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 second 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.

Out of Synch Economy Fooling the Fed - Could A.I. Come to the Rescue?

Throughout history, manufacturing and consumer cycles tend to go hand in hand as monetary and fiscal policy drive everything up or down in synch. The pandemic caused our economy to delink. Currently, we believe the industrial economy is in recession as evidenced by the latest reading on the ISM Manufacturing index of 46.0 (below 50 indicates contracting demand). From March 2020 until February 2022 the industrial side of the economy was on fire as consumers benefited from stimulus programs, reduced spending on services, and purchased goods (computers/furniture) aggressively as many worked from home. However, in February 2022 the services side of the economy began to heat up and goods demand cooled as the pandemic waned. Pent-up demand for travel, restaurants, and experiences skyrocketed. If you've traveled in the last six months, you've likely seen crowded airplanes and expensive airfare, hotels, and restaurants. Now that the bolus of pent-up demand for services has moved through the system, the ISM Services index sits at just 50.3 (down from 69) and has been trending lower over the past year. These out of synch trends have caused inflationary pressures to act very differently depending on whether you're looking at goods (commodities) or services (labor). Both of them are now falling rapidly and we expect that when the June CPI reading is released, it will be below 3.5%, which is well below the peak reading of 9.1% in June 2022. When the Fed paused their hiking cycle in the June meeting, they also sent very mixed messages and indicated that their "dot plot" projected two more rate hikes this cycle. We believe that the Fed should stand down and let the historically rapid rate hikes of the past year work through the already decelerating economy.

Gains in the stock market have been incredibly narrow this year with the seven largest stocks ("Magnificent 7") accounting for over 100% of the year-to-date gains in the S&P 500. With the recent Fed pause, stock market appreciation has broadened out with smaller caps participating in the month of June. Interestingly, earlier this year prior to the bank debacle, the Russell 2000 had a 473 basis point lead over the S&P 500 but ended the second quarter trailing by 880 basis points. The two indices finished the second quarter at +8.1% and +16.9%, respectively. The NASDAQ Composite is by far the year-to-date leader with a return of +32.3%.

In the balance of this newsletter, we'll discuss the state of the economy, our updated case for small caps and what impact the A.I. boom could have on the economy and on the stock market. 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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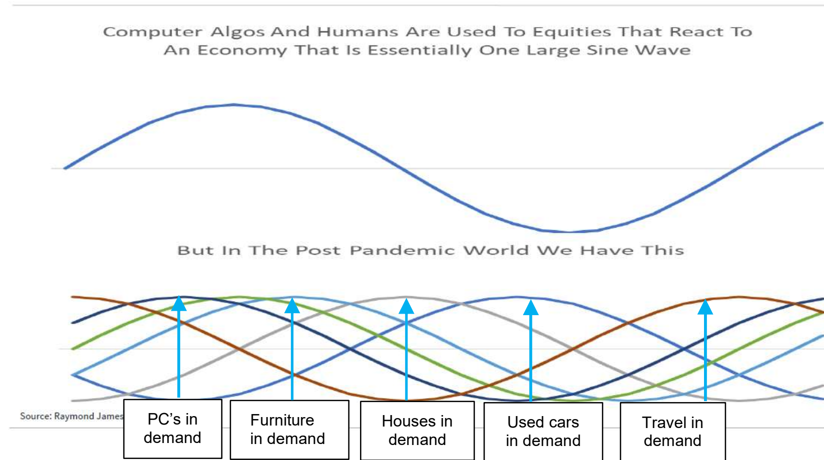
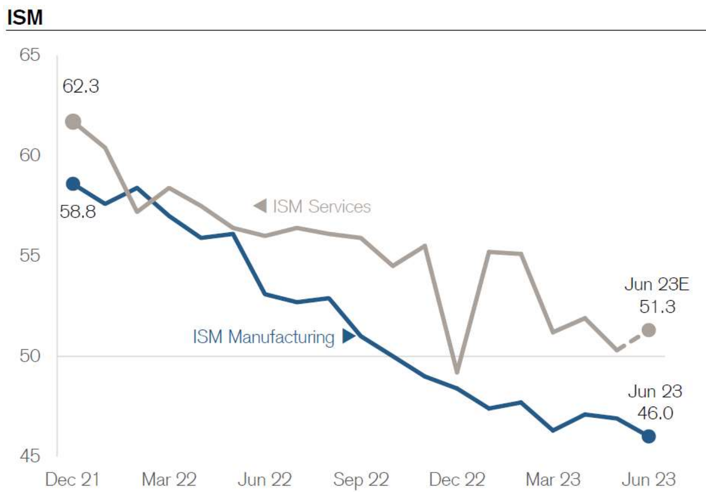
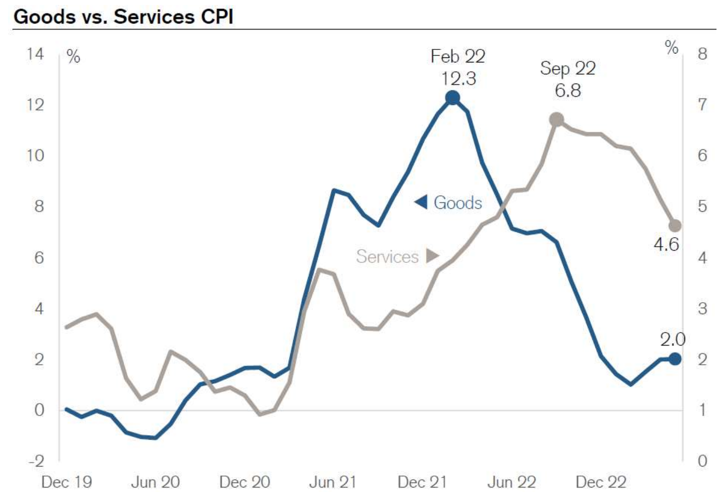
A Review of the Quarter: Out of Synch Economy Fooling the Fed - Could A.I. Come to the Rescue?

Throughout history, manufacturing and consumer cycles tend to go hand in hand as monetary and fiscal policy drive everything up or down in synch. The pandemic caused our economy to delink. The typical sine wave is shown in the top chart and what we experienced during the pandemic is in the bottom chart.

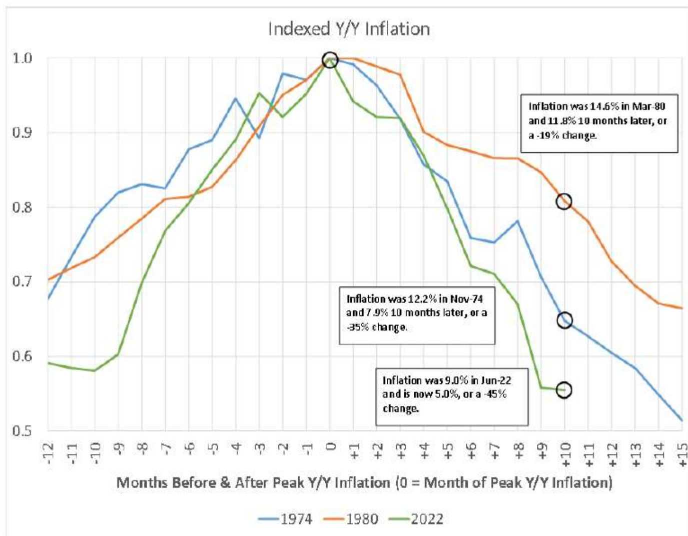


Currently, we believe the industrial economy is in recession evidenced by the latest reading on the ISM Manufacturing index of 46.0 (below 50 indicates contracting demand). See blue line on chart below left. It would be worse if it weren't for auto manufacturers still trying to catch up from supply chain woes that caused production levels to fall woefully short of demand over the past few years. From March 2020 until February 2022 the industrial side of the economy was on fire as consumers benefited from stimulus programs, reduced spending on services, and bought goods (computers/furniture) aggressively as many worked from home. However, in February 2022 the services side of the economy began to heat up, and goods demand cooled as the pandemic waned. Pent-up demand for travel, restaurants, and experiences skyrocketed. U.S. consumers planned trips that were canceled during the pandemic creating a bolus of demand for travel starting late in 2022. If you've traveled in the last six months, you've likely seen crowded airplanes and expensive airfare, hotels, and restaurants. Now that the bolus of pent-up demand for services has moved through the system, the latest reading on the ISM Services index sits at just 50.3 (down from 69) and has been trending lower over the past year. See grey line on chart below left. These out of synch trends have caused inflationary pressures to act very differently depending on whether you're looking at goods (commodities) or services (labor) as shown on the chart below right. Both of them are now falling rapidly and we expect that when the June CPI reading is released, it will be below 3.5%, which is well below the peak reading of 9.1% in June 2022. While the Fed paused their hiking cycle at the June meeting, they also sent very mixed messages and indicated that their "dot plot" projected two more rate hikes this cycle. We believe that the Fed should stand down and let the historically rapid rate hikes of the past year work through the already decelerating economy. *Note that goods inflation is already at +2% which is the Fed's stated goal for the overall inflation rate.*

