1492 CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

DECEMBER 2023 • VOL. 16 • ISSUE 12

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 fourth 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.

Fed's Quick Pivot Abruptly Ends "Higher for Longer" Narrative

Inflation is dead and so is the Fed's maniacal pursuit to squash it. Just three months ago at the Fed's September meeting, the Fed governors forecasted that it would leave interest rates elevated for longer than many investors had expected, which ushered in the "higher for longer" narrative. Like the march of the Lemmings to the sea, the markets bought into the Fed's view, hook, line, and sinker. However, by the November meeting, the Fed was already signaling that the economy was cooling. By the December meeting, they had unequivocally pivoted their views and incorporated 75 basis points of rate cuts into their 2024 interest rate forecast. Why so many trust the Fed's forecasting ability is beyond me as it is the same group that two years ago predicted that the Fed funds rate would be 2% at this point and not the current 5.5%. This change ignited a nine-week winning streak for the stock market. We closed out a unique year as 10-year Treasury rates quickly round-tripped the 120 basis point ascent that we saw from July through October and ended the year almost exactly where they were on June 30th. The rapid descent in rates made the year for almost any stock that wasn't one of the "Magnificent 7". Many have forgotten that small caps were outperforming large caps through February when two trend-changing events occurred. Namely, several regional banks failed, which called into question the health of the entire financial sector, in particular, small cap banks. Secondly, there was the awareness of AI, and the immense impact that this technology could have on our economy. For most of the first ten months of the year, it was all about the "Magnificent 7," and everything else was left in their dust. The year's final two months saw a speculative fervor return to the market with meme stocks, bitcoin, and heavily shorted stocks leading the way.

The NASDAQ Composite (+44.6%) had its best year since 1999, and the S&P 500 (+26.3%) reached a new, all-time high. The small cap Russell 2000 Index had a furious rally in December and completed the year with a respectable return of +16.9%. Interestingly, the 10-year Treasury yield ended the year at 3.88%, which is almost exactly where it began 2023.

In the balance of this newsletter, we will discuss many of the issues that are facing the markets in the year ahead including the Presidential election and why we believe the current Fed Fund futures curve is inconsistent with several other key metrics of the U.S. economy's health. Please read on to see our unique views of what's on tap for 2024, themes that we're investing in here at 1492, what we believe the key stock market drivers will be and indulge in some stock market trivia. We will be providing our strategy webinars and detailed performance information on 1492's strategies in a separate email in the coming week. If you would like to discuss any of our strategies with us, please contact Tim Stracka at 414-238-3398.

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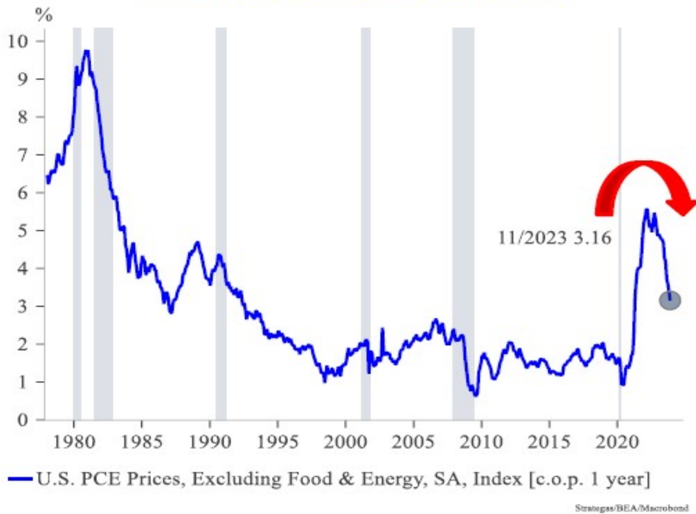
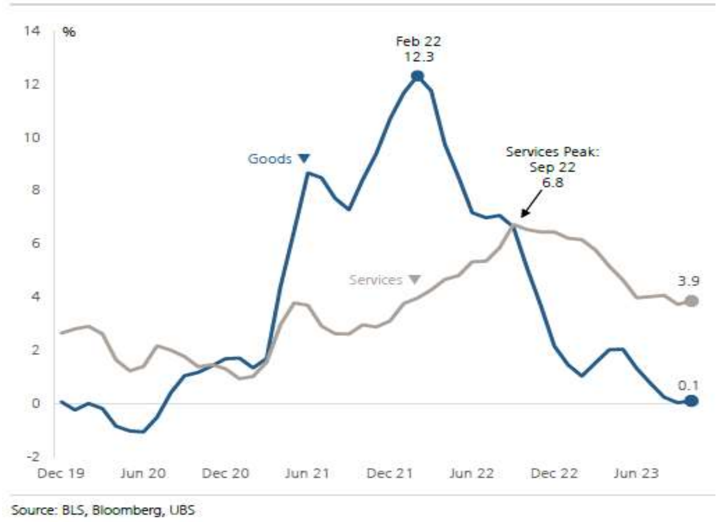
A Review of 2023: Fed's Quick Pivot Abruptly Ends "Higher for Longer" Narrative

Inflation is dead and so is the Fed's maniacal pursuit to squash it. The Fed's favorite measure of inflation, the Core PCE Deflator, which is just a fancy term for core inflation (excluding food and energy), is shown in the chart below left, and it's rapidly approaching their 2% target. When you break up the components between goods and services inflation as shown in the chart below right, you see that goods inflation is essentially 0% down from +12% in 2022, and services, which lagged in demand due to the pandemic, is rapidly retreating as well. Just three months ago at the Fed's September meeting, the Fed governors forecasted that it would leave interest rates elevated for longer than many investors had expected and ushered in the "higher for longer" narrative. Like the march of the Lemmings to the sea, the markets bought into the Fed's view, hook, line, and sinker. However, by the November meeting, the Fed was already signaling that the economy was cooling. By the December meeting, they had unequivocally pivoted their views and incorporated 75 basis points of rate cuts into their 2024 interest rate forecast. Why so many trust the Fed's forecasting ability is beyond me as it is the same group that two years ago predicted the Fed funds rate would be 2% at this point and not the current 5.5%.





The Fed's change in tone ignited a nine-week winning streak for the stock market. We closed out a unique year as 10-year Treasury rates quickly round-tripped the 120 basis point ascent that we saw from July through October and ended the year almost exactly where they were on June 30th. The rapid descent in rates made the year for almost any stock that wasn't one of the "Magnificent 7". Many have forgotten that small caps were outperforming large caps through February when two trend-changing events occurred. Namely, several regional banks failed, which called into question the health of the entire financial sector, in particular, small cap banks. Secondly, there was the awareness of AI, and the immense impact that this technology could have on our economy. For most of the first ten months of the year, it was all about the "Magnificent 7," and everything else was left in their dust. The year's final two months saw a speculative fervor return to the market with meme stocks, bitcoin, and heavily shorted stocks leading the way. The chart below left shows that the dispersion of returns between the S&P 500 equal weighted return relative to the S&P 500 was the greatest since the tech bubble in 1998. The chart on the right depicts the performance of the "Magnificent 7" stocks compared to the S&P 500 excluding the "Magnificent 7". The difference is quite remarkable.

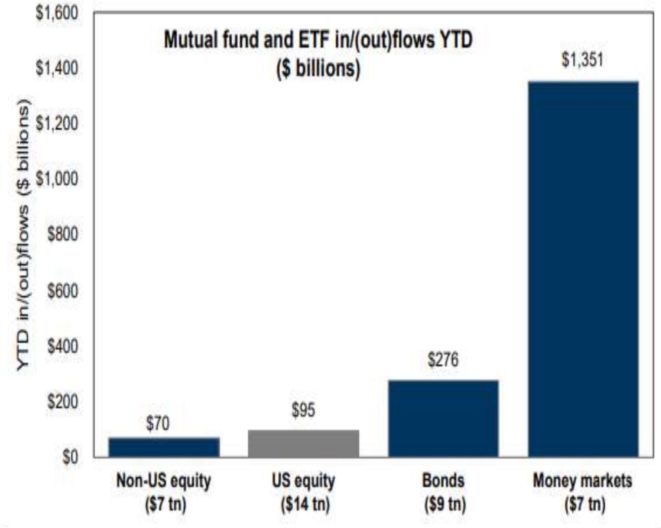
Source: Strategas

Driven by the "Magnificent 7's" outperformance, the concentrated stock market return for the year was nearly a record as shown in the table below left. The top 10 stocks in the S&P 500 accounted for 71.4% of the total S&P 500's return through mid-December. This feat is quite remarkable historically and is even more noteworthy in a year in which the S&P 500 rose +26%. What makes this accomplishment even more stunning is that there weren't massive flows into the stock market. Quite to the contrary, money market funds and bond funds saw inflows of nearly $1.4 trillion and $276 billion, respectively, during 2023 as higher interest rates attracted assets to those asset classes. U.S. equity funds witnessed just $95 billion of inflows during the year on a much larger base of assets.

