Quarterly Letter April 2020

Written April 3, 2020

THALASSA CAPITAL LLC

"When written in Chinese, the word crisis is composed of two characters – one represents danger, and the other represents opportunity."
– *John F. Kennedy*

If you are in this business long enough, it is likely you will encounter many different crises. It is also likely that each time the crisis will seem somewhat unique and historical; think of 9/11, a terrorist attack or the Great Financial Crisis in 2008, a combination of never seen before greed, incompetence and macro-economic imbalances.

Yet the present COVID 19 crisis truly does have unique characteristics. The combination of the human tragedy, the inconsistent policy responses and the general lack of historical parameters make any analysis a difficult task. While we had many dangerous epidemics in recent history (we have graphed most of them in a previous blog), none was a true pandemic. Under these conditions, the job of an investor to assess risk, opportunities and short term as well as long term value becomes a perilous yet necessary exercise.

Zooming on the financial markets, we note a few positives. High quality credit which in the first few days of the crisis was hit extremely hard has recovered some of the losses and certainly regained stability and functionality. No doubt, one key element was the unprecedented effort by the Federal Reserve to help stabilize a key component of our economy.

We also note that indiscriminate selling (at some point even Treasuries and gold were being sold off) has ended. Such dynamic is an indication that forced liquidation and deleveraging has probably run its course and that from here on , the buying and selling dynamic should be mainly a function of responses to fundamental changes, medical and economic related. On this note, JP Morgan estimates that approximately $1.5 trillion cash should be re-entering bond and equity markets as trading behavior normalizes. From an optimistic standpoint, that number could grow to $3.3 trillion as the economy recovers.

One question we should ask is if such deleveraging and de-risking process has indeed made risky assets cheap. The proper answer naturally hinges on how long the medical emergency will last. As a current snapshot, we can say that valuations have indeed corrected from being

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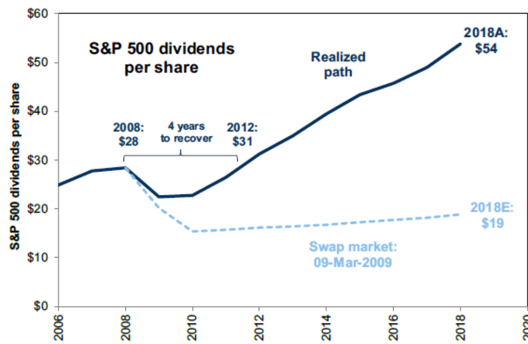
above historical averages to now being below average. However, the denominator (the earnings part) of the traditional P/E ratio is still a moving target. We know that the impact of social distancing is helping break the chain of contagion but at a significant cost to the economy. Forecast of short-term corrections in GDP vary from 10% to an eye-popping 30%. Such a sudden halt to normal economic activity translates into serious decreases in quarterly earnings. The consensus is that while Q1 will not be great and Q2 will be horrid, things should start turning around by Q3 and take off in Q4. Overall earnings will probably still be negative for 2020 but would lay the foundations for a solid recovery in 2021. Also, assuming that some kind of medical breakthrough might occur in the next 6 to 12 months (not necessarily a vaccine but a valid anti-viral remedy), one could make the case that 2022 should be the year of full normalization. In such a scenario, an investor should start valuing stocks based on normalized 2022 earnings, and on that front, a case of current underpricing could be made.

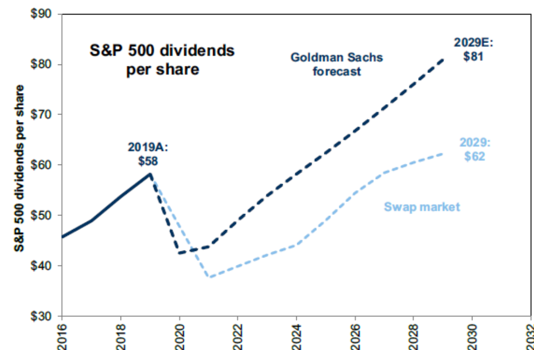
The chart below (courtesy of Bloomberg and Goldman Sachs) shows the Swap market for S&P 500 future dividends. The chart on the left shows how in 2008, dividend futures were projecting a much deeper dividend reduction and a terribly long path to recovery. The chart on the right shows today's situation. The Swap market indicates a deep contraction in dividends and a roughly 10-year long path to recovery. However, back in 2008 (chart on the left) the recovery occurred in 4 years. A similar and potentially quicker recovery might be occurring this time around indicating that specifically reliable dividend-payers might be undervalued.

Exhibit 11: Swap market implied vs. realized DPS around the Financial Crisis



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 12: Swap market implied vs. Goldman Sachs forecast path of DPS
as of March 27, 2020



Source: FactSet, Goldman Sachs Global Investment Research

On the matter of valuation and specific sectors, we would like to spend a few words on Commercial Real Estate. CRE is usually a stalwart of solid asset allocation models and it is generally viewed as less momentum driven and less prone to bouts of extreme volatility; a characteristic due to the real nature of its underlying assets and the generally stable stream of

cashflows (rents). Unfortunately, in this particular crisis, CRE (especially in the form of publicly listed REITs) has shown, in most subsectors, as much volatility (and occasionally more) than equities. In a nutshell, social distancing and real estate don't mix. If people are forced to stay home, the present usefulness of commercial buildings goes to zero. However, in the long term, one should remember that normal life dynamics will return and CRE usefulness will also return. Therefore, the question sits on short term liquidity and quality of assets. CRE's balance sheets are in much better shape than in 2008 when the crisis originated from within their sector. Today, CRE is an innocent bystander caught in the crossfire. The best performing subsector, unsurprisingly, was Data Centers. As we lock ourselves in our house, the need for cloud power increases exponentially. Conversely, the worst damage was seen in the Health Care related area; and yet the long-term favorable trend of Health Care CRE is still intact.

Unfortunately, any valuation analysis, as mentioned earlier, hinges on the course of the virus and our response. We have looked at a multitude of models in an attempt to project when it would be reasonable to relax social distancing measures and the data remains vague. We have followed with interest the work of Kinsa Insights which runs a predictive model based on the occurrence of atypical influenza like illness in different regions. In essence, Kinsa tries to collect statistically valid evidence of atypical illness over historical trends to project a COVID 19 emerging crisis in different communities. They also use their data to confirm if social distancing is working as they see atypical cases dropping below historical averages. For those who would like to follow in real time their effort, you can visit their website at www.healthweather.us. Kinsa also suggest that the peak for New York City might be occurring around now. The data shows that the measures being taken in the US are indicating positive results and that a return to normality might be measured in terms of weeks rather than months. Officials from Kinsa, however, also indicate the strong possibility of a wave 2 and 3 for which we should be preparing in terms of infrastructures and behavior.

In conclusion, we expect volatility to continue albeit with less violence than in the first two weeks of this bear market. We also expect the market to work toward a meaningful foundation upon which it could build a recovery path into 2022. The course of the virus and any medical breakthrough may shorten or lengthen such a path.

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

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