1492 CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

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INDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY

# 1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management's newsletter for the third 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.

## Like the Captain of the Titanic, Fed Chair Powell Goes Full Speed Ahead Despite What Lurks Beneath the Surface.

E.J. Smith, Captain of the RMS Titanic was famously quoted as saying, *"But in all my experience, I have never been in any accident… of any sort worth speaking about. I have seen but one vessel in distress in all my years at sea. I never saw a wreck and never have been wrecked nor was I even in any predicament that threatened to end in disaster of any sort."* However, we all know how the Titanic's maiden journey ended. In similar fashion, despite warning signs of what lies ahead, Fed Chair Powell and the FOMC continue to go full speed ahead with their aggressive interest rate-hiking plan. In fact, it's the most aggressive tightening cycle in modern history with a lot more to come in the months ahead if the Federal Reserve is to be believed. In keeping with his aggressive stance, Fed Chair Powell used his Jackson Hole speech in late August to deliver one of the shortest but to the point messages to the markets. In sum, he threw a penalty flag on the stock market for being offside and warned that the Fed was hellbent on hiking interest rates to stamp out inflation and emphasized that there would be pain ahead for Americans. The markets obviously didn't take this message well as in the subsequent weeks the S&P 500 fell nearly -17% from its August high and completely wiped out the +17.4% rise from the June market low. This boomerang action left the S&P 500 down -4.9% in the third quarter. The bond market wasn't exempt from the carnage either as interest rates spiked to levels not seen since the "Great Financial Crisis" of 2008. Falling -21.5% year-to-date, corporate bonds posted unprecedented losses and have recorded their worst year on record by far. This market is now on track to make its first ever back-to-back annual losses. This selloff left both the stock and bond market returns in negative territory for the third straight quarter, a feat not seen in modern market history.

Despite the volatility, small cap stocks outperformed large caps and ended a five-quarter underperformance streak, which was the worst since the first quarter of 1999. However, small caps are down -25.1% year-to-date and are off to the worst start to a year on record for the Russell 2000. In the balance of this newsletter, we'll discuss many of the warning signs that we're seeing and why we believe there has to be a better way for Fed policy. 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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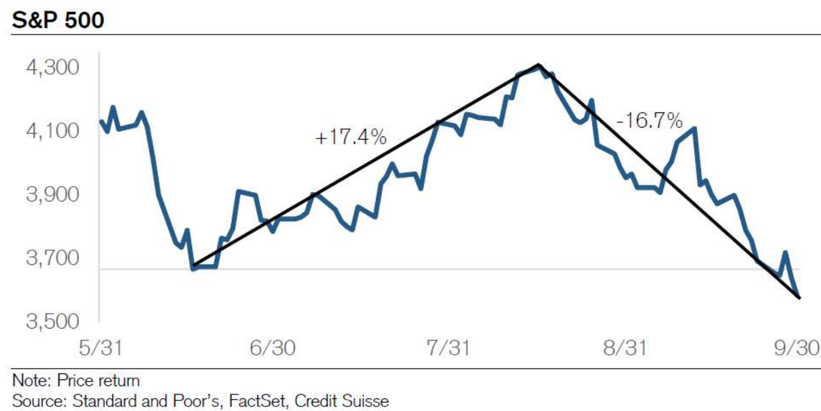
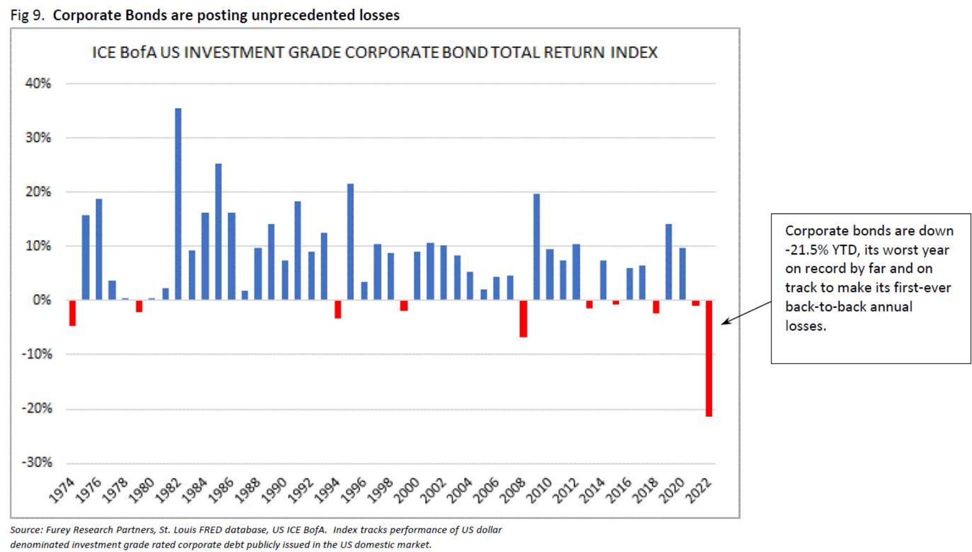
## Quarterly Review: Like the Captain of the Titanic, Fed Chair Powell Goes Full Speed Ahead Despite What Lurks Beneath the Surface

E.J. Smith, Captain of the RMS Titanic was famously quoted as saying, *"But in all my experience, I have never been in any accident… of any sort worth speaking about. I have seen but one vessel in distress in all my years at sea. I never saw a wreck and never have been wrecked nor was I even in any predicament that threatened to end in disaster of any sort."* However, we all know how the Titanic's maiden journey ended. In similar fashion, despite warning signs of what lies ahead, Fed Chair Powell and the FOMC continue to go full speed ahead with their aggressive interest rate-hiking plan. In fact, it's the most aggressive tightening cycle in modern history with a lot more to come in the months ahead if the Federal Reserve is to be believed. In keeping with his aggressive stance, Fed Chair Powell used his Jackson Hole speech in late August to deliver one of the shortest but to the point messages to the markets. In sum, he threw a penalty flag on the stock market for being offside and warned that the Fed was hellbent on hiking interest rates to stamp out inflation and emphasized that there would be pain ahead for Americans. The markets obviously didn't take this message well as in the subsequent weeks the S&P 500 fell nearly -17% from its August high and completely wiped out the +17.4% rise from the June market low. This boomerang action left the S&P 500 down -4.9% in the third quarter as shown in the chart below.




The bond market wasn't exempt from the carnage either as interest rates spiked to levels not seen since the "Great Financial Crisis" of 2008. Falling -21.5% year-to-date, corporate bonds posted unprecedented losses and recorded its worst year on record by far. This market is now on track to make its first ever back-to-back annual losses as shown in the chart below.




This selloff left both the stock and bond market returns in negative territory for the third straight quarter, which is a feat not seen in modern market history, as shown in the red outline in the table below. The global markets have fallen over $36 trillion this year. Much of this drop can be attributed to the aggressive interest rate hiking cycle going on around the globe.

**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% |
| | | | Sep-22 | -5.3% | -5.3% |

Source: Strategas Research

Despite the volatility, small cap stocks outperformed large caps and ended a five-quarter underperformance streak, the worst such streak since the first quarter of 1999. However, small caps were still down -2.2% in the quarter, are down -25.1% year-to-date, and are off to the worst start to a year on record for the Russell 2000. The table below shows how this year's Russell 2000 performance stacks up against the prior worst starts through nine months. The only redeeming quality of such a start is that the fourth quarter and subsequent year are generally strong, rising +9.7% and +21.2%, respectively, with both posting positive returns 83% of the time.

Fig 1. **'22 YTD is the R2000's worst start through nine months on record**

| | YTD thru: | R2000 | RELATIVE | 4th Qtr | Next Year |
|---|---|---|---|---|---|
| 1 | Sep-22 | -25.1% | -1.2% | -- | -- |
| 2 | Sep-02 | -25.1% | 3.1% | 6.2% | 47.3% |
| 3 | Sep-90 | -23.4% | -12.3% | 5.1% | 46.0% |
| 4 | Sep-11 | -17.0% | -8.3% | 15.5% | 16.3% |
| 5 | Sep-98 | -16.2% | -22.2% | 16.3% | 21.3% |
| 6 | Sep-01 | -15.4% | 5.0% | 21.1% | -20.5% |
| 7 | Sep-08 | -10.4% | 8.9% | -26.1% | 27.2% |
| 8 | Sep-20 | -8.7% | -14.3% | 31.4% | 14.8% |
| 9 | Sep-15 | -7.7% | -2.4% | 3.6% | 21.3% |
| 10 | Sep-81 | -7.4% | 7.0% | 10.2% | 24.9% |
| 11 | Sep-84 | -4.5% | -5.2% | -2.9% | 31.0% |
| 12 | Sep-14 | -4.4% | -12.7% | 9.7% | -4.4% |
| 13 | Sep-82 | -1.2% | 0.5% | 26.5% | 29.1% |
| | Average | -12.8% | -4.2% | 9.7% | 21.2% |
| | % Pos | *0%* | *38%* | *83%* | *83%* |

The R2000 is down -25.1% YTD marking its **worst start through the first three quarters on record** surpassing its 2002 start by less than 1 bp.

The fourth quarter following negative performance through the first three quarters is generally strong, up 9.7% on average and rising 83% of the time.

Similarly, the next calendar year also tends to be strong, up 21% on average and also rising 83% of the time. If the fourth quarter is also down, the next year has always been higher.

