1492 Capital Management

DISCOVERING OPPORTUNITY

MARCH 2021 • VOL. 14 • ISSUE 3

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 first quarter of 2021. 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.

Excesses Abound as Billions are Being Thrown Around Like Candy

Note that we refrained from using the term "bubble" in our heading above as it's referenced far too often to describe what's occurring on the investment landscape after an advance of any consequence. The term bubble should be reserved for periods like the Tulip bubble of 1636 or the tech bubble of 2000 which in hindsight were epic moves that stretched the bounds of reasonableness. This quarter's stock market returns were pedestrian, but nicely positive, when compared with what we've experienced since the pandemic low of March 2020. However, if you look under the hood of the market, there are clearly some excesses which may evolve into bubbles. These include "Meme" stocks like GameStop, Bitcoin, SPAC's, and Non-fungible tokens (NFT's). Whoever thought that Christies auction house could sell a unique digital token (NFT) that gave the owner the rights to a digital artwork for $69 million? This particular transaction fueled interest in all-things NFT like music, art, and media and forced CNBC to spend nearly a week of programming to explain what an NFT was to the investing public.

In our opinion, there are excesses also happening at the government level which may be the root cause of some of the previously mentioned items. Exactly one year ago in our March 2020 newsletter intro we wrote "March Madness of a Different Kind - Good News is that the U.S. Government has the Playbooks". Having experienced the Great Financial Crisis of 2008, our government had the playbooks for emerging from a recession. In short, the plan said to dump a lot of easy money on the economy and do it fast. They did just that over the last year. The U.S. government did a reasonably good job of minimizing the amount of time that the U.S. economy was in recession despite the pandemic lockdown. The Biden administration's recently passed $1.9 trillion stimulus program, which follows the Trump administration's $4 trillion of stimulus programs passed in 2020, seems excessive in that we're on the cusp of coming out of the pandemic. We'll explore the consequences of this massive spending later in the newsletter.

The post-pandemic recovery will likely be uneven around the world because as we write, many countries in Europe are experiencing another lockdown, even though it seems like the end in the U.S. is just a few short months away. Please read on to see our unique views of what's on tap for the balance of 2021, what some of the key themes are that we're investing in here at 1492, what the key stock market 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 the Quarter: Excesses Abound as Billions are Being Thrown Around Like Candy

Note that we refrained from using the term “bubble” in our heading above as it’s referenced far too often to describe what’s occurring on the investment landscape after an advance of any consequence. The term bubble should be reserved for periods like the Tulip bubble of 1636 or the tech bubble of 2000 which in hindsight were epic moves that stretched the bounds of reasonableness. This quarter’s stock market returns were pedestrian, but nicely positive, when compared with what we’ve experienced since the pandemic low of March 2020. However, if you look under the hood of the market, there are clearly some excesses which may evolve into bubbles. These include “Meme” stocks like GameStop, Bitcoin, SPAC’s, and Non-fungible tokens (NFT’s). Whoever thought that Christies auction house could sell a unique digital token (NFT) that gave the owner the rights to a digital artwork for $69 million? This particular transaction fueled interest in all-things NFT like music, art, and media and forced CNBC to spend nearly a week of programming to explain what an NFT was to the investing public.

In our opinion, there are excesses also happening at the government level which may be the root cause of some of the previously mentioned items. Exactly one year ago in our March 2020 newsletter intro we wrote “March Madness of a Different Kind - Good News is that the US Government has the Playbooks”. Having experienced the Great Financial Crisis of 2008, the government had the playbooks for emerging from a recession. In short, the playbook said to dump a lot of easy money on the economy and do it fast. That they did. The U.S. government did a reasonably good job of minimizing the amount of time that the U.S. economy was in recession. The Biden administration’s recently passed $1.9 trillion stimulus program which follows the Trump administration’s $4 trillion of stimulus programs passed in 2020 seems excessive given that we’re on the cusp of coming out of the pandemic within a few months. We’ll explore the consequences of this massive spending later in the newsletter. The chart below shows the updated fiscal and monetary stimulus measures that have been deployed to date in the largest economies in the world. Note that the total of the U.S. stimulus measures to date are in excess of 57% of GDP, which is a truly staggering number.

Global Monetary And Fiscal Stimulus To Fight COVID-19 Impact
Feb 2020 to Mar 2021 (CSM)

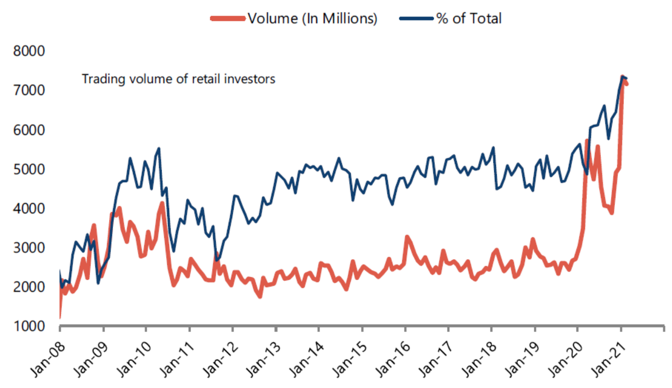
	Potential Central Bank Liquidity Injection		Potential Fiscal Stimulus		Central Bank Liquidity Injection and Fiscal Stimulus	
	$ Tln	% GDP	$ Tln	% GDP	$ Tln	% GDP
U.S.***	$6.21	29.0%	$6.09	28.4%	$12.30	57.4%
Eurozone	$2.38	17.9%	$4.39	33.0%	$6.78	50.9%
Japan**	$1.03	20.0%	$2.79	54.1%	$3.82	74.1%
U.K.	$0.57	20.7%	$0.69	25.1%	$1.26	45.9%
China****	$1.43	10.0%	$1.22	8.4%	$2.64	18.4%
Others*	$1.05		$2.97		$4.02	
Global	$12.66	14.6%	$18.15	21.0%	$30.82	35.6%

*incl RoW and ADB, IMF, WB ****China CB stimulus incl liq injections and other activities, e.g. re-lending, RRR, direct small biz lending, etc

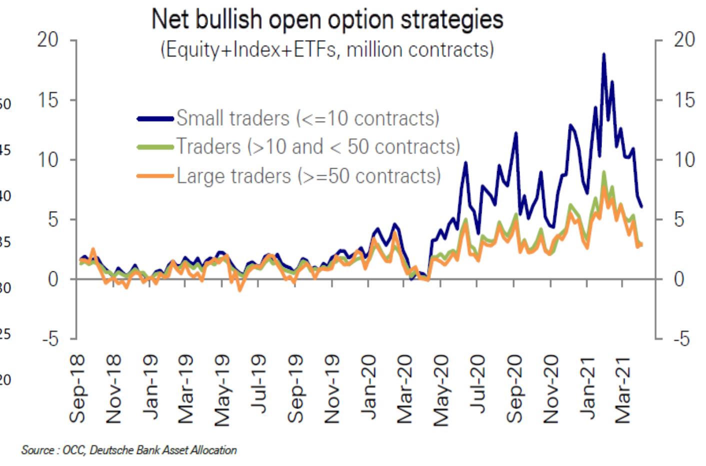
Source: Cornerstone Macro

“Meme/Reddit” stocks, like GameStop, became household names following social media posts touting their attractiveness and encouraged a herd of retail investors to buy these select stocks that were heavily shorted by institutional investors. The strategy worked fabulously well as three of the top four performing stocks were these “meme” stocks which have appreciated anywhere from 300% to 800% year to date. These winners include GameStop, AMC Entertainment, and Express, all of which we consider “melting ice cube” businesses that are slowly losing share to other alternatives in their respective industries and have no fundamental reason to be trading at their current egregious valuations. We expect that these stocks return to earth in time as the “greater fool” theory wanes. This highlights the fact that there is a lot of money sloshing around in retail investors’ hands, and many retail investors are spending an inordinate amount of time day trading ever since the COVID-19 lockdowns began. This trend is evident in the chart below left which shows the number of shares traded and the retail investors’ percentage of total shares traded, which soared at the inception of the COVID-19 lockdowns and stimulus measures. Retail trading now accounts for a record 47% of all shares traded on exchanges. The chart below right highlights that in many cases, retail investors used options to express their long positions in these “meme” stocks and supercharged their returns. Note the massive spike in the blue line which represents “small traders” activity in options contracts. They are highly correlated to the spike in the upward performance of the “meme” stocks, which started late last year and continued into the first quarter of 2021.

