Quarterly Letter January 2020

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THALASSA CAPITAL LLC

"An optimist stays up until midnight to see the new year in. A pessimist stays up to make sure the old year leaves."
– Bill Vaughan

As the year winds down, performance in 2019 enters the books as an historical run. Year to date, almost all asset classes have produced significantly positive returns in spite of – or perhaps because of – many of the worries that had ushered in the year last January.

In some ways, 2019 plays by the book by respecting the tradition of the Presidential Cycle; often, year three of an Administration is very strong in financial markets as the re-election efforts of the incumbent President translate into very friendly economic policies.

A slowdown did occur globally half way through the year but the proactive approach by most Central Banks (23 Central Banks eased in 2019) once more saved the day. Until when we should rely on the kindness of central bankers is unknown but their stance in 2020 would seem still very friendly and asymmetrical in their sensitivity to inflation. In other words, the messages we are getting betray a willingness to possibly let inflation overrun its higher band rather than run the risk of premature tightening.

After the November election, the role of the Fed specifically could also structurally change as the Central Bank may become subjugated to fiscal policy. A new Administration or a re-elected one would have, for different reasons, political capital and incentives to push the fiscal boundaries further. Given the high debt to GDP ratio already existing, a debt monetization process in which the Fed plays the role of the last resort buyer would not seem too far-fetched.

Truth be told, it was not just the Fed that saved the day as the economy retraced but some of the geopolitical headwinds also started to back down. A dramatic Brexit was taken off the table by a decisive victory by the Tories in the UK (albeit, the hard work for Johnson really starts now) and the US and China indicated the willingness to a truce in the two-year long trade war. The positive momentum seems to be marked by a general skepticism by the retail investor that has been sitting out most of this rally preferring to funnel money into bond funds. A reversal of this trend in money flows might fuel more upside in equities but also higher valuations. Simply put, as the economy slowed down, stocks did not correct much but as the economy recovers, we might also not see much of an upside in 2020.

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As we look at the fundamentals, we can rationalize that domestically our economy has performed rather decently in the last decade and that our response to the challenges of the Great Recession of 2008 was swifter and more efficient than in Europe or Asia. This factor helps explain the superior outperformance of US stocks versus international equities. Going forward however, the relatively much higher valuations of domestic equities make it difficult to expect another long stretch of outperformance.

In fact, equities might still be a better choice for investments, but domestic equities might not score as well as international equities.

In terms of sectors' expectations, we can focus on short-term and long-term trends. On a longer-term basis, as we elaborated in the past, we see the health care and biotech space as one of great opportunities. The combination of reasonable valuations, M&A, positive demographic trends and improved research approaches makes the sector a possible long-term winner. Sector volatility, especially in an election year, is a short-term headwind which we should expect and that might provide multiple opportunities.

Energy and energy infrastructures are also attractive from a valuation perspective but carry the much higher risk of a structural change in the underlying business model. On a very short-term basis, we might witness a classic first quarter rally and on a longer-term basis, we feel some companies will emerge as winners and superior cash-flow machines. Unfortunately, the space will need more rationalization and many companies might not survive in their present independent format. The energy and energy infrastructure sector are also now ready to be evaluated as an aggregate of more traditional companies (the survivors) and new dynamic players in the renewables and cleantech universe.

On a long-term basis, we also continue to expect superior performance by REITs, but we are conscious that currently their valuations are fairly high in most sub-sectors, an element that will provide a short-term headwind to many names in the space. However, the ability of REITs to generate superior dividends and superior growth of such dividends, a growth rate well in excess of inflation rates, makes this investment a staple of every solid asset allocation plan.

In conclusion, we expect 2020 to be more challenging than 2019 and we continue to advocate strategic diversification, long-term horizons and focus on dividends.

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

Youri Bujko

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