Quarterly Letter December 2018

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THALASSA CAPITAL LLC

"It is not certain that everything is uncertain."
Blaise Pascal.

When John Pierpont Morgan was asked what markets were likely to do in the coming year, he usually answered along these lines: "Stocks will go up and stocks will go down." So, if the man who singlehandedly controlled domestic financial markets would not have high certainties, why is it that on any given December, analysts, advisors, and economists cannot resist the temptation to forecast the future?

Perhaps, it is human nature to divine the impossible, or perhaps while conscious that our forecast may very well be off mark, it is still a good exercise that will force us to review our basic tenets of investing and allocation.

The short-term vagaries of markets are often hard to predict but more importantly, for most accounts, are also very difficult to act on. Very few investors have the luxury (or the curse) to follow and act on every little movement. It is costly in terms of resources, slippage and often tax attrition. However, the short-term noise can help fine tune the long view, which is the real end game for the typical investor.

We should always ask ourselves why we invest and remind ourselves constantly that the ultimate prize is to retain purchasing power over the years and possibly to achieve such grace with the least amount of volatility that may be possible.

Volatile markets such as the one we have experienced in the last few months make it harder to focus on the long view; especially when is seems that logic might have been thrown out of the window. And yet, discipline usually wins the day. Certainly, there are decades that are more generous and decades that are less giving as a function of valuations and surrounding policies but assuming the social construct remains functional, in the end risky assets will have to reflect the natural growth of demographics, technology and inflation premium. Even in the lost decade of 2000 to 2009, when the SP 500 produced incredible volatility and no returns, the level of dividends paid actually doubled. In fact, dividends grew at a much

higher rate of growth than underlying inflation. Purchasing power retained and mission accomplished.

The next ten years might not be as exciting as the last ten but dividends and distributions by strong companies and sound assets (such as commercial real estate and infrastructures) should continue in due course.

In our allocations, we tend to overweight two sectors that often show value and a fairly consistent growth of distributions over time: energy/midstream, and REITs.

Recently, the latter did behave as expected and helped portfolios with welcomed decorrelated performance. Energy and midstream on the other hand have so far disappointed. However, midstream has also actually started to show some relative performance in the last two weeks helped by interesting valuations, strong (and well covered) distributions and a simplification of the corporate structure. It's a niche play and in the last correction of 2015, the natural buyer (hard core income investor) was lost. The sector is struggling to replace such natural buyer with a new profile and many transactions have so far occurred in the private markets where Private Equity funds have been active in acquiring assets. It is reasonable to believe that eventually such mispricing will end, and a new investor's profile will be found.

Outside of midstream, energy integrated outfits have been held hostage by the historically high level of volatility of the underlying commodity. Crude oil is exhibiting trading behavior that is significantly more difficult to gauge than in the past. Analysts have pointed the finger at different causes such as the shorter and fragmented shale producing cycle, the uncomfortable thought that the market is practically controlled by only three characters: Putin, Trump and Saudi Prince MbS, and last but not least, the growing relevance of algorithmic trading. Whatever the reason, trading energy has become riskier as a few dedicated hedge fund closures have stressed.

And yet, it is hard to overlook a situation where many of these integrated energy outfits are producing great cash flows, paying strong dividends and selling a product that is still in increasing demand across the globe.

Rarely has it been the case when the macro-economic analysis was so relevant in crafting future projections for risky assets. As we are possibly coming into the end of a long economic expansion, we are struggling to reconcile economic data that are still pointing toward a continuation of the cycle and counterattacking elements such as an inverted yield curve and a slowdown in key areas such as residential real estate. As far as the flattening of the spread between the 2-year and the 10-year US Treasuries and the actual inversion of the 2-year and the 5 year (the inversion means that the shorter dated security uncharacteristically yields more than the longer dated), their predictions are generally dire. When the 2 and the