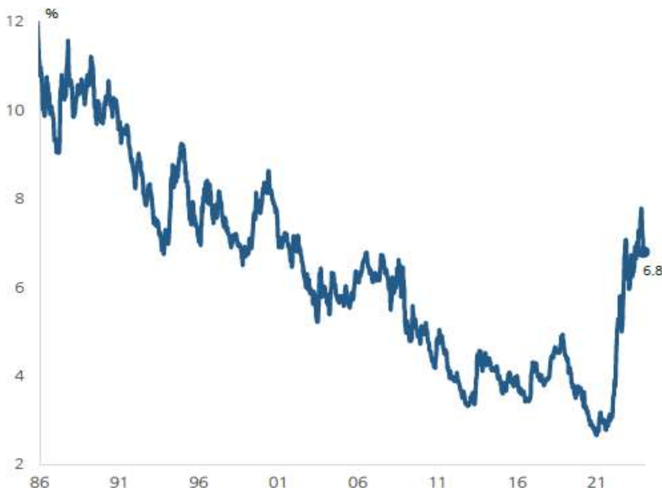
Annual S&P 500 Contribution of 10 Largest Weights During Positive Performance Years

Year	Top 10 as % of Total	S&P 500 % Perf.
2007	78.7%	3.5%
2023 YTD	**71.4%**	**22.4%**
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

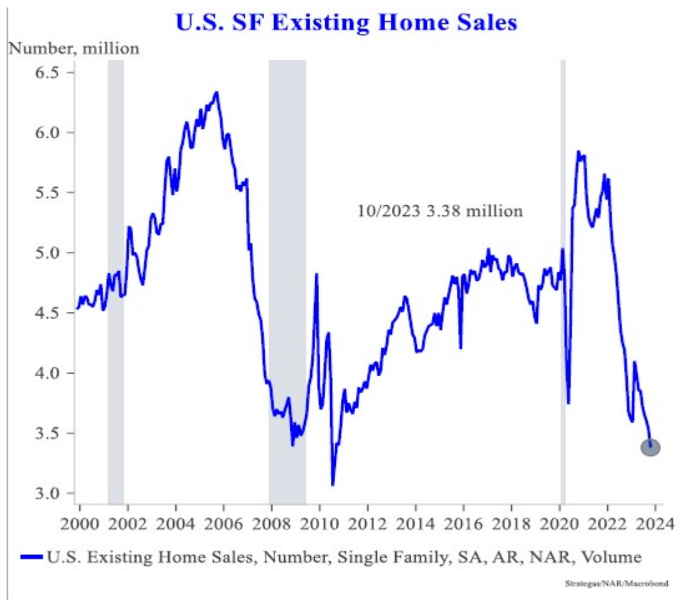
Source: Strategas

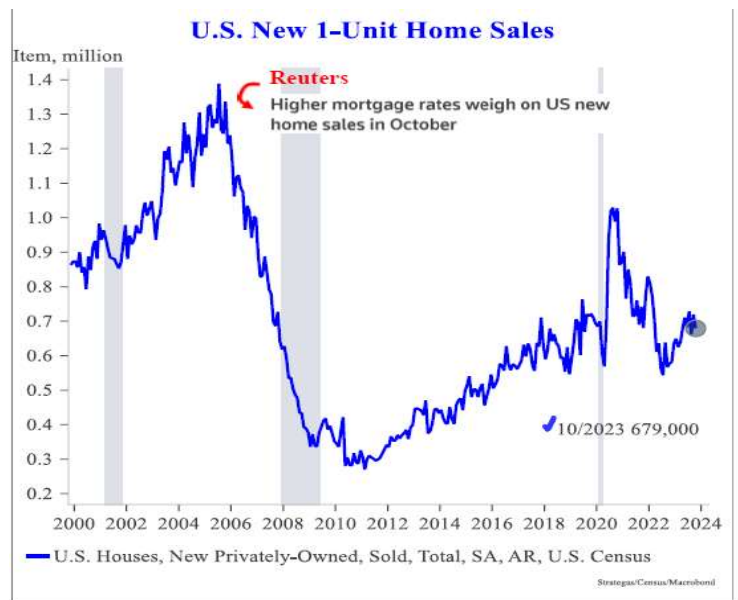


In last year's fourth quarter newsletter, one of the main sections of the newsletter was entitled, "Housing Market (err.. the Fed) Holds the Key to the Economy in 2023". The housing market is one of the largest industries in the U.S. economy at nearly $2 trillion annually, and it is quite sensitive to interest rates. There are also 7.5 million jobs associated with the homebuilding industry which is why it's such a key cog in the wheel of the U.S. economy. Despite the rapid escalation in interest rates due to the Fed rate hikes, the homebuilding industry was remarkably one of the best performing industries in the entire U.S. stock market in 2023. The SPDR S&P Homebuilders ETF (XHB) climbed a whopping 60.1% in 2023. This performance is despite 30-year mortgage rates approaching 8% at one point this year and now settling around 6.8% as shown in the chart below left. The combination of higher interest rates and high price points brought the housing affordability index to the lowest level in its history as shown in the chart below right. How is it possible that the homebuilding stocks performed exceptionally well in 2023?



First, the stock market is a discounting mechanism and anticipates what is likely to transpire (lower interest rates). However, even this idea doesn't explain the dramatic move in housing-related stocks. If you just examined the existing single family home sales chart below left, you would likely conclude that the homebuilding stocks should be in negative territory and not reaching new all-time highs. The existing home sales volume dropped precipitously as nearly 87% of current homeowners have a mortgage outstanding on their home, and they don't want to trade a 3%+ mortgage rate for one with a 7% handle. The bottom line is that nobody wants to roll into a much higher monthly payment unless they are forced to due to a job move or something similar. This condition has led to the current standoff between buyers and sellers. The answer to our question is that there is a structural shortage of homes in the U.S. of between 5.5 and 6.8 million units according to the National Association of Realtors with the gap widening each year. This shortage is primarily a result of the housing slump that followed the "great financial crisis (GFC)" of 2008-2009, and one can see what happened to new housing unit sales in the chart on the right immediately following the GFC. Interestingly, the number of homes being built at the latest read in October was 679,000 units on an annualized basis. While this level is up over 2022 and helps to explain some of the moves in the stocks, it still is only half of the rate that we saw in 2006. This supply tightness in the market is allowing homebuilders to make much better margins than the historical average on a home sale despite higher rates. Additionally, they've been using some of the higher profit margins to "buy down" mortgage rates for prospective home buyers. This program is allowing the rate-sensitive consumer to get past the sticker shock that a 7.5% mortgage rate may bring. We expect that 2024 will bring lower mortgage rates, and some of this stalemate subsides.





As shown in the table below, the stock market finished the year with a very strong fourth quarter, which salvaged the full year tally for all but the "Magnificent 7" and the tech-heavy NASDAQ Composite index. This index had been significantly in positive territory for much of the year and posted its best showing since 2003. Both the NASDAQ and the S&P 500 fell just shy of record highs while the Dow Jones Industrial Average reached a new high. Gains in these major indices nearly wiped out the losses of 2022. The small cap Russell 2000 Index had a furious rally in December and completed the year with a respectable annual return of +17%. Interestingly, the 10-year Treasury yield ended the year at 3.88%, almost exactly where it began in 2023. As shown in the table below, the stock market finished the fourth quarter in positive territory as dramatically lower interest rates triggered a booming rally to close out the year. Small caps had a wonderful month of December with the Russell 2000 posting a one-month gain of +12.2% which nearly accounted for the entire year's positive performance. The NASDAQ Composite was the gold medalist this year and reversed its last place finish in 2022.

Index Returns		
Index	Fourth Qtr. 2023 Return	2023 YTD Return
Russell 2000	+14.03%	+16.93%
Russell 2000 Growth	+12.75%	+18.66%
Russell 2000 Value	+15.26%	+14.65%
S&P 500	+11.24%	+26.29%
Dow Jones Industrials	+12.48%	+13.70%
NASDAQ Composite	+13.79%	+44.64%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Growth Index (+18.6%) beat the Russell 2000 Value Index (+14.7%) for the year. This performance broke a two year winning streak for the Value index. Both of the indices had a furious rally in the final two months of the year to finish with respectable annual returns. As recently as late October, both indices were running in the red for 2023. All sectors were in positive territory for the quarter except for energy (-6%) as recessionary fears and a warmer start to winter brought oil and natural gas prices lower. Lower interest rates accommodated every other sector nicely, and Financials' fourth quarter leading performance (+21.6%) helped to reverse an otherwise ugly year for that group. The worst-performing sectors for the year were the interest rate proxies like Utilities (-6.9%) which struggled mightily in an environment that saw much higher interest rates for most of the year. On the positive side of the ledger, Industrials (+27.4%) and Consumer Discretionary (+27.3%) were the winners as lower rates, strong government funding, and the AI boom helped these sectors outperform. The table immediately below highlights the performance of the Russell 2000 style indices by sector for the fourth quarter and year-to-date 2023. The second table below shows that there continues to be a significant market cap skew in the year-to-date numbers as the performance was linearly worse moving down the market cap spectrum. The fourth quarter saw some improvement.