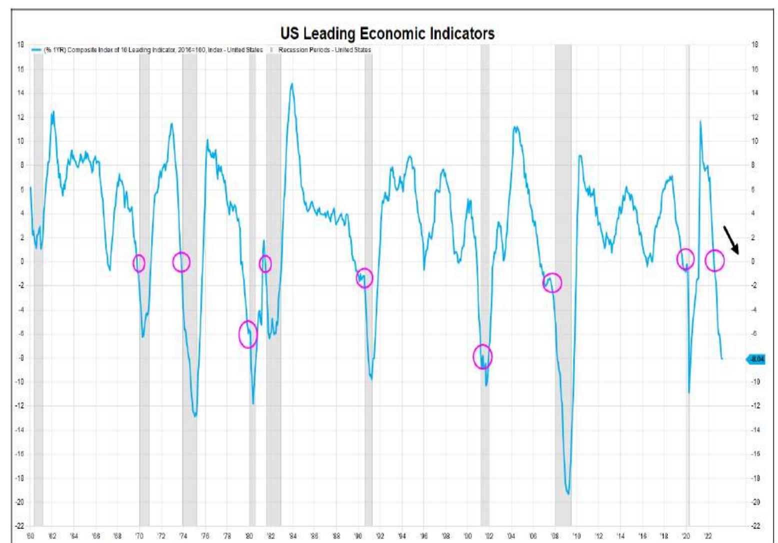




Every time the Fed has a meeting to discuss rate hikes, we wonder what they are looking at to conclude inflation is still a problem. The chart below left shows that this cycle's drop in inflation is happening at a much more rapid pace than prior cycles in 1974 and 1980 when inflation was also a problem. If the Fed would look ahead rather than in the rearview mirror, they would see a rapidly decelerating economic environment. One easy way to adjust the view is to examine the Index of US Leading Economic Indicators (LEI) as shown in the chart below right. The Conference Board publishes this index, and it's meant to provide an early indication of significant turning points in the business cycle and where the economy is heading in the near term. This index has a very good track record of predicting recessions (grey shaded areas on the chart). Whenever the index fell below -2, a recession was imminent. As the index has plunged rapidly to -8 currently, a recession can't be far off, if historical trends hold. According to the Conference Board's website, "*The US Leading Index has declined in each of the last 14 months and continues to point to weaker economic activity ahead….. The recession likely will be due to continued tightness in monetary policy and lower government spending."* So, it appears that we're not the only ones that think the Fed is missing the mark. We can't understand what the Fed Governors, who insist on several more rate hikes, are looking at as rate hikes act with a 12 to 18 month lag.



Source: Furey Research Partners, FactSet. Data as of 4/21/2023

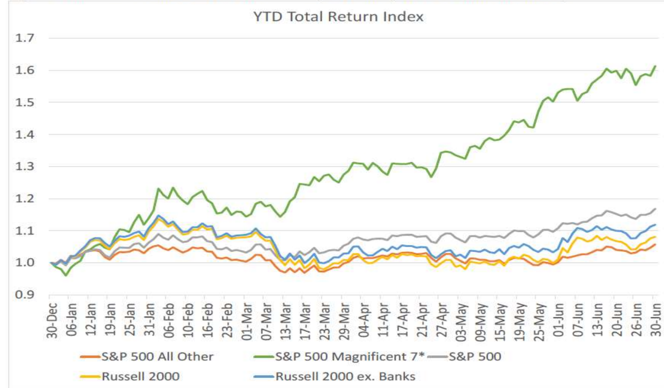


Source: Furey Research Partners, FactSet Research and US Treasury. Last data June 5th, 2023

So far this year, the "Magnificent 7" (AAPL, AMZN, GOOGL, MSFT, NVDA, TSLA, META) account for more than 100% of the S&P 500's year-to-date returns. A couple of things happened earlier this year that caused massive flows into these select mega-cap stocks. First, many hedge funds and foreign investors made a massive macro bet that the Chinese economy would accelerate early in 2023 as COVID restrictions were removed. The Chinese economy's rebound has been quite weak as goods demand around the world has slowed and as many companies who were burned by supply chain bottlenecks during the pandemic have shifted production away from China into other countries like Vietnam, Malaysia, and even back to the U.S. The large amount of money that was bet on an accelerating Chinese economy quickly pivoted to other Asian markets and to the largest, most liquid stocks in the world with fortress balance sheets (mega-cap tech). Thus, if you examine what other markets have done this year, it's no surprise that Japan (+28.7%) and Korea (+16.7%) lead the pack.

Second, the debt ceiling needed to be raised to avoid a default by the U.S. Treasury, and this issue was overhanging the market for much of this year. In typical Washington D.C. fashion, this decision was pushed to a last second agreement on May 31. Third, the bank debacle precipitated three rather large banks fail in a matter of weeks. This event caused the Russell 2000 Index, which has a much larger exposure to community banks and companies who may need financing, to go from a performance leader in January to a laggard in short order. In fact, earlier this year the Russell 2000 held a 473 basis point lead on the S&P 500 and ended the second quarter trailing by 880 basis points. The chart below left shows the massive year-to-date outperformance by the "Magnificent 7" stocks compared to every other U.S index. The Russell 2000 experienced a fairly rare occurrence this year when the index fell for four straight months (Feb through May). This decline has happened only six times previously. The good news is that the forward returns following these periods are quite robust as shown in the chart below right. Lastly the Federal Reserve took a temporary pause in hiking rates at their June meeting, but the market is pricing in another 25 basis point hike at the July meeting due to the Fed Chair Powell's hawkish tone.

Fig 10. The S&P 500 has been almost solely driven by those names at the top



Source: FRP, FactSet; as of 6/30/23; *Magnificent 7 are Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla and Meta

Fig 9. It's official – the R2000 declined four consecutive months ending May '23

R2000 FWD RETURNS FOLLOWING FOUR DOWN MONTHS	1 Mo.	3 Mo.	6 Mo.	12 Mo.
May-23	--	--	--	--
Aug-11	-11.2%	1.9%	12.4%	13.4%
Feb-08	0.4%	9.4%	8.5%	-42.4%
Aug-02	-7.2%	4.3%	-7.1%	29.1%
Oct-90	7.6%	22.0%	44.8%	58.6%
Mar-82	5.3%	-1.4%	9.0%	61.8%
Sep-81	8.5%	10.2%	-0.1%	8.8%
Average	0.6%	7.7%	11.2%	21.6%
%Pos	67%	83%	67%	83%

The R2000 declined -0.9% in May '23, making a fourth consecutive down month which is rare, happening only six times previously. Only twice did the R2000 continue to fall for a fifth month (Sep '11 and Sep '02). The R2000 has never been down six months in a row. Forward year returns are generally strong, up 22% on average, falling only during the GFC.

Source: Furey Research Partners and FactSet. Data as of 5/31/23.