*Source: Furey Research Partners and FactSet. Data as of 9/30/22. Based upon total returns starting 1979.*

As we showed in our boomerang chart above, this year has been a volatile one for the stock market. In fact, it's been one of the most volatile years on record. The chart on the left shows that the market has declined on over half of the year's trading days. The chart on the right shows that the market has dipped greater than 1% on more than one-third of the trading days this year.

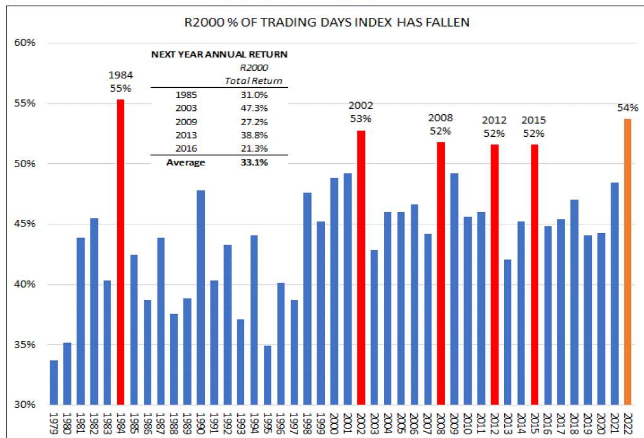



Fig 4. **The R2000 has fallen in over half the year's trading days**

*Source: Source: Furey Research Partners and FactSet. Based upon price return. "2022" is YTD as of 9/30/22.*

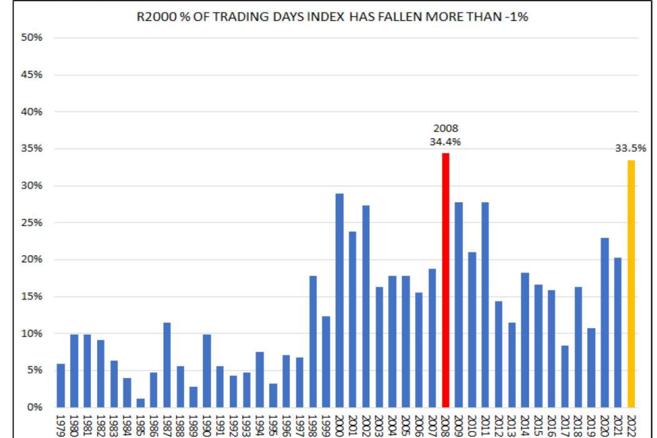



Fig 5. **Many of those down days were large**

*Source: Source: Furey Research Partners and FactSet. Based upon price return. "2022" is YTD as of 9/30/22.*

As we mentioned above, the overarching issue for the stock market during the quarter and for much of the year has undeniably been the Federal Reserve and how aggressive they will be in raising interest rates and in ending quantitative easing. In fact, their actions have been the market's key issue since they postured about raising rates last November. After the surprise 75 basis point hike in June, Fed Chair Powell continues to take a hard line against inflation. His tone, and that of the other Fed Governors continues to give the stock and bond markets pause, if not downright concern. Powell's Jackson Hole speech was the icing on the cake as he clearly communicated a very hawkish tone that is likely to last until the CPI numbers decline substantially. We'll give you our thoughts on inflation and the Fed below in the section entitled "*Fed Fallout- Economy is Cooling Rapidly, Taking Inflation With It*". Fed fund futures currently anticipate that the Fed Funds rate will push upward to 4.5% in early 2023. This datapoint would imply another 150 basis points of tightening, and the markets don't like this messaging. 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' retreat this year has discounted much of this potential outcome. As can be seen in the table below, it was a poor quarter for equities, but surprisingly small cap growth outperformed on the heels of strength in non-earners. Biotech stocks propelled the growth sector as they aren't viewed to be economically sensitive and, therefore, won't have earnings disappointments in the quarters ahead.

| Index Returns | | |
|---|---|---|
| Index | Third Qtr. 2022 Return | 2022 YTD Return |
| Russell 2000 | -2.19% | -25.10% |
| Russell 2000 Growth | +0.24% | -29.28% |
| Russell 2000 Value | -4.61% | -21.12% |
| S&P 500 | -4.88% | -23.87% |
| Dow Jones Industrials | -6.66% | -20.95% |
| NASDAQ Composite | -3.91% | -32.00% |

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (+0.24%) beat the Russell 2000 Value Index (-4.61%) in the quarter which broke a seven straight quarter win streak for the Russell 2000 Value Index. The bottom line is that there were few places to hide in the quarter and nowhere to hide in the month of September as every sector was down in an ugly month. Healthcare (+6.5%) and Energy (+5.7%) were the only two sectors that posted positive returns for the quarter in the Russell 2000 Index, Real Estate (-12.5%) and Communication Services (-10.9%) were the worst performing sectors for the quarter. On a year-to-date basis, the only sector that has a positive return continues to be Energy which is up +29.8% as oil and gas prices remain strong. The weakest sectors were Technology (-36.1%) and Communication Services (-41.0%), which both have more sensitivity to higher interest rates. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the third quarter of 2022 and year-to-date 2022.

**Table 1 - Index Performance by Sector**

| | Russell 2000 | | | Russell 2000 Growth | | | Russell 2000 Value | | |
|---|---|---|---|---|---|---|---|---|---|
| GICS Sector | September | 3Q2022 | YTD | September | 3Q2022 | YTD | September | 3Q2022 | YTD |
| Com Serv | -13.0 | -10.9 | -41.0 | -9.9 | -5.8 | -38.5 | -15.5 | -14.7 | -42.9 |
| Discretionary | -11.0 | -1.6 | -35.9 | -9.6 | 1.4 | -35.0 | -12.7 | -4.8 | -35.9 |
| Staples | -11.2 | -7.7 | -17.0 | -11.2 | -6.4 | -17.9 | -11.2 | -9.7 | -16.2 |
| Energy | -12.3 | 5.7 | 29.8 | -13.8 | 4.0 | 16.9 | -10.4 | 7.9 | 36.4 |
| Financials | -7.6 | -2.2 | -20.3 | -8.1 | -0.6 | -30.3 | -7.5 | -2.5 | -18.1 |
| Health Care | -5.0 | 6.5 | -26.0 | -4.5 | 8.1 | -25.8 | -6.0 | 3.2 | -26.1 |
| Industrials | -11.1 | -3.3 | -23.9 | -10.4 | -0.3 | -24.6 | -12.2 | -7.3 | -24.4 |
| Info Tech | -9.9 | -4.5 | -36.1 | -9.3 | -4.3 | -37.4 | -11.7 | -5.3 | -30.5 |
| Materials | -12.5 | -5.3 | -23.0 | -11.6 | -2.1 | -17.9 | -13.5 | -9.0 | -27.6 |
| Real Estate | -13.6 | -12.5 | -33.2 | -15.3 | -17.7 | -45.9 | -13.2 | -11.3 | -29.6 |
| Utilities | -10.3 | -7.6 | -8.6 | -12.0 | -3.1 | -20.5 | -9.7 | -9.2 | -9.1 |

Source: Jefferies

Returns in the international markets were varied across markets and many deviated from 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 lockdown in Shanghai and in several other major cities were relaxed. Their government postured that stimulus programs would be enacted to

compensate for the Covid-induced slowdown. However, ongoing sporadic lockdowns across China continue to give that market fits. Interestingly, Brazil's market was the best performer in the table below and was one of the countries that entered their rate hiking cycle much earlier than most. 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. However, European stock markets have generally fared better than the U.S. so far this year despite all of these concerns. The surge in interest rates has pushed bond prices lower for the third straight quarter. Volatility increased dramatically as one would expect with the market selloff during the quarter. Interestingly, lumber and oil were both substantially lower in the quarter which is indicative of broader trends across the commodity spectrum.

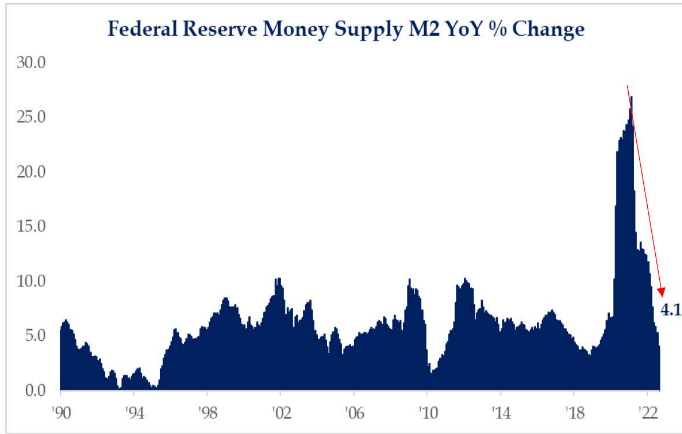
| Index | Third Qtr. 2022 Return | 2022 YTD Return |
|---|---|---|
| France | -2.5% | -17.1% |
| Germany | -5.2% | -23.7% |
| Brazil | +11.7% | +5.0% |
| India | 8.7% | +0.5% |
| China- A Shares | -11.0% | -16.4% |
| China- Shenzhen A Shares | -14.1% | -24.1% |
| Japan | -0.8% | -8.5% |
| Long-Term Treasuries (TLO) | -10.4% | -29.6% |
| Investment Grade Corp Bonds | -4.6% | -17.8% |
| Gold | -7.5% | -7.8% |
| Volatility- VIX index | +10.1% | +82.5% |
| Oil | -24.8% | +3.3% |
| Natural Gas | +25.5% | +97.0% |
| Lumber | -36.3% | -63.5% |