Table 9 - Russell 2000 Scorecard through December 29th

	December			4th Quarter			2023			
GICS Sector	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
Com Serv	9.29	0.22	-2.93	9.68	0.23	-4.35	8.36	0.21	-8.56	2.3
Discretionary	14.08	1.53	1.86	17.21	1.86	3.18	27.34	2.80	10.41	11.0
Staples	10.25	0.36	-1.97	13.03	0.46	-1.00	19.46	0.68	2.54	3.4
Energy	1.80	0.10	-10.42	-6.02	-0.68	-20.05	11.49	0.60	-5.43	6.9
Financials	14.81	2.54	2.60	21.56	3.71	7.53	11.06	1.86	-5.86	17.1
Health Care	17.10	2.47	4.88	16.35	2.32	2.32	7.93	1.48	-8.99	15.4
Industrials	10.99	1.89	-1.23	13.56	2.36	-0.47	27.37	4.37	10.44	17.0
Info Tech	11.81	1.59	-0.41	13.92	1.84	-0.11	26.27	3.42	9.35	13.6
Materials	11.29	0.50	-0.93	13.80	0.62	-0.23	16.44	0.75	-0.49	4.5
Real Estate	12.92	0.81	0.70	16.85	1.06	2.82	14.37	0.94	-2.56	6.2
Utilities	6.61	0.20	-5.61	7.83	0.24	-6.20	-6.91	-0.20	-23.84	2.7
Size Quintile	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
1 (Largest)	10.83	6.09	-1.39	12.89	7.27	-1.14	18.41	9.93	1.49	55.7
2	12.96	3.07	0.74	16.06	3.83	2.03	18.07	4.37	1.14	23.6
3	14.04	1.72	1.82	14.01	1.67	-0.02	17.36	2.21	0.43	12.4
4	15.75	0.88	3.53	15.74	0.86	1.71	6.11	0.34	-10.82	5.8
5 (Smallest)	20.52	0.46	8.30	19.37	0.43	5.34	0.12	-10.63	2.47	0.0

Source: Jefferies

Returns in the international markets were generally quite positive in countries like India, which may be a beneficiary of China's downturn and posted its eighth straight year of positive returns. Brazil and Japan also had record-breaking years. As we highlight in the section below entitled, "India is Taking the Global Growth Baton from China and Running With It", China's stock market continued to struggle as government involvement still soured investor's appetite for Chinese equities and as 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 were hiking interest rates to fend off inflation. However, European stock markets have generally fared well despite all of these concerns year to date. The recent decline in longer-dated interest rates pushed bond prices higher, which allowed fixed-income investments to narrowly avoid printing an unprecedented three negative years in a row. In line with the easing Fed posture, volatility significantly declined in the fourth quarter. Commodities were generally a mixed bag, but crude oil sagged in the quarter and year as markets feared oversupply and a global slowdown.

Index	Fourth Qtr 2023 Return	2023 YTD Return
France	6.20%	20.10%
Germany	9.30%	20.30%
Brazil	16.00%	22.30%
India	10.50%	20.30%
China- A Shares	-4.20%	-1.10%
China- Shenzhen A Shares	-3.80%	-7.00%
Japan	5.20%	31.00%
Long-Term Treasuries (TLO)	11.00%	0.00%

Index	Fourth Qtr 2023 Return	2023 YTD Return
Investment Grade Corp Bonds	8.30%	9.10%
Gold	11.00%	13.40%
Volatility- VIX index	-28.90%	-42.60%
Oil	-21.10%	-10.70%
Natural Gas	8.40%	-43.30%
Lumber	-%	9.50%

Source: 1492 Capital Management, LLC

A Look Back: Predictions and Prognostications for 2023 – How Did We Do?

While we aren't in the business of making formal forecasts on the economy or the stock market, we thought it would be interesting to review our 2023 outlook from a year ago and see where our prognostications hit or missed the mark. Our predictions/prognostications from our fourth quarter 2022 newsletter are in italics below.

1. *The economy enters a recession as the Fed's aggressive rate hikes take their toll. Likely a mild recession due to where unemployment stands today.*

The economy didn't go into recession as many, including us, had predicted as the service economy had more legs than we expected due to pent-up demand from the covid era.

2. *The Fed will be cutting interest rates by the end of 2023 as it becomes evident that they went way too far as usual.*

The Fed didn't cut rates by the end of 2023 as we predicted, but in their last meeting of the year, they indicated through their "dot plots" that they see three rate cuts in 2024. Our timing was off just a tad.

3. *The first part of the year will be the weakest as the Fed will still be in hiking mode and as earnings estimates retreat rapidly for 2023 as companies set a low bar to start the year.*

The first part of the year was the weakest for several reasons like the bank failures in March and a very aggressively postured Fed. We hit on this one.

4. *Small caps start what could be a multi-year outperformance cycle as big-cap tech takes a breather. Remember small cap stocks have been in a bear market since March 2021, which is much earlier than the rest of the market.*

Small caps were ahead of the S&P 500 through February which many have forgotten, but several regional bank failures in March and the explosion of AI quickly turned the tide in favor of large cap tech. The companies that became known as the "Magnificent 7" led the charge.

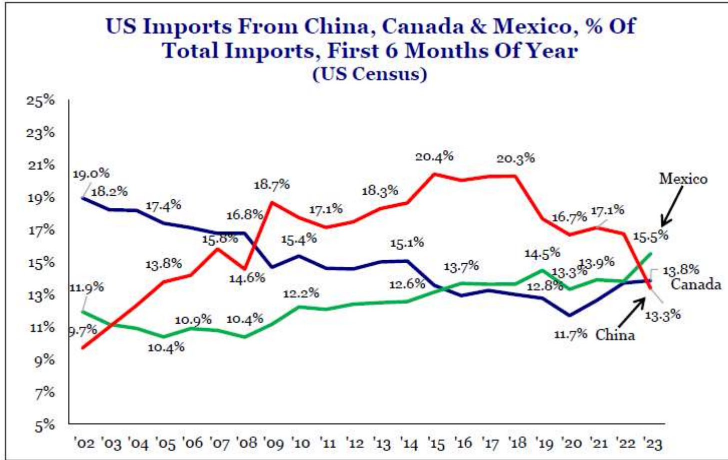
5. *Inflation drops rapidly and could be less than 4% by summer 2023.*

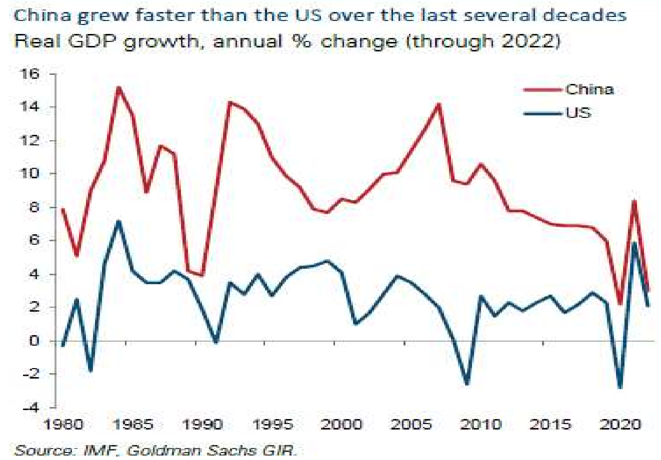
We were spot on in this out-of-consensus call as the CPI measure dropped to 3.0% by June 2023.

