1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
JUNE 2021 • VOL. 14 • ISSUE 6

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 second 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.

The Market's Olympic Moment: Many Hurdles to Clear in the Months Ahead
The pandemic-delayed Olympics are set to take place in Japan in just a few weeks. In keeping with this theme, the U.S. stock market is a gold medal winner since the pandemic lows of March 23, 2020. It is easily outpacing almost any other asset class over this time horizon with the S&P 500 and Russell 2000 up a whopping +96% and +135%, respectively. However, now the hard part begins as there are several hurdles to negotiate in the coming months for the stock market to continue its march higher. They include dragging an infrastructure deal across the finish line, which won't be easy as the agreed upon $1.2 trillion bipartisan deal now appears to be tied to a much larger reconciliation deal (reportedly nearly $6 trillion) that the Biden Administration wants to pass later this year. If this deal can't survive on its own merit, we're unlikely to have a deal other than what the Democrats can push through in reconciliation. The second hurdle to clear is the Fed's watchful eye on inflation and interest rates. As is typical, the stock market launched a mild taper tantrum earlier in June when some of the Fed governors moved up their dot plots at the most recent Fed meeting, which indicated a slightly earlier trajectory for rate increases. The next big test will be the annual Jackson Hole Economic Symposium in late August where Fed Chair Jerome Powell is scheduled to provide an updated view of Fed policy. Other hurdles for the stock market are tax hikes, less stimulus, inflation, and Covid variants, to name a few. The stock market will have to be in great shape to clear these hurdles and continue its reign as the dominant asset class.

While it's hard to believe that we've already hit the midpoint of the annual race to the finish line, it's been an interesting six months as we've dealt with "meme" stocks soaring, Bitcoin stumbling, Covid flaring up, and inflation pushing ever higher. Nevertheless, the stock market has continued its measured pace higher and has posted year-to-date returns of +15% and +18% for the S&P 500 and Russell 2000, respectively.

Value stocks have been the favorite over the past nine months, but can they maintain their lead for much longer? We'll take a swing at answering this question and a whole host of others in the balance of our newsletter. 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.

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Review of the Quarter: The Market's Olympic Moment: Many Hurdles to Clear in the Months Ahead

The pandemic-delayed Olympics are set to take place in Japan in just a few weeks. In keeping with this theme, the U.S. stock market is a gold medal winner since the pandemic lows of March 23, 2020. It is easily outpacing almost any other asset class over this time horizon with the S&P 500 and Russell 2000 up a whopping +96% and +135%, respectively. However, now the hard part begins as there are several hurdles to negotiate in the coming months for the stock market to continue its march higher. They include dragging an infrastructure deal across the finish line, which won't be easy as the agreed to $1.2 trillion bipartisan deal now appears to be tied to a much larger reconciliation deal (reportedly nearly $6 trillion) that the Biden Administration wants to pass later this year. If this deal can't survive on its own merit, we're unlikely to have a deal other than what the Democrats can push through in reconciliation. The second hurdle to clear is the Fed's watchful eye on inflation and interest rates. As is typical, the stock market launched a mild taper tantrum earlier in June when some of the Fed governors moved up their dot plots at the most recent Fed meeting, which indicated a slightly earlier trajectory for rate increases. The next big test will be the annual Jackson Hole Economic Symposium in late August where Fed Chair Jerome Powell is scheduled to provide an updated view of Fed policy. Other hurdles for the stock market are tax hikes, less stimulus, inflation, and Covid variants, to name a few. The stock market will have to be in great shape to clear these hurdles and continue its reign as the dominant asset class.

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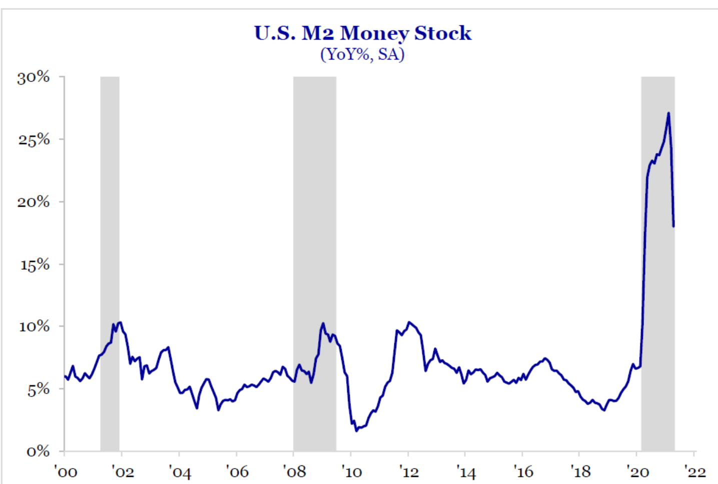
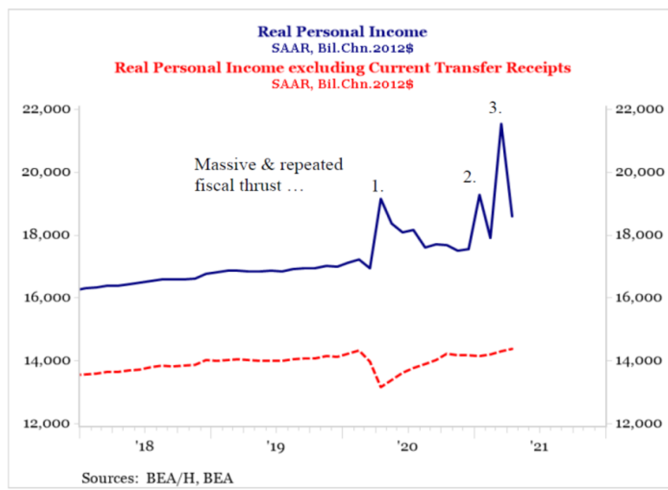
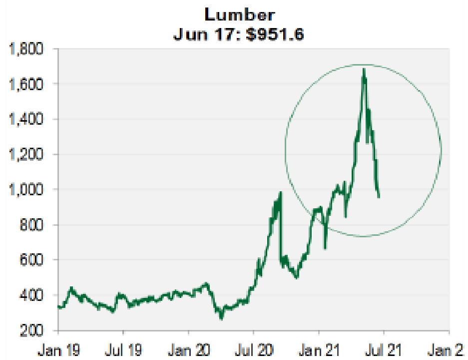
The root cause of inflation can be tied to money growth which materialized the Trump and Biden administrations' three massive stimulus programs that totaled over $6 trillion. As the chart below left shows, the money stock or M2 shows an unprecedented growth rate that exceeds 25%. This growth was done to flood the economy with liquidity and intentionally promote inflation. The chart on the right depicts the three separate stimulus boosts to personal income (blue line) and the subsequent rebound in real personal income (red line) following the pandemic related dip in the spring of last year.

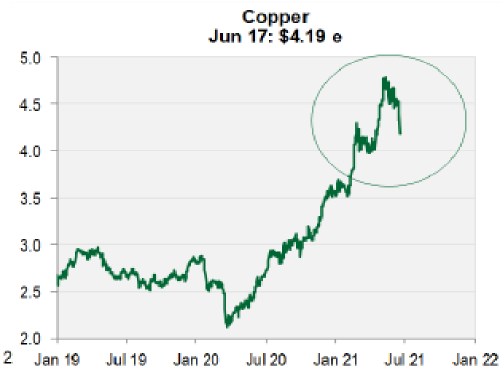


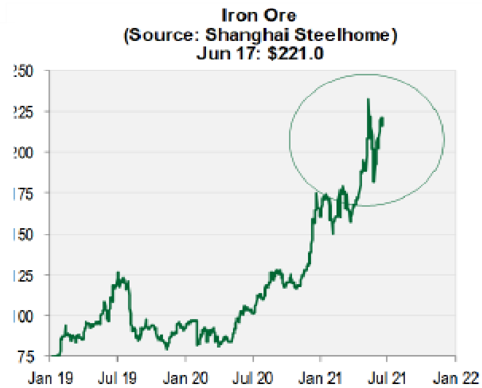


Source: Strategas Research

Inflation has been the topic du jour of late as commodities of all types have been surging. Inventories in many industries have been tapped out, and producers can't ramp their manufacturing facilities fast enough to meet the stimulus-driven demand. The charts below show some basic commodities that have witnessed epic upward price moves in the past year. Notice that they've all seen some corrections of late. As we're fond of saying, nothing kills high prices like high prices. In other words, high prices either invite more suppliers who want to take advantage of the robust end market, or the high prices kill end demand because buyers don't want to pay the inflated price for the good in question.

