1492 CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

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IDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY | VALUE INCOME STRATEGY

1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management's newsletter for the second quarter of 2022. 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 10 Year Treasury Note Tells You Everything You Need to Know- We're in a Recession
The bond market has historically been praised as the "smart" money in all of the markets, and we see no reason to alter that thinking now. After flirting with 3.5% just a few weeks ago when the Fed raised the Fed Funds rate a surprising 75 basis points, the yield on the 10 Year US Treasury Note is currently 2.8%. If the bond market honestly believed the market rhetoric that we have runaway inflation, it is unlikely that the 10 Year Treasury would be yielding 2.8% when the latest CPI reading was +8.6%. Instead, it's becoming a safe haven as the daily reported economic statistics are plummeting quite rapidly, and commodities of all sorts are dropping precipitously. One commodity that has historically correlated with the strength of the broader economy is copper, which is down -24% year-to-date, and other important commodities showing similar trends are lumber (-44%) and steel (-40%). When we wrote our newsletter at the beginning of the year, we opined that the Fed is likely going to mistakenly tighten into peak inflation and a slowing economy. Now that they've hiked 150 basis points so far and have signaled another 200 basis points of increases in the coming months, they've already pushed the economy into recession, and inflation is destined to plummet as commodities across the board are plunging. A recession is technically defined as two straight quarters of negative GDP growth, and the first quarter of 2022 was reported at -1.6%, and the second quarter looks to be -2% according to the Atlanta Fed's GDPNow model. Therefore, we are already technically in a recession. The stock market has certainly priced in a modest recession as the S&P 500 had its worst first half since 1970 with a retreat of -20%. Similarly, the NASDAQ posted its worst first half ever with a -29.2% drop and is now down -31% from its November high. The Russell 2000 Index had its worst second quarter ever at -17.2% and is down -23.4% year-to-date with the Russell 2000 Growth Index off -38.3% from its all-time high.

One recent anecdote that resonated with me and that demonstrates the immediate impact that higher interest rates have on the consumer is that two years ago, the 30-year mortgage rate was 3.1%, and the median existing home price in the U.S. was $283,000. Today the 30-year mortgage rate is 5.78%, and the median existing home price is $408,000. With a 20% down payment, that change creates a 96% increase in the monthly payment from $972 to $1,909. Ouch!!! Please read on to see our unique views of what's on tap for the balance of 2022, themes that we're investing in here at 1492, what we believe 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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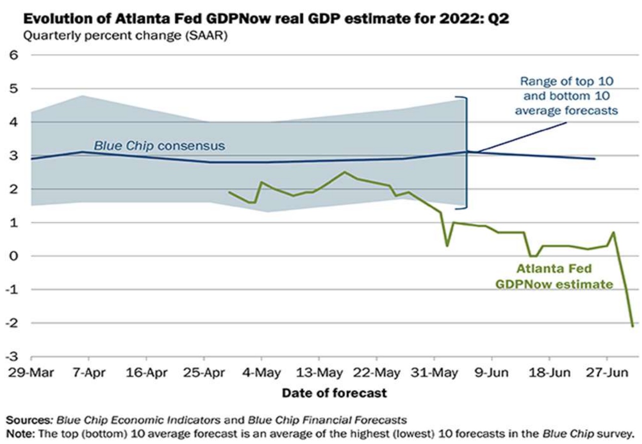
Quarterly Review: 10 Year Treasury Note Tells Everything You Need to Know- We're in a Recession

The bond market has historically been praised as the "smart" money in all of the markets, and we see no reason to alter that thinking now. After flirting with 3.5% just a few weeks ago when the Fed raised the Fed Funds rate a surprising 75 basis points, the yield on the 10 Year US Treasury Note is currently 2.8%. If the bond market honestly believed the market rhetoric that we have runaway inflation, it is unlikely that the 10 Year Treasury would be yielding 2.8% when the latest CPI reading was +8.6%. Instead, it's becoming a safe haven as the daily reported economic statistics are plummeting quite rapidly, and commodities of all sorts are dropping precipitously. One commodity that has historically correlated with the strength of the broader economy is copper, which is down -24% year-to-date, and other important commodities showing similar trends are lumber (-44%) and steel (-40%). When we wrote our newsletter at the beginning of the year, we opined that the Fed is likely going to mistakenly tighten into peak inflation and a slowing economy. Now that they've hiked 150 basis points so far and have signaled another 200 basis points of hikes in the coming months, they've already pushed the economy into recession, and inflation looks destined to fall rapidly as commodities across the board are plunging. A recession is technically defined as two straight quarters of negative GDP growth and the first quarter of 2022 was reported at -1.6%, and the second quarter looks to be around -2% according to the Atlanta Fed's GDPNow model. Note the precipitous drop in their forecast just in the final weeks of the quarter as shown in the chart below left. Therefore, we are already technically in a recession. The stock market has certainly priced in a modest recession as the S&P 500 had its worst first half since 1970 with a retreat of -20%. Similarly, the NASDAQ posted its worst first half ever with a -29.2% drop and is now down -31% from its November high. The Russell 2000 Index had its worst second quarter ever at -17.2% and is down -23.4% year-to-date with the Russell 2000 Growth Index down -38.3% from its all-time high. There was literally no place to hide as the bond market fell for the second straight quarter as well. This data point marks only the fifth time in market history where the bond market and stock market both fell for two quarters in a row. The chart below right shows the five periods where this double drop has occurred in the shaded boxes. *Stock investors have lost $14 trillion in their portfolios year-to-date which exceeds the $11 trillion of losses in all of 2008 during the great recession*.

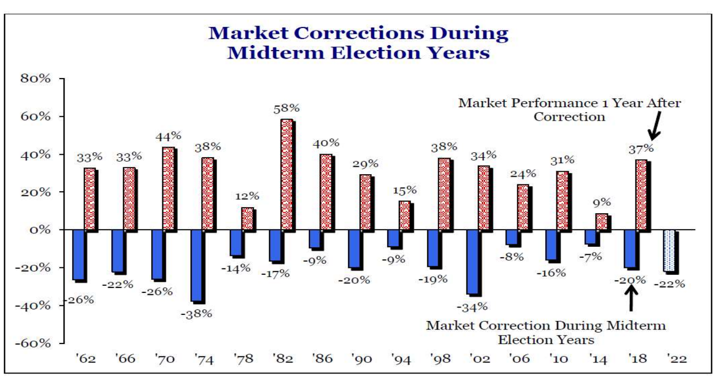


Quarters With Both Negative Returns For Stocks and Bonds

Quarter-End	S&P 500	Barclays Agg.	Quarter-End	S&P 500	Barclays Agg.
Mar-77	-8.4%	-0.8%	Mar-94	-4.4%	-2.9%
Dec-77	-1.5%	-0.1%	Jun-94	-0.3%	-1.0%
Dec-78	-6.3%	-1.4%	Mar-05	-2.6%	-0.5%
Dec-79	-1.3%	-3.1%	Jun-06	-1.9%	-0.1%
Mar-80	-5.4%	-8.7%	Jun-08	-3.2%	-1.0%
Jun-81	-3.5%	-0.3%	Sep-08	-8.9%	-0.5%
Sep-81	-11.5%	-4.1%	Jun-15	-0.2%	-1.7%
Jun-84	-3.8%	-2.1%	Mar-18	-1.2%	-1.5%
Mar-90	-3.8%	-0.8%	Mar-22	-4.9%	-5.9%
Mar-92	-3.2%	-1.3%	Jun-22	-16.4%	-3.9%

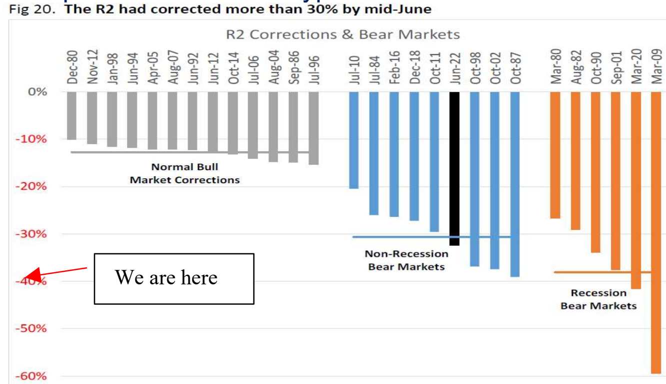
Source: Strategas Research

Midterm election years tend to have some pretty significant corrections that have averaged -19% with the current downdraft of -23% through the end of the second quarter as the chart below left shows. The correction for small caps, particularly growthier stocks, began last March, and the Russell 2000 Growth Index is down -38% over that timeframe. The Russell 2000 Index is off just shy of -30% since its peak last November. As the chart on the right shows, this bear market is squarely in the middle of a typical bear market drawdown. It appears that the stock market has priced in much of a typical recession.



