THALASSA
CAPITAL LLC

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THALASSA CAPITAL LLC

"There is no such thing as bad weather, only different kinds of good weather." – *John Ruskin*

After days of almost uninterrupted rain, a rare event in Southern California, we can agree with John Ruskin that our view of weather should not be confined to a bad versus good perception but rather be an observation of diversity. While the rain has caused many plans to change and some roads to be closed, ultimately, we got much needed rain for our water basins and snow for our mountains.

We like to view capital markets in much the same light, a spectrum of changing risk and opportunities rather than a blunt good or bad assessment. The last two years have certainly produced radical changes and wide dispersion of opportunities. The two jolts of the pandemic and the following "shock and awe" policy response have created dynamics that for financial assets have ended up being surprisingly positive. However, good returns on financial assets were not the only legacy of this turbulent period; employment dynamics have changed, inflation seems to be back, and monetary policy appears to have been pushed to a crossroad.

Over the last few quarters, we chimed on the shifting landscape and the steps we deem necessary to retain an edge going forward. Aside from the specific investment suggestions we passed on, we think we can summarize the present call of the day for investors in three words: **selectivity, diversification, and expectations**.

We mention selectivity because we think markets will continue to provide pockets of positive returns but not in a cross-sectional fashion as it has occurred in the last few years. Economic growth should continue above trend for at least another six months which means cyclically sensitive stocks might have the upper hand. Value and cyclical names may also be the ones that can fight margins pressure for a bit longer. This is because they may have a stronger hand in passing on to the final consumer any rise in input prices. Value and cyclicals are also the sectors with valuations that are more in line with historical averages compared to most other areas where multiple of valuations are statistically high.

Selectivity will help find companies that represent long-term franchises at reasonable valuations. Selectivity will also help focus one's attention on trends that may be emerging as a result of a shifting economic framework. If profitability should always be a classic

screening element, a renewed focus on global technological innovations that may help us deal in the future with the sort of disruptions we recently endured, is a clear new screening input.

As far as diversification, while we have always been keen on the idea of constructing a solid portfolio where different parts interlock into a stronger and less volatile compound, we feel this approach is needed more than ever. Portfolios should be built in recognition of two underlying elements: a transition from mid-cycle to late cycle conditions and the delinking of international economies.

The shift of mid to late cycle requires tactical adjustments to trend growth, generally squeezed margins, rising inflation and tightening monetary policy. The issue with international economies conversely, derives from what we perceive will be a different evolution of changes in monetary policy. We feel foreign central banks, and especially those in emerging markets, will have a different timing in pivoting monetary policy with implications on exchange rates, and on an economic recovery that will probably be a-synchronized.

On the importance to diversify, especially at this particular juncture, we would like to point out the increasing investors' concentration in the top 10 large caps. This type of action is often the precursor of choppy market activity. Apple and the other nine largest companies in the US make up 30% of the S&P 500 benchmark; if they falter, their stumbling will reverberate throughout the markets. And while these top ten are still wonderful businesses, historically, the performance of a stock once it joins this very exclusive club is generally disappointing. A recent article by the Wall Street Journal reports that in the decade leading a company to become a top ten by market cap, on average its performance would beat the index by 10% per year. However, in the next ten years, on average, performance lags the benchmark by 1.5% per annum.

And last but not least: expectations. On our blog, we have raised the issue of long-term capital market expectations and how the mix of high valuations and rising rates creates a strong headwind toward returns for the long run. In other words, returns will be mostly a function of increasing earnings and not expanding multiples of valuation. While the economy can continue to expand, prudent investors should expect a reversion to the long-term mean of returns. Such realization will suggest a lower risk level in portfolios and an acceptance of higher volatility.

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

Youri Bujko

Davide Accomazzo