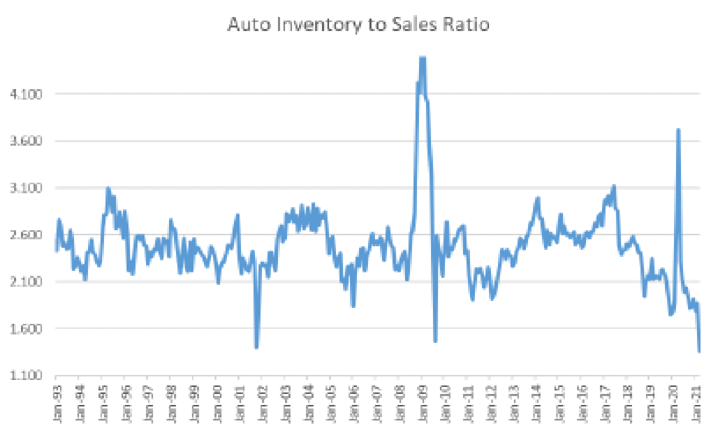






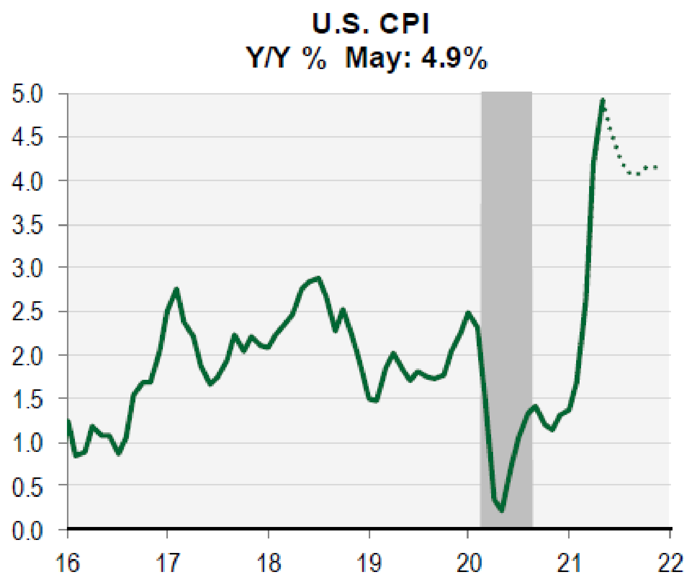
Source: Cornerstone Macro Research

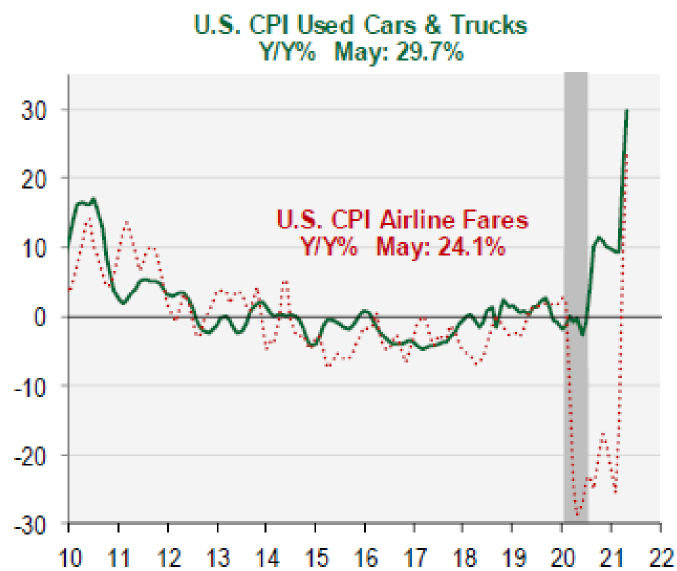
Add to this issue the inability to find enough workers in many industries in the U.S., the clogged supply chains and logistics globally, and Covid still wreaking havoc in many countries around the globe. Low inventory levels are a theme across most industries. Many of you have probably noticed the lack of "sale" signs in your local department store, or you've probably received emails from local car dealerships asking you to trade in your used car or turn in your leased car early. A lack of inventory is why these events are happening as can be seen on the two charts below. The chart below left shows the historically low inventory-to-sales ratio for auto dealers, and similarly, on the right, the chart shows why retailers don't feel compelled to put anything on sale.



Source: Raymond James

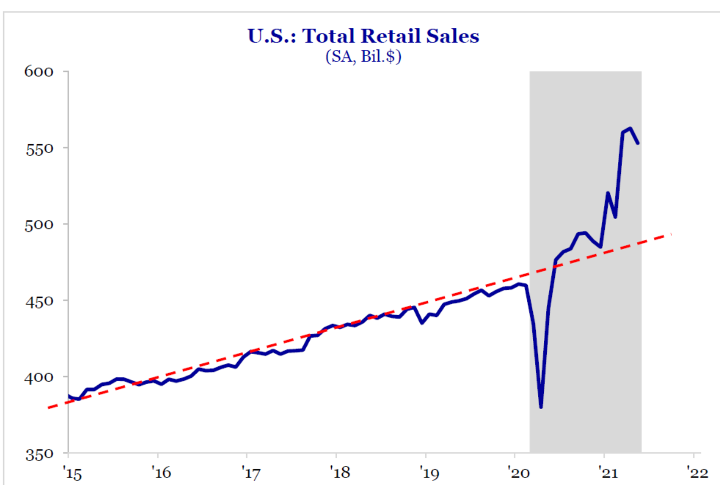
This effect is the perfect storm for inflation, but the root cause is too much money chasing too few goods. The too few goods issue in many industries can be tied to canceled orders at the beginning of the pandemic due to the massive uncertainty that was at hand as we'd never before seen a global shutdown. To make matters worse, shortages across the semiconductor industry continue to wreak havoc in many industries, including autos, as consumers scooped up all thing electronic as the work from home or entertainment at home trends soared during the pandemic. The chart below left shows the acceleration in the Consumer Price Index or CPI. One item to note on all the charts that show massive year-over-year acceleration in prices or activity, is that we are comparing to a near shut down a year ago during April to June, which makes the comparisons very easy and can produce some huge year-over-year percentage increases. Recall that oil traded below $0 per barrel for a very short period in the spring of 2020. The chart below right shows both used car prices, which are up nearly 30% over a year ago, and airline fares, which are increasing rapidly against very low levels a year ago when travel was nearly nonexistent.

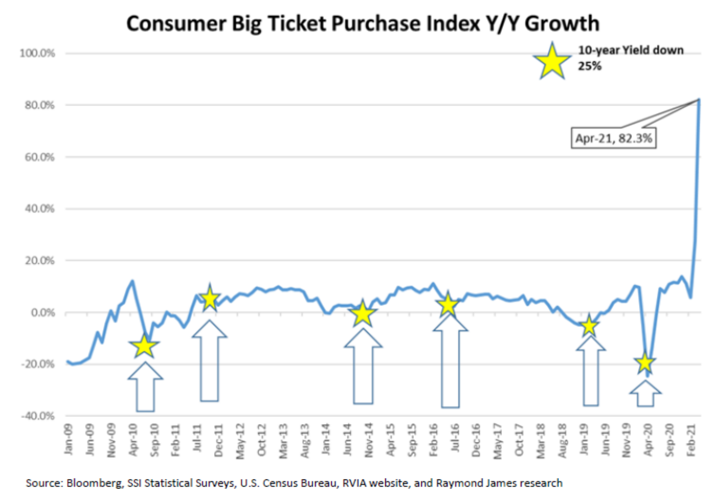




Source: Cornerstone Macro Research

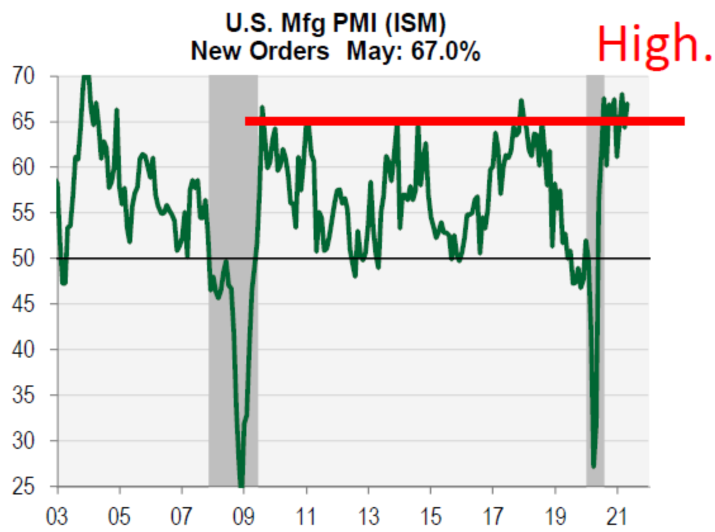
The combo platter of massive stimulus programs and the pandemic lockdown provided many U.S. consumers a windfall and a reason to spend that windfall on big ticket items primarily for use in the outdoors. As the chart below left shows, the initial uncertainty of the lockdown caused an immediate retrenchment in spending. However, once the stimulus checks hit, it appears we may have made up for the few months of below-trend spending and then some. On the right is a chart that shows big ticket purchases. Think cars, boats, RV's, ATV's, snowmobiles, and motorcycles. Once consumers received their stimulus checks, unemployment compensation, or returned to work, it appears that everyone went shopping and purchased something to make themselves feel better about being locked down and something that they could use outdoors. If you're in the market to buy a boat or an ATV, good luck. We already addressed the used car issue above.