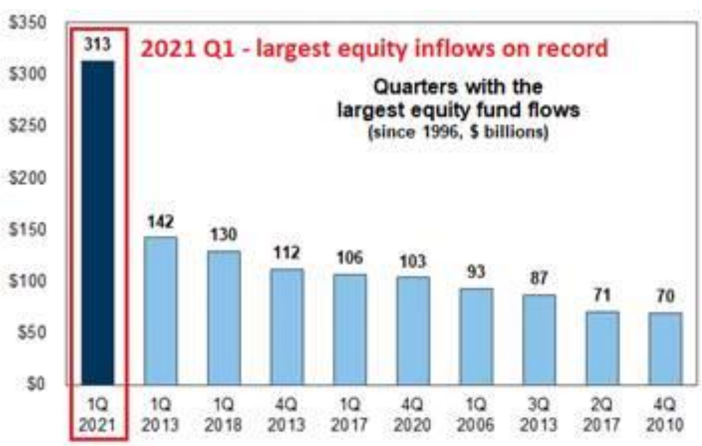
...And retail investors are now 47% of the total



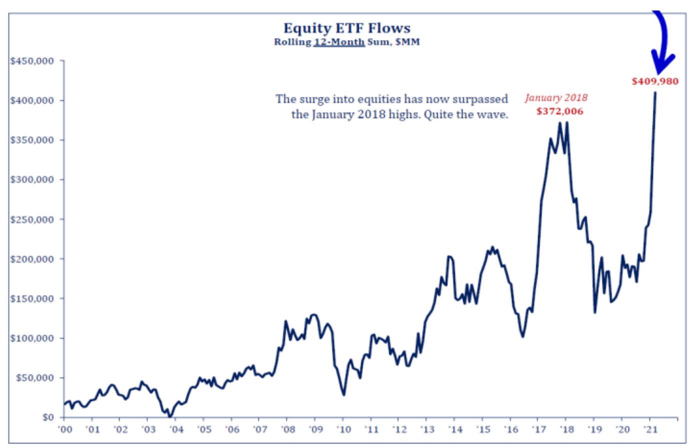
Source: FactSet, FTSE Russell; Jefferies.



Cash flows into the equity market have continued to add fuel to the market's fire and provide an underlying bid to the market. It's unclear if the flows are a function of stimulus, TINA - there is no alternative, FOMO - fear of missing out, or just money chasing returns. The chart below left shows the largest quarterly equity inflows on record. The inflows in the first quarter were more than double the previous record quarter. The chart below right shows a longer-term perspective on flows into equity ETF's. Inflows hit a record $410 billion on a rolling 12-month basis, which eclipsed the previous high from 2018.

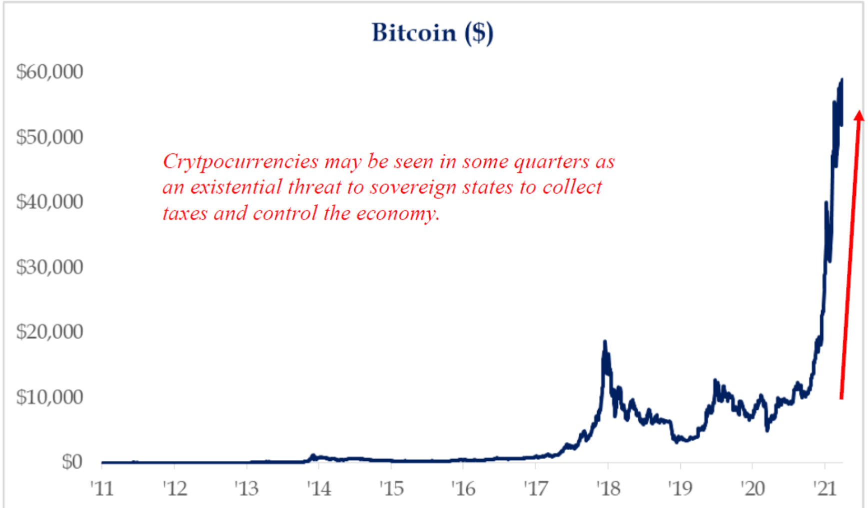


Source: Goldman Sachs



Source: Strategas Research

As we stated previously, excess can be found in several different areas but the one that seems to have captured everyone's attention is Bitcoin. While many people don't understand how Bitcoin and other cryptocurrencies work, it hasn't stopped investors/speculators from throwing money at it. While we don't have a formal opinion on Bitcoin, we find it difficult to get behind something that was created out of thin air, has no true fundamental value that can be objectively assessed, and is difficult to use in real world applications. It is the perfect asset for speculators for the following reasons: 1). the inherent value is difficult if not impossible to assess; 2). it has a limited supply and can only have 21 million coins; and, 3). it fits the narrative that fiat currencies will be devalued as governments around the world print money for stimulus purposes. What we find troubling is that another Bitcoin copycat could be derived out of thin air with potentially more attractive attributes and render Bitcoin worthless in short order. By investing billions of dollars into it and allowing purchase transactions using Bitcoin, several big names like Tesla have effectively endorsed the cryptocurrency. The Bitcoin frenzy has propelled its value more than five-fold in six months as shown in the chart below. How quickly people forget that Bitcoin's value fell 52% between February 13 and March 11, 2020. Buyer beware at this level.



Source: Strategas Research

The returns for the stock market in the first quarter weren't quite as spectacular as some of the assets we highlighted above, but it was a very respectable quarter overall for equities and in particular for small cap stocks. Optimism around the end of the pandemic as vaccines became widely available and an additional $1.9 trillion stimulus package from the Biden administration fueled the market. The spectacular returns of the "meme" stocks that we discussed above enhanced small cap returns, and in particular, small cap value returns. For the first time in quite a while, the NASDAQ Composite was the laggard in the quarter. We saw a large rotation out of the FAANGM (Facebook, Amazon, Apple, Netflix, Google, and Microsoft) stocks and into value stocks as investors shifted from "work from home" stocks that have succeeded through much of the pandemic to "reopening" stocks like consumer discretionary, financials and industrials. All of the major indices are at or near all-time highs.

Index Returns		
Index	First Qtr. 2021 Return	2021 YTD Return
Russell 2000	+12.70%	+12.70%
Russell 2000 Growth	+4.88%	+4.88%
Russell 2000 Value	+21.17%	+21.17%
S&P 500	+6.17%	+6.17%
Dow Jones Industrials	+7.76%	+7.76%
NASDAQ Composite	+2.95%	+2.95%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Value Index (+21.2%) handily beat the Russell 2000 Growth Index (+4.9%) for the quarter as there was a major rotation into more cyclically oriented sectors like financials, discretionary and energy. Healthcare stocks, which were a winner for much of 2020, struggled in the quarter and were the worst performers as biotech stocks, which are long duration assets, were pressured as interest rates began to climb substantially. Further, pharmaceutical stocks are expected to be targets of the Biden administration later this year as they look to focus on drug pricing to reduce healthcare costs. The best sectors in the Russell 2000 were Energy (+41.8%) and Consumer Discretionary (+26.6%). The worst sectors were Utilities (+3.4%) and Healthcare (+0.4%). The second table below shows performance by market cap quintile. In a continuation of the trend from the second half of 2020, the smallest of the small caps posted the best returns in the quarter. Part of this event is due to the performance of the "meme" stocks and stocks under $5 which the Reddit crew targeted to manipulate down and out stocks. The table immediately below highlights the performance of the Russell 2000 and style indices by sector for the first quarter of 2021.

	First Quarter 2021								
	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
GICS Sector	**Absolute**	**Contrib**	**Relative**	**Absolute**	**Contrib**	**Relative**	**Absolute**	**Contrib**	**Relative**
Com Serv	9.78	0.22	-2.92	1.65	0.03	-3.23	18.54	0.44	-2.62
Discretionary	26.59	3.36	13.89	18.41	2.28	13.53	35.85	4.51	14.69
Staples	15.39	0.48	2.70	11.86	0.31	6.99	18.57	0.66	-2.60
Energy	41.82	0.88	29.12	39.93	0.06	35.05	41.89	1.90	20.73
Financials	18.24	2.64	5.55	2.64	0.11	-2.23	20.70	5.51	-0.46
Health Care	0.36	0.34	-12.34	-2.35	-0.57	-7.22	16.27	1.20	-4.89
Industrials	16.04	2.51	3.35	11.85	1.72	6.98	19.73	3.38	-1.43
Info Tech	5.01	0.78	-7.69	2.70	0.48	-2.17	13.39	0.99	-7.77
Materials	19.95	0.83	7.26	13.44	0.32	8.57	22.71	1.38	1.55
Real Estate	10.09	0.55	-2.60	4.65	0.12	-0.22	12.45	1.03	-8.71
Utilities	3.36	0.11	-9.34	-0.61	0.02	-5.49	4.86	0.18	-16.30

Source: FactSet; FTSE Russell; Jefferies

	First Quarter 2021								
	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
Size Quintile	**Absolute**	**Contrib**	**Relative**	**Absolute**	**Contrib**	**Relative**	**Absolute**	**Contrib**	**Relative**
1 (Largest)	6.08	3.76	-6.61	0.79	0.77	-4.08	15.04	8.10	-6.13
2	17.94	4.12	5.25	9.92	2.08	5.05	29.36	7.11	8.20
3	28.09	3.06	15.40	8.99	0.97	4.11	24.91	3.27	3.75
4	24.08	1.27	11.38	16.91	0.77	12.03	30.12	1.95	8.96
5 (Smallest)	22.67	0.48	9.98	17.20	0.29	12.33	25.48	0.73	4.32

Source: FactSet; FTSE Russell; Jefferies

Returns across the international markets were generally positive as they are experiencing similar stimulus and COVID-19 trends as the U.S. market. The real surprise of the quarter was the lagging performance of the bond market as interest rates moved substantially higher in anticipation of a surge in inflation as the worldwide economy reopens. There are also significant shortages in many different supply chains globally. Long-term treasury bonds were by far the worst performer in the quarter as long-term bonds are most sensitive to interest rate changes. Despite ongoing pandemic lockdowns in parts of Europe, most European markets are hitting all-time highs in synch with the U.S. market. Commodities of all kinds continue their push higher as most industries haven't fully adjusted for the demand increases that they're seeing as economies reopen around the globe.