Source: 1492 Capital Management, LLC

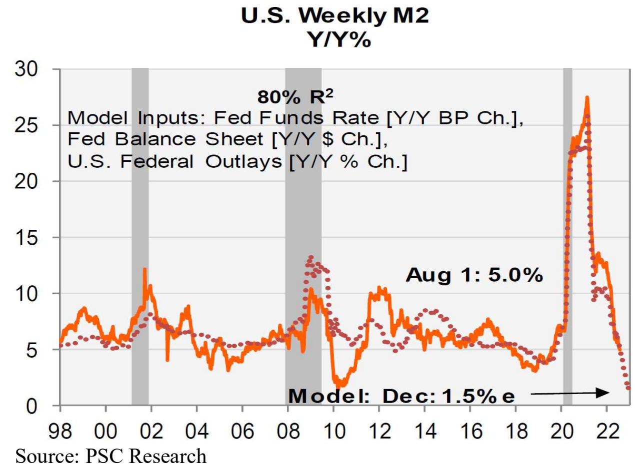
## Updated 2022 Outlook: There has to be a Better Way- Fed's Dual Mandate is Out of Date

The Federal Reserve's dual mandate is quite simply to 1) maintain maximum employment otherwise known as full employment and 2) keep prices stable. This policy was shaped in the 1970's when the country experienced both rapid inflation and high unemployment, which is known as stagflation. As we sit here today, the Fed is concerned about high inflation or price instability. The question is "how does addressing the price stability mandate jive with the full employment mandate?" The answer is that it doesn't. There is an inherent conflict. Fed Chair Powell told us as much in his Jackson Hole speech that the Fed would continue on the path of higher interest rates, and in the process, Americans would lose jobs and feel pain. In fact, he said "without price stability, the economy doesn't work for anyone." He has clearly decided one mandate (inflation) is more important than the other (full employment).

However, if we take a step back and contemplate how we got here, it's quite simple. During the decade of the 2010's, the Fed did everything that they could to get inflation sustainably above 2% (their stated target), and the one time that inflation threatened to go there and stay there in 2018, the Fed prematurely hiked rates but quickly realized their mistake and rapidly backtracked. The bottom line is that they couldn't get inflation sustainably to the level that they wanted. Then the pandemic hit, and the Federal government injected trillions of dollars into the economy, and the Federal Reserve cut interest rates to zero to keep Americans and the U.S. economy from sinking into an economic depression. These actions clearly kept the economy afloat while we dealt with the multiple waves of the pandemic. To make matters worse and just as the pandemic was ending, we had the first land-based military conflict in Europe since World War II when Russia invaded Ukraine which caused prices of many goods (primarily energy and food commodities) to soar. These events are not something you can predict or plan. The chart below left shows the dramatic change in the M2 money supply during the pandemic. Amazingly, the year-over-year growth is already back to pre-pandemic levels, but based on current Fed policy, it looks like it will continue to drop rapidly as shown in the chart below right.



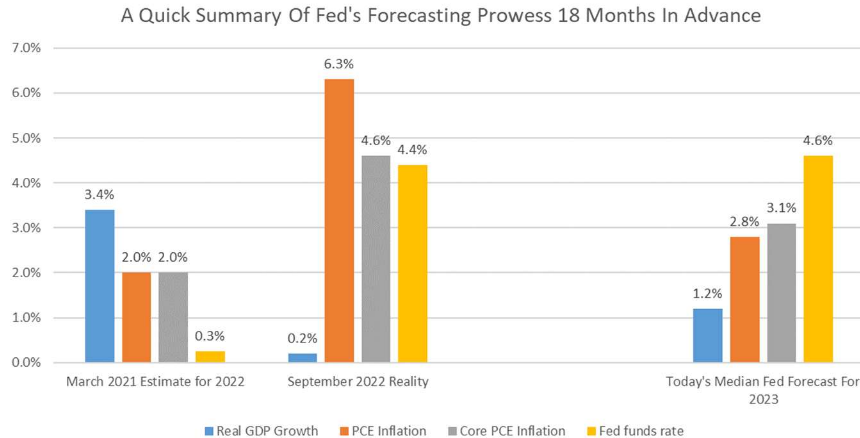

Source: Strategas Research




Source: PSC Research

In today's U.S. economy, the unemployment rate is one of the lowest in history at 3.7%. The great resignation that took hold during the pandemic as many qualified job hunters decided to go to the sideline and potentially take early retirement or wait for better opportunities affected this rate. However, the tools that the Fed has to execute their mandates are interest rate policy (Fed funds rate) and quantitative easing/tightening. However, interest rate policy is like using a sledgehammer and can have serious consequences. What is a better tool? Synchronizing Fed policy to fiscal policy would be a good start. All the while the Fed is trying to cool inflation, Congress and the Biden administration are passing spending bills like the Inflation Reduction Act (which actually has nothing to do with lowering inflation) which is estimated to cost $700 billion and is supposedly offset by other taxes and cuts, and the Student Loan Debt Relief Plan which forgives student loans up to $20,000 for qualifying borrowers. The cost of this plan has been forecast to be about $400 billion according to the Congressional Budget Office estimate. These efforts are in complete conflict with what the Fed is trying to do with higher rates and quantitative tightening.

Another solution is to focus on the supply side of the equation. Much of the inflationary pressures that came to be in the last 12-18 months are a function of the breakdown in supply chains around the globe. Why not address the supply issues by incenting companies to take certain actions to improve those supply chain bottlenecks or breakdowns. Many of these bottlenecks came from a lack of parts, people, or unavailability of certain transport modalities. Spending money to incent certain actions always seems to work in the real world and would likely have a long-term impact rather than swinging interest rates around wildly. Moreover the impact usually isn't seen in the real economy for 12- 24 months. Lastly, the Fed isn't known for being the greatest forecasters as the chart below shows. Their March 2021 forecast for core inflation in 2022 was just 2%. Obviously, the reality in 2022 is now around 5% with the latest CPI print at 8.3%. Given those failed forecasts, why should we put any credence into their 2023 forecasts? The bottom line is that there has to be a better way.

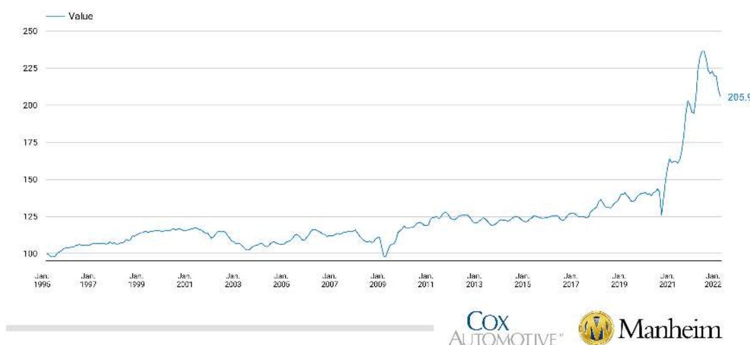



Source: Furey Research

## Updated 2022 Outlook: Fed Fallout- Economy is Cooling Rapidly, Taking Inflation with It

At 1492 Capital Management, we pride ourselves on doing proprietary fundamental research on current and prospective holdings. During our latest research roundup, a resounding refrain from many of these companies was that in mid-to-late June, it was like a switch was flipped. It became exceedingly difficult to close business, orders were canceled, or approvals had to be elevated to the C-suite. This change was particularly consistent in those businesses that have high price points or are one-time purchases. While this change of tone happened late in the second quarter for many companies and didn't necessarily impact the second quarter results, many lowered their forward-looking guidance as a result. The timing of this slowdown came right on the heels of the Fed's surprise 75 basis point rate hike in June. However, since June's hike, the Fed has added two additional 75 basis point hikes in July and September, respectively. Following the September rate hike announcement, the Fed indicated that they foresee a further 150 basis points of hikes with another 75 basis point hike in November, 50 more in December, and a further 25 in early 2023. From our perspective, a lot of damage is being done very rapidly and we can't understand what data points the Fed is viewing. The Fed claims that they are worried about runaway inflation and are particularly concerned with some sticky inflation categories like wages and rents. Over the past 15 months, we've commented frequently in this newsletter that wages are likely to be the stickiest inflation component because once you hire someone, you agree to pay that person a stated wage. In most cases, wages and salaries aren't going to be cut. However, when push comes to shove, headcount is cut, and employees join the ranks of the unemployed. If jobs become more difficult to get, companies won't be doling out the significant raises that were seen during the pandemic to lure people into new jobs or to retain existing employees. The Fed continues to use the low unemployment rate as cover for raising rates, but this data set is the most lagging of lagging indicators. Job cuts are the last thing that happens in a recession.