As shown in the table below, the stock market finished the second quarter in positive territory despite another rate hike and an ongoing economic slowdown. As noted above, small caps ended the quarter in positive territory but couldn't keep up with the blistering pace of the S&P 500 and NASDAQ Composite in the quarter which benefitted handsomely from the largest market cap companies in the world. The Dow Jones Industrial Average, which was the strongest performer in 2022, continues to lag as the index lacks most of the megacap tech stocks that have been driving the markets this year. The S&P 500 finished the quarter up +8.7%, which was a strong showing as robust gains in the technology sector offset the lagging bond proxies like Staples and Utilities.

Index Returns		
Index	Second Qtr. 2023 Return	2023 YTD Return
Russell 2000	+5.21%	+8.09%
Russell 2000 Growth	+7.05%	+13.55%
Russell 2000 Value	+3.18%	+2.50%
S&P 500	+8.74%	+16.89%
Dow Jones Industrials	+3.41%	+3.80%
NASDAQ Composite	+13.05%	+32.32%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (+7.05%) beat the Russell 2000 Value Index (+3.18%) for the quarter. The significant weight of bond proxies (Staples, Utilities, and Financials) in the value index continues to pressure this index as the market is enamored with Tech stocks as A.I. explodes. The Health Care (+11.5%) and Industrials (+10%) sectors were strong as Health Care benefited from an uptick in outpatient procedure volumes post the pandemic, and industrials gained on reshoring momentum as the U.S./China tensions rise. The Utilities sector (-3.6%) continued its underperformance as the market seems content to get yield from money market funds and Treasury securities. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the second quarter and year-to-date 2023. The second table below shows that there was a significant market cap skew in the quarter and year to date as performance was linearly worse moving down the market cap spectrum.

Table 1 - Index performance by sector

	Russell 2000			Russell 2000 Growth			Russell 2000 Value		
GICS Sector	June	2Q23	YTD	June	2Q23	YTD	June	2Q23	YTD
Com Serv	7.1	0.0	6.8	5.1	0.3	13.5	8.7	-0.2	1.4
Discretionary	10.4	3.0	15.4	8.6	0.7	13.5	12.3	5.6	17.4
Staples	4.5	2.7	8.8	5.4	7.5	16.9	2.9	-5.8	-4.7
Energy	12.7	4.0	0.0	15.5	6.3	-1.4	11.2	2.7	3.0
Financials	7.4	-1.1	-9.7	8.8	2.7	5.0	7.0	-2.1	-12.9
Health Care	3.6	11.5	9.3	4.4	13.2	13.1	1.6	7.4	0.8
Industrials	13.6	10.0	18.3	13.6	9.1	18.1	13.7	11.3	18.7
Info Tech	7.0	8.5	22.0	6.8	7.5	20.9	7.8	11.7	26.0
Materials	11.0	0.2	9.0	10.6	0.0	10.1	11.6	0.5	7.9
Real Estate	7.3	3.0	3.6	10.7	5.7	6.6	6.7	2.5	3.1
Utilities	-1.0	-3.6	-2.2	-0.1	-2.1	2.1	-1.4	-4.2	-3.6

Size Quintile	June Absolute	June Contribution	June Relative	2Q23 Absolute	2Q23 Contribution	2Q23 Relative	YTD Absolute	YTD Contribution	YTD Relative	Wgt
1 (Largest)	8.40	4.40	0.27	6.21	3.20	1.01	9.77	5.06	1.69	50.5
2	7.92	1.98	-0.21	3.48	0.90	-1.72	6.29	1.55	-1.80	26.0
3	8.33	1.10	0.20	6.13	0.83	0.93	10.19	1.36	2.10	13.6
4	8.03	0.51	-0.10	2.95	0.19	-2.25	1.37	0.13	-6.71	6.8
5 (Smallest)	6.06	0.14	-2.08	3.57	0.08	-1.63	-1.23	-0.02	-9.31	3.1

Returns in the international markets were generally quite strong except for in China as the Chinese economy hasn't rebounded as robustly as anticipated following the end of the COVID lockdowns. Other Asian stock markets did quite well as it appears money flows came out of China and migrated to countries like Japan, Korea, and India which all had very strong performance in the quarter and year to date. 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 increase in longer-dated interest rates pushed bond prices which made fixed income investments one of the worst performing asset classes during the second quarter. Despite ongoing economic concerns and the Fed's aggressive posture, volatility surprisingly significantly declined in the second quarter. Commodities were generally a mixed bag, but natural gas rebounded after getting pounded over the prior six months.

Index	Second Qtr. 2023 Return	2023 YTD Return
France	+3.5%	+17.4%
Germany	+3.3%	+16.0%
Brazil	+15.9%	+11.0%
India	+12.1%	+7.2%
China- A Shares	-4.6%	+0.8%
China- Shenzhen A Shares	-3.5%	+3.7%
Japan	+18.5%	+28.7%
Long-Term Treasuries (TLO)	-3.2%	+3.0%
Investment Grade Corp Bonds	-0.4%	+3.8%
Gold	-2.9%	+5.7%
Volatility- VIX index	-27.7%	-35.0%
Oil	-6.7%	-12.0%
Natural Gas	+25.2%	-32.4%
Lumber	-7.4%	+7.0%

Source: 1492 Capital Management, LLC

Updated 2023 Outlook: Too Early to Call A.I. a Bubble - It Could Remedy the Inflation Problem

In our last newsletter we wrote a piece on Artificial Intelligence called "Artificial Intelligence and Generative A.I., Like ChatGPT are Game Changers" (https://1492capitalmanagement.com/wp-content/uploads/2023/04/1492CM-1Q2023-Newsletter.pdf). In the few short months since our commentary, A.I. (Artificial Intelligence) has just exploded, and it certainly seems like it will join the ranks of the great tech innovations of the last 40 years. In our opinion, A.I. is not in a bubble from a stock market perspective, despite claims made by talking heads, as there are actually very few true publicly traded stocks where AI drives their results (MSFT and NVDA to name a few). Rather, it's experiencing a massive resurgence due to awareness around ChatGPT which is now the fastest growing app in history. A.I. has been around for decades, but as consumers, we've only seen limited applications like when we're dealing with voice activated menus or chatbots for example. The new wave of large language models which run generative A.I. sites like ChatGPT are much more powerful with some of them ingesting one trillion parameters. Generative is the key word in the new generation of A.I. applications as sites like ChatGPT can quickly generate a very targeted response to a query we posed such as "Provide a 5-day travel itinerary to visit the Great Smokey Mountains National Park, including hotel and restaurant recommendations, organized in a table format." In literally seconds, chatbots like ChatGPT will provide an answer like the one shown below. Now imagine embedding online plugins like travel website Kayak or restaurant reservation site Open Table into the chatbots, and you've essentially created your own online travel agent capable of making reservations that match

the ChatGPT output. If you haven't given A.I. a try, download the ChatGPT app on your mobile phone and experiment a little as you'll be amazed at the speed and quality of the answers.

