



## 1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management’s newsletter for the first quarter of 2023. 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.

### VC & PE Funds Bite the Hand that Feeds Them and Cause Bank Debacle

The collapse of Silicon Valley Bank and Signature Bank, which soured an otherwise strong start to the first quarter, was a bank anomaly in the context of their unique banking models. Both of them made a significant portion of their loans to venture capital and private equity funds which was a very lucrative business. The banking business has always had a duration mismatch between deposits (short term) and loans/investments (long term). As long as all depositors don’t want their money back at the same time, banks are able to meet withdrawal demands through cash on hand and reserves required to be held for just such an occasion. Interestingly, what brought both banks down were the investments that they made in the closest thing to a risk-free asset – U.S. government securities. Both banks saw massive deposit inflows from government subsidy programs and a robust capital markets environment in 2021. Based on the Federal Reserve’s outlook in March 2022 which forecasted interest rates to be just 2% in March 2023, the banks plowed these deposits into longer maturity government securities in hopes of garnering additional yield. However, over the ensuing year, the Fed, in their infinite wisdom, raised rates to 5 percent. As rates advanced, bond prices crumbled, which left both of these banks with major losses on their investment portfolios. When these losses became common knowledge, the Venture Capital (VC) and Private Equity (PE) funds realized that having all of their deposits in one bank was not such a great idea. They then announced on social media that they and everyone else should pull their deposits from these banks. This event started the classic run on deposits which inevitably caused these banks to collapse. Subsequently, the U.S. Treasury Department announced that deposits at these failed banks would be guaranteed as they tried to stem a contagion at other banks. Needless to say, these events caused panic in the stock market as most banks were immediately painted with the same brush. Surprisingly, the NASDAQ Composite still posted best returns for the first quarter (+17.05%) as investors piled into the tech industry’s version of safe havens – Apple and Microsoft. Conversely, the Russell 2000 Index, which has a significantly higher weight in regional bank stocks, outperformed the S&P 500 up until the bank debacle but trailed at quarter-end with returns of +2.7% and +7.5%, respectively.

In the balance of this newsletter, we’ll discuss the can of worms that the bank debacle has opened up and why we believe that the flawed Fed policy is nearing its end which should lead to the start of a new resurgence in small caps. Please read on to see our unique views of what’s on tap for the balance of 2023, 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.

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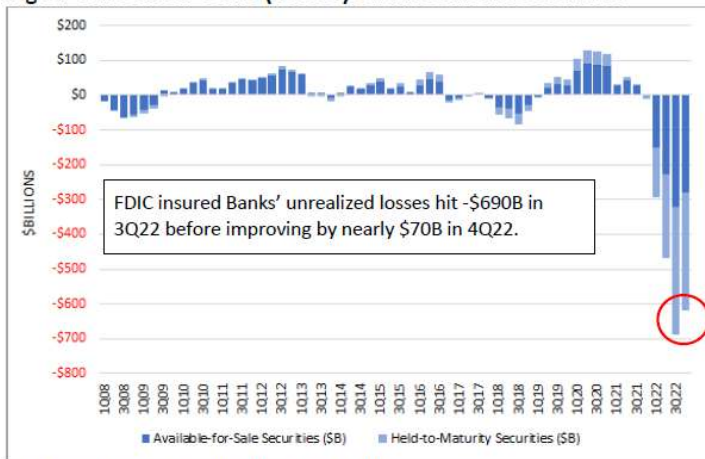
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## A Review of the Quarter: VC & PE Funds Bite the Hand that Feeds Them and Cause Bank Debacle

I refrained from using the word crisis in the headline as in this day and age it seems that every issue is labeled a crisis. This event isn't a bank "crisis" at least not yet. More on that later. The collapse of Silicon Valley Bank and Signature Bank, which soured an otherwise strong start to the first quarter, was an anomaly in the context of their unique banking models. Both of them made a significant portion of their loans to venture capital and private equity funds, which was a very lucrative business. The banking business has always had a duration mismatch between deposits (short term) and loans/investments (long term). As long as all depositors don't want their money back at the same time, banks are able to meet withdrawal demands through cash on hand and reserves required to be held for just such an occasion. Interestingly, what brought them both down were the investments that they made in the closest thing to a risk-free asset, U.S. government securities. Both banks saw massive deposit inflows from government subsidy programs and a robust capital markets environment in 2021. Based on their reliance on the Federal Reserve's outlook in March 2022, which forecasted interest rates to be just 2% in March 2023, the banks plowed these deposits into longer maturity government securities in hopes of garnering additional yield. However, over the ensuing year, the Fed, in their infinite wisdom, raised rates to 5 percent. As rates advanced, bond prices crumbled, which left both of these banks with major losses on their investment portfolios. The chart below left shows how the unrealized losses on U.S. banks' investment portfolios ballooned as the Fed aggressively raised rates. When these losses became common knowledge, the VC and PE funds realized that having all of their deposits in one bank was not such a great idea. They essentially then yelled fire in a crowd and announced on social media that they and everyone else should pull their deposits from these banks. This event started the classic run on deposits which inevitably caused these banks to collapse. The confounding actions of the VC and PE funds are that they are highly dependent on loans from these banks to lever up their equity capital and juice their returns. They essentially bit the hand that feeds them. What bank is going to be willing to step into the shoes of Silicon Valley and Signature Banks without substantially raising the cost of borrowing and requiring much more collateral?

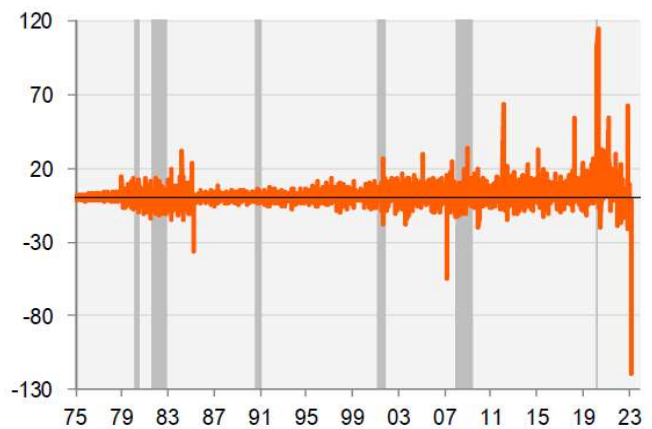
The chart below right shows the magnitude of the deposit exodus from the smaller regional banks. Note that it far exceeded the 2007 bank run. Silicon Valley and Signature Bank were top 50 banks in terms of assets. Subsequently, the U.S. Treasury Department announced that deposits at these failed banks would be guaranteed in hope of stemming a contagion at other banks. Needless to say, these events caused panic in the stock market as most banks were immediately painted with the same brush. This point can be seen in the third chart below which shows the KRE Regional Banking ETF (green line) plummeting on the heels of the Silicon Valley Bank collapse. Surprisingly, the NASDAQ Composite finished with the best returns for the first quarter (+17.05%) as investors piled into the tech industry's version of safe havens - Apple and Microsoft. Conversely, the Russell 2000 Index, which has a significantly higher weight in regional bank stocks, was outperforming the S&P 500 up until the bank debacle, but trailed at quarter-end with each posting returns of +2.7% and +7.5%, respectively. Despite these issues, all of the major U.S. stock indices posted positive returns for the quarter.

