1492 CAPITAL MANAGEMENT
DISCOVERING OPPORTUNITY
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INDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY

1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management's newsletter for the third quarter of 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 have tremendous 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.

Soft Landing Narrative Runs Headfirst into the Fed's Higher for Longer

Everything was going along quite nicely as the third quarter began and the market started to believe that a soft landing for the U.S. economy could be achieved despite one of the most aggressive tightening cycles in history. Inflation (CPI) had retreated from its peak rate of +9.1% in June 2022 to 3% in June 2023, and there appeared to be plenty of evidence that the Fed may have achieved the mythical unicorn status for financial markets - the elusive economic soft landing - often talked about but rarely seen. July's stock market performance was strong as investors cheered what appeared to be a successful mission to bring inflation under control without dismantling the economy. By July's end, the S&P 500 and NASDAQ Composite had posted five consecutive months of positive performance following the collapse of several banks in March, which had the market trembling for a time. However, armed with a rationale that we still don't comprehend, the Fed ratcheted up their hawkish rhetoric at the August FOMC meeting despite leaving interest rates unchanged and forecasted at least one more 25 basis point hike before they stand down. They also removed two forecasted rate cuts in 2024 that had been embedded in their prior dot plots of interest rate forecasts. This change subsequently sent the stock and bond markets on a downward trajectory as interest rates climbed over 100 basis points from their May low and did so in the seasonally weakest part of the calendar. Even the "Magnificent 7" stocks retreated, which added more fuel to the fire. We believe that the Fed has raised rates too fast and that many economic signs of weakness are beginning to appear and will worsen if the Fed continues down its forecasted path. The inflation metric that Fed Chair Powell continues to highlight as FOMC's north star, core PCE, also declined to 3.9% year-over-year in August. This metric has one major flaw which is the housing component that distorts the overall PCE metric as there is nearly an 18-month lag in how it's computed. This lag is particularly relevant now when owner-equivalent rent is falling meaningfully.

As a prelude to Halloween, the Fed's posture spooked the markets, which finished the quarter in the red with the S&P 500 and Russell 2000 falling by -3.3% and -5.2%, respectively. The saving grace is that all of the major indices remain in positive territory year-to-date with the NASDAQ Composite holding a commanding lead thanks to the "Magnificent 7".

In the balance of this newsletter, we'll discuss the state of the economy, our updated case for small caps, and what impact higher rates 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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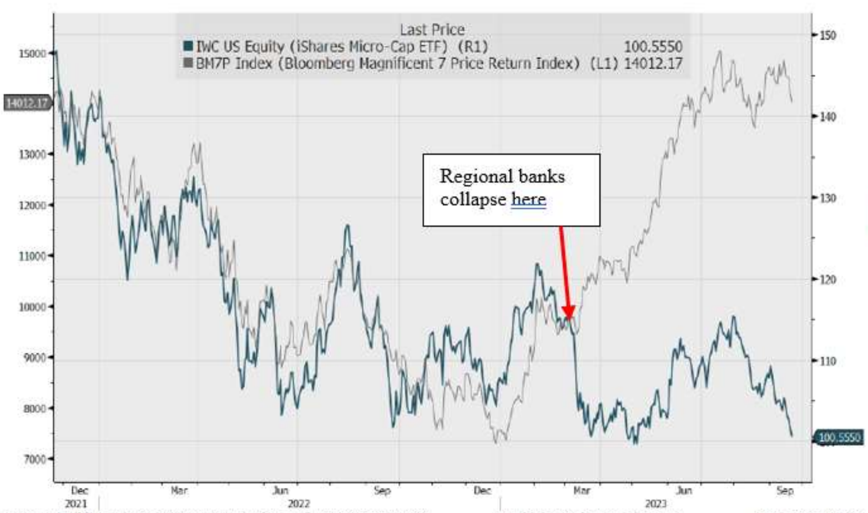
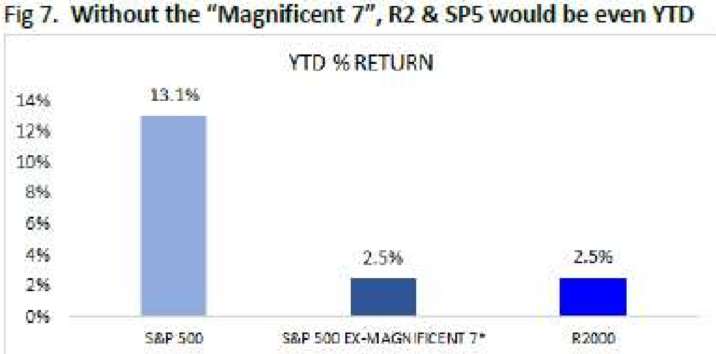
A Review of the Quarter: Soft Landing Narrative Runs Headfirst into the Fed's Higher for Longer

Everything was going along quite nicely as the third quarter began and as the market started to believe that a soft landing for the U.S. economy could be achieved despite one of the most aggressive tightening cycles in history. Inflation (CPI) had retreated from its peak rate of +9.1% in June 2022 to 3% in June 2023 and there appeared to be plenty of evidence that the Fed may have achieved the mythical unicorn status for financial markets- the elusive economic soft landing- often talked about but rarely seen. July's stock market performance was strong as investors cheered what appeared to be a successful mission to bring inflation under control without completely dismantling the economy. By July's end, the S&P 500 and NASDAQ Composite had posted five consecutive months of positive performance following the collapse of several banks in March, which had the market trembling for a time. However, for a rationale that we still don't comprehend, at the August FOMC meeting, the Fed ratcheted up their hawkish rhetoric despite leaving interest rates unchanged and forecasting at least one more 25 basis point hike before they stand down and removed two forecasted rate cuts in 2024 that had been embedded in their prior dot plots of interest rate forecasts. This subsequently sent the stock and bond markets on a downward trajectory as interest rates rose over 100 basis points from their May low, into the seasonally weakest part of the calendar. Even the "Magnificent 7" (AAPL, AMZN, GOOGL, MSFT, NVDA, TSLA, META) stocks retreated, which added more fuel to the fire. The market's change in sentiment along with higher rates caused one of the worst two-month selloffs in history. The chart below left shows the performance of the "Magnificent 7" compared with the Microcap index over the past two years. Interestingly, the two indices were tracking together up until March 2023 when several banks collapsed. This collapse caused an apparent shift to perceived high-quality stocks and an exodus from small/ microcap stocks. Small caps rallied while the "soft landing" narrative was in vogue, but it was short-lived as the chart shows and they retrenched back to their May low during the August/September selloff. The chart on the right shows year-to-date comparisons for the various indices and the "Magnificent 7". The performance numbers are ranked from largest market caps to smallest and bear out the massive bias to large-cap performance by the "Magnificent 7". Performance from 2014 is shown as a comparison as the largest Nasdaq stocks had a similarly strong run that year, but other asset classes also participated. Lastly, the third chart below shows that the year-to-date returns for the S&P 500 and Russell 2000 would have been nearly identical if not for the performance of the "Magnificent 7".



	2023*	2014
Index	YTD Return	Return
Average Magnificent 7**	87%	N/A
Median Magnificent 7**	50%	N/A
Nasdaq 100	34.40%	17.94%
Median NDX 100	18.30%	20.79%
S&P 100	17.77%	10.27%
S&P 500	11.99%	11.39%
Russell 3k	11.34%	10.45%
S&P 1500	11.18%	10.88%
S&P 400	3.55%	8.19%
Median S&P 500 Stock	1.07%	16.24%
Equal-Weight S&P 500	0.58%	12.35%
Median S&P 1500 Stock	0.14%	8.79%
S&P 600	0.14%	4.44%
Median S&P 600 Stock	-1.67%	4.23%
Median R3k Stock	-2.24%	6.85%
Micro-Cap	-6.89%	2.48%

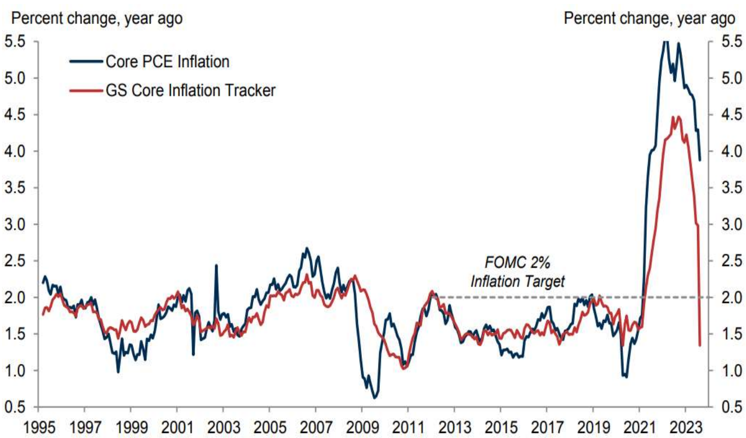
Fig 7. Without the "Magnificent 7", R2 & SP5 would be even YTD



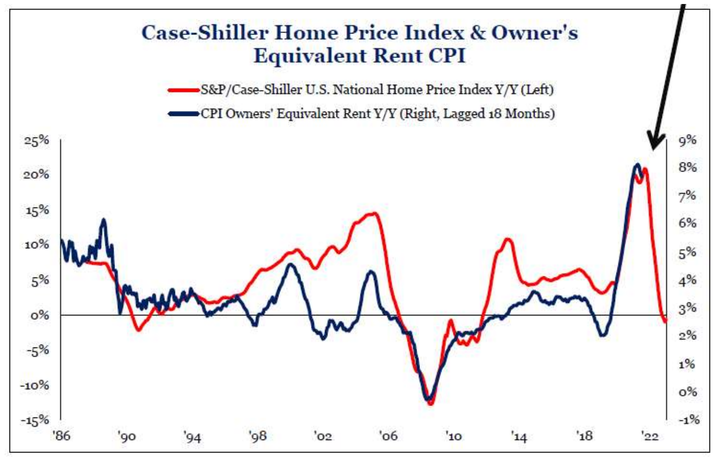
*Source: Furey Research Partners and FactSet. *Magnificent 7 are Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla and Meta. Data as of 9/30/23.*

The S&P 500 is up 13.1% YTD and outperforming small-caps by a sizeable margin. But almost all of that outperformance is due to the "Magnificent 7" which are up 55% YTD led by NVDA's near 200% gain. Without those seven stocks, the R2000 would be running even with the S&P 500 YTD.

