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"There is no such thing as a free lunch." **Milton Friedman**

As we get ready to uncork the proverbial bottle of champagne to welcome the New Year, it is with analytical reflection that we look back at the last twelve months to make sense of a rather interesting and unexpected string of events.

2016 has made fools of most forecasters as especially geopolitical events turned out much differently than reasonably anticipated. Financial markets started the year with a massive tantrum which turned out to be a good buying opportunity; a surprise markets repeated just after the unlikely election of Donald Trump as President. Along the way, we witnessed with disbelief the decision of English voters to break up with the European Union reversing decades of integration. Such vote was quickly followed by a similarly unexpected and crushing loss by modern reformers in Italy. OPEC also produced an unanticipated turn-around of its "pump at will" policy.

The sequence of political changes must be analyzed and contextualized for what it may mean in portfolio allocation and risk management. While the common slogans seem to be defining a new wave of populism and radical change, one must first discern between the populism emerging in Europe and the call for change occurring in the USA. In Europe, the biggest challenge seems to be focused on immigration and its links to Islamic terrorism. The response to such threat by the European Union has been less than firm and has led to a general discontent with the bureaucracy of the institution. Should this disenchantment lead to a serious loosening of the Union, such an event would translate into massive economic friction in the entire continent which would likely lead to a significant global recession. The odds are still in favor of status quo but a higher risk premium should be applied to all European assets.

In the United States, the call for change has a different flavor. President-Elect Trump has ridden a wave of discontent that is a mish mash of anti-globalization, demographics, anti-establishment ranting and so on. What is peculiar about the recent developments is that the medicine the new US administration seems incline to apply do not sound at all like change. What we hear are undetailed programs based on old fashion trickle-down economics and supply side tax cuts. This sound very Reaganesque, although supply side tax cuts and fiscal stimulus have never really been tried during an expanding economy as we are currently experiencing. Hence the reason for our initial quote from Milton Friedman; it is very possible that if most of the Trump manifesto gets implemented, risky assets should indeed experience an early expansion of valuation multiples and/or more favorable assessments of discounted cash-flows; however, that may come with a price to be paid later in the form of increased volatility, higher inflation and very unfriendly monetary policy.

Currently, equities may seem a little pricey by historical standards but a few caveats must be put forward. First of all, they are still a bargain when compared to fixed income, especially with the new backdrop of potentially higher inflationary pressures in the next 18 months. Furthermore, one must apply high probabilities to a corporate tax cut. Of all the campaign promises made, some kind of tax relief is most likely to occur given that it would please different parts of the Republican Party and some of the Democrats as well. Assuming a new 25% top tax rate, the new S&P500 earnings estimate for 2017 would be $144. At an average P/E ratio of 17, it would translate into an S&P500 value of 2448, roughly an 8% increase from current levels.

Another factor that may make equities look less expensive than presently assumed is the resurgence of operating earnings. In the third quarter of 2016, operating earnings finally turned up and rose 10% year over year. The new pro-growth policies could add fuel to the EPS momentum therefore forcing a valuation adjustment not by ways of P/E ratio deflation but by ways of growing the denominator in the equation – E – or earnings.

It must be noted that this positive scenario is not free of perils given that this new administration seems high on slogans but low on experience and diplomacy. Such higher level of uncertainty on execution of publicized directives, reinforces one of the most important tenets of investments: diversification.

Commodities could help diversify a portfolio in the new reflationary environment and especially Energy could have a strong run for the next 18 months. A resurgence in commodities should also help Emerging Markets, usually tied to the basic material cycle. Emerging Markets have been a value proposition for a while and in 2016 they did show some relative strength. Valuations and projected rates of growth still seem attractive but once again the unclear future path of this new administration policies cast a cloud over this asset class. Should a trade war, or even just a trade "argument" starts, Emerging Markets would be the first victims. Also, if interest rates rise faster than expected in response to overheating policies, currency and EM debt market dislocations could ensue for some time.

An additional asset class that has seen its risk level increase as a function of recent events is REITs. While the asset class remains one of the best performing diversifiers in any complete asset allocation, current valuations and possibly fast interest rate increases might produce headwinds. Some subsectors are actually trading at a discount to Net Asset Value but most of the space is fully valued. On a long term basis, we continue to like Health Care related names due to positive demographics and high distributions and Industrials due to the cyclicality of their business.

Last but not least is the Technology sector. Fundamentally speaking the sector retains a certain allure; multiples are not too high and projected revenues for 2017 are in the 25% range (source: JP Morgan). Longer term, we continue to be engaged in the great wave of connectivity or Internet of Things, an area where we see more and faster corporate and consumer adoption for years to come.

In conclusion, we head into 2017 with a generally positive outlook, especially for some of the strategies we directly focus on, but we are conscious of the fact that volatility will remain a big factor and tactical posturing may be required.

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

Youri Bujko

Davide Accomazzo

269 South Beverly Drive, Suite 1204, Beverly Hills, CA 90212
T.310.867.2255 - F. 310.388.1455 - Web. www.thalassacapital.com