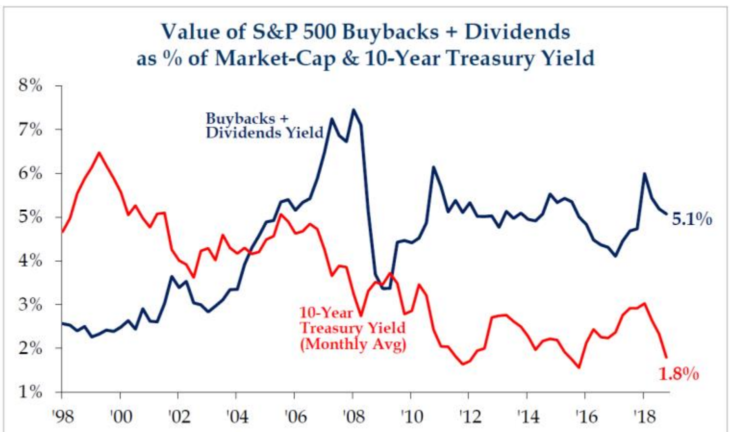
Investment grade bond yield spreads versus the 10 year U.S. Treasury note have tightened for much of the past year, which is a sign that there is little stress in the economy currently. This spread also has been a good proxy for where valuation levels have trended over time on the S&P 500 index. With spreads at 1.4%, the stock market is in a fair valuation zone currently.

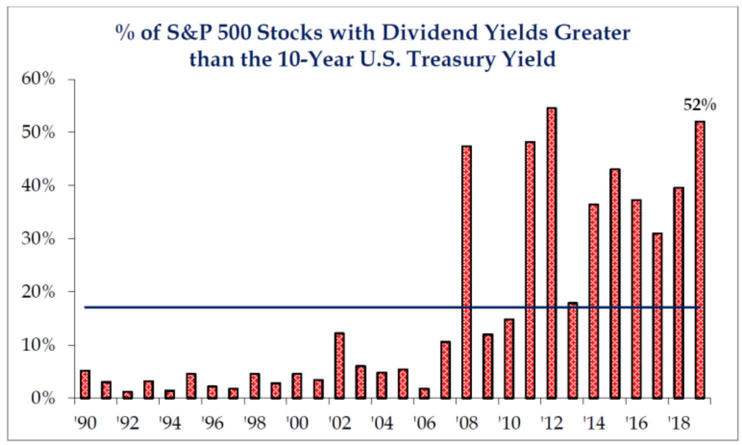


Source: Factset and Raymond James research



Dividends and stock buybacks continue to be a significant component of equity returns as seen on the left chart, particularly in comparison with the yield on the 10-year U.S. Treasury note. On the right is a chart that shows the percentage of companies in the S&P 500 with dividend yields greater than the 10-year U.S. Treasury note. This level is still pretty compelling.





Source: Strategas Research

Thematic Investing: Toss the Participation Trophies! – There is Something Better from Energy Equities in 2020

We believe that energy equities are well positioned to offer better returns in 2020. According to research from Jefferies, the Energy sector has been the worst performing Russell 2000 sector for the last three consecutive years and for five of the last six years. Due to this consistent wretchedness, the group has fallen off the radar for a large portion of investment professionals. However, as we enter 2020, the key negatives of weak global demand and rapid U.S. oil production growth that have held the group in check are fading away. Specifically to global demand, China's +100 efforts to stimulate their economy, the U.S. interest rate cuts, and the incremental demand from the shipping industry's replacement of high sulfur byproduct fuel oil with cleaner diesel fuel as part of the IMO 2020 regulation provide tailwinds to global oil demand. These tailwinds should create a reacceleration from roughly 1.0 million barrels per day (mmb/d) of demand growth in 2019 to roughly 1.2-1.3 mmb/d in 2020.

