THALASSA
CAPITAL LLC

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"As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality." Albert Einstein

Financial markets are often efficient but rarely certain and never fully shielded by structural asymmetries and behavioral influences. The feedback loop between future expectations and today's prices constantly morphs fundamentals inputs, making an economic equilibrium a never ending process.

The third quarter of 2015 was plagued by uncertainties of all kinds which reinforced highly destabilizing reflexive loops. The convergence of a potential slowdown in China and possible rising rates in the US was enough to depress global investors who started to project subpar global GDP rates and higher cost of capital.

The September Fed meeting, which was one of the most scrutinized in years, ended up increasing the level of uncertainty in the markets rather than marking an historical turning point in monetary policy. If Albert Einstein is right in his quote about the relationship between mathematics and reality, Fed Chairwoman Janet Yellen, might be excused for stressing the data dependency of her Fed and then generally disregarding such benchmarks. While US data seem to justify a start of the normalization process for interest rates, a fear of global deflation is putting the brakes at the Fed. The result is massive confusion of what the course of future decisions will be and therefore an increase in volatility.

If Fed indecision wasn't enough to cloud financial projections, the instability of the energy sector is another major destabilizing factor. Are lower energy prices positive or negative for the global economy? Is an equilibrium point closer or farther away as a result of the last 12 months of brutal repricing? The oil price war instigated by the Saudis might result in much higher volatility in the sector for years to come as the production landscape gets redesigned and long term projects get cancelled. Demand for energy keeps increasing but the Chinese slowdown keeps traders awake at night. So far, China has maintained its energy imports high as it replenishes strategic reserves; however, such demand is viewed as transitory and unstable. Yet, the energy bloodshed seems overdone as the oversupply might not be as significant as suggested by some headlines. US production is taking a hit which is increasing in magnitude and whose speed is about to grow as credit is cut and hedges expire. Furthermore, contrary to widespread belief, fracking production that gets shut down cannot

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actually come on line as quickly as believed. The much talked about reduction in fracking production costs, which lowers the US break-even point, is also very much overstated as it is in large part a function of the desperate conditions the sector players are managing. The cyclicality of energy continues to make this dislocation attractive but its timing uncertain.

As often quoted in financial circles, the word "crisis" in Chinese is made up of the signs for danger and opportunity; so in these times of financial asset crises where is the danger and where are the opportunities?

The energy and the emerging markets sectors seem to provide long term opportunities but high short term danger. Selectively, we continue to believe that long term holders should look into these areas.

REITs continue to trade at a significant discount to NAV, now widened to almost 13%, which implies good value but they are for the moment trapped by the fear of the above mentioned convergence of low growth and higher rates. With sector wide yields above 4% and specialized outfits paying over 6%, in this environment the bet seems relatively attractive.

Domestic equities are fairly priced compared to historical averages; however, if earnings start deteriorating greatly this quarter and trend toward the lower end of the 2016 forecasted range ($110 for the S&P 500,) a new equilibrium level could be found around the 1700 mark (or EPS $110 x 15.5 average P/E ratio = 1705). An unlikely scenario but certainly possible within this new slowdown framework.

Fixed income remains unattractive on a short term basis because of uncertainty on monetary policy and on a long term basis because of the mathematics of bonds and their current pricing.

Overall, the set of current opportunities is narrow and higher levels of cash combined with de-correlating strategies is a good way to mitigate the volatility that is sweeping most sectors.

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

Youri Bujko

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