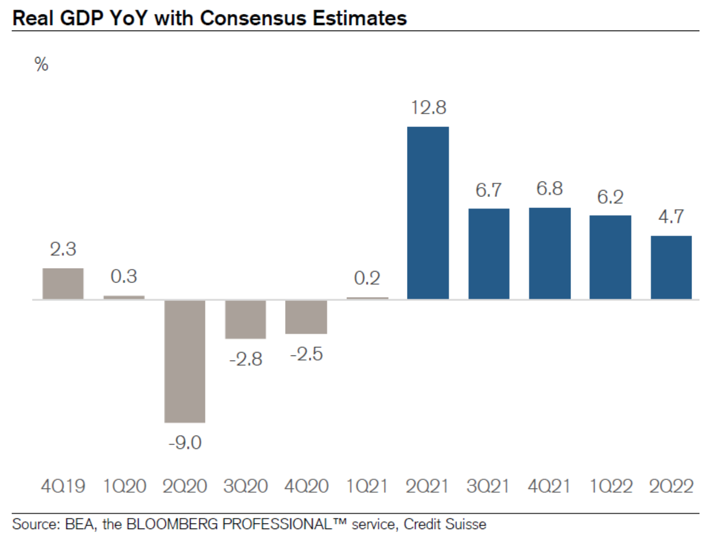


Source: Strategas Research

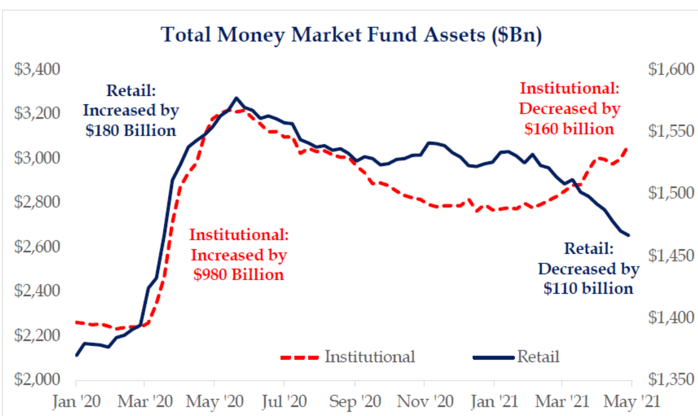
The drawdown in inventories coupled with surging demand as the economy reopened, has produced some very heady growth statistics of late. The rush to place orders to meet the surging demand can be seen in the chart below left. This chart shows that the "new orders" component of the U.S. Manufacturing PMI is flirting with all-time highs. The PMI statistic is a diffusion index which measures whether market conditions as viewed by purchasing managers are expanding, staying the same, or contracting. These surveys are done monthly so they are difficult to maintain at high levels for extended periods because the managers are comparing their current view to that of last month, and at some point things just can't get any better. Therefore, many times a peak in the PMI corresponds with peaks in GDP and in the stock market. However, as the chart below right shows, GDP growth is forecasted at an extraordinary level this year. We haven't seen these levels in decades. For reference, during much of the Trump administration, GDP growth was between 2% and 3% which was viewed as strong growth.



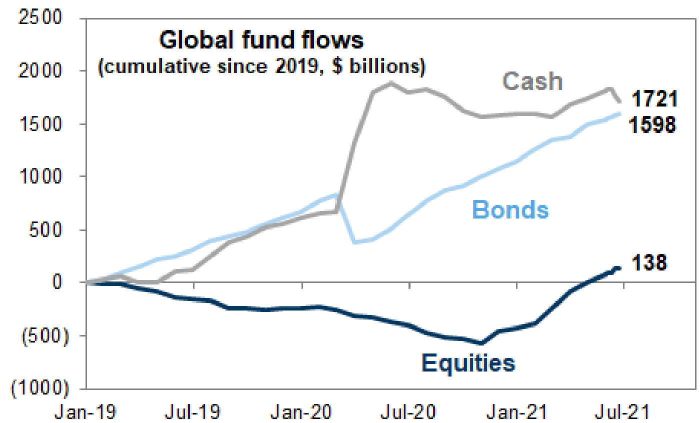
Source: Cornerstone Macro Research



Inflation is a concern for many economists, but stock market inflation is one that we can gladly tolerate ☺. All the stimulus and cash injected into the economy hasn't found its way into the stock market yet. Last quarter we wrote about the record number of retail brokerage accounts that were opened in 2020 and that retail investors now account for more than 47% of all trading on the U.S. exchanges- an all-time high. However, given all the cash sitting on the sidelines, there is still plenty of liquidity to fund further upward movements in the stock market. The chart below left shows total money market assets which currently total $4.5 trillion. Interestingly, you can see money market assets spiked last spring on the initial news of the pandemic as investors sought safety amid a plummeting stock market. However, while retail and institutional investors have put some of that money back to work in the stock market, there is still a tremendous cash hoard ($1 trillion more than pre-pandemic levels) that resides in these money market funds earning next to nothing. The chart on the right shows that equity fund flows, despite the all-time highs being set in the stock market, have barely moved into positive territory. Interestingly, equity fund flows trended lower through much of 2020 and only in the last nine months have we seen that trend reverse. This chart also shows the significant amount of cash that currently sits on the sideline.



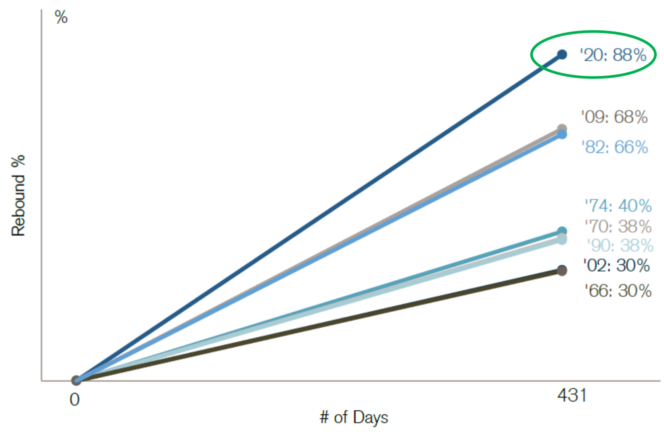
Source: Strategas Research



Source: Credit Suisse

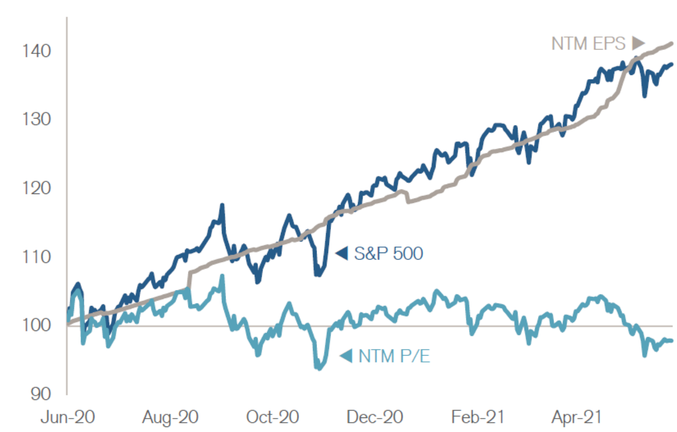
The cash that has found its way back into the stock market has certainly been rewarded. The stock market recovery since the recessionary trough of March 2020, has been the best in history. The chart below left shows how this stock market recovery stacks up against prior recessionary recoveries. Interestingly, despite the global pandemic lockdown, earnings growth has been surging as companies have, for the most part, posted robust earnings growth. The chart below right shows the S&P 500 (blue line), next 12 months earnings growth (grey line) and the P/E ratio for the S&P 500 (teal line), which are all indexed to 100 starting from June 2020. Interestingly, the market has advanced on the surge of earnings growth while the P/E ratio has been flat to slightly contracting. This action gives us confidence that there could be more fuel in the tank for the stock market as earnings growth is likely to continue for the next couple of years.

Market Rebound 431 Days post Recessionary Trough



Note: Price return
Source: Standard & Poor's, Haver Analytics®, Credit Suisse

Percent Change in S&P 500 Index, EPS and P/E



Note: Both PE and EPS are on NTM basis
Source: Standard & Poor's, Refinitiv, FactSet and Credit Suisse

As can be seen in the table below, the returns for the stock market in the second quarter were better at the larger market caps with the S&P 500 and NASDAQ Composite leading the way. However, on a year-to-date basis, small caps still hold a slim lead over large caps. By far, the best performing index was the Russell 2000 Value. As inflation surged, so did many basic material, industrial, and financial stocks which are more heavily weighted in the value indices. Late in the quarter, following the Fed's slight adjustment to their interest rate hiking timeline, the 10 Year U.S. Treasury interest rates fell, which implied that the Fed was going to put the brakes on the economy sooner than what the market had been anticipating. This thought led to a sudden shift back to growthier stocks and a retreat from value stocks. All the major indices are at or near all-time highs.

Index Returns		
Index	Second Qtr. 2021 Return	2021 YTD Return
Russell 2000	+4.29%	+17.54%
Russell 2000 Growth	+3.92%	+8.98%
Russell 2000 Value	+4.56%	+26.69%
S&P 500	+8.55%	+15.25%
Dow Jones Industrials	+4.61%	+12.73%
NASDAQ Composite	+9.68%	+12.92%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Value Index (+4.56%) slightly beat the Russell 2000 Growth Index (+3.92%) for the quarter as there was a major rotation into more cyclically oriented sectors like Financials, Consumer Discretionary, and Energy early in the quarter and then a reversal following the Fed meeting as mentioned above. Bond proxies like Utilities (-1.7%) and Consumer Staples (+2.1%) along with Financials (+.8%) were the laggards in the quarter as there is currently no appetite for defensive stocks at this juncture, and the recent pullback in interest rates has hurt the Financial sector as spreads continue to contract as interest rates decline. On the positive side of the ledger, Energy (+20.7%) and Commercial Service (+36.4%) sectors were the victors in the quarter. The rise in crude oil above $70 per barrel due to OPEC's restraint on production levels helped the energy sector, which is also the year-to-date medalist up +71.1%. The table immediately below highlights the performance of the Russell 2000 and style indices by sector for the first quarter of 2021.

