



Quarterly Letter December 2017

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THALASSA CAPITAL LLC

“For last year’s words belong to last year’s language and next year’s words await another voice. And to make an end is to make a beginning.”

T.S. Eliot

As we draw the curtains on 2017, it is time for some reflections on past events and an attempt at future projections.

Undoubtedly, 2017 turned out to be a surprise in many ways. We opened the year with concerns about the new administration, valuations that while not too rich were certainly not as attractive as they had been and, last but not least, worries about the pace of interest rate normalization.

We also had some tailwinds, such as a synchronized global recovery and political promises of pro-growth legislation. In the end, the worst case scenario never materialized and the tailwinds reinforced themselves along the way. Especially, the synchronization of the global economy provided rates of growth in earnings that were generally higher than expected.

This was, indeed, the pivotal element in 2017. Fundamentals did improve at a marked pace, just as you would expect in this phase of the bull market. This financial recovery was borne out of the generational low of March 2009, when short covering and central bank aggressive policies stopped the bleeding and engineered the secular turn in asset prices. The second phase of the recovery was a function of renewed friendly monetary policy and valuation multiples expansion. Now we find ourselves in the third phase, earnings expansion, which should temper some of the valuation exuberance. The last phase of this bull run should eventually materialize when euphoria will overtake rational analysis (for those who would like to witness an example, please review a Bitcoin chart).



The unexpected momentum behind risky assets in the last twelve months, left many active managers frustrated, as a simple long large caps (especially tech) strategy beat pretty much every other investment framework. We experienced a similar situation as our best returns came from our ETF rotation strategy which is in fact based on a classic momentum set of rules.

We experienced significant positive returns in other strategies such as our Water portfolio, thanks to an outperformance of Utilities, and in our IoT strategy. As far as the latter, while nicely positive, we underperformed the broad tech benchmark. Tech did extremely well in large caps and semiconductors; however, performance was more erratic in other niches. The emergence of the Internet of Things is an unstoppable trend and we continue to see very positive elements going into 2018. However, the different subsectors that at any given time will emerge as outperformers are still the result of an erratic process. We did very well in microchips and car automation but less well in security and dirty exposure via industrial conglomerates. Microprocessors and car automation will probably continue to be areas of interest in 2018 as much as “big data” analytical platforms.

On a long-term basis, one of our core exposure is real assets. We often carry an overweight in real estate and lately energy. As far as REITs (our vehicle of choice for liquid real estate exposure), our standard portfolio has beaten its benchmark thanks to a significant exposure to international real estate. Domestic REITs, were generally positive but performance was subdued. The cooling of valuations combined with other fundamentals that are still positive or at least not terribly negative (i.e. yield, interest rates) make the REIT space one of interest for 2018.

And then there was energy... Our bet on energy during the dislocation of 2015 worked well in 2016 and up to the first quarter of 2017. Then a consistent deterioration took us into negative territory until a bottom at the end of summer for the integrated energy outfits and November for the energy infrastructure sector. This was rather frustrating as the fundamentals were actually improving as we had expected. The supply-demand imbalance for crude oil was being rectified, domestic production of oil and gas was improving at a pace that should not be globally destabilizing, and balance sheets were being mended. None of this seemed to matter until recently. The IXC, our global energy benchmark, is now actually positive on the year and the MLP sector, while still negative, has experienced a significant recovery since the lows of November.

Absent a global recession in 2018, for which we have no signs and no expectations currently, we think Energy is one place to be for next year. A combination of valuations



and long term fundamentals moving in the right direction make the sector once again attractive.

From a more macro perspective, the following are our thoughts. Global synchronized growth should continue in 2018 albeit at a slower pace. In the US, growth might run into a lack of spare capacity. With unemployment rates at historical low levels, for instance, it may be difficult to increase production without fueling inflation. In Europe, monetary policy may become less effective and political risk may be on the rise again (i.e. Italy, Brexit negotiations). Emerging markets, on the other hand, may continue to be the engine of global growth with the possible exception of China.

As far as general investing themes, we expect equities to do well again on two counts: improving earnings (as mentioned) and relative valuations. Equities are not terribly cheap by historical standards and yet they are not even near levels that in the past were associated with significant tops. Furthermore, equities are quite cheap relative to bonds (especially government bonds). This cocktail of factors probably means moderate increase in equity prices within the context of increased volatility. It also means that fixed income may not be that useful and simple de-correlator in asset allocation. An underweight in fixed income continues to be a preference. In this space, we also note a preference for active fixed income strategies that may be able to benefit from different elements and not purely from traditional carry.

On the risk side, surprises might emerge from monetary policy missteps (in 2018 we are getting a new Fed Chairman), geopolitical issues such as increased frictions with North Korea and possible destabilization in Saudi Arabia and more political uncertainty in Europe.

More than ever, a well diversified portfolio might just do the trick.

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

Youri Bujko

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