Fig 8. Unrealized Gains (Losses) on Investment Securities

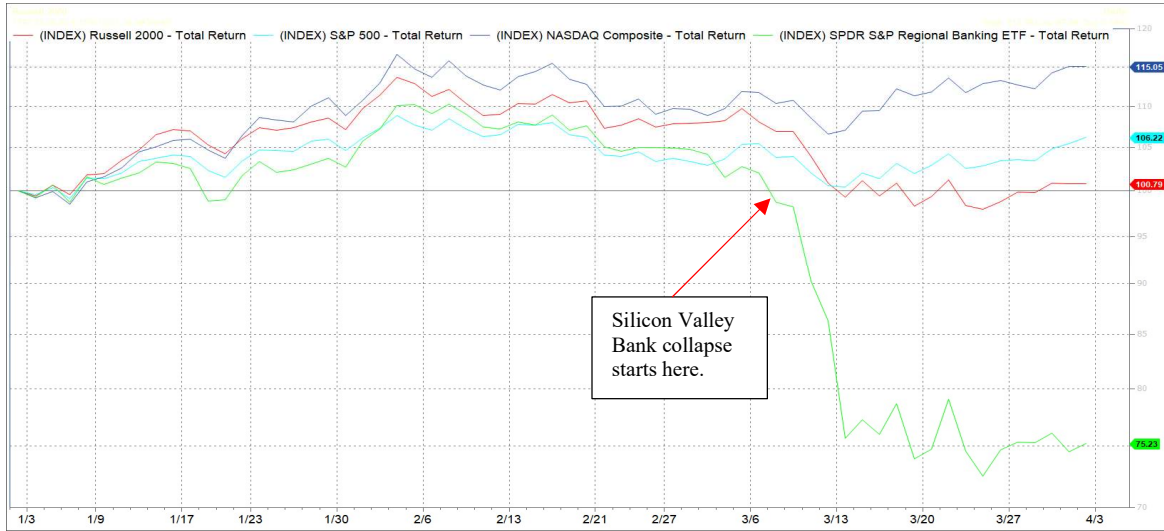


Source: Furey Research Partners and FDIC. Data as of 4Q22.

U.S. Small Bank Deposits  
W-W Ch. Mar 15: -\$120B

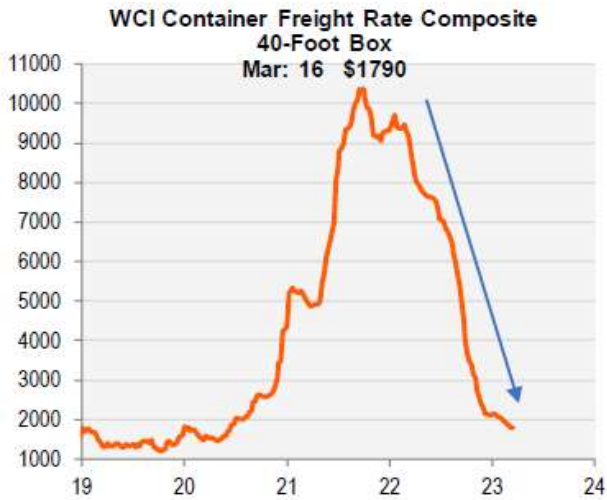


Source: PSC

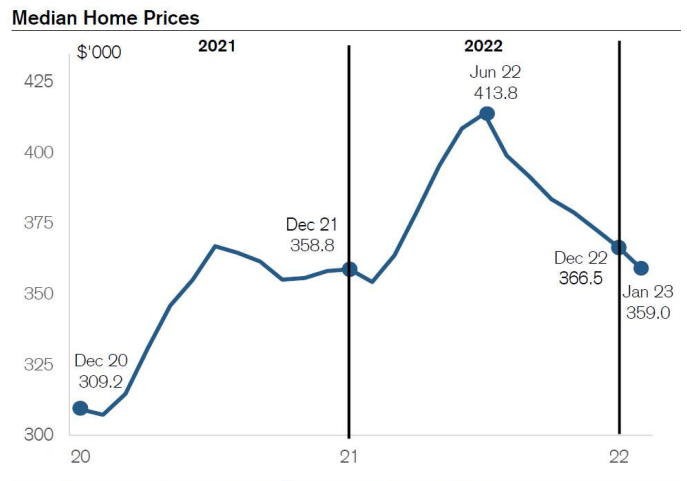


Source: 1492 Capital Management and Factset

Despite the calamity in the banking industry, the Fed somehow concluded that it was still a good idea to hike rates another 25 basis points on March 22, 2023. As regular readers of this newsletter know, we have been very critical of the Fed's aggressive rate hiking policy. The pandemic and the subsequent supply shortages across numerous supply chains, including labor, created much of the inflation that came into the system and caused the pricing of nearly everything to rise temporarily. Recall that for the 12 years from 2009 through 2020, inflation rarely exceeded 2%. Obviously the pandemic and the enormous amount of stimulus funds that entered the economy temporarily changed this level. However, the charts below show that many of these anomalies have already been corrected. The chart below left shows the now-famous freight container index. Recall that during the pandemic nearly every business was grousing about how much a shipping container cost to ship their goods to/from overseas. Notice the temporary five-fold spike during the pandemic, and now it's essentially back to pre-pandemic levels as supply chains have unclogged. The chart on the right shows that home prices have also begun to fall as the combo-platter of high home prices and a doubling in the 30-year mortgage rate have dramatically cooled the housing market with more likely to come.



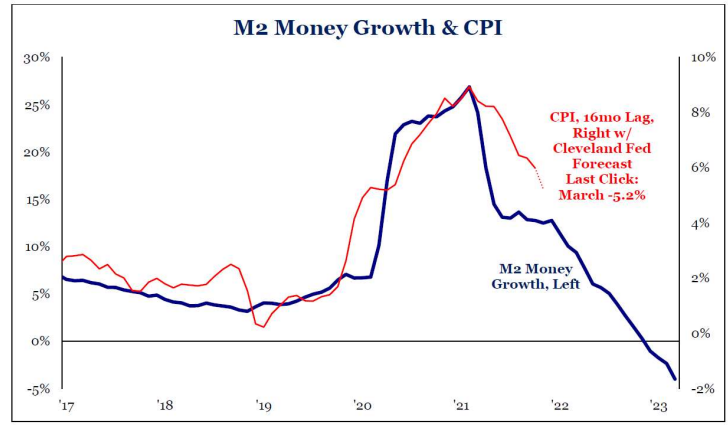
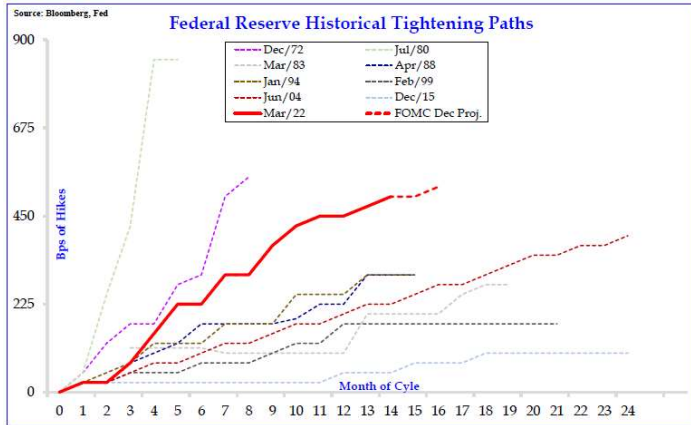
Source: PSC



Source: National Association of Realtors, the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

The Fed is acting like inflation will be a permanent fixture in our economy. We believe that this concept is wrong for many reasons. There are supposedly a lot of smart people on the Federal Reserve board who have access to enormous amounts of data. Nevertheless they can't seem to look ahead more than a few weeks and view what is coming at us due to the aggressive rate hikes that they've already initiated. Chair Powell's commentary from meeting to meeting seems to flip-flop in a matter of weeks. During the February Fed meeting press conference, he mentioned "disinflation" 15 times. In the most recent press conference following the Fed's March meeting, he mentioned disinflation exactly zero times because some of the lagging indicators were stubbornly strong. Yet, following the latest Fed rate hike, the entire treasury yield curve from three months out to 30 years is sporting an interest rate below that of the Fed Funds rate of 5%. This point implies that the bond market is already baking in rate cuts as the year progresses, which is something that we predicted months ago in our December 2022 newsletter. The Fed started the current rate hiking cycle in March 2022, just 12 months ago. It typically takes 12 to 18 months for rate hikes to impact

the real economy. However, there are some very important signals that are showing that they may have gone too far already. First, the chart below left puts the current rate hiking cycle into perspective. It is the fastest hiking cycle since 1980 (solid red line)! The chart below right shows the link between the money supply - M2 and the CPI (Consumer Price Index). Note that there is a 16 month lag between contracting money supply and CPI. This linkage is a fairly good predictor of where CPI is going in the coming months. The M2 money supply contracted for the first time in history in back to back months according to Barron's Magazine. However, the absolute money supply skyrocketed due to stimulus during the pandemic so we can't get too carried away by year-over-year percentage declines when the increases on the way up were historically large.