Table 1 - Index Performance by Sector

	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
GICS Sector	**June**	**2Q2021**	**YTD**	**June**	**2Q2021**	**YTD**	**June**	**2Q2021**	**YTD**
Com Serv	19.2	36.4	49.7	6.3	10.2	12.0	27.6	56.5	85.5
Discretionary	-0.3	5.4	33.4	1.3	5.3	24.6	-2.0	5.3	43.1
Staples	-0.5	2.1	17.9	0.8	7.5	20.3	-1.8	-2.6	15.5
Energy	8.6	20.7	71.1	12.7	24.6	74.3	8.0	20.0	70.3
Financials	-3.4	0.8	19.2	2.0	6.9	9.7	-4.2	-0.1	20.6
Health Care	7.8	2.9	3.3	8.9	3.1	0.7	4.3	3.7	20.6
Industrials	-1.2	0.4	16.5	0.8	-1.1	10.7	-2.8	1.5	21.5
Info Tech	6.1	5.9	11.2	6.7	6.2	9.1	4.1	4.9	18.9
Materials	-5.5	4.3	25.1	-6.6	3.0	16.8	-5.3	4.6	28.4
Real Estate	3.0	7.4	18.3	4.8	5.3	10.2	2.2	8.2	21.7
Utilities	-0.7	-1.6	1.8	0.5	0.8	0.2	-1.0	-2.3	2.5

Source: Jefferies

Returns across the international markets were generally positive and consistent with what we saw in the U.S. markets as they experienced similar stimulus and COVID-19 trends as the U.S. market. In certain markets that were seeing some Covid resurgence, like Japan, the markets were negatively biased. The bond market was a modest winner on the back of the Fed comments late in the quarter. The real action was in the commodity sector where there were big winners like oil and natural gas, which the reopening of many regional economies around the globe spurred. The losers included lumber that returned a portion of its epic run over the last year. Volatility was notably down despite some of the concern surrounding the Fed's next move. This point is a good sign for the market as it appears to be taking any negative news in stride. Like the U.S. markets, international stock markets are pressing near all-time highs as well.

Index	Second Qtr. 2021 Return	2021 YTD Return
France	+6.9%	+17.2%
Germany	+3.5%	+13.2%
Brazil	+8.5%	+6.5%
India	+4.7%	+9.9%
China- A Shares	+3.9%	+3.4%
China- Shenzhen A Shares	+10.6%	+5.9%
Japan	-2.2%	+4.9%
Long-Term Treasuries (TLO)	+5.9%	-8.9%
Investment Grade Corp Bonds	+3.4%	-1.2%
Gold	+3.3%	-6.6%
Volatility- VIX index	-18.4%	-30.4%
Oil	+24.2%	+51.4%
Natural Gas	+40.0%	+42.2%
Lumber	-29.1%	-17.4%

Source: 1492 Capital Management, LLC

Updated 2021 Outlook: Small Caps vs. Large Caps, Growth vs. Value - and the Winner is??

Before we answer the questions posed in the heading, we'll first provide our take on the overall outlook for the market. As we mentioned at the outset, there are several hurdles for the market to clear to continue its upward path, and they won't be easy. These hurdles are: 1). rising inflation leading to higher interest rates; 2). potentially higher corporate and capital gains taxes; 3). the inevitable falloff in government stimulus; and, 4). Covid variants and restrained economic reopening globally. We'll tackle these in reverse order.

With respect to Covid and the lingering impact around the globe, we expect that as vaccines get distributed more evenly around the world, the flare ups that we've seen should be tamped down in time. Currently, Japan, Australia, India and numerous other countries in Asia and Africa are seeing flare ups. This recurrence could impact much of the second half of the year and lead to some uneven activity around the globe. However, there is so much pent-up demand in those regions that are just beginning to reopen that it should be more than enough to offset the problem areas. We all know that every new headline with respect to variants popping up will likely temporarily spook the market. With respect to #3 above, it's just math. The U.S. won't be dropping another $6 trillion in stimulus checks to its citizens; therefore, the baton has to be passed from stimulus to the real economy accelerating, and currently it looks like that's happening as expected. The Biden administration has floated higher corporate and capital gains taxes as part of his grand plan. However, much of these increases are tied to his $6 trillion "infrastructure" package being passed into law. There doesn't appear to be an appetite for this large of a deal in Washington currently, but you never know as it's Washington. Should the corporate tax rate rise to the middle of the proposed range, it will likely shave off approximately 8% of earnings growth in 2022. Capital gains rates have been tampered with multiple times in the past. The chart below left shows what has happened through time. While it's not a death sentence for the stock market, it certainly hasn't favored small caps in the past. Lastly, inflation is likely to peak on a year-over-year basis in the second or third quarter as you lap some of the easiest comparisons from the lockdown a year ago. However, while we tend to agree with the Fed that inflation is likely transitory for the most part, we need to pay attention to wages. Wage inflation tends to be much stickier and if businesses want to hire the required number of workers, they will likely have to pay up. Wages rarely, if ever, go down across the board. This wage inflation could begin to pinch operating margins which have been a big surprise to the upside over the past year for corporate America. The bottom line is that there is always a cause to worry. However, if you use history as your guide, in the years when the first half posts double digit returns like in 2021, then the back half of the year tends to fare reasonably well, as the chart below right shows.

Table 2 - There have been 10 Capital Gains hikes since 1926, Small performs OK

		Year Prior		Year of Hike		One-Year After	
Year of Hike	**Change in Rate**	**Small**	**Large**	**Small**	**Large**	**Small**	**Large**
1935	11%	116.2	49.9	19.7	1.4	61.0	44.4
1942	10%	-10.3	-10.8	26.5	15.2	58.1	25.1
1952	1%	15.3	21.8	9.6	14.1	-2.9	1.3
1968	2%	63.9	21.7	31.8	9.2	-22.2	-7.3
1969	1%	31.8	9.2	-22.2	-7.3	-9.9	2.2
1970	3%	-22.2	-7.3	-9.9	2.2	20.3	14.5
1971	2%	-9.9	2.2	20.3	14.5	5.6	20.4
1972	3%	20.3	14.5	5.6	20.4	-34.3	-14.5
1987	8%	8.8	18.0	-6.9	3.9	24.8	16.0
2013	5%	18.4	15.9	43.4	33.5	4.3	13.0
Average	**5%**	**23.2**	**13.5**	**11.8**	**10.7**	**10.5**	**11.5**
Median	**3%**	**16.8**	**15.2**	**14.7**	**11.6**	**5.0**	**13.8**

Source: Congressional Research Service; IRS; CRSP; Jefferies

S&P Forward Performance Following Best 1H % Changes

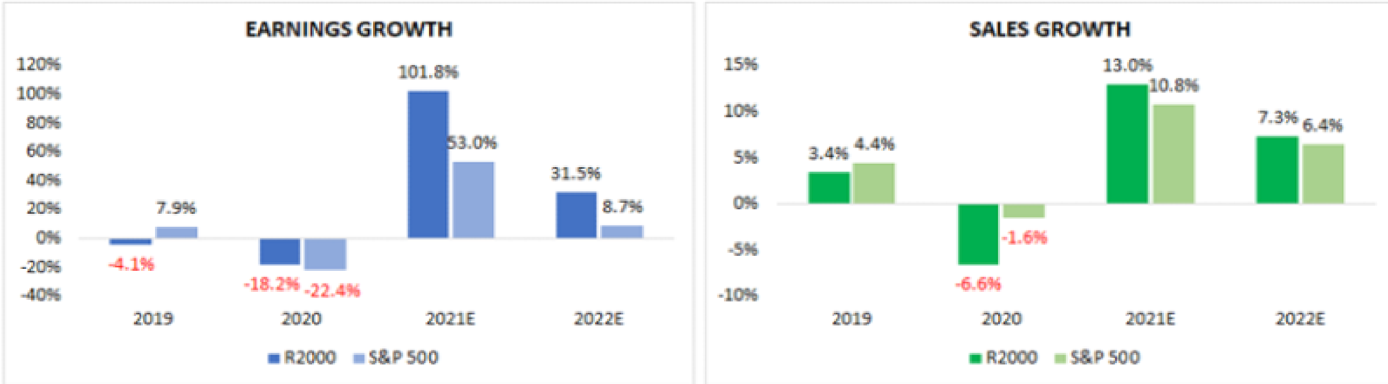
	Year	1H Perf.	3Q Perf.	4Q Perf.	2H Perf.
1.	1975	38.8%	-11.9%	7.5%	-5.3%
2.	1987	25.5%	5.9%	-23.2%	-18.7%
3.	1983	19.5%	-1.2%	-0.7%	-1.9%
4.	1997	19.5%	7.0%	2.4%	9.6%
5.	1986	18.7%	-7.8%	4.7%	-3.5%
6.	1995	18.6%	7.3%	5.4%	13.1%
7.	1954	17.7%	10.6%	11.4%	23.2%
8.	2019	17.3%	1.2%	8.5%	9.8%
9.	1998	16.8%	-10.3%	20.9%	8.4%
10.	1976	15.6%	0.9%	2.1%	3.0%
11.	1985	14.7%	-5.1%	16.0%	10.1%
12.	1989	14.5%	9.8%	1.2%	11.1%
13.	1955	14.0%	6.4%	4.1%	10.8%
14.	1958	13.1%	10.7%	10.3%	22.0%
15.	1967	12.8%	6.7%	-0.2%	6.4%
	2021	**14.4%**	**?**	**?**	**?**
		Average	2.0%	4.7%	6.6%
		% Positive	66.7%	80.0%	73.3%
		Historical Average	0.7%	4.0%	4.7%
		Historical % Positive	62.0%	78.9%	70.4%