The inflation calculation is simply basic math that looks at the price of the same basket of goods and compares that price to the price of that same basket of goods one year earlier. If the price of that basket of goods rise 5% then the CPI (Consumer Price Index) will be up 5%. As we examine the next four to five months, the comparisons are going to be much more difficult which means that if every price stays constant, the math indicates that the inflation rate will fall. For instance, used car pricing was one of the single largest components of the inflation increases earlier this year. As the chart below left shows, used car prices have been very stable over the past 30 years. Their prices increased or decreased a few percent per year until 2021 when prices spiked due to scarcity of cars (new car supply chain issues), stronger demand, and more cash in consumer pockets due to stimulus payments. The index spiked over 80% in less than a year and peaked in January 2022. Now if we roll forward the inflation calculation a few months to January 2023 and if the price of a used car is the same as it was in 2022, the inflation calculation will be 0%, which is a far cry from the 80% inflation factor recorded in 2022. However, as you'll note the index is already falling rapidly and is forecast to continue to drop as interest rate increases are making financing a used car purchase much more expensive and cools demand. Additionally, one part of the economy that seems to be accelerating is the production of new cars, which was hampered tremendously during the pandemic due to shortages of parts and semiconductors, as shown in the chart below right. The additional supply of new cars will help alleviate the shortage of used cars as trade-ins occur.

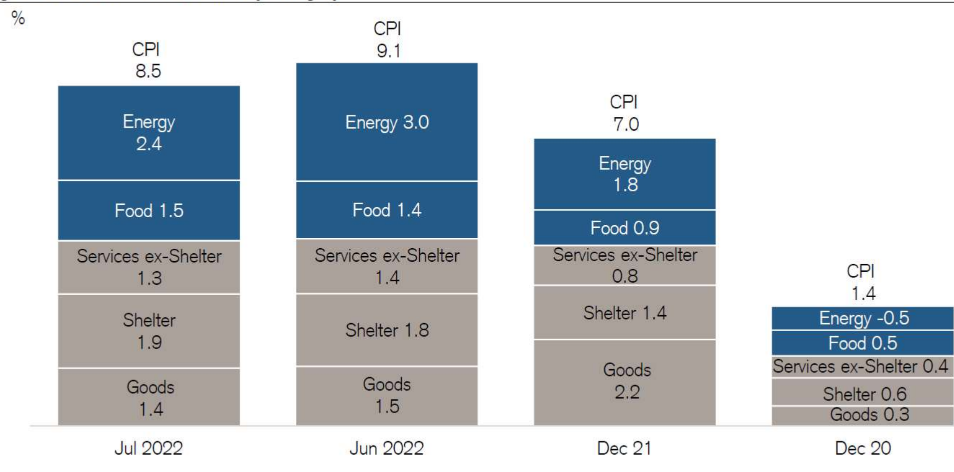


Source: PSC Research

Oil is another commodity that has declined significantly from earlier this year, and it has broad implications for both the headline and core inflation number as it's a vital input cost component for nearly every good and many services. Earlier this year, the price of a barrel of oil spiked to $130/barrel when Russia invaded Ukraine in early March. For many months of 2022, the price stayed well above $100/barrel until concern of a global recession and a strong dollar pushed oil down near $80/barrel in September. If the price of oil just stays flat at $80/barrel through next March, the impact on the inflation statistic will be significant

as you'll be comparing $120/barrel oil vs. $80/barrel oil or a -33% deflation. This change is particularly meaningful because oil has a significant impact on the overall inflation rate and has been responsible for a sizeable amount of the increase in the CPI calculation as shown in the chart below. In the far-right column are the CPI components in December 2020. Notice that energy had a -0.5% impact on the overall CPI rate in that period because we were comparing the price of oil at December 2020 ($49/barrel) with the price of oil on December 2019 ($62/barrel). Then at December 2021 we were comparing $75/barrel oil vs. $49/barrel at December 2020. Thus, the energy component went from a -0.5% impact in the December 2020 reading to a +1.8% impact in the December 2021 reading. Then the Ukraine war began in March 2022 which pushed oil up to $130/barrel and ultimately settled above $100/barrel for much of the second quarter of 2022. This advance forced the energy component up further in the June 2022 reading to +3.0%. However, as we move forward into 2023 and assuming that oil stays around $80 per barrel, the impact to the overall CPI rate will be deflationary. Energy's impact doesn't just show up in the price of gas at the pump, but in nearly every good and many services as they have an energy component to them in the manufacturing input process or in the transportation of the goods to market. As energy prices cool, it should also deflate the prices of other categories in the CPI basket as well like food, shelter, and goods.

**Figure 4: CPI YoY – Contribution by Category**



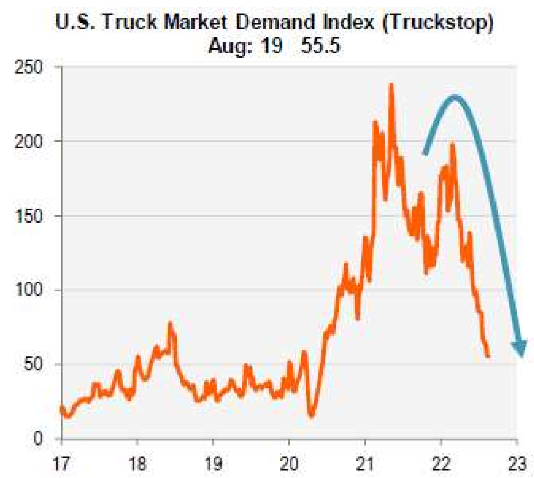

Source: BLS, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

Beside the price of oil, nearly every commodity has dropped substantially from their pandemic-induced highs as shown in the far-right column of the chart below left. Some very important commodities like lumber, aluminum, and gasoline are down more than 40% from their high. Trucking, which carries many of these commodities and finished goods around the country and is the best real-time indicator of the economy has rolled over significantly as shown in the chart below right. Recall that during the pandemic there were shortages of trucks due largely to lack of drivers.

**Commodity Dashboard**

| Commodity Dash Board | Average Price 2016 to 2019 | 2020 To Current High | Current | % Above '16-19 Average (sorted) | % Down From High |
|---|---|---|---|---|---|
| Natural Gas | $ 2.79 | $ 9.68 | $ 8.34 | 198.6% | -13.9% |
| Wheat | $ 451.94 | $ 1,367.75 | $ 937.25 | 107.4% | -31.5% |
| Corn | $ 367.30 | $ 818.25 | $ 712.25 | 93.9% | -13.0% |
| WTI | $ 54.07 | $ 123.70 | $ 87.99 | 62.7% | -28.9% |
| Brent | $ 58.94 | $ 127.98 | $ 94.22 | 59.9% | -26.4% |
| Cotton | $ 72.12 | $ 158.02 | $ 110.21 | 52.8% | -30.3% |
| Gasoline | $ 166.83 | $ 427.62 | $ 246.36 | 47.7% | -42.4% |
| Lumber | $ 379.19 | $ 1,686.00 | $ 548.50 | 44.7% | -67.5% |
| Iron Ore | $ 71.25 | $ 238.64 | $ 97.11 | 36.3% | -59.3% |
| Copper | $ 266.41 | $ 492.90 | $ 362.40 | 36.0% | -26.5% |
| Gold | $ 1,292.65 | $ 2,051.50 | $ 1,725.80 | 33.5% | -15.9% |
| Cattle | $ 116.62 | $ 145.80 | $ 145.80 | 25.0% | 0.0% |
| Aluminum | $ 1,879.38 | $ 3,849.00 | $ 2,286.00 | 21.6% | -40.6% |
| Silver | $ 16.51 | $ 29.42 | $ 19.67 | 19.1% | -33.2% |
| Steel Rebar | $ 3,514.26 | $ 5,975.00 | $ 3,918.00 | 11.5% | -34.4% |

Source: Strategas Research




Source: PSC Research

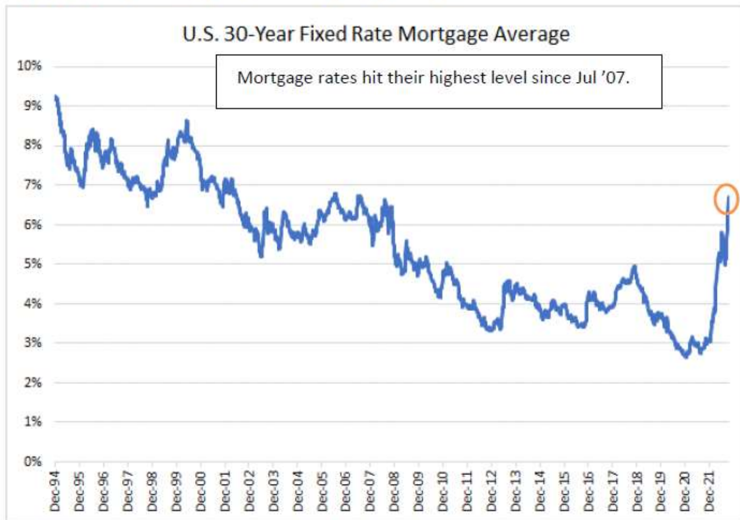
You may recall that during the peak of the pandemic, many newscasts would feature the clogged shipping ports like that of L.A./Long Beach. Those ship traffic jams are no longer, and the Baltic Dry Index shown in the chart below left, which measures the price to move commodity goods via ship, has returned to pre-pandemic levels after spiking fourfold during the pandemic.

Also, the crazy price increases in ship containers that are used to transport goods from trucks to ships, and back to trucks, have started a steep descent back to pre-pandemic levels as shown in the chart on the right.