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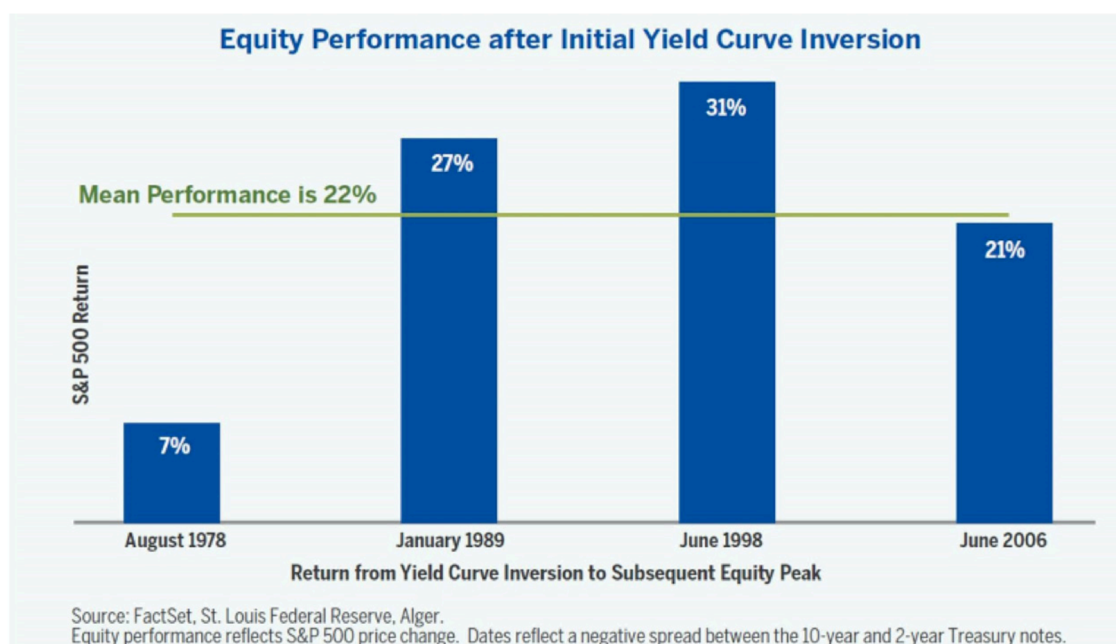
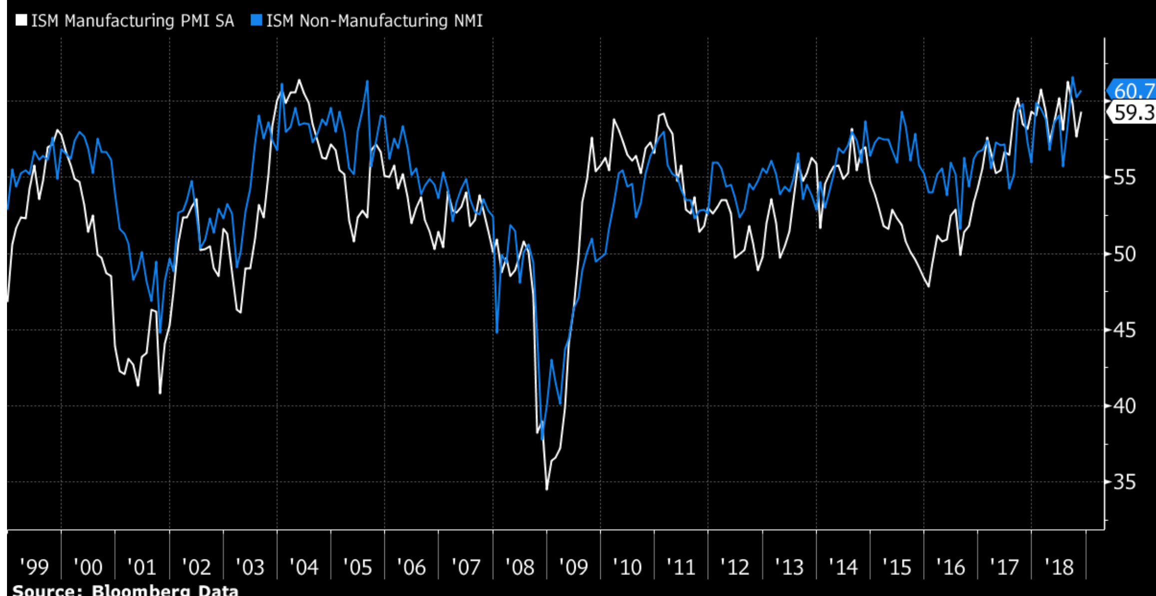
10-year curve inverts, often a recession follows. However, even when a recession follows, there is a fairly long lead of up to approximately 20 months. Based on this data, the Federal Reserve Bank of Cleveland puts the odds of a recession within a year at only 20%, up from 16% a couple of months ago.

Interestingly, the Saint Louis Federal Reserve has also published a related chart (shown below) indicating how between a yield curve inversion and the subsequent equity peak, stocks can still produce a very meaningful positive performance.



Additionally, we can see from the following chart (courtesy of Bloomberg) that such high levels of the ISM manufacturing and services indexes (both reliable leading indicators of future performance) have rarely been associated with close recessions and weak equities. Values of 50 would be more indicative of doom and gloom rather than the roughly 60 level we are witnessing currently.



In conclusion, we continue to stress the importance of strategic asset allocation, strong dividend growth, and long-term discipline.

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

Youri Bujko

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