On the supply side of the ledger, the rapid growth of U.S. oil production in excess of global oil demand increases in both 2018 and 2019 created the oil market's sole reliance on OPEC to balance the market through supply cuts, which the investment community shunned. We believe that the oil industry in the U.S. is finally experiencing the capital investment discipline that it has sorely lacked. The expectation of free cash flow generation has replaced the long held growth for growth sake mantra amongst oil and gas producers. The commitment to keep capital expenditures below cash flow quite simply slows production growth. An oil field is not a factory with consistent capacity but a depleting asset that requires significant capex to keep volumes flat after the first few months of production. With less capital available to sink into the ground, domestic production growth slows. A key leading indicator of this slowing volume growth is the oil drilling rig count in the U.S., which has declined 24% from a year ago. This slowdown in drilling precipitates smaller production increases. In the aggregate, most sellside forecasts have U.S. liquids (oil and natural gas liquids) production growth slowing from 1.5-1.6 mmb/d in 2019 to a range of roughly 0.4-

0.7 mmb/d in 2020. With the investment community demanding free cash flow from the domestic oil industry, the negative sentiment from never-ending excess U.S. production growth is dissipating as we enter 2020. Combine this sizable deceleration event with the recently announced additional 500,000 barrels per day production cut from OPEC and other non-OPEC producers that begins January 1, 2020 and the Energy sector has a much improved supply picture in the new year even after factoring in the ramping of production from a large Norwegian North Sea oil field.

Table 10 - 2: Supply/demand balance for 2020*, mb/d

	2019	1Q20	2Q20	3Q20	4Q20	2020	*Change* 2020/19
(a) World oil demand	**99.80**	**99.78**	**99.79**	**101.78**	**102.12**	**100.88**	**1.08**
Non-OPEC supply	64.30	65.82	66.09	66.46	67.49	66.46	2.17
OPEC NGLs and non-conventionals	4.80	4.83	4.83	4.83	4.83	4.83	0.03
(b) Total non-OPEC supply and OPEC NGLs	**69.09**	**70.65**	**70.91**	**71.28**	**72.31**	**71.29**	**2.20**
Difference (a-b)	**30.71**	**29.13**	**28.88**	**30.50**	**29.81**	**29.58**	**-1.12**

*Notes: * 2019 = Estimate and 2020 = Forecast.*

Totals may not add up due to independent rounding.

Source: OPEC Secretariat.

The table above depicts OPEC's estimates for 2020 oil demand and supply from their December monthly report. Based on the commentary that we outlined above, we can adjust their oil demand up by roughly 200,000 barrels per day and their non-OPEC supply figure down by 800,000 barrels per day. Despite a declining U.S. rig count, OPEC is currently forecasting almost ludicrous growth of 1.5 mmb/d of U.S. supply increases in 2020. Combining these two adjustments (0.2 +0.8) would add roughly 1.0 mmb/d to the 29.58 mmb/d difference figure or 30.58, which is the required OPEC oil production needed to balance the market. Importantly OPEC production in November was pegged at just 29.55 mmb/d, which is obviously before the additional 500,000 barrels per day of OPEC/non-OPEC production cut announced in early December for January 1st. Injecting more realistic assumptions into this demand/supply forecast creates a much more robust oil macro picture and a bullish outlook for oil prices in 2020. Energy sector earnings will clearly benefit from higher oil prices and will also have the tailwind of lower prices for oilfield equipment and services. With the commitment to free cash flow generating restrained capital spending, there is a surplus of virtually all oilfield equipment and services for 2020. According to Furey Research Partners, Russell 2000 Energy sector earnings should rebound roughly 21% in 2020 after a 22% decline in 2019. This growth should prove conservative as Jefferies research shows 26% and 46% energy earning growth in 2020 from large and mid caps, respectively. In conclusion, we believe that the energy equities will follow earnings higher in the New Year.

