THALASSA
CAPITAL LLC

Quarterly Letter July 2019

Written July 3-5, 2019

THALASSA CAPITAL LLC

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."
– Charles Darwin

The first half of 2019 is behind us and, while it was marked but higher volatility and a few instances of political drama in the background, it has produced one of the best performances on record. Of course, it must be noted that part of such positive performance was a rebalancing move after the dismal action at the end of 2018.

In any case, multiples are expanding in response to a much friendlier monetary policy than expected and lackluster earnings growth. Unfortunately, the increase in valuations reduces the opportunities available and the margin for error should any macro variable take a negative turn or should a policy mistake materialize. However, overall, it seems that some of the main elements of this post-2008 recovery continue to linger: slow growth, low inflation, generally friendly monetary policy and this is not necessarily a negative for investment portfolios.

The current environment, however, forces any investor to be more vigilant and possibly to be more tactical about the allocation process.

The new stance at the Fed has some specific portfolio implications and not just macro influence. Bonds remain expensive (even more so now) but probably a much lesser allocation risk than during times of normalization for monetary policy. US agency and non-agency mortgage backed securities would seem to benefit from this environment as they also offer seniority in the capital structure. As far as corporate bonds, newly found Fed's friendliness certainly helps but valuation issues remain a significant constraint especially in the lower quality segment of the market.

Equities in general seem to be fully priced and they will probably need a re-acceleration of earnings to justify significant increases in prices. At the style level, we note opportunities in the Small Cap Value segment where current P/E ratios are well below the 20-year averages (14.2 versus 16.1 – source: JP Morgan). Every other style is above its long-term average by a minimum 3% margin (Large Cap Value) to a maximum 23.2% spread (Small Cap Growth).

On a sector base, we can single out Financials and Health Care as the two sectors with a Forward P/E ratio below their 20-year average. Energy is also below its long run average albeit battling some structural changes in the industry.

Midstream Infrastructures have also produced an excellent first half of the year, occasionally even outperforming the SP500 benchmark (an event that has not occurred in a long time) and also shoving a decreased correlation to crude oil (an old characteristic of this sector that had disappeared since the rout in oil began).

REITs have fulfilled our expectations so far as one of the best sectors in the market and continue to benefit from rates generally lower than expected. However, valuations are stretched especially for some subsectors and therefore a more selective approach is warranted.

From a macro perspective, we would like to introduce a few major themes that could be major disruptors in the not so distant future. These ideas were the topic of discussion at the recent Secular and Cyclical Economic Forum at bond-house PIMCO.

1. China. No surprise here; whichever way we look at it, China will be a major disruptor for years. Strategically and economically, the path of the Western world and China are going to cross many times and sometimes clash. More specifically, we can point to their really large build up of internal debt as a source of systemic instability. Of course, this issue has been raised many times before with little impact in the real economy. However, any significant slowdown in the future could be more difficult to manage because of this debt imbalance. A possible consequence could be a significant devaluation of the Yuan and a domino effect in other currencies.
2. Demographics. Slower population growth and increased longevity affect the real rates of economic growth and inflation expectations. They also force modification in portfolio allocations compared to the models used in the past. Demographics may also push central banks and governments into blurring that line between standard monetary policy and fiscal policy. The recent appointment of non-standard leaders at the Federal Reserve and now the ECB (Jay Powel and Christine Lagarde are lawyers by training and have no pure economics background but are high in political capital) might be a good example of such dynamic.
3. Technology. No surprise here either; technology has been disrupting business models for a while. However, the pace at which technological change might be occurring may be faster than our systems are ready to accommodate with the result of political and social backlashes.

THALASSA
CAPITAL LLC

Ultimately, common sense allocations based on matching risk profiles, long term trends and current valuations should go a long way toward achievement of financial goals.

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