2024 Outlook: India is Taking the Global Growth Baton from China and Running With It

It's been a while since we wrote about the international markets but given that *India posted its eighth straight year of positive stock market performance*, we thought we would present what is behind this rising world economic power. Part of what is driving India's economy is a derivative of the negative issues impacting China. First, for China, it appears that their lack of respect for intellectual property laws, real estate overbuilds, lack of financial transparency, increased tariffs, technology embargoes, and constant saber-rattling over Taiwan has finally outweighed the attractiveness of the large consumer market and cheap labor. The chart below left shows the significant decline in imported goods from China. Not coincidentally, this decline began right after President Trump imposed significant tariffs on goods coming out of China to penalize them for stealing intellectual property and

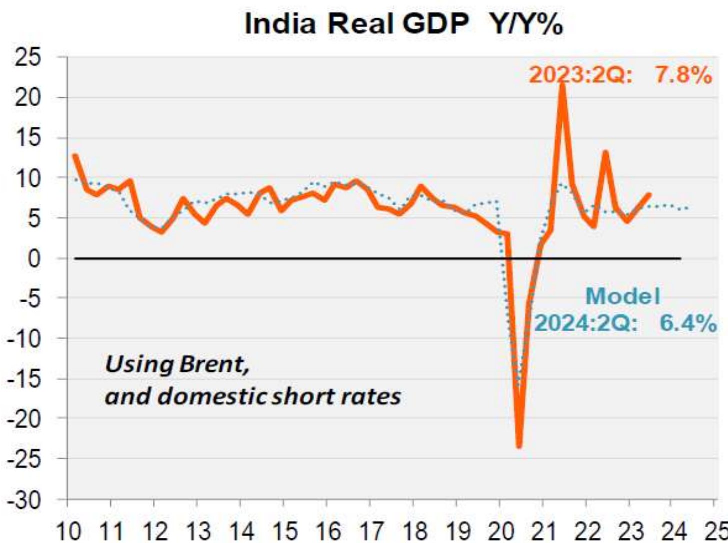
for dumping of subsidized goods into the U.S. markets which hurt U.S. competitors. They are also facing strong headwinds from demographic shifts related to the longstanding one child policy, excessive regulation, housing bubble, and lack of access to cutting-edge technology. All of these issues are causing capital flight to other Asian countries like Vietnam, Singapore, and Thailand. The surprise of 2023 for China was the lack of economic growth despite lifting the pandemic-era lockdowns. Amazingly, China's GDP growth, which has materially exceeded U.S. GDP growth for decades by a wide margin, has slowed materially and is now in line with the current growth of the U.S. economy as shown in the chart below right.

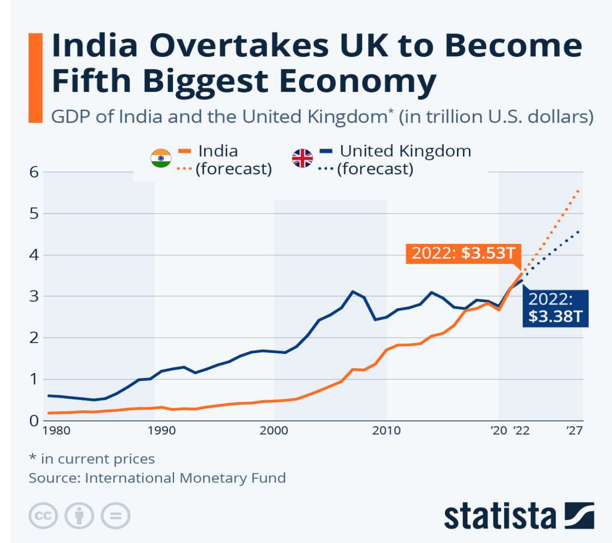




Source: Strategas

As for India, they are seeing a consistently strong economy due to the exact opposite factors that are plaguing China. Namely, these positives are a large English-speaking population, a large and growing middle-class consumer base that is identical in size to China, business laws that are more like U.S. law, favorable demographics, and significant onshoring from major corporations. While there are negatives like rapid wage inflation and higher interest rates, the country's cyclical and secular tailwinds have led to amazingly consistent growth and allowed them to post GDP growth rates north of 5% annually for much of the past 15 years. It's no wonder that their stock market has seen eight straight years of positive returns.



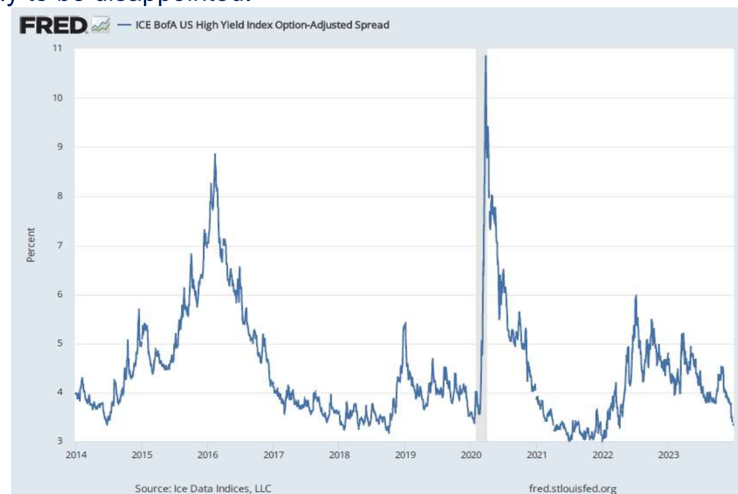


Source: PSC

2024 Outlook: Our Fearless Forecast - Market's Contradictory Expectations Don't Add Up

At first blush, those reading this section heading might interpret it to be bearish. Quite the contrary, we are bullish on the stock market for 2024 and, in particular, on small cap stocks. The heading refers to the dramatically opposing expectations that are set up in the markets as we enter 2024 and that make little sense to us. First, the Fed is expecting a total of 75 basis points of rate cuts through 2024 with the first one projected to arrive as early as March. The Fed Funds futures, which are the market's current predictions of where the Fed Funds rate will be in the coming years, currently implies a whopping six 25 basis point cuts through December 2024, which is twice that of the Fed dot plots. This contradiction isn't the one that we're referring to, rather we're showing where current expectations lie. We've consistently stated in this newsletter that we believe the Fed has over-tightened on the economy over the past two years and this inflationary episode that we've seen since the start of the pandemic

was not the result of a 1970s engrained inflation. It was rather a period of temporary supply shocks and demand spikes that arose out of the pandemic. This concept is playing out as we stated earlier as inflation has dramatically slowed over the past 18 months. However, there is no question that the economy has slowed over the past few months which could be the cumulative effect of the rate tightening as it typically takes 12 to 18 months for higher rates to impact the economy. Recent earnings reports from FedEx and Nike, who report their earnings off cycle, showed softening economic conditions, and their management teams both gave disappointing outlooks. There are other slowing drivers as well like the resumption of student loan repayments, tapped-out pandemic-era savings, and geo-political tensions. ***The contradiction is the following***: Current consensus earnings expectations for the S&P 500 are for earnings to grow approximately +10.7% with earnings climbing from $221.87 in 2023 to $245.55 in 2024. Second, high-yield spreads hit a new year-to-date low and are well below their long-term average as shown in the chart below. If there was perceived stress in the economy, the spreads would be going up not down as they did during the start of the pandemic. By our math, six interest rate cuts by the Fed are not consistent with +10% earnings growth and lower high-yield spreads. Something is going to have to give, and this change may play out early in the year as markets try to reconcile this anomaly. Somebody is likely to be disappointed.



About 18 months 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 events have happened since then like inflation receding faster than most predicted at the time, reshoring accelerating, and small caps outperforming- *for a brief period*. Since that bold statement in June 2022, small caps beat 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 year to date by about 940 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 AI. We believe that neither of these items change our initial thesis that small caps are poised for a significant outperformance cycle. It has simply been deferred a bit as the basic premise of our call still holds. **As promised, here is our forecast**.

1. The consensus view is that a recession is imminent. Most who predicted a recession in 2023 are merely pushing it to 2024. We are going against the grain here and are in the no-recession camp as unemployment is low, real wage growth is accelerating as inflation falls, and employers will be reluctant to cut heads because of how hard it was to find workers following the pandemic. This period is very different from past cycles. With the unemployment rate at 3.7%, it will take a meaningful change to push this a lot higher. See chart below left.
2. Inflation is a dead issue barring an unpredictable geo-political event.
3. The first part of the year will be the weakest as the market reconciles the contradictory expectations that we identified above.
4. Artificial intelligence (AI) moves down market cap and is not just the domain of mega cap tech stocks. Many software and service companies roll out AI-based offerings, which should see strong demand as nearly every company, regardless of industry, can benefit from certain aspects of AI. The AI movement should also drive tech spending and capex to levels not currently forecasted.
5. Small caps finally start what could be a multi-year outperformance cycle as some of the "Magnificent 7" aren't as magnificent in 2024. We see potential issues with Tesla and Apple as both see more competition and a lack of earnings growth which may impact valuation levels. Small caps don't need the "Magnificent 7" to do poorly to outperform.
6. Government balance sheet (deficit) becomes an issue but less so if the Fed cuts rates. Interest expense for the U.S. government is surging - see chart below right.