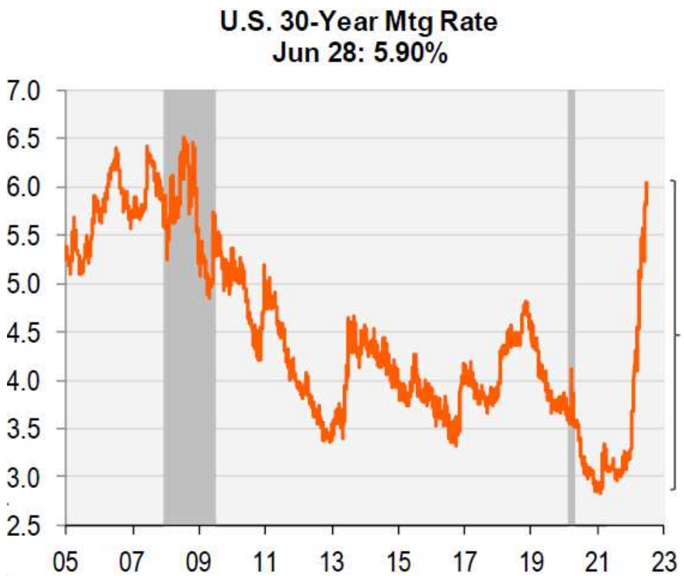
Source: Strategas Research

Fig 20. The R2 had corrected more than 30% by mid-June

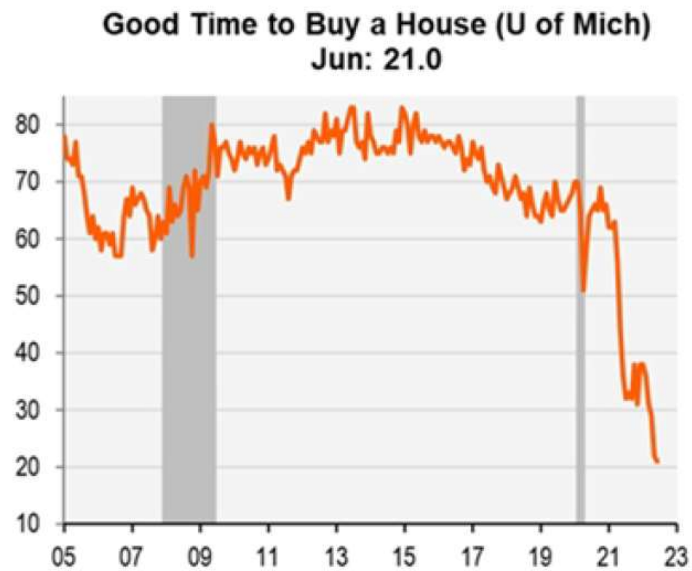


Source: FRP, FactSet; as of 6/30/22

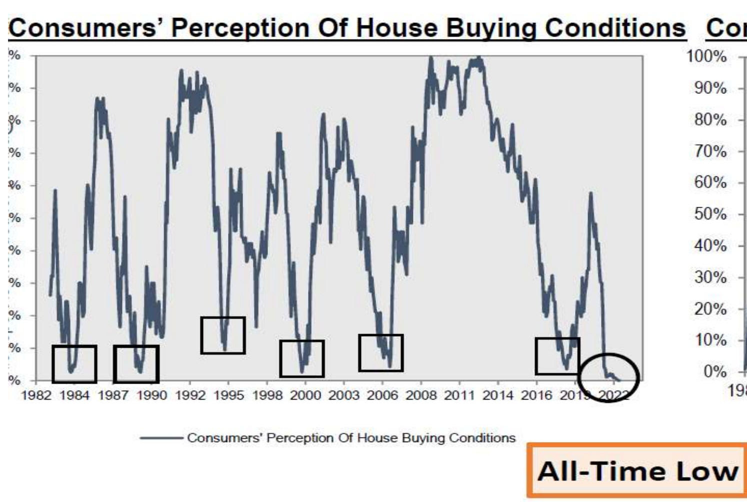
One recent anecdote resonated with me and demonstrates the fairly immediate impact that higher interest rates have on the consumer is that two years ago, the 30-year mortgage rate was 3.1%, and the median existing home price in the U.S. was $283,000. Today the 30-year mortgage rate is 5.78%, and the median existing home price is $408,000. *With a 20% down payment, that change is a 96% increase in the monthly mortgage payment from $972 to $1,909. Ouch!!!* The impact of higher rates doesn't just affect housing but any big-ticket purchase that is typically financed like cars. The dramatic change in mortgage rates is shown in the chart below left. We haven't seen a spike like this one in recent history which is causing the consumer to step on the brakes. The combo platter of soaring prices and mortgage rates approaching 6% has pushed the Good Time to Buy a House Index (below right) to its lowest level since 1983. The charts further below show that the consumer perception of home and auto buying conditions are both at all-time lows. The combination of higher interest rates, inflation, and the Ukraine war are all playing on the psyche of the U.S. consumer.

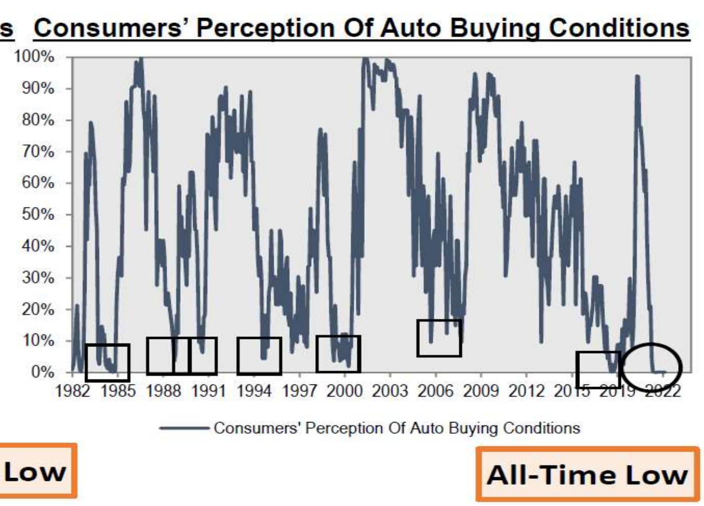


Source: PSC



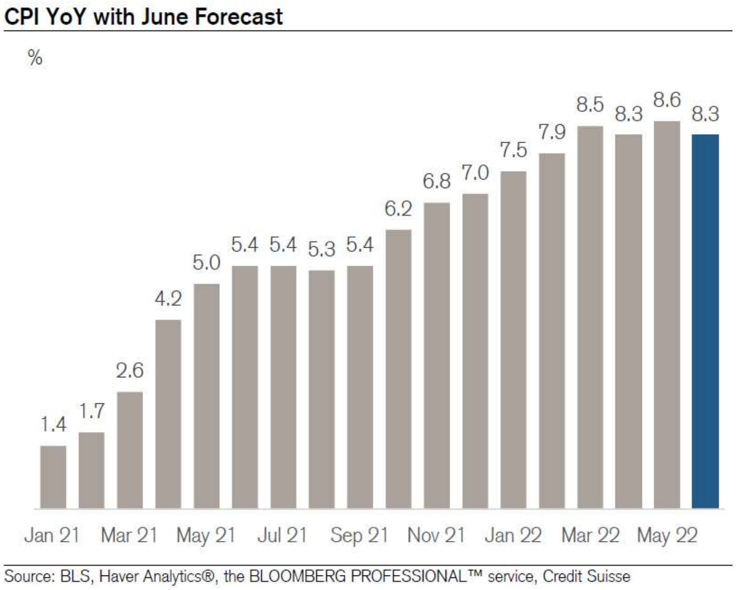
Source: PSC

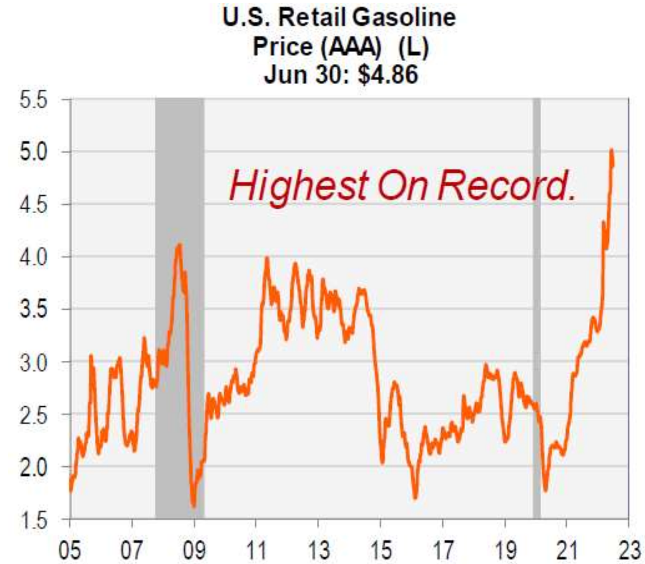




Source: Raymond James

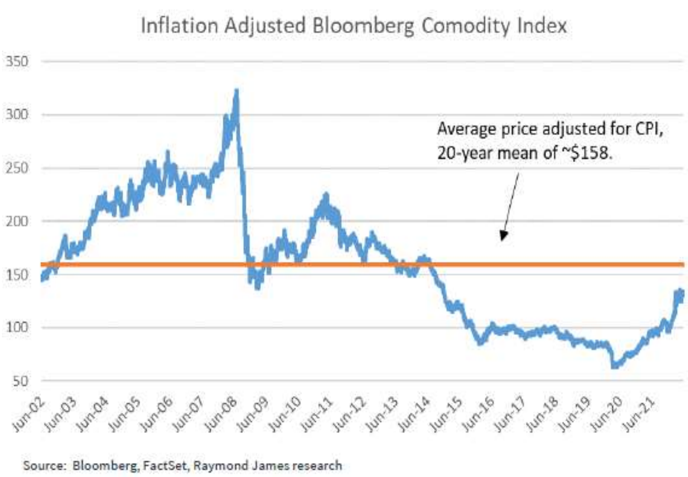
From our perspective, while technically we are in a recession as defined by two quarters in a row of negative GDP growth, this time period could actually be a "pause." The dramatic rapid movements we've seen in the price of goods and interest rates may be causing the consumer to pause. For example, used car prices rose an unheard of 50%, year-over-year, in January but have since retreated as demand has waned due to high prices, to soaring interest rates, and to now spent pandemic-induced savings. Inflation has been the bogeyman for the past several months as every newscast talks about the price of gas at the pump and of food at the grocery store. However, we must remember that we're comparing against a Covid locked down economy and that supply chain issues are still abundant but improving rapidly. The chart on the left shows the headline CPI (consumer price index) numbers. We will be more concerned about durable inflation if we don't see lower numbers in the months ahead as year-over-year comparisons are tougher and as many commodities have dropped significantly of late as we discussed earlier. The chart below right is the headline grabber- gas at the pump is the highest on record. Yes, that headline is true in nominal terms; however, if you adjust for inflation over time, the $4.10 per gallon price hit in 2008 would be the equivalent of $5.57 in today's dollars.

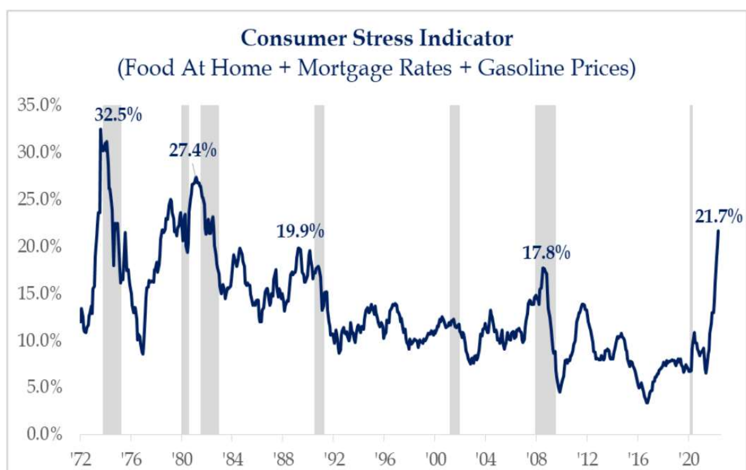




Source: PSC

The chart below left puts commodity inflation in perspective. Adjusted for inflation, the Bloomberg Commodity Index hasn't even reached the average level for the past 20 years. The largest inflation surge came in 2008 when nearly every commodity peaked at record levels before we entered the great financial crisis. Much of that surge was the result of China's incredible building efforts during the decade of the 2000's. The chart below right is a bit more disturbing in that each time that the consumer stress indicator reaches this level, a recession has ensued. This indicator considers the sum of the percentage increase in food at home, mortgage rates, and gas prices. The only difference that should be flagged is that we're comparing against a locked-down economy due to Covid in 2020 and 2021.