Day	Activity	Restaurant	Hotel	Popular Destinations
Day 1	Arrival and Explore Gatlinburg	- Cherokee Grill (American cuisine)	- Glenstone Lodge	- Gatlinburg Space Needle
	- Visit the Gatlinburg Space Needle	- The Peddler Steakhouse (Steak and seafood)	- Courtyard by Marriott Gatlinburg Downtown	- Gatlinburg Parkway
	- Stroll along the Gatlinburg Parkway	- The Park Grill (Southern cuisine)	- Margaritaville Resort Gatlinburg	- Ripley's Aquarium of the Smokies
	- Enjoy local cuisine and shopping	- Pancake Pantry (Breakfast and brunch)	- The Lodge at Buckberry Creek	- Great Smoky Mountains Arts and Crafts Community
Day 2	Cades Cove and Wildlife Spotting	- Elvira's Cafe (Southern and Mexican fusion)	- Dancing Bear Lodge	- Cades Cove Loop Road
	- Drive the Cades Cove Loop Road	- The Townsend Gateway Inn	- Tremont Lodge and Resort	- Historic Buildings and Churches in Cades Cove
	- Observe wildlife, such as deer and bears	- Trailhead Steakhouse (Steaks and seafood)	- Richmont Inn	- Abrams Falls
	- Explore historic buildings and churches	- Apple Valley Creamery (Ice cream)	- Dancing Bear Lodge	- John Oliver Cabin
Day 3	Hiking and Waterfalls	- The Old Mill Restaurant (Southern comfort food)	- Twin Valley Bed and Breakfast	- Laurel Falls Trail
	- Choose a hiking trail, such as Laurel Falls or Chimney Tops	- The Applewood Farmhouse Restaurant (Homestyle cooking)	- Buckhorn Inn	- Chimney Tops Trail
	- Enjoy the scenic beauty and fresh air	- The Wild Plum Tea Room (Lunch and desserts)	- Berry Springs Lodge	- Clingmans Dome
	- Discover picturesque waterfalls along the way	- The Lodge at Buckberry Creek	- Highland Manor Inn	- Rainbow Falls
Day 4	Explore Great Smoky Mountains National Park	- Smoky Mountain Brewery (Pub and pizza)	- LeConte View Motor Lodge	- Newfound Gap
	- Drive the Newfound Gap Road	- The Park Grill (Southern cuisine)	- The Lodge at Buckberry Creek	- Clingmans Dome Observation Tower
	- Stop at Clingmans Dome for panoramic views	- The Peddler Steakhouse (Steak and seafood)	- Margaritaville Resort Gatlinburg	- Roaring Fork Motor Nature Trail
	- Visit visitor centers and learn about the park's ecology	- The Appalachian Clubhouse	- Courtyard by Marriott Gatlinburg Downtown	- Sugarlands Visitor Center
Day 5	Day Trip to Pigeon Forge	- The Old Mill Pottery House Cafe and Grille	- The Inn at Christmas Place	- Dollywood Theme Park
	- Visit Dollywood Theme Park	- Local Goat (American cuisine)	- Black Fox Lodge	- Titanic Museum
	- Explore the Titanic Museum	- The Alamo Steakhouse	- Margaritaville Island Hotel	- The Island in Pigeon Forge

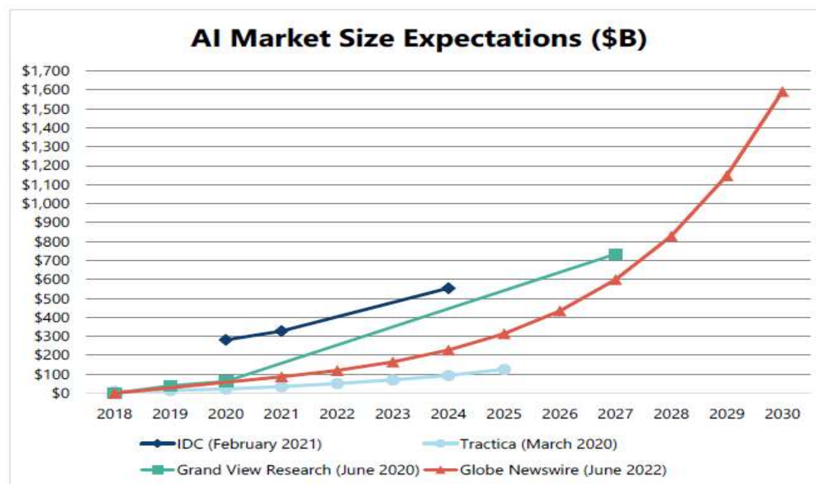
Source: ChatGPT

However, assuming that everything that a chatbot spits out is accurate can be problematic. This issue is where trouble can arise as chatbot hallucinations can occur. Hallucinations is the term that refers to incorrect answers to the query presented. Many times, the chatbot responses are so eloquent that people blindly trust them. However, there is already a famous case involving a lawyer who used a chatbot to summarize case law related to a case he was trying in court. He cited several cases as precedent in his argument that a chatbot generated without validating them. Despite a very eloquent response, the chatbot unfortunately fabricated the cases which brings us to the downside of A.I.

Potential Downside of A.I.

1) Incorrect answers or hallucinations.
2) May violate trademarks or patents unknowingly.
3) Privacy issues could be a concern, particularly in health care related queries.
4) Bias-Reputational risk.

Despite some of these potential issues, the upside is absolutely enormous, and the benefits are numerous. For example, it could be used to replace workers in low skill positions that are hard to fill for companies. Examples could be order taking at a fast food restaurant or software coding which can be done five to seven times faster, and a massive productivity boom is created. Several weeks ago, we attended an investor conference where we met with about 20 companies over a few days. In every meeting, either the management team spoke about how they were planning on using A.I. internally to improve their services or externally with their customers to improve their experience. It didn't matter if the company was a restaurant, software company, ad-tech company, or a manufacturer of widgets. They are all focusing on using A.I. to their advantage and moving quickly. The amount of money that is projected to be spent on A.I. in the coming years is enormous. The chart below shows how estimates of A.I. spending have changed over a relatively short timeframe and are forecast to increase at a rapid pace. We bet that even the most aggressive estimates will likely be exceeded.



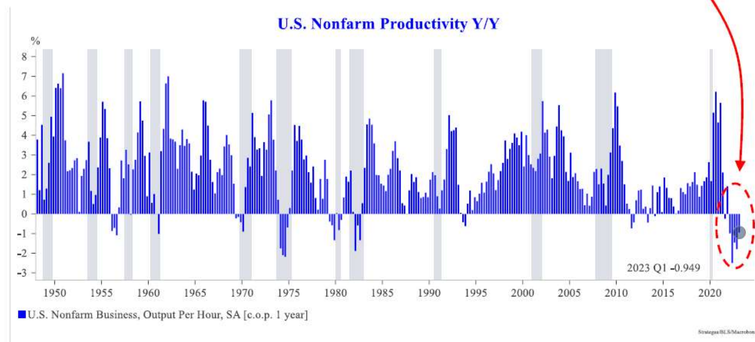
Source: IDC, Tractica, Grand View Research, Statista, GlobeNewswire, Jefferies

Business use cases are in their infancy but include:

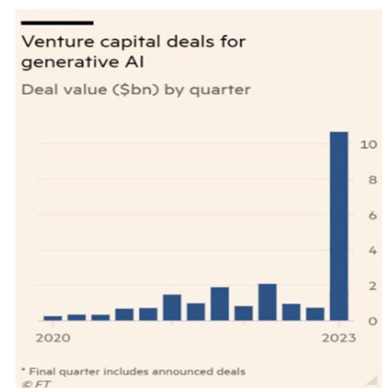
1) Data analysis - searching, analyzing, and formatting data, customer and market intelligence, reviewing contracts, etc.
2) Content generation - drafting sales/marketing materials, legal contracts, web content, user manuals, guides, etc.
3) Customer service/practical tasks - support interaction with customers, itineraries, and language translation.

Generative A.I. doesn't have to be just text based. It also can be speech to speech (language translator) or text to image, which we find very impressive with the Dall-E2 app. Human language translators may find themselves out of a job in short order.

Generative A.I. could be the inflation fighter that the Federal Reserve is searching for as one of the root causes of inflation coming out of the pandemic was a labor shortage due to early retirements, sickness, lack of willingness to work, etc. This shortage caused productivity of the U.S. economy to drop precipitously as shown in the chart below left. Generative A.I. can do many of the mundane tasks that humans don't want to do at a fraction of the cost. We expect productivity to increase in the coming year or two as many more use cases are put to work. One key example that will see immediate benefit from A.I. is software coding where coders can use generative A.I. to write code five to seven times faster than a human, according to Deutsche Bank research. We expect many A.I. themed IPOs to come to market in the coming year and possibly repeat the "internet frenzy" of the late 1990's. The chart below right shows the amount of money pouring into A.I. companies from Venture Capitalists. This flow is likely just the beginning, and it won't be long before we see the first generation of A.I. companies testing the IPO market.



