Quarterly Letter April 2021

Written April 6 – April 7, 2021

THALASSA CAPITAL LLC

"What interests me in life is curiosity, challenges, the good fight with its victories and defeats." – Paulo Coelho

As expected, our global fight with the COVID-19 virus is slowly but surely moving toward a positive resolution. Great human ingenuity has risen to the occasion and, especially in the US, we are beginning to see tangible results of our vaccination campaign.

The rapid improvements we are making in getting rid of the virus have provided tailwinds for equities in the first quarter of the year. The equity run, however, showed a rotation from "stay-at-home" and speculative names to more traditional value companies and firms with business models anchored in a reopening of traditional economic activities.

Overall, the strangest (and fastest) bear-bull market sequence of all times has produced a set of equity valuations that by historical comparison are now fairly high. Whether we measure valuation by the most common metrics such as Price to Earnings ratio or Price to Book or more long-term metrics such as the Shiller's CAPE, we get values in the top of the range of the last 25 years. Some solace comes from looking at equity valuations in the context of bonds. If we measure the Earnings Yield of equities (the reciprocal of the Price to Earnings ratio) in relationship to the yield provided by Treasuries or Corporate bonds, we get a much friendlier picture. In other words, in the context of really low government interest rates and low corporate yields, equities are actually not such a bad deal. A continuation of low government rates hinges on Central Bank's action and its reaction to inflation numbers. It is a given that inflation will tick up in the short term as demand comes back and bottlenecks in supply will take some time to be resolved but whether inflation will rise enough to force the hand of the Federal Reserve into aggressively raising rates remains to be seen.

Another tailwind for equity comes from the ISM Index, a measurement of manufacturing activity. Unsurprisingly, this index is shooting up as the economy re-opens with a value in March of 64.7 (any value over 50 indicates the economy is expanding), well above economists' expectations. The S&P 500 index is highly correlated to the year-over-year change in the ISM which means that especially traditional value companies should see a surge in profits and possibly better stock prices.

If equities are pricey but still in a positive context, the picture for bonds is a little more clouded. Rates have recently risen in response to inflationary expectations but have now stabilized as it is unclear how sticky price increases will be. For instance, one element that worried bond vigilantes was the rumored infrastructure plan by the new administration. However, once unveiled, the plan seemed a lot less inflationary than previously thought given the implication for higher taxes and the long duration of its implementation.

The mixed view on domestic bonds leads us to prefer Emerging Market bonds which still trade at much better valuations (from an exchange rate perspective as well) and non-traditional fixed income sectors such as non-agency mortgages and global structured products.

The future picture of inflation naturally influences the commodity sector as well. In line with the economic re-opening trend, basic materials have done well year to date and it is reasonable to expect a continuation of the move. Oil and energy stocks have experienced a good run since the lows marked last year at the height of the pandemic fear. However, energy related stocks are still trading at a deep discount to their pre-COVID levels, and their prices are implying a price of oil of around $45 per barrel compared to the current WTI price of about $60 per barrel. The implication of such discrepancy is that either the market is pricing in much more drilling to occur domestically and therefore more supply coming or energy stock are significantly undervalued. Reality will probably fall somewhere in the middle as more supply should come from domestic producers, but it will probably be very constrained by significantly less friendly capital markets. OPEC as well will most certainly start relaxing production cuts but as long as the US producers will remain in check, it is likely that it will increase supply very cautiously and only by matching rising demand.

So off we go into another quarter with the expectation that we are one step closer to defeating the pandemic and that the probabilities of economic normalization are rising rapidly providing new opportunities and new risks.

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

Youri Bujko

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