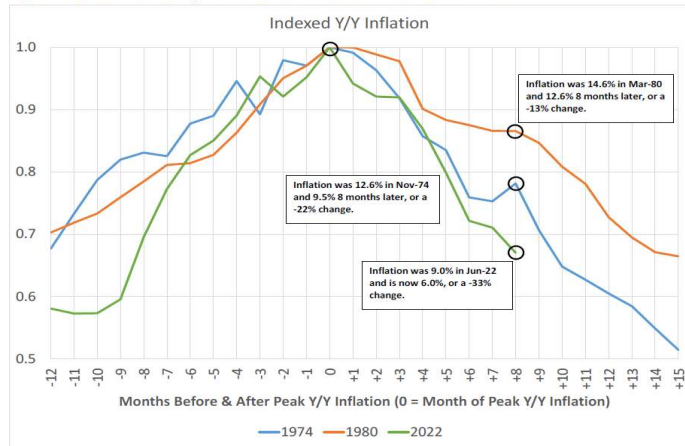


Source: Strategas

Source: Strategas

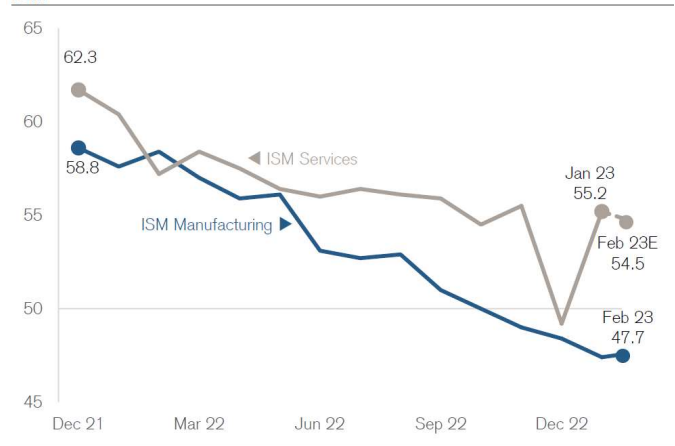
Despite the Fed's itchy trigger finger on rate hikes, inflation is cooling at a faster pace than it did during the 1974-75 and 1980-81 inflation battles as shown in the chart below left (green line). Also remember, we haven't even hit the anniversary of peak inflation from this cycle which was recorded in June of 2022 at 9.1%. Comparisons will continue to get increasingly difficult on a year-over-year basis just as the economy and inflation are cooling quickly. Additionally, the broadest measures of economic activity for both manufacturing and services, the ISM data, are both showing slowing trends as depicted on the chart below right. The ISM Manufacturing index is below 50 which indicates a shrinking of the economy. The ISM Services index remains choppy but above 50 for the time being as consumers who likely booked trips a year ago or are getting back out to restaurants after avoiding them for much of the pandemic generate much of this strength. This statistic too, likely continues to cool as the rest of the economy slows.

Fig. 19. Inflation is falling faster than it did in 1974-75 and 1980-81



Source: Furey Research, FactSet; as of 2/28/23

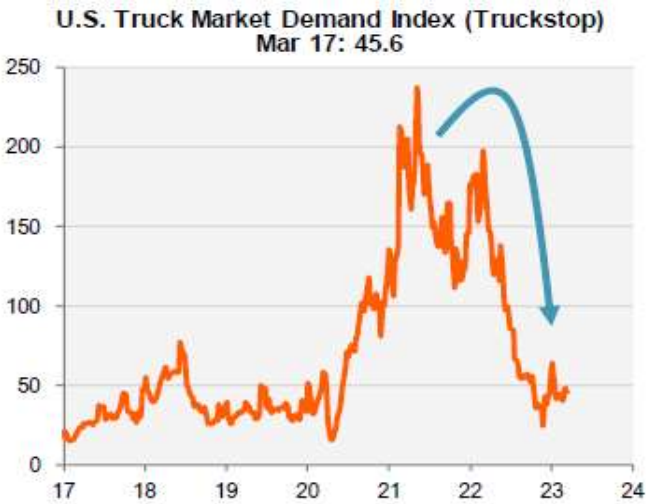
ISM



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

If the above charts aren't enough to cause the Fed to pause their rate hikes, maybe the charts below will. The charts below are some of the best real-time indicators of business strength. The first is the Truckstop.com Market Demand Index shown below left. Trucking is almost a real time reflection of the economy as goods need to be shipped in a timely manner to satisfy demand. We recently participated in a research call with several private trucking operators. They all agreed that tonnage has fallen off precipitously of late and that pricing in certain trucking lanes across the country is being accepted at below cost just to keep from laying off drivers who were so hard to find during the pandemic. Most of the companies were hopeful for a second half 2023 pickup, but except for a Fed pause or interest rate cuts, they had no real fundamental basis on which to hang their hat. The next indicator shown below right is the cardboard box shipment indicator. Similar to trucking, if there is demand for goods, manufacturers and shippers like Amazon need cardboard boxes for shipments. Note that the latest reading is down about 8%

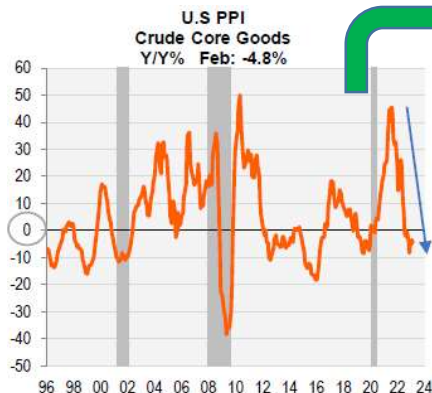
and is beginning to reach levels last seen in 2009 during the “Great Financial Crisis”. Lastly, the series of three charts below show the PPI or Producer Price Index at three different stages of production from crude goods (inputs) to intermediate goods (in process) to finished goods (ready to ship). If you think of these as three separate buckets, the goods move from left to right as the manufacturing process progresses. Clearly, the crude goods have seen a significant decline in price which should carry over into intermediate and finished goods with a lag. The Federal Reserve should take note of these fairly simple charts as you don’t have to be a rocket scientist to see which way the trends are going.



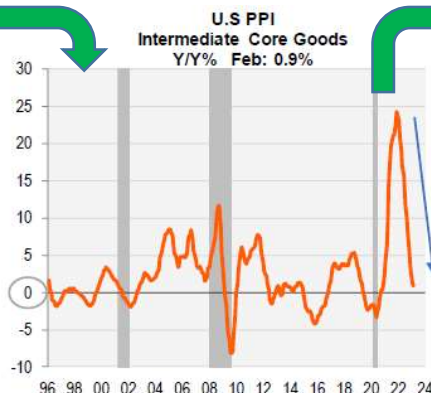
Source: PSC



Source: FBA, KeyBanc Capital Markets Inc.



Source: PSC



As shown in the table below, the stock market finished the first quarter in positive territory despite two rate hikes and a bank debacle. As noted above, small caps ended the quarter in positive territory but surrendered all of their lead over the S&P 500 since the Silicon Valley Bank issue hit. Interestingly, the NASDAQ Composite (+17.1%) was the strongest performer as the mega caps and semiconductors soared +27% during the quarter. The Dow Jones Industrial Average, which was the strongest performer in 2022, barely broke even for the quarter and was the worst performer of the major U.S. indices for the three months. The S&P 500 finished up +7.5%, which was a respectable showing as the strength in the technology sector offset the downdraft in financials.

Index	1st Qtr / YTD Return
Russell 2000	2.74%
Russell 2000 Growth	6.07%
Russell 2000 Value	-0.66%
S&P 500	7.50%
Dow Jones Industrials	0.38%
NASDAQ Composite	17.05%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (+6.07%) beat the Russell 2000 Value Index (-0.66%) for the quarter. The significant weight of bank stocks (18%) in the value index really dragged this index lower with the bank fallout. The dispersion amongst sectors was quite dramatic in light of the bank events in March as the Financial sector (-8.7%) was easily the worst performer while Technology was the best performer (+12.3%) and rebounded after a very poor year in 2022. The Energy sector (-3.8%) continued its underperformance following a collapse in natural gas prices after a warmer-than-expected winter in Europe and strong U.S. production growth bailed out the European continent which at one point was fearing natural gas prices above \$20/Mcf. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the first quarter of 2023. The second table below shows that there was a significant market cap skew in the quarter as performance was linearly worse as you moved down the market cap spectrum.

