THALASSA
CAPITAL LLC

Quarterly Letter October 2012

Written September 28, 2012

THALASSA CAPITAL LLC

"They always say time changes things, but you actually have to change them yourself."
Andy Warhol

At THALASSA CAPITAL we strongly agree with Andy Warhol's view of change and we have made 2012 a year of significant transformation. In the past nine months, the firm took a radical leap into a higher league in the galaxy of financial institutions.

THALASSA CAPITAL added depth to its investment team, rolled out new investment strategies, created new services, built up its technology infrastructure and started producing proprietary research. We also created a new website experience for the members of our community; this was meant to be true to our ideal that our firm should not be just a monochromatic advisory but a distinctive, organic, usable tool in the hands of our advocates.

The institution of this Quarterly Letter is an additional step in the direction of creating bridges of information between you and us. The game of investing is centered on the ability of investors to positions themselves in the most strategic place in the information flow and on their capacity to process the available data; we will do our best to improve your standing in this delicate process.

Naturally, THALASSA CAPITAL is not the only entity changing in the financial universe; over the last quarter, global monetary policy and political stances have continued to shift in not so mysterious ways and global QE Infinity (Quantitative Easing open ended) was ushered in by the Federal Reserve and the European Central Bank.

This new injection of massive amounts of liquidity in the global financial plumbing system (the Bank of Japan followed suit with a more modest program) should have investors question the finality of this experiment as well as the shorter term consequences. As per granted expectations, risky assets "en masse" rallied on the news – after all, each previous QE was quite friendly for most assets classes – but especially in equities much of the early upside has already been given back. Is the market just

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swing-trading or is it looking beyond the cosmetic aspect of QE and try to focus on the longer term fundamentals of Main Street?

Textbook investing teaches us that fighting Central Bankers' determination is a foolish game and the resilient upside of gold and TIPS would indicate that, at least on a nominal basis, investors should keep the faith and continue to hold risky exposure. However, such unlimited quantitative easing may also indicate a certain worrying despair on the part of Chairman Bernanke (more on Super Mario Draghi's despair in a moment). If the tripling of the Fed's balance sheet since the inception of the crisis alongside a deterioration of its credit quality and an increase in its duration could only produce a stalling of the economic fall and the weakest recovery on record, we may be witnessing a structural mixture of elements outside the reach of the Fed. In a balance sheet recession such as the one we are witnessing, monetary policy can only go so far and a combination of time and structural reorganizing will be needed to heal us. Eventually, here and in Europe as well, inflation will be used to speed up the process albeit with possible unintended consequences.

The macro-picture is starting to look like a mild repeat of 1970s stagflation; low real economic growth (we are witnessing slowdowns in Europe, China and now also here in the US) with creeping inflation. In the US, CPI is being reported well below 2% but that is pure statistical fiction as most real life goods and services are increasing in price fairly rapidly. A real rate of inflation higher than the general level of interest rates (negative rates), a situation called financial repression, is being implemented by design. The idea is to push consumers and investors out on the risk curve and jump start the economic cycle one more time. Central bankers seem to be baffled by reality not playing along with the rule-book. Unfortunately, the multiple shocks endured by investors in the last fifteen reckless years have made everyone rightfully skeptical.

But now back to Super Mario. Mr. Draghi in the first year as Head of the ECB has already taken a very different approach than his predecessor Trichet. Once he understood the inability of the European Union political system to proceed consistently and at the speed required by the markets, he decided that a Super Mario approach was needed: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." This statement was in July and now he presented his open plan to buy bonds in the periphery based on specific conditionality – i.e. Brussel's supervision over budgets of nations asking for a bail-out.

Will this be enough to save the Euro? We believe so. It will be a path full of "faux pas" but ultimately, we believe it will succeed (with Greece a possible sacrificial lamb).