Thematic Investing: China Trade Dispute May Open the Door to the Untapped China Consumer

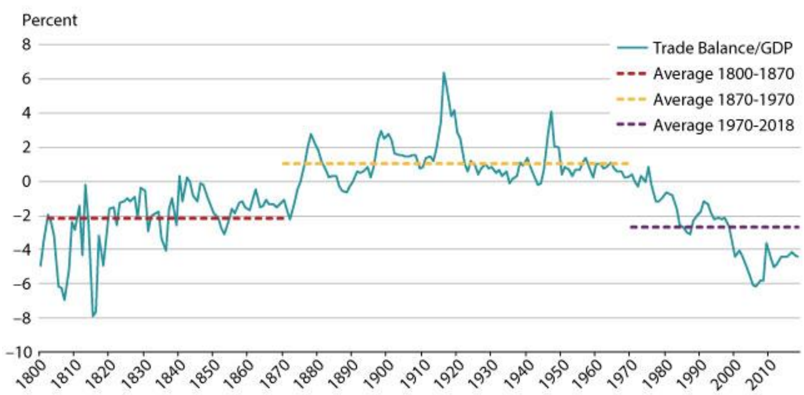
2020 marks the year of the Rat in the Chinese Zodiac calendar. Accordingly, rats are quick-witted, resourceful, and smart but lack courage. With rich imaginations and sharp observations, they can take advantage of various opportunities well. In Chinese culture, rats represent working diligently and thriftiness, so people born in a Rat year are thought to be wealthy and prosperous. While most all of us have enjoyed reading these Chinese prognostications at one time or another, we thought it would be interesting to discuss what the year 2020 may look like, especially as it pertains to growth opportunities in China and retail stocks in particular. Will 2020 be a year of wealth and prosperity? Where will the investment opportunities be? How much courage will the Trump administration exercise when dealing with Xi Jinping?

We believe 2020 could turn out to be a seminal point in U.S.- China relations. The stakes are high but the negotiations between Washington and Beijing over the next 12 months could very well shape how the next decade of trade and foreign relations plays out. There is no shortage of topics to debate when it comes to analyzing the world's two largest economies. Is China friend or foe when it comes to global trade? To help answer this question we believe it's important to take a quick history lesson on how China has grown to be a $13.4 trillion economy.

As it stands today, there are approximately 1.3 billion people living in China. While the country has the world's second largest economy next to the U.S., it is still a relatively poor nation. Economic historians point to 1976 as the start to the post-Mao Zedong reform. While central government control did begin to loosen after Mao's death, the acceleration in reform didn't really emerge until the 1990's, the decade prior to China's inclusion in the World Trade Organization (WTO). The initial phase of reform was highlighted by the return of private farming. During Mao's reign, he ruthlessly implemented collective farming which resulted in over 40 million famine deaths during the 50's and 60's. Once private farming became national policy in 1982, the floodgates were opened. This was the beginning of the formation of private companies, initially in rural areas of China, and is now referred to as the "marginal revolution". As part of the marginal revolution, Special Economic Zones were created by Beijing. Capitalism was allowed to co-exist with socialism on a limited basis, as an experiment by Beijing but could be quashed at the Communist Party's behest if they felt things went awry. These economic zones were created more out of social pressure than by political leaders being enlightened by the virtues of capitalism. It was Beijing's attempt to save state control while appeasing the masses. The next phase of China's transformation occurred in the 1990's following price reform in 1992, tax reform in 1994 and the privatization of state enterprises. This opened up regional competition within the country composed of 32 provinces, 282 municipalities, 2,862 counties, 19,522 towns and 14,677 villages. With a budding capitalist economy and a softening of the "strongman" politics following Premier Deng Xiaoping's death in 1997, China started making a case to be included on the global trading platform.

