1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
SEPTEMBER 2021 • VOL. 14 • ISSUE 9
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 third 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.

Accumulating Headwinds Bring an End to Several Stock Market Streaks

After a valiant effort to hold off the inevitable, the S&P 500 finally corrected by more than 5%, which breaks a streak that was intact for 335 days and one that dates back to October 30, 2020. It took until the last trading day of the quarter to push the index down more than -5% from its high as mounting headwinds finally exacted their toll. However, the 335 day streak was one of the longest in stock market history. The second streak that was broken was a seven month winning streak for the S&P 500. Unfortunately, this streak also ended in September which is statistically the worst month for the stock market. This year it held to form as the S&P 500 fell -4.65% for the month but managed to post a modestly positive return for the quarter. The accumulating headwinds became too much for the stock market to rise unchecked. These headwinds include: the Covid Delta variant; inflation fears; supply chain issues; semiconductor shortages; China imposing an escalating number of suffocating regulations on their homegrown companies and citizens; China saber rattling with Taiwan and Hong Kong; concerns over Fed tapering and tightening; the U.S. government battling over infrastructure bills; and, the debt ceiling, just to name a few. With a list like this, the carnage could be far worse. While the FANGM stocks buoyed the S&P 500 index from the end of February through September, there was far more damage underneath the hood of the market. For example, the Russell 2000 marked time through this period compared to a +14% return for the S&P 500. This return disparity between large and small caps is one of the largest in history over such a short timeframe within the context of a bull market.

While you might expect us to project a cautious tone due to the headwinds we mentioned above, we are fairly constructive as we expect the dissipation of some of the aforementioned headwinds in the coming months. However, the market will likely be performing a bit of a tightrope act for a while as we navigate these issues. The good news is that we're now three-fourths through the year which leaves the statistically strongest part of the year for the market.

There are many wildcards ahead and we'll try to address as many of them as possible in the balance of the 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.

IN THIS ISSUE:

A Review of the Quarter: Accumulating Headwinds Bring an End to Several Stock Market Streaks……….Page 2

Updated 2021 Outlook: Rubber Band is Pulled Back and Tension is Building for Small Caps……………….Page 7

Thematic Investing: Strategic Resources, Strategic Resources…Get Your Strategic Resources Here!……..Page 13

Updated 2021 Outlook: A Picture is Worth a Thousand Words…………………..Page 15

Stock Market Trivia….Page 16

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

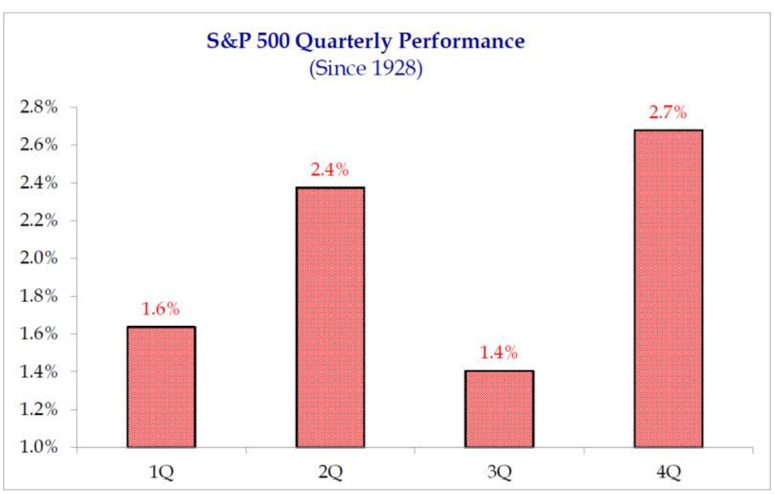
Review of the Quarter: Accumulating Headwinds Bring an End to Several Stock Market Streaks

After a valiant effort to hold off the inevitable, the S&P 500 finally corrected by more than 5%, which breaks a streak that was intact for 335 days and one that dates back to October 30, 2020. It took until the last trading day of the quarter to push the index down more than -5% as mounting headwinds finally exacted their toll. However, the 335 day streak was one of the longest in stock market history. The second streak that was broken was a seven month winning streak for the S&P 500. Unfortunately, this streak also ended in September which is statistically the worst month for the stock market. This year it held to form as the S&P 500 fell -4.65% for the month but managed to post a modestly positive return for the quarter. The accumulating headwinds became too much for the stock market to rise unchecked. These headwinds include: the Covid Delta variant; inflation fears; supply chain issues; semiconductor shortages; China imposing an escalating number of suffocating regulations on their homegrown companies and citizens; China saber rattling with Taiwan and Hong Kong; concerns over Fed tapering and tightening; the U.S. government battling over infrastructure bills; and, the debt ceiling, just to name a few. With a list like this, the carnage could be far worse. While the FANGM stocks buoyed the S&P 500 index from the end of February through September, there was far more damage underneath the hood of the market. For example, the Russell 2000 marked time through this period compared to a +14% return for the S&P 500. This return disparity between large and small caps is one of the largest in history over such a short timeframe within the context of a bull market. However, all is not lost from the broken streaks. As the chart below shows, when seven months up streaks end, history shows that the next six month performance is healthy with a median return of +10.5%.

Figure 8: History following 7 consecutive up months

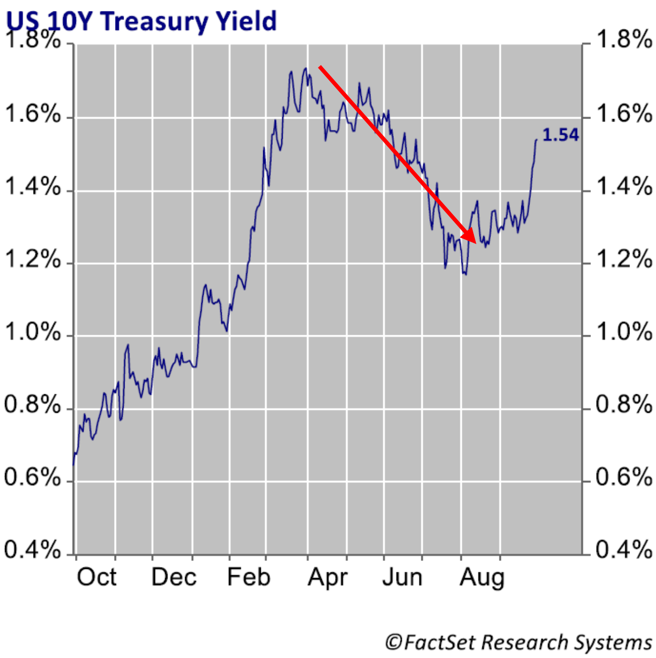
				Max Drawdown from 7th month-end over next 6-months				Max Gain from 7th Month-end Over Next 6-Months		
Month End	SPX	Consecutive Up Months	New High?	Date	SPX	% Chg	# of Days	Date	SPX	% Chg
9/30/1958	50.06	11	Yes	10/1/1958	49.98	-0.16%	1	3/13/1959	56.67	13.20%
5/31/1961	66.56	7	Yes	7/18/1961	64.41	-3.23%	33	11/27/1961	71.85	7.95%
6/30/1964	81.69	8	Yes	8/26/1964	81.32	-0.45%	40	11/20/1964	86.28	5.62%
10/31/1980	127.47	8	Yes	2/20/1981	126.58	-0.70%	75	11/28/1980	140.52	10.24%
2/28/1983	148.06	9	Yes		None			6/22/1983	170.99	15.49%
5/31/1991	389.83	7	Very close	6/25/1991	370.65	-4.92%	17	11/13/1991	397.41	1.94%
3/31/1993	451.67	7	Yes	4/26/1993	433.54	-4.01%	17	8/31/1993	463.56	2.63%
6/30/1995	544.75	8	Yes		None			12/13/1995	621.69	14.12%
5/31/1996	669.12	8	Yes	7/24/1996	626.65	-6.35%	37	11/25/1996	757.03	13.14%
12/29/2006	1418.30	8	52-wk high	3/5/2007	1374.12	-3.11%	42	6/4/2007	1539.18	8.52%
9/30/2009	1057.08	7	No	10/2/2009	1025.21	-3.01%	2	3/23/2010	1174.17	11.08%
5/31/2013	1630.74	7	Yes	6/24/2013	1573.09	-3.54%	16	11/27/2013	1807.23	10.82%
10/31/2017	2575.26	10	Yes	11/15/2017	2564.62	-0.41%	11	1/26/2018	2872.87	11.56%
8/31/2021	4522.68	7	Yes	9/30/2021	4307.54	-4.76%	21	9/2/2021	4536.95	0.32%
					Avg.	-2.72%	26.5		Avg.	9.04%
Source: Bloomberg/ Canaccord Genuity					Median	-3.11%	17.0		Median	10.53%

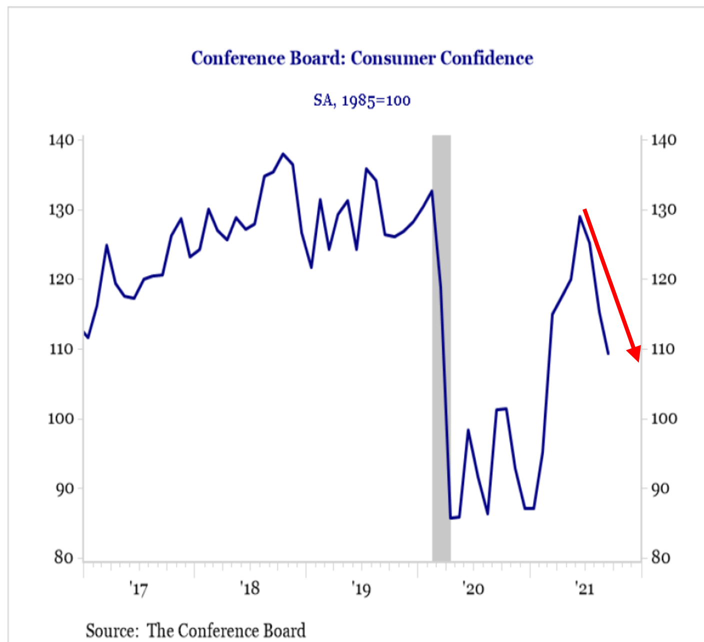
While you might expect us to project a cautious tone given the headwinds we mentioned above, we are fairly constructive if some of the aforementioned headwinds dissipate as we expect in the coming months. However, the market will likely be doing a bit of a tightrope act for a while as we navigate these headwinds. The good news is that we're now three-fourths of the way through the year which leaves the statistically strongest part of the year for the market ahead. The chart below highlights the seasonal performance of the S&P 500.