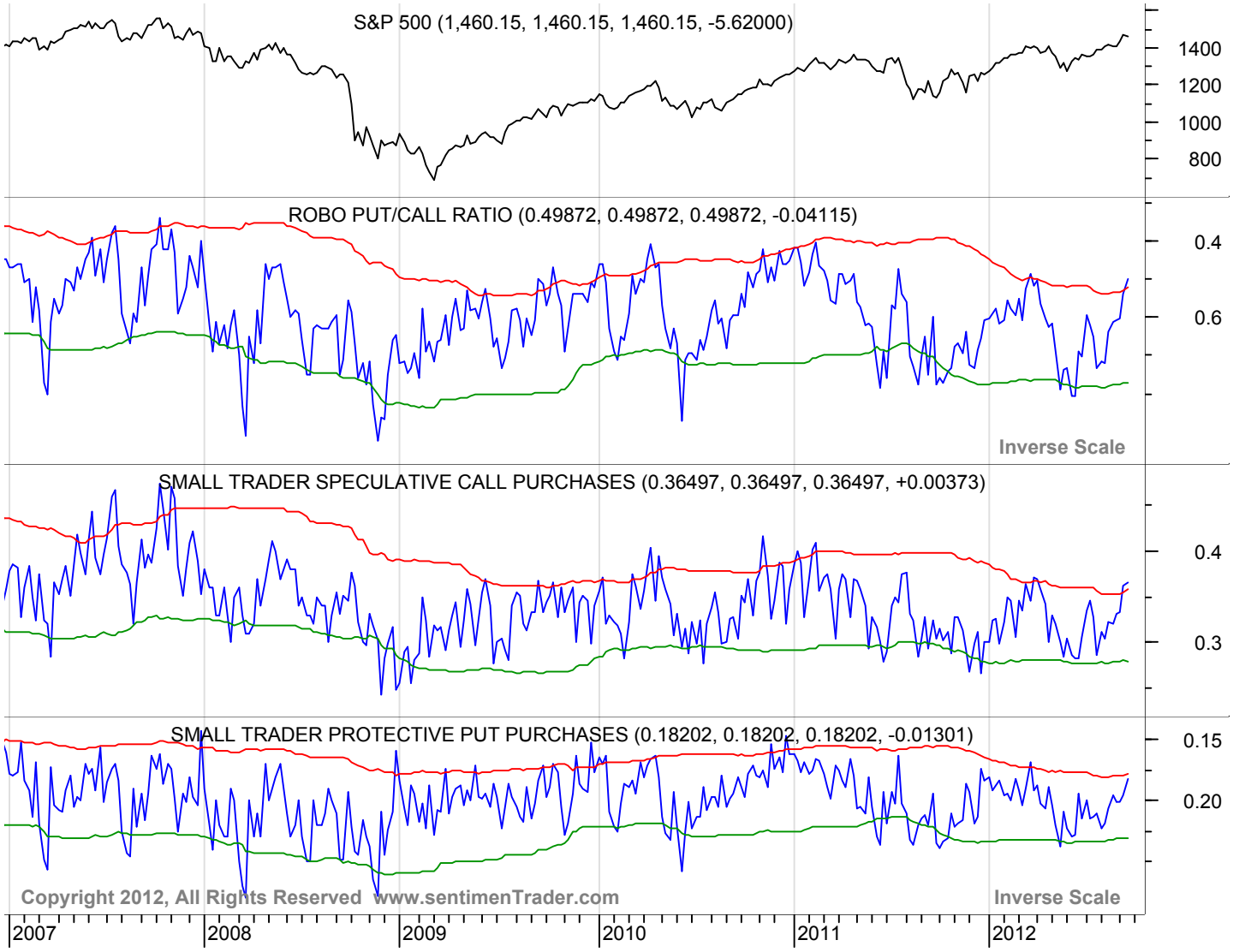
Given this macro background, we believe certain major themes should be incorporated in most investment approaches. The long term requires an inflation hedge via

diversified exposure to real assets; equities engaged in the management of real assets seem to be uniquely qualified to provide such hedge.