In 1990 the U.S. purchased $15.2B worth of goods from China and had a $10.4B trade deficit. Over the next decade as China's economic and political reform took place, those U.S. purchases grew to $100.0B in the year 2000 and the trade deficit was $83.8B. During that same time China's GDP tripled in size from $394.5B to $1.2T. Significant progress by any measure! However, the real game changer for China came with its inclusion in the WTO. China entered the WTO on December 11, 2001. To become a member, the Chinese government had to agree to make significant changes to its usual way of doing business. Most importantly it had to open its doors to foreign investment, to reform its banking system and to agree to respect and enforce intellectual property rights. One of the underappreciated consequences at the time China joined the WTO, was it marked the beginning of a mass exodus of U.S. jobs as companies shifted manufacturing overseas to take advantage of the seemingly endless supply of low cost labor. From 2001 through 2017, a study published by the Economic Policy Institute estimates that 3.4 million American jobs were lost to China, mainly in the manufacturing sector. Not surprisingly, the trade deficit between the U.S. and China ballooned at the same time. By 2010, the U.S. purchased $364.9B worth of goods from its eastern trading partner and had a whopping $273.0B trade deficit. The stats for 2018 were $539.7B of imports and a deficit of $419.5B. And as we previously stated, China's GDP is now $13.4T, number two behind the U.S. at $20.5T. While there has been historical precedent for the U.S. to run longstanding trade deficits, the imbalance with China over the past 3 decades has exacerbated the issue.

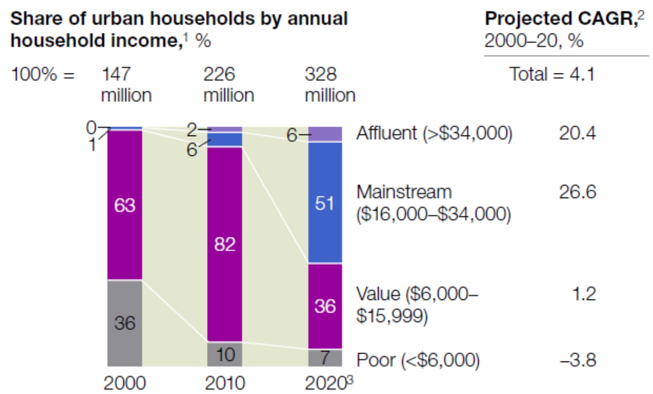
Figure 1
U.S. Goods Trade Balance to GDP



SOURCE: Bureau of Economic Analysis, World Trade Historical Database, Measuring Worth, and authors' calculations.

One could argue that the U.S. and its taxpayers/consumers have paid for China's economic revolution and helped tens of millions of its citizens to rise out of poverty. To be sure, Americans have benefitted immensely at the same time in the form of low cost imports. It's no coincidence that Walmart (WMT) rose to Wall Street glory during the 1990's and 2000's while taking advantage of importing low cost Chinese goods to satisfy seemingly insatiable consumer demand here in the U.S. However, one can also argue that China has taken an unfair advantage of its WTO membership over the past 19 years through currency manipulation, anti-competitive dumping, blatant disregard for environmental protections, lackluster consumer protection, and continued theft of intellectual property. We believe President Trump is attempting to level the playing field for the benefit of the U.S. in his negotiations with Beijing. There is no doubt the series of tariffs implemented over the past couple of years has dampened economic growth and raised prices for consumers. In the long-run however, we believe a more compliant China will benefit the U.S. and global economy, will put American manufacturing on a more competitive footing and help to raise environmental standards in China. Importantly, it's likely that President Trump sees China as an immense market opportunity for U.S. goods and services over the next decade as the country continues its transformation to a consumer led economy. By making China play by the rules, it will allow U.S. firms to more effectively sell its goods and services to the east.

