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CAPITAL LLC

Quarterly Letter December 2012

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THALASSA CAPITAL LLC

As we are beginning to reach for the party hat and the unmistakable bottle of champagne to celebrate the arrival of the New Year, we should pose for a moment and reflect if our strategic positioning is still aligned with the most likely scenario for the next twelve months. 2012 produced positive returns in many asset classes but there is a distinct possibility that 2013 may bring higher volatility overall and more muted performances.

This is a clear possibility as economies around the world are showing marked slowdowns. However, the coming year is also ripe with political shifts and many policies are at important junctures in a number of relevant economies. This political climax has the power to fuel a significant rise in global volatility.

The valuation starting point for domestic equities is somewhat agnostic. The US equity market is still favorably priced in absolute terms and relatively to the bonds. Morningstar's Fair Market Value indicates an equity discount of about 3%. However, this percentage is not too significant as the market has arbitraged most of the 20% discount to fair value reached at the October 2011 bottom. Relative to bonds, equities are still attractive but in this case also not as attractive as not only the 2011 bottom but the June 2012 through as well.

Commodities, with the exception of gold, were mostly subdued in 2012 as the global economy started sending signals of fatigue. For 2013, the commodities outlook remains tied to global activity and specifically China.

Economic Outlook for 2013

Major global and internal imbalances, a legacy of pre-2008 policy dislocations and post-2008 crisis response are unfortunately still the focus of any economic outlook. Developed economies are struggling to shift away from artificial stimulus policies to a more normalized growth environment at the same time when their fiscal imbalances are resulting too difficult to manage. Uncertainty in the future framework of regulations is also contributing to a difficult real economic adjustment and is slowing a true unleashing of creative capitalism. Developing economies continue to struggle with a mercantilist model that is obviously reaching the end of its run. Emerging markets are still wrestling with a transition to more balanced economic systems but large income inequalities, entrenched interests and a combination of rising idle capacity, decreasing productivity and cost increases are slowing down significantly this due process.

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United States

A 2013 outlook for the domestic economy rests on the resolution of the "fiscal cliff." A compromise is quite likely but its quantification is more difficult to map. A few forecasts expect the US economy to grow next year by anywhere between 1.25% and 1.75%. Such low growth would make it difficult for the unemployment number to come down significantly. If this scenario is correct, it is likely that rates will continue to remain at the zero bound and monetary policy similar to 2012. We think that the surprise could be to the upside if the fiscal and regulatory mess is brought under control. In such a scenario, equities could do very well, bonds would see much volatility and commodities would see a mixed bag but mostly rising prices.

The worst case scenario would be low growth and creeping inflation within a context of exhausting options by the Central Bank. We would rate this situation a lower probability for 2013 but above average.

Japan

The Land of the Rising Sun is certainly at an interesting political juncture. The dramatic LDP victory on December 16th, 2012, has handed a popular mandate to the new government to pass inflationary policies in an attempt to end the economic disease that has been afflicting Japan. The Yen has been reflecting the new playbook by falling significantly; however, poor demographics, a crushing public debt and a strained relationship with China make Japan a weak bet at best for 2013.

China

China, in our view, will continue to slowdown as they manage a forced transition to a more balanced economic model. Rising inflation, diminishing productivity in a slowing world are hardly elements that can foster continued superior growth; in this light, savvy investors should monitor shifts toward domestic services, from financial options to consumption related services. A rate of growth of between 6.5% and 7% is our most likely scenario.

Europe

European equities start 2013 from a much more attractive valuation level than US stocks but from a foreign investor's perspective they carry a level of forex risk. The steps taken by the ECB probably insure the time needed for the difficult European Union political process to develop a common solution. European problems are mostly political and can be resolved; however, complex political issues have higher probabilities of failing spectacularly. Italian elections are on the horizon and as always they can be highly de-stabilizing.

The trick for Europe is the ability to find the right mix of austerity and growth measures within a context of policy confusion. As European growth in 2013 will almost certainly be negative, with a contraction of approximately 1%, the right vision for the future will

become paramount. A few steps that may be taken in the next 12 months that would be positive equity catalysts are:

- Refocusing the banks on capital adequacy and asset quality
- A Euro-wide deposit insurance scheme (so far refused by Germany)
- More aggressive ECB intervention

Special Focus: Energy and Dollar

The new trend in the US toward energy independence has been a hot economic topic for all of 2012. New technological developments in fracking have allowed the US to regain top spots in energy production. Fracking uses pressurized water and chemicals to extract oil and gas from shale rocks at reasonable costs.

According to Bloomberg, fracking has helped the US meet 83% of its energy needs in the first eight months of 2012 (the time span for which we have data available as of this writing). It is also believed that energy independence could be achieved within the next ten years. Such developments not only help foster a manufacturing renaissance in the US but they also have geopolitical implications and can alter currency dynamics.