The long term macro shift from the West to the East should also require investors to look at demographic and infrastructure trends and reposition accordingly.

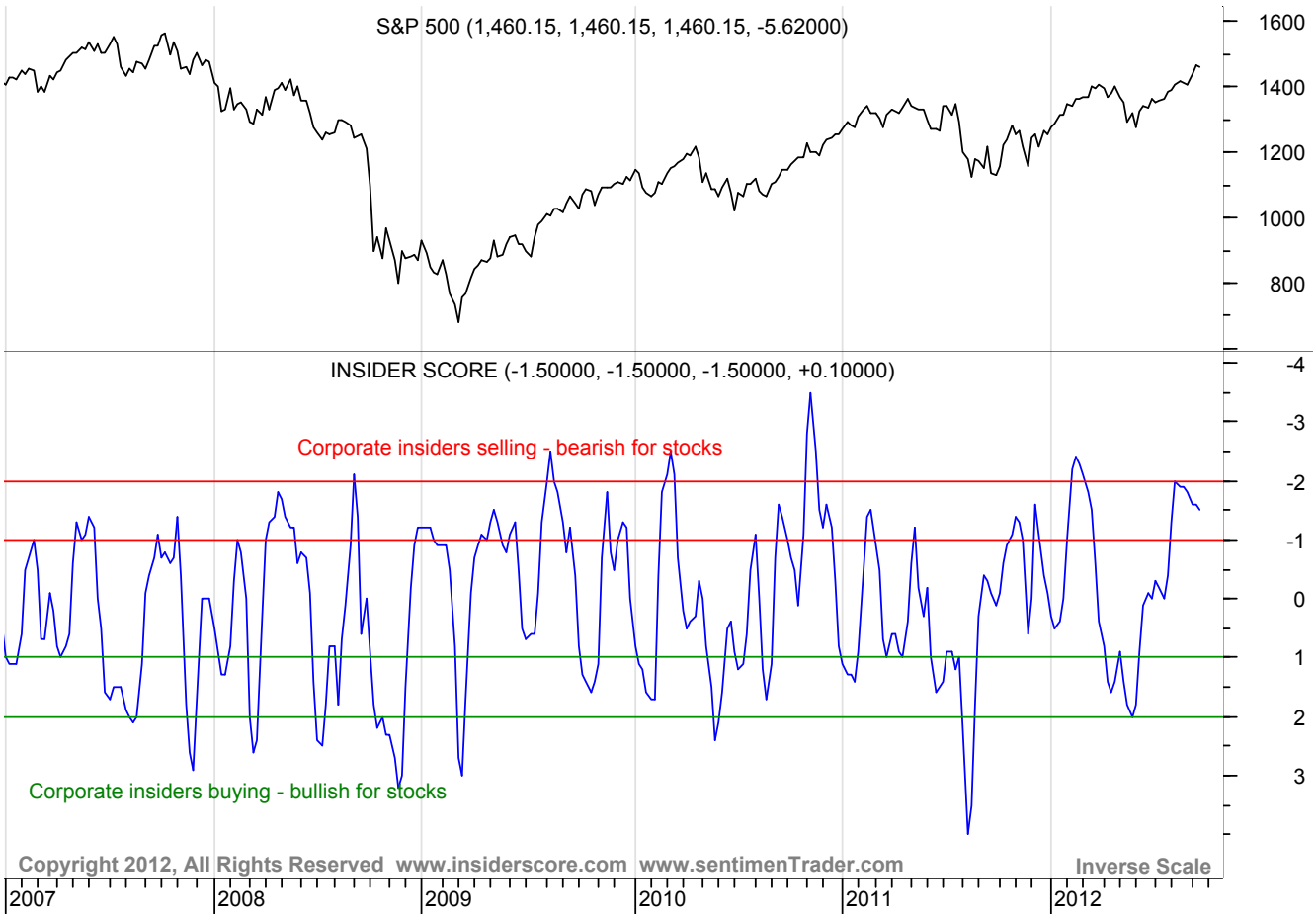
Additionally, the sophisticated investor should move over traditional asset allocation and create layers of exposure via diversified assets but also via diversified and possibly uncorrelated strategies.