Source: Strategas



Updated 2023 Outlook: The Case for Small Caps Revisited

Exactly one year ago in our second quarter newsletter we penned a section of our newsletter called "Quite Possibly the Best Opportunity in Small Cap Stocks in Decades". The gist of this call was predicated on valuation levels that we hadn't seen in decades, on the underperformance relative to large caps for over a decade, on inflation peaking and beginning to fall, and on a big move to reshoring of the U.S. supply chain which should benefit small caps with their higher domestic exposure. Since that bold statement in June 2022, small caps outperformed large caps through January 2023 by over 600 basis points, but as we pointed out earlier, there was a massive reversal earlier this year in which large caps went on a tear to outperform on a year to date by 880 basis points. This reversal of fortune for small caps was due to the bank debacle earlier this year as the Russell 2000 has a much larger weight in community banks than the S&P 500 and a move into large cap tech stocks with the excitement around A.I. We believe that neither of these items change our initial thesis that small caps are poised for a significant outperformance cycle. It simply has been deferred a bit as the basic premise of our call still holds.

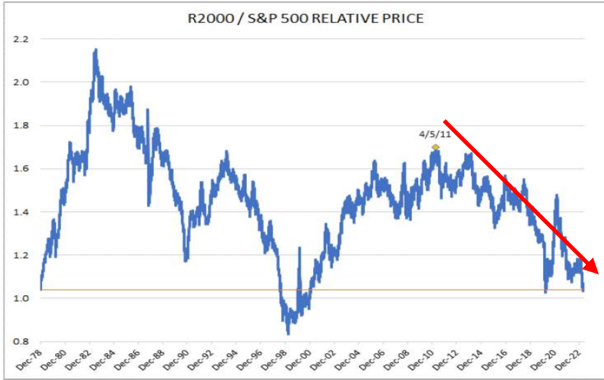
Potential Headwinds to our Forecast

1. Fed continues with their aggressive tightening and rhetoric.
2. Inflation doesn't cool as expected due to an unforeseen event (similar to Ukraine war). Geopolitical tensions rise.
3. Supply chain disruptions continue to hinder productivity. This disruption should be a much smaller issue in 2023 than it was in 2022.
4. Corporate earnings decline more than expected as nominal growth slows with inflation.
5. Energy costs rise due to poor policy decisions.

Potential Tailwinds to our Forecast

1. Valuation disparity between large caps and small caps is at a generational discount that favors small caps.
2. Inflation continues its downward trajectory from high levels which has historically favored small caps.
3. The "Magnificent 7" stocks or mega caps underperforming shifts equity dollars elsewhere.
4. Private equity funds with cash go shopping in the public markets which have been marked down compared to private markets.
5. China awakens from COVID slumber and poor policy (tech crackdowns) to provide a global growth catalyst.
6. Supply chains around the world normalize, which brings costs down and productivity up.
7. Funds from legislation like the Infrastructure Investment and Jobs Act and Inflation Reduction Act get injected into the economy.

Now we present the case for small caps. As we stated at the outset, this environment is one of the best setups for small caps that we've seen in decades. There are a number of items that are coming together to create a perfect setup. Small cap stocks historically have gone through cycles where they are out of favor on a relative basis to large caps. This occurrence is what we've seen for much of the last decade-plus going back to the Great Financial Crisis of 2008/2009. The environment has generally been favorable for large caps due to the low interest rate environment and the emergence of the mega-cap tech stocks. Low interest rates provided large caps cheap growth and acquisition capital and allowed them to grow both organically and inorganically and to pay dividends that were generally above treasury rates. The chart below left shows the small cap cycles through time. When the blue line is going up, small caps outperformed and vice versa. The table below right shows the longest losing streaks for small caps through time. This current under performance period is quite long, but performance coming out of these streaks can be quite powerful in favor of small caps. However, after more than a decade of large cap outperformance over small caps, the valuation disparity between large and small caps has widened to a level that has historically led to a changing of the guard. These cycles can be very impactful, and we think we're on the cusp of a new cycle that favors small caps.



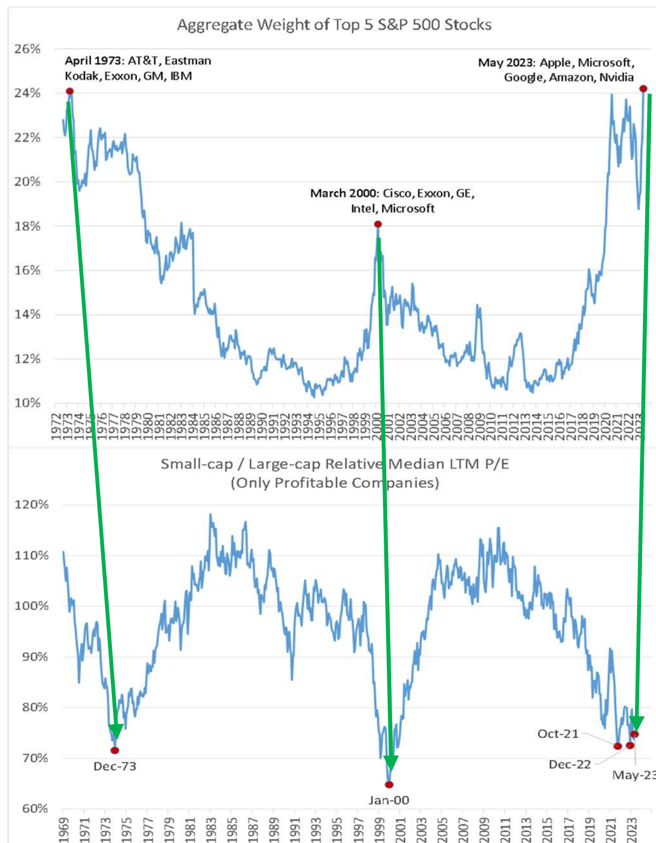
Source: Furey Research Partners and FactSet. Based upon our capitalized loss earnings model. Data as of 5/12/23

This has been one of the longest losing streaks for Small caps

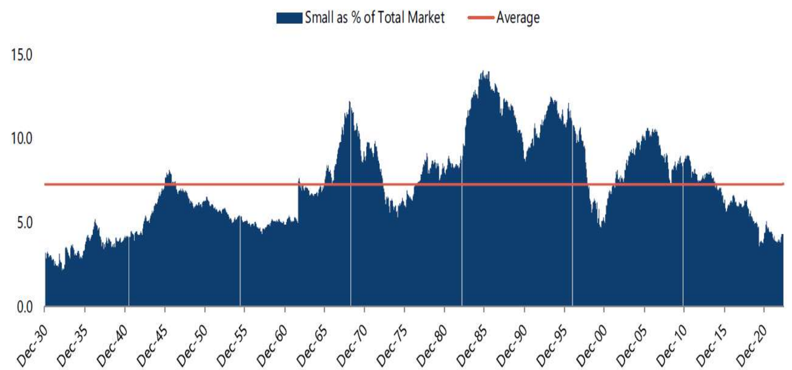
Period	Length	Small Caps		Large Caps		Relative Performance		1Yr Subs Relative Perf		3Yr Subs Relative Perf		5Yr Subs Relative Perf	
	(In Years)	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized
Jan. 1926 to May 1932	6.3	-81.8	-23.6	-52.6	-11.1	-61.6	-14.0	82.2	82.2	65.5	18.3	144.7	19.6
Feb. 1937 to June 1939	2.3	-48.1	-24.5	-27.7	-13.0	-28.2	-13.2	8.8	8.8	26.2	8.1	81.2	12.6
May 1946 to June 1949	3.1	-35.4	-13.2	-12.6	-4.3	-26.1	-9.3	2.7	2.7	1.6	0.5	-4.6	-0.9
Dec. 1968 to Dec. 1973	5.0	-41.5	-10.2	11.8	2.3	-47.7	-12.2	2.2	2.2	51.1	14.8	112.2	16.2
July 1983 to Oct. 1990	7.3	35.9	4.3	149.3	13.4	-45.5	-8.0	22.2	22.2	40.6	12.0	27.0	4.9
Feb. 1994 to Mar. 1999	5.1	79.1	12.1	219.0	25.6	-43.9	-10.7	23.9	23.9	63.9	17.9	98.3	14.7
Feb. 2014 to Jan. 2016	1.9	-14.4	-7.8	7.3	3.7	-20.2	-11.1	13.3	13.3	5.2	1.7	7.8	1.5
Dec. 2016 to May 2023?	**6.4**	**52.1**	**6.8**	**108.9**	**12.2**	**-27.2**	**-4.8**	**?**	**?**	**?**	**?**	**?**	**?**
Average (Excludes Current)	**4.7**	**-6.8**	**-7.0**	**50.4**	**3.6**	**-39.0**	**-11.2**	**22.2**	**22.2**	**36.3**	**10.5**	**66.7**	**9.8**

