Valara
Capital Management, LLC

April 12, 2021

Dear Friend of Valara Capital Management,

For the first quarter, ended March 31, 2021, Valara Partners, LP. produced total returns, net of fees, of 14.53% versus 6.17% for the S&P 500 index. Value, as a style, outperformed the broader market.

QUARTERLY REVIEW

The first quarter saw the continuation of the recovery that began last summer, with a strengthening economic expansion and rising stock markets. It started on a dramatic note with protests at the Capital and the subsequent fallout – Trump's second impeachment, the occupation of Capital Hill by National Guard units and a Trump news blackout. Fortunately, tensions eased steadily through the quarter after Joe Biden's inauguration passed. While less remarkable, the political news kept coming with a record number of executive orders by the new President and the passage of yet another major Covid-19 stimulus package – on top of the one passed by, lame duck, Donald Trump in December. In addition, as the quarter drew to a close, the market was presented with a Biden proposal for a two trillion dollar infrastructure plan (over eight years) which, although needed and better than unproductive giveaways, would contribute to fiscal deficits for years to come. We may require a 12-step sobriety plan for Congress and the Executive Branch. Janet Yellen's (the new Secretary of the Treasury) confirmation hearing commentary was summed up as: spend big now, pay down debt (tax increases) later. I would suspect that "later" ends up meaning the next administration, but we have not paid down debt in my lifetime (the last time was 1957). Meanwhile, the Federal Reserve, with the prospect of booming economic growth in the periods immediately ahead, has remained full tilt accommodative, which may prove necessary as the Treasury plans on issuing a new pile of debt to finance all of this. It will not be surprising to see the Federal deficit for fiscal 2021 top last year's record $3.13 Trillion. Our national financial condition remains a simmering problem.

The above aptly introduces the most important development of the first quarter – a material rise in interest rates. The positive spin would be that the bond market is anticipating a strong economic expansion as the Covid vaccine rollout reduces cases and businesses reopen to the public in a more normal manner, bringing back workers/incomes in the process. The less positive view is that inflation is really picking up and not just because of supply constraints but driven by deficit spending and money printing. To be fair, at this stage, it is hard to tell which case is correct or whether it is a little of both. Either way, rising interest rates have launched a mania in housing as buyers rush to lock in still attractive rates before they are gone. There is a sense of panic in the housing market for the first time in a while.

The last highlight worth touching on is the whiff of speculative frenzy in stocks in the quarter – most notably around some of the markets most shorted names. Companies like GameStop and AMC Entertainment traded wildly in the first few months of the year and, with various other speculative stocks, threatened the solvency of certain hedge funds which were imprudently (massively) short. Most of these stocks have clear business model issues and are highly leveraged so it was unusual to see them double, triple and more. Without delving into the explanation behind all of this, the takeaway message is one of latent market instability.

PERFORMANCE COMMENTARY

For the second quarter in a row, value outperformed growth and the S&P 500. We, happily, beat all three. Small-cap stocks outperformed large-caps, which suggests an elevated level of confidence in the backdrop and an appetite for above average risk. The continued narrowing of corporate bond spreads would seem to confirm this interpretation. The leading sectors for the period were, in order of outperformance, Energy, Transportation, Financials and Industrials. The laggards were Consumer Staples, Utilities, Technology and Healthcare. Note that if Gold Mining were a sector, it would have been dead last in the quarter.

On balance, sector weighting was a modest drag on performance, with the benefit of our overweights in Energy and Industrials being offset by our overweight in Precious Metals Mining. Our stock selection was hugely positive. GAP, Fluor and Discovery were all up over 40%, with Mosaic, Mohawk, Murphy Oil and ConocoPhillips up over 30% and MetLife, Quanta and AIG up over 20%. Our biggest decliners were Viatris, Agnico Eagle, Barrick Gold and Pan American Silver.

It was another fairly active quarter for trading. We sold virtually all of our Discovery position into an incredible rally to $78.00 per share. We had the last of our position for sale with our trading desk (partially executed) on the day the stock ended its run and began a dramatic pull-back. We still have a very small position (3% of our year end 2020 holdings) and are considering next steps. Otherwise, we trimmed substantial positions in Mosaic, Mohawk and Quanta into strength, deploying the proceeds into Pfizer, Viatris, Gilead, Citigroup, NOV, BorgWarner, and a few of our existing precious metals positions. I am very pleased with our portfolio structure and holdings at quarter-end.

OUTLOOK

With the rollout of the Covid-19 vaccine going well and all of the stimulus being thrown around, the overwhelming consensus is that the economy will get noticeably stronger as 2021 progresses. As a base case for the immediate future, I would go along with that view. Investing, however, is not a six-month exercise and the real question is where we are going over the next few years. As I was writing this, Goldman Sachs's Chief US Equity Strategist came out with a piece that reiterated the old mantra "don't fight the Fed". The argument was that the Fed is going to get the inflation it appears to want. The counter argument has been that it is very difficult to get inflation with the high level of debt that we have, because any rise in interest rates will cause an economic contraction (which would be deflationary). In this instance, however, I think Goldman is correct. We will get inflation because the Fed knows we need it to manage debt that has reached alarming levels. There are two ways to recover from over indebtedness: cut spending or grow revenues (to produce surplus current income). Further, there are two ways to grow revenues: produce more (raise your productivity) or somehow raise your prices (inflation anyone?). Politicians faced with a choice between discipline, sacrifice and thrift or largesse and inflation will almost always choose the latter. The paths are, ultimately, equally painful but the average person is less inclined to blame politicians for inflation because they are not well versed in how it comes about. Those that argue that the Fed/Treasury tag-team will not be able to generate inflation are underestimating the desire of those in charge to avoid the political downside of austerity. All this is to say that my view of the future has not changed – inflation is coming. I do not have any unusual insight into the path this will take, nor would I be surprised to see future bouts of economic weakness that are again met with forceful response by the financial authorities. In my opinion that is the long-term base case. This will repeat until the US dollar weakens appreciably, ending the process.

I remain confident that our portfolio is well positioned to favorably navigate both the immediate and longer-term views expressed above. Most importantly, the weighted average P/E of our holdings is roughly 10x normal earnings power – a substantial discount relative to the S&P 500, which is over 20x. As always, we will stick to our disciplined investment process whatever the future brings. Thank you for your continued support. Please call or email me with any questions or concerns you may have.

Sincerely,

Robert W. Simmons, CFA
Principal