**Table 1 - Index Performance by Sector**

GICS Sector	Russell 2000		Russell 2000 Growth		Russell 2000 Value	
	Mar	1Q23	Mar	1Q23	Mar	1Q23
Com Serv	-5.1	6.7	-0.9	13.1	-8.6	1.6
Discretionary	-2.4	12.0	-1.7	12.8	-3.1	11.2
Staples	0.8	5.9	3.2	8.7	-3.3	1.2
Energy	-7.0	-3.8	-6.8	-7.3	-7.2	0.4
Financials	-13.8	-8.7	-8.8	2.4	-14.9	-11.0
Health Care	-4.9	-2.0	-3.5	-0.1	-8.2	-6.4
Industrials	-3.6	7.6	-3.2	8.4	-4.3	6.6
Info Tech	1.4	12.3	1.2	12.2	1.7	12.7
Materials	-3.0	8.8	-3.8	10.1	-2.2	7.4
Real Estate	-4.4	0.6	-4.9	0.8	-4.3	0.6
Utilities	1.3	1.5	1.6	4.2	1.2	0.6

**Table 4 - Russell 2000 Scorecard through March 31**

Size Quintile	March			1Q2023			Wgt
	Absolute	Contribution	Relative	Absolute	Contribution	Relative	
1 (Largest)	-3.06	-1.57	1.72	3.45	1.81	0.71	53.7
2	-5.65	-1.40	-0.87	2.41	0.56	-0.32	24.3
3	-5.76	-0.77	-0.98	4.01	0.53	1.27	13.3
4	-9.92	-0.68	-5.15	-1.73	-0.07	-4.47	6.3
5 (Smallest)	-13.38	-0.35	-8.60	-4.34	-0.09	-7.08	2.3

Source: Jefferies

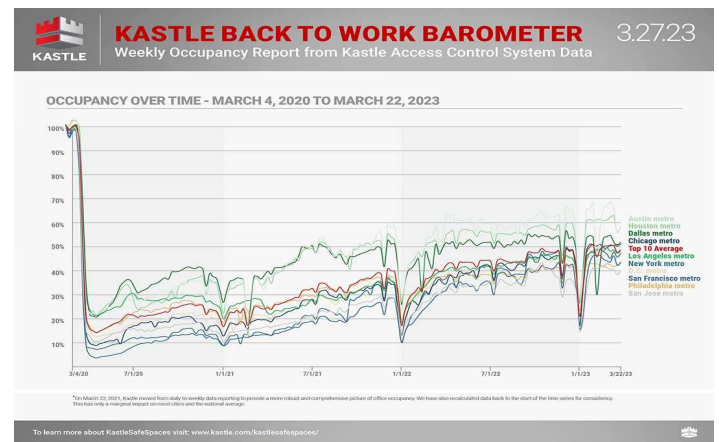
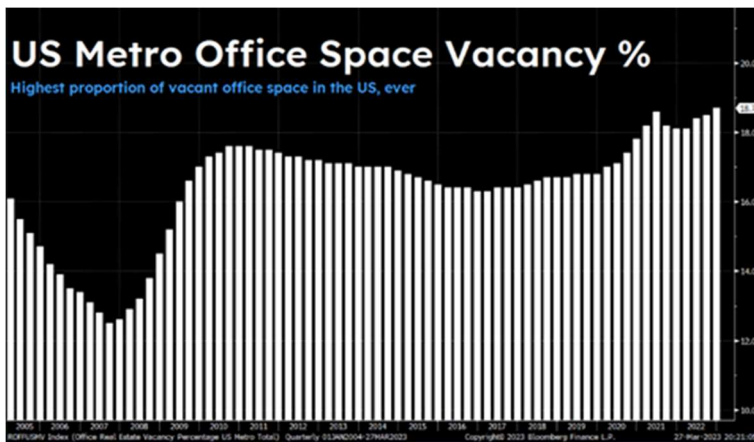
Returns in the international markets were varied across markets and many deviated widely from those seen in the U.S. markets. In general, returns in Europe, Middle East and Africa markets were slightly better than the U.S. Despite worsening fundamentals due to the Ukraine war, valuations in those markets were much lower than those in the U.S. entering 2023. The Asia Pacific region performed in line with the U.S. markets, particularly those exposed more directly to technology. The Chinese market had been as bad as the rest of the world until the COVID lockdown was canceled. Their government postured that stimulus programs would be enacted to compensate for the COVID-induced slowdown. This news led to a significant rally in Chinese equities that helped that market recoup losses from last year. Interestingly, Brazil and India's markets were among the worst performers globally, which reversed a trend from last year. 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. despite all of these concerns. The recent decline in longer dated interest rates pushed bond prices higher during the first quarter and broke a streak of negative returns for the bond market. Despite the banking debacle, volatility surprisingly declined in the first quarter. Interestingly, lumber and oil were both modestly lower in the quarter, but natural gas was substantially lower year-to-date due to a warmer than expected winter.

Index	1st Qtr / YTD Return
France	13.40%
Germany	12.30%
Brazil	-7.20%
India	-3.50%
China- A Shares	6.50%
China- Shenzhen A Shares	8.00%
Japan	8.50%
Long-Term Treasuries (SPTL)	6.90%
Investment Grade Corp Bonds	4.20%
Gold	8.80%
Volatility- VIX index	-10.10%
Oil	-5.70%
Natural Gas	-46.00%
Lumber	-0.60%

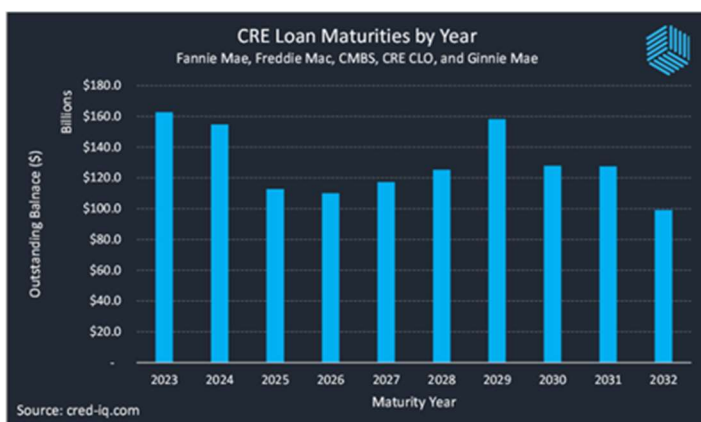
Source: 1492 Capital Management, LLC

## Updated 2023 Outlook: Banks Under the Microscope- Commercial Real Estate is Next Focal Point

The recent bank collapses have brought renewed focus on bank balance sheets and what may cause the next collapse in the U.S. banking system. Undoubtedly the U.S. banking system is far better positioned than it was entering the 2008 Great Financial Crisis from both a capital and risk standpoint. The collapse of Silicon Valley and Signature banks is not a banking crisis in our view, at least not yet. These two banks were pushing the envelope in the quest for better yields in their already aggressive portfolios and got caught. However, in light of the Federal Reserve's aggressive rate hiking cycle, the risk of a true crisis has certainly increased. Commercial real estate is the next focal point for a couple of reasons. First, cheap money since 2010 has created a surge in supply. The pandemic met this surge head-on, which brought demand dramatically lower as "work from home" became an efficient and preferred method of working for many professions. The chart below left shows that the vacancy in the metro U.S. markets is now at its all-time highest level of 18.7%. This level is likely understated when you examine the current occupancy levels as measured by the "Kastle Back to Work Barometer" which uses actual entry and exit data from employee key cards used for building access. As shown in the chart below right, the current occupancy for the 10-city large metro areas is only 48.4% and has basically flatlined despite a call by many CEO's for a return to the office. Employees seem to hold the upper hand currently due to the tight job market. This idea implies that many businesses are likely sitting on way too much office space and will likely begin shedding it as leases come up for renewal. Unfortunately, office REIT's that hold much of this property on their balance sheets will eventually need to mark these properties down as demand wanes and as a higher cost of capital kicks in due to higher interest rates. Office REIT's have been one of the worst performing asset classes over the past year as a result.