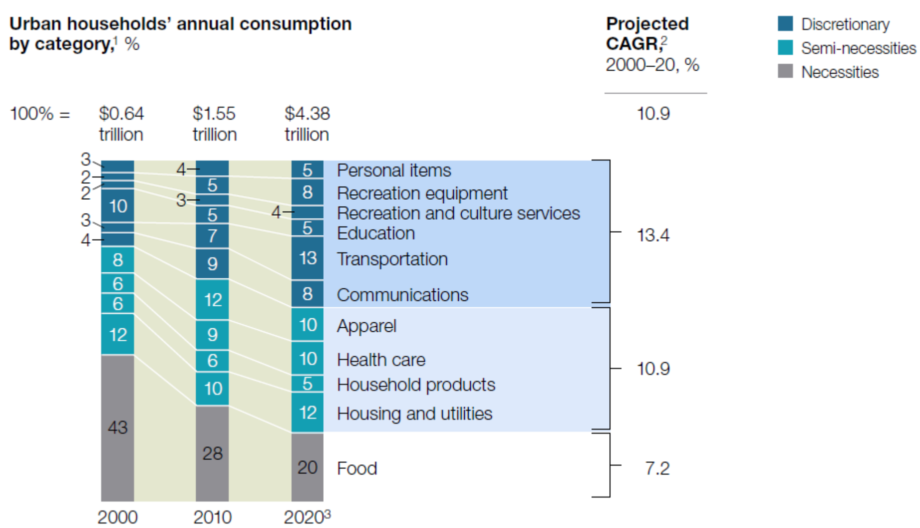
Looking forward, will there be an American company to emerge over the next decade akin to Walmart (WMT), only this time taking advantage of U.S. brands and technology that will be sold to the Chinese consumer? Unlike the prior economic boom in China, which occurred prior to 2008, that was driven by infrastructure spending, we believe the next phase of growth in China will be led by consumerism. Savings rates are down in China and consumer debt is up as Chinese buyers are getting accustomed to a higher standard of living. This shift in demographics and consumer wealth are similar to the changes we saw in Japan in the 1950s and 1960s and in South Korea/Taiwan in the 1980's. Per capita household disposable income has doubled for China in the past 10 years from $4,000 to $8,000. This is still significantly below the $35,000 level in the U.S. but growing rapidly.



[1]In real 2010 dollars; in 2010, $1 = 6.73 renminbi.
[2]CAGR = compound annual growth rate.
[3]Forecast.

Source: McKinsey & Company

What U.S. based companies are poised to take advantage of the expanding consumer base in China? We already know the Chinese have an affinity for American brands with a reputation for quality and fashion. As wealth and disposable incomes rise, we believe several American companies are primed to experience unprecedented growth over the next several years as they strategically tap into the rapidly expanding Chinses consumer base.



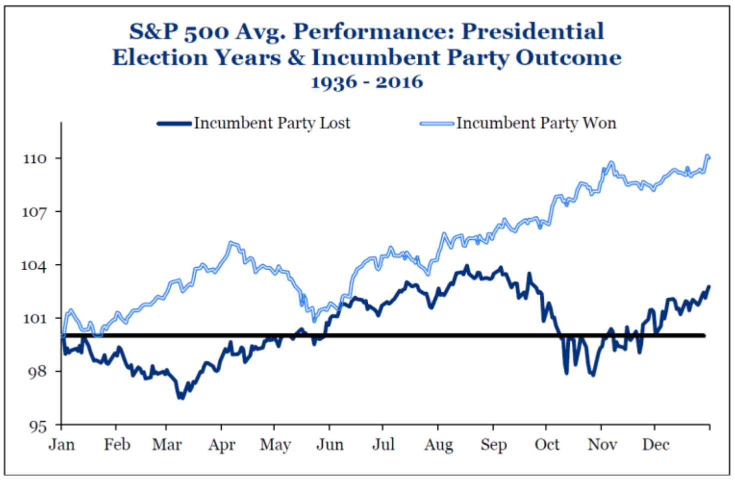
[1]In real 2010 dollars; in 2010, $1 = 6.73 renminbi. Figures may not sum to 100%, because of rounding.
[2]Compound annual growth rate.
[3]Forecast.