Source: Strategas Research

The overarching issue for the stock market during the quarter was undeniably the Federal Reserve and how aggressive they would be in raising interest rates and in ending quantitative easing. In fact, their actions have been the key issue for the market since they postured about raising rates last November. The surprise change in tone that was articulated by Fed Chair Powell and that was leaked to the press just days before the June FOMC meeting spooked the market and messaged that we might be in for a prolonged period of aggressive rate hikes. Just prior to this in May, several Fed Governors were discussing a pause after consecutive 50 basis point hikes at the June and July meeting. If you recall, this call for a potential pause caused one of the strongest weekly rallies in market history in May. Obvioiusly, the tone change in June arrived when the CPI numbers were persistently high as shown above. Instead of a possible pause, we received a 75 basis point hike in June and indications of another 75 basis point hike in July and 50 more in September with further hikes on the horizon that would take the Fed Funds rate to 3.5% by 2023. In our opinion if we get all the rate hikes that the Fed is posturing, we will be in a deep recession. These concerns are acting as a dark cloud over the stock market for the time being, and we believe that the stock markets' drop this year has discounted much of this potential outcome. As can be seen in the table below, it was a downright ugly quarter for equities but even worse for those indices that have a growthier bend to them like the NASDAQ and Russell 2000 Growth Index. Growth stocks don't like higher interest rates as the rate used for discounting a long duration asset increases and lowers the present value of the equity. This concept is why the growthier indices are down nearly 30% year-to-date.

Index Returns		
Index	First Qtr. 2022 Return	2022 YTD Return
Russell 2000	-17.20%	-23.43%
Russell 2000 Growth	-19.25%	-29.45%
Russell 2000 Value	-15.28%	-17.31%
S&P 500	-16.10%	-19.96%
Dow Jones Industrials	-11.25%	-15.31%
NASDAQ Composite	-22.28%	-29.23%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Value Index (-15.3%) beat the Russell 2000 Growth Index (-19.3%) in the quarter for the seventh straight quarter. There has never been a period in market history where this outperformance has occurred for eight straight quarters. The bottom line is that there was no place to hide as every sector was down during the quarter, and only two sectors had less than a double-digit loss, which were Consumer Staples and Utilities down -2.9% and -4.1%, respectively. On a year-to-date basis, the only sector that has a positive return is Energy which is up +22.8% as oil and gas prices remain strong. The weakest sectors were Technology, Commercial Services, and Real Estate which all have more sensitivity to higher interest rates. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the second quarter of 2022.

Table 1 - Index Performance by Sector

	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
GICS Sector	**June**	**2Q2022**	**YTD**	**June**	**2Q2022**	**YTD**	**June**	**2Q2022**	**YTD**
Com Serv	-11.7	-29.0	-33.7	-7.8	-26.1	-34.7	-14.4	-31.0	-33.0
Discretionary	-12.6	-21.4	-34.9	-11.6	-21.1	-36.0	-13.9	-21.5	-32.7
Staples	0.6	-2.9	-10.1	2.7	-2.2	-12.2	-1.7	-3.6	-7.2
Energy	-21.0	-13.0	22.8	-22.9	-16.6	12.4	-20.4	-11.8	26.5
Financials	-7.1	-12.5	-18.5	-7.5	-18.6	-29.9	-7.0	-11.3	-16.0
Health Care	2.0	-18.8	-30.5	3.0	-19.3	-31.3	-0.2	-17.5	-28.3
Industrials	-8.4	-16.4	-21.3	-6.9	-16.8	-24.4	-9.9	-16.2	-18.4
Info Tech	-9.7	-22.3	-33.0	-9.0	-23.1	-34.6	-12.4	-19.3	-26.5
Materials	-13.3	-17.6	-18.7	-13.4	-16.7	-16.2	-13.3	-18.4	-20.4
Real Estate	-10.0	-20.0	-23.7	-9.8	-24.5	-34.2	-10.0	-18.8	-20.7
Utilities	-3.0	-4.1	-1.0	1.2	-8.6	-18.0	-3.3	-3.9	0.1

Source: Jefferies

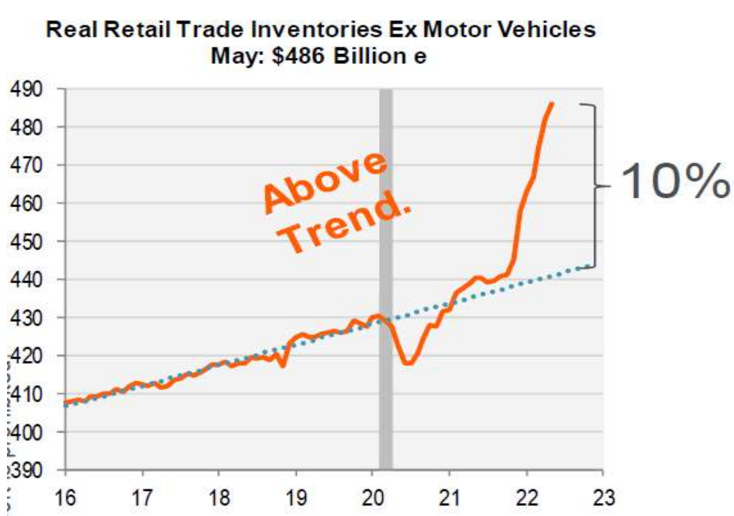
Returns across the international markets were broadly similar to those seen in the U.S. markets. One notable exception was China. The Chinese market had been as bad as the rest of the world until the Covid lockdowns in Shanghai and in several other major cities were relaxed, and the government postured that stimulus programs would be enacted to compensate for the Covid-induced slowdown. The ongoing war in Ukraine continues to hamper the European economy as high gas and oil prices crimp demand, and similar to the U.S. Fed, the ECB and BOE are hiking interest rates to fend off inflation. The surge in Interest rates has pushed bond prices lower for the second straight quarter. Volatility increased dramatically as one would expect given the market selloff during the quarter. Interestingly, lumber and natural gas were both lower in the quarter which may be indicative of broader trends across the commodity spectrum.

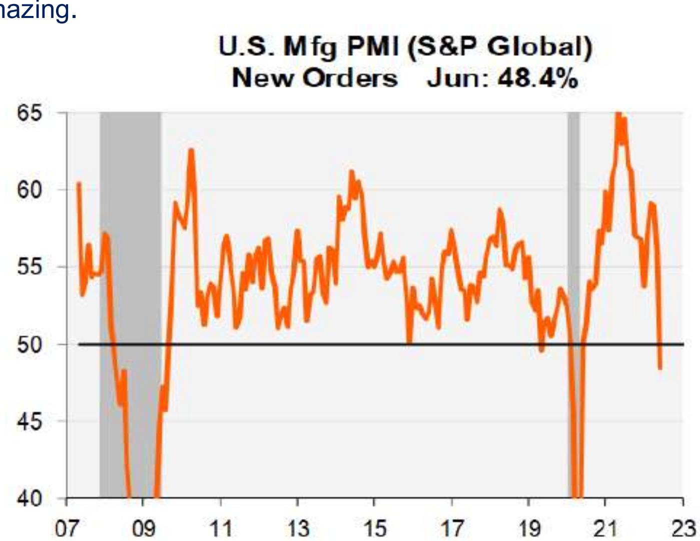
Index	Second Qtr. 2022 Return	2022 YTD Return
France	-11.1%	-17.2%
Germany	-13.8%	-22.0%
Brazil	-17.9%	-6.0%
India	-9.5%	-9.0%
China- A Shares	+4.5%	-6.6%
China- Shenzhen A Shares	+5.0%	-12.1%
Japan	-5.1%	-8.3%
Long-Term Treasuries (TLO)	-12.6%	-21.5%
Investment Grade Corp Bonds	-6.8%	-13.6%
Gold	-7.5%	-1.2%
Volatility- VIX index	+39.6%	+45.2%
Oil	+5.5%	+40.6%
Natural Gas	-4.4%	+51.6%
Lumber	-31.3%	-42.2%

Source: 1492 Capital Management, LLC

Updated 2022 Outlook: Two Pauses- One Bad and One Good- Target is the Canary in the Coalmine

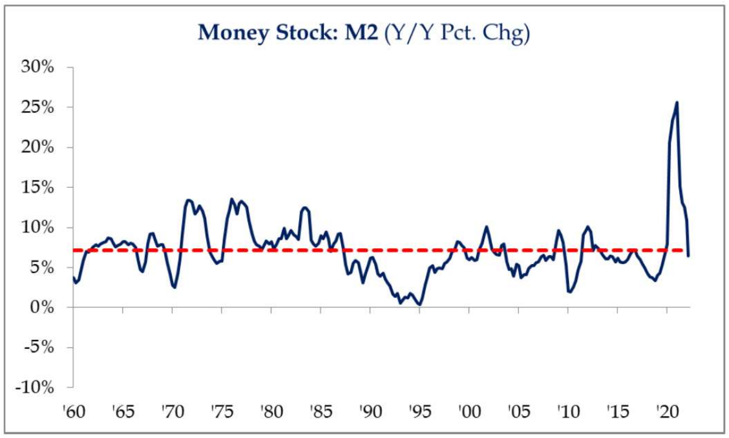
If you read the preceding part of this newsletter carefully, you will have noticed that we used the word "pause" several times in reference to two different thoughts. The first pause, the "bad" one, is the U.S. consumer's pause which is being thrust upon them from the spike in interest rates and in all things commodity related from food to gasoline. As we noted earlier, this pause has pushed us into a recession, at least temporarily, as consumers try to come to grips with higher prices and no more stimulus dollars in their bank accounts. For those who don't watch the stock market on a daily basis, it's rare for a large cap stock to drop 25% in a single day. However, on May 18th, Target Corporation's stock fell 25% in a single trading session. Why? They claimed that they had too much inventory and in the wrong categories. As a result, they would have to take markdowns which would negatively impact earnings. While part of their excuse may be valid in that they may have had some of the seasonal products wrong, we find it hard to believe that they could misread the U.S. consumer that badly in a single quarter. They've been analyzing and selling to the same consumer for decades. Instead, we believe that they are the "canary in the coalmine." In other words, they were the first ones to see both the Fed-induced slowdown and the shift from spending on goods, as most consumers did during the pandemic, to services like travel and restaurants. The consumer's "pause" has become Target's "pause" as they are now over-inventoried and will need to make purchasing adjustments to account for the new "normal." Pandemic stockouts have quickly transitioned to overstocks as the chart below left shows. Current inventories excluding autos, are significantly (+10%) above trendline and will likely need to be managed down which will pressure new orders. This action is already being reflected downstream in the "new orders" component of the U.S. Manufacturing PMI (purchasing managers index) which has fallen rapidly to 48.4% as shown in the chart below right. Anything below a reading of 50 is considered a contraction. The speed and severity of the contraction is quite amazing.