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

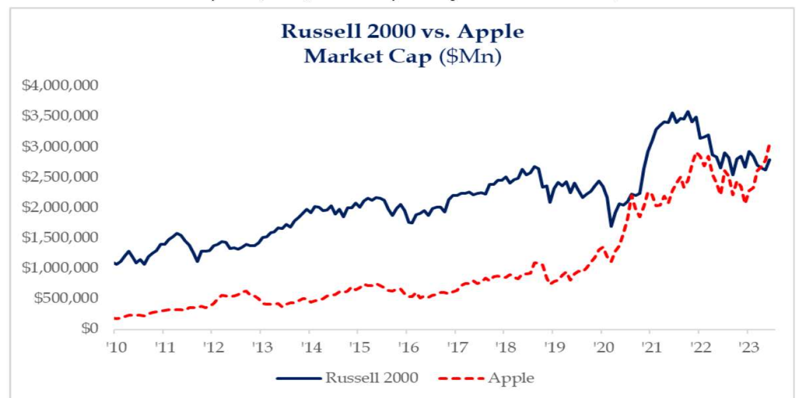
Looking at valuations on a P/E (price to earnings ratio) basis, small caps appear exceptionally attractive from an historical basis. The two charts below left that are stacked on each other show an interesting symmetry, and we tried to align the red dots on each chart which indicate key turning points in the performance of small caps relative to large caps. The top chart shows the weight of the top five stocks in the S&P 500, and the bottom chart shows relative P/E ratios of large caps versus small caps. This setup shows that the relative P/E ratio between large and small caps has rarely been this low. Note the red dots or inflection points that occurred in 1973, 2000, and again recently. Interestingly, the valuation and the weight of the largest stocks peaked at nearly the same time which ignited a changing of the guard and the start of a new small cap cycle. We believe that is where we are currently. The top chart on the right shows that small caps as a percentage of the total U.S. stock market has fallen to 4.3% recently versus an average weight of 7% through the last 90 years. This drop can be explained partially by the chart below right which shows that for the first time in history, a single stock's market cap (Apple at $3 trillion) is now larger than the entire market cap of the Russell 2000. The total market value of the top five stocks in the S&P 500 is enough to buy the entire Russell 2000 three times over. Therefore, even small shifts out of these mega-caps can be a big boost for small caps. It would take only two basis points of market cap to shift out of the top five stocks to buy the average stock in the Russell 2000. However, in order for that to happen, these mega cap tech stocks need to falter slightly. However for the time being, the "Magnificent 7" has some powerful trends behind them like A.I.



Source: Furey Research

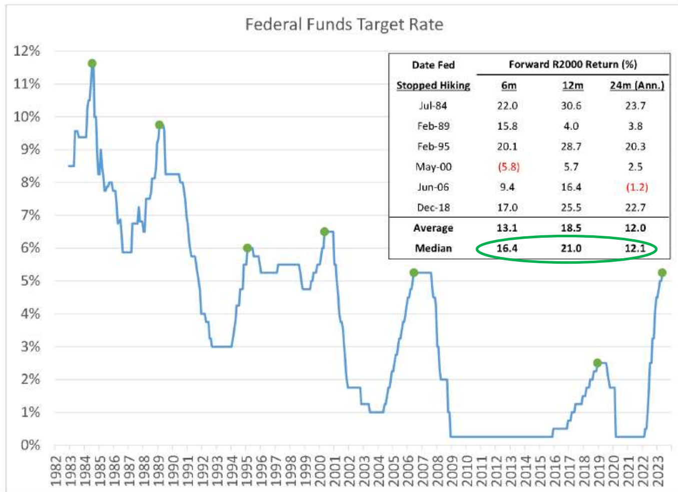


Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies



Source: Strategas

While valuation alone won't start a new small cap cycle, other influences like the Fed and interest rates can certainly change the tide. The chart below left shows the Fed interest rate hiking cycles throughout time. The table within that chart shows that when the Fed has stopped tightening in past cycles, it unleashed small cap cycles with very strong returns over the next one- and two-year timeframes as shown in the green circle. Whether the Fed does one or two more interest rate hikes, we know that we're getting much closer to the end of this hiking cycle. If our economy happens to fall into a recession as many economists are forecasting as a result of too many Fed interest rate hikes, that change is also a catalyst for small caps to outperform large caps as shown in the table below right. Lastly, in our first quarter newsletter we pointed out that the amount of dry powder held in private equity funds is enormous. As of the end of 2022, it stood at nearly $3.7 trillion and has increased at a 15% compounded growth rate since 2016. Additionally, money market funds are exploding and now total more than $5.2 trillion. The combination of private equity and money market funds could trigger an amazing run in small cap stocks.



Date Fed Stopped Hiking	Forward R2000 Return (%) 6m	12m	24m (Ann.)
Jul-84	22.0	30.6	23.7
Feb-89	15.8	4.0	3.8
Feb-95	20.1	28.7	20.3
May-00	(5.8)	5.7	2.5
Jun-06	9.4	16.4	(1.2)
Dec-18	17.0	25.5	22.7
Average	**13.1**	**18.5**	**12.0**
Median	**16.4**	**21.0**	**12.1**

Source: Furey Research Partners and FactSet. Data as of 3/31/23. Based upon R2000 index returns following the '88/'89, '94/'95, '99/'00, '04/'06, '15/'18 and current Fed hiking periods.

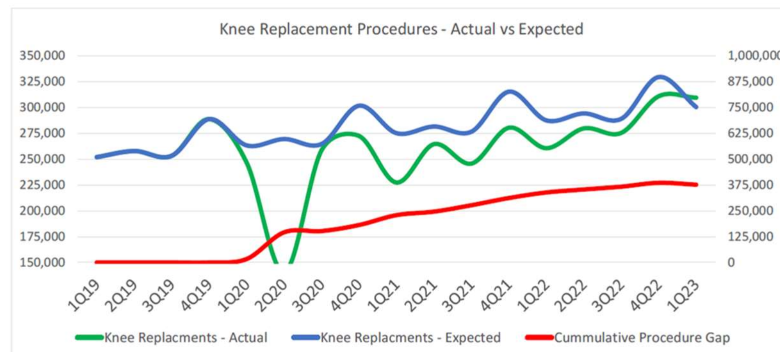
Small-cap Forward Return after GDP Declines in 2 Straight Quarters* (%)

Quarter-end	+1m	+3m	+6m	+12m	+24m	+36m
Jun-49	3.1	11.6	27.0	34.8	33.9	25.8
Dec-53	1.2	4.5	19.1	50.0	32.2	24.3
Mar-58	4.3	13.4	28.2	56.0	22.5	25.6
Mar-70	(10.0)	(9.9)	2.1	41.5	23.4	3.7
Dec-74	4.6	16.9	30.6	51.2	39.3	29.0
Sep-80	7.3	3.2	15.2	4.1	9.3	18.2
Mar-82	(2.8)	(7.8)	18.3	64.8	25.2	20.8
Mar-91	4.8	2.1	9.6	17.1	16.4	15.9
Dec-08	(12.2)	10.5	26.6	37.8	34.6	23.0
Jun-20	5.6	4.2	40.9	52.0	NA	NA
Average	**0.6**	**4.9**	**21.8**	**40.9**	**26.3**	**20.7**
Median	**3.7**	**4.4**	**22.9**	**45.8**	**25.2**	**23.0**
Best	**7.3**	**16.9**	**40.9**	**64.8**	**39.3**	**29.0**
Worst	**(12.2)**	**(9.9)**	**2.1**	**4.1**	**9.3**	**3.7**