Index	First Qtr. 2021 Return	2021 YTD Return
France	+9.6%	+9.6%
Germany	+9.4%	+9.4%
Brazil	-2.0%	-2.0%
India	+3.9%	+3.9%
China- A Shares	+0.8%	+0.8%
China- Shenzhen A Shares	-3.1%	-3.1%
Japan	+7.8%	+7.8%
Long-Term Treasuries (TLO)	-13.5%	-13.5%
Investment Grade Corp Bonds	-3.9%	-3.9%
Gold	-9.4%	-9.4%
Volatility- VIX index	-14.8%	-14.8%
Oil	+22.2%	+22.2%
Natural Gas	+7.7%	+7.7%
Lumber	+15.5%	+15.5%

Source: 1492 Capital Management, LLC

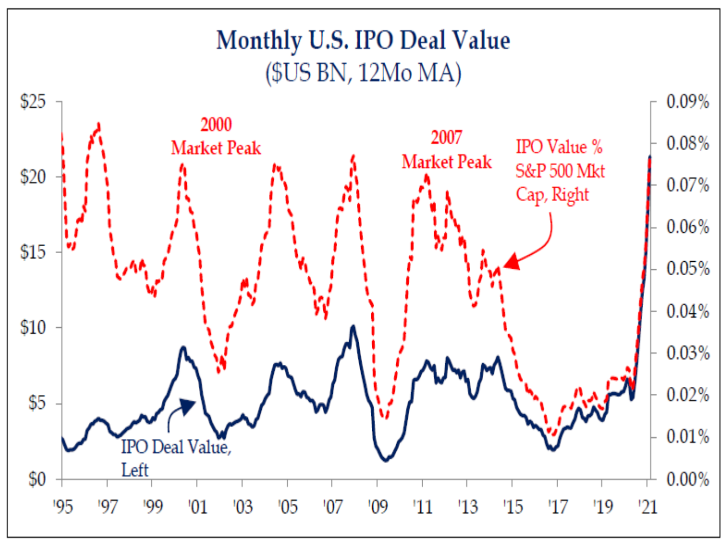
Updated 2021 Outlook: SPAC's Part 2 - Too Much of a Good Thing?

Last quarter we penned a section of our newsletter entitled "SPACs are the Flavor of the Day but are Likely Here to Stay" in which we explained how a SPAC works and what makes it attractive as an alternative to a traditional IPO. However, we never anticipated the barrage of SPAC's that would come to market in the first quarter. In typical Wall Street fashion, if some is good, more is better, which ultimately kills the strategy. Signs of excess are clear in this segment of the market, and we expect that much of it is due to the great response the first tranche of SPAC's received in 2020. However, there appears to be a "get rich quick" sentiment that now surrounds them. This thought is due to some of the potentially lucrative incentive structures that sponsors (those individuals or entities that are behind a given SPAC) have built into the terms of the deal. Some groups are receiving up to 20% additional shares if the stock price reaches a given price within a period of time. The way that many SPAC's traded last year provided many of these management teams massive windfalls in a matter of months. We've seen a noted change in the willingness of investors to award such lucrative incentives in the more recent offerings. As a sign of a peak, many celebrities and sports personalities have lent their name to a SPAC. These SPAC's include Shaquille O'Neill, Alex Rodriguez, Steph Curry and Serena Williams to name a few, which acts as window dressing for retail investors. The absolute explosion in the number of SPAC's is shown in the table below left. The number of SPAC deals in the first quarter were more than the entire year of 2020 and nearly eclipsed the total number of SPAC deals in all of history. The chart on the right shows the monthly dollar value of IPOs on a rolling 12-month basis. This total includes SPAC's as they are technically IPO's but without an operating company attached to it at inception. Note that the total dollar value has spiked tremendously, and it's more than double the 1999/2000 timeframe which was the hottest IPO market of all time.

Special Purpose Acquisition Company
Initial Public Offering Activity In The United States

Year	Value ($BN)	Deal Count
2009	$0.1	4
2010	$1.2	16
2011	$1.4	27
2012	$0.6	8
2013	$2.3	18
2014	$2.2	18
2015	$4.4	24
2016	$4.0	17
2017	$12.0	38
2018	$9.9	37
2019	$13.9	54
2020	$98.0	299
2021	$127.7	431

Source: Strategas Research

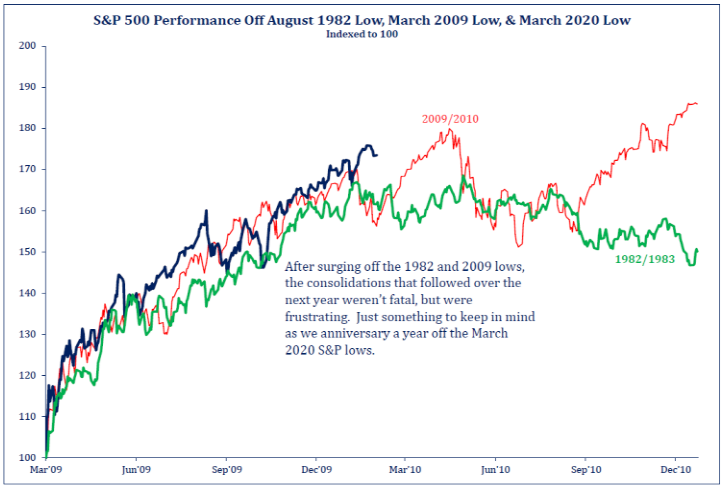


Source: Strategas Research

Further evidence of the overheated SPAC market lies in the transactions that SPAC sponsors are doing and the amount they are paying for their target companies. One example is the number of EV (Electric Vehicles) related SPAC acquisitions that have been completed in the last year. We count in excess of 20 companies that have some sort of tie to the EV market that have been bought by SPAC sponsors. And as we stated in our newsletter tittle, billions are being thrown around like candy. In the case of the EV related SPAC's, many of them were valued at four to five times what the latest private market valuations were in hopes of finding the next Tesla. Many of these EV stocks took off at inception based on the hype surrounding the EV market and the success of Tesla, which put a halo over the entire industry. However, many of them have come crashing back to earth as the size and timing of their opportunity caught up to reality. An interesting data point we recently came across is that McKinsey predicts that there will be over 400 new EV models on the market by 2023. As a result, the competition will be intense, and the billions being thrown around at many EV companies will end up in the junk yard.

Updated 2021 Outlook: End of Pandemic Brings Optimism but What's Further Out on the Horizon?

As we mark the one-year anniversary of the start of the COVID-19 pandemic, it's hard not to get excited about the impending conclusion after a difficult year for almost everyone. The stock market has certainly shared this enthusiasm over the past twelve months with the Russell 2000 up +125% and the S&P 500 up +80% off the March 23, 2020 low. As the chart below left shows, the significant bounce off the bottom that we've experienced in the past year isn't uncommon for a recession recovery. In fact, it appears to be right on track with the performance off the 1982 and 2009 recession lows. It's what lies ahead, which doesn't look as good. In the second year following a bear market low, history shows reasonably good performance averaging +12.7% in all the observations dating back to the 1950's, and none of them were negative. However, we need to brace for the inevitable pullback which has averaged -9.8%.