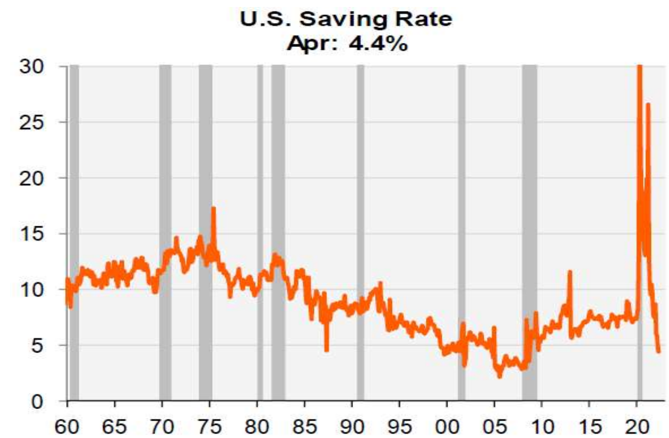


Source: PSC

The Federal Reserve is sucking liquidity out of the system rapidly through both their rate hikes and their end to quantitative easing. This simultaneous action is such a unique situation in that in normal periods of slowing growth or contractions in the economy, the Fed would normally be riding to the rescue to prop up the economy. Not so this time- at least not yet. They are aggressively tightening to fend off inflation and, in our opinion, mistakenly so. The chart below left shows the money supply or M2 percentage change year-over-year. Note the dramatic rise in 2020 and 2021 during the pandemic when the government doled out trillions of dollars of stimulus funds. Absent these funds and further Fed tightening, we've seen money growth return to a normal level. Similarly, the chart on the right shows the U.S. savings rate over the past 60 years. There was a spike in savings during the pandemic as consumers weren't out and about spending like normal and were simultaneously receiving stimulus dollars in their bank account. The excess savings have now been exhausted on delayed trips and restaurant visits, and the consumer is pausing as their finances normalize.

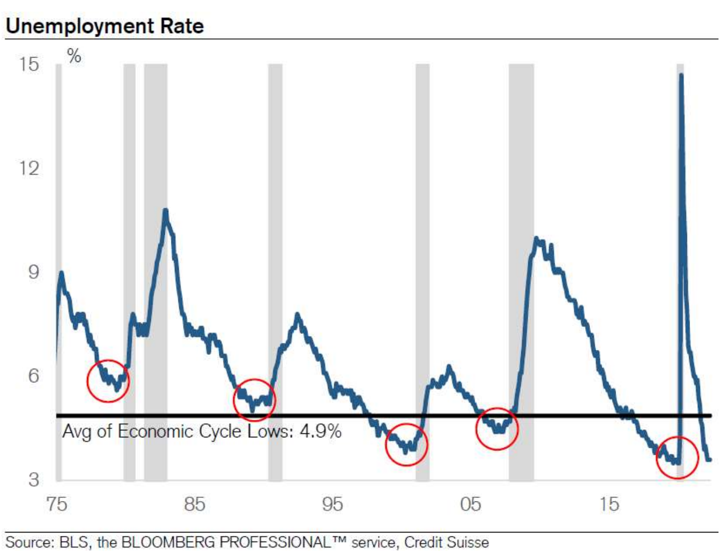


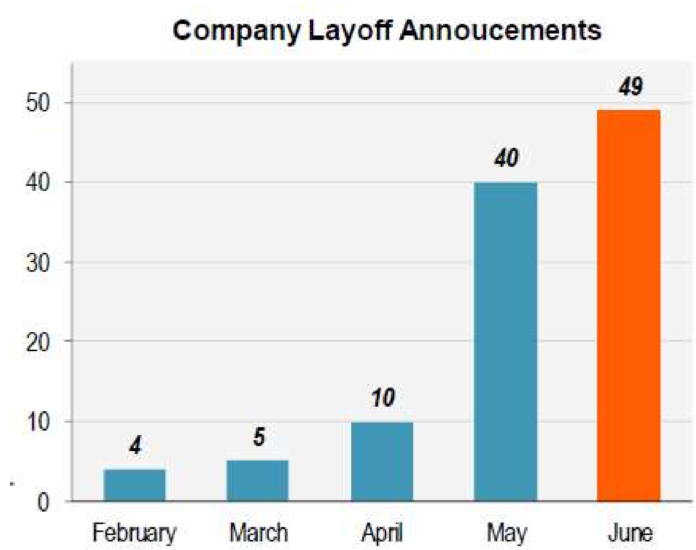
Source: Strategas Research



Source: PSC

The Federal Reserve appears to be emboldened to tighten so aggressively because one part of their dual mandate, full employment, is quite strong, and job openings appear to be at near record levels. The chart below left shows the unemployment rate through time. The current rate of 3.6% is quite low historically and is well below the typical cycle low for now. However, job openings are probably one of the squishiest economic statistics to look at as jobs can be posted to multiple outlets and can easily be pulled in a heartbeat. Anecdotally, we spoke to an executive in Silicon Valley in the past week who said that many of the "unicorns" (those companies that have been anointed as the next great company and valued in the billions of dollars) are for the first time in his recollection cutting staff aggressively. The prior mandate of growing at any cost without regard for profitability in order to receive a high IPO valuation appears to have ended. Adding in the massive contraction of cryptocurrency valuations and the commensurate issues with numerous firms associated with the sector, it would appear that those firms will be making massive layoffs in the coming weeks/months too. The chart below right shows the number of companies of size that have announced layoffs in the last few months. This number is accelerating and should continue to do so as we move through the year.

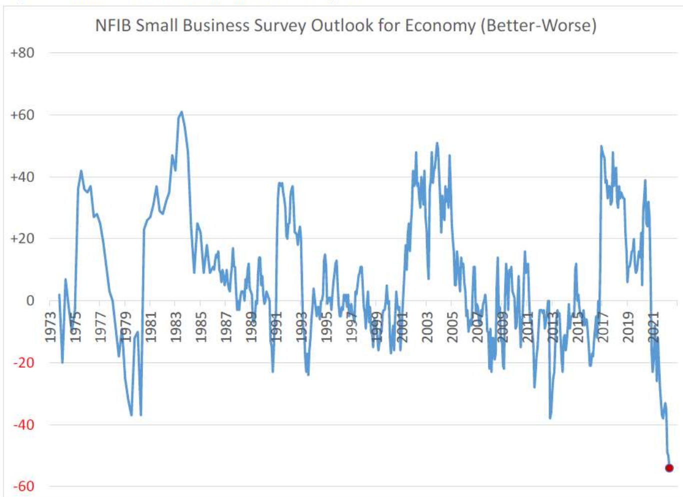




Source: PSC

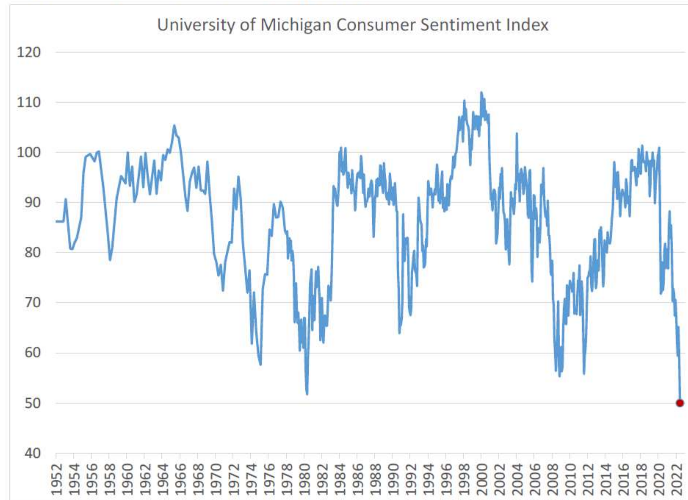
Whether it's Ukraine, inflation, Covid flare ups, crime, or interest rate hikes, the sentiment for both corporations and individuals has plummeted. While it's hard to believe that the current sentiment is worse than it was in the great financial crisis of 2008, post 9/11, or in the 1980's when interest rates were 18% and we were in a recession, it's what the numbers say. This sentiment doesn't bode well with both corporations and individual consumers feeling so badly about the outlook ahead. This feeling is what's behind the "bad pause" that we referred to earlier.

Fig 33. Small business sentiment is at a 48-year low



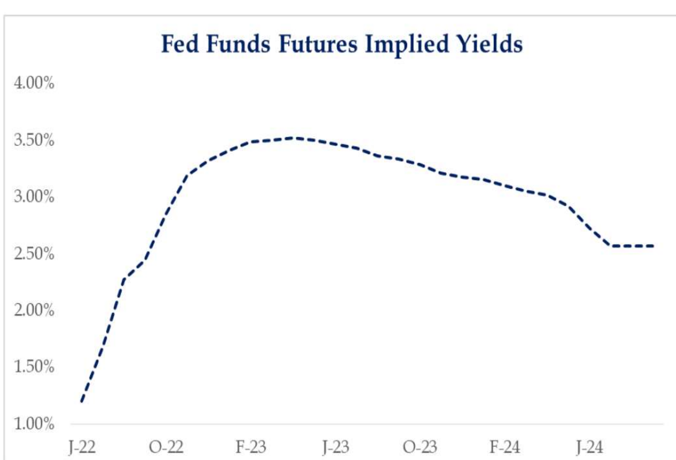
Source: FRP, FactSet; as of 5/31/22

Fig 34. Consumer Sentiment is at a 70-year low

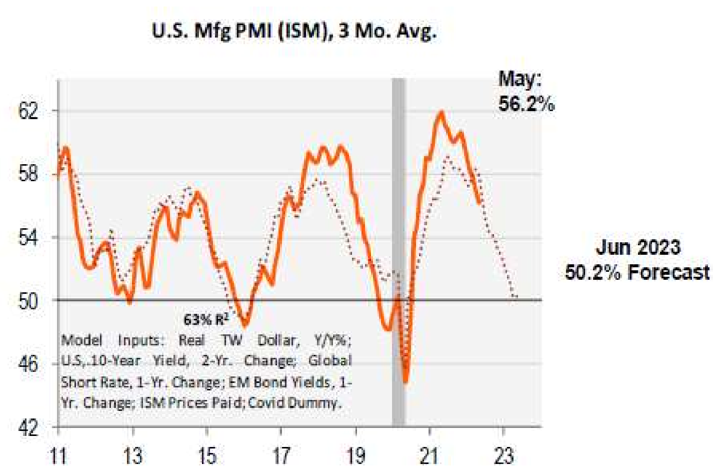


Source: FRP, FactSet; as of 6/30/22

The second pause that we referred to earlier is the "good" pause. A Federal Reserve pause will be required in order to see a substantial rebound in the stock market in my opinion. In other words, the messaging from Fed Chair Powell or other Federal Reserve governors needed is that they are done with the rate hikes and that they have satisfied the second component of their dual mandate which is price stability (i.e., inflation has been contained). The chart below left shows the current Fed Funds future rates. Note that the futures are baking in an additional 200 basis points of rate hikes from the current level of approximately 1.5% to ultimately reach 3.5% in early 2023. Interestingly, the futures are also discounting some rate cuts later in 2023 as the Fed seemingly always overshoots in the tightening phase of the cycle. Perversely, rate cuts typically start four or five months after the last rate hike and that seems to be anticipated at this point. The pause in rate hikes may not be too far off if the chart on the right plays out as forecast. To date in this tightening cycle, there have been over 200 central bank rate hikes around the globe. This cumulative impact is substantial and underway. There is usually a 12-18 month lagged impact from the date of tightening to achieve its intended effect which is a demand slowdown. One of our favorite charts, below right, shows the forecast for the U.S. PMI which currently stands at 53.0 and is forecast to drop rapidly. The forecast is simply looking primarily at the change in global short rates (like the fed funds rate) and plotting those changes with some delay as it takes time for the rate hikes to impact demand. The path isn't good and that is what concerns the stock market. A reading below 50 implies contraction. The "good" pause may not be too far off if this forecast is correct.