*Source: FRP, FactSet; as of 7/28/22; *Assumes the GDP number is reported one month after quarter end. Periods longer than 12m are annualized.*

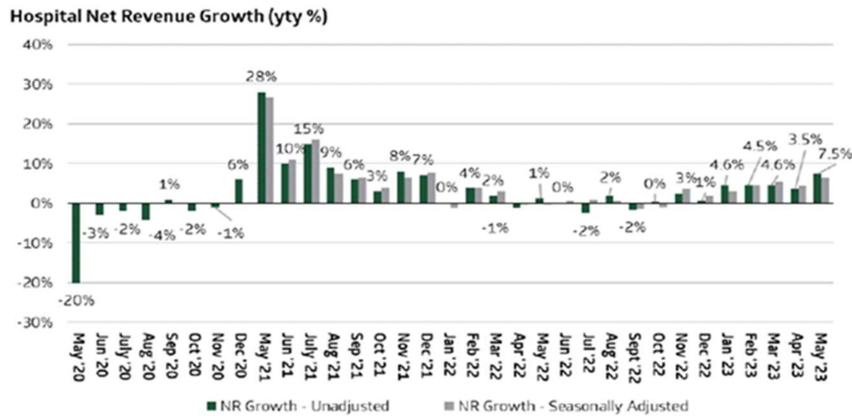
Thematic Investing Update: The Post Pandemic Medical Procedure Recovery is Underway

As many may recall, you had a better chance of locating the Holy Grail during the COVID19 pandemic than receiving an elective medical procedure. While this comment reeks of sarcasm, the pandemic and the priorities and restraints that it precipitated created a massive backlog of medical procedures in the U.S. during this period of lockdown. As it has often been said, a person consumes the bulk of his or her healthcare usage in the later stages of one's life, and consequently the return of the elderly (Medicare) consumer to the elective medical procedure market is a key driver for a reduction in this historic backlog. Interestingly United Healthcare recently commented that the pace is quickening for medical utilization in its Medicare business with outpatient surgeries for items like knees and hips are on the rise along with behavioral health treatments. Goldman Sachs research suggests that roughly 385,000 knee replacements failed to be performed during the 2020-2022 period. As seen in the chart below, the backlog of knee procedures as the red line indicates has finally started to rollover in the first quarter as actual replacements exceeded expected procedures.



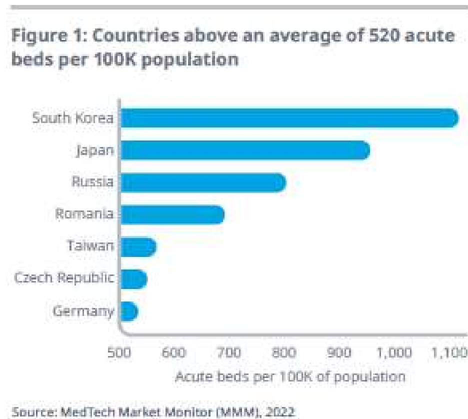
Source: Goldman Sachs Global Investment Research

Goldman Sachs currently estimates that it could take anywhere from two to three years to work through this backlog in the U.S. This scenario provides an attractive profit tailwind for a variety of areas in healthcare like inpatient rehabilitation facilities for post-surgical care, medtech equipment companies with the required surgical hardware, and pharma companies with pain management products. Our 1492 Capital Management strategies have deployed multiple holdings in these previously mentioned areas of healthcare. As seen in the chart below, TD Cowen's recent hospital survey also confirms the commentary from United Healthcare with hospital net revenue growth rising from the 3.5-4.5% year over year growth range to start 2023 to a robust 7.5% growth rate for the month of May.



Source: TD Cowen Hospital Survey, May 2023, [n=312]

Nevertheless, there will be governors on as to how fast this healthcare procedural growth can accelerate as there remains a shortage of hospital beds and of healthcare labor in the U.S. Based on research from MedTech Market Monitor, the U.S fails to make the top seven nations for countries above an average of 520 acute beds per 100,000 population as seen in the chart below.



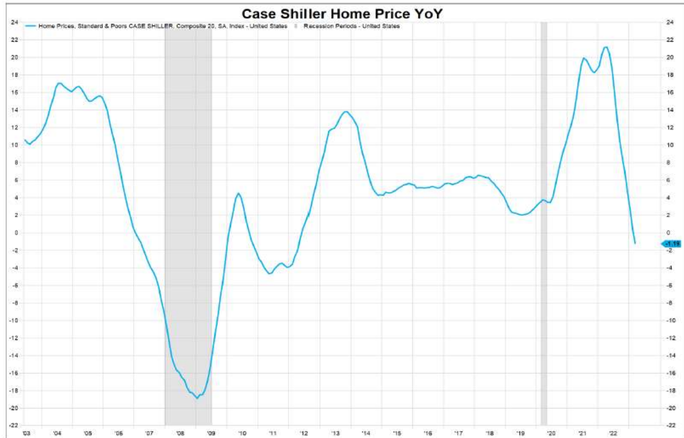
A 2023 roundtable sponsored by the American Society of Anesthesiologists commented on how the industry struggles with a shortage of certified registered nurse anesthetists (CRNAs) and how they often are staffed with 50% travelling nurses in their operating rooms. One professional sited a 40% vacancy rate with their surgical technologists while another is shorthanded with general radiology technologists. Anesthesiologists were cited as the "air-traffic controllers" for surgical procedures. Along with a shortage of hospital beds, these nagging labor inefficiencies are likely to extend the time period needed to exhaust the backlog of medical procedures. As always, where there are shortages, we often find investment opportunities at 1492 Capital Management. With our medical innovations theme that is deployed across our small cap investment strategies, we look to capitalize on additional holdings that can both aid and benefit from this multi-year recovery in medical procedures.

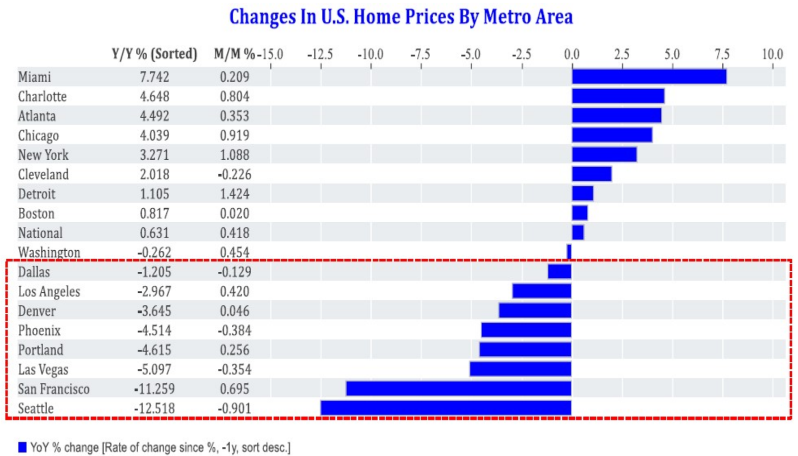
Updated 2023 Outlook: A Picture is Worth a Thousand Words

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

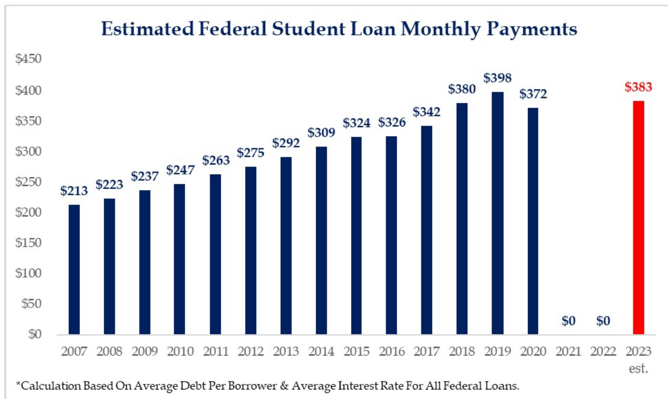
we'll let you interpret what we view as some compelling charts. We'll provide a bullet point or two of explanation as to why we think the chart or graphic is important.