We believe the Fed has raised rates too fast and that many economic signs of weakness are beginning to appear and will worsen if the Fed continues down its forecasted path. The inflation metric that Fed Chair Powell continues to highlight as the FOMC's north star, the core PCE metric, also declined to 3.9% year-over-year in August (Blue line on the chart below left). This metric has one major flaw: the housing component, which distorts the overall PCE metric as there is nearly an 18-month lag in this component, particularly now when owner equivalent rent is falling meaningfully as shown by the red line in the chart below right. This calculation anomaly artificially inflates the PCE statistic when there are such large swings in the cost of housing over relatively short periods. Goldman Sachs does an alternative PCE computation using current "owners' equivalent rent" (housing costs) and that is shown as the red line on the chart on the left. This computation indicates that the Fed would have already achieved their 2% core PCE target if their calculations used current housing data.

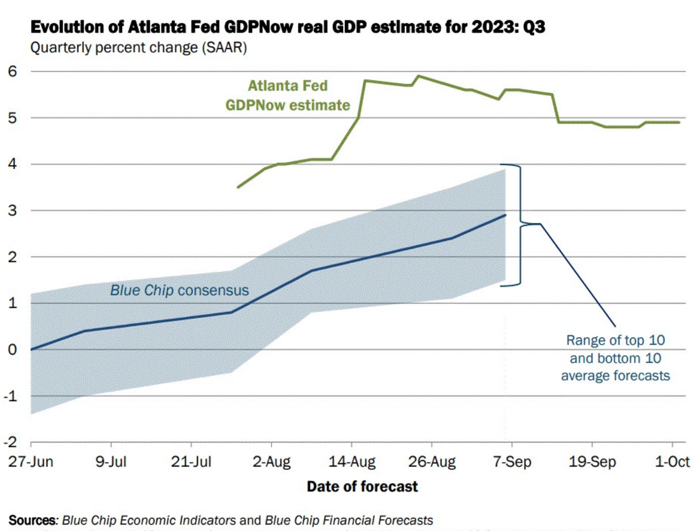


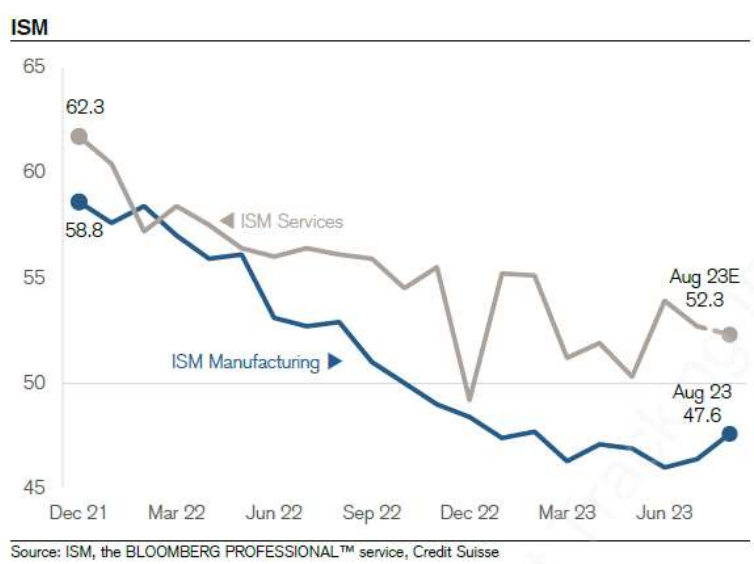
Source: Strategas



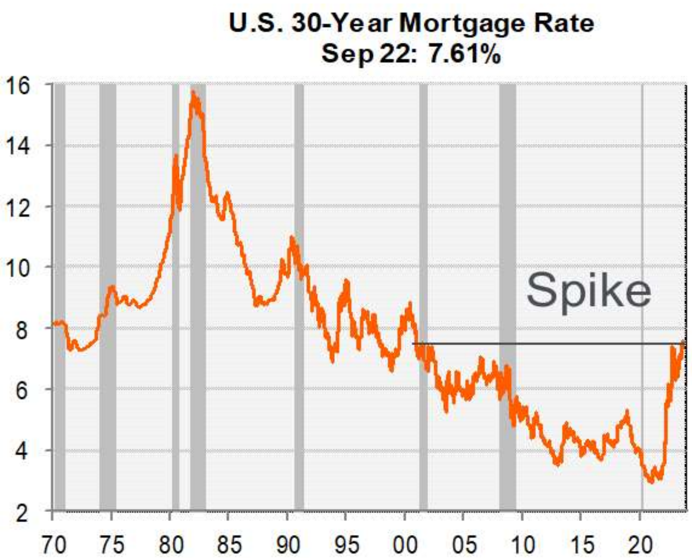
Source: Strategas

So, the question is "What spooked the Fed into sending the higher for longer message?" We surmise that in part, it was the Atlanta Fed's GDPNow statistic which is readily accessible on their website and represents their best guess at what GDP growth is in real time. In the chart below left, the green line represents the GDPNow estimate for the third quarter. Note that it began dramatically accelerating in early August before plateauing in late August at nearly +6% growth and then retreated slightly through the end of September. This estimate compares with current consensus estimates of about +2.5% GDP growth. Therefore, it's possible they saw this acceleration and wanted to tamp that down quickly before inflation was able to take off again. The chart on the right shows the ISM manufacturing and services purchasing managers indices. A value below 50 denotes shrinking. Note that manufacturing has been below 50 since late last year and the services component (restaurants, travel, consumer services) has been decelerating and is rapidly approaching 50. In fact, the two indices are hovering right around 50 as of the September reading. We believe that the recent acceleration may be due to seasonal effects where companies build inventory in front of the Christmas buying season. With low inventories across multiple industries, the orders coming through may reflect inventory replenishment and provide a cushion in advance of strikes that were well-telegraphed in the auto industry for example.





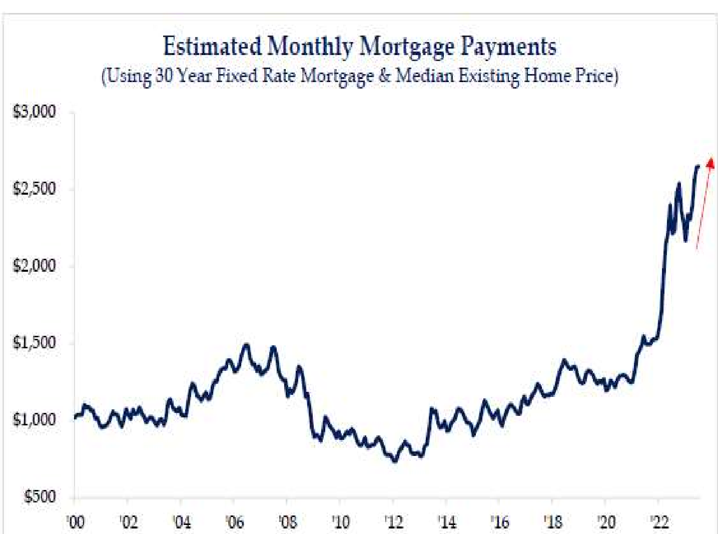
We mentioned the housing component above as it relates to inflation and the PCE computation. However, with interest rates pushing near 8% for a 30-year mortgage as I write this newsletter, the housing industry could be in for a hard landing of its own. This industry is a key cog in the U.S. economy and composes a significant portion of GDP when you include all the components. Up until the recent spike in interest rates, the homebuilding industry stocks were some of the best-performing in the entire stock market in 2023. The thesis was that as long as rates didn't go too high, demand should stay relatively healthy with a backdrop of a shortage of supply. The higher rates would prevent an overbuilding as banks are pulling back hard on their lending standards which favors large publicly traded builders over "mom and pop" builders. Now that rates have spiked up meaningfully and are back to levels that we haven't seen since 2000 (see chart below left). Housing affordability is rapidly deteriorating as the combo platter of higher rates and tight supply have pushed this metric to a record low as shown in the chart below right.