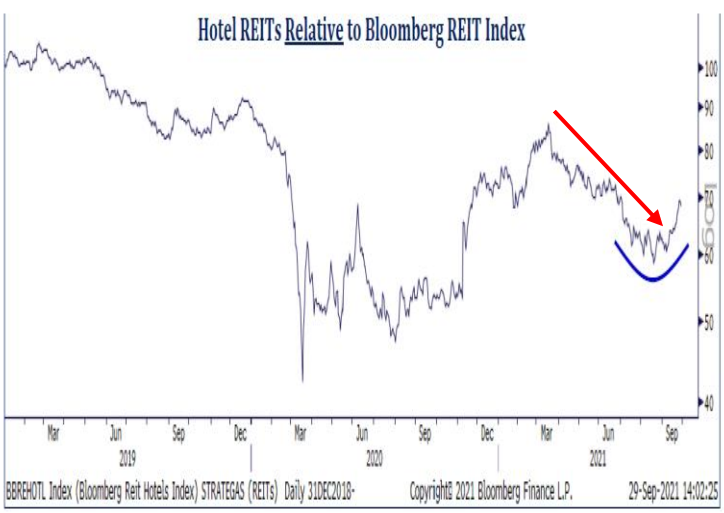


Source: Strategas Research

Since the Covid Delta variant became a common term and a concern in the U.S. beginning in late February, there have been some very subtle but important movements in the markets. Despite the number of Covid cases spawned by the Delta variant not picking up significantly until the summer months, the markets seemingly anticipated the Delta wave beginning in mid-to-late February and caused a secondary global lockdown. This lockdown is when something started to change under the hood of the markets. You'll notice that in each of the charts below that beginning in late February, there was a marked change in risk aversion. In the first chart below left you'll see that the bond market started preparing for risk off as the U.S. 10-Year Treasury yield began to inexplicably decline despite the reopening of the world economy and significant stimulus in the system. Subsequently, consumer confidence began to retreat as the chart below right shows. Right on cue, other signs of consumer distress simultaneously arrived with hotel stocks starting to see bookings wane as Covid accelerated. See second chart below left. Ultimately, as concerns about Covid rose, the consistent growth of the FANGM stocks became attractive again and launched a secondary advance that carried the entire S&P 500 Index higher. However, the move of these five large stocks camouflaged what was happening under the surface. As you can see in the fourth chart below right, there was significant deterioration off the February highs for the average stock within the respective indices as depicted in the lower panel. Ultimately what transpired over the seven months from February to September was one of the largest outperformance cycles in a bull market by large caps over small caps. The outperformance totaled over 1,300 basis points with the average stock within the Russell 2000 declining over 27% from the February high.





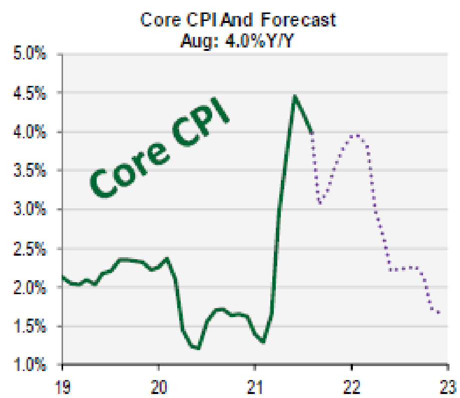


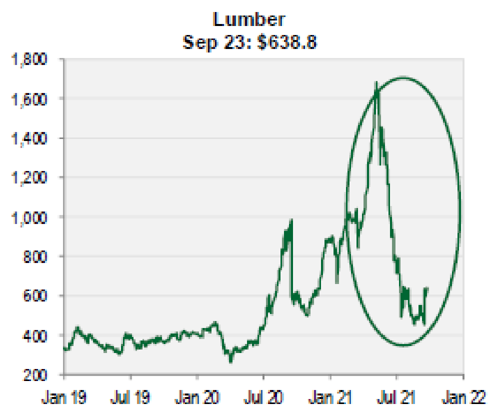
Source: Strategas Research

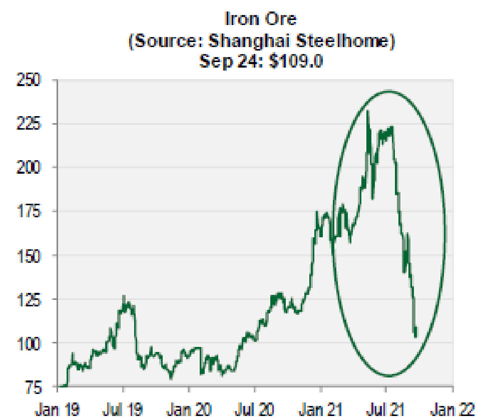
Index % Decline From High	
Nasdaq 100	-2.2%
S&P 500	-2.3%
Russell 2000	-5.2%
Average Stock % Decline From High	
S&P 500	-11.3%
Nasdaq 100	-12.4%
Russell 2000	-27.0%

Source: Strategas Research

The topic du jour is clearly inflation. It's mentioned in nearly every meeting that we attend, and it's pounded into consumers heads every day with the prices that they are paying at the gas pump or grocery store. If you recall, in our first quarter newsletter we did a segment on inflation and in our view commodity inflation is transitory, but wage inflation is much more sticky. As we said then, nothing kills high prices like high prices. That is to say that when prices rise for any commodity, either more supply is created by those that want to exploit the high price environment or demand falls as consumers pass on paying what they view as too high of a price for the good. The headline inflation numbers that we're all seeing via the CPI (cosnumer price index) or PCE (personal consumption expenditures) price index have shown a substantial uptick since late last year as shown in the chart below left. The problem with many of these indices is that they are quoting year-over-year changes which can be tremendously misleading. The charts below middle and below right show the substantial rise and subsequent fall of lumber and iron ore, respectively. There was clearly panic buying to drive the prices up, but supply also came on line as producers attempted to maximize their profits. Additionally, we've all heard of price spikes for many commodities over the past several months. The good news is that many of the price spikes for materials like lumber, iron ore, copper and many other base commodities have rolled over and have retreated to sane levels.

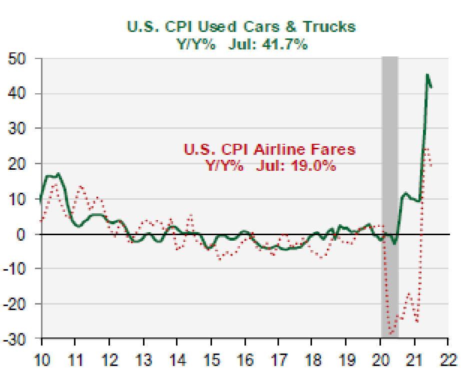


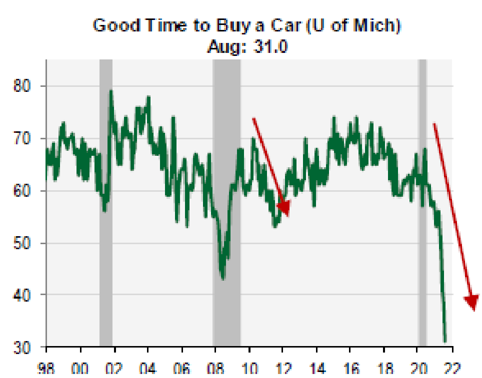


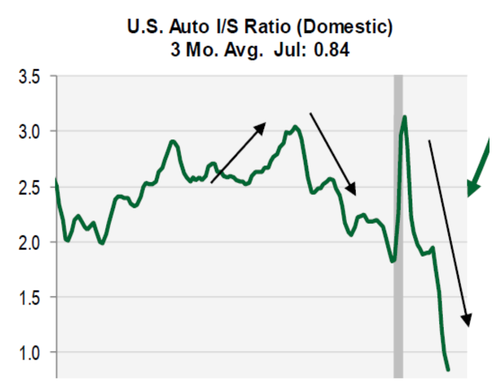


Source: Cornerstone Macro

For the past five months we've been comparing current prices versus the pandemic lockdown prices of a year ago when virtually every commodity plummeted. In fact, recall that the price of oil actually went negative for a very brief moment in the spring of 2020. This datapoint sets up very easy comparisons from a year ago. Simplistically if something was down 30% last year, it would need to be up over 40% this year just to be back to even. This phenomenon can be seen in the chart below left with airline fares (red line). They plummeted in 2020 as travel was non-existent for a time and even though they are over 20% higher this year, they aren't even back to where they were pre-pandemic in dollar terms. This math exercise is what we're witnessing in so many of these inflation statisitics currently. They will begin to normalize in the coming months as we lap more normal periods. Another issue consumers have been dealing with is shortages due to supply chain problems or semiconductor shortages for instance. The chart below left shows the realized inflation in used cars and trucks (green line). In July, consumers were seeing 40%+ increases in used car prices due to auto shortages from a lack of semiconductor chips and from Covid-related shutdowns of car manufacturing facilities as seen in the chart on the right in the plummeting inventory to sales ratio for U.S. cars. This ratio will normalize in time as OEM's ramp up production once the semiconductor shortages subside, which should be in the next six months. The chart below middle shows what the consumer thinks about buying a car currently. They literally have sticker shock.