Source: Strategas Research

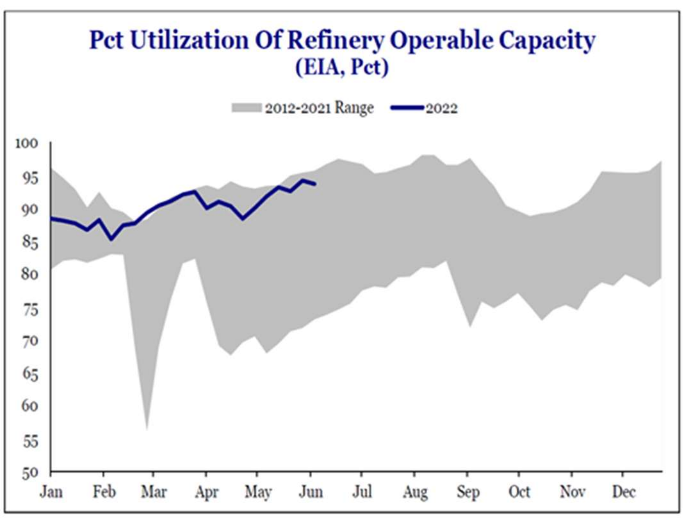


Source: PSC

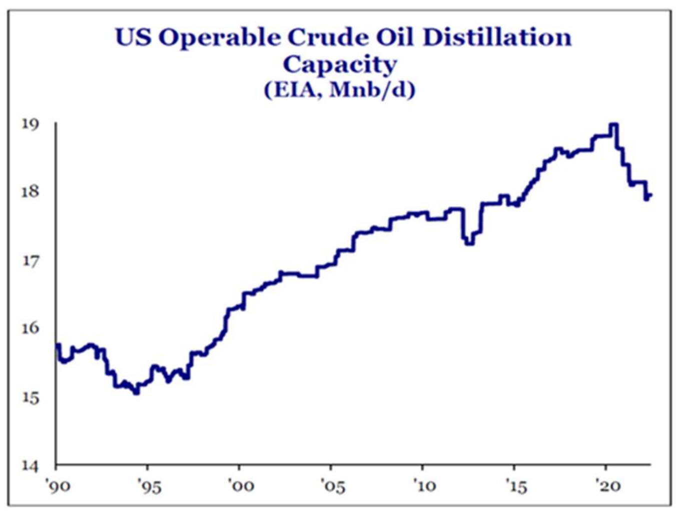
Thematic Investing: Current U.S. Energy Policy- Keep Throwing Stuff (We Said Stuff) Against the Wall – Something is Bound to Stick!

As a student of economics, it is always fascinating to watch allegedly smart people ignore the simplicity of supply and demand. In the real world, the Biden administration has found itself in the position of a lack of supply growth in the U.S. due to a new mantra of fiscal discipline from the oil and gas industry. Like many other cyclical businesses where adding capacity just leads to eventual oversupply when the economy heads south and curtails demand, the public companies in U.S. oil and gas industry have boarded that same cyclical train as well with much lower production growth goals. Due to reduced current and future Russian oil flows, Washington now has to go and ask for more oil supply from Saudi Arabia. For the better part of two years, the Saudis have watched the Biden administration's renewable energy policy promote the demise of their country's primary source of revenue. How keen are the Saudis to help when the green policy mantra will return post their oil bailout? We'd argue that they are not very interested. While OPEC did accelerate this September's oil production increase equally into July and August, the Saudis know that barring an economic catastrophe like COVID again, the small amount of demand for oil that is lost due to a recession is financially much more acceptable than oversupplying the market, cratering the oil price, and angering Russia the other key member of OPEC+ group. The Saudis are surely watching the idea floating around of price limits on Russian oil sales as a less bad punishment to the Russians and to the countries in Europe that are dependent on their oil, and they are questioning the resolve of the Russian import ban that is on its way by year-end and the real lost supply.

Our list of items from the Biden administration that come screaming across as headlines to help have included crude oil export bans, demands for higher refinery utilization, windfall profit tax schemes, and gasoline tax holidays. Simplistically, a crude oil export ban raises the price of oil outside of the U.S., namely Brent crude, as supply is reduced to other nations. A refiner buys oil and processes it into products like gasoline and diesel, and global gasoline prices are set off the international Brent oil price. Refiners in Europe export gasoline to the U.S., particularly to the Northeast, so raising their raw material cost with higher oil prices precipitates higher global gasoline prices. We will also still need to import oil types that are different than what is produced domestically as the U.S. refinery system is designed to maximize its products with a blend of globally sourced oils as a feedstock. With respect to demanding higher refinery utilization and capacity via the Defense Production Act, this request is both a safety issue and a lost capacity issue. As seen below left, both historically and currently refiners are running at 93-95% capacity utilization at this time of year and to push higher than that can create safety issues where you lose the whole refinery due to unscheduled maintenance downtime from an accident. As depicted in the chart below right, the green movement has also encouraged many small refineries to switch from refining crude oil to refining fats, corn oil and soybean oil into renewable diesel, which has reduced gasoline capacity in the U.S.



Source: Strategas Research



Source: Strategas Research

The windfall tax bill that would apply a 21% additional tax to oil companies with over $1 billion in revenue and with 10% or higher profit margins was conceived to offset the lost revenue for infrastructure spending from a gas tax repeal. Throughout the course of economic history if you repeal a tax and thus lower the price of the product, doesn't demand accelerate and shortly thereafter price? We believe that this gas tax repeal idea is nothing more than stop-gap political theater. According to Piper Sandler Macro Research, a windfall profits tax would also have to be part of a reconciliaton bill that Senator Manchin from West Virginia will very likely block.

To counter the multitude of temporary and likely to be unsuccessful actions, in our opinion, that the Biden administration has offered, the American Petroleum Institute countered with several proposals in mid-June that focus on making it easier to grow oil and natural gas supply in the U.S. Some of these items include lifting bans on federal lands and waters, defining specific permitting timelines, and designating critical energy infrastructure projects that have streamlined review and permitting in one year or less. This approach focuses on domestic supply growth which offers greater odds of success both economically and strategically than attempting to manage demand through governement policy in our opinion. Economic forces will manage demand as we've seen with oil prices retreating from over $120 per barrel to the mid $90's per barrel level as the market discounts a potential recession. Greater oil and natural gas supply growth provides levers in aiding Europe with U.S. exported liquified natural gas (LNG), in offering stable, natural gas based domestic power generation for manufacturers reshoring back to the U.S., and in supplying the world with U.S. oil to counter dwindling OPEC spare capacity. As we mentioned countless times in previous newsletters, the near-term cure for higher prices is higher prices and thus the curtailment of some demand for the commodity while the long-term cure is additional supply of the resource. It's a simple concept that if thrown against the wall has historically shown to stick.

Updated 2022 Outlook: Quite Possibly the Best Opportunity in Small Cap Stocks in Decades

The title of this section may be aggressive at first glance, but I'll try to convince you that we haven't gone off the deep end. Unfortunately, the only way that we are able to make such a statement is what happened to get us here and that is a severe selloff since November 2021 (-30%) for many stocks and since March 2021 (-40%) for growth stocks. Much of our argument is predicated on the absolute and relative valuation of small caps. Should we have an ugly recession similar to 2008 where earnings drop precipitously, then all bets are off, but we don't think this recession will be anything like what happened then. Companies' balance sheets are far stronger with less debt and more cash as many companies learned about the negative impacts of leverage in the 2008 downturn. A secondary argument in favor of small caps is that they have been out of favor for a number of years and basically ignored. A modest flow of funds could ignite the asset class as the market cap of the top five stocks in the S&P 500 could buy the entire Russell 2000 Index member companies three times over. In review, the first half of the year was downright ugly with the worst second quarter ever and the worst first half since 1973 for the Russell 2000 Index. The chart below left shows the performance of the Russell 2000 Index in the June quarter compared to the other poor quarters in history. The chart below right shows the dismal first half performance of the Russell 2000 Index and the market returns in the subsequent 12 months following exceptionally bad six-month periods. Note that the median return is +36.5% in the subsequent 12 months with 100% of the observations being positive.

