THALASSA
CAPITAL LLC

Quarterly Letter October 2014

Written October 1st, 2014

THALASSA CAPITAL LLC

"Neither a borrower nor a lender be." William Shakespeare

It would seem from the above quote that Mr. Shakespeare did not believe in leveraged markets and probably he would never have put a credit derivative in his pension account. Certainly, financial markets have changed greatly from the times of McBeth and the Merchant of Venice and in spite of recurrent crises, our capital markets are more efficient and more functional for a better society.

However, the dangers of being a borrower or a lender have not changed much and still depend on one's ability to understand risk in order to properly manage it.

At this economic juncture, understanding risk, and especially risk emanating from the credit markets, is paramount. As of this writing, the Fed is about to wind down its latest QE program and that cushion of liquidity, so helpful in supporting risky asset valuations, will no longer be there. Monetary policy will remain friendly for a little longer given low inflation numbers but it is unclear how most assets will react to a world without Fed buying.

Financial assets are beginning to show some increased volatility, which we have been expecting for a few months, as the trifecta of an ending QE, European economic slowdown and an unfriendly Russia are forcing the case for profit taking.

The hard question is if this increase in volatility is an opportunity to welcome or the dawn of a more serious and more fundamental asset re-pricing.

As we analyze the short and the long term view, we note the asymmetrical position of the Fed and the two other major Central Banks, ECB and BOJ. This asymmetry is resulting in the natural strengthening of the US Dollar. The immediate reverberation is in the commodities universe which have been weakening in an almost perfect negative correlation to the currency.

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

The longer term picture however could develop with a number of positive ramifications. A strong Dollar and a relative stronger economic performance in the US versus Europe and Japan could ignite a virtuous cycle domestically and provide a number of additional years to this bull market. Not only equities may benefit but bonds as well, a dynamic that could help temper the rise in rate engineered by the Fed and again reinforce the positive cycle. This scenario has happened in the past (1990s) and to the extent that no significant inflationary pressures arise, it could occur again.

In essence, we think longer term markets will be fine and equities should continue to outperform; however, we do think that the times of simple beta based returns may be behind us and a more active and tactical approach may be in need. Additionally, in light of changing monetary policy, we have also run studies on especially rate sensitive sectors which have prominent roles in our allocations: REITs and MLPs.

REITs have actually started to price rate increases pre-emptively and have posted a sector correction since the highs at the beginning of September of approximately 10%. We are looking to add in this correction, focusing on REITs that may have a business model advantage (health care) and/or that have a history of increasing distributions consistently. In the past seven periods during the last 40 years when rates increased, REITs prospered 5 times and showed losses 2 times.

As far as MLPs, the sector is churning at the highs and so far it has shown more resilience than the REITs. However, we have noticed an increase in secondary offerings, a sign of full valuations. We continue to like the long term energy renaissance story but we would like to add only on a more significant correction.

Staying on the subject of energy, the sector (pure energy plays and not MLPs) is one of the few areas in the markets that still shows some undervaluation. The fair value estimate from Morningstar shows a discount to intrinsic value of approximately 10%. The sector was briefly overvalued earlier in the year but it was generally trading at a discount in the last three years.

Oil supplies are plentiful but generally expensive to take out of the ground and OPEC is cutting production in an effort to bring prices back above $100 per barrel (Brent oil). With all the geopolitical risk abounding around the world and domestic economic growth potentially picking up, volatility risk may be building on the upside.

In conclusion, while the month of October has a reputation for financial crashes, it also offers many opportunities as volatility usually works in both directions, up and down. We will monitor for dislocations in areas where we retain a long term positive view and will continue to act opportunistically.

Sincerely,

Youri Bujko and Davide Accomazzo