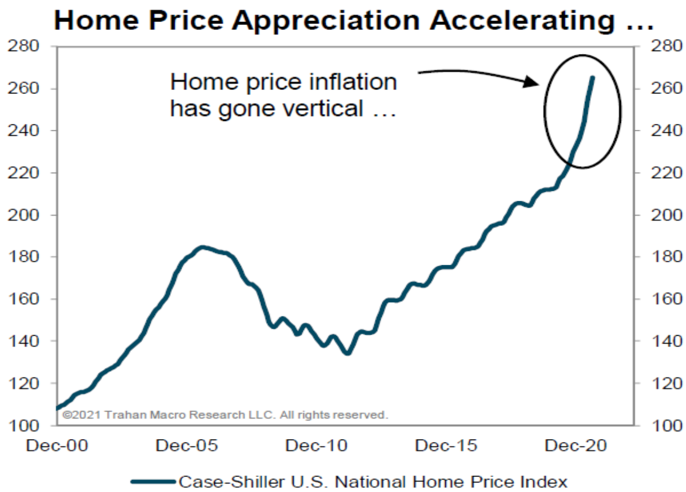


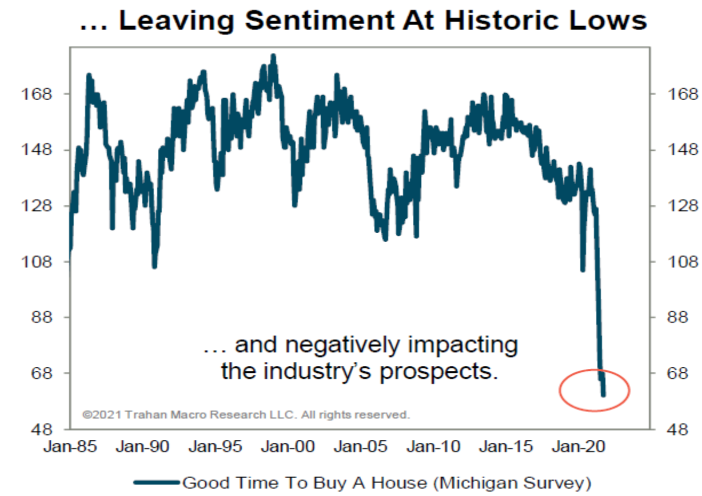




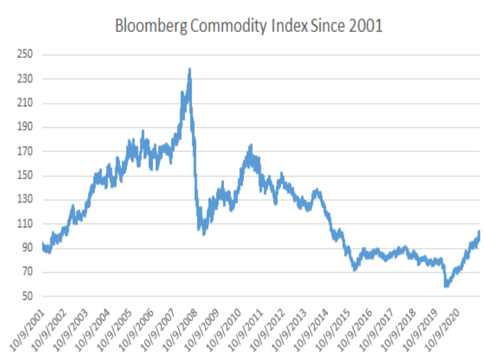
Source: Cornerstone Macro

The housing market is another example of inflation killing demand. As many home buyers decided that the work-from-home environment would let them live wherever they wanted, housing demand spiked and took prices with it. As the chart below left shows, home prices are up over 20% in the last year due to little inventory and to commodity price spikes like lumber. This rapid increase in home prices has left home buyers feeling less than optilmistic about purchasing a home in the current environment as sentiment has reached 50 year lows as shown in the chart below right.

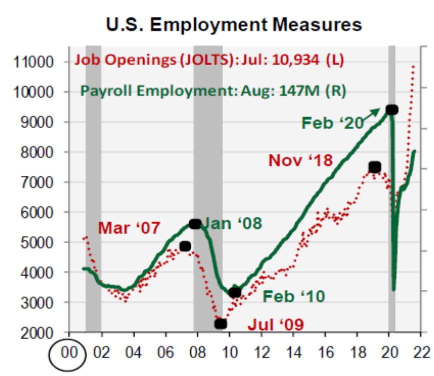




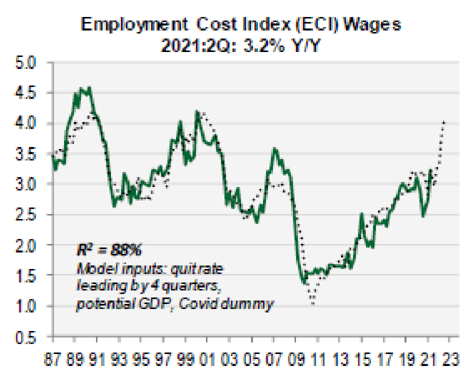
However, to put things in perspective, we show the Bloomberg commodity index chart from the past 20 years below left. The current spike in prices appears relatively mild when viewed over a longer term hoizon. How quickly people forget that the price of a barrel of oil was nearly $150 in 2008. Lastly, as we mentioned above, we view wage inflation as the one to watch as it is much more sticky. When have you heard of businesses lowering their per hour labor rates? Probably not ever. If there is a downturn, they may let people go but not take wages down. Currently there is a massive shortage of employee help with 11 million job openings in the U.S. as shown in the chart below middle. This shortage is leading to wage increases across the board. Wages are forecast to rise +4% in the coming quarters which would put the increase on par with levels that we haven't seen since the late 1990's as shown below right. Wages are the key to inflation and to whether or not interest rates need to be hiked to slow their growth.



Source: Raymond James

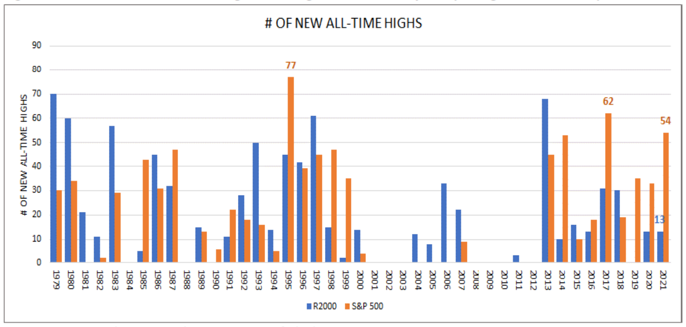


Source: Cornerstone Macro



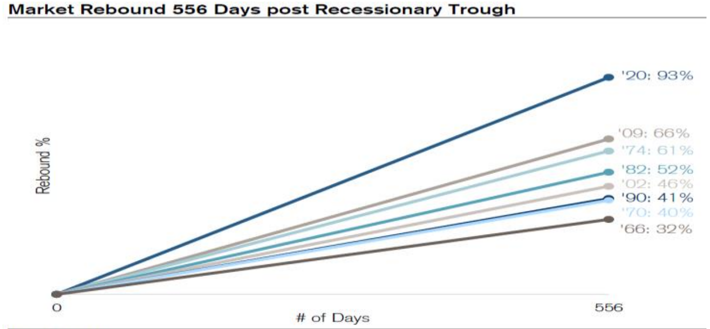
Despite the inflation and Covid concerns, it still took until the last day of the quarter to push the S&P 500 index down more than 5% from its most recent all-time high. On its way to the all-time high, the S&P 500 recorded 54 new all-time highs this year. That figure is the third highest number in the last 40 years and the fourth highest since 1928 as can be seen in the chart below left. The market rebound that began on March 23, 2020 is still the best one in history as shown in the chart below right. However, the small cap Russell 2000 Index hasn't been able to keep pace this year.

Fig 7. **S&P 500 # of New All-Time Highs is 3rd highest in last 40+ years (4th highest since 1928)**



Source: Furey Research Partners and FactSet. Data as of 9/30/21.

Market Rebound 556 Days post Recessionary Trough



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

As can be seen in the table below, for the second quarter in a row the returns for the stock market in the third quarter were stronger for the larger market caps with the S&P 500 and NASDAQ Composite hovering around breakeven for the three months. However, on a year-to-date basis, small caps return remains competitive as it's within spitting distance of the other major indices due to their strong start to the year. The best performing index in the quarter and the only one to breech positive ground was the S&P 500. 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 hint that the tapering process would likely begin in November, the U.S. 10-Year Treasury yield rose. This advance gave financial stocks a boost as the yield curve steepened.

Index Returns

Index	Third Qtr. 2021 Return	2021 YTD Return
Russell 2000	-4.34%	+11.92%
Russell 2000 Growth	-5.55%	+2.75%
Russell 2000 Value	-3.19%	+21.76%
S&P 500	+0.23%	+14.68%
Dow Jones Industrials	-1.91%	+10.58%
NASDAQ Composite	-0.38%	+12.11%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Value Index (-3.19%) slightly beat the Russell 2000 Growth Index (-5.55%) for the quarter as there was a major rotation into more cyclically oriented sectors like Financials and Energy very late in the quarter. Covid shutdowns and rising interest rates dragged down Commercial services (-14.5%) and Healthcare (-10.4%). Cyclicals like Energy (+1.9%) and Financials (+1.4%) were beneficiaries of Fed speak. Concerns over energy shortages in Europe and China as we approach the heating season drove upward movements in oil and natural gas related stocks. On a year-to-date basis, the Energy sector (+74.3%) is by far the gold medalist as rising oil and gas prices have put a floor under that sector all year. The table immediately below highlights the performance of the Russell 2000 and style indices by sector for the third quarter of 2021.

