Quarterly Letter September 2013

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THALASSA CAPITAL LLC

The Macro Picture

The much awaited FOMC meeting of September 18th has come, surprised everyone, and has gone. The consensus expectation of an initial "tapering" of the Quantitative Easing program by at least $10 million per month did not materialize.

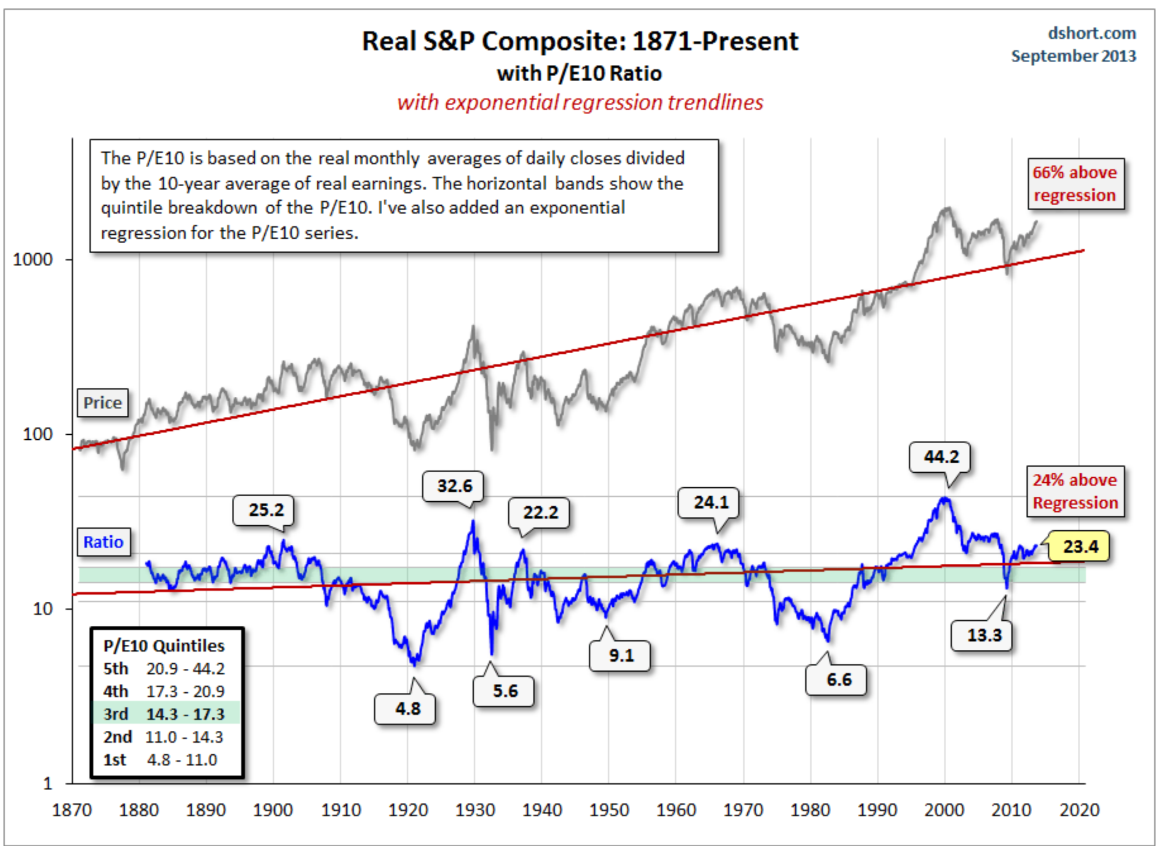
Fed Chairman Ben Bernanke spent much of the last three months building a case for less generous monetary policy by making clear that there was on the table a more than tentative schedule of reduction of security purchases. However, last week, Mr. Bernanke had to retract and added flexibility to the Fed actions. The Fed refrained from tapering and indicated that future decisions remain very data dependent. The real reason behind the volte-face might have been the looming showdown in Congress, where the Republicans and the Democrats are both showing signs of inflexibility in the upcoming negotiations over the debt ceiling. This is deja-vu as we already went through such an unnecessary confrontation in 2011 with very negative short term consequences for risky assets.

The combination of more volatile monetary policy risk and higher political risk certainly makes the case for a more cautious approach to risk exposure. Yet the now increased longevity of the "Bernanke put" (or in other words the persistent injection of liquidity in the system to support assets) also helps make the opposite case.

In our view, barring some really disastrous outcomes from the political confrontation, the longer term horizon remains unchanged and short term fluctuations should be used to re-position the portfolio tactically.