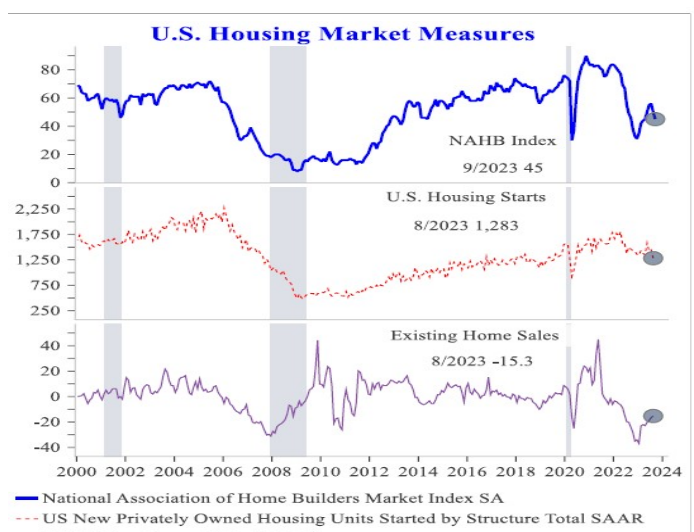
Source: Cornerstone Macro

Source: Cornerstone Macro

The dual impact of higher mortgage rates and home prices that spiked nearly 40% during the pandemic for the median-priced home in the U.S. is pretty eye-opening in real dollar terms as shown in the chart below left. The panel of charts below right shows the NAHB Index (homebuilders sentiment survey), housing starts, and existing home sales since 2000. Note that all three of these statistics have shown a weakening trend since the pandemic peak but has witnessed a more recent bounce. This bounce is possibly due to the spring selling season and the period before rates advanced to current levels of nearly 8% for the 30-year fixed rate mortgage. These bear watching as the homebuilding group is quite sensitive to these movements, and with the strong stock performance of this industry, they could be vulnerable to profit taking. One positive takeaway is that housing starts (middle panel below) remain muted and well below where they were in 2006, and we've been underbuilding relative to household formations for the past 15 years which may provide some demand support even if rates remain elevated.

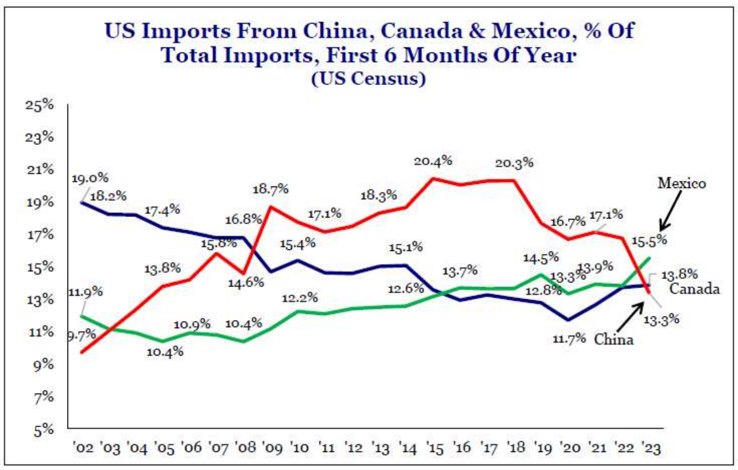


Source: Strategas



Source: Strategas

One topic that seems to have faded from the narrative is China. Late last year there was a consensus view that a great place to invest was in China or China-related plays that would benefit from the reopening of the Chinese economy post the pandemic. However, that rebound has been very muted, and Chinese-related stocks have been some of the worst performers so far this year. A key question is why the Chinese economy didn't rebound as other regions around the world did post the pandemic. This failure is a complex issue but besides all of the back-and-forth trade sanctions of the past few years, a more meaningful explanation is the Trump administration's tariffs imposed back in 2018 and the reshoring or near-shoring to locations much closer to the U.S. to avoid supply chain issues that plagued almost every goods-producing company during the pandemic. The chart below left shows that the percentage of imported goods into the U.S. from China has declined from 20.3% to just 13.5% since 2018. Not coincidentally, 2018 is when the Trump tariffs were implemented. Clear beneficiaries have been both Mexico and Canada as their share of imports into the U.S. have grown markedly over the same timeframe. China may have also been slow to enact stimulus measures as can be seen in the chart below right. Many of the prior stimulus measures that were in place going into the pandemic have expired like those for EV cars and housing. It appears that they are taking measures to get back in the stimulus game as they've lowered interest rates recently, which is going against the grain of nearly every other country around the globe.



Source: Strategas

Source: Strategas

As shown in the table below, the stock market finished the third quarter in negative territory as dramatically higher interest rates weighed on investor psychology. As noted above, small caps ended the quarter in negative territory and relinquished the gains made in June and July. None of the major U.S. indices posted a positive return in the quarter. If you're looking for a silver lining, all of the major U.S. indices are higher on a year-to-date basis. The NASDAQ Composite continues to lead the pack with the outsized exposure to the "Magnificent 7".

Index Returns

Index	Third Qtr. 2023 Return	2023 YTD Return
Russell 2000	-5.13%	+2.54%
Russell 2000 Growth	-7.32%	+5.24%
Russell 2000 Value	-2.96%	-0.53%
S&P 500	-3.27%	+13.07%
Dow Jones Industrials	-2.62%	+1.09%
NASDAQ Composite	-3.94%	+27.11%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (-7.3%) trailed the Russell 2000 Value Index (-3%) for the quarter. There was an interesting dynamic that occurred during the quarter as it relates to the healthcare sector. The explosion in the use of GLP-1 drugs (more on this in the section below entitled *"GLP-1's Are Being Heralded as Healthcare's Latest "Silver Bullet""*) which are aimed at treating Type 2 diabetes and obese patients, became all the rage. In typical Wall Street fashion, stocks in nearly every healthcare specialty area that treats chronic disease of any kind were assumed to be going out of business as our society was somehow going to become fit and healthy overnight. In difficult market environments, the healthcare sector typically shines because patient demand tends to be stable even in a bad economy. However, in the third quarter, it wasn't the case as the Healthcare sector (-15.1%) was the worst-performing sector in the Russell 2000 by a wide margin. Bond proxies like Utilities and Real Estate were also dismal performers in the quarter as these sectors generally perform poorly in rising rate environments.

The market seems content to get yield from money market funds and Treasury securities. The best-performing sector in the quarter by a country mile was Energy (+18.7%) which benefited from a surge in oil prices during the quarter on OPEC supply constraint and stronger growth. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the third quarter and year-to-date 2023. The second table below shows that there continues to be a significant market cap skew in the quarter and year-to-date as the 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	**September**	**3Q23**	**YTD**	**September**	**3Q23**	**YTD**	**September**	**3Q23**	**YTD**
Com Serv	-6.0	-7.5	-1.2	-4.5	-9.1	3.2	-7.1	-6.3	-5.0
Discretionary	-7.1	-5.8	8.6	-7.1	-6.6	6.0	-7.1	-5.0	11.5
Staples	-5.3	-2.9	5.7	-6.9	-3.5	12.8	-2.6	-1.9	-6.5
Energy	2.4	18.7	18.6	1.8	19.0	17.3	2.7	18.5	22.1
Financials	-4.7	1.2	-8.6	-3.3	2.0	7.1	-5.0	1.0	-12.0
Health Care	-9.1	-15.1	-7.2	-8.9	-14.8	-3.6	-9.5	-16.0	-15.3
Industrials	-5.0	-5.2	12.2	-5.5	-6.1	10.9	-4.4	-3.9	14.0
Info Tech	-8.3	-9.2	10.8	-7.8	-8.4	10.8	-9.9	-11.8	11.1
Materials	-5.8	-6.1	2.3	-7.9	-9.8	-0.7	-4.0	-3.0	4.7
Real Estate	-6.7	-5.5	-2.1	-7.7	-9.6	-3.7	-6.6	-4.9	-2.0
Utilities	-6.0	-11.7	-13.7	-7.7	-12.0	-10.1	-5.4	-11.7	-14.9

	September			Third Quarter			YTD			
Size Quintile	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Absolute**	**Contribution**	**Relative**	**Wgt**
1 (Largest)	-5.50	-3.05	0.38	-4.49	-2.50	0.64	4.86	2.31	2.32	55.4
2	-5.90	-1.38	-0.02	-4.08	-0.95	1.05	1.89	0.51	-0.65	23.4
3	-6.66	-0.85	-0.77	-6.61	-0.83	-1.48	2.92	0.47	0.38	12.6
4	-6.51	-0.39	-0.62	-9.62	-0.58	-4.49	-8.47	-0.46	-11.00	6.0
5 (Smallest)	-8.73	-0.23	-2.85	-10.15	-0.26	-5.02	-11.26	-0.28	-13.80	2.6

Returns in the international markets were generally weak except for India which may be a beneficiary of China's downturn. As mentioned above, the Chinese economy hasn't rebounded as robustly as anticipated following the end of the COVID lockdowns. 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 year to date. The recent increase in longer-dated interest rates pushed bond prices lower, which made fixed income investments one of the worst-performing asset classes during the third quarter. In line with ongoing economic concerns and the Fed's aggressive posture, volatility significantly increased in the third quarter. Commodities were generally a mixed bag, but crude oil rebounded after being pounded over the prior six months.