Table 1 - Index Performance by Sector

	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
GICS Sector	September	3Q2021	YTD	September	3Q2021	YTD	September	3Q2021	YTD
Com Serv	-5.2	-14.5	28.0	-4.0	-11.7	-1.0	-6.1	-16.4	55.0
Discretionary	-3.9	-6.9	24.2	-3.3	-6.2	16.9	-5.0	-8.4	31.1
Staples	-3.8	-5.3	11.7	-4.3	-5.8	13.3	-3.1	-4.4	10.4
Energy	16.1	1.9	74.3	16.0	-1.4	71.9	16.1	2.9	75.3
Financials	0.0	1.4	20.9	-2.2	-1.3	8.3	0.4	2.0	23.0
Health Care	-5.9	-10.4	-7.5	-6.5	-11.8	-11.1	-4.3	-6.7	12.6
Industrials	-3.1	-1.8	14.3	-2.9	-0.2	10.4	-3.2	-3.3	17.4
Info Tech	-3.5	-1.8	9.2	-2.8	-1.1	7.9	-6.1	-4.8	13.3
Materials	-4.9	-5.9	17.8	-5.0	-7.1	8.5	-4.9	-5.0	21.9
Real Estate	-3.3	-0.8	17.3	-3.8	-0.2	10.0	-3.2	-1.0	20.5
Utilities	-7.5	-3.6	-1.9	-7.6	6.9	7.1	-7.4	-4.3	-1.9

Source: Jefferies

Returns across the international markets were mixed at best as Europe and Japan were generally positive, but emerging market countries like China and Brazil were off due to slowing growth, interest rate hikes, and bad regulations. India was nicely positive as they emerged from their Covid lockdown. The bond market was a modest loser 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 natural gas, spurred by the reopening of many regional economies around the globe. The losers included lumber that returned a portion of its epic run over the last year. Volatility was notably higher on concern surrounding the Fed's next move. Like the U.S. markets, international stock markets are pressing near all-time highs as well.

Index	Third Qtr. 2021 Return	2021 YTD Return
France	+0.2%	+17.4%
Germany	-1.7%	+11.2%
Brazil	-12.5%	-6.8%
India	+12.7%	+23.8%
China- A Shares	-0.7%	+2.7%
China- Shenzhen A Shares	-2.9%	+2.8%
Japan	+2.3%	+7.3%
Long-Term Treasuries (TLO)	-0.0%	-8.9%
Investment Grade Corp Bonds	-0.8%	-2.99%
Gold	-0.8%	-7.3%
Volatility- VIX index	+46.2%	+1.7%
Oil	+2.1%	+54.6%
Natural Gas	+60.7%	+132.2%
Lumber	-12.4%	-28.1%

Source: 1492 Capital Management, LLC

Updated 2021 Outlook: Rubber Band is Pulled Back and Tension is Building for Small Caps

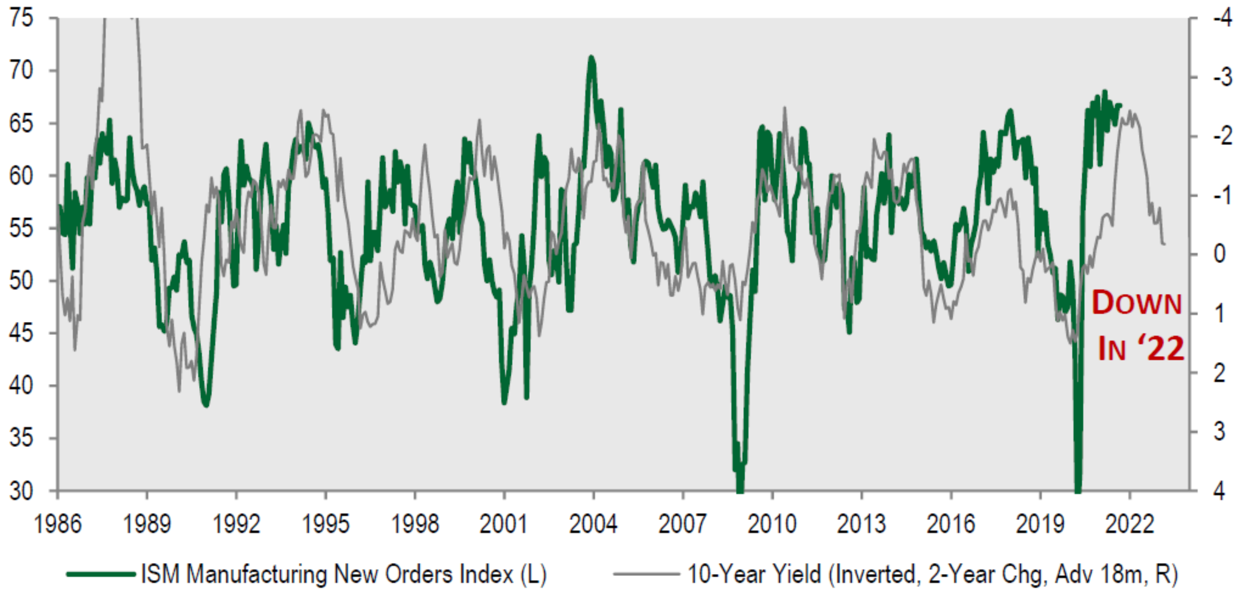
If you've ever pulled back a rubber band in your fingers to the point that the tension is enough that you can pluck it and it makes a sound, only one of two things can happen from that point. One is that the rubber band snaps, and your hand gets a nice stinging slap. The second is that you can let it go, and the rubber band flies away to hit its target. Bringing this analogy to the stock market, it appears that for small caps the rubber band is nicely taut, but we're not sure if it's going to fly or slap our hand. The key determinant is whether we can overcome the critical headwinds that have been building in the markets over the past several months. These issues include the following.

1. Global rate tightening
2. China's egregious regulations against their citizens and homegrown companies and debt problems
3. Fiscal cliff around the globe
4. Economic slowdown due to broken supply chain
5. Peak margins
6. Infrastructure bills and tax hikes

We'll address these issues in order and provide you with what we're concerned with and what is a potentially positive outcome.

Global rate tightening

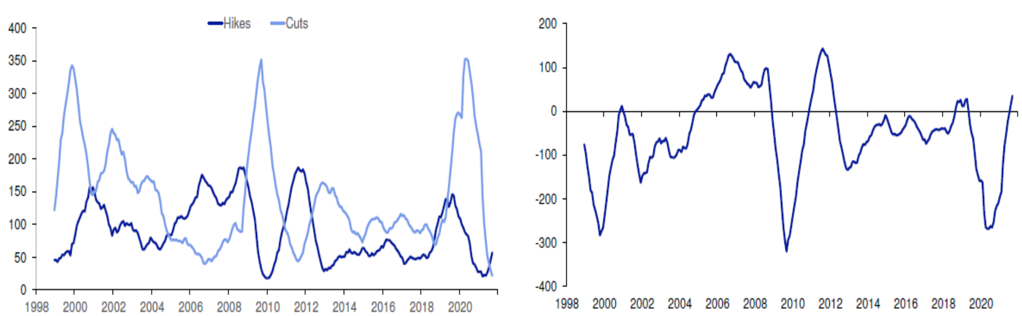
If I had to pick one metric to provide me a clue about what lies ahead in the stock market over the mid- to long-term, I would choose the chart below. This chart shows the two-year change in the 10-Year yield inverted and advanced 18 months and then overlayed on top of the ISM new orders index. As you can view from the chart below, the correlation that is presented over 40 years is strong. It's not foolproof, and there are leads and lags as you can see. However, directionally it has proven to be pretty good. The message is that the ISM new orders index is bound to slow which has a high degree of correlation with the overall health of the economy and, hence, corporate earnings. Given the uptick in interest rates of roughly 100 basis points since the pandemic low, the model is predicting that growth rolls over in 2022. If the Fed blinks and begins hiking rates earlier than what's currently anticipated due to persistently high inflation, it will then be difficult to overcome the natural slowing that occurs as money growth tightens and as money becomes more expensive. However, the one item that can potentially turn the tide is the absolute low level that global interest rates reside currently. The U.S. 10-Year treasury rate is currently at 1.5%, but this level is still near the bottom of the channel for interest rates through time.



Source: Cornerstone Macro

One can't ignore what's happening overseas either with respect to rates. For the first time since 2018, central bank rate hikes globally are outnumbering the cuts as shown in the chart immediately below. The hikes now number 38 so far this year, which is an absolute low number, but central bank rate hikes are unfortunately happening at a rapid rate of late as countries such as Brazil and Russia are fighting back high inflation rates with multiple rate increases as seen in the table below right. This event adds to our concern as well.

Figure 1: Number of global central bank hikes and cuts (left) in our sample and hikes minus cuts (right) – both on rolling 12 month basis



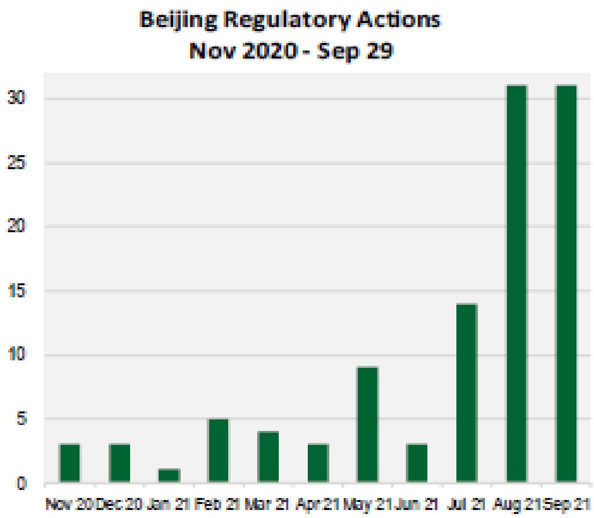
Notes: 21 countries from 1999, 50 from '05, 60 from '07, 70 from '10, 79 from '13, 80 from '15
Source : Various Central Banks, Haver Analytics, Deutsche Bank