Fig 3. **Exceptionally bad quarters usually portend strong forward returns**

	R2 Total Return (%)			
Date	**Past Qtr.**	**Fwd 3 Mo.**	**Fwd 6 Mo.**	**Fwd 12 Mo.**
Sep-81	(17.5)	10.2	(0.1)	8.8
Dec-87	(29.1)	19.1	27.0	25.0
Sep-90	(24.5)	5.1	36.3	45.1
Sep-98	(20.1)	16.3	10.0	19.1
Sep-01	(20.8)	21.1	25.9	(9.3)
Sep-02	(21.4)	6.2	1.4	36.5
Dec-08	(26.1)	(15.0)	2.6	27.2
Sep-11	(21.9)	15.5	29.8	31.9
Dec-18	(20.2)	14.6	17.0	25.5
Mar-20	(30.6)	25.4	31.6	94.8
Jun-22	(17.2)			
Average		**11.8**	**18.2**	**30.5**
Median		**15.0**	**21.4**	**26.3**
% Positive		**90%**	**90%**	**90%**

Source: FRP, FactSet; as of 6/30/22

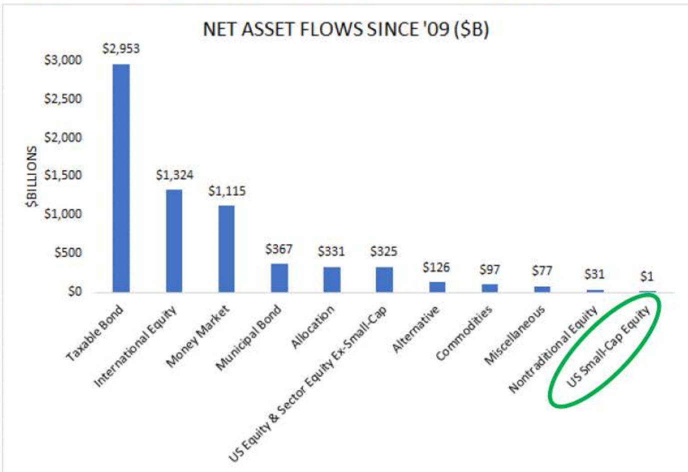
Fig 4. **The same can be said for consecutive quarter periods**

	R2 Total Return (%)			
Date	**Past 6 Mo.**	**Fwd 3 Mo.**	**Fwd 6 Mo.**	**Fwd 12 Mo.**
Dec-87	(26.1)	19.1	27.0	25.0
Sep-90	(21.6)	5.1	36.3	45.1
Dec-90	(20.6)	29.7	27.7	46.0
Sep-98	(23.9)	16.3	10.0	19.1
Sep-02	(28.0)	6.2	1.4	36.5
Dec-08	(26.9)	(15.0)	2.6	27.2
Mar-09	(37.2)	20.7	44.0	62.8
Sep-11	(23.1)	15.5	29.8	31.9
Mar-20	(23.7)	25.4	31.6	94.8
Jun-22	(23.4)			
Average		**13.7**	**23.4**	**43.2**
Median		**16.3**	**27.7**	**36.5**
% Positive		**89%**	**100%**	**100%**

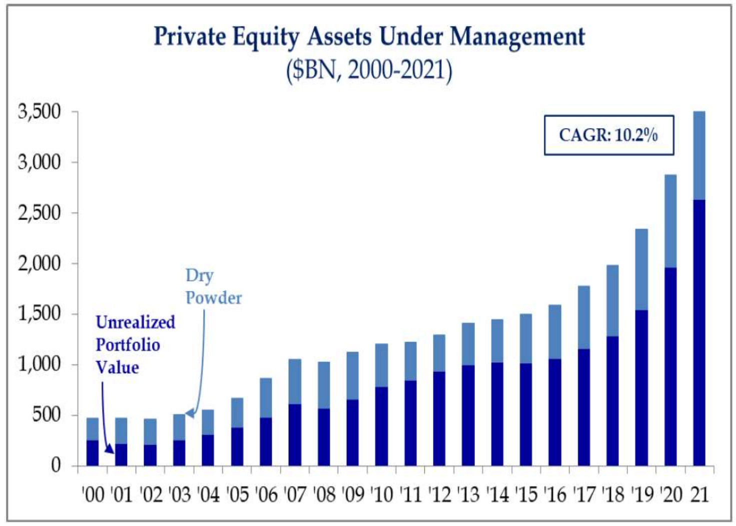
Source: FRP, FactSet; as of 6/30/22

Asset allocators have seemingly ignored small caps as an asset class since the great recession of 2008. Why is that? Our explanation is that these allocators have directed significant sums to "alternative" asset classes like hedge funds and private equity funds. Private equity has become the flavor of the day and may be viewed by some as a substitute for small caps. Since 2009, asset flows have been nearly non-existent into small caps as the chart below left shows. Since 2009, net flows into small caps have been a paltry $1 billion. This flow is quite amazing given the amount of dollars being allocated globally and is almost a rounding error. Conversely, private equity funds, the number which has grown from under 1,000 funds in 2004 to over 3,500 today, have seen massive inflows that total trillions of dollars as shown in the chart below right.

Fig 1. U.S. Small-Caps have received the least net flows since the GFC



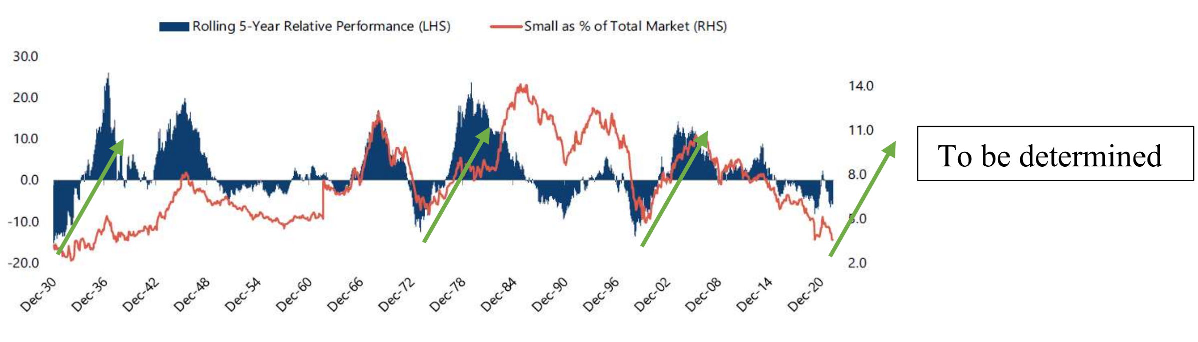
Source: Furey Research Partners and Morningstar. Based upon Morningstar's ten U.S. category groups with U.S. small-cap equity separated from other U.S. Equity. Includes all US Open-end & ETF & MM & FoF, active and passive. Data as of 4/30/22. Excludes "Unclassified" funds.



Source: Strategas Research

The attraction to private equity is that they've somehow convinced the asset allocators that they are able to achieve consistently better returns with less volatility than publicly traded equity funds. This pitch is an interesting concept in light of the fact that they take on substantial leverage of many times more than five-fold the capital deployed. How is this possible through times like we're currently experiencing, particularly with the leverage? Remember your finance 101 class- there is no such thing as a free lunch. The trick is they don't mark-to-market daily like the rest of the publicly traded funds do, and hence investment boards are pitched that these PE funds provide significantly less volatility. However, we're just now seeing a number of private equity firms mark down their portfolios by 25 to 50% to account for the absolute beating the publicly traded comps have taken in the recent downturn. Private equity funds have also seen a lot more competition for their buyout targets due to the SPAC explosion over the last two years. SPAC's (special purpose acquisition companies) raised funds through publicly traded stocks to go out and purchase privately held companies and created significant competition for PE funds. With this competition and the subsequent rout of stock prices in small caps, it may force PE funds to target publicly traded companies for acquisitions due to the big disparity between public and private valuations currently. To further support this view, small caps currently account for less than 4% of the overall U.S. stock market. As the chart below shows, small caps at times have comprised nearly 14% of the U.S. stock market value. However, in the few rare cases when small caps have been less than 5% of the market, the forward returns have been spectacular as shown in the table below, and the batting average or percent of time that small beats large is quite high.

Small less than 4% of US market; Performance has been awful; We normally get bounce



5-Year Relative Performance	Relative Subsequent Performance Next Year	Next 3-Years	Next 5-Years	Batting Average Next Year	Next 3-Years	Next 5-Years
Q1 (Best)	3.4	0.1	0.8	61.6	49.3	51.1
Q2	2.3	1.2	0.6	49.8	49.3	49.8
Q3	2.1	1.7	2.1	53.1	48.6	52.2
Q4	1.8	3.3	3.1	53.0	53.3	65.5
Q5 (Worst)	**7.2**	**7.6**	**8.1**	**65.3**	**78.5**	**84.2**
Overall	**3.4**	**2.6**	**2.8**	**56.6**	**55.3**	**59.8**

Note: Performance is annualized; Batting average is % of time small beats large.
Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

If the Fed achieves their goal of curbing inflation, once again, history shows that small cap returns can be quite positive on both an absolute and relative basis compared to large caps. The chart on the left shows the small cap nominal returns (+22.4% on average) in a situation in which inflation is above 3% and decreasing. Similarly, the chart on the right shows the relative returns of small vs. large caps in the same scenario, an outperformance of 6.1% annually.

Ann. Inflation vs. SmCap % NOM. Return (1950-2021)

Rate of Change	Starting Level: Below 3%	Above 3%	All
Decreasing	17.0	22.4	18.9
Increasing	15.7	5.6	14.8
All	16.5	16.9	16.6

Ann. Inflation vs. SmCap % REL. Return (1950-2021)

Rate of Change	Starting Level: Below 3%	Above 3%	All
Decreasing	0.2	6.1	3.2
Increasing	-2.1	-8.7	-4.1
All	0.0	3.3	0.5

Source: Furey Research Partners

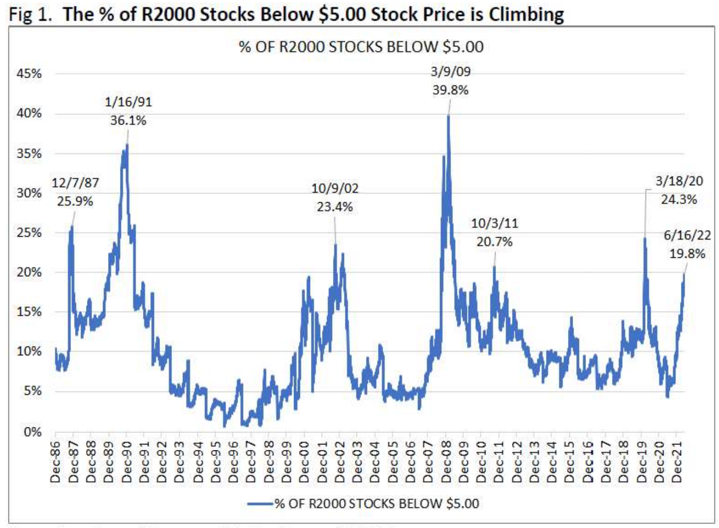
It's been a rare occurrence over the past 25 years when I could look at my computer screen and see P/E ratios of less than ten times for many stocks in our portfolios. That valuation is the case currently. Now one could argue that this situation is a value trap, and, in some cases, it will be as there is a sentiment currently that many companies over-earned during the pandemic. During that period, many companies were able to keep their revenue intact or increase it due to strong pricing but had no travel and entertainment expenses. Another metric that has us excited about forward prospects is that more than 10% of stocks in the Russell 2000 Index trade at less than net cash on the balance sheet as shown on the chart below left. This percentage is quite rare. It last happened was in 2008, and the subsequent years were quite strong on a relative basis. The chart on the right shows the percentage of stocks that trade at less than $5. Absolute prices don't tend to mean much in that you can split your stock and theoretically create any price you want in your shares without changing the value of the company. However in prior instances where 20% or more of the Russell 2000 Index stocks traded at $5 per share or lower, the forward 12 month returns averaged nearly 33%, and returns were positive almost 100% of the time as shown in the table below the charts.