Index	Third Qtr. 2023 Return	2023 YTD Return
France	-3.4%	+13.4%
Germany	-4.7%	+10.5%
Brazil	-1.3%	+6.2%
India	+3.4%	+8.3%
China- A Shares	-2.6%	-1.8%
China- Shenzhen A Shares	-6.8%	-3.3%
Japan	-3.3%	+24.5%
Long-Term Treasuries (TLO)	-12.5%	-9.9%
Investment Grade Corp Bonds	-2.9%	+0.7%
Gold	-3.3%	+2.2%
Volatility- VIX index	+28.9%	-19.2%
Oil	+28.5%	+13.1%
Natural Gas	+5.6%	-28.6%
Lumber	-5.6%	+1.0%

Source: 1492 Capital Management, LLC

Updated 2023 Outlook: GLP-1's Are Being Heralded as Healthcare's Latest "Silver Bullet"

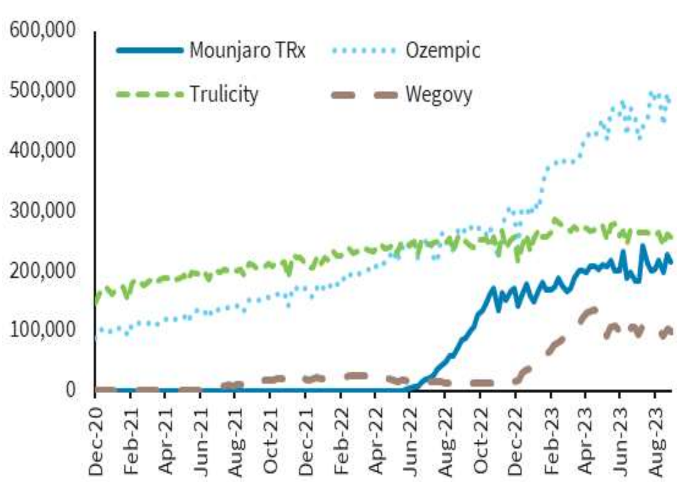
First, let's define what GLP-1's are: GLP stands for Glucagon-like peptide receptor agonists and not the "Get Less Patients" that one Wall Street analyst has coined. Interestingly, GLP-1's have been around since 2005 when the first one was approved for the treatment of Type 2 Diabetes. According to Jefferies, they work by increasing the amount of insulin secreted by the pancreas (which lowers blood sugar) and by suppressing the release of glucagon (which causes the liver to produce sugars), which in combination help to manage Type 2 diabetes and functionally reduce appetites. However, it wasn't until 2017 when Semaglutide was approved for Type 2 diabetes and subsequently approved for an indication for weight loss in 2021. A recent study showed it also improved cardiovascular risk, which caught the attention of patients and doctors alike. The GLP-1 drugs that are currently approved are shown in the chart below. You've probably seen the commercials for Ozempic, Rybelsus, and Mounjaro over the past several months as they appear to have bigger ad budgets than Coke or McDonalds. While these three are only currently approved for the treatment of Type 2 diabetes, they are all pursuing approval for chronic weight management. Rybelsus is essentially Ozempic in the form of a pill rather than an injection. Novo Nordisk manufactures both, and they have the same active ingredient, Semaglutide. The injectables come with more active ingredients over time which can accentuate the effectiveness in weight loss. Despite Wegovy being the only approved GLP-1 for chronic weight management, the other GLP-1's appear to be generating tremendous use off-label for weight loss. There are nearly 40 million Americans with Type 2 diabetes, and 40% of U.S. adults are considered obese currently. Many of these patients haven't been introduced to the drug class yet.

Current FDA-approved GLP-1 agonists*

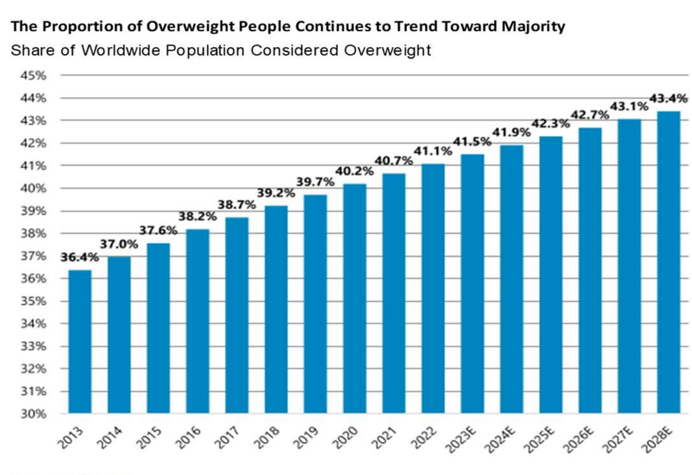
Drug	Manufacturer	FDA approval year	Indication
Ozempic (semaglutide)	Novo Nordisk	2017	Type 2 diabetes
Rybelsus (semaglutide)	Novo Nordisk	2019	Type 2 diabetes
Wegovy (semaglutide)	Novo Nordisk	2021	Chronic weight management
Mounjaro (tirzepatide)	Eli Lilly	2022	Type 2 diabetes

Source: PitchBook • Geography: Global
*As of September 29, 2023

The public enthusiasm for GLP-1 use as a weight loss or management treatment is unbridled at this point, and celebrity and influencer posts on social media are promoting how much weight they lost after taking a GLP-1. Not only has it been fueled in this fashion, but the pharmaceutical companies' medical trials that have been reported have also been extremely positive and demonstrate weight loss in many instances that range from 15% to 30%+ of total body mass over time. Some doctors have reported seeing some morbidly obese patients lose 60% of their body weight in combination with bariatric surgery. Recently, Novo Nordisk announced that Wegovy showed a 20% decline in major adverse cardiovascular events. This study exacerbated already optimistic expectations for the GLP-1 drugs on Wall Street. A dramatic increase in the use of all of these drugs as shown in the prescription trends over past year as shown in the chart below left reflects this optimism. The number of obese people around the globe continues to grow unchecked and is almost approaching a majority of the global population as shown in the chart below right. Thus the market potential is enormous and is currently estimated to be a $25 billion market today that could grow to be in excess of $100 billion by 2030.



Source: Jefferies



Clearly, there is a reason for optimism with the groundbreaking results these drugs are producing, but in typical Wall Street fashion, investors have immediately assumed that GLP-1's will cure obesity, diabetes, and cardiovascular issues associated with obesity. As a result, investors have pummeled nearly every stock associated with diabetes like continuous glucose monitors and insulin pumps (the diabetes group was down -40% in the third qtr. alone), bariatric surgery, and sleep apnea. They are even going as far as assuming orthopedic companies that replace hip and knee joints will see far less business over time as a thinner, healthier population won't require these procedures anymore. The SPDR Healthcare ETF sank 21% during the months of July and August alone. A counterargument could be that the thinner, healthier population would be more active, live longer, and require more joint replacements over time.

As we mentioned earlier, the Healthcare sector was the biggest loser during the quarter at -15.1% within the Russell 2000 Index. However, there are several serious problems with the bullish assumptions being made. First, it will be many years before these drugs will be available to everyone in the diabetic or obese populations. This delay is due to a number of issues, with the biggest being insurance coverage. Currently, about 16 million lives are covered under the Type 2 diabetes category, however, insurance isn't covering the obesity category yet. This fact makes the out-of-pocket cost the key hurdle, and at a monthly cost to the patient of between $1,000 and $1,500 per month, this expense puts the treatment out of reach for a significant part of the population. Many plans under the Affordable Care Act currently exclude coverage for obesity and weight loss treatment due to these plans' sensitivity to premium increases. Additionally, Medicaid which is administered at the state level and contains the most applicable population that is susceptible to obesity, doesn't currently cover GLP-1's for obesity. Lastly, Medicare can't cover it until sometime in 2027 due to regulations put in place in 2003 which prohibited this body from covering drugs for weight loss. Several health plans and self-insured companies have taken the GLP-1's off of their formulary because of skyrocketing costs to their plans. It will be interesting to see how long it takes for health plans to cover these costs in exchange for lower costs down the road due to a healthier population. This transition will likely take 3-5 years for the data to prove that there is a long-term benefit that reduces total healthcare costs. The table below shows the national revenue results for a significant part of the healthcare system (hospitals and outpatient clinics) in the U.S. As the column boxed in green depicts, the year-over-year costs haven't shown any declines as of yet. In the meantime, we fully expect the prescription trends for GLP-1's to continue to increase for the foreseeable future.

National Revenue Results

Revenue % Change	Month-Over-Month	Year-Over-Year	YTD 2023 vs. YTD 2022	YTD 2023 vs. YTD 2020
Net Operating Revenue	8.0%	6.0%	6.0%	21.0%
Gross Operating Revenue Less CARES	9.0%	8.0%	9.0%	32.0%
Inpatient (IP) Revenue	4.0%	4.0%	4.0%	17.0%
Outpatient (OP) Revenue	12.0%	10.0%	12.0%	47.0%
IP/OP Adjustment Factor	4.0%	3.0%	4.0%	10.0%
NPSR per Adjusted Discharge	-1.0%	0.0%	0.0%	8.0%
NPSR per Adjusted Patient Day	3.0%	4.0%	4.0%	6.0%
Bad Debt and Charity	-1.0%	2.0%	3.0%	-4.0%
Bad Debt and Charity as % of Gross	-9.0%	-5.0%	-5.0%	-28.0%

Source: Kaufman, Hall & Associates

Updated 2023 Outlook: The Case for Small Caps Revisited

From our perspective, the stock and bond markets are chasing their proverbial tail. The inconsistencies within the narratives that are being traded on a week-to-week basis are quite maddening. Small catalysts are causing outsized market movements, which reverse a week or two later. Recall how July's narrative was that the U.S. economy was in the midst of a soft landing as inflation was receding as planned. Then, investors expected a rise in oil prices and inflation to return but also a weak U.S. and China economy. Then they expected a U.S. recession but still higher interest rates. Then it was that the last 25 basis point hike that the Fed implied would tip the economy into a recession after nearly 5% of cumulative hikes already. Many of these narratives make absolutely no sense, but it is the market environment of uncertainty that causes short-term swings. This jostling is nothing new in the markets as certainty doesn't exist. However, from our perspective, there are always headwinds and tailwinds, but more recently the headwinds have risen in the collective narrative. Some of the latest headwind additions include strikes in the Auto and Healthcare sectors and others being threatened, a dysfunctional U.S. government in Washington D.C. (not really new), and an expanding deficit due to higher interest payments.