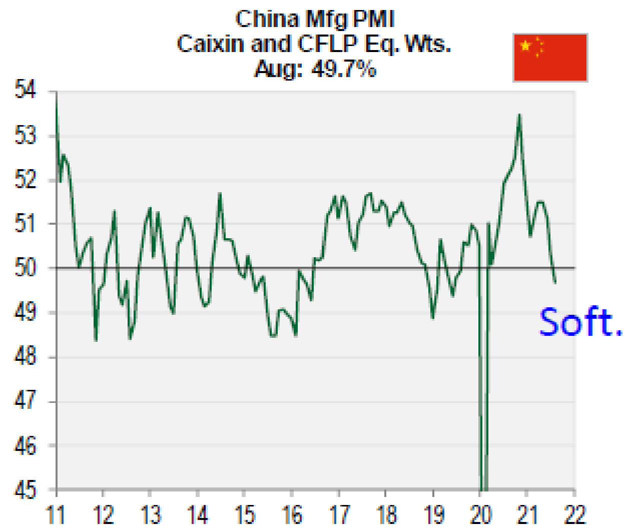
Central Bank Tightenings

Count	Countries	Date	BP Ch	Current Rate
1.	Russia	2/12/2021	25	4.50
2.	Brazil	3/17/2021	75	2.75
3.	Turkey	3/18/2021	200	19.00
4.	Russia	3/19/2021	25	4.50
5.	Ukraine	4/15/2021	100	7.50
6.	Russia	4/23/2021	75	5.00
7.	Brazil	5/5/2021	75	3.50
8.	Iceland	5/19/2021	25	1.00
9.	Russia	6/11/2021	50	5.50
10.	Brazil	6/16/2021	75	4.50
11.	Hungary	6/23/2021	30	0.90
12.	Czechia	6/23/2021	25	0.50
13.	Mexico	6/24/2021	25	4.25
	:			
26.	S Korea	8/25/2021	25	0.75
27.	Chile	8/31/2021	75	1.50
28.	Moldova	9/6/2021	100	4.65
29.	Ukraine	9/9/2021	50	8.50
30.	Peru	9/9/2021	50	1.00
31.	Russia	9/10/2021	25	6.75
32.	Hungary	9/21/2021	15	1.65
33.	Paraguay	9/21/2021	50	1.50
34.	Brazil	9/22/2021	100	6.25
35.	Norway	9/23/2021	25	0.25
36.	Colombia	9/30/2021	25	2.00
37.	Mexico	9/30/2021	25	4.75
38.	Czechia	9/30/2021	75	1.50

<u>China's egregious regulations against their citizens and homegrown companies and debt problems</u>

China quite simply has been a mess of late. They have repeatedly shot themselves in the foot with numerous new regulations that hamper growth and overseas investment. Many of these moves are aimed at the very successful homegrown companies that are being asked to pay for social programs to improve the economic status of their citizens. It is a modern day Robinhood approach. Recently, the Communist party banned all trading in cryptocurrencies like Bitcoin and made them illegal. This ban followed on the heels of El Salvador declaring that Bitcoin was now their national currency. I guess one man's trash is another man's treasure. The chart below left shows the ramping number of regulations that their government enacted over the past year. It has had a dampening effect on their economy as can be seen in the chart on the right which shows the manufacturing PMI falling below 50 which indicates contraction. To make matters worse, there are debt problems surfacing for a couple of their major real estate players like Evergrande and Fantasia that are defaulting on their debt payments. There has been speculation in the markets for years about the enormous amount of leverage that some of these Chinese real estate companies employ, and many expected an unraveling years ago. Is this the cockroach theory where if you see one, there are several more? Given that China is the world's number two economy, we better hope that this doesn't spill into a worldwide problem.

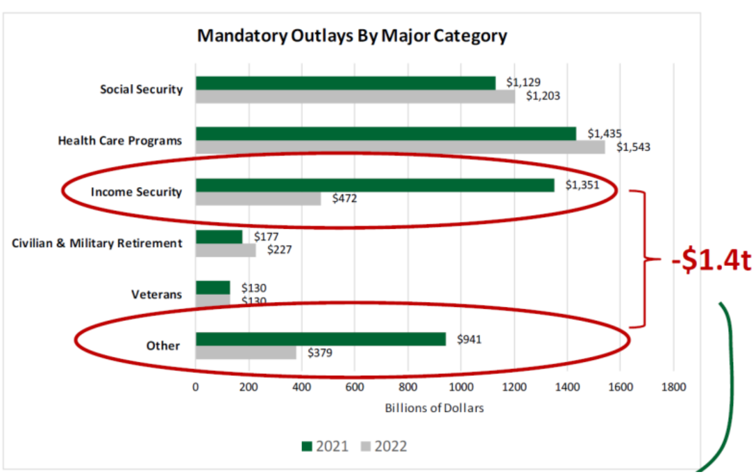


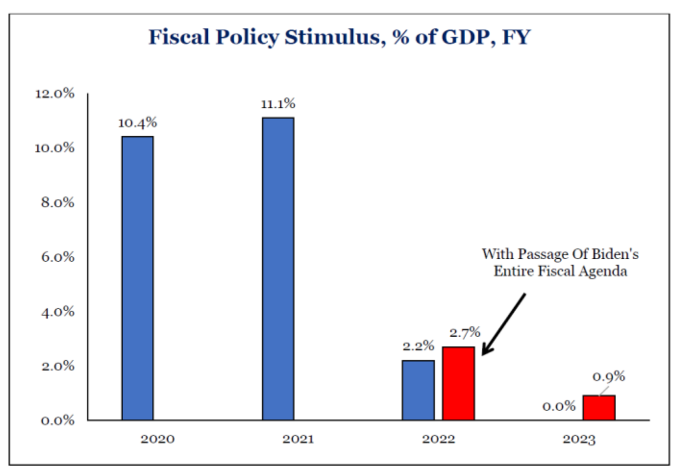


Source: Cornerstone Macro

Fiscal cliff around the globe

Nearly every country around the globe has injected massive amounts of stimulus into their economies during the pandemic. Most of these programs have ended or will end very shortly. A fiscal cliff lies ahead, and we'll fall off that cliff if we don't get the real economy to recover and take over for the stopgap programs that were launched at the start of the pandemic. The two charts below show what a fiscal cliff looks like in the U.S. The chart on the left shows that there will be a $1.4 trillion drop off in government transfer payments from 2021 to 2022. This decline is mostly in the form of income security payment programs like stimulus checks and unemployment compensation payments. The chart on the right shows what a cliff looks like as a percent of GDP. The stimulus drops from 11% of GDP to only 2% from 2021 to 2022. Even if Biden's entire fiscal agenda gets passed, it only aids GDP fractionally as the $3.5 trillion plan is to be implemented over a ten-year period. Therefore, we need the real economy to kick in and get these 11 million open jobs filled as soon as possible.





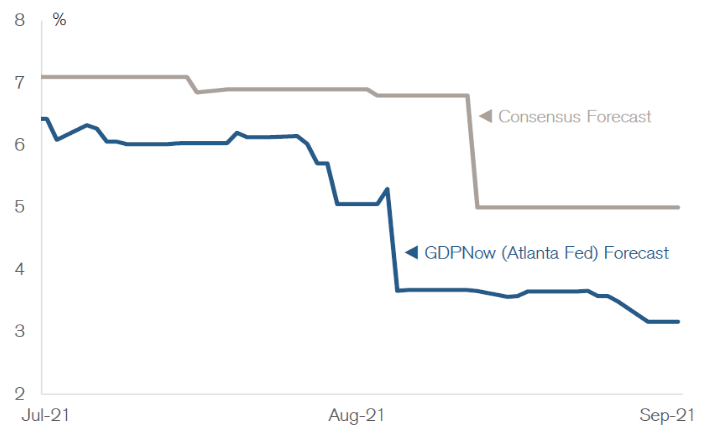
Source: Cornerstone Macro

Source: Strategas Research

Economic slowdown due to broken supply chain

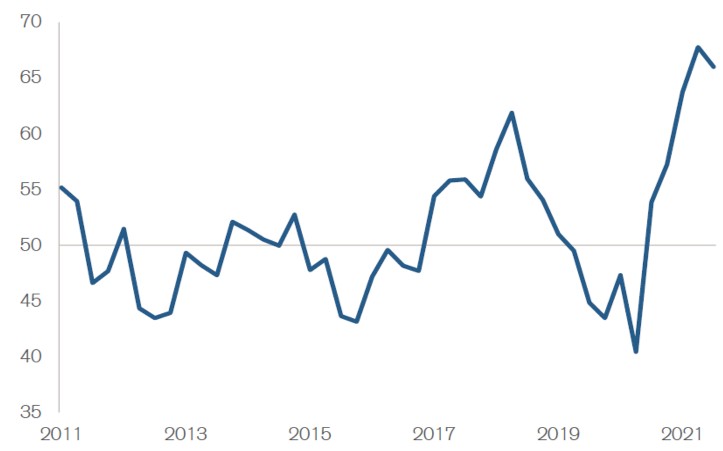
Earlier in the newsletter we wrote about the problems with the supply chain. The following charts depict just how big of a problem a broken supply chain is to the economy. For example, the U.S. auto manufacturers were forecast to build 12.5 million vehicles this year in the U.S. However, due to supply chain issues like the semiconductor shortage, they will only be on pace for roughly 9 million vehicles in the third quarter. This shortfall is a massive hit to GDP growth as they slow their factories down. The direct impact can be seen in the chart on the left. The consensus GDP growth for the third quarter earlier in the year was 7.5%. The latest Atlanta Fed forecast is now sub-2% for third quarter GDP which is even lower than the chart shown below as this figure has deteriorated rapidly due to the supply constraints in many industries. The positive outcome on this very negative development is that inventory levels in almost all businesses are at all-time lows and need to be replenished in order to meet demand. Therefore, it appears that as the supply chain improves, we should see a reacceleration in growth into 2022 and beyond, which most economists aren't currently modeling. This thought is the glass half full view. The chart on the right would validate this thesis as the backlog of orders is very strong and should provide a tailwind to manufacturers down the road.