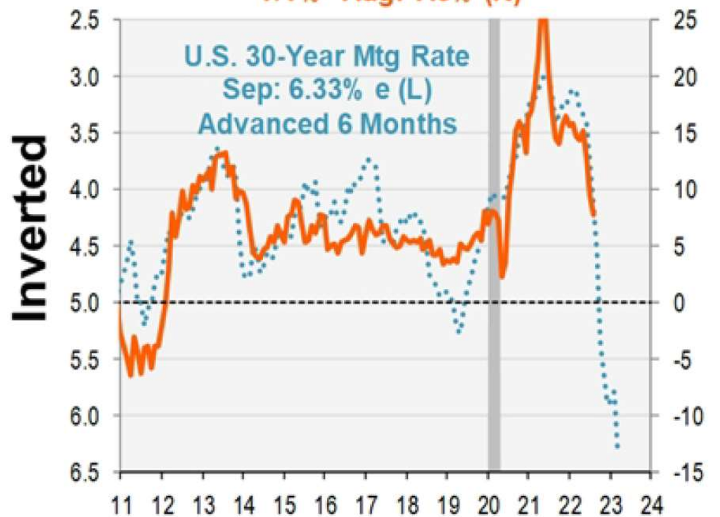
Source: PSC Research

Source: PSC Research

House prices and rents are generally thrown in the bucket of sticky inflation items. However, after some pretty steep increases seen during the pandemic, prices have begun to decline rapidly, and they are forecast to continue to do so as long as the Fed continues their aggressive rate hiking policy. The chart on the left shows the surge in the 30-year mortgage rate to nearly 7%, which is a level that we haven't seen since July 2007. On the right is a chart that shows the median house price in the U.S. (orange line) overlaid on top of the 30-year mortgage rate (blue dashed line) advanced 6 months ahead. Based on the rate increases that we've seen to date, the forecast is for housing costs to rapidly plunge more than -10% into 2023. With all of these data points which show inflation is rapidly declining, it makes one wonder what the Fed is looking at to make their rate hike decisions.



*Source: Furey Research Partners and St. Louis FRED database. Data as of 9/30/22*



Source: PSC Research

## Updated 2022 Outlook: What do FedEx, Nike, Micron, and Carnival Cruises Have in Common?

The answer to the question posed above is that they really don't have anything in common. However, they are large U.S. based companies that don't report their financial results on a normal calendar quarter and, therefore, reported in the past two weeks

during the quiet period for the 95% of companies who report their earnings on a calendar quarter basis. They gave us a preview of what earnings season may look like for the broader swath of companies that will begin reporting their third quarter earnings and outlooks starting in mid-October. Keep in mind that they represent four different industries: freight/ecommerce, shoes, semiconductor memory, and a cruise line. Despite being in four completely different industries, they all reported ugly earnings and lowered forward guidance significantly. Forward earnings estimates were reduced by -27% for FedEx, -21% for Nike, -48% for Micron and -42% for Carnival Cruise Lines. If these reductions are any indication of what lies ahead, it could be a very ugly earnings season for third quarter earnings reports in the coming weeks. This fear is of particular concern in that consensus estimates for the S&P 500 for 2023 are projected to be up +7.3% over 2022 levels. This increase is a pipe dream if the Fed maintains course and pushes us into a recession. According to Strategas Research, in a typical recession, the median decline in earnings is -22%. This datapoint should serve as a warning for anyone that doesn't think we're already in a recession. Fed, are you watching?

## Thematic Investing: It Might Not Be the Other Shoe to Drop

It's more likely that the dress or shirt will drop rather than the shoe. We use that figurative phrase to make a point on the state of indigestion that's ongoing in the consumer discretionary sector. Bloated inventories at so many retailers are leaving management teams with few alternatives but to "invest in price" (aka promote) and slash prices to clear the way for either what's on board a vessel from Vietnam or in the back storeroom in advance of the upcoming holiday season. One trend that we've noticed is that it's not the price tag on shoes as much as it's the price tag on apparel that already is and will be the next to drop as the forces of excess supply and weakened demand remain intact.

Source: PSC Research

Combining the supply chain disruptions and the giddiness of consumers to spend during the pandemic, production continued, but the buying trend changed and markedly so in the retail apparel segment. Because pictures are easy to process, we offer the chart above which shows the trajectory of retail inventories that far exceed the dotted trendline. There are too many companies to count that have come forth admitting that stockpiles have formed and that the choices are few in dealing with those excesses. When it comes to apparel and fashion – terms that can often be interchangeable – the risks are too great to hold over the inventory with hope of selling in a future period, and thus discounting is fast and furious. With this approach, margins are squeezed, cash flows are cut, and earnings inevitably drop, which is obviously not a good set up for owning stock of such companies. Valuations are near 20-year lows with some apparel retailers trading at low to mid-single digit price to earnings and enterprise value to EBITDA multiples. Importantly, we are hearing through our due diligence process that the shoe segment has held up better from a supply – demand perspective and therefore a pricing perspective. We are cautious not to paint a broad stroke but with our fundamental, bottom-up research, we are investigating those companies that are positioned with a compelling footwear offering that will keep the profitability shoe from dropping.

## Thematic Investing: Carrying A Big Stick: The U.S. Flexes Its Energy Muscles

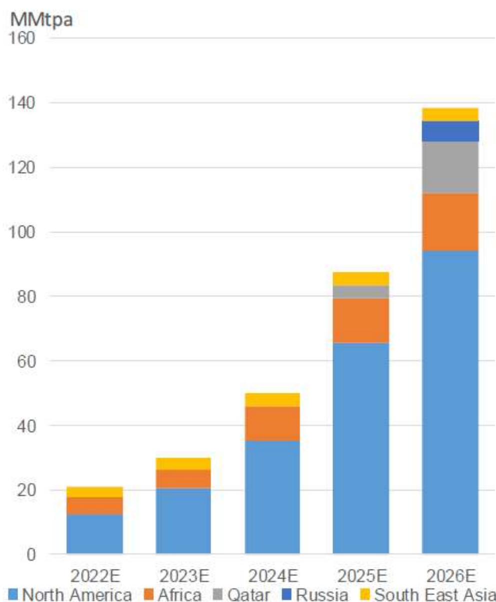
As we approach winter in the northern hemisphere, we are bombarded with the back and forth going on in Europe as to how the EU countries will both stay warm and conduct commerce with the Russians controlling 40% of their natural gas needs. The

most recent "sabotage" of the key Nord Stream 1 and 2 pipelines that flow natural gas from Russia into Germany add an additional element of concern. The explosions of parts of these pipelines that according to Piper Strategic Research lie at depths of 260 ft on the Baltic Sea floor and are protected by several inches of concrete reek of state sponsored sabotage. How many "issues" will these pipelines accidentally have this winter as a negotiating tool for the Putin regime? Western Europe is now in an unenviable position of having "jumped the gun" into renewables and away from fossil and nuclear energy for baseload and peak power. Now they have to scramble to keep themselves warm and engaging in manufacturing this winter amid a spike in European natural gas prices.

One of the solutions to the European crisis is for the countries to source natural gas from the rest of the world through the importation of liquified natural gas (LNG). The Germans are on board with this idea as they are leasing regasification vessels that allow LNG to be shipped to German ports in its usual liquid form. The LNG is then warmed in these vessels to a natural gas state for delivery through their domestic pipeline system. Longer-term plans in Germany call for the building of permanent LNG import infrastructure. Other countries interested in being unshackled from Russia are very likely to pursue similar plans which creates strong demand for LNG, the natural gas used to make it, and LNG ships and infrastructure. As seen below in the bar chart on the right, this LNG demand will be met over the 2022-2026 period with a roughly seven-fold increase in LNG capacity with North America leading the charge. As shown in the table on the left, the U.S. Gulf of Mexico area has several large new projects ramping over the next four years as U.S. natural gas production expands to fill these LNG facilities. U.S. pipeline infrastructure should also grow to bring these gas molecules to the gulf coast for liquefaction for export. Our research team has deployed multiple investments across the 1492 Capital strategies that should benefit from rising natural gas production and the buildout of the LNG facilities.