Chart 1 - More than 10% of the Russell 2000 trades below cash, a new all-time high

Note: We excluded Financials from universe.

Source: FactSet; FTSE Russell; Jefferies

Fig 1. The % of R2000 Stocks Below $5.00 Stock Price is Climbing



Source: Furey Research Partners and FactSet. Data as of 6/17/22.

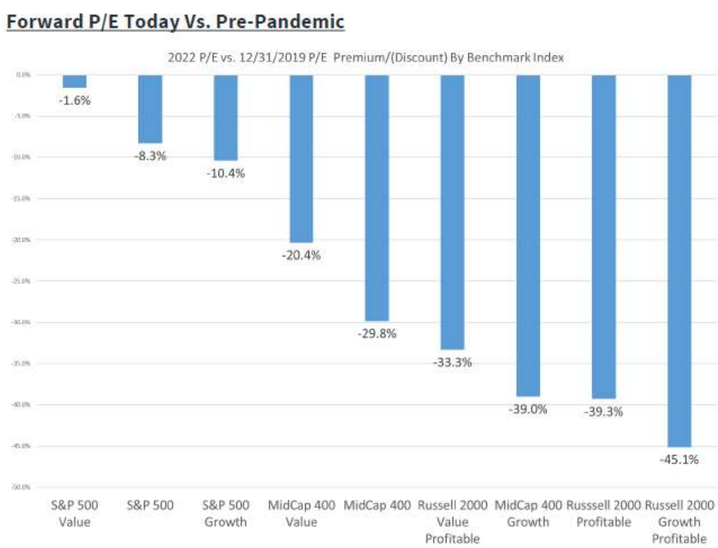
Fig 2. Uncommon for so many R2000 Stocks to be below $5.00 share price

% OF R2000 STOCKS BELOW $5.00	AVERAGE FWD YR PERFORM	% Pos	% of DAYS
10%	17.5%	79%	44%
15%	25.9%	92%	19%
20%	32.9%	98%	8%
25%	43.1%	100%	3%

Source: Furey Research Partners and FactSet. Data as of 6/17/22.

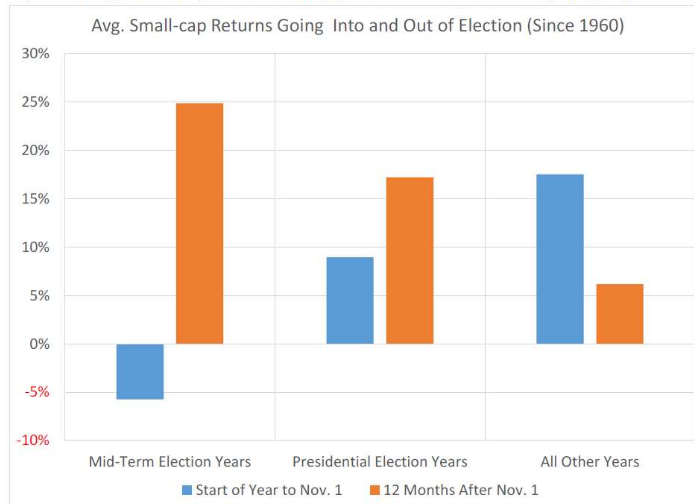
It's uncommon for the percentage of R2000 stocks with below $5.00 share prices to reach 20% and has only occurred 8% of the time. Even more rare is for the percentage of stocks below $5.00 to near 25% with those observations clustered around four events – the COVID-19 initial sell-off (reached 24.3%), the Great Financial Crisis, the First Gulf War and '91 recession and following the '87 Crash. When the **percentage** of R2000 stocks **below $5.00** share price **reaches 20%,** the R2000 is **up almost 100% of the time in the forward year with an average 33% gain.**

To further our case, stock valuations compared to pre-pandemic levels are extraordinarily cheap, particularly as you move down the market cap spectrum as shown in the chart below left. At 45% currently, profitable small cap growth stocks have the largest discount to where they traded pre-pandemic. The chart below right shows a strange anomaly that occurs in midterm election years. The return leading up to the election is on average modestly negative, but the 12-month post-election returns average nearly 25%. This inflection may coincide with when the Fed begins messaging that they are done tightening interest rates for this cycle which would be a major catalyst for the market overall.



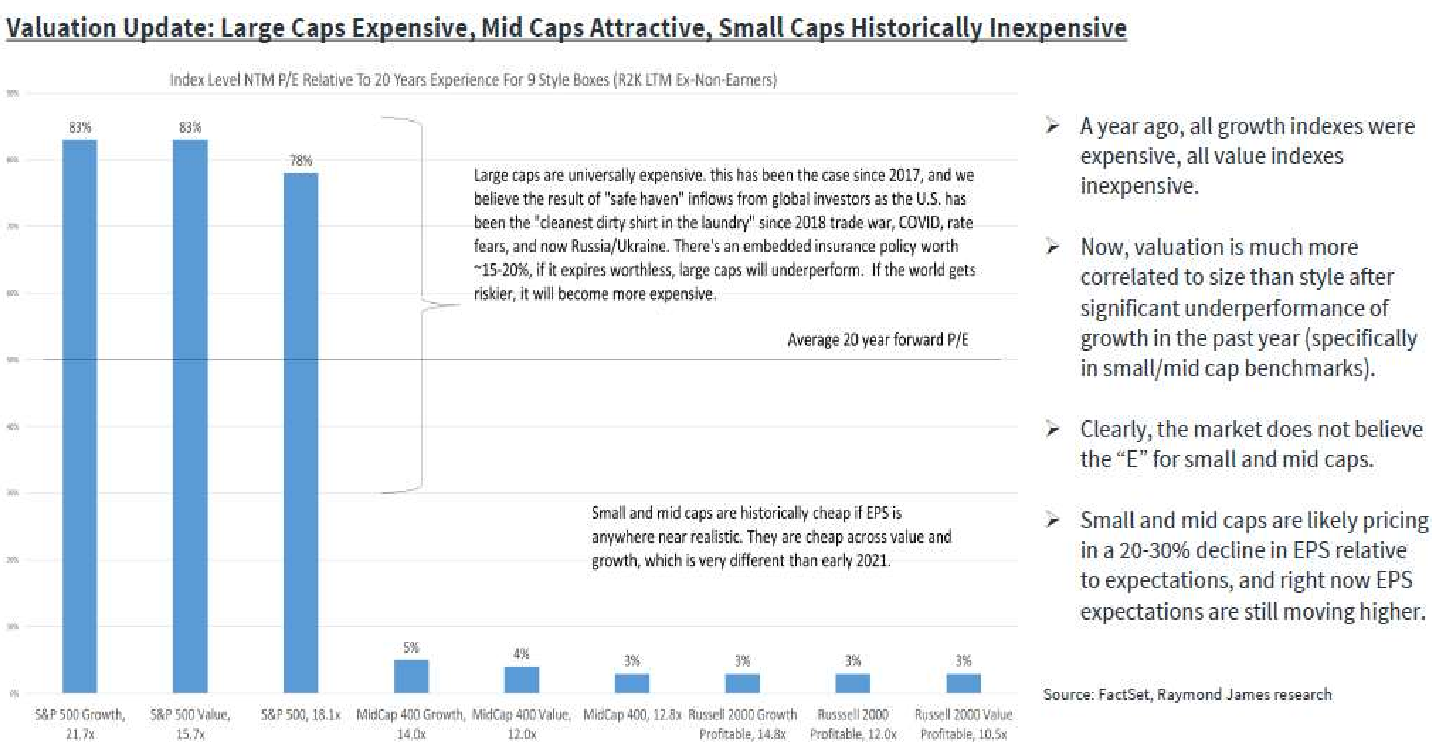
Source: Raymond James

Fig 19. **Average small-cap returns following a mid-term election are eye-popping**



Source: FRP, FactSet; as of 6/30/22

Slicing and dicing valuation metrics further, small caps currently trade in the 3rd percentile relative to their average 20-year forward Price/Earnings ratio, whereas large caps occupy the 80th percentile. Even if earnings estimates are too high, the relative discount for small caps is extremely wide.



Lastly, while nobody knows if the stock market bottom is in yet, the metrics for a rebound off a bear market bottom are very compelling, and the case for small cap outperformance is quite strong.

Fig 22. **Returns from small-cap bear market bottoms are exceptionally strong**

R2 Bear Market		Price Chg.	R2 Absolute Price Change (%)			R2 Price Change Relative to SP5 (%)		
Start	Bottom	From Peak (%)	Fwd. 6M	Fwd. 1Y	Fwd. 2Y (A)	Fwd. 6M	Fwd. 1Y	Fwd. 2Y (A)
02/08/80	03/27/80	(26.7)	60.1	75.2	20.7	29.1	38.1	14.0
06/15/81	08/12/82	(29.2)	62.1	92.4	30.6	20.6	34.7	4.9
06/24/83	07/25/84	(26.0)	18.7	30.5	23.3	(0.4)	1.8	(3.2)
08/25/87	10/28/87	(39.1)	36.5	39.7	26.6	23.9	19.1	5.4
10/09/89	10/31/90	(34.0)	45.7	54.0	28.9	20.5	24.7	11.4
04/21/98	10/08/98	(36.9)	32.7	37.7	25.6	(8.9)	(1.5)	4.4
03/09/00	10/09/02	(46.1)	13.9	59.4	32.9	1.7	25.7	12.6
10/09/07	03/09/09	(59.4)	66.2	95.1	55.0	16.0	26.5	15.2
04/23/10	07/06/10	(20.5)	35.3	42.6	17.8	11.6	12.5	2.2
04/29/11	10/03/11	(29.6)	37.0	37.9	33.0	8.4	6.4	9.0
06/23/15	02/11/16	(26.4)	28.9	45.6	25.0	9.4	19.0	4.5
08/31/18	12/24/18	(27.2)	19.8	32.4	25.9	(4.1)	(4.7)	0.6
02/20/20	03/18/20	(41.6)	56.6	128.8	44.3	15.4	65.5	8.7
11/08/21	06/16/22	(32.5)						
		Average	**39.5**	**59.4**	**30.0**	**11.0**	**20.6**	**6.9**
		Median	**36.5**	**45.6**	**26.6**	**11.6**	**19.1**	**5.4**

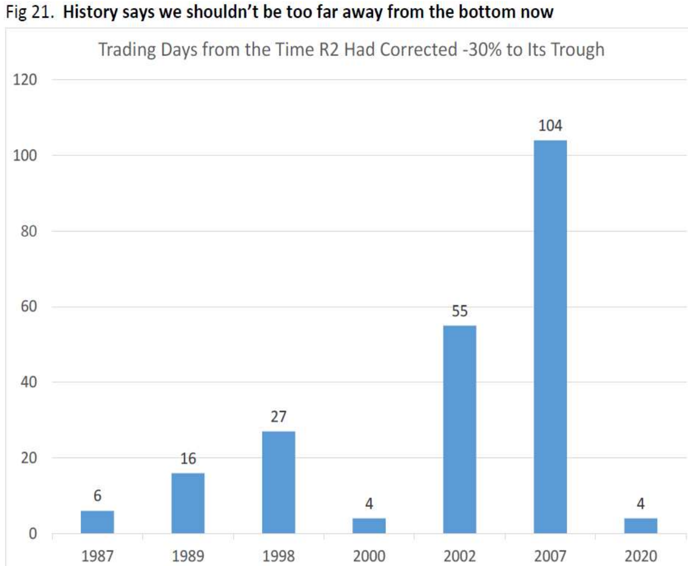
Source: FRP, FactSet; as of 6/30/22

Updated 2022 Outlook: A Picture is Worth a Thousand Words

We articulated our updated 2022 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.