Source: Strategas Research

Small Caps vs. Large Caps

Now we'll tackle the "small vs. large cap" debate. When we think about what drives stock performance, it's a pretty simple mix of fundamentals and valuation. At this point in time, both point in favor of small caps. With respect to fundamentals, as the chart directly below shows, sales and earnings growth through 2022 favor small caps. Part of this favorability is a function of many smaller cap companies being part of the service economy that has been hammered due to Covid lockdowns and as these businesses are allowed to reopen at full capacity, their sales and earnings growth should be explosive. Contrast this factor to some of the largest companies in the U.S. stock market like Amazon, Microsoft, Apple, and Facebook which were all beneficiaries to some degree of the lockdowns due to "work from home" and more time on social media platforms. While these larger companies won't see business fall off, they just won't have the easy comparisons that many smaller companies possess.

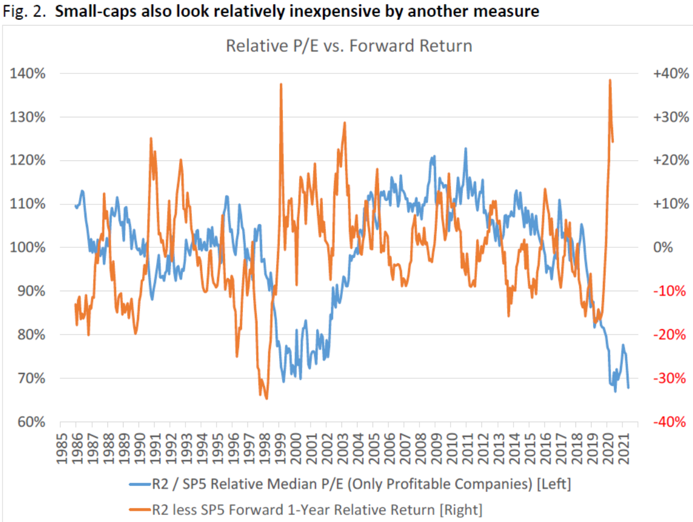
Fig 2. **R2000 and S&P 500 Expected Earnings & Sales Annual Growth**



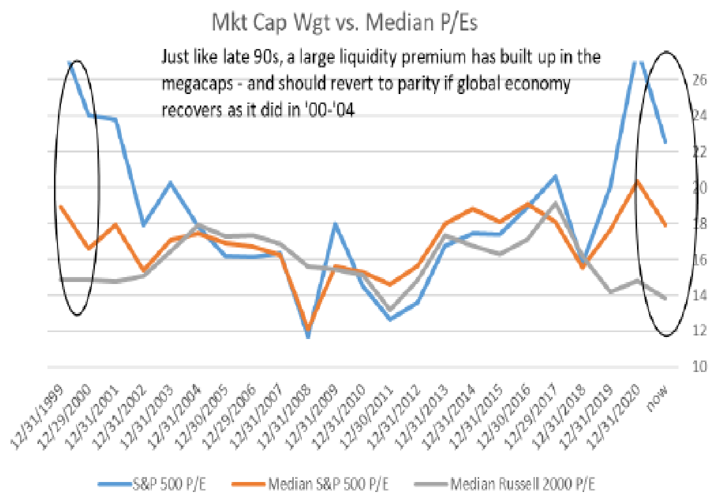
Source: Furey Research Partners and FactSet. Data as of 4/28/21.

From a valuation perspective, small caps win this argument too. The chart below left shows that the relative P/E ratio (price/earnings) of large caps vs. small caps (blue line) is at its lowest point in the past 35 years. The chart only uses profitable companies in both indices. The orange line shows the relative forward twelve month return which is also skewed in favor of small caps. When the relative valuation has been this cheap in favor of small caps historically, small caps have had strong outperformance relative to large caps. The chart on the right compares the median P/E ratio of the S&P 500 (orange line) to the median P/E ratio of the Russell 2000 (grey line). Note that the gap has widened to about four multiple points. A similar phenomenon developed back in the 1999/2000 tech bubble. This gap subsequently closed over the next few years. Observe that for much of the period from 2004 through 2018, the P/E ratios of small caps and large caps were quite similar. We expect that this gap will narrow over the coming years.

Fig. 2. **Small-caps also look relatively inexpensive by another measure**



Source: FRP, FactSet; as of 5/28/21



Source: FactSet, Bloomberg, and Raymond James research

Using history going back to the 1930's as our guide, small cap outperformance cycles typically last an average of 5+ years and can have periods of massive outperformance for small caps during these episodes as the chart below shows. The numbers in the green box represents the average for all the prior outperformance cycles. Note that the average annualized excess returns of small caps over large caps in these cycles was +18.3%. Pretty meaningful outperformance over an extended timeframe.

Table 1 - When small beats large, do so for an average of 5-years, we only hope

We are here

		Small Caps		Large Caps		
Period	**Length of Period**	**Cumulative**	**Annualized**	**Cumulative**	**Annualized**	**Excess**
05/32-02/37	4.8	1045.7	67.1	343.3	36.8	30.3
05/40-05/46	6.1	521.8	35.6	166.9	17.8	17.8
01/64-12/68	5.0	210.2	25.9	49.8	8.6	17.3
12/74-06/83	8.6	1089.1	33.8	236.3	15.3	18.5
10/90-02/94	3.4	138.6	29.8	66.1	16.4	13.4
03/99-03/06	7.1	144.2	13.6	6.1	0.9	12.7
02/09-11/15	6.8	292.7	22.5	215.4	18.6	3.9
3/18/20 to ?	**1.3**	**135.0**	**96.7**	**87.1**	**64.2**	**32.5**
Average	**5.4**	**447.2**	**40.6**	**146.4**	**22.3**	**18.3**

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

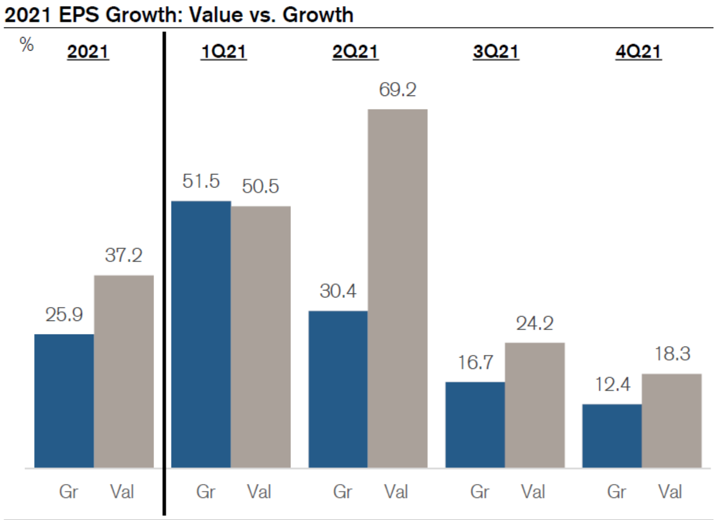
Growth vs. Value

The decision to be in growth or value is never an easy one but there are times when the weight of the evidence tends to clearly favor one over the other. Now isn't one of those times, and it's very murky for a number of reasons. The first of which is recent history. When you examine the data in the table below, I would bet that many don't realize that the Russell 2000 Value Index outperformed the Russell 2000 Growth Index since the pandemic low of March 23, 2020 through June 30, 2021. How we arrived here was filled with a couple of dramatic shifts in leadership in relatively short timeframes. As the table below highlights, as we bounced off the pandemic low on March 23, 2020, the market tilted to a growth mentality as growth was likely going to be scarce due to the pandemic lockdown. Then as stimulus became visible and as the elections ended, there was a dramatic shift to value as inflation was visible and as interest rates started ticking up which helped the financial and material sectors (larger weighting in value indices). Then in June 2021, the Fed met and moved their timeline for rate hikes ever so slightly which caused a shift back to growth in very short order. So, therefore it's very difficult to call where we go from here.