3Q21 Projected vs. Consensus GDP – QoQ Annualized



Note: 3Q21QoQ Saar Real GDP; Projected from Atlanta Fed GDPNow
Source: Atlanta Fed, The BLOOMBERG PROFESSIONAL™ service, Credit Suisse

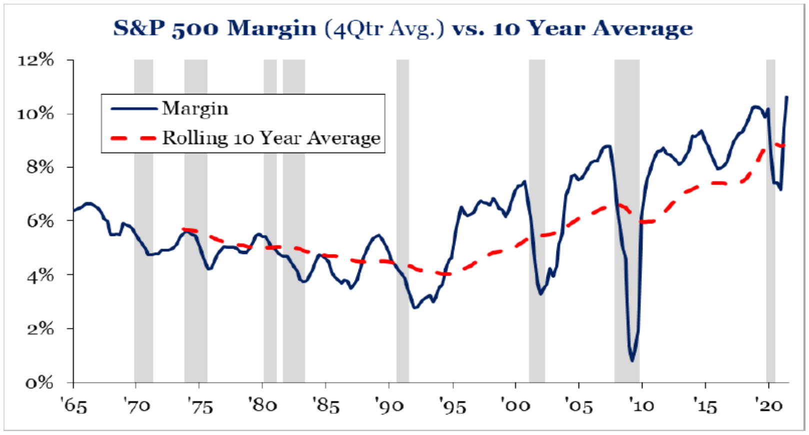
ISM Manufacturing: Backlog of Orders Index



Source: ISM, Haver Analytics®, Credit Suisse

Peak margins

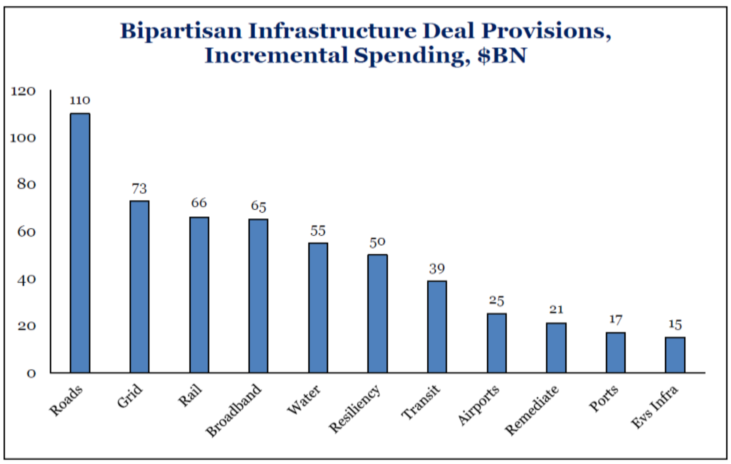
Can corporate operating margins get any better? There has clearly been a steady march higher in operating margins for corporate America since the 1990's as productivity and technology propelled margins ever higher. Surprisingly, the pandemic has been helpful to the margin profiles of many industries except for those that were directly impacted by travel restrictions like airlines, hotels, etc. However, the lack of travel and the ability to work remotely has paid off in spades for many companies as the dollars that were historically spent on what now looks like wasteful sales and marketing trips, now fall to the bottom line, as seen in the chart below. It remains to be seen if corporate management teams have learned their lesson that they don't need people flying all over the globe to make business happen. Corporate management is going to have to push price in order to keep margins intact, in our opinion, as nearly every company is seeing inflation manifest in their business currently.

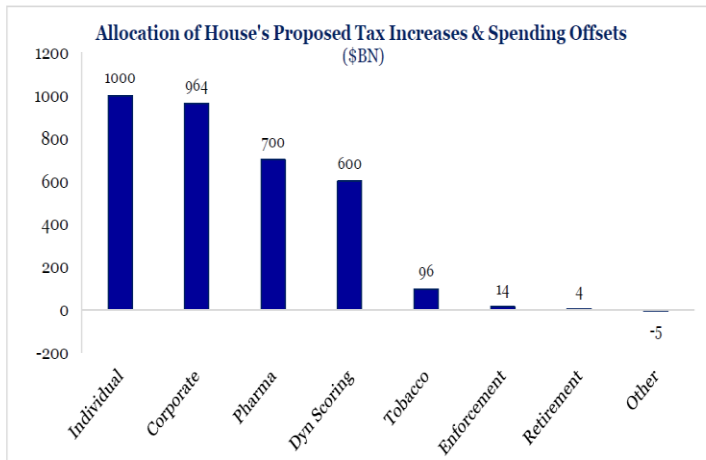


Source: Strategas Research

Infrastructure bills and tax hikes

As we watch how the sausage is made in Washington D.C., we can't help but think there must be a better way. In any event, the debates and political wrangling around the two infrastructure bills that are making their way through our legislative process could be a nice boost for our economy beginning in 2022. However, the longer it takes to pass these bills the less of an impact they will have in 2022, and the positives will likely be pushed to 2023. In our mind the $1.2 trillion bipartisan infrastructure package is much more impactful for the economy. The chart below left shows how the dollars would be allocated based on the current legislation. As the CEO of one of our infrastructure stock holdings said, it could triple the amount of dollars available for true infrastructure projects for bid if passed. The social infrastructure package is causing a lot of heartburn due to its sheer size and how it would be funded. It appears at this point that the Democrats may agree on a $1.5- 2.0 trillion package. Unfortunately, it needs to be paid for and it currently appears that tax hikes are imminent. What seems to be lost on many is that taxes would be higher on individuals more than on corporations according to what has been disseminated to date. The chart on the right highlights where the money would appear to pay for the social infrastructure package. Higher taxes have never proven to be great for the economy no matter whom they target. One of the key provisions for paying for the social infrastructure package is increasing the corporate tax rate from 21% to 28%. What seems more likely is that the final rate comes in around 25%. This level of increase is a 5% hit to corporate profits if enacted in 2022 and is a major headwind to overcome even with a better economy.

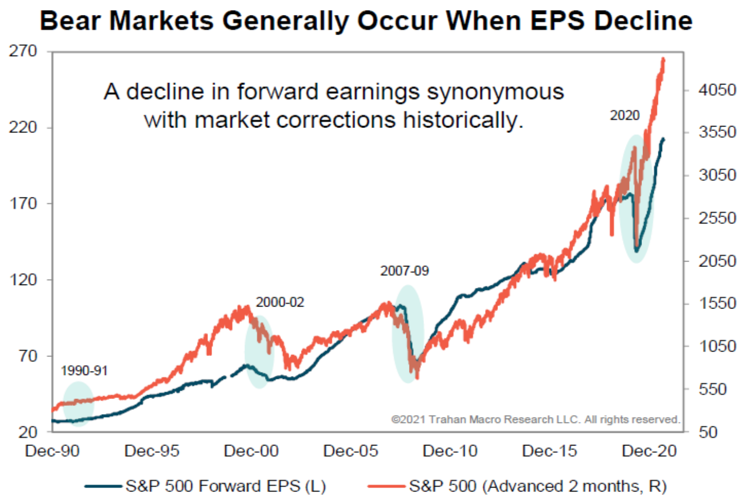




Source: Strategas Research

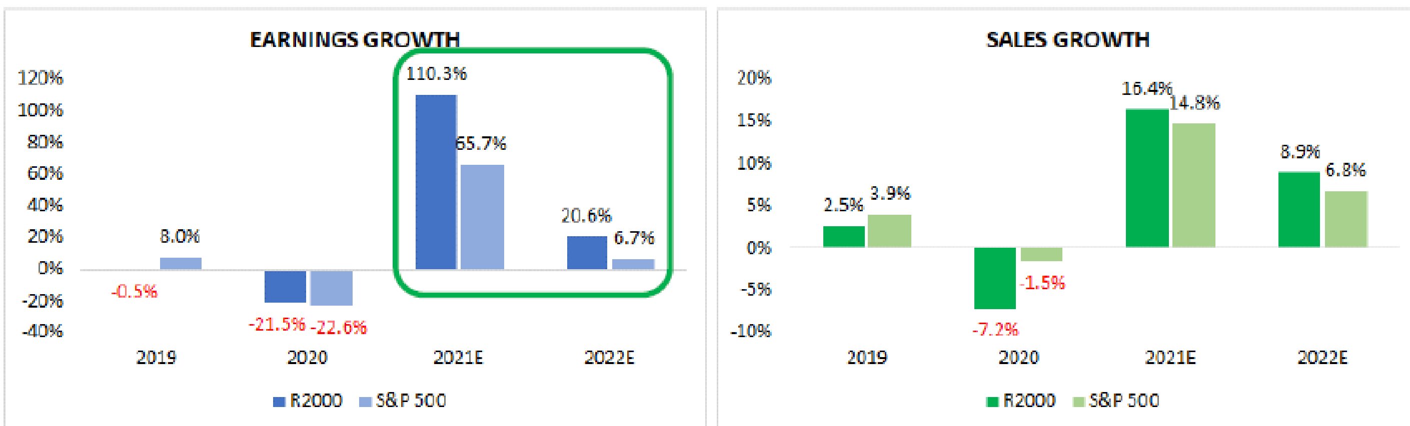
Bringing it back to the stock market - Small Caps vs. Large Caps

As we said at the top of this section, the rubber band is pulled back and ready to fly. However, it's now a matter of whether the stock market can overcome the headwinds that we enumerated above or does the rubber band snap and we get stung. We believe that there is significant pent-up demand in the system which should be able to overcome the obstacles we highlighted. The first chart below seems obvious but bears repeating. Earnings drive the stock market, plain and simple.



Now we'll tackle the "small vs. large cap" debate. We penned a similar piece in last quarter's newsletter which we'll reiterate portions of here. 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.

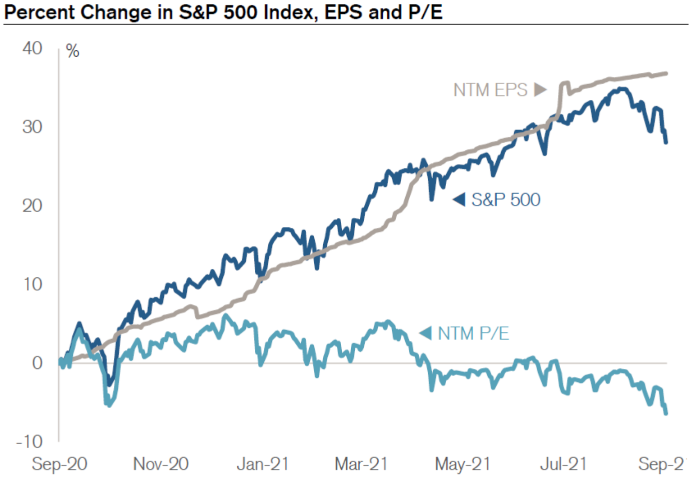
Fig 81. **R2000 and S&P 500 Sales & Earnings Growth Expectations**



Source: Furey Research Partners and FactSet. Data as of 9/30/21. Based upon our "capitalized losses" earnings model using historical constituents.