**Exhibit 8: LNG Trains Entering the Market Through 2025**

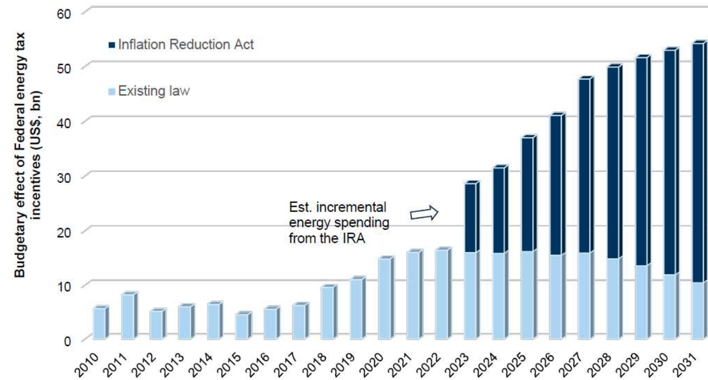
| Project | Location | Capacity | 2022E | 2023E | 2024E | 2025E | 2026E |
|---|---|---|---|---|---|---|---|
| Calcasieu T1-9 | US Gulf | 10.0 | 6.0 | 10.0 | 10.0 | 10.0 | 10.0 |
| Corpus Christi LNG Train 3 | US Gulf | 4.5 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Coral FLNG | Mozambique | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 |
| Tangguh Phase 2 | Indonesia | 3.8 | 2.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| Tortue FLNG | Senegal | 2.5 | 2.0 | 2.5 | 2.5 | 2.5 | 2.5 |
| Sabine Pass LNG T6 | US Gulf | 4.7 | 1.5 | 5.0 | 5.0 | 5.0 | 5.0 |
| New Fortress Fast LNG 1-5 | US Gulf | 7.0 | - | 0.4 | 2.8 | 5.6 | 7.0 |
| Plaquemines T1-18 | US Gulf | 13.3 | - | - | 6.7 | 13.3 | 13.3 |
| NLNG T7 | Nigeria | 8.0 | - | - | 5.0 | 8.0 | 8.0 |
| Golden Pass LNG T1 | US Gulf | 5.2 | - | - | 3.5 | 5.2 | 5.2 |
| Golden Pass LNG T2 | US Gulf | 5.2 | - | - | 1.3 | 5.2 | 5.2 |
| Energia Costa Azul | Mexico | 3.3 | - | - | 1.0 | 3.3 | 3.3 |
| Plaquemines T19-36 | US Gulf | 13.3 | - | - | - | 6.7 | 13.3 |
| Qatar North Field Expansion T1 | Qatar | 8.0 | - | - | - | 4.0 | 8.0 |
| LNG Canada T1 | Canada West | 7.0 | - | - | - | 3.5 | 7.0 |
| Golden Pass LNG T3 | US Gulf | 5.2 | - | - | - | 2.6 | 5.2 |
| Corpus Christi Stage 3 | US Gulf | 13.1 | - | - | - | 0.4 | 7.8 |
| LNG Canada T2 | Canada West | 7.0 | - | - | - | - | 7.0 |
| Qatar North Field Expansion T2 | Qatar | 8.0 | - | - | - | - | 6.0 |
| Arctic LNG 2 T1 | Russia | 6.6 | - | - | - | - | 5.0 |
| Mozambique Area 1 T1 | Mozambique | 6.4 | - | - | - | - | 3.8 |
| Qatar North Field Expansion T3 | Qatar | 8.0 | - | - | - | - | 2.0 |
| Arctic LNG 2 T2 | Russia | 6.6 | - | - | - | - | 1.7 |
| | | | 20.7 | 30.1 | 50.0 | 87.4 | 138.4 |




Source: Stifel Research

As the Europeans feel the pinch and as the price of oil is at the mercy of Russia's actions, the U.S. Congress has passed the exceptionally poorly named Inflation Reduction Act (IRA) to bolster the development of additional forms of ESG friendly energy in the U.S., which allows the country to have more flexibility in balancing domestic consumption needs and exports. The IRA creates roughly $386 billion for energy and climate spending over ten years which includes tax incentive increases of nearly $265 billion. These monies and credits will help drive the expansion of carbon capture, blue/green hydrogen production for use in fuel cells, and battery storage to name just a handful of areas that benefit substantially from the act. According to Goldman Sachs research, the 30% investment tax credit for battery storage and the up to $3/kg credit for green hydrogen are transformational events for the accelerated development of these industries. With the new subsidies in solar, research from Credit Suisse suggests that the U.S. solar demand can be met with domestically sourced product with the possibility of exports versus our previously heavy reliance on Chinese product. It is also interesting to note that the credit for EVs has a provision that assigns a premium for domestically sourced critical minerals and components as we have commented in previous newsletters to develop our own strategic resources to reduce reliance on China. The extension of the renewable diesel (RD) tax credit is also an incremental positive for our holding of our RD producer that is deployed across the 1492 Capital strategies. We currently have holdings in blue/green hydrogen through a fertilizer producer, in LNG with an equipment provider and domestic natural gas producers as previously mentioned, and in strategic minerals with both lithium and rare earth metal

producers. We look to expand our alternatives/sustainable energy theme with additional holdings that have the wind at their back from the large federal tax incentive increases from the Inflation Reduction Act as seen in the chart below.

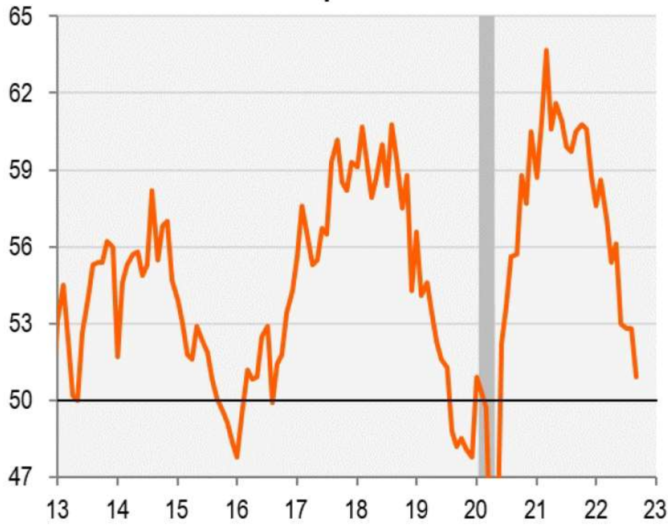



Following President Teddy Roosevelt's advice to "speak softly and carry a big stick," the IRA along with the proliferation of LNG export facilities and ample domestic natural gas reserves to supply them provide the U.S with a balanced portfolio to both satisfy our own domestic power needs and export energy to our allies that are suffering from the pitfalls of their own policies.

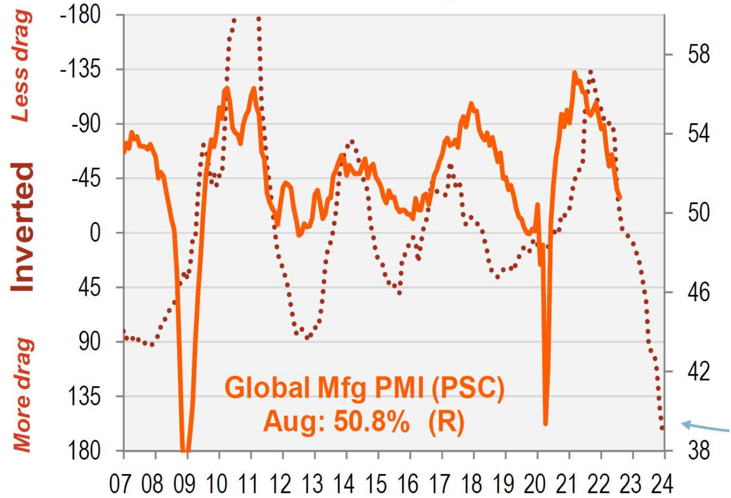
## Updated 2022 Outlook: Central Banks Hold All the Cards for Now

Last quarter the title of this section was "*Quite Possibly the Best Opportunity in Small Cap Stocks in Decades*". While this statement was admittedly aggressive, it was predicated on the significant selloff that we had seen in small cap stocks since November 2021 (-30%) and in small growth stocks since March 2021 (-40%). Given that the market fell further in the third quarter, that argument is only stronger. This level of decline is consistent with recessionary environments. The second piece of our argument was predicated on absolute and relative valuation which still holds as we'll show you below. However, the big change since June is the Central Banks' aggressive tightening that has been happening around the globe in lockstep. Unfortunately, we're at the mercy of these banks as they hold all the cards currently and the market is unlikely to sustainably rally until they indicate that they are nearing the end of the tightening cycle. ,

We think that we're getting close, and as we wrote earlier, the U.S. Fed may have already gone too far, too fast. The chart below left shows the U.S. Manufacturing PMI, which is an indicator for the health of the economy. The latest reading is 50.9% and heading lower. Recall that below 50 indicates a shrinking economy. The new orders component, which can be viewed as a leading indicator of the overall PMI came in at 47.1% in September. If the Fed sticks to their talking points and tightens another 150 basis points, all bets are off because we believe this action will push us into a worse recession than what is currently contemplated (mild and short). One of our favorite charts that we've shown in this newsletter throughout the years is below right. It hits at the heart of what we're talking about- Central Bank tightening. The dotted line represents the 12-month change in global short rates (i.e., fed funds rates) advanced 16 months. Advancing the change in rates 16 months reflects the time it takes for rate hikes to impact the global economy historically. At the current pace of rate hikes, it predicts that the Global PMI will continue to fall rapidly. While the correlation isn't perfect, it is pretty good directionally.