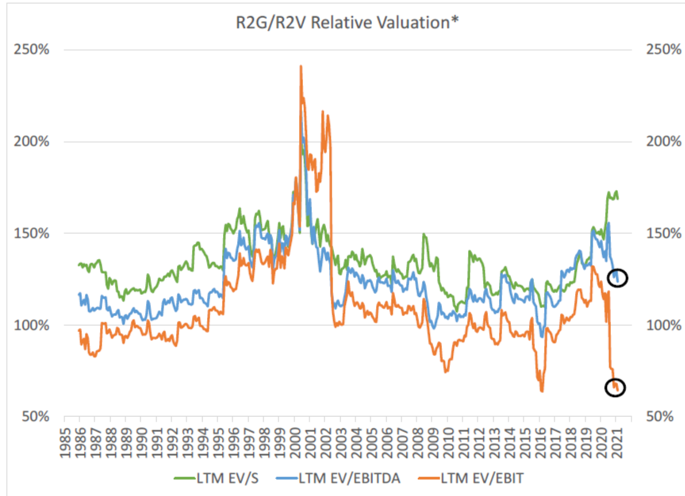
	Russell 2000 Growth	Russell 2000 Value	Russell 2000 Growth-Russell 2000 Value
March 23, 2020 – October 31, 2020	+61.8%	+45.9%	+15.9%
October 31, 2020- May 31, 2021	+33.9%	+64.1%	-30.2%
May 31, 2021- June 30, 2021	+4.7%	-.6%	+5.3%
Total March 23, 2020- June 30, 2021	**+126.9%**	**+138.1%**	**-11.2%**

Source: 1492 Capital Management, LLC and FactSet

Here's what we're thinking about as we look ahead to determine whether growth outperforms value or vice versa. The key variable that has caused some of the prior flip-flops has been inflation which influences interest rates. If inflation can be maintained at reasonable levels and not overheat, value stocks should outperform as reasonable inflation would allow businesses, particularly those that are commodity based, to realize pricing power for a longer period. If inflation gets too hot, then the Fed steps in sooner than expected and raises interest rates, which implies that the economy will ultimately slow, and growth will become scarce again. There is no doubt that the inflation numbers will look historically high in the coming months given the comparisons of a year ago, but they should stabilize to a range of 3-4% as we progress through the year and then fall further into 2022 as supply chains normalize. From a fundamental viewpoint, value stocks will show much stronger earnings in the June quarter compared to growth stocks, and then that gap will narrow as we move through the year as shown on the chart below left. However, the market has likely already priced this in. From a valuation standpoint, relative valuations for the Russell 2000 Growth Index versus the Russell 2000 Value Index currently favor the Russell 2000 Growth as shown in the chart below right. The orange line, which we believe is the most relevant, compares the valuation of the two indices using Enterprise Value (EV) to EBIT (earnings before interest and taxes). As you can see, the relative valuation is back to 35-year lows. Note that on all the metrics shown in this chart, the growth index usually trades at a significant premium to value because of the compounding factor of growth commands a premium valuation. Now you know why we think it's a toss-up. We'll watch for signals from inflation, interest rates, and the Fed in the coming months. Now I sound like a politician.



Source: Russell, Refinitiv, FactSet and Credit Suisse



*Source: Furey Research Partners, FactSet; as of 2/26/21; *Excludes Financials & Biopharma*

Thematic Investing: Retail: We Can Rebuild It…We Have the Technology. Better Than It Was Before…Better, Stronger, Faster.

If I had to make a guess, I'd say that management teams from consumer products companies and retailers have latched onto this mantra from the 1973 television series, "The Six Million Dollar Man". If they didn't, their show has likely been cancelled at least in terms of Wall Street's eyes.

Looking back 15 months or so, manufacturing came to a screeching halt as inventory orders were cancelled and as uncertainty was the only thing that was certain. Goods that already had been ordered were stuck on ships outside of ports without labor to move them. Demand was believed to have temporarily vanished. Brick-and-mortar retailing came to a screeching halt and forced stores to shutter and companies to file for bankruptcy. For some companies it was a time to hunker down and figure out how to do business under the new rules of better, stronger (more profitably), and faster. In other words, they had to figure out how to remain visible and relevant with a backdrop of massively scaled e-tailers (think Amazon) that had key technological advantages.

Moving forward in time from March 2020, as stimulus checks ramped around the globe and as savings amassed from money that would've been spent on travel was pocketed, demand began to return. For some industries, the demand returned in a big, big way. Anything recreational or leisure-related had a short shelf life like boats and RV's and even automobiles (for a whole other reason) and became waitlist items at higher and higher prices. For many retailers of soft goods like clothing, for example, demand returned more slowly, but for some other retailers, demand rebounded very strongly as disruption in brick-and-mortar sales was captured through e-commerce. Whether that business was created via the digital turbine of social media and influencers or was out of pure consumer necessity, the companies that figured this approach out have, in our opinion, posted the strongest results. Acronyms invented prior to the pandemic, such as "BOPUS" (buy online and pick up in store), have become commonplace vernacular for consumers and have become higher margin models for retailers. The ones that realized these adjustments have been able to use stores as warehouses with skinny labor models to move product at lower costs and with lower promotions. Many more specialized clothing retailers found themselves "comping" or generating same store sales at previously unimaginable rates over year-to-date 2019 sales, which drives financial leverage, generates cash, increases earnings and hopefully drives stock valuation! In fact, a well-known branded athletic shoe and apparel manufacturer was so successful at this approach that in their most recent quarterly earnings release, their sales were nearly $1 billion greater in North America alone at a much lower "demand generation expense" (marketing) than Wall Street analysts had forecasted. Who would have thought?

More time is needed to see how and when the new normal settles in, but our belief from meetings with several of these management teams over the past year is that those who have repositioned will generate higher comparable store sales and higher margins with fewer promotions than we've seen in years, *if ever*, in the coming quarters. Unfortunately, not all retailers have seen or appreciate the 1970's television series referenced above which means that many more stores may have to be rationalized. Retail and consumer industry experts have estimated that thousands of stores will close each year over the next five years as companies figure out how to do things better, stronger, faster than before.

Thematic Investing: The Much-Maligned E&P Stocks Have Religion and Upside

Ordinarily any industry that is demonstrating both unprecedented capital spending discipline and an increased shareholder returns focus would experience expanding valuations for its equities. Couple these positives with a favorable macro demand and supply picture and one might expect investors to be stampeding toward this sector. Nevertheless, despite leading all Russell 2000 sectors over the last 12 months and besting the second largest sector advance by roughly 43 percentage points, the valuations for exploration and production (E&P) companies in the oil and gas sector remain very reasonable. Historically a small cap E&P stock would historically trade between roughly four to eight times EBITDA. As you can see in the table below on 2022 EBITDA estimates that are based on forecasted $67/$3.14 WTI oil prices and Henry Hub natural gas benchmark prices, respectively, from Simmons Energy, the SMID caps' multiples average between 4-4.4 times.

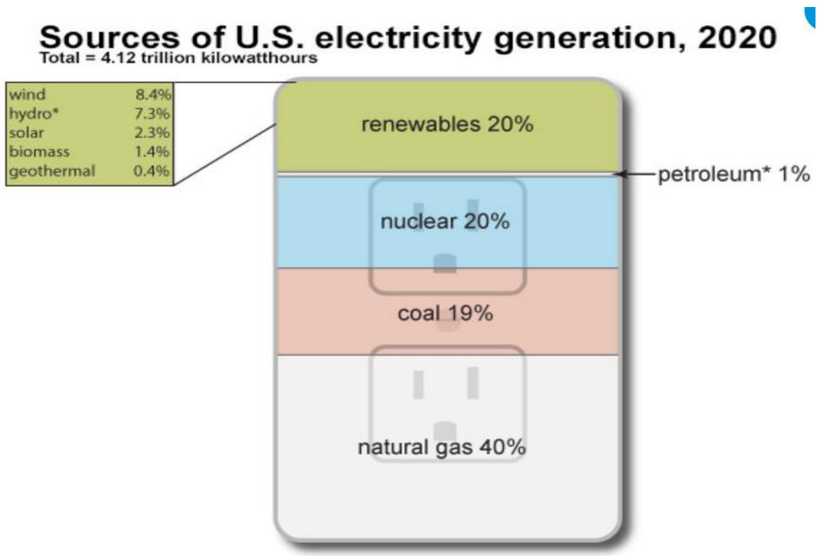
Company Name	Ticker	Price Jun 25	EV/EBITDA '21E	EV/EBITDA '22E	Net Debt/EBITDA '21E	Net Debt/EBITDA '22E
BP p.l.c	BP	$27.32	4.2x	3.8x	1.3x	1.1x
Chevron Corporation	CVX	$107.30	6.6x	6.3x	0.8x	0.6x
ConocoPhillips	COP	$61.31	4.9x	4.4x	0.4x	0.2x
Exxon Mobil Corporation	XOM	$64.66	8.3x	8.0x	1.4x	1.3x
Royal Dutch Shell	RDS.A	$41.89	4.3x	4.1x	1.1x	0.9x
Total SA	TOT	$47.59	5.2x	5.1x	1.4x	1.3x
Hess Corporation	HES	$89.32	11.0x	10.4x	2.0x	1.9x
Occidental Petroleum Corporation	OXY	$32.91	6.9x	6.6x	3.5x	3.1x
Average Mega Cap/IOC			**6.4x**	**6.1x**	**1.5x**	**1.3x**
Apache Corporation	APA	$22.20	3.9x	4.3x	1.9x	2.0x
Cimarex Energy Co.	XEC	$73.05	7.8x	5.0x	1.1x	0.2x
Continental Resources, Inc.	CLR	$39.40	5.2x	5.5x	1.1x	0.8x
Devon Energy Corporation	DVN	$29.76	4.9x	5.1x	1.0x	0.8x
Diamondback Energy, Inc.	FANG	$96.31	5.8x	5.8x	1.6x	1.0x
EOG Resources, Inc.	EOG	$87.65	5.7x	5.7x	0.0x	-0.2x
Marathon Oil Corporation	MRO	$14.07	4.7x	4.7x	1.1x	0.6x
Murhpy Oil Corporation	MUR	$25.29	5.0x	5.6x	2.2x	2.1x
Pioneer Natural Resources Company	PXD	$165.17	6.2x	5.3x	0.8x	0.2x
Average Large Cap			**5.5x**	**5.2x**	**1.2x**	**0.8x**
Berry Corporation	BRY	$6.82	2.5x	2.5x	1.4x	1.0x
Centennial Resource Development	CDEV	$7.33	4.8x	5.0x	1.8x	1.3x
Laredo Petroleum, Inc.	LPI	$87.23	3.7x	2.8x	2.2x	1.3x
Magnolia Oil & Gas Corp.	MGY	$16.21	6.0x	5.3x	0.1x	-0.2x
Northern Oil & Gas	NOG	$20.54	5.0x	4.4x	1.9x	1.5x
Whiting Petroleum	WLL	$54.85	4.4x	3.6x	0.0x	-0.6x
Average Oil Levered SMID Cap			**4.4x**	**4.0x**	**1.2x**	**0.7x**
Cabot Oil & Gas Corporation	COG	$16.82	4.9x	4.7x	0.5x	0.3x
CNX Corporation	CNX	$14.68	4.6x	4.0x	1.9x	1.4x
Comstock Resources	CRK	$6.50	3.9x	3.9x	2.7x	2.3x
EQT Corporation	EQT	$22.03	6.4x	5.2x	2.6x	1.7x
Range Resources Corporation	RRC	$16.65	5.1x	5.0x	2.4x	1.8x
Southwestern Energy Company	SWN	$5.63	3.5x	3.8x	2.0x	1.7x
Average Gas Levered SMID Cap			**4.7x**	**4.4x**	**2.0x**	**1.5x**

