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Quarterly Letter June 2021

Written June 29 – June 30, 2021

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"What was scattered gathers. What was gathered blows away." – ***Heraclitus***

The current financial backdrop finds itself in a curious situation. While asset valuations seem long in the cycle, the actual economic rebound feels more like a mid-cycle environment and monetary policy appears still stuck in a typical early cycle stance. Welcome to the post-pandemic universe… where true and tried macro relationships seem to have morphed into something new.

The conflicting picture is actually not so difficult to frame as the fast and furious central bank's response to COVID-19 underpinned the quickest bear-bull market sequence in history. The economic recovery is also the result of a speedy and relatively successful vaccination campaign while central banks' action reflects a global sentiment of erring on the side of caution rather than ending monetary support too hastily.

Making sense of the present condition should not only help us navigate today's market fluctuations but it should also guide us into future evolutions of the macro picture.

As we have discussed in recent missives, the core issue revolves around the nature of emerging inflationary pressures. Most analysts expect such pressures to be transient and not permanent, a concept the Federal Reserve also currently adheres to. The underlying logic of this argument rests on the idea that current inflation is the result of bottlenecks created by COVID which will surely disappear by mid-2022. Current CPI is above 3% but it is generally expected to decrease toward the 2% level early next year. Goldman Sachs for instance projects core CPI in 2022 at 2.3%. Goldman also notes that any one percentage point increase in the inflation rate would lift S&P500 sales by about the same amount, but it will also reduce margins by 10 basis points. Reduced profitability would make it more difficult to justify high valuation multiples. Goldman assumes that should their forecast for inflation prove correct and should the yield on the US 10 -year Treasury not rise above 2%, an S&P500 valuation of 4700 would be possible. However, should higher inflation and rates occur and/or higher corporate taxes be passed, it is also reasonable to expect a correction of more than 10%.

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The scenarios we just explored demonstrate why the discussion around future inflation levels is so important. From an asset allocation perspective, we continue to believe this backdrop calls for a diversified portfolio with an inflation hedge and a tilt toward macro cyclicality.

This means that value companies, usually more exposed to macro-economic cycles, should continue to be overweighted. The value sector has outperformed YTD and it should continue to do so unless the Fed will turn out to be much more hawkish than everyone expects.

On the fixed income side, we believe that inflation protected securities are now much less attractive but still a very functional inflation hedge. We also like Emerging Market bonds, sovereign and corporates, as a play on a possibly weakening US Dollar, fiscal budgets generally better than in the US and a natural exposure to higher economic growth rates should the economic expansion continue to evolve.

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

Youri Bujko

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