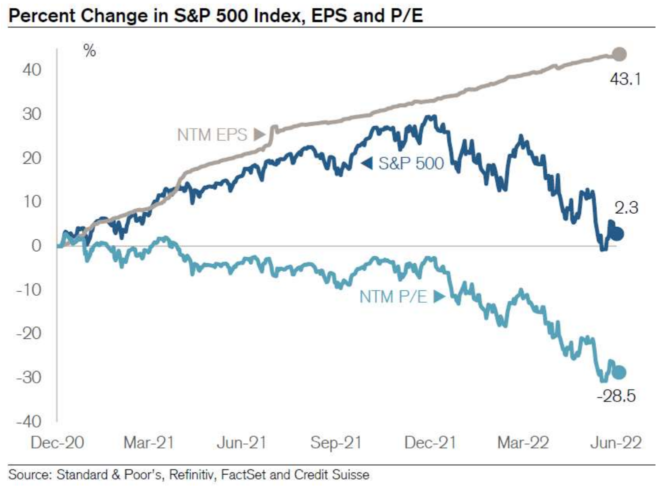
This chart shows the number of trading days that it took to reach the trough in prior 30% corrections in the Russell 2000 Index.

Fig 21. **History says we shouldn't be too far away from the bottom now**

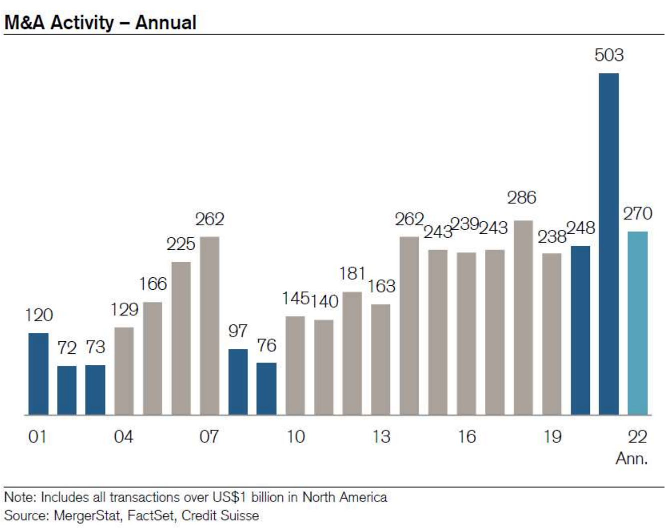


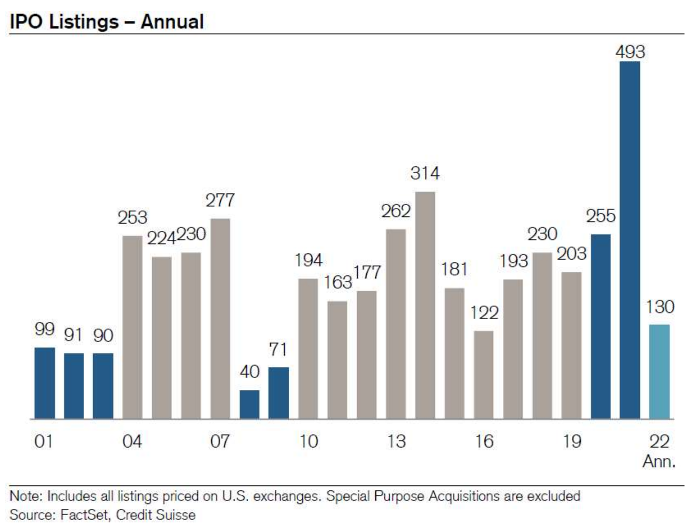
Source: FRP, FactSet; as of 6/30/22

This chart shows the breakdown of the returns of the S&P 500 between earnings growth and P/E compression since December 2020 through June 30th. There has been strong earnings growth of 43%, but the P/E compression is -28.5%.

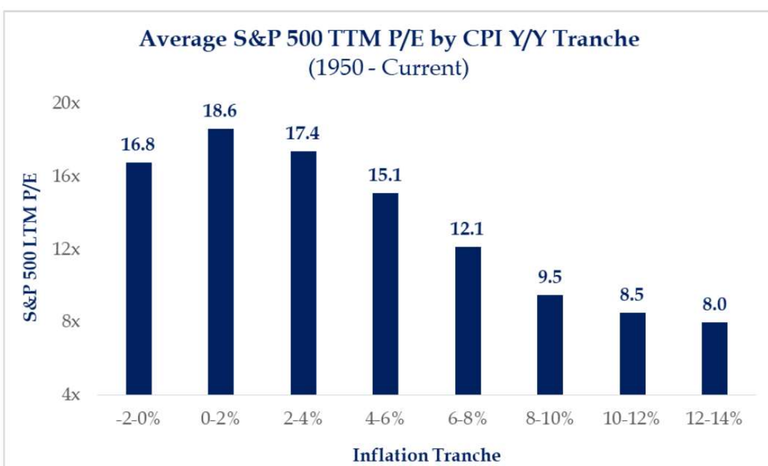


Merger activity and IPO issuance have been relatively muted compared with 2021 when the SPAC boom caused both an onslaught of IPO's and subsequent mergers when they identified their targets. IPO activity is particularly subdued this year.





The following chart shows the historical P/E ratio for the S&P 500 during various periods of inflation. Obviously, the market doesn't believe that the current inflation rate of 8.6% will be sustained otherwise a P/E ratio of 9.5 times would be appropriate.



Source: Strategas

Stock Market Trivia

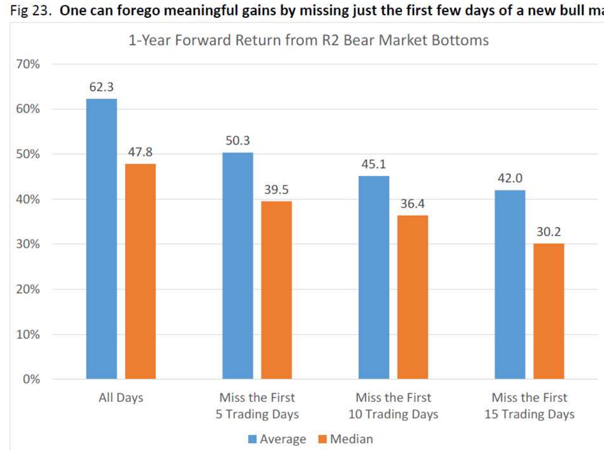
Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. This quarter we focus on stock market returns following a bear market. The good news is that returns exiting a bear market can be quite spectacular for small caps. The bad news is that you've had to endure a bear market to see the snap back on the other side. While the current bear market has only lasted for six months for the S&P 500 and eight months for the Russell 2000 Index, the drop from the highs have been on par with the "typical" bear market. The good news is that the forward one-year median return coming out of a bear market is +45.6% as shown on the chart on the left. The one difference this time around is that we likely won't have an accommodative Fed right away as is the case for most other historical bear markets for fear of reigniting inflationary pressures. The chart on the right shows the one year forward median return following a 30% correction in the Russell 2000 Index. The punchline here is that market timing can be hazardous to your financial health because if you miss just a few of the trading days once the market begins its rebound, your potential returns fall precipitously.

Fig 22. **Returns from small-cap bear market bottoms are exceptionally strong**

R2 Bear Market		Price Chg.	R2 Absolute Price Change (%)			R2 Price Change Relative to SP5 (%)		
Start	Bottom	From Peak (%)	Fwd. 6M	Fwd. 1Y	Fwd. 2Y (A)	Fwd. 6M	Fwd. 1Y	Fwd. 2Y (A)
02/08/80	03/27/80	(26.7)	60.1	75.2	20.7	29.1	38.1	14.0
06/15/81	08/12/82	(29.2)	62.1	92.4	30.6	20.6	34.7	4.9
06/24/83	07/25/84	(26.0)	18.7	30.5	23.3	(0.4)	1.8	(3.2)
08/25/87	10/28/87	(39.1)	36.5	39.7	26.6	23.9	19.1	5.4
10/09/89	10/31/90	(34.0)	45.7	54.0	28.9	20.5	24.7	11.4
04/21/98	10/08/98	(36.9)	32.7	37.7	25.6	(8.9)	(1.5)	4.4
03/09/00	10/09/02	(46.1)	13.9	59.4	32.9	1.7	25.7	12.6
10/09/07	03/09/09	(59.4)	66.2	95.1	55.0	16.0	26.5	15.2
04/23/10	07/06/10	(20.5)	35.3	42.6	17.8	11.6	12.5	2.2
04/29/11	10/03/11	(29.6)	37.0	37.9	33.0	8.4	6.4	9.0
06/23/15	02/11/16	(26.4)	28.9	45.6	25.0	9.4	19.0	4.5
08/31/18	12/24/18	(27.2)	19.8	32.4	25.9	(4.1)	(4.7)	0.6
02/20/20	03/18/20	(41.6)	56.6	128.8	44.3	15.4	65.5	8.7
11/08/21	06/16/22	(32.5)						
		Average	39.5	59.4	30.0	11.0	20.6	6.9
		Median	36.5	45.6	26.6	11.6	19.1	5.4

Source: FRP, FactSet; as of 6/30/22

Fig 23. **One can forego meaningful gains by missing just the first few days of a new bull market rally**



Source: FRP, FactSet; as of 6/30/22

We hope that you found our second quarter 2022 review and updated 2022 outlook newsletter to be insightful and interesting. Should you have any questions about anything discussed herein or would like more information about 1492 Capital Management, please call us at 414-276-1492.

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