Source: Simmons Energy

This level of valuation still provides an interesting investment entry point. If we use the enterprise value to 2022 EBITDA estimates multiple average of 4.2 time above for the two SMID cap groups and then take the commodity prices down to roughly $60/$2.29 (currently $74.96/$3.66), the multiple only expands to roughly 4.7X, which still resides on the low end of the traditional range. Simplistically, as cyclical stocks the market is either telling us that 2022 is a peak year for profits and thus demands a low multiple, or the market is wrong. With memories running long of the multi-year underperformance of energy despite the strong last twelve months, the valuations, the change in business strategy, and an objective view of the macro environment are telling us that there is still upside to E&P stocks. Consider how the business models have changed in the last year or so. The industry is now emphasizing free cash flow, debt reduction, returns to shareholders via fixed and variable dividends, and much lower production growth. This new approach compares to the multi-decade strategy of E&P's cash flowing $1 and spending $2 or more for growth for growth's sake. The valuations of E&P stocks may also suggest that investors believe that the industry will lose this religion as oil prices remain robust. We believe that E&P companies are getting the same "we'll leave you for dead" message from the investment community that other previously terrible investment areas like airlines received. Heeding their warning, the airlines became a much more disciplined industry in terms of adding capacity and became more shareholder friendly, and investors returned to their stocks. We believe that the same change is underway in the E&P sector, and there is no turning back.

With a better business model and still poor valuations, the other roadblocks to investors appear to be ESG (environment, social and governance) and EV (electric vehicles) related. With respect to EVs, the thought process is often that we cannot invest in oil and gas because of the long-term secular gasoline demand decline associated with EV adoption. As economist John Maynard Keynes once said, "in the long run, we are all dead." As with many things in life, it depends on the investment time frame here. Next year the world should consume roughly 100 million barrels per day. In a report by Cowen Equity Research, they estimate that when factoring in EV and hybrid growth, passenger transportation oil demand should decline by roughly 5.1 million barrels per day from 2019 through 2030 or just over 400 thousand barrels per day per year. They also forecast gains in commercial transportation demand of 3.5 million barrels per day over the same period. Netting these figures implies that we will see a 1.6 million barrels per day decline in oil transportation demand on a total base demand of 101 million barrels per day in 2019 by 2030. This figure is small and nearly a decade away. With additional petrochemical demand growth for oil over the next several years as well, Cowen forecasts that global oil demand will rise through 2030. We believe that oil's death by EVs is a difficult bet to make when the data is examined closely. In addition, after OPEC's return to nearly full production return over the next several months to satisfy 2022 demand, the U.S. E&P industry will be adding much less supply to the picture over the same time period with their new financial discipline. Barring another round of a pandemic, OPEC's measured pace of supply adjustments and the improved U.S E&P capital discipline should create a more stable macro environment for oil and natural gas. This stability should improve the E&P sector's valuation as well.

On the natural gas side of the ledger, as seen below, it comprised roughly 40% of our electrical generation in the U.S in 2020 according to the EIA. With nuclear, hydro, and coal seeing no growth or declines in the years ahead, natural gas will remain both the preferred source for additional baseload electrical power growth and a key player in supplying EVs with the electricity that they require.



Source: EIA

We also remain interested in the bridging technologies from traditional energy to non-petroleum based alternative energy like renewable diesel. Benefitting from strong demand in the U.S. and Europe, this product is the chemical equivalent to diesel but derived from soybean oil, fats and used cooking oil. It should have a long runway for growth before electric semi-trucks gain significant market share many, many years down the proverbial road.

The other reason that keeps investors from the E&P sectors is the idea that it's not ESG-investable. We would argue that investing is often about rate of change, and the E&P sector is witnessing nice ESG gains. Any publicly traded E&P company now has multiple slides in their corporate presentation discussing the three components. On environmental, the industry is working diligently on reducing natural gas flaring and on recycling water that is used in their fracking operations. E&Ps earn more money when they can sell natural gas versus flare it and when they reduce costs by recycling water versus buying more volumes, so their pocketbooks benefit right alongside with the environment. On the social, a great deal of work is being done on diversifying management and the board room. On governance, more traditional financial ratios are deployed for bonus targets versus the reliance on just growth in production and reserves. In fact, over the 2017-2020 period, Raymond James

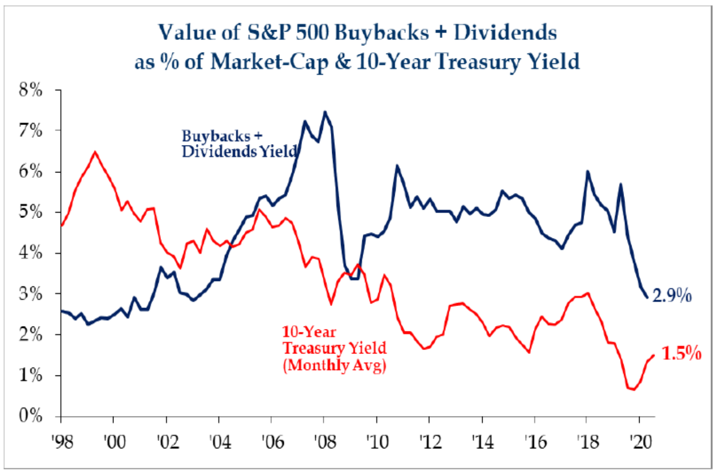
Equity Research estimates that there has been a 50% reduction in volume and reserve addition performance in bonus metrics for their E&P coverage group with a 100% increase in return on capital metrics.

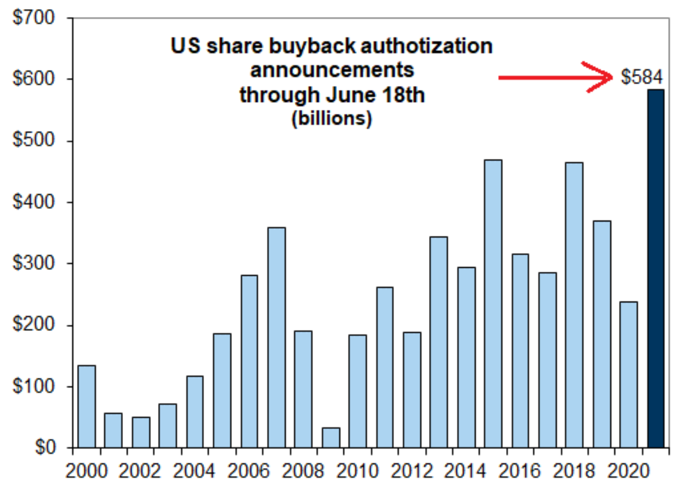
Armed with compelling valuations even at lower oil prices, E&P equities remains fertile ground for investment as investors realize that the industry's corporate strategy is very much new and improved, that EVs' impact on oil volumes has minimal near-term demand impact, and that ESG is alive and well in the industry despite the dirty oil drumbeat to the contrary.

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.