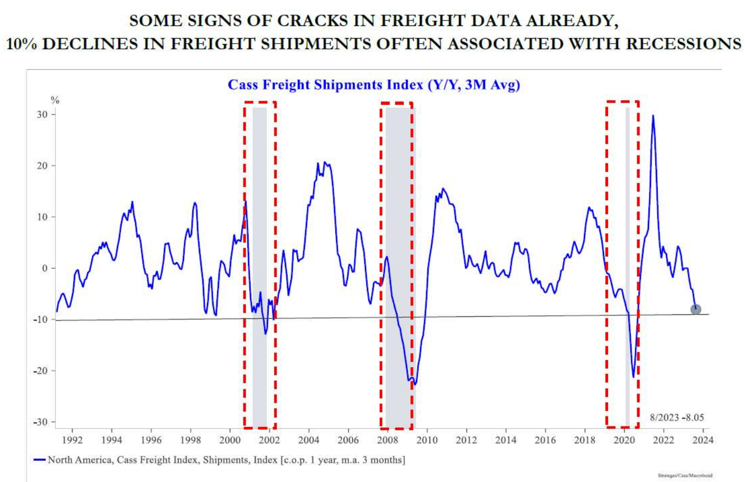
A little over one year ago in our second quarter 2022 newsletter we penned a section of our newsletter called, "Quite Possibly the Best Opportunity in Small Cap Stocks in Decades". The gist of this call was predicated on valuation levels that we hadn't seen in decades, on the underperformance relative to large caps for nearly 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. Many of these things have happened since then like inflation receding faster than most predicted at the time, reshoring has accelerated, and small-caps outperformed- *for a brief period*. 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 about 1050 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 to 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.

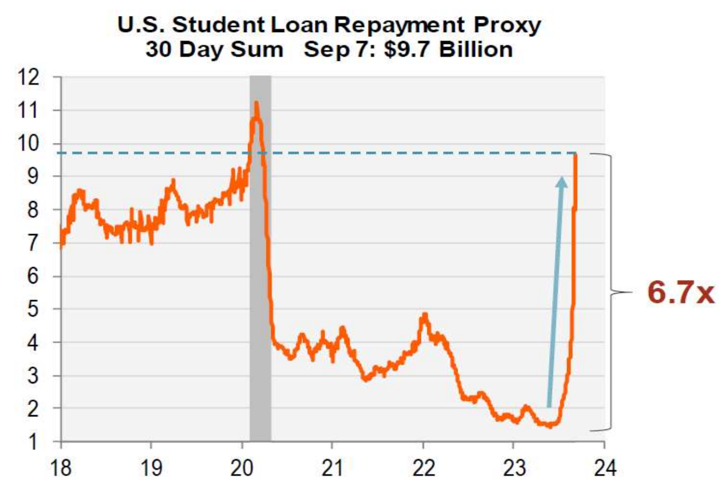
Potential Headwinds to our Forecast

1. Fed continues with its aggressive tightening and rhetoric pushing us into a mild recession. Freight trends are nearing recession level - see chart below left.
2. Geopolitical tensions rise.
3. Corporate earnings decline more than expected as nominal growth slows with inflation.
4. Energy costs rise due to poor policy decisions.
5. Student loan debt repayments lower savings and begin to impact consumer spending trends with a $120 billion annualized headwind- see chart below right.

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. Real uses of Artificial Intelligence provide productivity boosts and enhance corporate margins.
7. Funds from legislation like the Infrastructure Investment and Jobs Act and Inflation Reduction Act are injected into the economy.

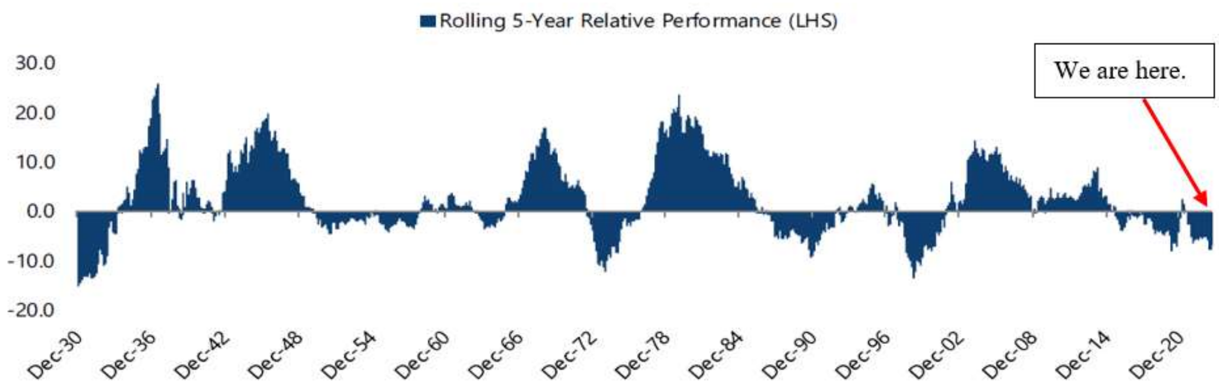




Source: Cornerstone Macro

Now we present the case for small caps. As we stated at the outset, this environment is one that should be favorable for small caps as small caps generally outperform as inflation wanes. However, the fear that the Fed will keep hiking rates is what is keeping the small-cap cycle from taking hold. Small-cap stocks generally have a longer duration earnings stream than large-caps and are more susceptible to higher interest rates when computing their valuation. What do we mean? To demonstrate let's take an extreme example comparing the duration of Proctor and Gamble (large cap) to ABC Biotech (small cap). Proctor and Gamble has a stable earnings stream today with very modest growth prospects out into the future. Whereas ABC Biotech is working on a cancer drug that won't hit the market for at least five years. At which time, it should then see a very rapid growth profile. When a higher interest rate is used to discount the two companies' future earnings streams back to today, Proctor and Gamble's current valuation of those earnings streams is far less affected than ABC Biotech's, which are much further into the future. This comparison is an extreme example to demonstrate duration in equities, but it is very real. This duration is one reason why we believe that there is such a valuation disparity between small and large caps today.

The Fed needs to get out of the way and stop hiking rates in order to catalyze this small-cap cycle in our opinion. Small-cap stocks historically have gone through cycles where they are out of favor on a relative basis to large caps. This idea is what we've seen for much of the last decade as shown in the graph below. When blue lines are below the horizon line, small caps are underperforming. The environment has generally been favorable for large caps due to the low interest rate environment and the emergence of 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 second table below shows the longest losing streaks for small caps through time. This current under-performance period is quite long, but performance emerging from these streaks can be quite powerful in favor of small caps. However, after nearly 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.

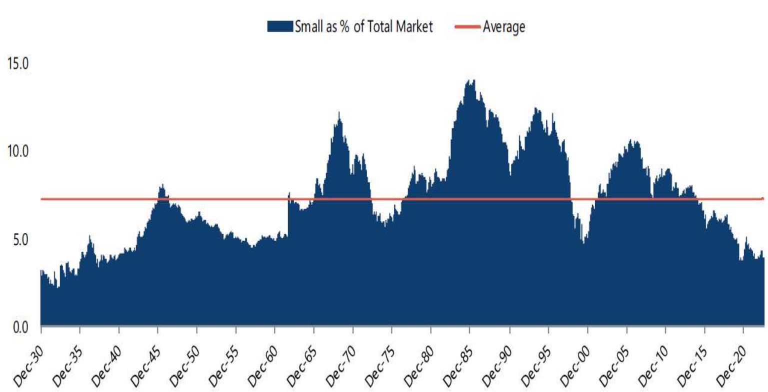


Source: Jefferies

Period	Length (In Years)	Small Caps Cumulative	Small Caps Annual	Large Caps Cumulative	Large Caps Annual	Relative Performance Cumulative	Relative Performance Annual	1Yr Subs Relative Perf Cumulative	1Yr Subs Relative Perf Annual	3Yr Subs Relative Perf Cumulative	3Yr Subs Relative Perf Annual	5Yr Subs Relative Perf Cumulative	5Yr Subs Relative Perf Annual
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**

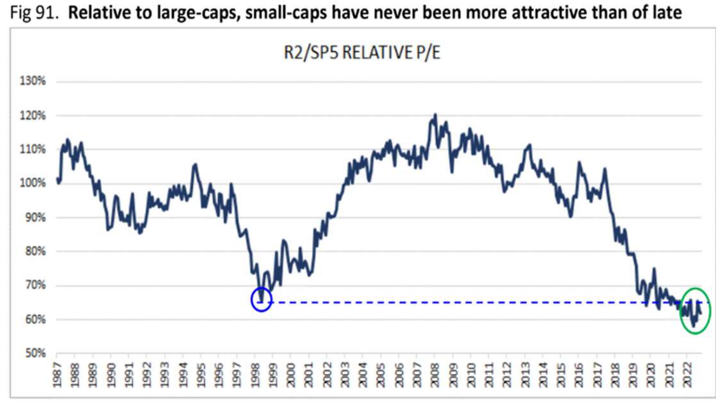
Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

Examining valuations on a P/E (price-to-earnings ratio) basis, small caps appear exceptionally attractive on an historical basis. The chart on the left shows that small caps as a percentage of the total U.S. stock market has fallen to 3.9% recently versus an average weight of 7.3% through the last 90 years. This drop can be explained partially by the chart below right. This chart shows that small cap's P/E ratio relative to large cap's P/E ratio sits at one of the lowest points in history. Only during the start of the pandemic was it lower. However, in order for this to reverse, the mega-cap tech stocks need to falter slightly, or the Fed has to get out of the way. Nevertheless, for the time being, the "Magnificent 7" has some powerful trends behind them like A.I.