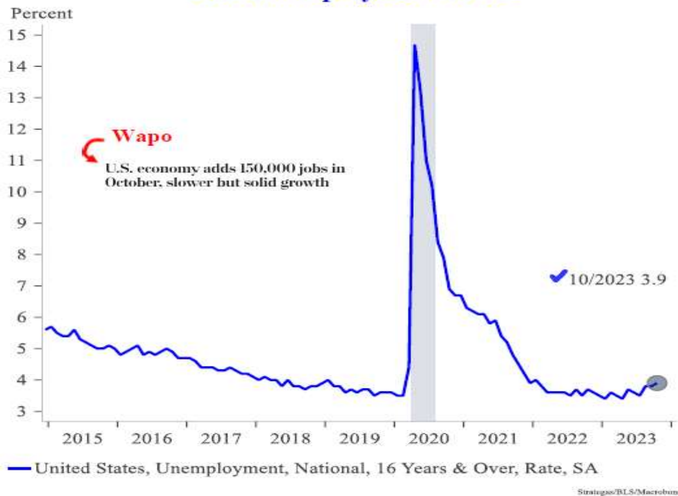
7. The Fed cuts rates, but not six times by the end of 2024. They hiked too far as usual in this cycle.

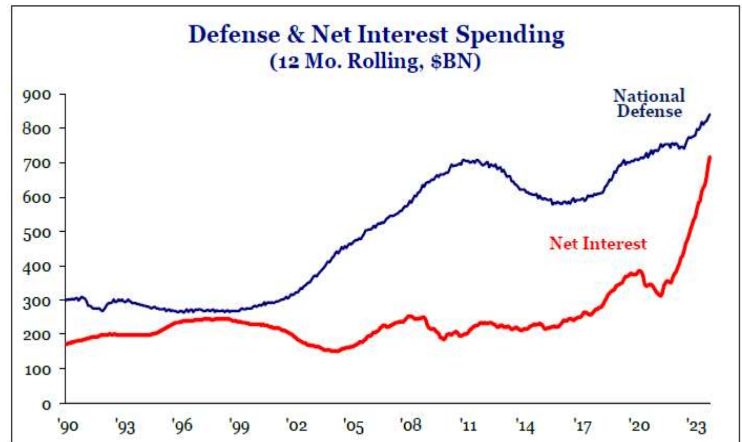
Potential Headwinds to Our Forecast

1. Feds rate hikes to date push freight trends lower as they are already nearing recession level. See FedEx.
2. Geopolitical tensions rise and push energy prices higher which stokes inflation.
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 and lower savings begin to impact consumer spending trends with a $120 billion annualized headwind.
6. Presidential election year politics create uncertainty.
7. In anticipation of lower interest rates, consumers put off large ticket purchases causing a temporary slowdown in the economy.

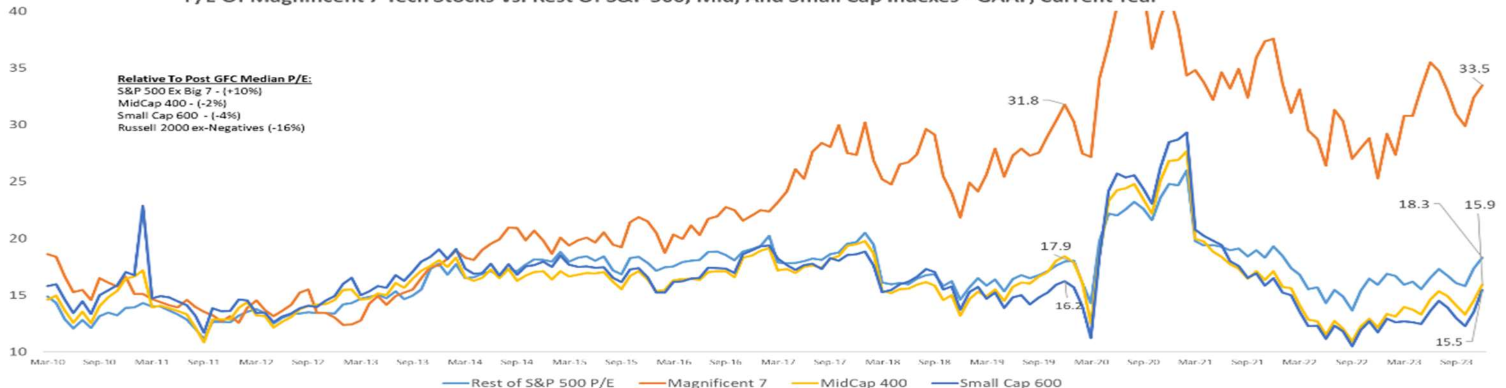
Potential Tailwinds to Our Forecast

1. Valuation disparity between large caps and small caps is still at a generational discount that favors small caps.
2. Inflation continues its downward trajectory from elevated levels which has historically favored small caps.
3. The “Magnificent 7” stocks or mega caps underperforming shifts equity dollars elsewhere. Valuations appear challenging for the “Magnificent 7”. See third chart below.
4. Private equity funds with cash go shopping in the public markets which have been marked down compared to private markets.
5. As interest rates drop, a large amount of funds exits money market funds for fear of missing out.
6. China stimulates its economy more than expected as low growth and large numbers of unemployed create angst.
7. Real uses of Artificial Intelligence provide productivity boosts and enhance corporate margins.
8. Funds from legislation like the Infrastructure Investment and Jobs Act and Inflation Reduction Act are injected into the economy and provide a buffer to slowing growth.





Source: Strategas

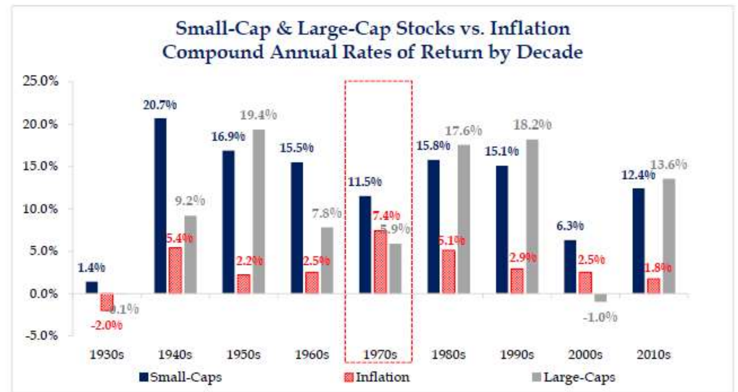


Source: Raymond James

Now we present the case for small caps. As we stated at the outset, this environment should be favorable for small caps as they generally outperform as inflation wanes, interest rates fall, and longer-duration asset classes (like small caps) outperform. This setting would be a continuation of the trends we saw late in 2023. With interest rates declining, banks should do better. If banks do better, small caps should have a relative advantage over large caps as there is a larger exposure to banks in the Russell 2000 compared to the S&P 500. The following phrase was borrowed from Furey Research which is a small-cap-focused research firm- "Rising 10-year yields are like Kryptonite for small caps". We subscribe to this view, and it has proven true over the past two years. If interest rate cuts take place in 2024, small caps should win. As the chart below left shows, small caps have historically outperformed both large and mid cap stocks in the 12 months following the first Fed rate cut. The small cap asset class is the only one that has historically beat inflation in every decade going back to the 1930's as shown in the chart below right. With inflation waning, hopefully, this level will be a low bar to get over in 2024.

Chart 3 - Rate cuts are coming in '24 and should boost small caps

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



Source: Strategas

As we've stated in previous newsletters, the Fed needs to get out of the way and stop hiking rates to catalyze this small cap cycle in our opinion. The Fed's recent pivot helps, and it may catalyze flows into the small cap arena, which have been nonexistent since 2009 as shown in the chart below left. Given the relative underperformance of small caps since 2016 (although there were years where small caps outperformed like 2021) and the enormous outperformance of large cap tech stocks over this timeframe, the small cap asset class is now only 4% of the entire U.S. equity market and the top five stocks in the S&P 500 are essentially worth the entirety of the Russell 2000 three times over. 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.