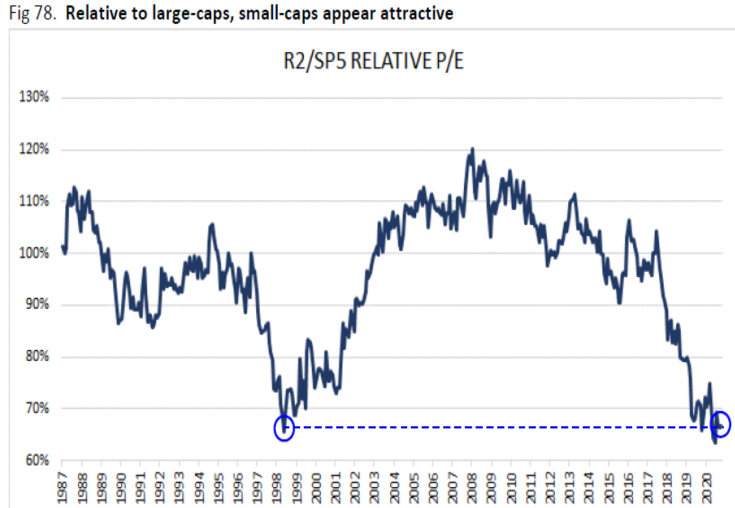
From a valuation perspective, small caps win this argument, too. The chart below left shows that during the current bull market run, it's been the earnings growth (grey line) that has carried the market higher and not P/E (price/earnings) multiple expansion (teal line). This factor emphasizes the importance of earnings growth into 2022 to sustain the bull market. The chart below right shows that the relative P/E ratio of large caps vs. small caps is at its lowest point in the past 35 years. The chart only uses profitable companies in both indices. When the relative valuation has been this cheap in favor of small caps historically, small caps have had strong outperformance relative to large caps.

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

Fig 78. **Relative to large-caps, small-caps appear attractive**



Source: Furey Research Partners and FactSet. Data as of 9/30/21. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only.

Using history 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 during these episodes as the chart below shows. The numbers in the green box represent 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 +17.6%, which is pretty meaningful outperformance over an extended timeframe. In conclusion, we anticipate that some of the headwinds mentioned above will dissipate and we believe that the stock market will continue to march higher over the next year. If that happens, small caps are a solid bet to outperform.

We are still in the mindset that we are in the midst of an outperformance cycle...

We are here

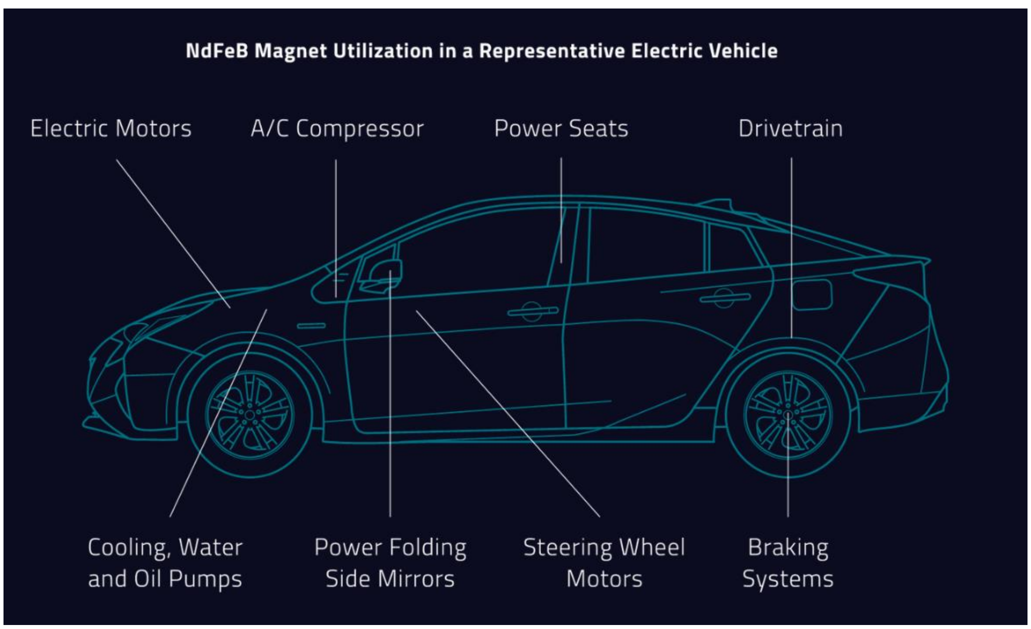
		Small Caps		Large Caps		
Period	**Length of Period**	**Cumulative**	**Annualized**	**Cumulative**	**Annualized**	**Excess**
05/32-02/37	4.8	1045.7	67.1	343.3	36.8	30.3
05/40-05/46	6.1	521.8	35.6	166.9	17.8	17.8
01/64-12/68	5.0	210.2	25.9	49.8	8.6	17.3
12/74-06/83	8.6	1089.1	33.8	236.3	15.3	18.5
10/90-02/94	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 ?	**1.6**	**129.1**	**68.8**	**89.0**	**49.5**	**19.3**
Average	**5.4**	**443.2**	**38.6**	**143.9**	**21.0**	**17.6**

Source: Furey Research Partners

Thematic Investing: Strategic Resources, Strategic Resources...Get Your Strategic Resources Here!

As the United States moves to reshore more of its manufacturing back to the U.S., the demand for readily accessible strategic resources from domestic and friendly foreign sources will undoubtedly increase. Couple this trend with the growth of moving the country to more ESG friendly power and transportation and we have a secular trend of resource development here and in countries that favor U.S. relations over those with the Russians or Chinese.

In the transportation arena, the move to electric EVs (electric vehicles) is underway and its growth prospects are heavily dependent on the ability to expand the production of the minerals used in the autos' construction. These minerals include the much-discussed rare earth metals, lithium, nickel, copper, manganese, graphite and cobalt as well. As a quick refresher, rare earth metals like neodymium and praseodymium are used in the permanent magnets that are essential to the EV motor and, as seen below, a variety of other parts.



Source: MP Materials

The concern here is the dominance of the Chinese in providing these key rare earth metals. According to Adamas Intelligence, a rare earth metal consulting firm, China currently mines about 65% of the rare earth oxides (REOs) and more importantly controls 90% of the processing that takes you from ore to final magnet stage. The Chinese have recently taken a tougher position on illegal domestic mining of rare earths to tighten world supply as their leadership has referred to these key metals as industrial gold. In the U.S, we are the world's second largest producer with a mine in California, and currently we are shipping the ore back to China for processing. Does this sound like the U.S. is currently well positioned to drive our own destiny in electrifying our passenger transportation? While more of an interesting exercise than a practical one, if the U.S. were to electrify its entire fleet of vehicles by 2035, we would need 37 times our current rare earths demand according to Adamas. Unfortunately, new mine development of almost any mineral is fraught with delays and can easily average seven to ten years to move from the exploration stage to final development. The development of non-Chinese rare earths supplies and magnet processing sources is absolutely pivotal to the EV/ESG trend in the U.S.

The growth in EVs also requires an expansion of the supply of metals like lithium, nickel and copper. Any auto maker will want sustainable, visible supply sources in these metals before ramping additional EV production. While the resources are available in deposits throughout the world, they are worthless until they can be consistently mined. Lithium and nickel, key components of the EV battery, suffer from their own production difficulties. A great deal of lithium comes from salares in South America where you use limited sources of water to pump the ore to the surface and then wait for the weather to dry it out. Conceptually, the growing ESG trend may hamper miners' ability to tap these water sources. In the U.S., additional lithium production is in the works with one deposit in North Carolina that was reexplored in 2017, is in the final stages of feasibility, and then needs permits, financing and construction which results in the previously mentioned 7–10 year exploration to production cycle. According to Wood Mackenzie, a metals consulting firm, nickel demand for auto and energy storage batteries should grow from 5% in 2019 to 40% by 2028 and thus double the size of total global nickel demand. Battery grade nickel is made from Class 1 nickel (99.8%) purity and is difficult to produce but serves as a good substitute for cobalt which is sourced largely from the Democratic Republic of the Congo, which is an ESG nightmare. While there are many sources of nickel supply to be added in Indonesia, the type of mining projects underway, according to Roth Capital, have historically suffered from cost overruns, long delays, and difficulty producing the Class 1 nickel needed.

With respect to power generation and the move to more wind and solar, we find ourselves in need of rare earths for the permanent magnets in wind turbine motors and of substantial copper for the power grid and batteries. As seen in the table below, the International Energy Agency projects that the clean energy transition's copper demand will increase from 5.7 million tonnes in 2020 to 8 million tonnes in 2030.

	Stated Policies Scenario		
Demand	**2020**	**2030**	**2040**
(thousand tonnes, kt)			
Copper	**5 715**	**8 007**	**10 001**
Low-carbon generation	621	991	1 289
Solar PV	346	502	795
Wind	217	387	415
Other renewables	44	74	68
Nuclear	14	29	11
EV and battery storage	119	772	1 084
EVs	110	717	951
Battery storage	8	55	133
Electricity networks	4 975	6 237	7 613
Hydrogen	0	7	15

Source: IEA

While there is additional supply of copper from new projects in 2023 and beyond, the base load of copper from the two largest producers, Chile and Peru, is suffering from lower ore grades and higher costs from their old mines and from future economic uncertainty due to the discussion of rising royalty rates in Chile and a new president in Peru who speaks of nationalizing mines and wealth redistribution.