Source: Strategas Research

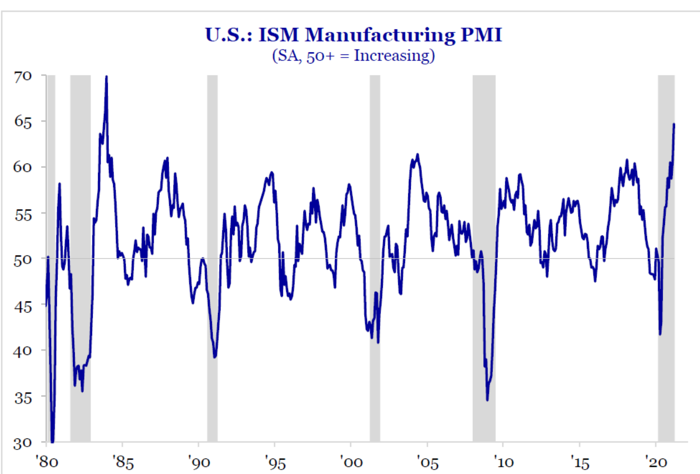
S&P Performance 1st & 2nd Year Following Bear Market Low

Bear Market Low	1st Year Off Low	2nd Year Off Low	2nd Year Max Drawdown
10/22/1957	31.0%	9.7%	-9.2%
6/26/1962	32.7%	17.4%	-6.5%
10/7/1966	32.9%	6.6%	-10.0%
5/26/1970	43.7%	11.1%	-11.0%
10/3/1974	38.0%	21.2%	-5.1%
8/12/1982	58.3%	2.0%	-14.7%
12/4/1987	21.4%	29.3%	-9.2%
10/11/1990	29.1%	5.6%	-6.8%
10/9/2002	33.7%	8.0%	-8.8%
3/9/2009	68.6%	15.7%	-17.1%
3/23/2020	+75.1% over 11 Months!		
Average	42.2%	12.7%	-9.8%

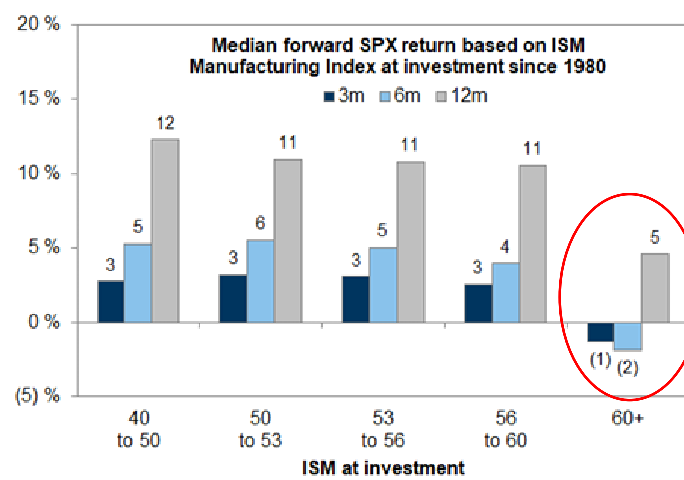
Year 2 of a new bull market is historically still decent for returns, but that doesn't mean there isn't a correction along the way.

Source: Strategas Research

The recent economic statistics have been very strong as optimism around the reopening of our economy surges. As evidence of this, the ISM Purchasing Managers Index (PMI) for both goods and services have shown marked increases and moved into the mid-60's range as shown in the chart below left, which is a level not seen since 1983. However, peaks in the PMI index typically are met with peaks in the stock market as the stock market figures that things can't get much better. The forward-looking stock market returns when the PMI pushes above 60 aren't very good as shown in the red circle on the chart below right.

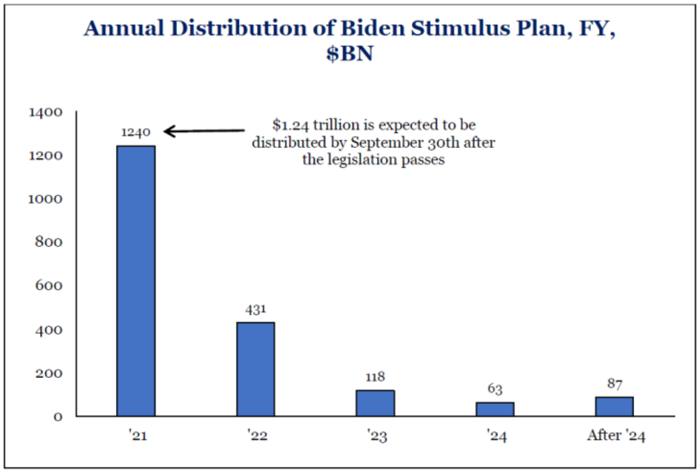


Source: Strategas Research



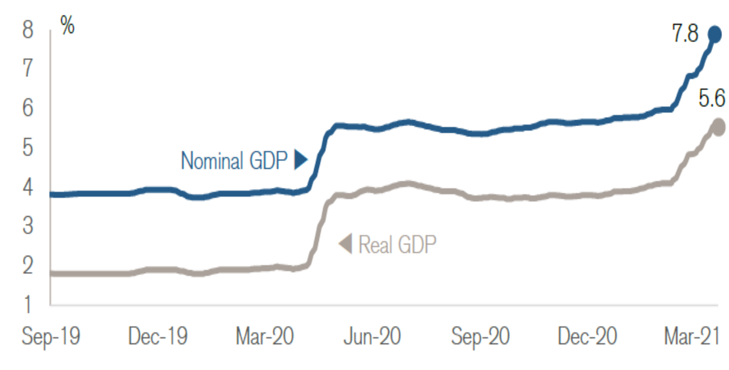
Source: Credit Suisse

However, before we let doom and gloom set in, this time may be different. While it's always risky to say it's different this time, there are plenty of items that are truly different. There is likely going to be a tremendous amount of pent-up demand for services. Airlines and hotel chains are already seeing tremendous upticks in forward bookings, particularly in the second half of 2021. In addition, Biden's $1.9 trillion stimulus package will start to be deployed with much of that being spent by September 30th as shown in the chart below left. The economic recovery coupled with stimulus and easy comparisons, will likely push GDP growth to greater than +10% late in 2021, which is a level not seen since the 1950's. The forecast for the first quarter GDP has already advanced to +7.8% as shown below right, and this is before the country has fully reopened.



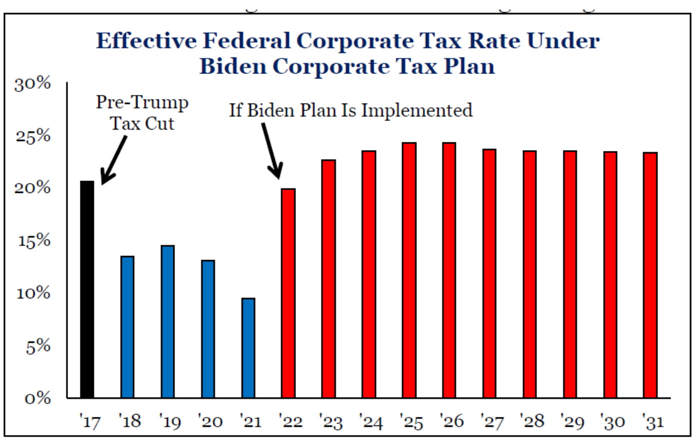
Source: Strategas Research

Figure 2: U.S. GDP Estimates – 2021

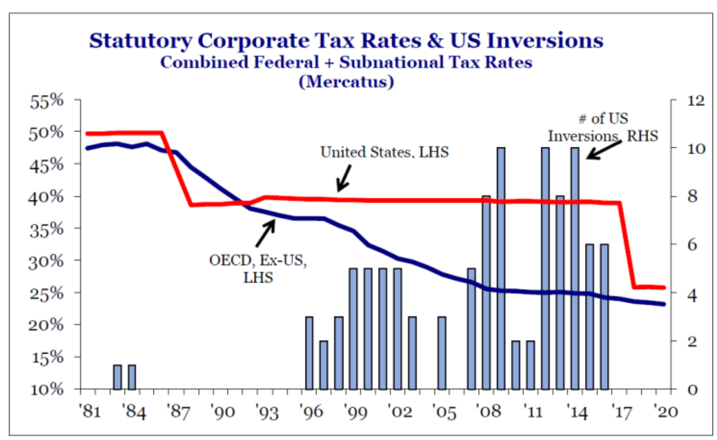


Note: 5-day moving average
Source: BEA, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Not everything is coming up roses. Unfortunately, there are offsets to Biden's infrastructure plans. Currently, Biden is proposing two separate spending programs. One is focused on infrastructure which is pegged at $2.3 trillion, and a second plan that concentrates more on social/job creation for $1.7 trillion. The fact of the matter is that only 44% of the infrastructure plan is aimed at what we normally consider infrastructure like roads, bridges, rails, and airports. Much of the spending is going toward a home health program and EV infrastructure. However, in order to pay for these programs, he has proposed to raise taxes to the tune of $3.5 trillion. The problem with this plan is that infrastructure spending is a one-time deal whereas taxes tend to be permanent. The tax increases are almost exclusively focused on corporations. His proposal is to raise the corporate tax rate to 28% from the current 21% rate. This change would effectively completely undo the Trump tax cuts of 2017 and ultimately the effective tax rate would be even higher than the Pre-Trump tax rates as shown in the chart below left. According to Strategas Research, the Trump tax cuts were equivalent to a one-time 21.5% increase in corporate profits. Based on their current estimates, they believe that the hit to corporate profits in 2022 will be around 10%, which is quite significant. If these tax increases go through, the U.S. tax rate will once again be significantly higher than the average OECD country and render us less competitive on a global basis. The chart below right shows how it took decades for our corporate tax rates to get in line with the rest of the world. The red line on the chart shows the U.S. corporate tax rate through time. It took the Trump tax cuts to bring our rate down and make us competitive globally. You'll notice too that the number of U.S. inversions (companies move their tax domicile overseas by relocating their corporate headquarters into a low tax jurisdiction), which are shown by the blue bars on the chart, have effectively been eliminated under the Trump tax regime. We fear that the Biden tax increases could reverse all the progress made should congress pass these changes.