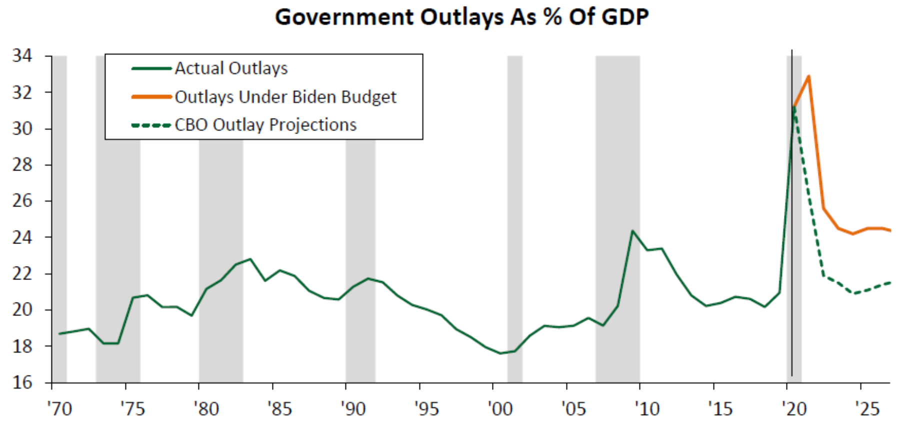
Relative to current 10 Year Treasury interest rates, the stock market currently provides nearly twice the yield through return of capital in the form of dividends and stock buybacks. Share buyback announcements have been incredibly strong of late.





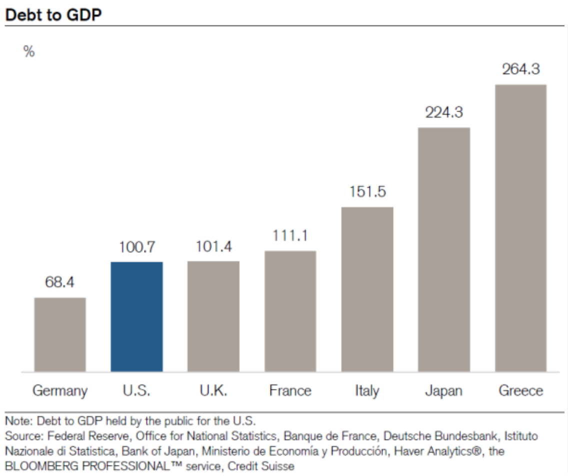
Source: Strategas Research

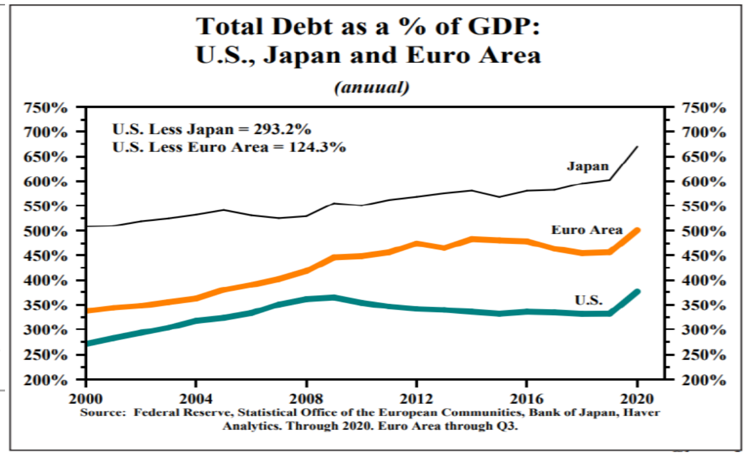
If the Biden administration's budget is passed as currently proposed, government spending as a percentage of GDP will be a record by a wide margin in a non-recessionary environment as shown by the orange line in the chart below.



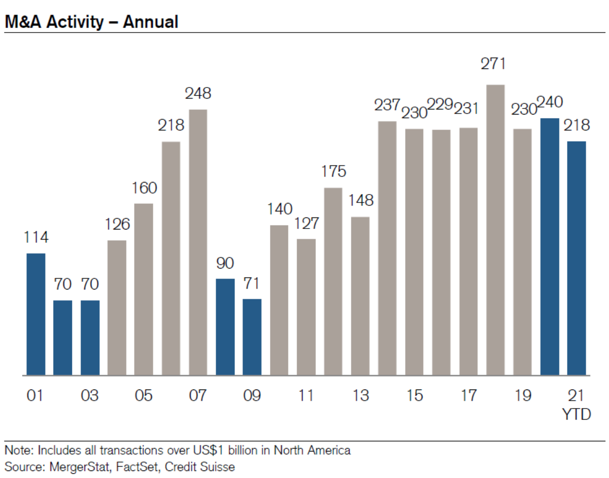
Source: Cornerstone Macro

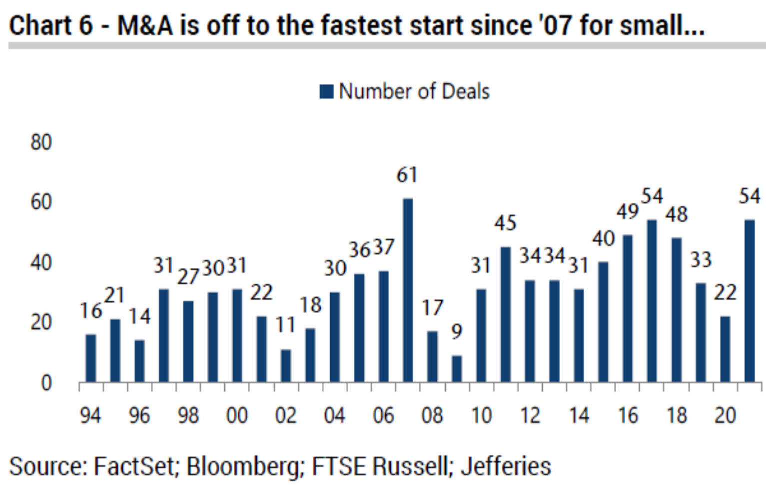
The U.S. government debt is rising rapidly due to the pandemic-induced stimulus. We're a good house in a bad neighborhood in comparison with other countries. When you look at the chart on the left, you must wonder how it's possible that Greece's 10 Year Treasury bond yields only .82% currently. This makes no sense.



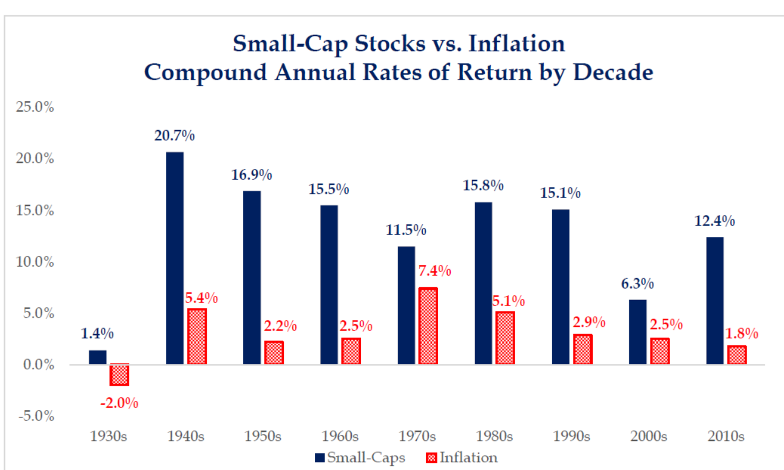


Merger and acquisition activity has been white hot so far this year as seen on the chart on the left. We've almost surpassed the total for all of 2020 in just six months. The chart on the right shows a similar situation for small cap deals.





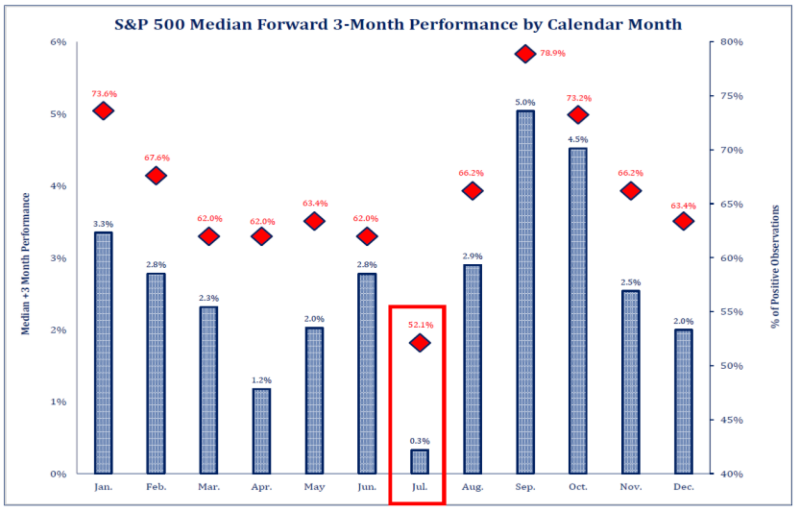
Going all the way back to the 1930's, small caps stocks have proven to be a great hedge against inflation.



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 performance as we move through the calendar. The chart below shows the three month forward performance by calendar month. As you can see, July has historically had the worst forward three-month performance as it contains the dog days of summer months as well as September which has historically been the worst month of the year on a stand-alone basis. Interestingly, the best two-week period of the entire year falls in July. It's the first two weeks of July, which includes both a time that is historically quiet for the Fourth of July holiday and a period of calm before the storm of earnings season that begins mid-July.



Source: Strategas Research

We hope that you found our second quarter 2021 review and updated 2021 outlook newsletter to be insightful and interesting. Stay safe and healthy. GO USA in the Olympics!! 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.

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