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

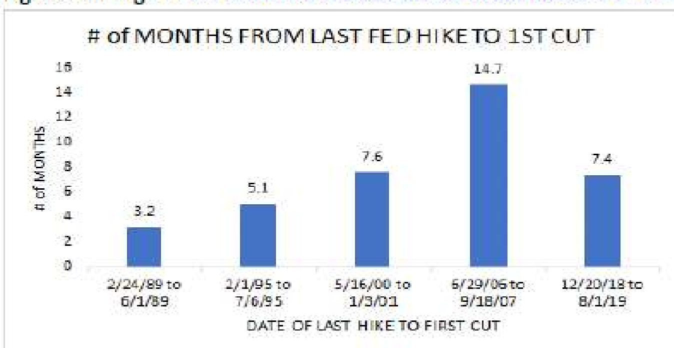
Fig 91. **Relative to large-caps, small-caps have never been more attractive than of late**



Source: Furey Research Partners and FactSet. Data as of 9/30/23. Represents median P/E using latest available trailing 12-month earnings. Profitable companies only.

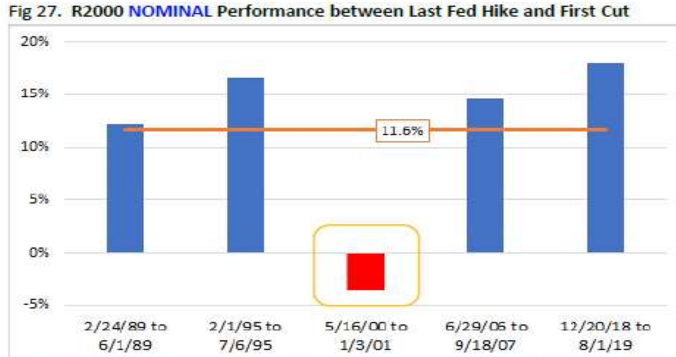
While valuation alone won't start a new small-cap cycle, other influences like the Fed and interest rates can certainly change the tide. As small-cap strategist, Jim Furey recently stated, "Rising 10-year yields are like Kryptonite to small caps". The chart below left shows that on average there are only 7.5 months between the last Fed rate hike and the first rate cut to start a new cycle. The chart below right shows that small caps generally post strong nominal returns during the period between the last Fed rate hike and the first rate cut, which averages +11.6% over that timeframe. Only in the period following the internet bubble collapse did small caps post a negative return. Whether the Fed does one more interest rate hike, 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 recession spurred rate cuts are historically a positive catalyst for small caps. 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.

Fig 26. Average of 7.5 Months Between the Last Fed Hike and 1st Cut



Source: Furey Research Partners, Federal Reserve and FactSet.

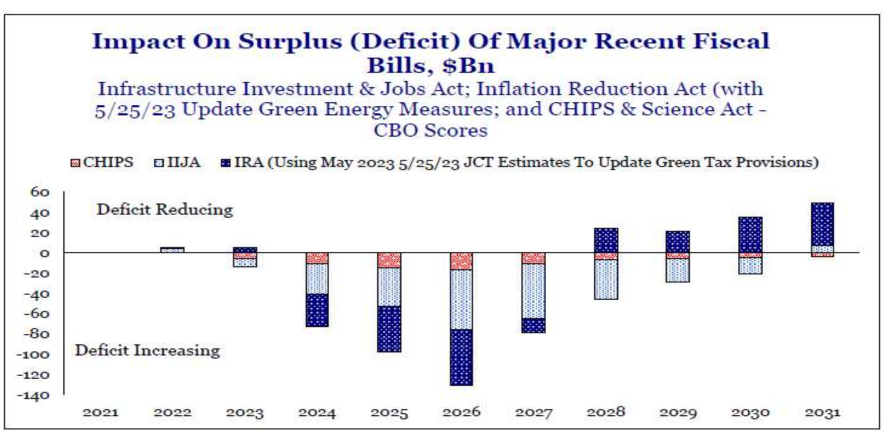
Fig 27. R2000 NOMINAL Performance between Last Fed Hike and First Cut



Source: Furey Research Partners and FactSet. Data as of 9/30/23. Based upon R2000 index returns following the '88/'89, '94/'95, '99/'00, '04/'06, '15/'18 Fed hiking periods.

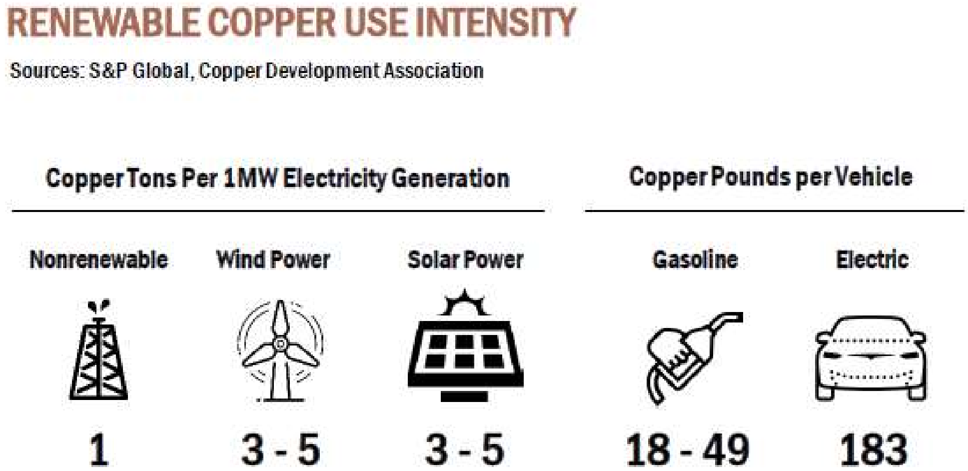
Thematic Investing: The "Picks & Shovels" Suppliers for the U.S. Infrastructure Upgrade

As you may recall, the 1492 Capital Management thematic investing approach involves researching beyond the first line of beneficiaries to an investment theme and into the vertical supply chain that may also experience tailwinds. We have deployed a U.S. infrastructure upgrade theme across our small-cap strategies with several holdings among engineering and construction firms. These companies should experience multiple years of strong backlog and profit growth from the variety of government policies that are funding utility upgrades, renewable energy projects, bandwidth deployment, and highway infrastructure development to name but a few areas. The chart below shows the billions of dollars that will be deployed over the next few years as a result of the CHIPS Act, Inflation Reduction Act, and the Infrastructure Investment and Jobs Act. Along with these healthy sectors that are benefitting from stimulus tailwinds, the reshoring of manufacturing back to the U.S. is also driving construction growth. As we expand this theme, we are now researching the "picks and shovels" providers that will supply materials and services to the engineering and construction firms' execution on a wealth of projects over the next several years. As a reminder, the picks and shovels concept originated with the Gold Rush where the suppliers of mining supplies made consistent money during this era while the miners experienced feast but usually famine in their strike it rich mining ventures. The picks and shovel providers for this theme can include a variety of entities that supply construction equipment, site preparation and services, and copper and copper wire.



Source: Strategas

With respect to copper, that market finds itself in a healthy demand/supply picture over the next several years. As seen in the chart below left, the copper content needed for one megawatt of electricity generation at least triples as we transition from nonrenewable to renewable solar and wind power. On the right side of the chart, the bullish trend continues as we need at least ten times the copper per electric vehicle versus your traditional gas-powered car.



The demand for copper through 2030 looks to dwarf the supply growth in the metal. The lack of new mine development and its lengthy period to bring on new production is coupled with declining grades (less copper per ton mined) at the existing large mines to keep supply growth in check. Inevitably when demand outstrips supply, the commodity price rises to both curtail demand and encourage more investment in new and expanding mines and in recycling. As you can see in the table below from Jefferies, the renewable's electrical network-grid category and the rest of the world EVs should be the drivers for future copper demand.

