Valara
Capital Management, LLC

January 10, 2024

Dear Friend of Valara Capital Management,

For the fourth quarter and twelve months ended December 31, 2023, Valara Partners, LP. produced returns, net of fees, of 8.72%, and 9.51% versus 11.69% and 26.29%, for the S&P 500, respectively. The Nasdaq 100's rally in 2023 was one for the record books and it ended on a strong note, up 14.60% and 55.13% for the quarter and year, respectively – dragging the S&P 500 up with it.

QUARTERLY REVIEW

The fourth quarter began on a discouraging note with the Hamas attack on Israel. There is no way to sugar coat it from any angle – the human, political and economic perspectives are all bad. The last thing the world needs right now is more war, conflict and polarization. So far, the global economic impacts have not been crippling. The same cannot be said for the local ones. With tensions high, it remains to be seen where the conflict goes from here. The war in Ukraine is looking increasingly like it has been lost by NATO/the West. Ukraine has exhausted its human capital and the world is short of money and equipment. Many pundits are now conceding that it is just a matter of acceptance and negotiating the peace. One hint that the tide had turned for Ukraine was when the New York Times removed Ukraine as a tab on its website and shifted focus to other issues. So, it appears, has the US administration and Congress. It is unfortunate that the US dollar had to suffer a loss of credibility in the process.

The US economic news has been surprisingly good. Third quarter GDP growth came in at a robust 4.9%, despite rising interest rates which appear to have provided more of a headwind in Q4. Labor markets and consumer confidence remain resilient. Inflation continued to moderate, leveling out around 3.5%, with lower energy prices being the largest contributor. Weak growth in the EU and China contributed to softer crude demand, with OPEC cuts and Russian sanctions being offset by resurgent US drilling and production. The consensus economic forecast for the US continues to consolidate around a soft landing.

The December Fed meeting was probably the market story of the quarter. The step taken towards rate cuts surprised everyone, as only two weeks earlier they (Powell/Board of Governors) were still firmly committed to the higher (interest rates) for longer mantra. It was such a surprise that stocks and bonds took off on a rally that lasted right through the holidays. It also prompted a large amount of speculation and debate about what changed in their view of the outlook. It would not appear that the shift was related to overt weakness in the economy nor a collapse in inflation to their 2% target. My guess is that it had more to do with the supply/demand balance for Treasury debt, in light of the continued heavy deficit spending expected in 2024 and/or the liquidity of the treasury market itself - more below.

PERFORMANCE COMMENTARY

As noted above, 2023 was just not value's year. In the fourth quarter the RLV lagged the S&P 500 and the Russell Growth index by 2.3% and 5.1%, respectively. For the full year it was worse. The excitement surrounding artificial intelligence and the anticipation of Federal Reserve easing drove the divergence. With the exception of China, emerging markets outperformed western ones in the quarter, which was mirrored by the US small cap index and corporate bonds spreads. Globally, there was an active appetite for risk.

Technology stocks were the hands-down leader for both the quarter and the year. The returns were so concentrated in the large tech leaders that the media coined the term "the Magnificent Seven" for, Microsoft, NVidia, Tesla, Apple, Google, Meta and Amazon. To be sure, there were a significant number of other mega-cap technology winners. The point is that it's hard to keep up with extreme moves in the very biggest stocks. Other leading groups included

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REITS, gold miners and financials, in that order. Energy, Consumer Staples, Healthcare and Utilities were the laggards. Our heavy weight in the gold miners helped keep our sector weighting to a modest negative. Our overweight in energy and underweight in tech were the primary detractors. Our stock selection was neutral. Even though we had a longer list of winners, including Foot Locker +36%, Kinross Gold +33%, Citigroup +25%, Barrick Gold +24%, Ralph Lauren +24% and Wheaton Precious Metals +22%, on average we had larger positions in our losers. Our biggest detractors included BorgWarner -11% and our energy names: Murphy -6%, Baker Hughes -3% and NOV -3%.

Our trading was limited to the elimination of Foot Locker into a substantial rally and the redeployment of the proceeds into Mohawk, Mosaic and Warner Brothers Discovery.

OUTLOOK

For some time now I have expressed the opinion that the Federal Reserve would raise interest rates in an effort to cool the economy and tame inflation until something broke (in the economy or markets). Frequently it's obvious when something breaks, like the banking failures that we had earlier this year; but sometimes it's not. In 2019 the Federal Reserve had to abruptly end its tightening program (shrinking its balance sheet) because liquidity in the repurchase market got scarce – a nuance that was not on the evening news. The recent banking crisis (March 2023) was ably handled but remains ongoing, with the amount drawn on the BTFP expanding through the year (partly due to an arbitrage opportunity with the Fed's IOER rate) and many smaller banks still reserve challenged. While I am sure that the Federal Reserve and the Treasury are watching this, I wonder whether the Q3 interest rate spike (100 basis points in seven weeks), combined with muted foreign interest in Treasuries and forecasts for another $2 trillion deficit in 2024, peaked their anxiety. With the downshift in global Treasury demand, and bank reserves and non-bank excess liquidity in decline, as the Fed shrinks its balance sheet, the question becomes can the markets absorb the flood of additional Treasury issuance. This is particularly problematic with consumer debt expanding again. The Fed decision to tease the possibility of easing in 2024 may have more to do with dwindling market liquidity (available reserves and excess cash) than economic weakness or inflation's retreat. The same as it was in Q4 2019.

As noted earlier, the economy seems to be holding up relatively well, even if it depends somewhat on who you ask. The bond market has taken the hint (from the Fed) and pushed longer dated bond yields lower making the yield curve more inverted – historically, suggesting that a slowdown is ahead. However, the economic consensus is for a soft landing (limited/muted recession) and with the Fed's new posture that seems more possible. If the Fed eases without a meaningful recession it would revive the question of inflation. Oil prices have been the primary driver of lower CPI and the strategic petroleum reserve is waiting to be refilled. Geopolitical risks remain elevated and continue to impact businesses views on supply chains and redundancy; there is a gaping skills gap in our labor force; and our work ethic is a shadow of its former self. All of that suggests that inflation has a structural tailwind. Without sustained demand weakness it is likely to resurge.

I have spent the last few years focusing our investments in companies with strong balance sheets and/or strong and repeatable cash flow and excellent valuation appeal. While valuation is a permanent part of our strategy, the emphasis on strong financial position reflects the possibility of rough sailing and strong winds (economically) at some point in the future. I continue to believe that this emphasis is warranted and remain confident that our portfolio will outperform as we move forward. Thank you for your continued support. Feel free to call or email me with any concerns or questions you may have.

Sincerely,

Robert W. Simmons, CFA
Managing Member