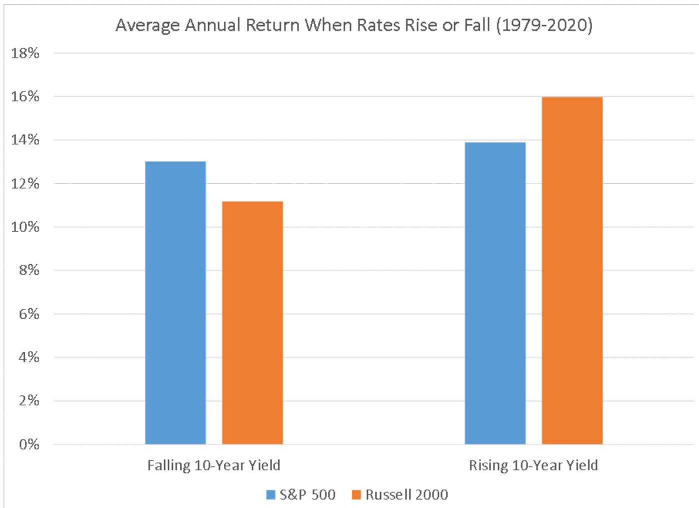


Source: Strategas Research

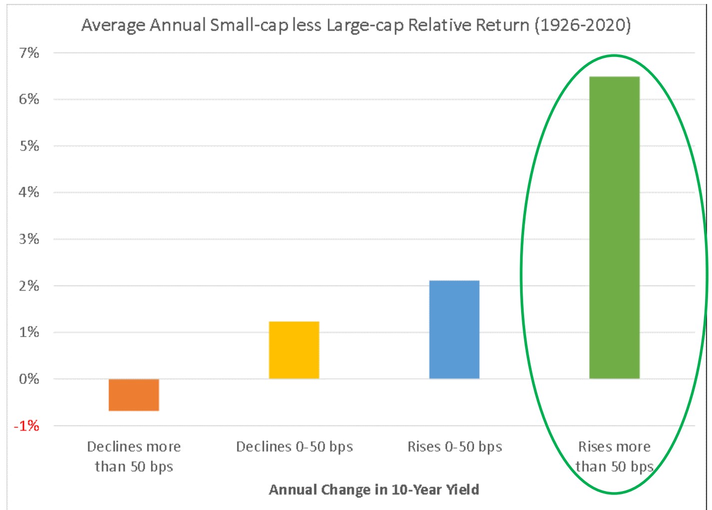


Source: Strategas Research

The other major narrative that the market has been focused on is inflation and the subsequent impact on interest rates. See our section below entitled "Investor Focus on Inflation is Beginning to Drive Volatility" in which we elaborate on the inflation narrative. The 10-year treasury interest rates have spiked by over 100 basis points since last September. The common view of many market observers is that if interest rates go up, stocks must go down. However, this idea isn't factual. As the chart below left shows, stocks perform better in periods of rising rates, and small caps outperform large caps in that environment. In fact, as the chart on the right shows, since 1926 when interest rates rise by more than 50 basis points in a year's time, small caps outperform large caps by an average of 650 basis points.



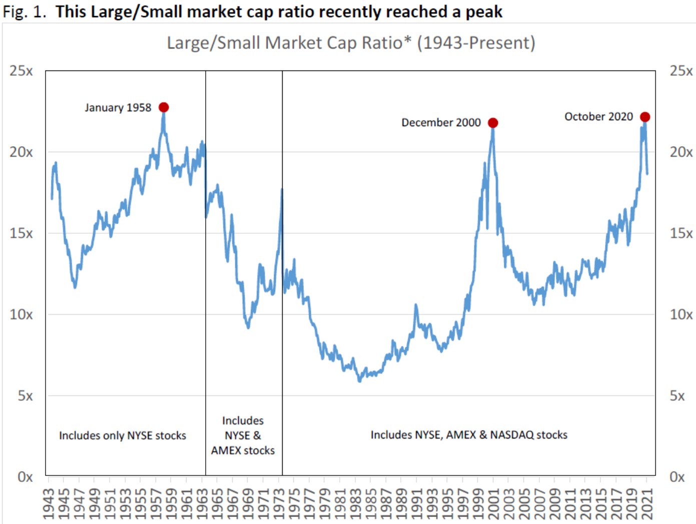
Source: Furey Research



Source: Furey Research

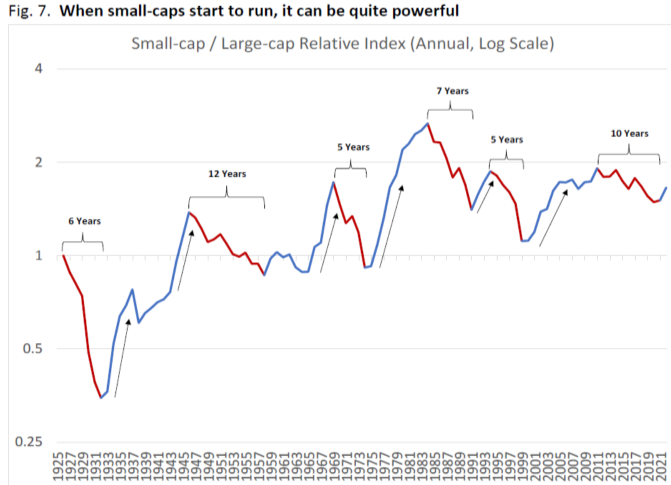
Bringing it all back to small caps, the prospect for further outperformance of small caps over large caps looks encouraging given that small caps still trade at a significant valuation discount when compared to large caps. Additionally, as shown below left, the ratio of large cap to small cap market capitalization reached a peak in October that we've seen only twice before. The tremendous outperformance of the FAANGM stocks over the past several years precipitated this peak. While we don't necessarily view all these as overvalued, there has been a clear rotation out of the high growth stocks into cyclicals of late. These periods of reversal tend to start small cap outperformance cycles that can last multiple years as shown in the table on the right. As small cap specialists, we certainly hope that history repeats.

Fig. 1. **This Large/Small market cap ratio recently reached a peak**



*Source: FRP, CRSP, Ken French (Dartmouth College); as of 1/29/21; *Large comprises the aggregate market value in the top 2*
Small comprises the aggregate market value in the 6th, 7th and 8th CRSP market cap deciles

Fig. 7. **When small-caps start to run, it can be quite powerful**

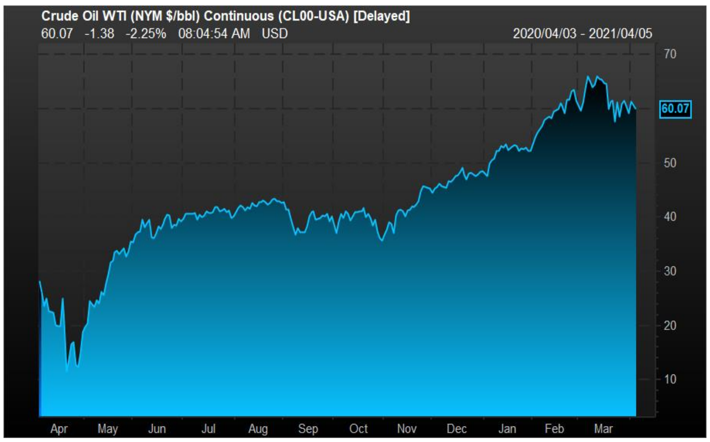


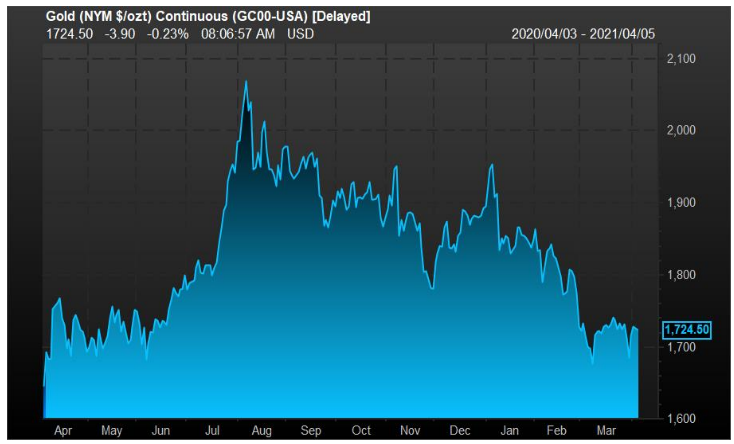
Source: FRP, Factset; as of 3/18/21
**Large-cap returns are based on S&P 500 index, Small-cap returns are based on CRSP 6-8 Decile index before 1979 and Russell 2000*

