THALASSA
CAPITAL LLC

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"The two most powerful warriors are patience and time." *Leo Tolstoy*

As Tolstoy eloquently stated many decades ago, one's best allies are usually patience and time. This is certainly true in the investing game where long term planning and lots of patience help us make it thru periods of inconsistent noise.

Currently, the wall of worry is building as tensions mount between our Administration and "Rocket Man" in North Korea; perhaps Kim and Don would have been better characters for a reality TV match-up rather than a real life confrontation. Nevertheless, the world has had difficult relationships with the Hermit Kingdom since the end of the Korean War and presumably this shall pass too.

More worries are keeping investors up at night as stocks churn around high levels and high valuations just as the Fed continues its reversal of easy monetary policy.

It is a long lived Wall Street truism that bull markets climb a wall of worry and in this instance investors' large cash balances seem to validate such a dynamic. To this point, UBS and Blackrock recently revealed, in separate studies, that about 35% of the average self-managed portfolio of Ultra High Net Worth investors was sitting in cash.

Equity valuations are certainly not very attractive and yet they should be put into the relative context of the economic background and historical averages. As shown by figure 1 (courtesy of PIMCO) we can see how much lower the range or real rates has been and still is compared to the previous economic cycle. The telegraphed paced of rate increases by the Fed would still keep rates far below danger levels. This is important when analyzing valuation metrics and multiples; in time of low rates and low inflation, multiples can expand to higher levels than in other historical periods as a dollar earned in low inflation is worth more than one earned in other times. Current P/E ratios are about 10% above long time averages and when set into the context of low rates, they are just about where they should be.

Figure 1: U.S. real rates appear fair relative to PIMCO's New Neutral policy rate

U.S. REAL YIELD, 5-YEAR, 5-YEAR FORWARD

Source: Bloomberg as of 30 June 2017. The fair value range, indicated by shaded areas, for 5-year, 5-year real yields and the New Neutral rates are PIMCO estimates.

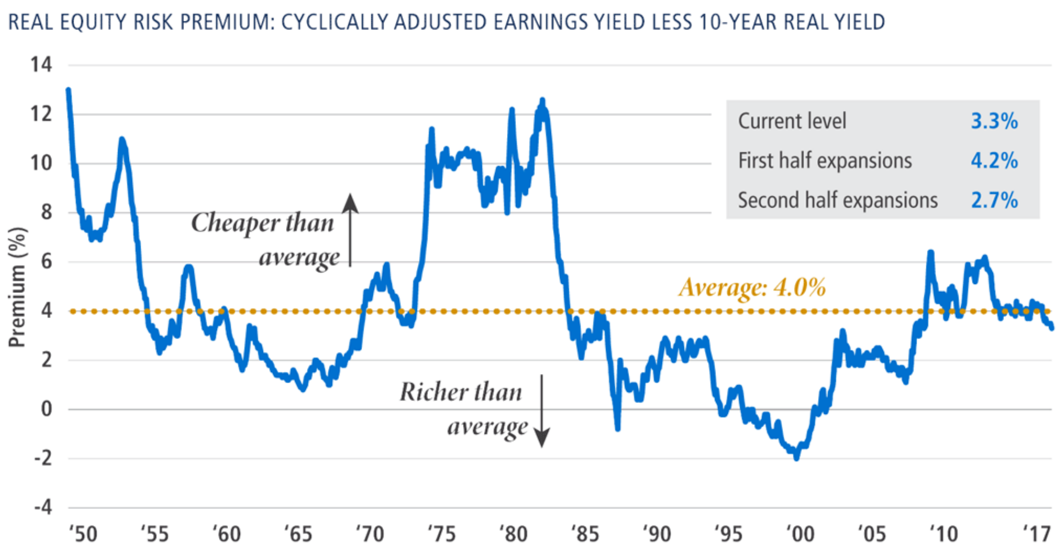
[1]Realized real fed funds rate since 1995.