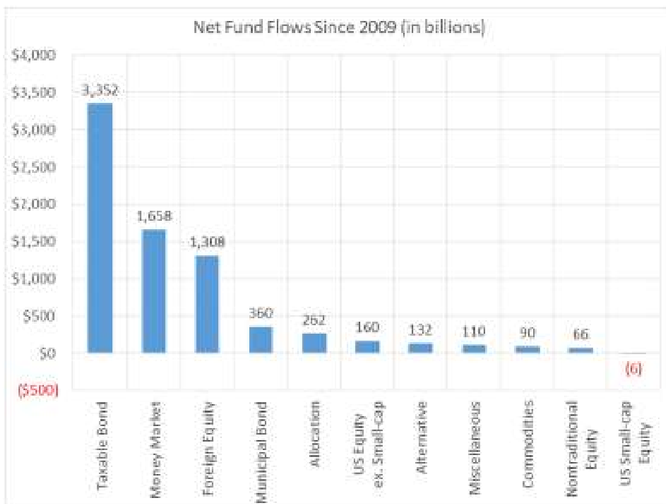
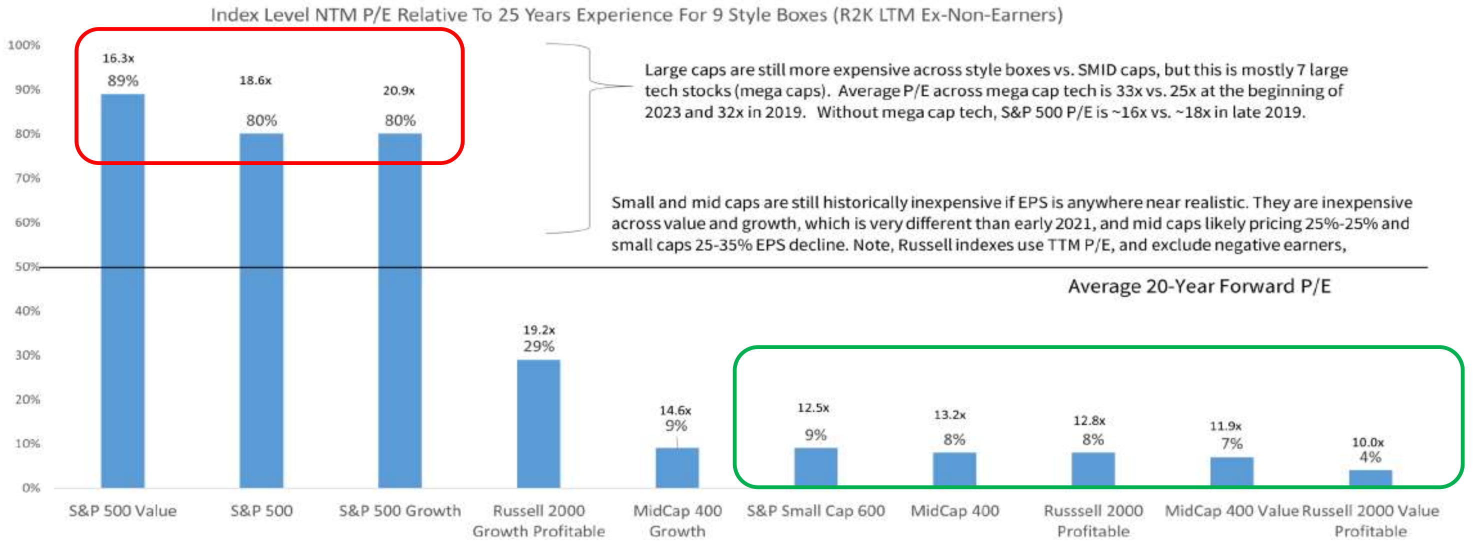


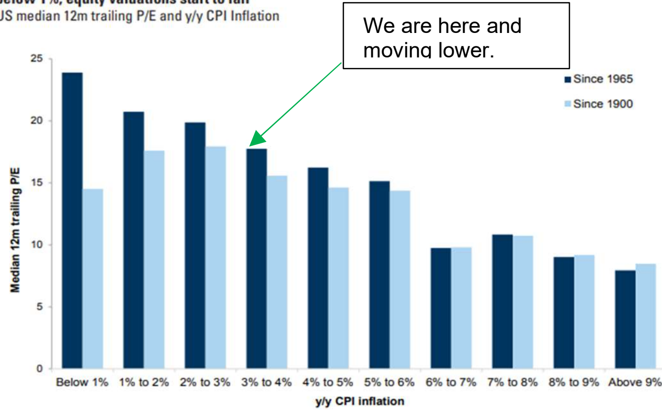
Chart 12 - Small is now less than 4% of the US equity market...

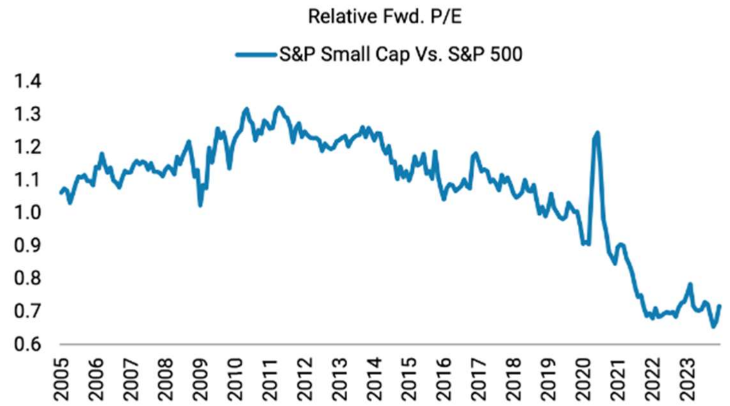
Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

While low relative valuations alone won't start a new small cap cycle, other influences like the Fed and interest rates can certainly change the tide. However, looking at valuations on a P/E (price-to-earnings ratio) basis, small caps appear exceptionally attractive on a historical basis compared to large caps. The chart below shows that small caps' current valuation level places them in the single-digit percentiles of their long-term valuation average, whereas large caps are hovering in the 80th+ percentile of their historical valuation level.

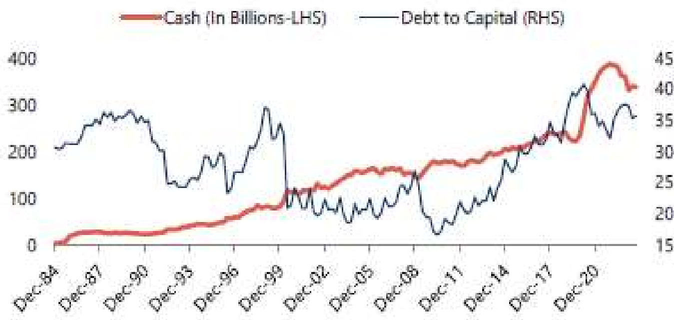


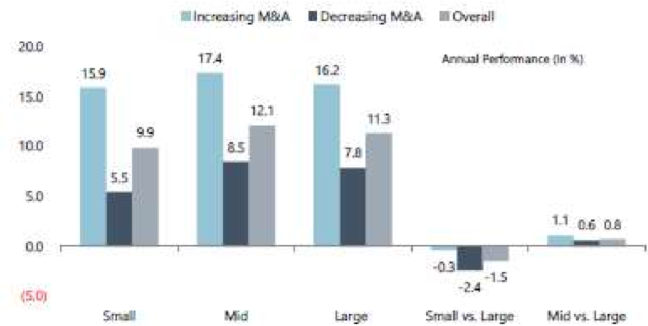
With inflation receding rapidly and interest rates falling, the conditions to sustain higher valuations for the stock market broadly are entering their most favorable valuation environment. The chart below left shows that as inflation recedes, the Price/Earnings ratio (P/E) of the stock market rises. With the absolute valuation of profitable small caps stocks currently in the 12 P/E range as shown above, there is significant room for small caps to appreciate on both an absolute and relative basis. What many don't realize is that small caps have historically traded at a premium relative to large caps except for the most recent decade when large cap tech stocks have been the driving force behind the market. The chart below right shows that for much of the past 20 years, small caps traded at a premium to the S&P 500. With the S&P 500 currently trading at a P/E of 18.4X, any sort of premium would yield impressive small cap gains compared to the S&P 500.





Contrary to popular commentary, small cap balance sheets are actually in quite decent shape. Debt within the small cap realm tends to be concentrated within a relatively small percentage of the Russell 2000. In fact, roughly half of the debt carried by Russell 2000 constituent companies is in companies that represent only 16% of the index's market capitalization. In aggregate, cash balances exceed debt balances within the Russell 2000 constituents as shown in the chart below left. As we point out in our capital market section later in the newsletter, we expect 2024 to be a robust year for mergers and acquisitions after a very subdued environment in 2023. The chart below right shows that when M&A activity increases, the performance of the entire market does significantly better.





Regardless, of which asset class outperforms, history shows that following a year in which the S&P 500 appreciates more than +20% as it did in 2023, the following year is up 80% of the time with a median return of about +12%, which is not too shabby.