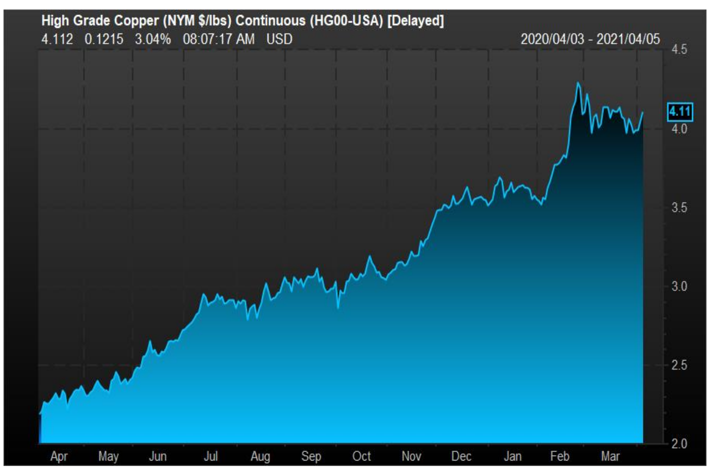
Updated 2021 Outlook: Investor Focus on Inflation is Beginning to Drive Volatility

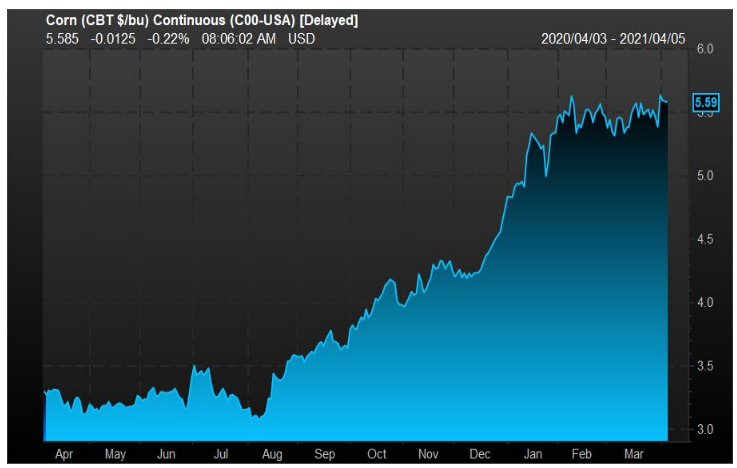
Everyone is attempting to make a directional call on interest rates for the year, which results in violent swings in the equity markets as interest-rate sensitive stocks spike and plummet day-to-day depending on the sentiment du jour. Short-term bond rates have been near zero for so long that we believe it is difficult for investors to fathom any step-change in the near to intermediate future. Considering that the U.S. and global economies are still in the early innings of reopening from a year of COVID-19 induced shutdown of activity, the consensus is that it is unlikely the Federal Reserve will take a hawkish stance until 2022 at the earliest. However, with commodity prices on the rise and the recent release of robust employment data, investors are speculating that the Fed may move sooner than expected with a potential hike in the Fed Funds rate sometime this year. On trading days where this hawkish stance is predominant, long duration stocks such as unprofitable technology and biotech stocks have sold off precipitously with a corresponding rotation into banks and certain value-oriented industrials. Our experience has been that whenever there is a strong consensus on the direction of interest rates, the market has been surprised with a move in yields in the opposite direction of expectations. Time will tell whether the current expectations for the Fed to remain on the sidelines in 2021 hold true.

Despite the Fed's attempt to make their intentions more transparent, prognosticating the direction of interest rates is still a murky effort. We believe it is important however to take a deeper dive into what we believe will ultimately drive interest rates and the slope of the yield curve. Simplistically, inflation expectations drive the level of long-term rates. The most obvious question is inflation of what? We can measure inflation in many ways, and the price changes of commodities like oil, gold, copper, and corn is one technique. Here are a few price charts of these key commodities over the past 12 months.



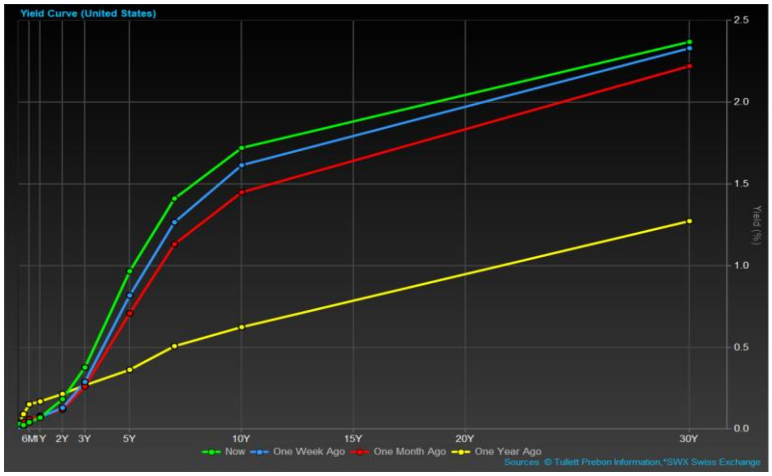




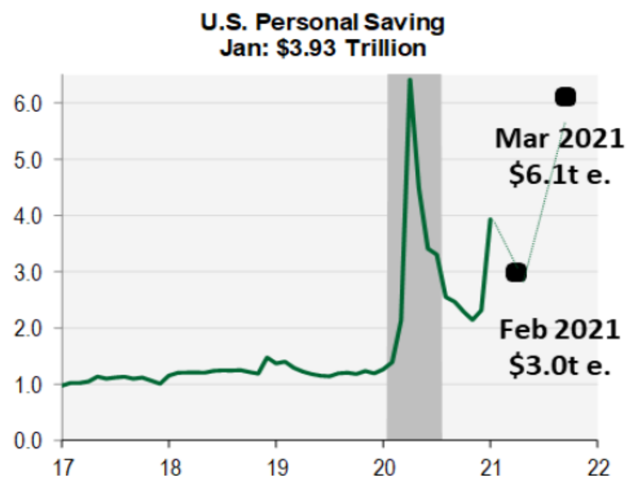


Source: Factset

If we were only looking at these key commodities, we could assume long-term bond rates must surely rise, which they have. Here is a chart of short-term and long-term bond yields (yield curve) plotted over the past year.

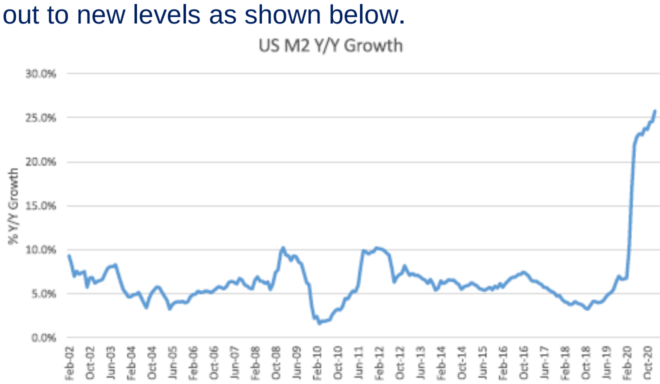


We are clearly amid a yield curve steepening with the 30-year bond yield up over 100 basis points since the same time last year, albeit at still low absolute yields. What is driving rising prices of these commodities? Roughly four trillion dollars of fiscal stimulus passed under the Trump administration and Biden's $1.9 trillion package are the answers. The magnitude and scope of these spending bills are unprecedented in our nation's history. Consider also that the savings accounts for Americans spiked to record highs during the pandemic last year and reached over $6 trillion.



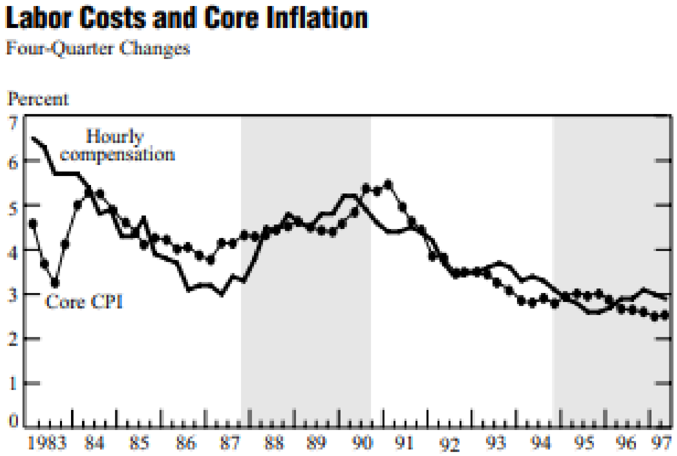
Source: Cornerstone Macro Research

Cornerstone's chief economist forecasts that consumer spending will grow 10% in 2021 versus last year and could be up as much as 20%. As these trillions upon trillions of dollars move through the U.S. and global economies over the next couple of years, one can invariably expect prices to rise. Money supply as measured by M2, which is often used as a leading economic indicator, has clearly broken out to new levels as shown below.