Figure 2 (courtesy of PIMCO) shows the Cyclically Adjusted Earnings Yield (CAEY is a reversal of the Cyclically Adjusted P/E ratio) in the context of interest rates. In simple words, this model takes the CAEY which calculates the inflation adjusted 10 year average earnings of the SP500 over its price and then subtracts the 10 year US Treasury yield.

This formula provides an equity risk premium that can easily be calculated over long periods of time. As the chart shows, we are just slightly above historical averages. Interestingly, severe correction do not seem to start from similar levels of risk premium but they seem to need tighter spreads.

In other words, valuations are not exciting and yet they are not out of line as we would normally see in long lasting tops. This is not to say that volatility may not rise, in fact, given the really low levels of the VIX (one popular volatility index) one should expect a rise in market noise. However, the wall of worry dynamic combined with fair overall valuations may prompt more of a sector rotation response and a potential buy the dip action than the start of a bear market.

Figure 2: For U.S. equities, risk premium tighter than historical average



Source: Robert Shiller, Yale database, Bloomberg, PIMCO as of 30 June 2017. Equity risk premium (ERP) = S&P 500 cyclically adjusted price-to-earnings ratio 1/(CAPE) – 10-year real rate. CAPE is calculated by dividing the inflation-adjusted price of the S&P 500 Index by the median of the last 10 years' inflation-adjusted earnings. This is a variant of Shiller's P/E ratio. The real rate is the 10-year TIPS yield since 1998 and nominal rates less 36-month trailing inflation before 1998.

As far as sector rotation, we think we may be already witnessing validating money flows as technology slows down and energy and pharma seem to be picking up speed.

On the energy sector we may sound repetitive but we think opportunities are available. Energy has been a core allocation for us and one that has not been rewarded lately but rather one that has required patience year to date. However, our thesis of an underestimated demand amidst shrinking supply is suddenly a more commonly accepted analysis.

Especially in the MLP space, we think value abounds. With yields in the 6.5% range and probably no more dividend cuts occurring, midstream assets carry value and strategic weight. Furthermore, these dividends are supported by close to 90% fee based cash-flow, an element that should discourage MLPs' correlation to oil.

MLPS can now be appealing to two different classes of investors; traditional income investors may find better values in midstream assets rather than traditional utilities which are currently very pricey and long term institutional investors may want to gain exposure in value assets with a strategic connotation and projected rates of growth higher than average. The recent Blackstone deals are a validation of the institutional interest. Year to date the private equity leader Blackstone has invested approximately $20 billion either in direct investments in midstream operations or in pipeline specialized asset managers. Naturally, a recession would decrease energy demand and hurt these assets as well; however, most macro data are not warranting at all such a scenario (unless Rocket Man and Mr. Trump decide to move beyond words and insults). Eventually, a recession will come but normally it should be telegraphed by an inverted yield curve, a situation where short term rates spike higher than longer term ones. For now, the global economy is enjoying rapid earnings growth in the double digits. By some measures, we have not seen such a pace in 15 years.

Another sector that is witnessing a fundamental rebound and that may be benefiting from value based sector rotation is Pharma. Pharma was out of favor for a long time due to the political cycle and due to a market that was mostly focused on momentum sectors. Recently, political winds have changed and the value proposition has become harder to ignore.

Interestingly, it is not just traditional Pharma that trades at a discount but Biotech as well. A recent report by Bank of America indicates how biotech offers higher than average expected long term growth rates than all the eleven sectors in the SP500 index and yet it trades at half the median P/E ratio of the highest growth tech stocks.

As of this writing, the current Administration announced a new tax reform plan which includes a corporate tax cut, a simplification of the taxable income brackets and the elimination of a few deductions. Interestingly, the plan also includes a cap rate of 25% for income earned by pass-through vehicles like MLPs. Currently, income earned by such investment structures is passed entirely to the partners (unitholders) and taxed at ordinary income levels which could be sensibly higher than the proposed 25% cap.

Of course, the road to approval of such plan is long and if the attempt at repealing Obamacare has taught us anything is that this Administration will have a really tough time in producing legislative results. Time (and patience) will tell…

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

Youri Bujko

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