Home prices spiked during COVID as shown on the left but have been in a free fall since the Fed started their rate hiking cycle. Home values across the country are starting to roll over, particularly on the west coast.





The U.S. Supreme Court recently overturned Biden's plan to forgive student loan debt. The chart on the left shows that the average monthly payment is $383 per month, and once payments start again in September, it could be a $180 billion headwind for the economy. Retailers most exposed to consumers with student loans are shown in the table on the right.



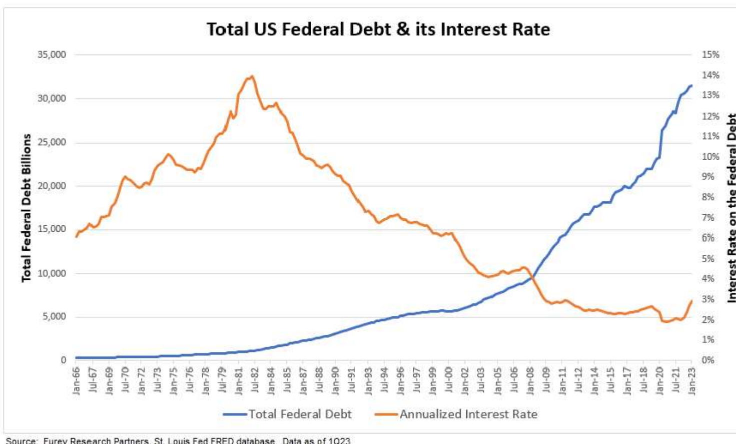
Source: Strategas

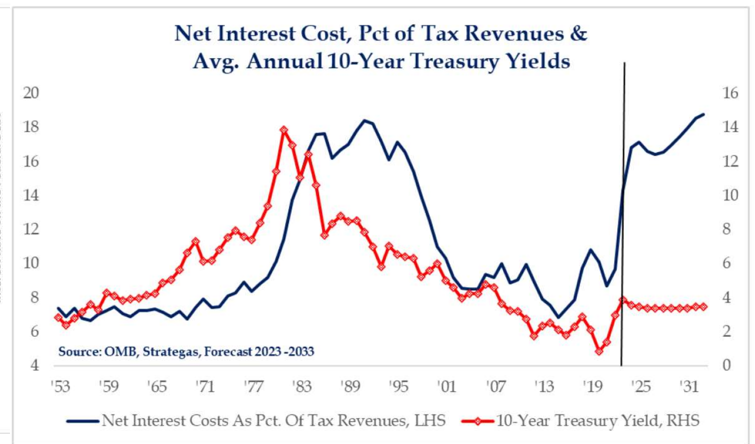
Chart 1 - Retailer Rank of Exposure to Consumers With Student Loan Balances Who Expect Monthly Payments to Resume When the Pause Ends

Rank	Retailer	% of Spend	Size Adj. Rank
1	Amazon	18.58%	1
2	Walmart	11.76%	6
3	Target	5.96%	3
4	Costco	4.24%	7
5	TJX Companies	2.23%	2
6	Sam's Club	1.16%	8
7	Dollar Tree	0.82%	5
8	Dollar General	0.50%	9
9	BJ's	0.13%	11
10	Five Below	0.12%	4
11	Ross	0.09%	12
12	Ollie's	0.02%	10

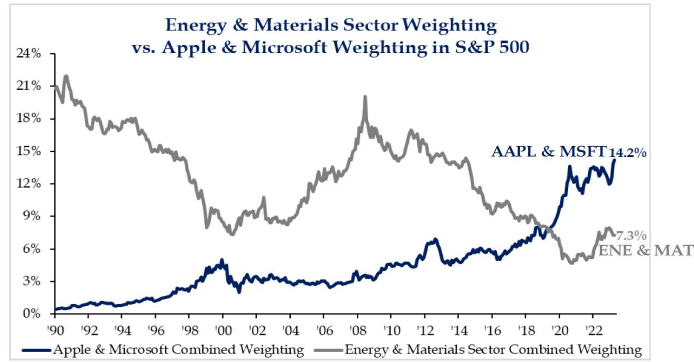
Source: Numerator, FactSet, Jefferies

The charts below show the U.S. Federal debt and the interest cost on this pile of debt. As the Fed has hiked rates, the cost to the U.S. government is growing rapidly, and the interest expense on the debt is expected to reach 15% of tax revenues.



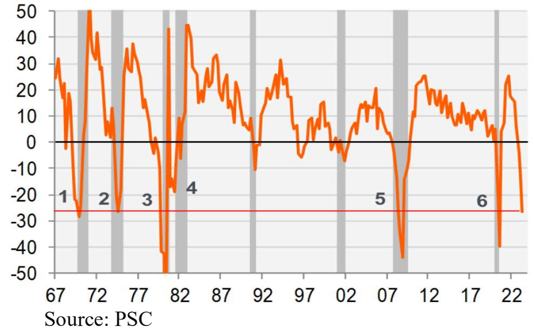


Apple's and Microsoft's weight in the S&P 500 is now 14.2% and is nearly double the combined weight of the entire Energy and Materials sectors within the S&P 500. A true change of the guard has occurred over the past few decades.



Source: Strategas

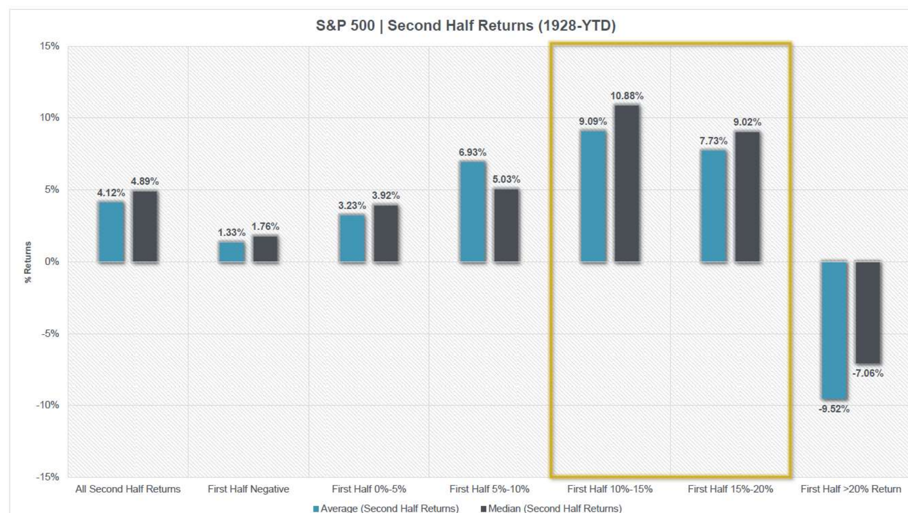
Banks are tightening up on credit. When they've tightened in prior cycles, the economy was already in recession or very close.



Source: PSC

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 second half of the year returns for the stock market as we're at the halfway point. The chart below shows that when the S&P 500 is up between 10% and 20% in the first half of the year as it is this year (S&P 500 is +16.9% in first half 2023), the second half of the year tends to be quite strong. The area of the chart highlighted in gold is the average and median performance for the second half of the year when returns in the first half are very healthy. If history repeats, then the median return for the second half of 2023 could approach +9%. That move would be a pretty good year despite higher rates and a lot of hand wringing over a slowing economy.



We hope that you found our second 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.

Kathleen Daley Adam France Joe Frohna Nancy Frohna Tim Stracka

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