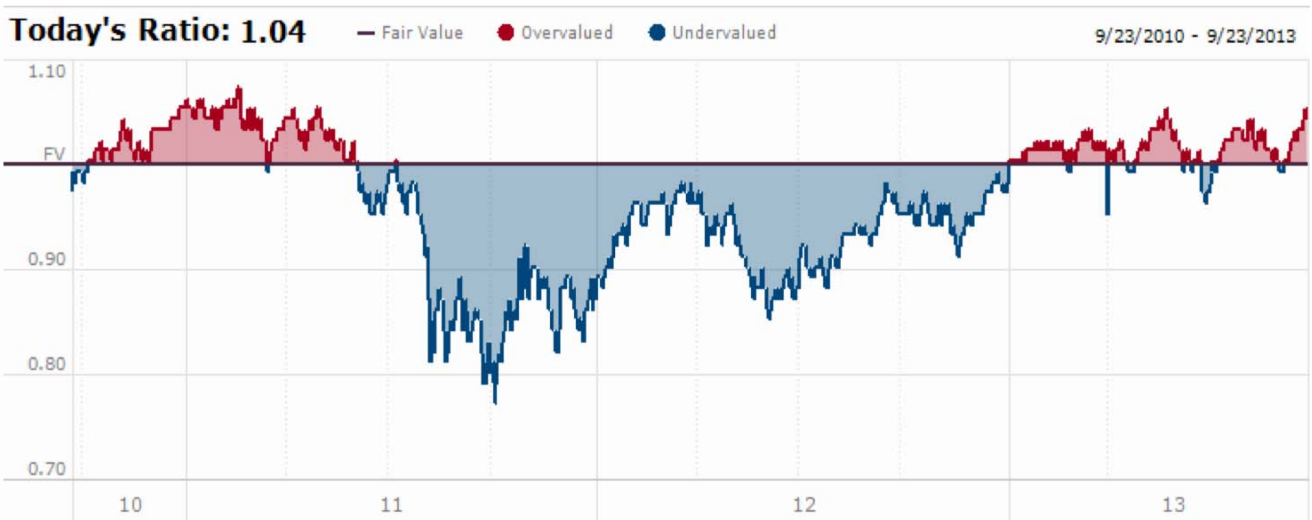
Equities are showing signs of fatigue after the spectacular run they had year to date; some valuation metrics are not as encouraging as they were a few months ago. P/E ratios are in line with historical averages and in the case of longer term averages such as the Cyclically Adjusted P/E ratio (CAPE) by Robert Shiller, valuations seem pricey.

The chart below shows the CAPE (or P/E10) and the price of the real S&P Composite Index going back to 1870, the first year when aggregate earnings were reported. The long term average of the CAPE is 16.5 and we are now at 23.4. The chart also shows that we are 24% above the regression line. These values indicate overvaluation but not excessively.



Source: www.advisorperspectives.com

Morningstar Market Fair Value model, which is a system based on discounted cash-flow calculations, is also showing modest overvaluation. The chart below shows a 4% premium to fair value.



Source: www.morningstar.com

All this favors a tactical higher level of cash to be deployed opportunistically during spikes of volatility.

Alternative sectors that we usually like such as Master Limited Partnerships and REITs find themselves at interesting junctures. MLPs have been trading in a range for months now after a turbo-charged first part of the year which topped in May. MLPs yields are still attractive when compared to other income instruments and their fundamental story remains positive. In aggregate, the MLP spread over the 10 year US Treasury is at approximately 330 basis points versus a pre-crisis average of 225. Spreads of over 400 basis points indicate significant undervaluation.

We would add opportunistically, in sync with specific situations. We also expect the next few weeks to show a number of secondary offerings coming to the market adding to supply; technical weakness could eventually create opportunities.

REITs tend to be more sensitive to interest rate volatility and in fact they corrected much more vehemently since Bernanke's talk of tapering. Yields have become much more attractive, especially in niche sectors. Global REITS are showing interesting yields and opportunities for smart diversification.

Fixed Income finds itself at an interesting juncture. The longer term trend remains unchanged; tapering was merely postponed and not canceled. For this reason, duration risk continues to be a concern; however, the new more relaxed schedule of tightening warrants a less aggressive hedging stance. Additionally, the recent sell-off has created some opportunities in Emerging Markets (countries with current account surpluses) and Municipal bonds.

As far as commodities, the new stance by the Fed may affect primarily gold. In theory, the yellow metal should benefit from continuing QE and in fact its immediate response after the announcement was to rally significantly. However, until official statistics start recognizing higher levels of inflation, the upside would seem limited. We believe that a modest allocation still makes sense for most diversified portfolios but we would hedge overweight positions.

In the commodity space, we continue to like Energy. Energy related equities still trade at interesting valuations and their average yield is quite attractive for companies that sport quality balance sheets (in the AA range). We also like direct exposure to oil but in conjunction with derivatives hedging.

Overall commodities should have better performance going forward on the back of an industrial rebound.

Special Focus: Europe and Euro

As we expected at the end of last year when we launched our Europe Value strategy, the Old Continent produced some positive surprises: improvements in the current account balance, rising net capital inflows and GDP growth. Undervalued equities are catching a wind and they could outperform US equities. These positive developments have consequences for the Euro as well. Reasonably, the common currency should be trading at lower values given some of the unresolved issues related to the inconsistency of a monetary union and a fiscal fragmentation; in fact, based on the International Monetary Fund fair value measure, the Euro is roughly 10% overvalued compared to the US Dollar. Other analyses based on trade weighted calculations also show an overvaluation of the Euro around 6%.

On a comprehensive fundamental basis, the Euro should trade lower. However, currency markets are presently focusing (and not only in Europe) on current account balances and the rising surplus in Europe seems to be acting as a strong support to the currency. This situation could continue for an extended period of time.

Source: www.stockcharts.com

Sincerely,

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