With respect to nuclear power's place in the carbon-free power stack of U.S. baseload capacity, the Chinese are rapidly developing additional reactors that will boost uranium demand, and according to uranium producer Cameco, there are 51 nuclear reactors under construction globally on a base of 443 units. While there are some plant retirements particularly in

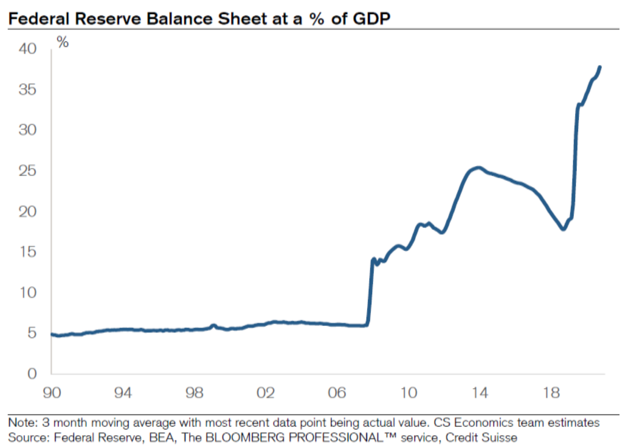
Europe, the global demand remains in an uptrend and the U.S uses about 50 million pounds of uranium for power generation per year with about one million pounds domestically sourced and about another 22% sourced from Canada. In 2020, Russia, Kazakhstan and Uzbekistan combined for 46% of our uranium needs according to the Energy Information Agency (EIA). This sourcing structure is risky with nuclear energy representing roughly 20% of the U.S. electricity generation.

While oil independence has been achieved in the U.S. due to its short time cycle development from drilling to production, our ability to source the strategic resources, domestically or from allies, that are needed for the secular growth of EVs, and clean energy is much more difficult and will likely precipitate shortages and price spikes in the near and medium term. Expanding ESG demands will also help to accelerate the demand for "friendly" mining production. Much needed strategic resource development is, in our opinion, a very interesting long-term investment theme across a variety of metals and elements.

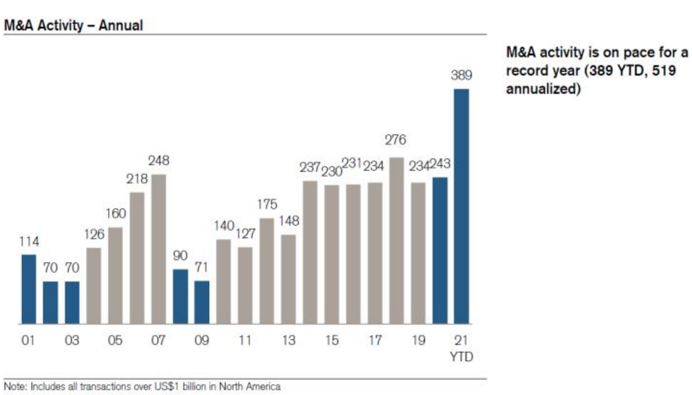
2021 Outlook: A Picture is Worth a Thousand Words

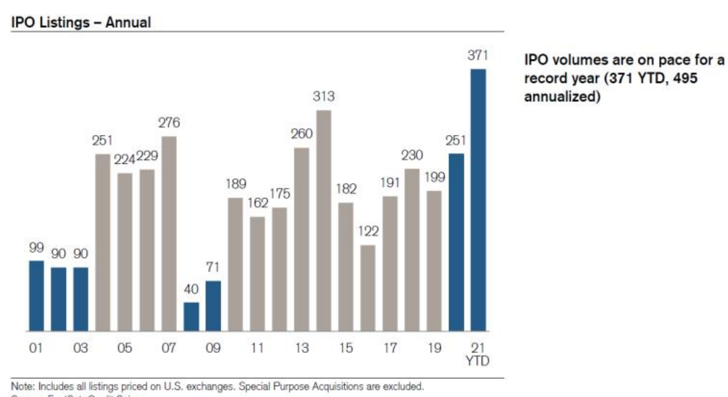
We articulated our updated 2021 outlook above and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided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

If some is good, more is better?? The Fed is just on the verge of tapering, but tapering doesn't mean the balance sheet shrinks.

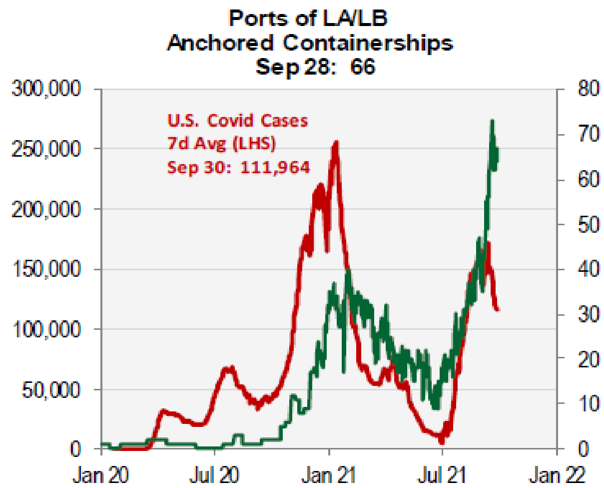


Investment bankers are ringing the register as merger and acquisition activity has been white hot so far this year. Year-to-date deal activity has surpassed all prior years as seen on the chart on the left. The chart on the right shows a similar situation for the IPO market which an enormous number of SPAC deals have propelled.





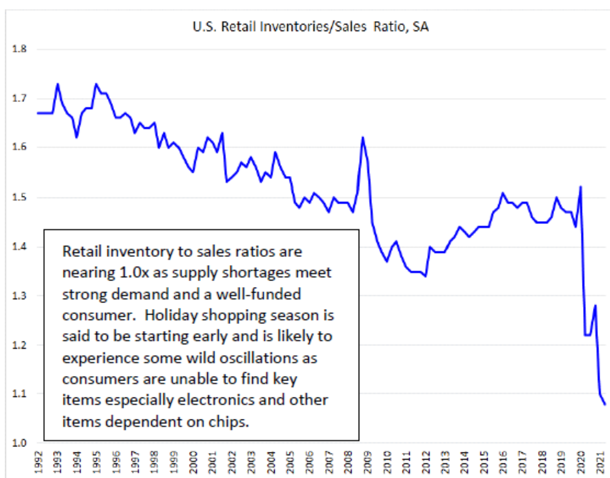
The number of containerships docked off the coast of Los Angeles and Long Beach have had a strong correlation with the amount of Covid cases. Clearly they can't get enough workers to offload the ships and to load the containers on trucks.



Source: Cornerstone Macro

The inventory-to-sales ratio are at all-time lows which should give fuel to the fire of our economic engine.

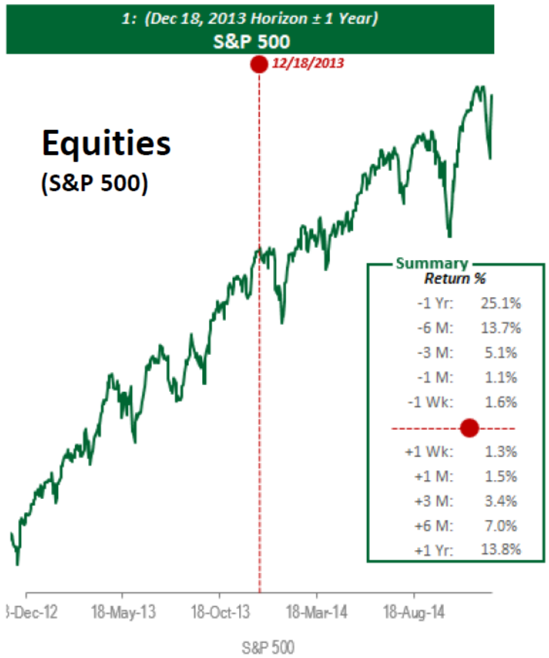
Fig 18. **Inventories to Sales Ratios are at all-time lows**

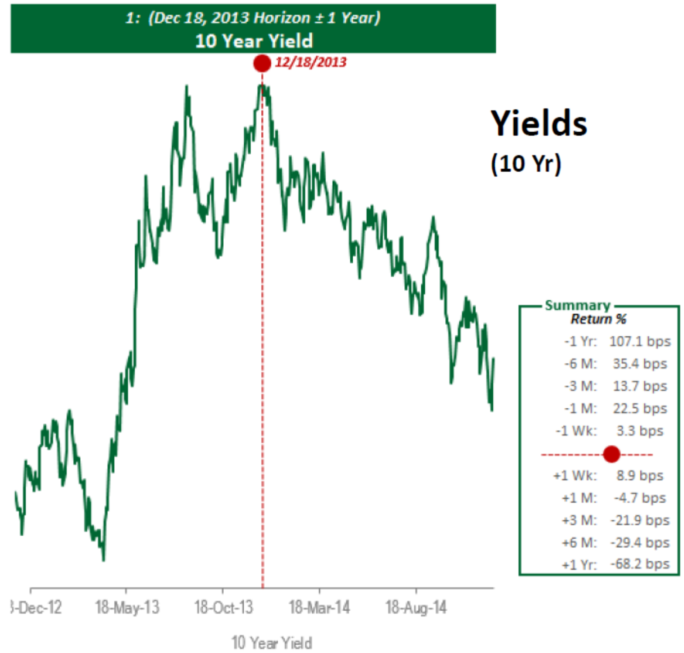


Source: Furey Research Partners and FactSet. Quarterly data as of most recently availab

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 a Fed tapering cycle. The Fed recently indicated at their last FOMC meeting that they would likely begin the tapering process (less bond buying) in November. The chart below shows the one-year forward performance for both the stock market and the bond market in the last tapering cycle in 2013. As you can see on the left, the stock market performed admirably and appreciated nearly 14% over the year following the start of tapering. Conversely, on the right is the performance of the bond market. Interestingly, the bond market rallied despite less support from the Fed's buying of bonds. This rally would imply that the bond market was assuming that the start of tapering inevitably meant a slowdown was coming, and money flowed into bonds as a safe haven. I would not have expected this result.





Source: Cornerstone Macro

We hope that you found our third 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   Adam France   Nancy Frohna   Tim Stracka

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