Exhibit 1 - Global Copper End Markets, Including Investment in the Grid for Energy Transition

Copper Demand (kt) (incl. investment in grid for decarbonization)	2022	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E	CAGR (2023E-30E)
China: Property and Energy Transition										
Property Market	2,248	2,166	2,069	1,969	1,865	1,825	1,782	1,736	1,683	**-3.5%**
Renewable Energy	398	416	413	425	527	579	636	699	785	**9.5%**
Electric Vehicles	211	218	231	236	241	246	252	258	263	**2.7%**
RoW Renewable Energy	627	630	603	605	750	824	905	995	1,118	**8.5%**
RoW Electric Vehicles	430	590	846	1,173	1,310	1,467	1,646	1,851	2,090	**19.8%**
Construction (ex-China Property)	3,903	3,893	4,092	4,409	4,575	4,744	4,851	4,962	4,944	**3.5%**
Electrical Network - Grid (ex-renewables)	5,332	5,715	5,932	5,532	5,551	5,693	5,838	5,986	6,134	**1.0%**
Electrical Network - Grid (renewables)	243	304	607	1,336	2,307	3,157	4,372	5,586	6,375	**54.5%**
Electrical Network - Non-grid	347	356	366	345	359	373	388	404	423	**2.5%**
Consumer Goods	5,492	5,658	5,868	6,046	6,043	6,041	6,162	6,159	6,157	**1.2%**
Transportation (ex-EVs)	3,029	3,013	3,110	3,204	3,268	3,333	3,400	3,468	3,537	**2.3%**
Industrial Machinery/Manufacturing	2,861	2,919	2,997	3,073	3,150	3,181	3,179	3,178	3,209	**1.4%**
Total	**25,121**	**25,878**	**27,134**	**28,352**	**29,946**	**31,463**	**33,411**	**35,283**	**36,719**	**5.1%**
y/y % change	*1.3%*	*3.0%*	*4.9%*	*4.5%*	*5.6%*	*5.1%*	*6.2%*	*5.6%*	*4.1%*	

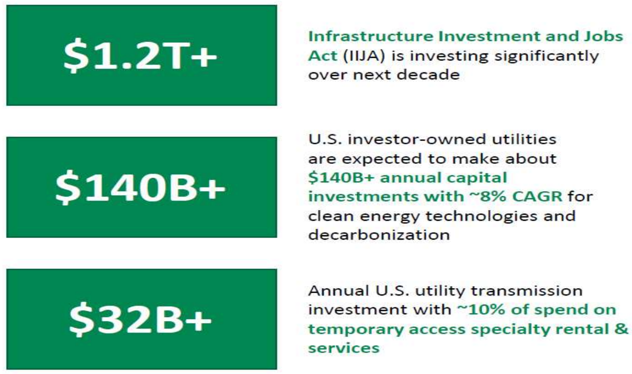
Source: Jefferies

Where the rubber meets the road for copper as part of the U.S. infrastructure upgrade theme is in the supply and demand shortfall. As seen in the table below, demand growth should comfortably exceed supply growth through 2030 and strengthen the pricing of the metal. The term Dr. Copper is often used to refer to the metal as an economic indicator due to its widespread use across multiple sectors. Dr. Copper is now an interesting component for our infrastructure theme as its favorable demand/supply characteristics benefit from reshoring, utility upgrades, and EV growth over the remainder of the decade.

Copper Supply/Demand (kt) (includes investment in grid for decarbonization)	2022	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Total Supply	25,144	25,533	26,341	26,795	27,149	27,729	28,420	28,627	29,122
Total Demand	25,121	25,878	27,134	28,352	29,946	31,463	33,411	35,283	36,719
Surplus (Deficit)	23	-344	-793	-1,556	-2,797	-3,734	-4,992	-6,656	-7,597
Growth in supply	2.5%	1.5%	3.2%	1.7%	1.3%	2.1%	2.5%	0.7%	1.7%
Growth in demand	1.3%	3.0%	4.9%	4.5%	5.6%	5.1%	6.2%	5.6%	4.1%

Source: Jefferies

Continuing on with researching down the supply chain of a theme, we recently learned that roughly 10% of annual U.S utility transmission investment is spent on temporary access rental and services according to Brookings. As seen in the exhibit below, the Infrastructure Investment and Jobs Act (IIJA) and utility investments will propel heavy project spending.



Source: Brookings.edu / Whitehouse.gov

Temporary access rental and services encompass all of the products and services needed to prepare a worksite for utility, construction, pipeline, or oil and natural gas projects. As a picks and shovels type provider, a company that supplies the relatively mundane equipment and services to help execute the startup of spending on reshoring construction projects, utility grid upgrades, and renewable energy projects should enjoy a multi-year tailwind within our U.S. Infrastructure Upgrade theme.

Thematic Investing: "Supersizing" Your Fries is Long Gone, Minimizing is Likely Here to Stay

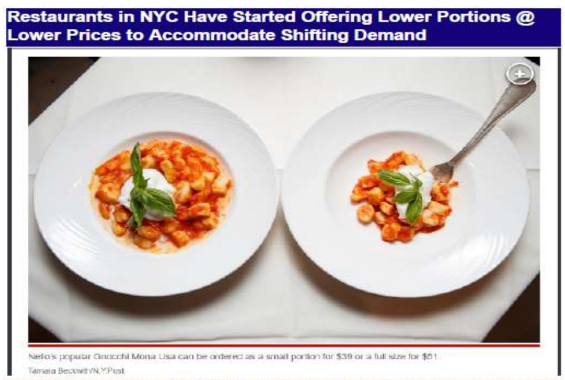
Nearly 20 years ago McDonald's said 'goodbye' to the supersized drinks and fries supposedly to simplify their menu. Today, we'd be more apt to say, "Minimize me" or "No Coke, just the burger". This idea is not necessarily news but as investors, we look forward and see multiple headwinds that today's consumer is facing which require us to dig deep into the stories that corporate management teams are telling us. Whether it's rising interest rates on creeping credit card debt, loan delinquencies, skyrocketing mortgages or rent payments, rising prices at the gas pump, food inflation, student loan repayments, depleted savings, or a combination of all of these, the consumer might just be crying UNCLE! The chart below shows seated diners around the globe by month. There is clearly a slowing trend as we anniversary the post-pandemic pent-up demand. Something has to give as we look ahead and it's our job to figure out where that will occur. Parents will buy shoes and clothes for their growing kids, but they might not buy the new pair of $100 jeans for themselves, and they may wear last year's kicks. They may forego the appetizer, cocktail, or dessert at the restaurant, and stick to the main course if they're lucky enough to have the wherewithal to dine out. Think about that. Assume a young, educated family of four could dine out for $100 last year at a mid-scale restaurant (taxes and tips are ignored for simplicity). They ordered an appetizer for $8, four entrees at $18 each, a couple of beers and milks for another $20. Now, from the restaurant's perspective, let's say they earned a 15% margin on that sale. That's $15 in their pocket. Fast forward to October 2023 and these educated young parents have to start repaying $300 per month each in student loans, which leaves them only a small slice of their disposable income to dine out. Now their restaurant visit might look something like four entrees and waters all the way around! Well, there's been inflation, and those entrees now are $20 each for a total of $80. It then costs the restaurateur more to make (commodities) and serve (labor), and now their margin is 12%. Their profit has just notched down to $9.60, a decrease of -$5.40 on that sale for a year-over-year decline of -36% in profits! Yikes! Again, some of this is "known," but we argue that the magnitude may not be fully understood and reflected. Is "minimizing" here to stay?

Change In Seated Diners By Month
2023 vs. 2022 (Source: OpenTable)

Country	23-Sep	23-Aug	23-Jul	23-Jun	23-May	23-Apr	23-Mar	23-Feb	23-Jan
Global	-6%	-4%	-2%	-3%	-2%	-3%	-2%	4%	23%
Australia	-8%	-6%	-1%	-5%	-3%	-5%	2%	9%	28%
Canada	-3%	-2%	0%	-2%	2%	4%	3%	24%	61%
Germany	-1%	3%	6%	-1%	2%	11%	20%	27%	45%
Ireland	-7%	-1%	-3%	-5%	-4%	-3%	-1%	0%	14%
Mexico	-6%	-5%	-2%	-3%	-6%	-5%	-4%	4%	24%
United Kingdom	-4%	-3%	0%	-4%	-5%	-2%	-5%	-2%	9%
United States	-7%	-5%	-2%	-3%	-2%	-4%	-4%	2%	21%

Source: Strategas Research

There might be something else to ponder and that is the impact of the GLP-1 weight loss drugs – *please read the section of this newsletter, "GLP-1's Are Being Heralded as Healthcare's Latest "Silver Bullet".* These drugs work to increase the feeling of fullness by slowing the movement of food from the stomach to the small intestines and by interacting with the brain to suppress one's appetite. Incorporating this concept into the example above, let's assume this couple has packed on a significant amount of weight since graduating from college and they've both started getting injections of this drug. It's still October 2023 and now their order at that restaurant looks like two appetizers at $10 each and two entrees at $20 each with waters all the way around for a $60 bill. Assuming the same 12% profit margin, the restaurateur now clears only $7.20 profit, which amounts to a -52% decline in profits from the year-ago total! Quick back-of-the-envelope math on a restaurant chain with 500 stores serving 30 such families per day for 360 days a year will have a potential decline of tens of millions of dollars in annual restaurant profits. Astounding. While we don't generally use our thematic process when investing in consumer discretionary stocks, we believe that most of these headwinds are reflected in restaurant stock valuations. We then focus our efforts on the future and look to uncover that which is not widely known or understood. For example, we search for management teams who are innovative, substituting technology and robotics for headcount, and those who are able to navigate around some of these obstacles through new and compelling menu offerings. Interestingly, restaurants in New York City are already offering smaller portions as a lure to keep consumers visiting their establishments due to the widespread use of GLP-1's in that market. We consider these thoughts in the greater context of where we are in the post-pandemic world and how consumer behaviors and restaurant same-store sales are normalizing to create a potential investment opportunity.