Source: PSC Research

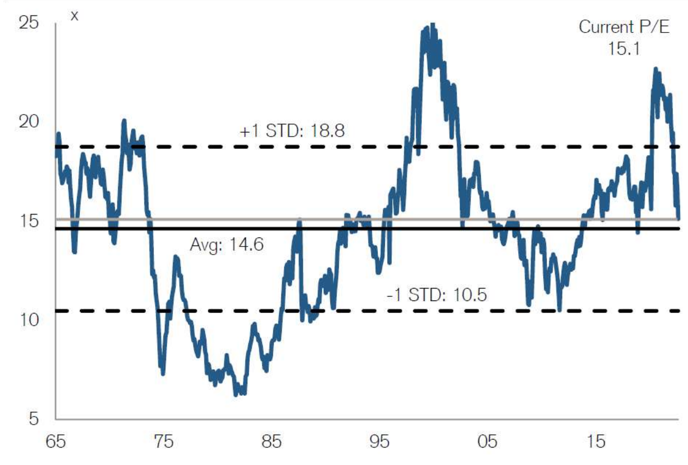


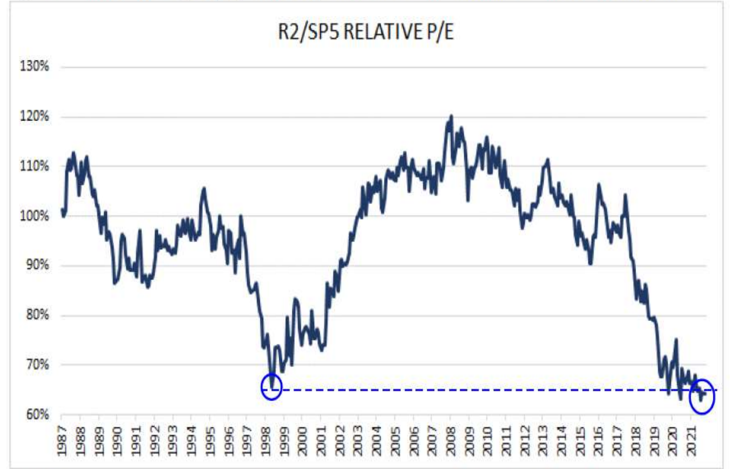
Source: PSC Research

One other issue that arose in the last quarter that could chip a little bit away from the foundation of our argument is that for the last decade, you've probably heard the phrase, "there is no alternative" or "TINA" for short. With the backup in interest rates, a 4% risk free yield on the 2-year Treasury Note may be compelling for some conservative investors. However, rates likely begin to ease, if not fall as the Fed hints that they are done with rate hikes or actually start to cut rates if the economy maintains its current downward trajectory. The chart below shows the dividend yield on the S&P 500 is currently 1.8%, whereas the yield on the 10-Year Treasury Note is currently 3.8%. For much of the last decade, the dividend yield was on par with or above the 10-Year Treasury yield.

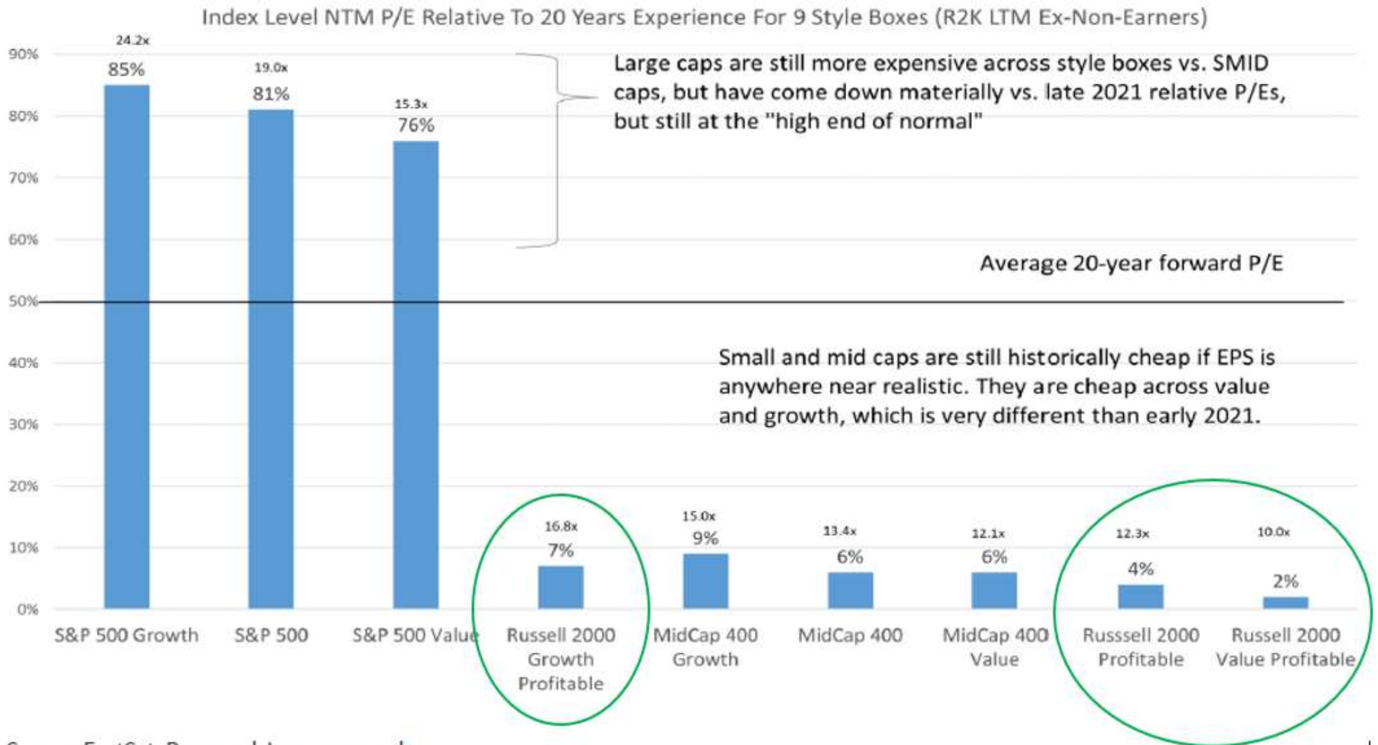
Source: Standard & Poor's, Federal Reserve, FactSet, Credit Suisse

Valuation continues to be at the heart of our bullish argument for small caps. The chart below left shows the average P/E ratio (price/earnings) for the S&P 500 going all the way back to 1965 which is at 15 times. Interestingly, the current P/E ratio is 15.1X. We would argue that the current P/E ratio should be higher than the long-term average as current interest rates, even though higher than 12 months ago, are well below the historical average going back to 1965 and this idea is a key driver to valuation. The chart on the right shows the relative P/E ratio of the Russell 2000 (R2) compared with the S&P 500. Note that the current ratio is now at the lowest point in over 40 years. If you are now saying to yourself that the "E" of the P/E ratio is way too high and understates the current P/E ratio, please continue reading.

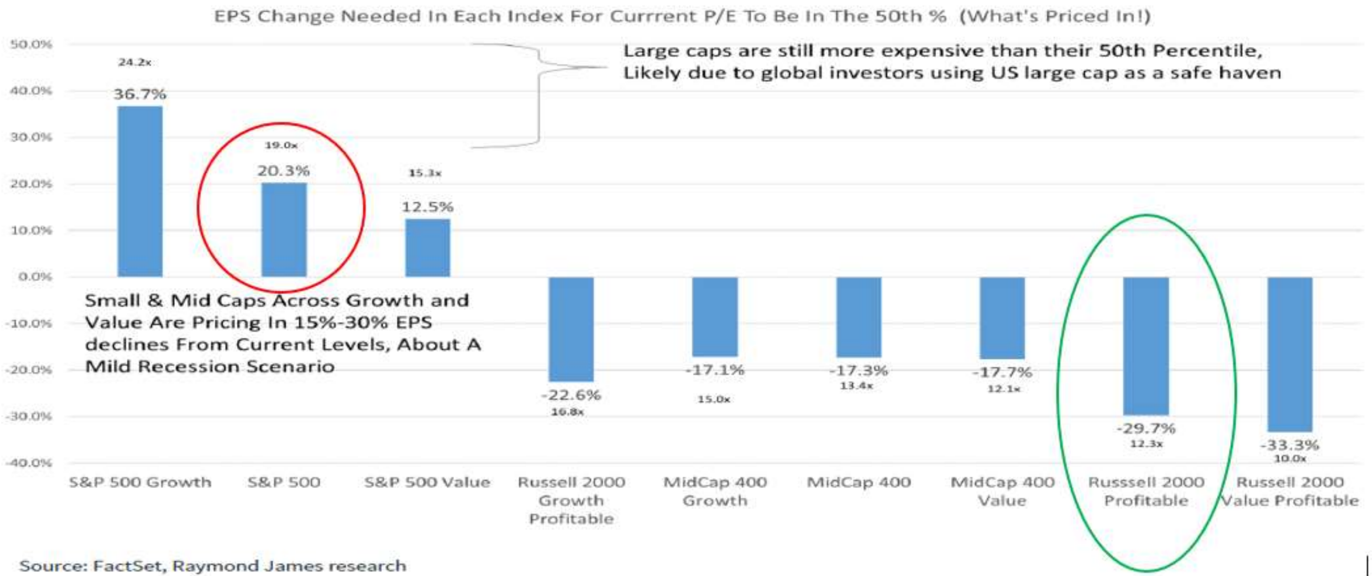



Slicing and dicing valuation metrics further, profitable small caps currently trade in the fourth percentile relative to their average 20-year forward Price/Earnings ratio, whereas large caps occupy the 80th percentile. Even if earnings estimates are too high, the relative discount for small caps is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




As we sit here today, we believe earnings estimates are too high given the Fed's path. How much can earnings be reduced and still make a compelling argument that valuations are attractive? The chart below holds that answer. In order for the P/E ratio to fall into the 50th percentile for the S&P 500, earnings would need to grow 20% as shown in the red circle below. Whereas the Russell 2000 Index would need to see earnings slashed by nearly 30% for the P/E to be in the 50th percentile shown in the green circle below. The bottom line is that a lot of negative earnings revisions have been priced into small cap stocks.