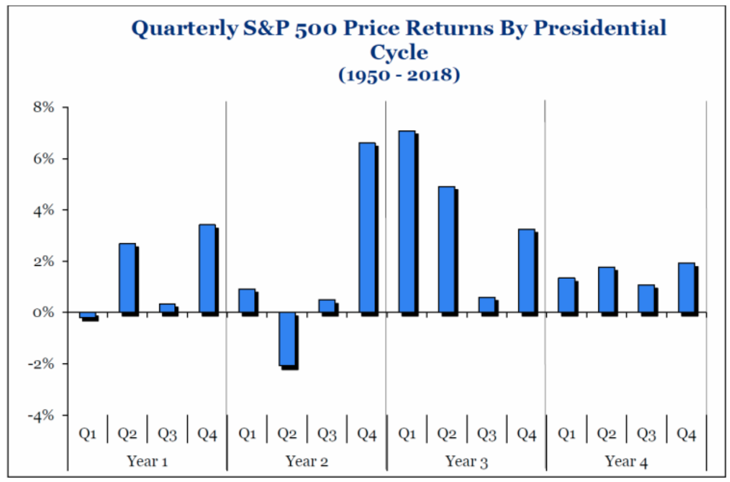
Source: McKinsey & Company

While market investors have left most retail and consumer oriented stocks for dead over the past couple of years here in the U.S. as Amazon (AMZN) has dominated the consumer landscape, we believe there may be a resurgence in 2020. Our focus will be on those companies with a global sales and marketing strategy and especially on those with an opportunity to sell goods to the Chinese consumer. The tariff overhang will dissipate over the next year as Washington and Beijing hammer out a long-term trade agreement which will be the catalyst for strong stock performance in our opinion. We've already begun implementing stocks into the portfolio that are leveraged to this investment theme and will continue to expand it as the year unfolds.

Stock Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. As we've noted several times in this newsletter, 2020 is going to be loaded with a lot of political noise. The chart below left shows that when the incumbent party wins the Presidential election, the stock market has an easier go of it. When the incumbent party loses, the market typically has a selloff going into the election as it signals that there will be more uncertainty in implementing the new President's policies versus the status quo under a second term of the incumbent President. The stock market seemingly has a way of figuring out who is going to win prior to the actual vote. Watch the market signal as we approach the November election.

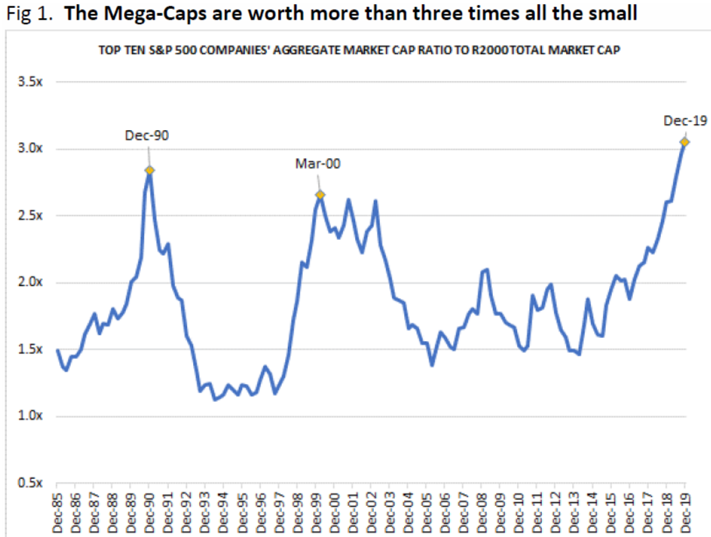




Source: Strategas Research

The chart below shows the aggregate market cap ratio of the S&P 500 compared to the Russell 2000. The current reading is over 3.0X and is at its highest level in the past 35 years. Following crescendos like this, there is a reversion to the mean period that favors small caps stocks over large caps. The performance of stocks like Apple and Microsoft that were up +89% and 58%, respectively, this year fueled the crescendo. A feat that is unlikely to repeat.

Fig 1. **The Mega-Caps are worth more than three times all the small**



Source: Furey Research Partners and FactSet. Data as of 12/19/19.

We hope that you found our fourth quarter 2019 review and 2020 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:

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

1492 Capital Management, LLC
309 North Water Street
Suite 210
Milwaukee, WI 53202
Main: 414-276-1492
Fax: 414-224-9158
www.1492CapitalManagement.com