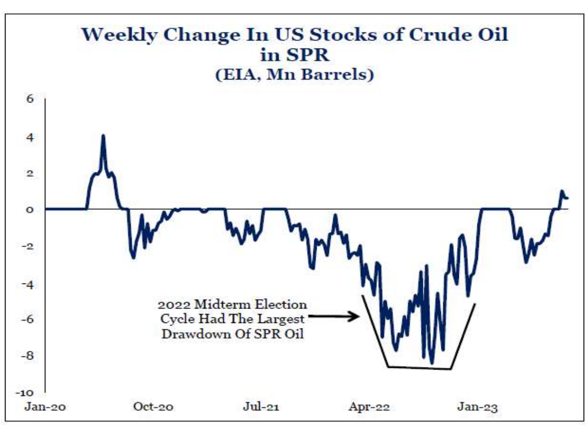


Source: https://nypost.com/2023/03/14/ozempic-craze-has-restaurants-scrambling-to-adapt/, MSUSA

Updated 2023 Outlook: A Picture is Worth a Thousand Words

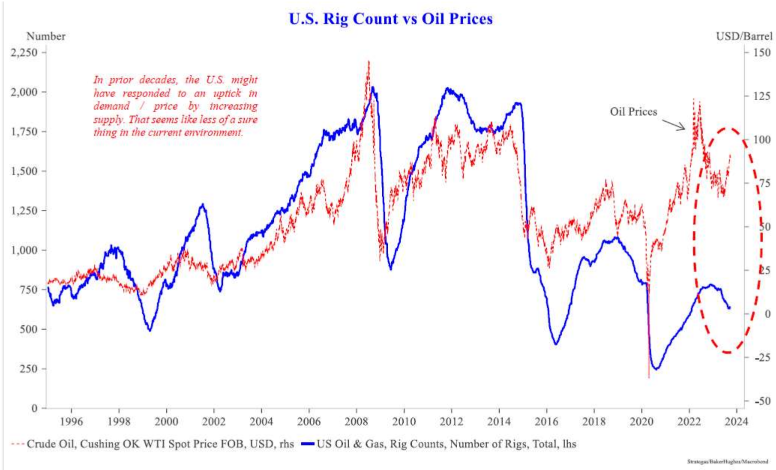
We articulated our updated 2023 outlook above and the key issues and drivers for the stock market. Yet, we believe that there are other topics that we haven't spent a great deal of time on that deserve some mention. In order to provide you with a shorter read, as everyone's time is valuable, we decided 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 Strategic Petroleum Reserve was supposed to be used for emergency use, like wartime, yet the Biden administration has used it aggressively over the past two years to keep oil prices lower following the Ukraine/Russia war as the chart below shows. If they want oil prices lower, why are they buying oil now to refill the reserve??



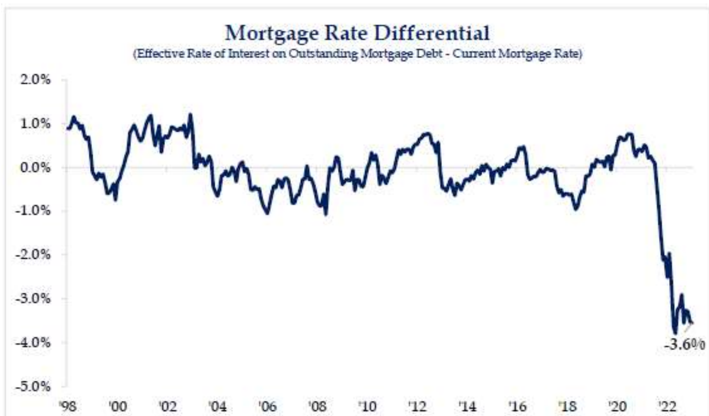
Source: Strategas

This chart shows the price of oil vs. the rig count drilling for oil. Despite higher oil prices, oil exploration companies continue to remain disciplined as the stock market has demanded over the past few years.



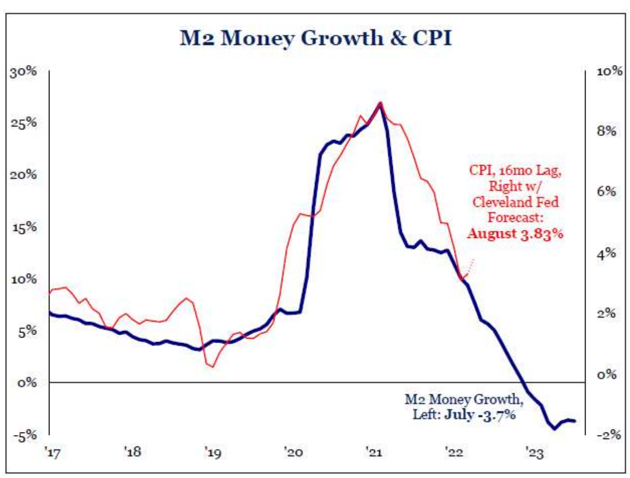
Source: Strategas

The chart below shows the interest rate differential between the average outstanding mortgage loan interest rate and the current mortgage rate. This gap is clearly why home sales have lagged as nobody wants to incur this stepped-up cost.



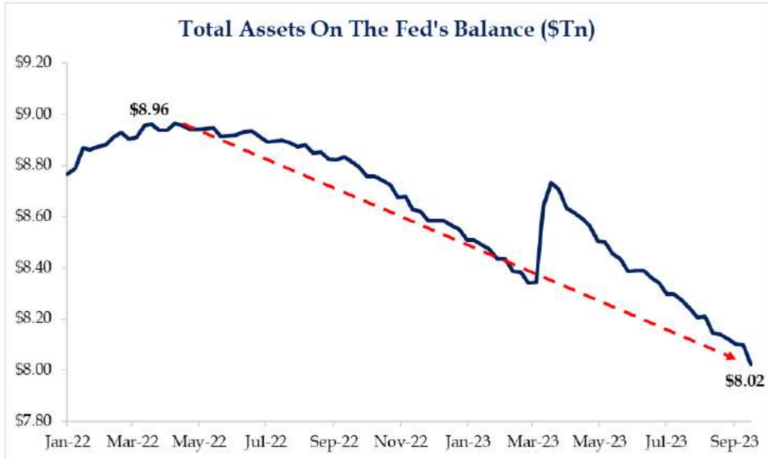
Source: Strategas

M2 Money growth has clearly slowed as the Fed has tightened monetary policy. CPI follows quite closely historically.



Source: Strategas

As promised, the Fed has aggressively reduced its treasury note holdings by nearly $1 trillion over the past year while trying to refinance the rest of the government's debt at higher and higher rates. They're raising their/taxpayers' cost of debt by doing so.



Source: Strategas

Stock Market Trivia

Each quarter we offer a piece of market trivia that we believe is interesting or timely, or both. This quarter we are focusing on the stock market return following a bad August and September. As we mentioned at the top, the Russell 2000 had a poor August and September cumulatively (7th worst on record). However, following the 10 worst August/September periods on record, the average return for the balance of the year was +11.1% and was positive in every case as shown below. Where do I sign up for this performance?

Fig 2.

R2000 Worst Aug/Sep Returns

	Year	Aug/Sep	RoY
1	1990	-21.0%	5.1%
2	2011	-18.9%	15.5%
3	2001	-16.3%	21.1%
4	1981	-15.5%	10.2%
5	1998	-13.1%	16.3%
6	2022	-11.4%	6.2%
7	2023	-11.0%	NA
8	2015	-10.9%	3.6%
9	2002	-7.4%	6.2%
10	1985	-7.0%	16.2%
	Avg	-13.2%	11.1%
	%Pos	*0%*	*100%*

Source: Furey Research Partners and FactSet.
'23 YTD as of 9/27/23.

Lastly, given that there has been so much talk about recession in the media for the past year, we thought that we would look ahead to the 2024 presidential election given that it's just about a year away and the debate circus has already begun. President Biden take note - do everything you can to stay out of a recession if you want to be re-elected. The track record for re-election is untarnished if there is no recession in the two years before re-election.

No Recession Two Years Before Re-Election

President	Recession?	Re-Elected?
Obama	No	Yes
Bush II	No	Yes
Clinton	No	Yes
Reagan	No	Yes
Nixon	No	Yes
LBJ	No	Yes
Eisenhower	No	Yes
Truman	No	Yes
FDR	No	Yes
FDR	No	Yes
FDR	No	Yes
Wilson	No	Yes

Recession Two Years Before Re-Election

President	Recession?	Re-Elected?
Trump	Yes	No
Bush I	Yes	No
Carter	Yes	No
Ford	Yes	No
Hoover	Yes	No
Taft	Yes	No

Source: Strategas

We hope that you found our third 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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