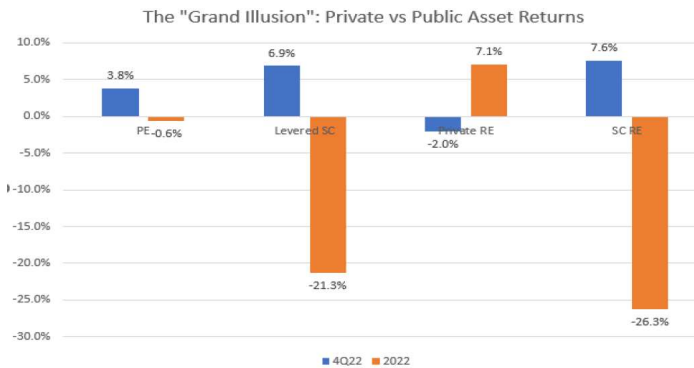
Unfortunately, banks made the loans on much of this real estate, and if the ultimate owners default, they are going to have problem loans on their books. It's estimated that over \$160 billion worth of Commercial Real Estate (CRE) loans that are backed by government entities like Fannie Mae, will have to be refinanced in 2023 alone as shown on the chart below left. Banks have a similar exposure on their balance sheet as well, particularly small banks, which viewed CRE loans as a major growth vehicle for loans over the past decade. Refinancing of these loans in the next few years will pose major risks as owners of these properties will undoubtedly see a higher financing cost than what they're currently paying just as they see plummeting occupancy and hence, slumping cash flow from these properties, which likely increases default risk. The stock market has only recently started to price this seeming inevitability into companies like Office REITs and heavily exposed banks as shown in the chart below right. This progression is something that we'll be watching in the coming months as it may truly become a "crisis" if the Fed stays on their rate-hiking war path.



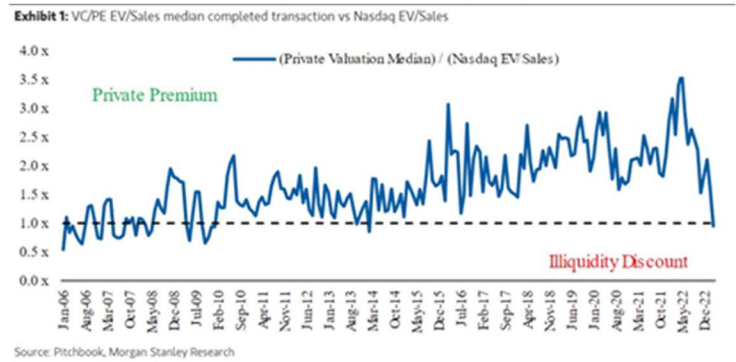
Source: Strategas

## Updated 2023 Outlook: Surging Cash Balances and Private Equity Losing its Luster May Benefit Small Caps

For much of the past 15 years, investments in private equity have become a preferred vehicle for pensions and endowment fund allocations of capital. The investment pitch has been that it's an untapped illiquid market that can generate oversized returns through tremendous leverage and generate less volatile returns over time. However, why would an investment that in many cases is leveraged 5 to 7 times have lower volatility returns? In the public markets, companies levered more than 4 times their run rate EBITDA are avoided like the plague as they tend to be tremendously volatile. Historically, think of the airlines and auto companies that carried enormous amounts of debt on their books. These stocks tended to have extraordinary volatility as business fundamentals and interest rates ebbed, which caused enormous shifts in the portion of the company's value that was ascribed to equity holders versus the debt holders. One of the other attributes of private equity investments is that they are illiquid and portfolio investments typically have seven year holding periods or longer. Isn't there still a concept called an illiquidity discount for assets that can't be readily marked to market or valued and sold in a public market? According to finance textbooks there is, but why doesn't anybody question why this doesn't hold in the private equity world? One needs to look no further than 2022, which was a year that saw both the S&P 500 and Russell 2000 Indices fall nearly 20% and the NASDAQ Composite drop 30%. How is it possible in that environment that a private equity investment which is levered up at least five-fold, can have better returns by a wide margin and show dramatically less volatility than publicly traded stocks? The answer is it shouldn't, and private equity funds aren't taking proper markdowns on their investments as the environment changes. Recently, several high profile private equity and venture capital firms including Tiger Global, Softbank, and Sequoia have announced portfolio markdowns in excess of 30%, but so far they are in the minority. The chart below left shows that reported returns for PE (private equity) firms were dramatically better in 2022 at -0.6% compared to -21.3% for levered small caps. Similarly, for private real estate in the third set of numbers, they posted returns of +7.1% vs. -26.3% for small cap real estate stocks in 2022. Something doesn't smell right here. Secondly, as the chart below right shows, since 2006, private valuations were trading at an increasing premium to NASDAQ listed stocks until just recently. Where did the illiquidity discount go? This valuation disparity between private and public markets has many private equity firms focusing their efforts on public market companies according to several analysts and investment bankers that we've spoken to lately. This focus is occurring as private market valuations haven't adjusted to the reality of higher cost of capital and lower valuations in the public markets following last year's stock market correction.



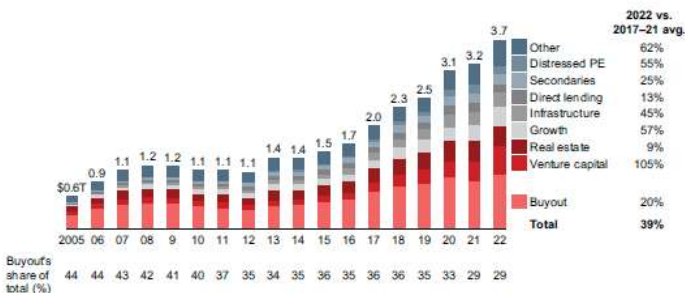
Source: Furey Research



Source: Pitchbook, Morgan Stanley Research

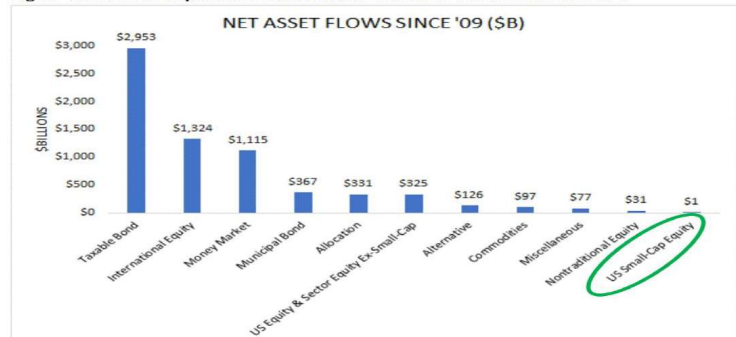
The amount of dry powder held in private equity funds is enormous, and as of the end of 2022, it stood at nearly \$3.7 trillion and has increased at a 15% compounded growth rate since 2016 as shown in the chart below left. Compare this total with the asset flows that have gone into other asset classes since 2009 as depicted in the chart below right. Amazingly, only \$1 billion of net flows have been invested into small cap equities over this period. Imagine what could happen if the private equity sector begins to target small cap equities which carry some of the lowest valuations anywhere in the public markets (see paragraph below).

Global private capital dry powder, by fund type (\$T)



Notes: Buyout category includes balanced, coinvestment, and coinvestment multimanager funds; other category includes fund-of-funds, mezzanine, and hybrid; discrepancies in bar heights displaying the same value are due to rounding. Source: Preqin

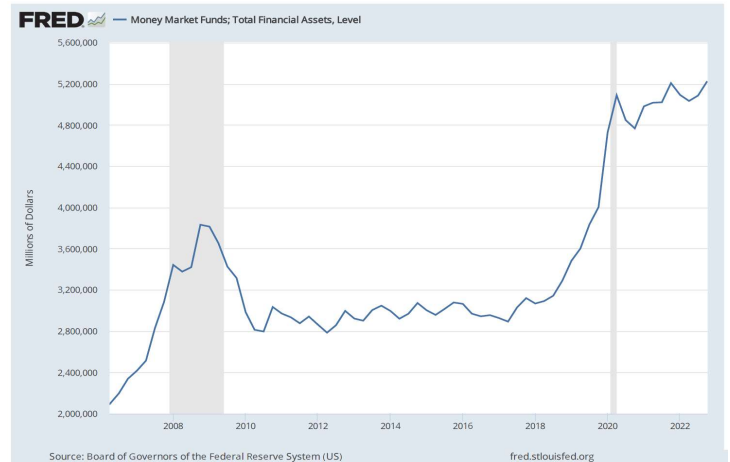
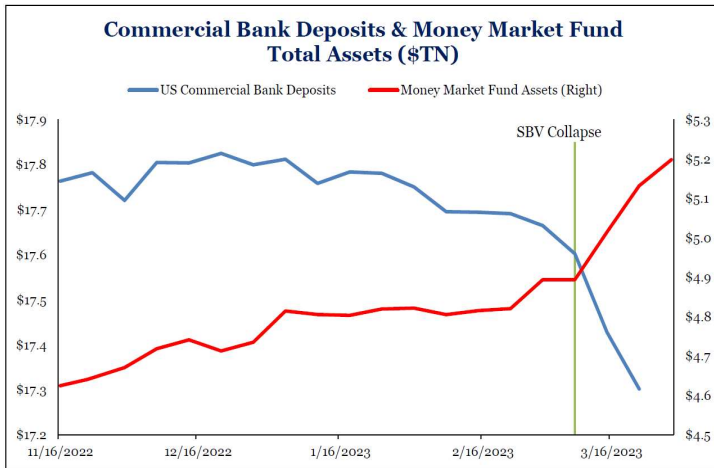
Fig 1. U.S. Small-Caps have received the least net flows since the GFC



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.