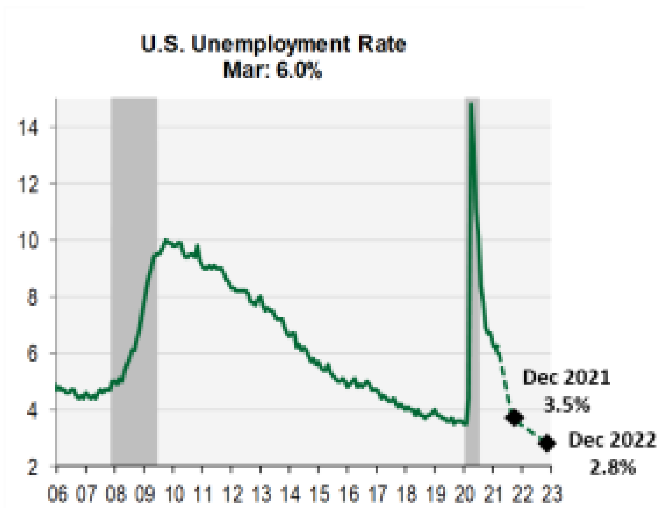
Source: FactSet and Raymond James research

At the core of inflation and the CPI however is labor inflation. From this chart you can see the historical correlation is high.



Sources: U.S. Department of Labor, Bureau of Labor Statistics; author's calculations.

What is the current plight of the U.S. labor force and what are the expectations? Unemployment obviously spiked during the pandemic, especially for service-oriented industries like restaurants, hotels, cruise lines and other leisure-oriented industries. As the COVID-19 vaccine program continues to roll out, there are early signs of a tremendous amount of pent-up demand for socializing and traveling. People are steadily reengaging in the work, which reduces the unemployment rate.

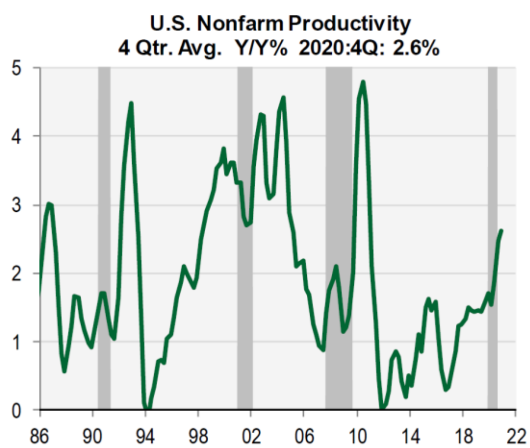


Source: Cornerstone Macro Research

The offset to the potential labor pressures and resulting wage rate inflation is an ever-expanding workforce combined with gains in productivity. Labor force participation rates (LFPR) had been climbing for several years prior to the pandemic of 2020, and we would expect this trend to resume over the next few years as the economy regains its footing.

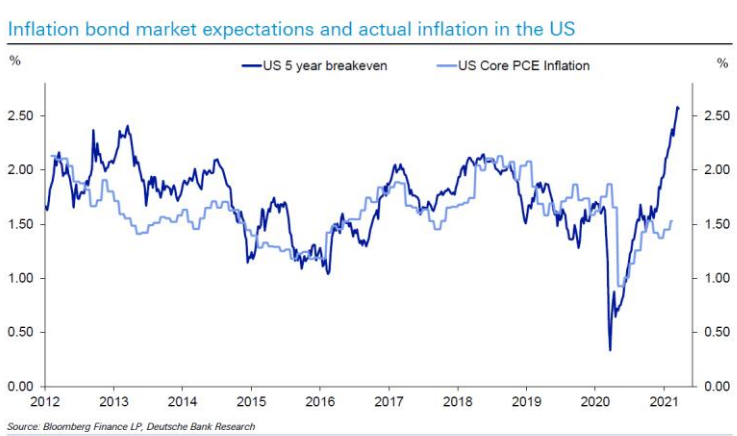
Source: Cornerstone Macro Research

If the LFPR returns to the same levels experienced in the late 90's, it would add an additional one million workers to the labor pool. Additionally, corporate America has steadily been investing in technology and automation over the past several years to improve productivity. The importance of automation was made even more acute during the pandemic when entire factories were shut down due to COVID-19 outbreaks. We expect that these productivity enhancing investments will accelerate further going forward which will lessen the need for manual labor and curtail wage inflation.



Source: Cornerstone Macro Research

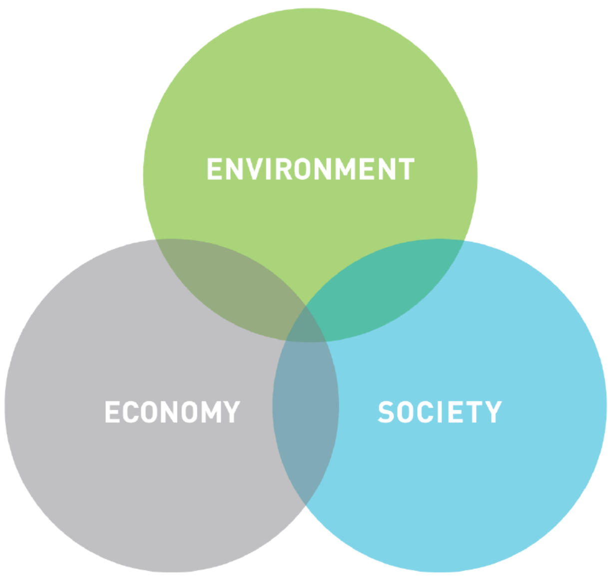
In conclusion, while there are definite signs that prices of goods and services are on the rise, we don't expect a repeat of the 80's with double digit inflation rates. While the bond market may be bracing for markedly higher inflation in the out years as seen in this chart, the reality of it may be much more benign.



With the backdrop of a potential 10% GDP growth in 2021, we have positioned our investment strategies to take advantage of this expansion. The cyclical nature of this rapid rebound will most likely favor some of the traditional value sectors like financials and industrials. As we mentioned in our fourth quarter newsletter, we boosted our Regional Banks – Tax Haven States theme exposure late in 2020 to be positioned for both the steepening yield curve and better economic growth. As the exodus from high tax states like California and New York continues, no state income tax states like Texas, Florida and Tennessee benefit from the population migration. With the economic rebound underway, we believe that our well-positioned bank holdings will benefit from improving credit, lower funding costs, and the stronger loan growth associated with these population magnet states. Stay tuned for more news on our current investment themes.

Thematic Investing: Sustainability - A Plethora of Options in the Long-Term Investment Theme

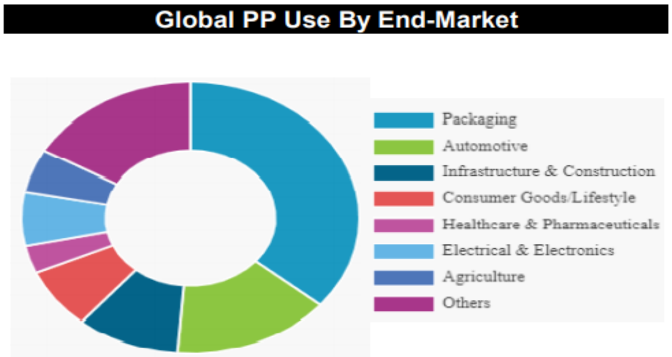
While the word sustainability is now uttered with breathtaking frequency on the conference calls that we listen to every day here at 1492 Capital Management, we need to understand the word before we can intelligently analyze its potential as an investment theme. When googling for a simple definition, it yields an excellent quote from a United Nations paper that sustainability is "meeting our own needs without compromising the ability of future generations to meet their own needs." When viewed this way, it becomes an investment theme with many, many years of wind for its sails, and one with a massive variety of options for deploying this mega-trend. As seen in the picture below, achieving sustainability involves the integration and cooperation of the three giant entities of environment, society and economy for its success.

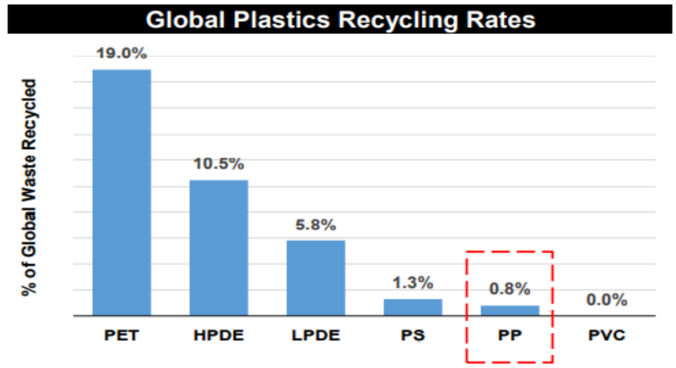


Source: University of Alberta

As we have commented on in previous newsletters, we have concentrated on companies that have business plans focused on renewable energy efforts that effectively synthesize these three entities in the sustainability theme. We have deployed investments in renewable diesel companies that can produce the chemical equivalent of oil derived diesel from rendering plant feedstock, used cooking oil, or soybean oil. Several small traditional refineries have announced that they are converting their facilities to participate in the growth of renewable diesel to reduce greenhouse gas (GHG) emissions. We will also look for a reentry point to participate in the renewable natural gas (RNG) arena. Focusing on reducing GHG emissions, RNG involves capturing the methane released from the decomposition of landfill material and from waste from large scale livestock breeding and processing it into pipeline quality natural gas. According to the EPA, landfills and manure accounted for roughly 28% of 2018 methane emissions. Flaring natural gas from producing oil wells is also a massive methane issue, and we look for technologies that can reduce these emissions. Interestingly, we see bitcoin mining which entails massive computing to derive the coin and thus requires substantial electrical power as a potential solution. Several bitcoin miners have set up their data processing facilities in areas like North Dakota where they can buy this wasted methane gas for their cogeneration facilities to produce power. We believe that GHG emissions reduction will remain on the front burner for sustainability efforts well into the future.

