Valara Capital Management, LLC

April 14, 2023

Dear Friend of Valara Capital Management,

For the first quarter ended March 31, 2023, Valara Partners, LP. produced returns, net of fees, of 4.53%, versus 7.50%, for the S&P 500, respectively. As additional context, the Russell 1000 Growth Index returned 14.37%, while the Russell 1000 Value returned 1.01%.

QUARTERLY REVIEW

The first quarter of 2023 unfolded much as expected. The economy appears to be slowing, geopolitical tensions remain high and gradually increasing, inflation is cyclically moderating as the Federal Reserve raises rates and drains liquidity and the pressure that goes along with these Fed actions continues to cause economic fractures/dislocations. The most recent incident was the flurry of bank failures that occurred in March. This was a liquidity issue, driven by the movement of deposits out of checking accounts to money market funds, exacerbated by poor asset/liability management decisions at a handful of banks. By my count, this was the second important credit market event, with the cryptocurrency failures of 2022 being first. I expect others to come – see below.

In terms of economic statistics, job creation has softened, albeit from impressive strength, retail sales have slowed and business confidence continues to make new cycle lows, reaching recessionary levels. With the war in Ukraine still mired in stalemate, relations with China gradually deteriorating, and the Fed focused on taming inflation, it's not surprising businesses lack confidence. The last three months saw at least half a dozen announcements by various countries to collaborate on trade away from the US dollar. These countries include: China, Brazil, India, Russia, Iran, Saudi Arabia and South Africa, among others. China has had a central role in most of these arrangements, but US incompetence/complacency has been important as well. These days the United States and Western Europe spend the bulk of their time borrowing money, playing dress up and crusading over perceived micro-aggressions, while the rest of the world looks on in bewilderment at our utter loss of seriousness and discipline. The US Federal budget deficit for the <u>month</u> of March was $378 billion, bringing the year-to-date total to $1.1 trillion, with six months left to go. It calls to mind Aesop's fable of the Ant and the Grasshopper – a classic morality tale of Western Civilization. One noteworthy bright spot has been the slowing rate of inflation. With everyone on recession watch and layoff announcements on the rise, it seems probable that this trend continues for a while. However, the labor force participation rate remains critically low and supply chains are still reorganizing to reflect new geopolitical realities. China has opened-up again after many months of zero-Covid and is gearing up for growth. These are reasons to remain cautious on inflation, longer term.

Global equity markets were generally strong in the quarter with Brazil and India bucking the trend. Mexico, Russia and Germany/EU were the leaders with the S&P 500 squarely in the middle of the pack. Credit markets rallied as the growth outlook slowed. Not surprisingly (given slowing growth), credit spreads widened and the Russel Small-Cap index struggled.

PERFORMANCE COMMENTARY

As noted above, Growth significantly outperformed Value, with Technology, Communication Services and Consumer Discretionary being the leading sectors. Financials, Energy and Health Care were the laggards. Our modest overweights in Discretionary and Communication were positive. Happily, for Valara, if Gold Miners were a sector, it would have ranked fourth; and, its performance helped our results considerably. Our underweight in Financials also helped our performance but our overweight in Energy did not. On average, our sector weighting detracted from our overall results, largely because we were so under-represented in Technology. Our stock selection was essentially a neutral. We had both big winners: Warner Brothers Discovery +59% and BorgWarner +22% and big losers: Viatris -14% and NOV -11%. AIG was our worst performing stock, -20%, but it was not a big position so it had less of an impact.

Our trading was limited this quarter and I am proud that our annualized turnover for the last 12 months is only 13.7%. Most of the selling we did was into strength which included Ralph Lauren, Textron, Fluor, Omnicom, and TechnipFMC. We sold a part of our Viatris position under the heading of risk control. The company is bringing in a new CEO that I am not yet sure about. I eliminated our position in MetLife as the least attractive of our financials at a time when credit risk is on the rise. The proceeds of the above sales went primarily into a new position in Fidelity National Information Services (FIS), a financial technology company, and additions to Citigroup, Mohawk, Pan American Silver and Warner Brothers Discovery. The net effect of these trades is to add significant future appreciation potential to the portfolio.

OUTLOOK

Even with expectations for another 25 basis point increase in the Fed Fund's rate in early May, it is now consensus that a recession is coming in the next twelve months. The bond market has priced-in roughly 50 basis points of Fed interest rate cuts by year end. Jerome Powell has repeatedly contradicted this view - stating it is likely that, even when tightening is over, the policy rate will stay high for some time (higher for longer). The difference in opinion would appear to hinge on how much increased debt service the economy can stand. The market knows that our economy is poorly positioned to withstand short-term Treasury rates of 5%. For the last 10 years the financial press (Bloomberg, Reuters, WSJ, Moody's, S&P... included) has occasionally referred to zombie companies, a term hyperbolic enough to make most people roll their eyes and scroll along. There is an important point to take away from these stories and it is something that routinely shows up in our research work. There are an unusually large number of Fortune 500 companies, with alarmingly high balance sheet leverage and dubious cash flow fundamentals, that might be in perilous positions, as going concerns, under adverse conditions – such as sharply higher interest rates. The list of names includes (but is not limited to) Bed Bath and Beyond, Walgreen Boots, all of the cruise lines, most of the Airlines, Whirlpool, Macy's and even AT&T, General Electric and General Motors. I am not saying that all these companies will fail in a 5% T-Bill environment. Some will, and the rest will struggle as debt reprices and demand falls off. Whole sectors, like commercial real estate, are going to be tested, as will much of Main Street America. While the Fed and the FDIC have stepped in to support the banks, deposits will continue to move to higher paying options, keeping the pressure on from a liquidity and funding perspective. At some point, the Federal Reserve is going to have to choose between fighting inflation and supporting the economy. History suggests that supporting the economy will win out unless/until inflation becomes a much bigger problem. In short, I think the bond market is right.

Our partners know that Valara does not invest solely on macro opinions – our investments are from the bottom up, based on valuation. In assessing valuation, we do take all factors, including macro ones, into consideration. For at least the last 5 years, we have been wary of financial leverage and favored high, predictable cash flow. This is not about to change. The portfolio remains very conservatively valued, with excellent long-term appreciation potential; and, I am excited about our future, regardless of the concerns I have expressed. As always with stocks, which are long term investments, patience may be required. I appreciate your continued confidence and welcome your questions or comments.

Sincerely,

Robert W. Simmons, CFA
Managing Member