A 20% Yearly Gain Suggests More Green, But Don't Expect A Bigger Year Than 2023

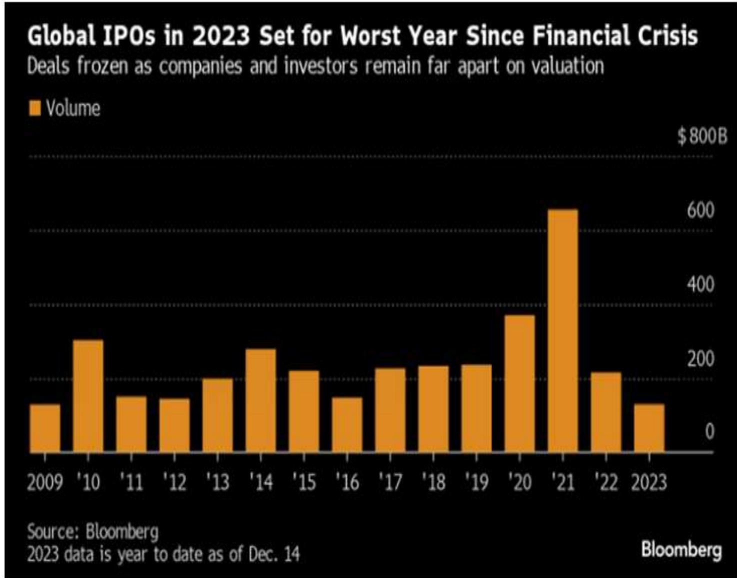
20% Yearly Gains For The S&P 500 And What Happened Next

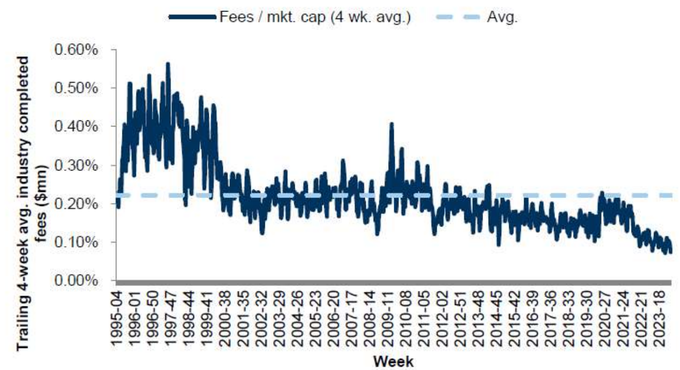
		S&P 500 Index Returns		
Year	Return	Next Year	Higher?	20%?
1950	21.7%	16.3%	No	No
1954	45.0%	26.4%	No	Yes
1955	26.4%	2.6%	No	No
1958	38.1%	8.5%	No	No
1961	23.1%	-11.8%	No	No
1967	20.1%	7.7%	No	No
1975	31.5%	19.1%	No	No
1980	25.8%	-9.7%	No	No
1985	26.3%	14.6%	No	No
1989	27.3%	-6.6%	No	No
1991	26.3%	4.5%	No	No
1995	34.1%	20.3%	No	Yes
1996	20.3%	31.0%	Yes	Yes
1997	31.0%	26.7%	No	Yes
1998	26.7%	19.5%	No	No
2003	26.4%	9.0%	No	No
2009	23.5%	12.8%	No	No
2013	29.6%	11.4%	No	No
2019	28.9%	16.3%	No	No
2021	26.9%	-19.4%	No	No
2023	24.2%	?	?	?
Average		10.0%		
Median		12.1%		
% Higher		80.0%		

Source: Carson Investment Research, FactSet 12/29/2023 (1950 - Current)
@ryandetrick

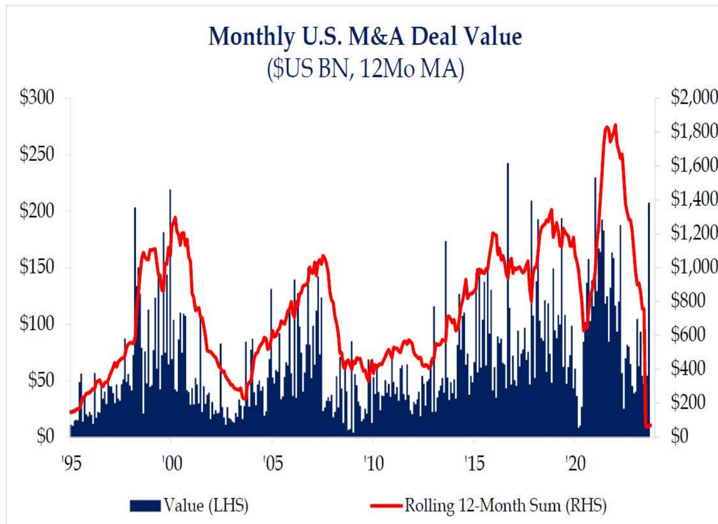
Thematic Investing Update: Releasing the Pent Up M&A and Financing Demand in 2024

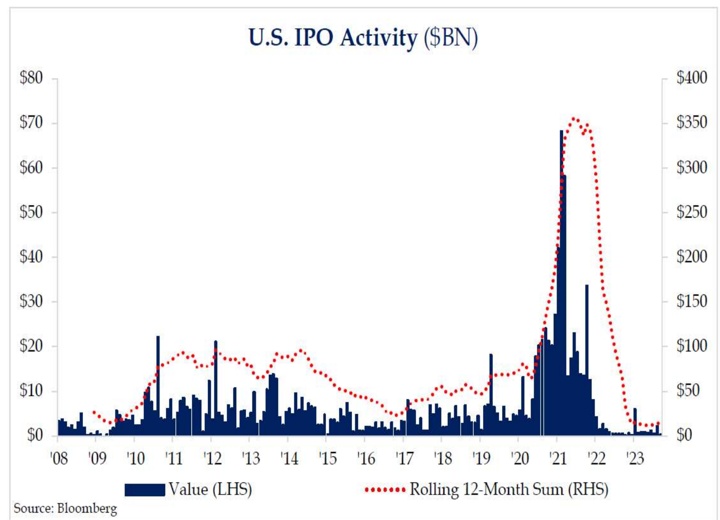
With paltry mergers and acquisitions activity and slim capital markets fundraising in 2023, we are confident that the stabilization and/or reduction of interest rates in 2024 is highly likely to create a much improved environment in both areas in the new year. In the second half of 2023 with the Federal Reserve on pause with interest rate hikes, we deployed our capital markets theme across our small cap strategies. Our theme deployment reflects the old contrarian proverb to “buy straw hats in winter” as the chart below left depicts that 2023 was the worst year for global IPOs in over a decade according to Bloomberg. As seen in the chart below right, with so little activity available, completed fees for M&A and equity and debt financings have been pressured and recorded all-time lows in 2023 as a percentage of market cap (solid blue line).





As for U.S. IPO activity, 2023 was among the slowest in 15 years but with 134 offerings, the year compared favorably with an anemic 2022 total of 98 according to Roth Capital. Highlighted by the Arm Holdings' $4.9 billion offering, there were only three IPOs that generated over $1 billion in proceeds this past year versus 31 in the glory days of 2021. With the Federal Reserve on hold, we believe that the animal spirits will return to both the M&A and capital markets. Deals have been on hold as the gap in the bid/ask spread between the buyer and the seller, respectively, reflected the uncertainty of interest rates. The stabilization of interest rates should allow for greater clarity for the completion of M&A deals. Vastly improved equity and debt markets in the last two months of 2023 should also boost confidence in executing financings. In fact as seen in both the last blue bars on the far right of each chart below, both M&A and IPO activity even showed some life in October.





Source: Strategas

We believe that this strengthening will continue in 2024. Structurally the biotech and REIT industries are notorious consumers of capital and should help drive equity fundraising. According to BTIG, healthcare IPO and follow-on activity just posted -22.9% and -66.4% year-over-year declines in notional issuance dollars in October and November, respectively. Biotechs will need to visit the equity trough to keep their cash burning operations running. With interest rate stability in 2024, a greater number of real estate property acquisitions should be completed and are likely to be largely equity funded after the strong stock market gains in this sector to close out 2023.

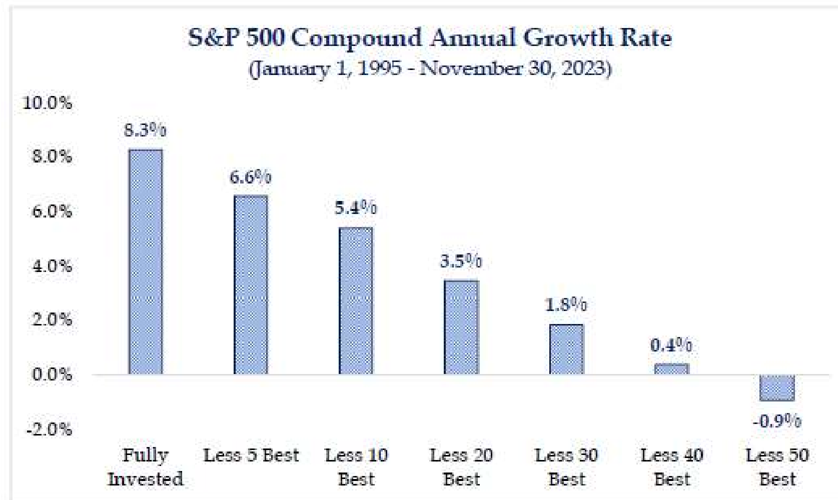
Lastly, private equity exits from middle-market companies (deals of $25 million to $1 billion) were also hamstrung in 2023. According to Pitchbook, the value of private equity (PE) exits from middle market companies totaled just $23.2 billion in the third quarter of 2023, which is the second lowest figure since the second quarter of 2010 with the pandemic-induced second quarter of 2020 being the worst. Interestingly, they also noted that the median holding period from investment to exit for private equity

grew to 6.3 years as of the end of the third quarter 2023, which is the first time since 2014 that their holding period has exceeded six years. In addition, there is roughly $101 billion and $185 billion of leveraged loans due in 2025 and 2026, respectively, which private equity portfolio companies actively hold according to PwC. Along with a rebound in M&A activity, this refinancing wave in the debt market and the reopening of the IPO spigot for private equity exits should bode well for the investment banking equities that comprise our capital markets theme in the 1492 Capital Management's small cap strategies.