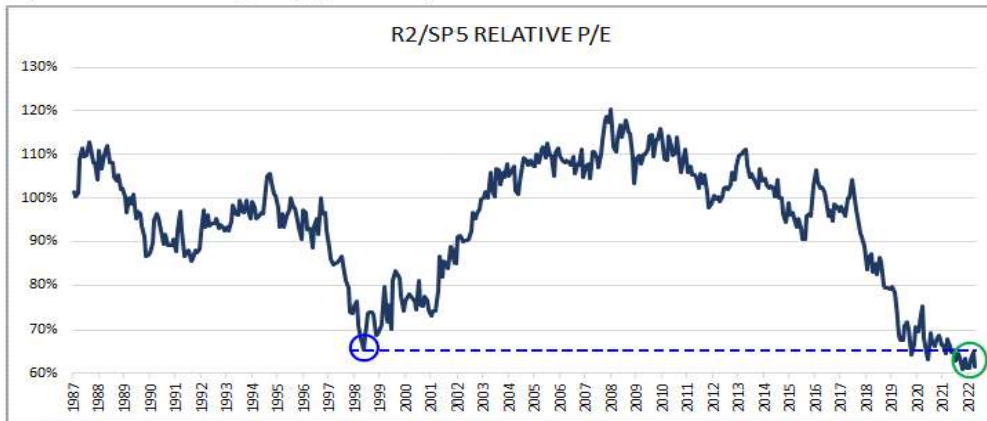
The recent banking debacle caused a lot of money to move around due to the concerns over FDIC insurance levels at banks capping out at deposits of \$250,000 or less. This cap sent money flying out of bank checking and saving accounts into money market funds and CD's, which generally are currently offering better rates of return than banks anyway. The first chart below left shows that bank deposits were already contracting as depositors were chasing yields in other instruments. The Silicon Valley Bank collapse accelerated this process, and more deposits left banks and headed into money market instruments. The chart on the right shows money market levels since 2007. Note that the "Great Financial Crisis" of 2008 and the pandemic caused major inflows into money market funds. The current flows have pushed money market balances to a new high in excess of \$5.2 trillion.



Source: Strategas

The amount of cash sitting on the sideline in the form of money market funds and in dry powder from private equity funds could trigger an amazing run in small cap stocks, which are poised to continue their outperformance relative to large caps. As the chart below shows, small cap valuations relative to large caps have never been this attractive. The last time small cap relative valuations were this low was in 1998 which started a decade of outperformance relative to large caps. Last June we predicted that small caps were poised to begin such a run. In fact, from June 16, 2022, when small caps bottomed through March 8, 2023, small caps outperformed large caps by nearly 500 basis points. However, in the last three weeks of the first quarter following the Silicon Valley Bank collapse, small caps surrendered all of that lead and then some and trailed large caps by 700 basis points. We suspect that small caps will regain this lost ground as investors realize that it isn't a bank crisis like 2008 and that valuations are exceptionally low in the small cap asset class.

Fig 97. Relative to large-caps, small-caps have never been more attractive than of late



Source: Furey Research Partners and FactSet. Data as of 3/31/23. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only.

Small-cap relative valuation continues to appear attractive.

Small-cap relative P/E has only been less expensive during Sep '22, Nov '22 and Dec '22. Based upon relative P/E alone, **there has been no other time in the R2000's history that it has been as attractive relative to large-caps as in recent times.**

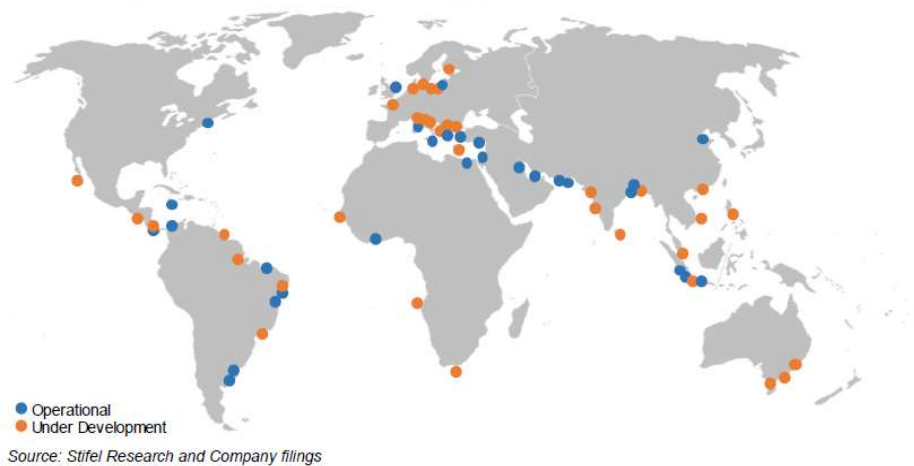
## Thematic Investing: One Winter Does Not a Trend Make: Liquified Natural Gas (LNG) Has Legs

To paraphrase the poet T.S. Eliot, the 2022/2023 winter both in the U.S. and in Europe came and went "not with a bang but a whimper." As we commented on in our third quarter newsletter piece, Western Europe would have to scramble to secure natural gas to replace sanctioned Russian natural gas to survive a normal winter. However, according to European Union data, the period from December 1, 2022, to February 28, 2023, was the second warmest European winter in recorded history. For the same time period in the U.S., the National Oceanic and Atmospheric Association (NOAA) ranked this winter as the 17<sup>th</sup> warmest with 29 states recording a top 10 warmest winter. The multi-month outage at a Freeport LNG plant also amplified weak U.S.

natural gas demand. These balmy conditions have punished natural gas prices since December 15<sup>th</sup> to the tune of -64% and -70% drops in Europe and the U.S., respectively and have soured investor sentiment on the global secular growth trend of liquified natural gas (LNG). We believe that this reaction is short sighted particularly when we factor in the surprise OPEC+ production cut that was just announced. OPEC+ has just agreed to trim 1.15 million barrels per day of oil production, and the Russians have agreed to extend their production cut of 500,000 barrels per day through year end versus their prior plan to continue through June. Assuming they maintain their track record of compliance, this surprise move will put the oil market in a supply deficit for the next three quarters with particularly large deficits in the second half of the year. Barring a significant global recession, this cut and a more normal level of demand from China should put upward pressure on oil prices and have energy users looking to LNG as a replacement fuel where appropriate.

According to Stifel research, European natural gas inventories are now 56% full versus a 10-year average of 36%. With Europe gobbling up LNG in the second half of 2022 to prepare for winter, the Asian buyers stepped out of the way with China imports down 20.5% on a trailing 12-month basis through January 2023. With lower prices now available, the Asian buyers are expected to return in 2023. On the supply side, global LNG production growth, according to Stifel, should accelerate each year from a roughly 4% increase in 2023 to upwards of +10% in 2026 as new projects ramp volumes in both the U.S. and internationally. All of this supply growth requires a massive effort on both the construction and transportation side. The LNG industry is finding that using Floating Storage Regasification Units (FSRU) can substantially speed the completion time of projects and lower upfront capital costs. These FSRUs are ships that can be docked at the delivery point for LNG and can turn the liquid cargo from an LNG carrier back to natural gas for onshore pipeline transport. As seen in the chart below, the proposed floating regasification facilities comfortably outnumber the existing facilities and are a key driver for cost-effective growth in the LNG industry.

