Quarterly Letter April 2019

Written April 8th, 2019

THALASSA CAPITAL LLC

"In investing, what is comfortable is rarely profitable."
– Robert Arnott

The first quarter of 2019 was a mirror image of the disappointing downward move in December 2018. Markets quickly recovered their footing and indexes are now flirting with new highs.

This reversal of fortune was not just the product of behavioral irrationality, albeit the return of liquidity after the holidays and the usual positive seasonality certainly helped right the ship, but also a quick response to changes – real and perceived – in fundamental factors.

The economic slowdown we mentioned in our last quarterly missive in combination with the increase in volatility forced the Fed into a more moderate stance. Fed Chairman Powell pivoted from a systematic approach to a reduction of the Fed's balance sheet and a moderate yet consistent increase in rates to a much more patient and dovish approach. The Fed has also acknowledged that the current level of interest rates is now perceived to be at neutral. A dovish monetary policy stance is usually a great tailwind for risky assets.

This is especially true when the macro picture is certainly showing signs of fatigue but remains a story of very low interest rates, full employment, low inflation rates and possible increases in fiscal stimulus from China. Speaking of China, the much feared trade war with the US might be reaching some kind of a short term resolution which could also work as a tailwind for equities.

Valuations are also not extreme but just in line with long term averages; for instance, the P/E ratio for the S&P500 now stands at 16.4 versus a 25-year average of 16.2.

To be sure there are risks as it is always the case in financial markets. While the risk of recession seems to us as a remote possibility in the short term, there is mush talk about a recession in profits. Earnings are notoriously cyclical, and this cycle is undoubtedly mature; however, wage pressures are surprisingly mild in spite of the very low rate of unemployment and commodity prices should remain in check.

And then of course there is political risk. As far as the trade war with China, we are picking up positive signals, but we do admit that this particular "poker game" is hard to call and hinges on personalities much more than other political quagmires. On the subject of political quagmires, the mother of all seems to be Brexit. A never-ending saga of political ineffectiveness, self-damaging posturing, lack of vision and more. When and even if the UK will leave the EU and on what terms is still a completely open question two and half years after the tumultuous (and may we add unnecessary) referendum. This element too is quite hard to call and most likely we will witness many more twists and turns before the end of it.

In terms of specific sectors, the recent change in the Fed stance on monetary policy seems to imply a lower US Dollar, which in turn favors international allocations. Emerging Markets are still trading at some discount over long term averages and a weak USD would greatly improve their total return from a US centric perspective.

Midstream assets continue to simplify their structures and reduce leverage while paying superior distributions. Looking at the future, free cashflow should also materially increase as the required build-out of pipelines should peter out by the beginning of 2020 with the effect of reducing capex and improving income.

REITs are in the neutral category currently, as they will benefit from a dovish Fed and past peak supply, but they will be generally constrained by full valuations.

The Fed's new stance naturally should have positive influence on bonds as well and given the Fed's inclination to accept some inflationary pressure in exchange for growth, would seem to favor TIPs.

The new earnings season is about to beginning bringing with it some short-term volatility and perhaps longer-term answers.

We will be watching.

As always, we would like to thank you for the renewed confidence in our work,

Youri Bujko

Davide Accomazzo

269 South Beverly Drive, Suite 1204, Beverly Hills, CA 90212
T.310.867.2255 - F. 310.388.1455 - Web. www.thalassacapital.com