On a short term basis we have a few indicators indicating an overbought situation which may resolve in a temporary correction; see below the Retail Only, Buy to Open Put/Call ratio, a contrarian indicator indicating high speculative activity at the small investor level (usually the least informed investor in the market):



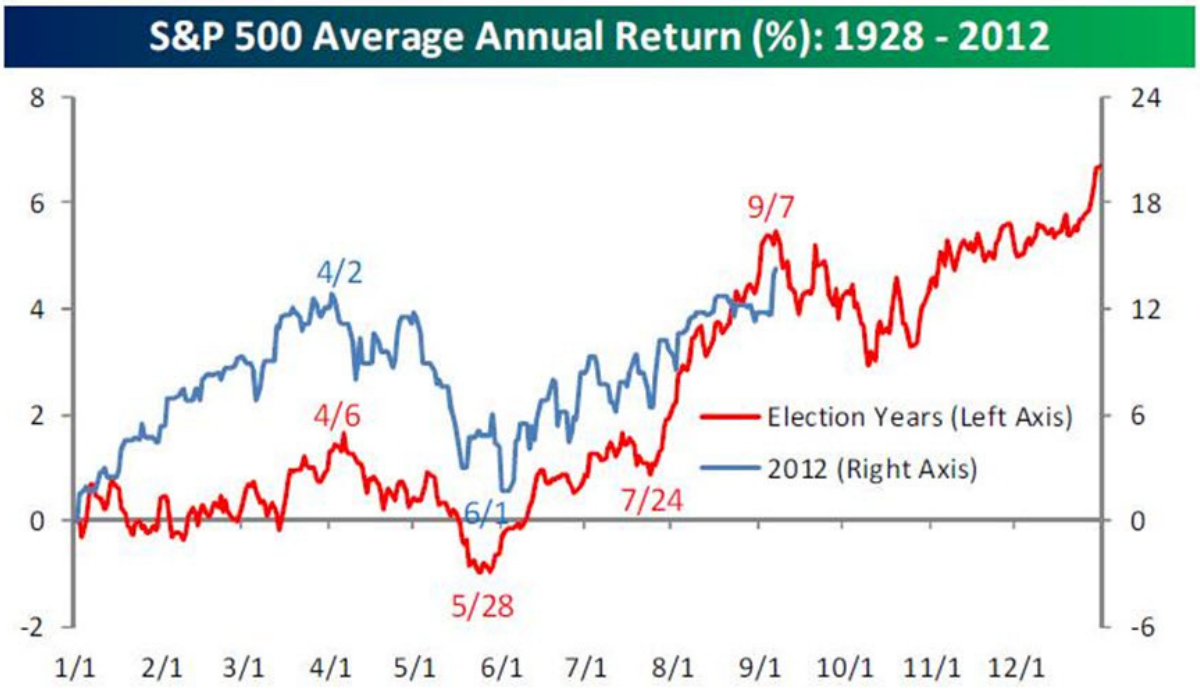
Source: www.sentimentrader.com

Insider activity indicators (what corporate managers are doing in respect to buying or selling their company's stock) are also flashing caution:



Source: www.sentimentrader .com

From a technical and cyclical standpoint we are following closely a classic Presidential Election Year trading pattern:



Source: Bespoke Investment Group.

In conclusion, we quote what J.P. Morgan once said when asked what his forecast was for stocks: "Stocks will go up and stocks will go down…." In the end the difference will be made by our ability to single out overly hazardous areas and manage systematic risk properly.

Sincerely,

Youri Bujko and Davide Accomazzo