THALASSA
CAPITAL LLC

Quarterly Letter June 2013

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THALASSA CAPITAL LLC

The second Quarter of 2013 has provided investors with a sudden return to volatility in most asset classes. As the Federal Reserve started to prepare the ground for a possibly imminent exit from Quantitative Easing, the market response was predictably volatile.

In the two previous instances when the Fed paused its QE programs - in 2011 and then again in 2012 - the investors' response had been a negative one. This time, an end to QE will certainly be met with even more volatility as leveraged positions would have to be significantly reduced or closed as the monetary trend changes for good; however, in the intermediate term, a normalization of monetary policy against the backdrop of a sustainable recovery could be very positive for equities and for some commodities as well.

We continue to think that the macro picture is improving as some of the recent economic data is confirming. Retail sales were up 0.6% in May after a couple of soft data points and constructions related statistics such as housing starts and permits were also at their best levels since the crash. GDP could surprise to the upside in the upcoming Quarters as consumer confidence takes hold and unemployment retreats.

The combination of an improving economy and a less accommodative Federal Reserve spells trouble for bonds. The yield on the 10 year US Treasury has already started to rise but equally worryingly we are witnessing a drying of liquidity in the fixed income market across the board, including the often quiet municipal bond market. The Wall Street Journal reports how bond dealers are keeping inventories in corporate bonds at a quarter of the size they used to have before the crisis. This liquidity vacuum may either turn into a disorderly readjustment in bond prices or may force the Fed to delay its exit even in the face of possible future inflationary pressures.

Fed Chairman Bernanke indicated after the last Fed meeting that while the committee remains data dependent, it is reasonable to expect a reduction in asset purchases by the end of 2013 and a termination of QE by mid-2014. The main parameter offered remains the unemployment level at 7% as the trigger for an exit from Quantitative Easing. Bernanke also indicated that the Fed will not sell any of its agency paper.

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Potential unexpected problems could come from China which has recently experienced a huge spike in its short term rates. On June 20th, Chinese short term rates spiked above 13% from a usual range of 2% to 4%. Rumors circulated that a few major banks were on the brink of collapse in a moment reminiscent of Lehman Brothers. The People's Bank of China stepped in and calmed markets. The PBoC should have enough tools and credibility to keep the situation under control; however, it is also logical to expect these bouts of instability to return.

Should China suffer a banking crisis most scenarios will change including the planned exit of the Fed from QE.

On the subject of Emerging Markets, Bernanke's words hit them more violently than US markets. Michael Pettis, a US academic teaching in China, defined Emerging Markets as "Volatility Machines" – the title of one of his earlier writings – and volatile they certainly were this past few weeks. Emerging Market Debt was sold indiscriminately, an action exacerbated by a liquidity vacuum typical of these instruments. Brazil was also sold off aggressively as riots were breaking up in different parts of the country.

Eventually these dislocations will provide outstanding opportunities; we are monitoring the situation carefully.

The Emerging Market situation and especially China's dynamics, are going to be the main drivers of price formation for commodities. We expect energy to fare better than most other commodities under most scenarios.

The confluence of Fed's tightening and opposite policies in Japan, probably China and eventually Europe as well, should contribute to a stronger dollar in the second half of the year; a lower Euro should ultimately be favorable for large European based multinationals.

Special Focus:

Two new books have been published this Quarter on the subject of Alternative Investments:

"*Alternative Investments: Instruments, Performance, Benchmarks, and Strategies"* published by Wiley and co-authored by your Investment Manager Davide Accomazzo

and

"The Alternative Answer: The Non-Traditional Investments Tha Drive the World's Best-Performing Portfolios" published by Harper Business and authored by Bob Rice.

Alternative investments and strategies are becoming more and more essential to modern portfolios. The traditional 60/40 model split between equities and bonds has proven inadequate in a world of rising correlations, booms and busts and increasing influence by Central Bankers.

Alternative strategies are increasing their accessibility to all classes of investors and should be fully understood. So called liquid alternatives are now available and expense ratios are decreasing rapidly. At THALASSA we have been at the forefront of this portfolio revolution, stressing significantly and for a long time, the importance of incorporating in investment models assets such as Timber, REITs and Master Limited Partnerships. We have also stressed the importance of hedging and option overlays as risk management tools.

Our version of the Endowment Model is at the core of our investing philosophy because of its bent toward strategic diversification as a tool for risk mitigation and long term capitalization of value based expected rates of return.

Sincerely,

Youri Bujko and Davide Accomazzo

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