**Exhibit 54: Map of Current and Proposed Floating Regasification Facilities**



It is particularly interesting to note the number of orange dots in northern and southern Europe as they plan their non-Russia dependent energy future. On the other end of the LNG process is the growth in the use of floating liquified natural gas (FLNG) technology where a specialized vessel can liquify natural gas at an offshore field for an LNG carrier to transport. Similar to FSRUs this reduces the amount of land-based infrastructure and also eliminates long pipelines from the offshore field to a land-based LNG facility. It allows for sizable, previously stranded and flared natural gas reserves to become a viable energy source. While still in its infancy, this FLNG technology should witness explosive growth over the next decade. This FSRU and FLNG growth opportunity is an attractive hunting ground to augment 1492 Capital Management's investments in the LNG industry. With the old political saying of "never let a good crisis go to waste", the loss of investor enthusiasm for the LNG sector due to a very warm winter in two important natural gas markets has created more attractive entry points to capitalize on LNG's long-term tailwind as a reliable and consistent global energy source.

## **Thematic Investing: Artificial Intelligence and Generative AI, Like ChatGPT are Game Changers**

In a world full of hype and proclamations that "this" is going to be the next great thing, it's easy to overstate the significance of technological breakthroughs. Only a couple of them in my lifetime have truly lived up to the hype which include the PC, the cellphone, and the internet. However, I'm seriously considering adding artificial intelligence or AI for short, to the list. AI has been around for decades and was an overused term to make companies sound like they were on the cutting edge of technology. In many cases as we've interviewed companies over the years who claim that they use AI to improve a process or software application, it turns out that they were using nothing more than an excel spreadsheet or comparable capabilities to generate efficiencies or identify anomalies in their processes. Traditional AI has been helpful in making predictions of outcomes, while generative AI is about generating content such as text, video, images, or computer code, which wasn't previously possible. The

current iteration of AI has taken things to a whole new level, and we are believers. Let's first define some terms associated with AI.

**Artificial Intelligence (AI):** The simulation of human intelligence processes by machines, especially computer systems. Specific applications of AI include expert systems, natural language processing, speech recognition, and machine vision.

**Generative AI:** Leverages machine learning techniques such as deep learning and neural networks. It can recognize patterns and create new outputs based on the understanding. Generative AI is designed to create outputs that are entirely new, rather than simply predicting or categorizing data.

**Responsive AI:** Designed to interact with users in a flexible and adaptive manner.

**Natural Language Generation (NLG):** NLG focuses on the automatic generation of human-like language, such as text or speech.

**Large Language Models (LLM):** A type of machine learning model that is trained on large parameters of inputs while using natural language to process queries. Once trained, a LLM can string together coherent thoughts and words given word patterns that it's been trained on.

**ChatGPT:** A natural language processing tool driven by AI technology that allows users to have human-like conversations. It is built on an LLM. It was developed by a company called OpenAI which is partially owned by Microsoft and founded by several individuals including Elon Musk of Tesla fame. GPT is short for generative pre-training transformer. GPT-3 was released in 2020 and is powered by a 175 billion parameter model. GPT-4 was recently released to the general public this year.

**DALL-E2:** An AI model that was developed by OpenAI which translates natural language to images.

ChatGPT is the fastest growing app ever and has reached 100 million users in January 2023 after its launch in November 2022. The beauty and the promise of ChatGPT is that anyone can interact with the app, and they don't have to know how to write computer code or know a special language. It understands basic written language and provides a written output that is quite eloquent, even if it doesn't have the correct answer. Microsoft recently made waves when they announced that ChatGPT would be embedded in its Bing search engine product and would compete with Google search. The next day Google announced their version of ChatGPT which is called Bard, but it was less than enthusiastically embraced as ChatGPT received all of the press and media attention. Both of these tools have been in development for years, and billions of dollars have been spent on their development. For now, it appears that generative AI will remain in the domain of large well-funded companies as it costs billions of dollars to develop a fully functional app and potentially hundreds of millions of dollars to run as it must constantly be trained. It also takes significant compute power, storage, and cloud resources in order for it to function at a high level. The current expectation is that ChatGPT and other competitors will be able to displace jobs such as data entry, paralegal, translator, telemarketer, transcriptionist, programmers, and even accountants to some degree. Efficiency and displacing mundane jobs are clearly in its sights. Universities are quivering as these tools can be used to write essays or help cheat on exams. Students be warned - universities are already ramping up their defenses and utilizing tools that can identify when a generative AI app has created something. Let the battles begin. The bottom line is that we are only in the top of the first inning with respect to the applications and uses of generative AI.

The following are a couple of examples of what ChatGPT generated when I asked it some specific questions. If you haven't had an opportunity to use it, I recommend just playing with it for a few minutes because it's fascinating, fast, and you can appreciate the endless possibilities that such an app could have in the real world. Below are a few examples of what my queries (red letters) were and the related output from ChatGPT (green letters). Each one literally took just seconds to get a response. You'll notice one of the shortcomings right out of the gate is that it doesn't know about current events unless it's been trained with up to the minute data. However, its responses are quite eloquent, nonetheless.

**What caused the bank crisis of 2023?**

As an AI language model, I do not have access to real-time information and cannot predict future events. Additionally, since the Bank Crisis of 2023 is a hypothetical event, it is not possible to provide a specific cause. However, historically, banking crises have been caused by a combination of factors such as excessive risk-taking, poor management, inadequate regulatory oversight, and macroeconomic conditions, among others. For example, in the financial crisis of 2008, some of the causes included the subprime mortgage crisis, over-leveraging, and inadequate regulation and oversight of the financial industry.

It is important to note that effective regulation and oversight of the financial industry can help to prevent or mitigate the impact of financial crises. Governments and regulatory bodies may take actions such as imposing stricter regulations, increasing capital requirements for banks, and improving transparency and disclosure requirements to promote stability in the financial system.

It is also important to note that crises can have significant and far-reaching impacts on the broader economy, financial markets, and individuals. As such, it is important for investors to maintain a diversified portfolio and consult with a financial professional to assess their risk tolerance and investment strategies.

### What were the returns of the Russell 2000 index by year from 2010 through 2020?

Here are the annual returns of the Russell 2000 index from 2010 through 2020:

- 2010: 26.85%
- 2011: -5.45%
- 2012: 16.35%
- 2013: 38.82%
- 2014: 4.89%
- 2015: -4.41%
- 2016: 21.31%
- 2017: 14.65%
- 2018: -11.01%
- 2019: 24.51%
- 2020: 19.96%

The Russell 2000 index is a benchmark index that tracks the performance of small-cap stocks in the United States. The index includes approximately 2,000 stocks with a market capitalization between \$300 million and \$2 billion.

It's important to note that past performance does not guarantee future results, and the performance of the Russell 2000 index can be influenced by many unpredictable factors such as macroeconomic conditions, corporate earnings, and global events. Investors should always consider their risk tolerance, financial goals, and time horizon before making any investment decisions.

### Where would you go for a warm weather vacation with white sandy beaches?

There are many destinations with warm weather and white sandy beaches that you can consider for a vacation, depending on your preferences, budget, and travel restrictions. Here are a few popular options:

1. The Maldives - This tropical paradise is known for its crystal-clear waters, colorful marine life, and luxurious overwater villas.
2. Hawaii - The islands of Hawaii offer a diverse range of beaches, from the black sand beaches of Punalu'u to the golden sands of Waikiki Beach.
3. The Caribbean - With its many islands, the Caribbean has no shortage of white sandy beaches and turquoise waters. Some popular destinations include the Bahamas, Jamaica, and the Virgin Islands.
4. Cancun, Mexico - Cancun is a popular destination for its white sandy beaches and vibrant nightlife, with plenty of all-inclusive resorts to choose from.
5. Phuket, Thailand - Phuket is a tropical paradise with stunning beaches, crystal-clear waters, and plenty of opportunities for outdoor adventures like snorkeling and kayaking.
6. Bali, Indonesia - Bali is known for its picturesque beaches, lush landscapes, and rich cultural heritage.

No matter which destination you choose, be sure to research local travel restrictions and safety guidelines before booking your trip.