If the US can break its dependence from foreign oil, the classic inverse correlation between oil and US Dollar can also be broken. Goldman Sachs, Citigroup and Blackrock have all issued research highlighting a new future positive correlation between the Dollar and oil as the US moves toward an energy position less reliant on foreign oil.

In terms of energy, we like exposure to the sector, even within possible global GDP deceleration, as a store of value within a context of geopolitical uncertainty and negative real yields.

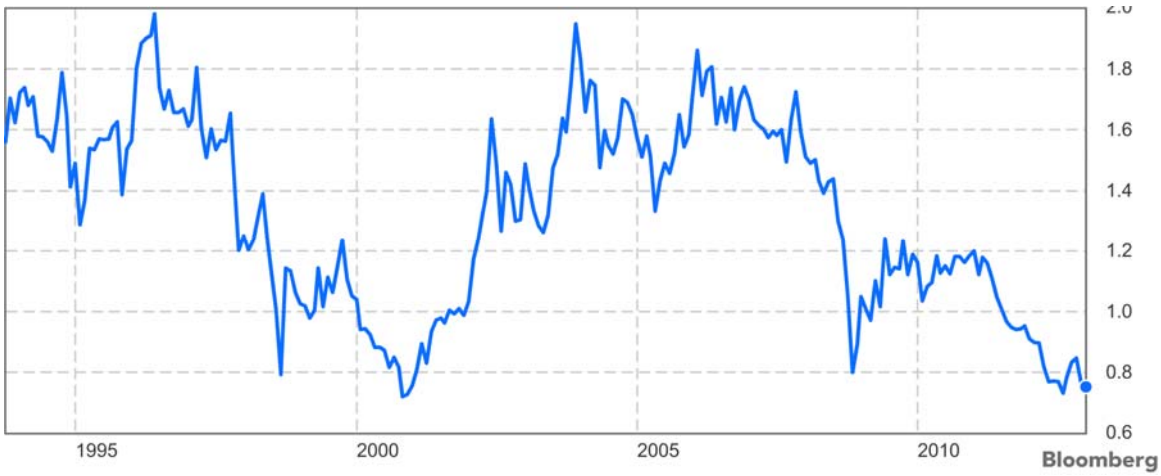
Special Focus: Gold

Gold is ending another successful year on a soft note; the yellow metal has priced in a lot of the Bernanke's balance sheet expansion and additional large moves may have to come from an implementation of monetary commitments by the ECB. Long term, we still agree with a World Gold Council study which indicates a gold weight of approximately 4.4% for portfolios diversified in terms of asset classes and alternative investments. Each situation is different but a yellow metal buffer of such size can help during difficult times by providing crisis alpha.

It is interesting to note the continued underperformance of gold mining stocks versus the actual precious metal:

The ratio of an index tracking shares of gold-mining companies to the price of the precious metal is close to this year's low in May. That shows gold stocks have become a relatively cheap alternative to buying the metal itself, according to Jack Ablin, chief investment officer at BMO Private Bank.

Ratio of NYSE Arca Gold Miners Index to gold prices



Special Focus: Alternative Strategies

Even if we assume continued sub-par growth, it is a recognized fact that inflation, while under control, has been slowly rising. The inflationary risk are tilted toward a possible acceleration of the headline CPI number even if growth remains low (remember stagflation in the 1970s?). And in the case growth surprises everyone on the upside or the downside, tail risk strategies become essential components of diversified portfolios. Dynamic investors should target exposure to alternative strategies, with a blend of trend-following strategies and tail risk hedges in options. Trend following and long volatility approaches should help significantly de-correlate portfolios performances. Forex markets and real assets are natural markets to get engaged with such strategic moves. In 2012, we have also witnessed an increase in Debt Financing via Private Equity Vehicles. This is an alternative strategy to earn higher yields and yet mitigate interest rate risk by exploiting niches and anomalies in the fixed income market. P.E. vehicles can replace some of the liquidity withdrawn by banks and can enter long term bets such as non-agency mortgages providing investors with an illiquidity premium.

Conclusions

In conclusion, the evolving dynamics of global socio-economics and central banking actions are, in our view, pushing investors toward three major themes. A reduction of deflationary exposure should commence now even as global growth may continue to slow for a little longer. Real assets – energy, metals, selective real estate - should be

favored as inflation risk rises. These assets should continue to be producers of real dividend yields and provide capital appreciation in sync with price index increases.
We also think that Central Banks actions will continue to be massive and therefore close monitoring of the Fed, ECB, PBoC and BOJ remains mandatory. Strategically, investors should try to capitalize on opportunities derived by such actions and try to align their portfolios as much as possible with Central Banks decisions.
As we salute the Year of the Dragon, according to Chinese astrology, we get ready to welcome the New Year of the Snake; nevertheless, we do not expect the 2013 Snake to be any less theatrical than last year's Dragon.

Sincerely,

Youri Bujko and Davide Accomazzo