Other areas of sustainability that are particularly interesting for investment include agri-food technology and plastics recycling. Agri-food technology involves using data to understand the soil and the prospects for reducing the synthetic chemicals applied to it as well as to create controlled environment agriculture which entails using more greenhouse type environments to grow crops in places where nature historically has not allowed. Plastics recycling is also particularly intriguing, and we have an investment in this area currently. Roughly 75% of produced plastic becomes waste which precipitates a massive investment opportunity for recycling. According to research from brokerage firm Craig Hallum, polypropylene (PP) is the most used plastic globally. As seen below, PP is used in a variety of applications, and less than 1% of it is being recycled today. This growth in recycling PP would greatly enhance sustainability efforts.





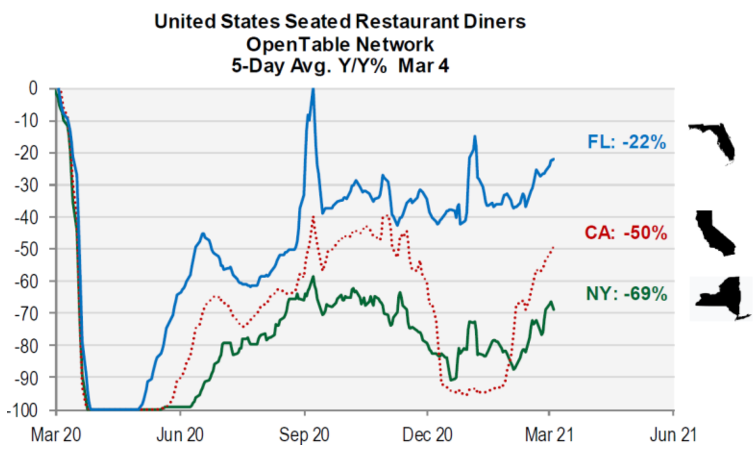
Source: Craig Hallum

While we have detailed only a few, tip of the iceberg examples of the sustainability investment theme, this trend will continue to unveil opportunities for investment across all economic sectors for the 1492 Capital Management strategies.

2021 Outlook: A Picture is Worth a Thousand Words

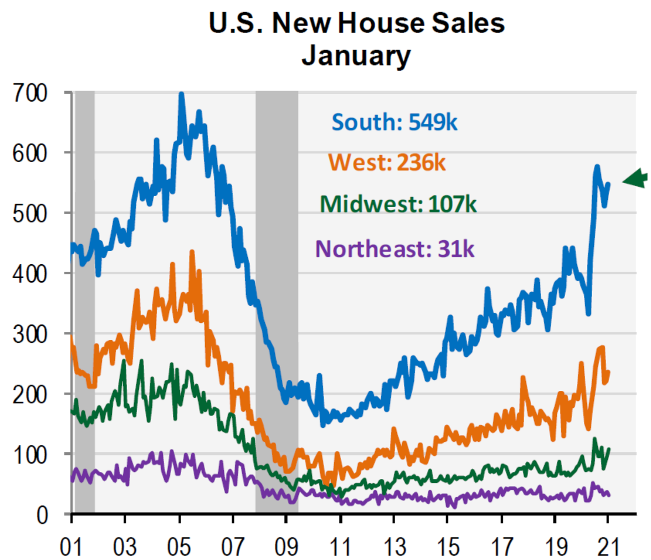
Above we articulated our updated 2021 outlook and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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.

There is a striking difference in activity state by state. Those in COVID-19 lockdown mode like CA and NY continue to show very weak activity, and yet they have some of the highest COVID-19 positivity rates in the country.



Source: Strategas Research

New home sales have rebounded from their 2020 lows but there is clearly a preference to go South due to work from home policies that have allowed employees to choose where they want to live. There is clearly an exodus out of the Northeast to Florida that has been well-documented.

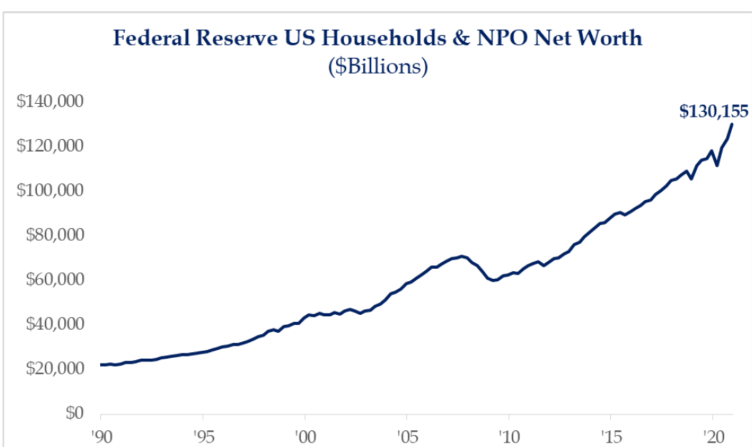


Source: Strategas Research

The uptick in demand for homes as shown in the chart above and the inabiity of the homebuilding industry to get ahead of demand have left home inventory at a record low.

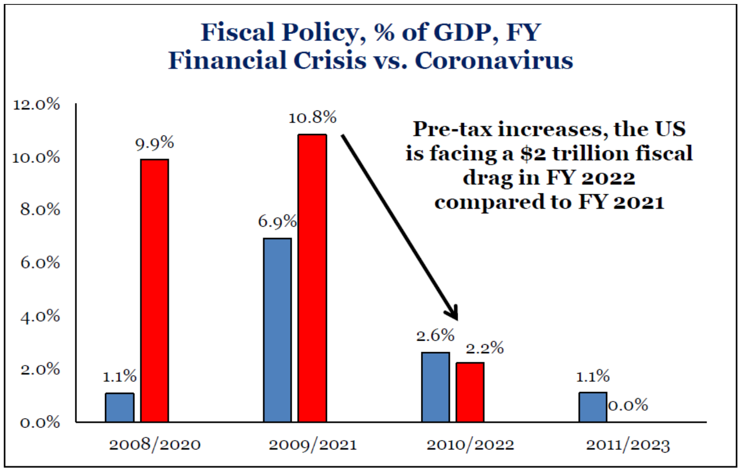
Source: Strategas Research

The stock market decline in March 2020 at the onset of the pandemic is barely a blip on the chart for the net worth of Americans because of what's transpired over the past 12 months.



Source: Strategas Research

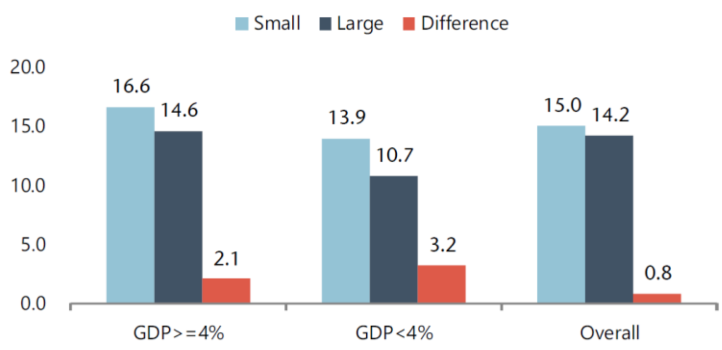
The stock market is going to have to ween itself off the massive stimulus of 2020 and 2021 as we look at a signficant cliff ahead in 2022.



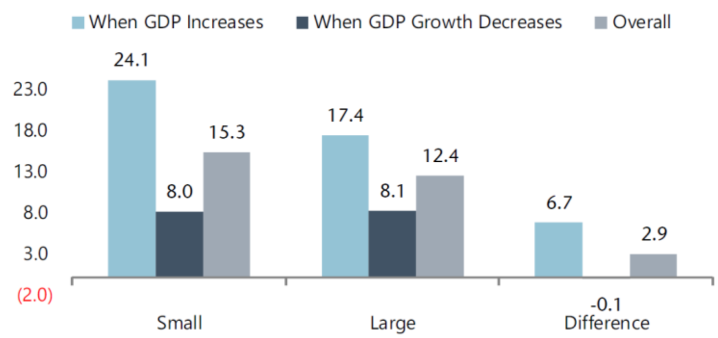
Source: Strategas Research

Stock Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. This quarter we focus on what the stock market tends to do in different GDP growth environments. We find it particularly timely as we expect GDP growth to approach 10% later in 2021. As the chart below left shows, when GDP growth is in excess of 4%, small caps outperform large caps and average +16.6% annualized returns. The chart on the right shows a comparison between small caps and large caps when GDP growth increases and decreases. When GDP growth increases, small caps average annualized return is +24.1%, which compares to a +17.4% return for large caps.



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

We hope that you found our first quarter 2021 review and updated 2021 outlook newsletter to be insightful and interesting. Stay safe and healthy. 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

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