The following are examples generated from the DALL-E2 app which translates natural language into images. This translation is very fascinating, and you can imagine the many uses an app like this could take.

Create a picture of a Bernese Mountain Dog and a Golden Retriever laying in the snow. The DALL-E2 app generated numerous pictures for me from which to choose. I chose the one below because it was closest to what I requested. The only problem is that the tan dog pictured isn't a golden retriever. The second picture generated below came from the following request. Create an impressionist painting of an upward rising stock chart floating in outer space. Yes, the request is really nonsensical but it goes to show you what is possible to create in just seconds using these powerful engines. The image is pretty darn close to what I requested even though I didn't know what to expect.



Source: DALL-E2

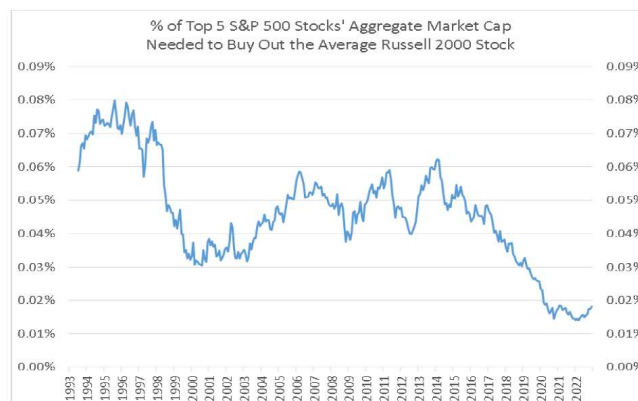


The risks associated with Generative AI include content moderation or misinformation, copyright infringement, privacy, and ethical issues. Many are calling for regulation in these tools, but many of these tools are being deployed already in a host of applications and once the horse is out of the barn, it may be impossible to get it back in. For now, the investment possibilities are somewhat limited to the big players like Microsoft, Google, Nvidia (GPU's), IBM, Adobe, and Meta, to name a few. Many other companies will participate in time as companies create other ways to utilize these models within a specific application or software. A couple of our existing small cap holdings have already announced ways in which they plan to leverage these technologies in their existing business to add features or provide more efficient outcomes. We'll continue to scour the investment landscape for further opportunities to develop this theme as it is likely to be a game changing technology for years to come.

**Updated 2023 Outlook: A Picture is Worth a Thousand Words**

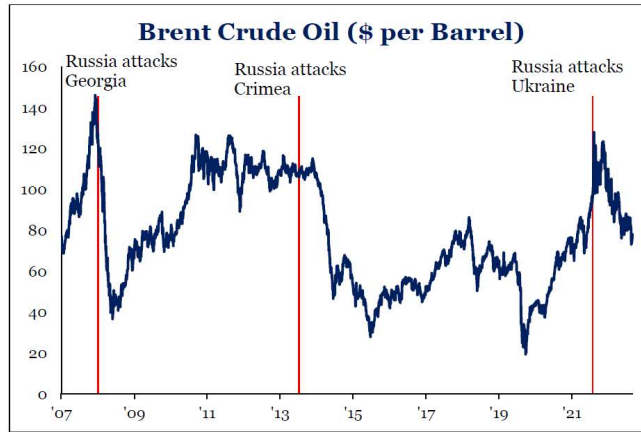
We articulated our updated 2023 outlook above and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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.

The surge in the value of the top five stocks in the S&P 500 is notable as it would take less than .02% of the total value of the top five stocks to buy out the average Russell 2000 stock.



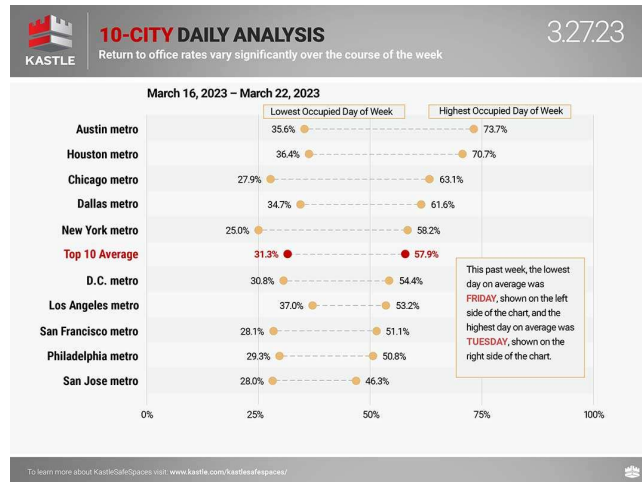
Source: Furey Research

Russia tends to time their aggressive land grabs just as oil prices reach peak levels presumably to finance their economy and protect against extended sanctions against it.

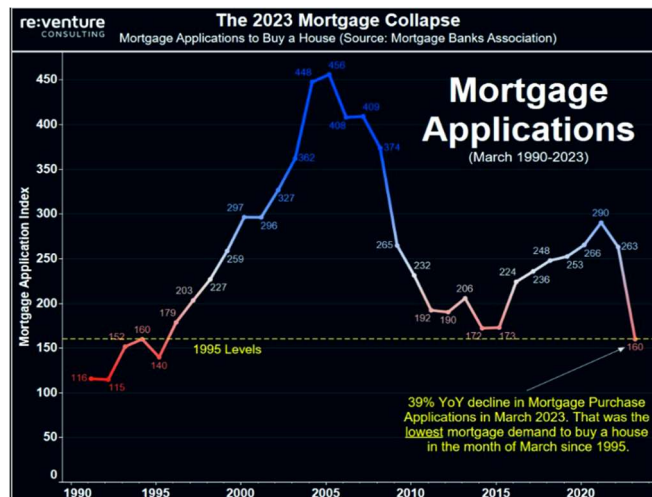


Source: Strategas Research

The chart below shows that workers who are not required to be in the office each day choose to be in the office most regularly on Tuesdays and least likely on Fridays. Interesting that they aren't regularly in on Friday's and Monday's - hmmm- trying to loop four-day weekends?



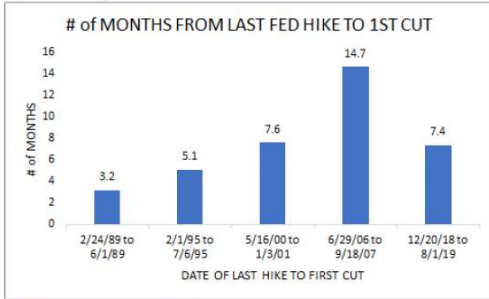
The most recent data on mortgage application volumes shows that March 2023 volumes were the lowest for the month of March since 1995.



## 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 the transitional period between Federal Reserve rate hikes and rate cuts. As we've stated, we expect the Fed to be cutting rates before year end as the rate hikes initiated to date prove to be excessive. The first chart below shows that on average, there are 7.5 months between the last Fed hike and the first rate cut. If that average holds, and the Fed doesn't hike again, which is debatable, the first cut would come in November. The second chart below shows the performance of the Russell 2000 Index between the last Fed hike and the first rate cut. The average of prior periods is +12% with only one period during the tech bubble posting a negative return.

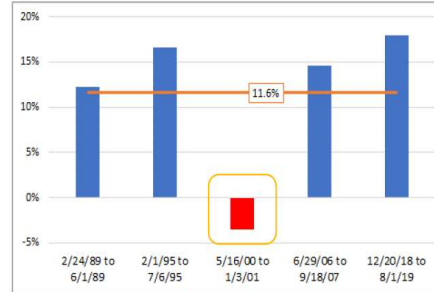
Fig 20. Average of 7.5 Months Between the Last Fed Hike and 1<sup>st</sup> Cut



Source: Furey Research Partners, Federal Reserve and FactSet.

There is an average of 7.5 months from the last Fed hike to the first Fed cut.

Fig 21. R2000 NOMINAL Performance between Last Fed Hike and First Cut



Source: Furey Research Partners and FactSet. Data as of 3/31/23. Based upon R2000 index returns following the '89/'95, '94/'95, '99/'00, '04/'06, '15/'18 and current Fed hiking periods.

The R2000 rose an average of 12% in the periods between the last Fed hike and the first Fed cut following the last five interval periods. Only the period following the Internet Bubble collapse witnessed negative small-cap returns.

We hope that you found our first quarter 2023 review and updated 2023 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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