2024 Outlook: A Picture is Worth a Thousand Words

We articulated our 2024 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. 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.

Market timing is quite difficult, and this chart shows how investment returns are negatively impacted by missing just a few of the best days of stock market returns.

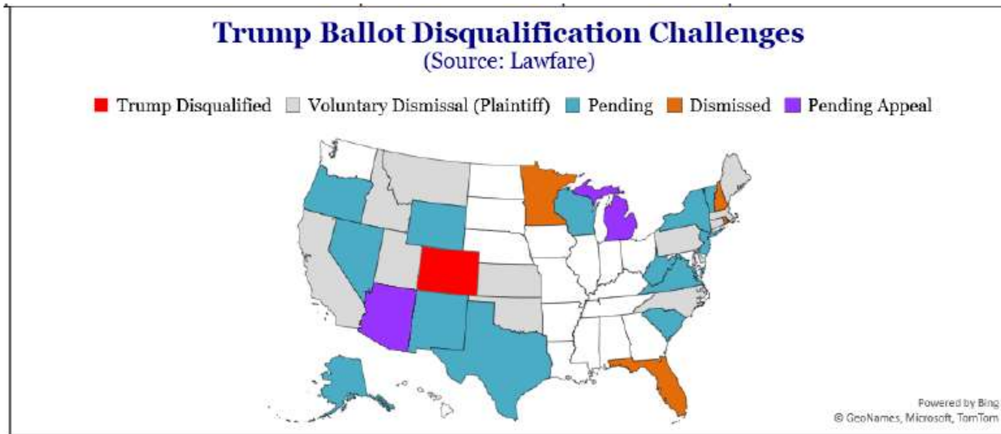


Source: Strategas

The Fed's aggressive interest rate tightening has led to a massive spike in credit card rates. This advance has negative implications for consumer spending in 2024.

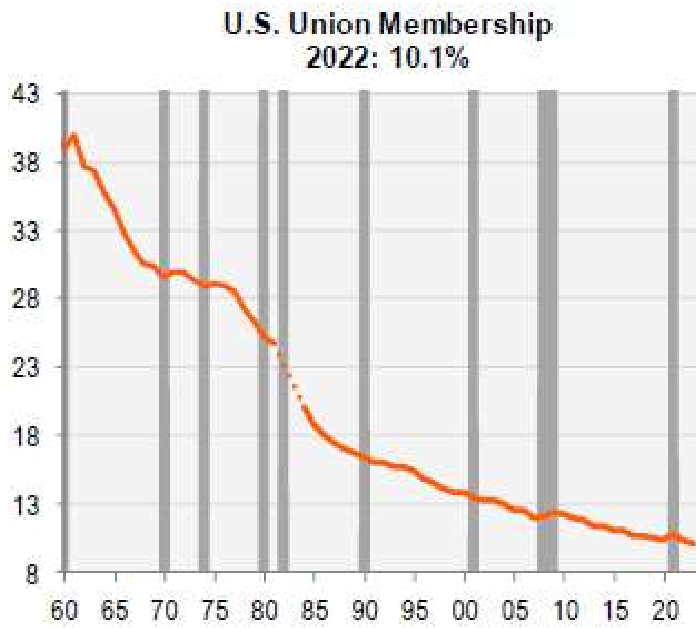
Source: PSC

This election ought to be interesting with Colorado already disqualifying Trump from the 2024 Presidential election ballot, and many more state rulings are pending. This decision is likely to become a Supreme Court issue before long.



Source: Strategas

Union membership has plummeted over the decades, and despite efforts to unionize businesses like Amazon or Starbucks, the numbers continue to shrink.

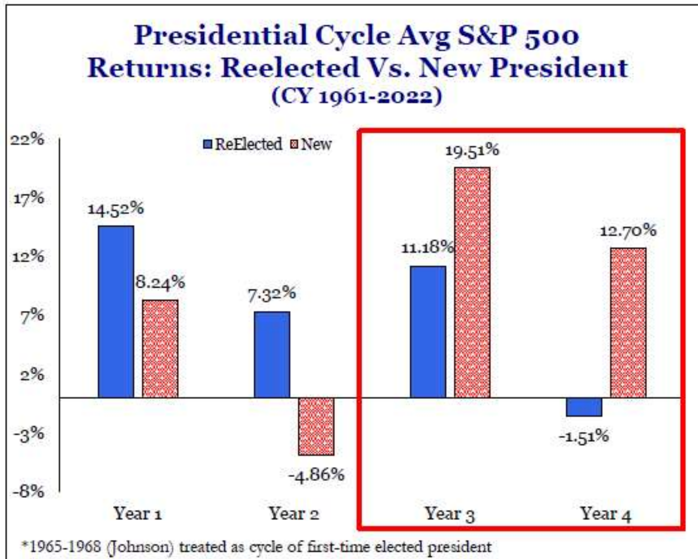


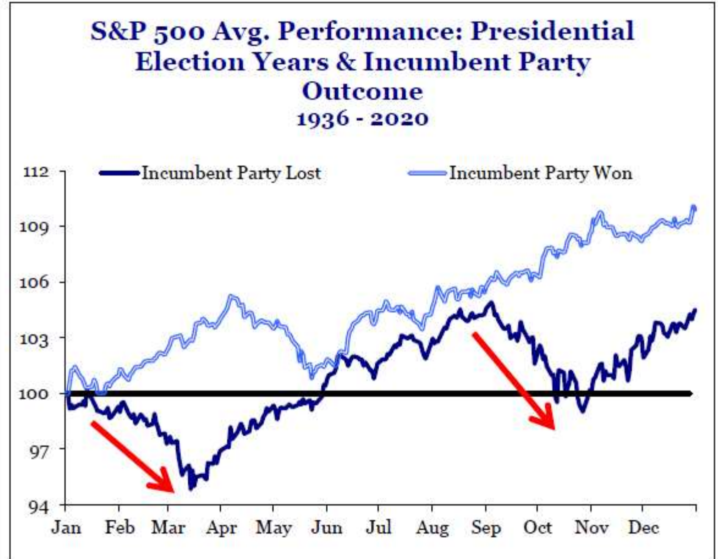
Source: PSC

The “Magnificent 7” stocks were on a tear in 2023 and now represent nearly 30% of the entire S&P 500 Index of stocks.

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 returns during a Presidential election year. The first chart below left shows the returns of the S&P 500 Index in each year of a Presidential cycle and compares a reelected President to a "new President". 2024 will be year four for President Biden. As he is a new President running for reelection, returns are generally quite positive with the theory being that a President up for reelection will try to do everything to make the economy positive in advance of the election to win reelection. The chart below right shows the average performance for the S&P 500 Index in years in which the incumbent party won reelection compared to years in which the incumbent party lost. The years in which the incumbent party lost have more volatility in theory because of the uncertainty that a new administration and its policies bring to the U.S. economy.





Source: Strategas

The table below shows the performance of large, mid, and small cap stocks for each election year going back to 1928. The good news is that election years have generally been positive for the stock market overall with a skew to favoring small caps.

Election Year	Large	Mid	Small
1928	39.0	40.0	33.3
1932	-8.8	-5.5	-2.6
1936	30.7	36.2	53.2
1940	-7.5	-5.1	-5.2
1944	18.2	30.4	41.8
1948	2.8	0.1	-4.3
1952	14.1	11.9	9.6
1956	8.6	7.8	6.5
1960	1.3	2.2	-3.2
1964	15.7	18.1	16.5
1968	9.2	21.1	31.8
1972	20.4	9.1	5.6
1976	22.4	39.8	50.7
1980	33.1	31.4	33.1
1984	8.3	-1.0	-2.2
1988	16.0	21.7	24.8
1992	6.9	16.1	17.4
1996	22.9	16.8	18.1
2000	-12.0	-7.8	-11.1
2004	9.9	18.2	21.1
2008	-36.3	-38.0	-37.6
2012	15.9	16.3	18.4
2016	12.5	15.8	21.5
2020	23.2	21.2	28.1
Average	**11.1**	**13.2**	**15.2**
Median	**13.3**	**16.2**	**17.7**

Note: The performance was calculated (or Derived) based on data from CRSP
Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

We hope that you found our fourth quarter 2023 review and 2024 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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