THALASSA
CAPITAL LLC

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THALASSA CAPITAL LLC

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

It would be an understatement to say that we live in uncertain times. We witness uncertainty in the development of the COVD-19 crisis, we question the uncertainty of a political process that seems increasingly dysfunctional and we wonder if the economy that will emerge post-pandemic will look at all like the one we left behind.

Investors generally abhor uncertainty because it makes it difficult to project cash flows and proper discount rates and therefore it endangers the understanding of fundamental values for assets. And yet, uncertainty is the essence of markets; returns are highly correlated to risk taken and risk is statistically defined as dispersion of possible outcomes.

And for these reasons, investors are expected to think long term, manage outliers and make risk adjusted bets that have reasonable expectations of a positive outcome. At the current juncture, there are a few items that we need to analyze that fall into these three brackets.

In terms of the outliers, a clear one is the upcoming election. Since our last quarterly letter, we have moved the focus from a potential Democratic sweep and its ramification on markets and valuations to an increasingly high probability that this will be a very long and contested election. It is reasonable to expect short and intermediate term volatility to reflect that element and we might have begun to see the market reaction in the end of quarter correction. In the more tactical, shorter term allocations, we have started to buy peripheral hedges as a small help.

In the case of a reasonable resolution of the election outcome in combination with a Democratic sweep, one should align portfolios along the lines of fiscal policy expected to be stimulative for a couple of years. Should this happen, inflationary pressures might start to build into our economic system and such an event would favor the inclusion in portfolios of Treasury Inflation Protected Securities, gold, cyclical stocks and possibly infrastructures.

The other outlier is the timing of the release of successful vaccines. While, the preliminary results seem encouraging, it would seem to be overly optimistic to see a fully successful medical solution before at least the second half of 2021. From an investor's perspective, vaccine approval and distribution would probably move the needle toward value and cyclicals and away from momentum growth names. It may also mean global flows may start to rotate more aggressively into international equities as US equity indexes are generally much more growth and tech heavy.

Outside of volatility induced by outliers, we must also face a wide dispersion of valuation levels among all the sectors. Technology has gotten quite expensive (even after the recent pullback) thanks to its superior growth rate but also because of its recent and quite bizarre "flight to safety" status. Tech was never a refuge for safety, but COVID-19 dynamics managed to upend even such a tried and true expectation. Pharma and some pockets of biotech are still sporting somewhat attractive valuations in combination with long-term favorable tailwinds.

From a value and long-term perspective, REITs still deserve a good hard look. While COVID-19 once again has created some havoc, it is probably more an acceleration of previous trends such as the significant resizing of brick and mortar retail. However, COVID cannot change some of the positive demographics behind medical related real estate and it even helped strengthen the position of industrial warehouses and data centers. On the office space front, the situation is more nuanced. In our view, the death of traditional office space is greatly exaggerated, to paraphrase Mark Twain. While space will be re-organized and rationalized to respond to a new perception of optimized working environments, we believe eventually people will return to operate in professional spaces. In this context, high quality space might be trading at a discount to future cash flows.

In conclusion, we expect the next few months to be volatile, but we expect an eventual cyclical upturn in many sectors. Longer term we feel opportunities will be available in a few special sectors while broad index returns should be lower than historical averages.

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

Youri Bujko

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