We showed the charts below last quarter, but it bears repeating as inflation is enemy #1. If the Fed achieves their goal of curbing inflation, 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)**

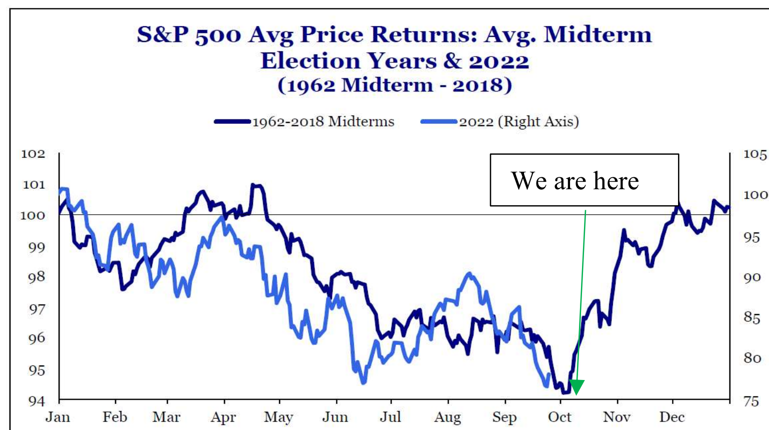
| Rate of Change | Starting Level: Below 3% | Above 3% | All |
|---|---|---|---|
| Decreasing | 17.0 | 22.4 | 18.9 |
| Increasing | 15.7 | 5.6 | 14.8 |
| All | 16.5 | 16.9 | 16.6 |

**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: PSC Research

Lastly, positive seasonality of the stock market is upon us. The seasonality impact is magnified in a midterm election year as shown in the chart below. Let's hope the seasonal factors kick in, but we think the Fed is going to have to soften their stance in order for this history to play out.

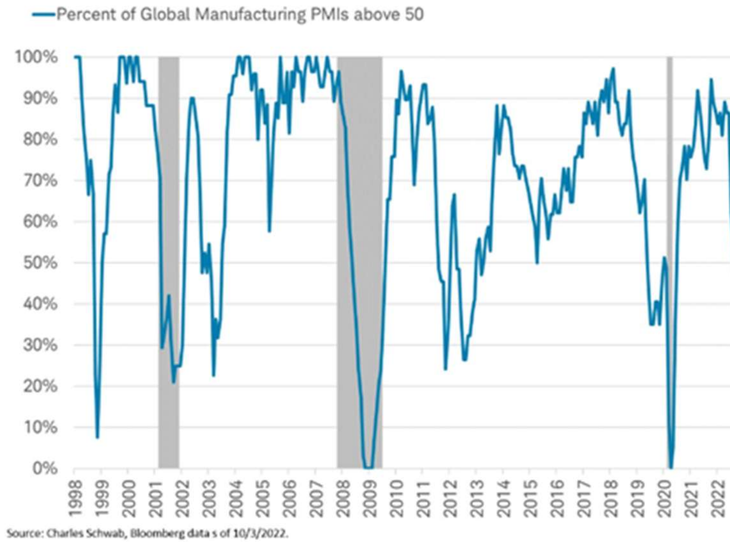



Source: Strategas Research

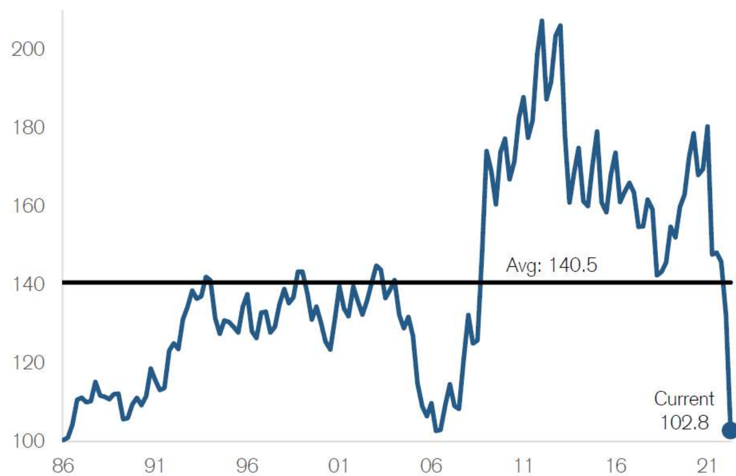
## Updated 2022 Outlook: A Picture is Worth a Thousand Words

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 percent of countries whose PMI is above 50. The 50 level is the breakeven between growing and shrinking. Many more countries are beginning to see their economies shrink rapidly.




This chart shows the affordability of housing in the U.S. which is a combination of price and interest rates. Since the Fed started hiking, affordability has plummeted to levels last seen in 2006.



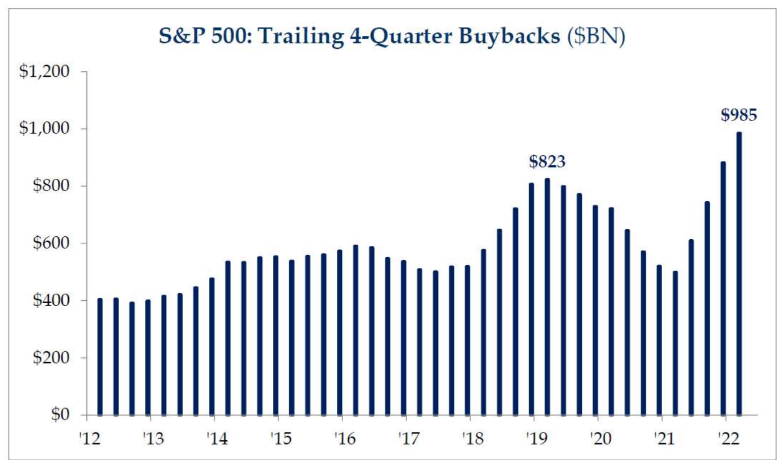
With the decline in the stock market as we approached quarter end, the Volatility Index or VIX moved above 30. If history holds, performance in the coming three months should be pretty strong.

**VIX and Future Equity Returns**

| % | Large Cap | | Russell 2000 | |
|---|---|---|---|---|
| | Return | Annualized | Return | Annualized |
| **When VIX > 15** | | | | |
| Subsequent 3 Months | 3.6 | 15.3 | 4.2 | 17.7 |
| **When VIX > 20** | | | | |
| Subsequent 3 Months | 5.8 | 25.5 | 8.1 | 36.8 |
| **When VIX > 30** | | | | |
| Subsequent 3 Months | 8.1 | 36.6 | 10.3 | 48.2 |
| **When VIX > 40** | | | | |
| Subsequent 3 Months | 15.3 | 76.4 | 19.4 | 103.0 |

Source: CBOE, Standard & Poor's, Russell, Haver Analytics®, Credit Suisse

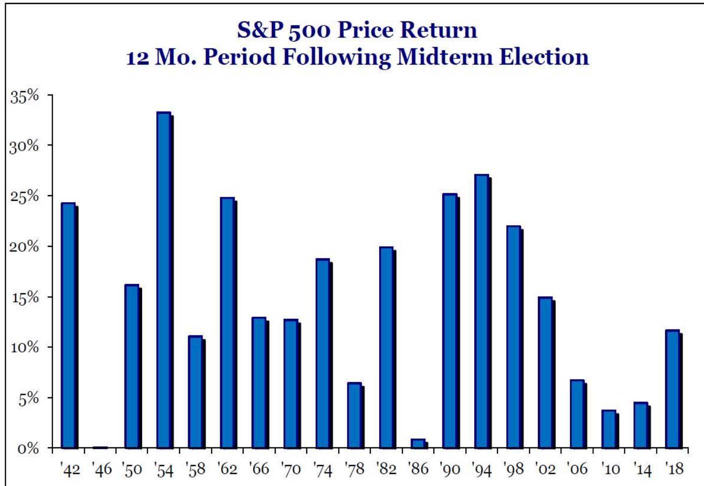
The following chart shows the S&P 500 companies' amount of stock buybacks over the trailing four quarters. The Inflation Reduction Act places a 1% tax on stock buybacks once it goes into effect. We may see a continued acceleration in buybacks as a result.

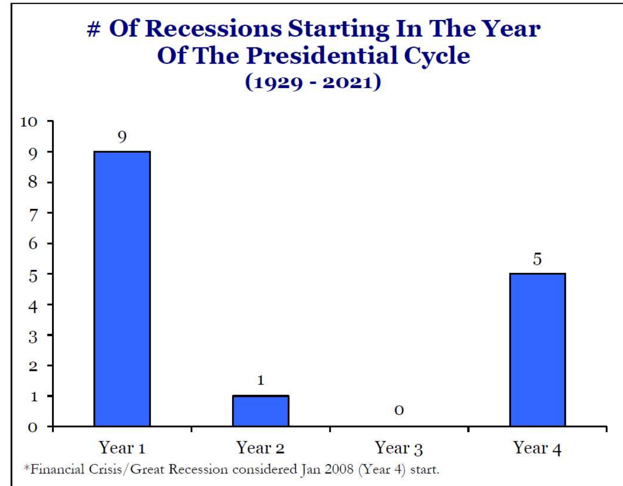



Source: Strategas Research

## Stock Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. This quarter we focus on stock market returns following the midterm election and recessions by Presidential cycle. The chart on the left shows the 12- month returns for the S&P 500 following the midterm elections which are only one month away. Amazingly, every 12-month period following the midterms has been positive going all the way back to 1942. The chart on the right shows the number of recessions starting in the third year of the Presidential cycle which will be 2023. Interestingly, there has never been a recession that began in the third year of the Presidential cycle. Most occur in the first year as a new administration brings uncertainty and their biggest policy changes to the table. Let's hope both of these trends continue for 2023.




Source: Strategas Research

We hope that you found our third 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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